Islamic Finance

'An all-encompassing platform'

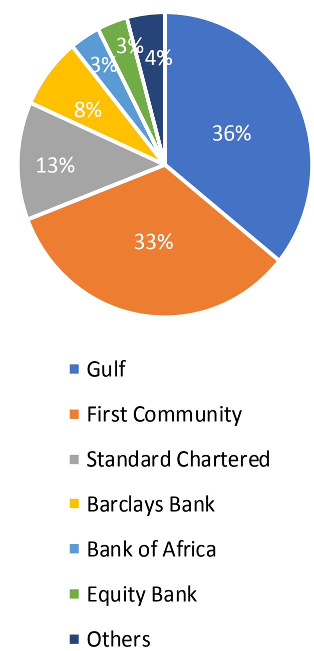
What is Islamic finance?

Islamic finance is a financial system based on the Islamic Sharia—laws and guidance given by the Holy Quran, the *Hadith* (sayings) and the Sunnah of the Prophet Muhamad—which fundamentally prohibits the giving or taking of *Riba* (interest) and instead advocates for profit and loss sharing in financial transactions. The system is firmly built on the belief that the concept of interest discourages people from engaging in real economic activities. This ideology affirms that the development of real trade skills, industry and construction is the only way the real interests of the people can be safe-guarded.

Islamic finance in Kenya has grown through leaps and bounds since its inception in 2006 by Barclays Bank under the 'La Riba account' product. Kenya now has more than three fully fledged Shariah compliant Islamic banks – Gulf African Bank, First Community Bank, Dubai Islamic Bank – with many conventional banks launching separate windows to operate Islamic finance products and services. By March 2017, the total assets under Gulf African Bank and First Community bank stood at KES 41.7B with the industry's global average growth rate currently estimated at 15.0% y/y - the fastest in the financial services sector.

Islamic finance products' appeal among investors continues to grow day by day rendering the current market capacity inadequate in satisfying the overwhelming demand. Despite this impressive growth, there has been very little awareness on Islamic finance which has resulted in the slow uptake of Islamic finance products locally among individuals; Muslims and non-Muslims alike. We therefore seek to break down the main features of Islamic finance in a bid to answer some of the frequently asked questions, allay fears and illuminate the role of Islamic finance in the modern capital markets.

Public awareness of Islamic finance institutions in Kenya



Source: Factors influencing Islamic banking in Kenya by Saida Aden.

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Difference between Islamic finance and conventional banking

Islamic finance is an interest free finance system. It is asset based as opposed to currency based. A deal is structured on exchange or ownership of assets and money is simply the payment mechanism to effect the transaction. The basic framework of Islamic finance is based on elements of Shari'ah, which governs Islamic societies -
The major difference between Islamic finance and conventional banking is that money itself has no intrinsic value under Islamic teachings and forbids people from profiting by lending money without accepting any level of risk. Interest cannot be charged. Wealth can only be generated through legitimate trade and investment. Any gain or loss relating to this trading must also be shared between the parties concerned.

Principles of Islamic Finance

Paying or charging interest. "All forms of interest are *riba* and hence prohibited". Islamic rules on transactions have been created to prevent use of interest.

Investing in businesses involved in activities that are forbidden (haraam). These include things such as selling alcohol or pork or producing media such as gossip columns or pornography.

Charging extra for late payment. This applies to *murâbaḥah* or other fixed payment financing transactions, although some authors believe late fees may be charged if they are donated to charity, or if the buyer has "deliberately refused" to make a payment.

Maisir. This is usually translated as "gambling" but used to mean "speculation" in Islamic finance. Involvement in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future is *maisir* and forbidden in Islamic finance.

Gharar. *Gharar* is usually translated as "uncertainty" or "ambiguity". Bans on both *maisir* and *gharar* tend to rule out derivatives, options and futures. Islamic finance supporters believe these involve excessive risk and may foster uncertainty and fraudulent behaviour such as are found in derivative instruments used by conventional banking.

Engaging in transactions lacking "material finality". All transactions must be "directly linked to a real underlying economic transaction", which excludes "options and most other derivatives".

Islamic finance products

Mudarabah is an equity-based contract where one partner provides money to another and the latter manages the money by investing it in commercial projects to earn profit which is shared among the two in a predetermined ratio, while losses are borne solely by the capital provider, provided such loss is not due to the manager's negligence or violation of specified conditions.

Musharakah is a partnership-based contract or an investment product with a partnership structure for sharing profits and losses. It involves investment from all the partners and an agreement to share profits in a predetermined ratio and to share losses in the ratio of contribution. Parties to the contract of *Musharakah* are referred as "*musharik*" which literally means partner.

Murabahah - it refers to the sale of goods at a price which includes a profit margin, i.e. cost plus. A Murabahah contract has an honest declaration of cost and the expenses incurred on the product, along with the profit mark up being taken by the seller (the bank in most cases). The uses of Murabahah include short term, medium term and long-term financing for inventory, raw materials, assets, export, import, vehicle, consumer goods, land and property, education, etc.

Sukuk are Islamic bonds that are structured in a way to generate returns to the investors, without any transaction involving *riba* (usury). Sukuk are shares in the ownership of tangible assets with reference to a particular project or an investment activity. Bond holders share the beneficial ownership (profit or loss) of the asset or the project that the bonds represent. Sukuk are generally issued to raise long term finance for a particular project and may take the form of Murabahah, Musharakah, Ijarah (Asset), Istithna (Project) or Istithmar (Investment). Many governments are today turning to sukuk bonds to raise long term capital for various projects.

