The potential of Microfinance in increasing Financial access to Kenya's unbanked population

A case study of Islamic Microfinance in Nairobi, Kenya.

Submitted by

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Registration No BBA/10168/81/DF

A RESEARCH REPORT SUBMITTED TO THE SCHOOL OF BUSINESS MANAGEMENT (BANKING AND FINANCE DEPARTMENT) KAMPALA INTERNATIONAL UNIVERSITY IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF DEGREE IN BACHELOR OF BUSINESS ADMINISTRATION.

MARCH 2011

DECLARATION

I hereby declare that this research report entitled; The Potential of Islamic Microfinance in Increasing Financial Access to Kenya's Unbanked Population has not been presented anywhere else for any academic purposes or otherwise and that is my original work done for a degree in Business Administration.

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Date: 8|4|2010

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ACRONYMS AND ABBREVIATIONS

AMFI/K	Association of Microfinance Institutions in Kenya
ASCAs	Accumulating Savings and Credit Associations
CGAP	Consultative Group to Assist the Poorest
FSD	Financial Sector Deepening
GoK	Government of Kenya
HMFP	Hodeidah Microfinance Program
KPMG	Klynveld Peat Marwick Goerdeler(an Audit and Advisory Firm(
MF	Microfinance
MFI	Microfinance Institution
Ms	Microsoft
PLS	Profit and Loss Schemes
ROSCAS	Rotating Savings and Credit Associations a.k.a merry go/rounds
SPSS	Statistical Package for Social Sciences
YR	Yemeni Rial
SACCOs	Savings and Credit Cooperative Organizations
SMEs	Small and Medium Enterprises
UNCDF	United Nations Capital Development Fund

Chapter 1

INTRODUCTION

1.1 Background

A study conducted in 2008 by CGAP revealed that globally, an estimated 72 percent of people living in Muslim-majority countries did not use formal financial services. Even where financial services were available, some people viewed conventional products as incompatible with the sharia financial principles set forth in Islamic law (CGAP, 2008).

Islamic microfinance represents the confluence of two rapidly growing industries: *microfinance and Islamic finance*. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Studies confirm that unlocking this potential could be the key to providing financial access to millions of Muslims in the lowest socio-economic segment of the population who reject microfinance products that do not comply with Islamic law. (CGAP, 2008 and Obaidullah, M. 2008).

Whereas Islamic microfinance is still in its infancy and business models are just emerging, it could be argued that sharia compliant financial services provide an immense opportunity to the microfinance industry to meet its mandate of providing financial services to the low-end socio-economic segments of the population.

The supply of Islamic microfinance is very concentrated in a few countries, with the top three countries (Indonesia, Bangladesh, and Afghanistan) accounting for 80 percent of global outreach. The demand, however, remains strong as surveys in Jordan, Algeria, and Syria, for example, revealed that 20-40 percent of respondents cited religious reasons for not accessing conventional loans (CGAP, 2008). The global Islamic finance industry is rapidly growing although the total estimated global outreach of Islamic microfinance is estimated at only 380,000 customers. This accounts for an estimated one-half of one percent of total microfinance outreach (Microfinance Information eXchange, 2007a). Whereas conventional microfinance products have been very successful in Muslim majority countries such as Indonesia and Pakistan, these products do not fulfil the needs of many Muslim clients. (CGAP, 2008).

Muslim scholars recognize the important role of microfinance in lifting communities out of poverty. But they come to a consensus that microfinance operations must comply with the Sharia. They note that most of the available conventional models are a modification of the Grameen Bank in Bangladesh and the Grameen Foundation in the US. The conventional models, however, have an interest element which is prohibited according to the *Q'uran* hence making them unsuitable for replication in Islamic environments. This has led to the need for Islamic Microfinance models.

In 2008 the global developments in Islamic banking had started being felt in the Kenyan financial services sector and a few institutions had started positioning themselves to tap in to this hitherto untested market niche by developing sharia-compliant products. This was however being done by mainstream commercial banks as Kenya's microfinance institutions had either shown lack of interest or had no expertise in product development for Islamic microfinance products.