Islamic finance and investment in stocks and equity funds?

Islamic finance allows for investment in stocks and equity funds provided that the company one wishes to invest in conforms to the screening guidelines, each company stock must be looked at and analyzed to confirm it is Shari'ah compliant. Shari'ah compliance focuses on two aspects of the company:

1. **The business**

The type of business operation the company is engaged in should not be prohibited by the Shari'ah laws.

2. **Financials of the business**

Some Shari'ah scholars have come up with the following financial analysis guidelines that can be used to ascertain the compliance of a stock:

- Income generated in non-halaal (not allowed) activities should not exceed 33% of the total investment portfolio;
- Interest income to total income should not exceed 5% of the total income generated by the company.
- Total interest-bearing debt to total asset should not exceed 45%Illiquid assets to total assets should be more than 10%
- Total interest-bearing debt to total asset should not exceed 45%

Islamic finance landscape in Kenya

Strengths	Weaknesses	Opportunities	Threats
Kenya has a population of approx. 4.3M Muslims which provides a large client base for Islamic finance products.	Lack of an oversight authority to ensure that financial institutions actually offer Shariah compliant products.	Low market penetration creating headroom for growth in the industry.	Intense competition among Islamic and conventional banks may keep profit margins at minimum.
Kenya's strategic position as the region's economic hub attracts foreign investment in Shariah compliant economic projects.	Inadequate human capital/ expertise in Islamic finance.	Launch of new products e.g Sukuk bonds will raise the competitiveness of Islamic finance in the market.	Adverse regulatory framework may discourage uptake of Islamic products.
The government's endorsement of the industry as an economic driver expected to drive market penetration.	Low levels of public awareness on Islamic financial products.	One of the world's fastest-growing economic sectors and has opportunities to grow in emerging economies.	Fluctuations in interest rates
Entrance of new players expected to help address the overwhelming demand for Islamic Finance products.	Constrained investment opportunities in the money market pose a challenge in liquidity management		

Role of Islamic finance in modern capital markets

As the Islamic finance wave slowly but surely ripples in the financial market waters, and as the gradual shift in focus to Shariah compliant products mounts, one ponders on the role of this new financial frontier in today's modern capital markets. Do the financial products offered under Islamic finance qualify on financial merit as substitutes to conventional banking products for individuals, institutional investors and governments alike? While Kenya's Islamic finance industry is yet to mature and realize an evolution in its products, we discuss below the viability of Islamic finance as a wealth creation vehicle for capital markets stakeholders.

1. Sukuk Bonds

Sukuk are defined as certificates with each *sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture. These assets may be in a specific project or investment activity in accordance with Sharia rules and principles. The main differences between sukuk and conventional bonds are:

- Sukuk must represent ownership shares in assets or commercial or industrial enterprises that bring profits or revenues
- Payments to Sukuk-holders should be the share of profits (after costs) of the assets or enterprise
- The value payable to the Sukuk-holder on maturity should be the current market value of the assets or enterprise and not the principal originally invested.

The resilience of the Islamic Banks during the 2008 financial crisis sparked a renewed global interest in Islamic finance and the structure of sukuk products. Today, Africa boasts a population of approx. more than 400M Muslims, 25% of the world's total. As a result, many countries in Africa have revised their regulation to accommodate the issuance of sukuk, consequently improving their attractiveness for Gulf investments. While talk of sukuk issuance first sprouted in North Africa, it's the sub-Saharan market that has been at the forefront in spearheading the movement. Among the countries in Africa that have issued sovereign sukuk include Senegal, Togo, Cote d'Ivoire, Niger and Nigeria with the South African USD 500M issue being 4 times oversubscribed.

Kenya has ticked several milestones in revising the finance act as it prepares to issue its first sovereign sukuk. The issuance of a sovereign sukuk could not be timelier as the government's 'big four' agenda takes root. With a population of over 4.3M Muslims combined with its strategic position as the regional economic hub, Kenya is well poised to take advantage of a sukuk issuance to finance government projects in infrastructure development, provision of cheap housing, construction of healthcare facilities and to promote growth in the largely stunted manufacturing industry. Similarly, corporates should consider issuance of commercial sukuk as an alternative means in capital raising to finance major projects and expand capacity into frontier markets.

2. The Shari'ah compliant portfolio

Based on the strict rules under Shari'ah law and criteria enacted by Muslim scholars with regard to investing in stock markets, we would like to recommend the following equities listed on the NSE that would qualify as Shari'ah compliant:

- **Safaricom (SCOM) - Current price: KES 27.25, Target price: 33.15, Upside: 21.7%**
- **Bamburi Cement (BAMB) – Current price: KES 176.00, Target Price: KES 194.00, Upside: 10.2%**
- **Kenya Power (KPLC) - Current price: KES 6.80, Target Price: KES 7.70, Upside: 18.8%**
- **KenolKobil (KENO) – Current Price: 18.00**

Criticism and Controversy

Most Islamic finance products have come under harsh criticism for purportedly operating under the structures of conventional finance systems. For example, according to Sheik Muhammad Taqi Usmani – Muslim scholar – approx. 85% of sukuk issued have taken the characteristics of conventional interest-bearing bonds, as they do not return to investors more than a fixed percentage of the principal, based on interest rates, while guaranteeing the return of investors' principal at maturity. A major concern is that with the growth of Islamic finance, gradual dilution of Shari'ah law precepts governing Islamic finance may encourage conformity of Islamic finance products to conventional banking.

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