Exploring the potential of Islamic finance in Kenya seemed to be a priority objective of Kenya's plan to achieve rapid economic growth through increased financial access to the large unbanked population. (GoK, 2008). The impact of Islamic finance had already sent strong signals to Kenya's Financial Services Sector to the point of being highlighted in the latest amendments to the Finance Act 2008 at the time. Section 16A (2) of the Act was amended to include a requirement by all institutions to pay a "return" on all savings accounts kept and operated in accordance with the Islamic law. The Central Bank of Kenya (CBK) clarified that the amendment applied to institutions offering Islamic products which did not permit payment of 'interest'. (CBK, 2009).

Whereas the gazzettement of the Microfinance Act 2006 set a milestone in the regulation of the microfinance industry, most of the large Microfinance Institutions like Kenya Women Finance Trust (KWFT), had shifted their focus to tap in to client deposits, a strategy that shifted the target population to the second and third quintiles of the socioeconomic pyramid rather than the lowest quintile. The niche of microfinance institutions lies in designing products that increase financial access to the lowest quintile of the country's socio-economic profile that are usually referred to as the "unbankable" by the traditional banking industry.

1.1.1 The advent of Islamic Finance in Kenya

In 2008 Sharia-compliant Banking was rapidly being adopted in Kenya by both local conventional banks and international Islamic banks with country offices in Kenya. This was happening at a time when mainstream commercial banks were also aggressively entering the low end market segment previously the preserve of the microfinance industry. This implied that the forward looking bankers, some of whom already had experience in Islamic banking, could as well have introduced Sharia-compliant products in Kenya's microfinance sector thereby reaching out to the Muslim populations who, because of their religious values, were being underserved by financial service providers in Kenya's financial market including the very same MFIs whose target they were.

When a few years before then Equity Bank entered the Kenyan market targeting the lower end segment of the financial market, the mainstream commercial banks did not take note. This defined the *first revolution* in Kenya's banking industry. Years before, these older more established mainstream commercial banks had cast away their lower end market customers in preference for the up-market and corporate clients. Equity Bank emerged as a definitive bank with cutting edge services that its competitors were barely able to imitate. As a result of Equity's banking model, Kenya's banking industry had suddenly focused on the low end market segment as its backbone.

But observers noted that the banking industry was on the verge of another revolution – the *second revolution,* the introduction of Sharia-compliant banking. Already two Sharia-compliant banks were giving the rest of the conventional banks a run for their money. The two banks, Gulf African Bank and First Community Bank, had created a strong appeal, not only to Kenya's 8 million Muslim populations, but to the rest of the conventional customers as witnessed by the numbers of conventional bank clients who switched over to these Islamic institutions. (Financial Post, November 2008). First Community Bank Limited was the first commercial bank operating entirely under Islamic Sharia principles to be licensed to operate in Kenya in May 2007 by the then Finance minister, Mr. Amos Kimunya. (The Standard, May 2007). In January 2008 Gulf African Bank commenced its operations in Kenya as the first fully fledged Islamic bank to operate in Kenya (Daily Nation, August 2008).

Kenyan conventional commercial banks were, however, not left behind. In June 2008 Kenya Commercial Bank (KCB) – Tanzania was cleared to introduce Islamic banking in Tanzania, for instance. Muslims comprised 50% of Tanzania's population (The East African, June 2008) and so could not be neglected, naturally.

The entry of banks with new Sharia-compliant products was perhaps one of the most critical developments in Kenya's financial services sector given the key role this sector plays in the economic growth and development of the country. Kenya's vision 2030 *First Medium Term Plan, 2008 – 2012* states that the Financial Services sector was expected to play a key role in mobilizing the savings and investments required to implement the Medium Term Plan. According to this plan the financial service strategies that were to be implemented were the reorganization of the National Social Security and Pension system; Insurance and Banking sectors as well as SACCOs and capital markets with a view to facilitating higher savings and investment. It further stated that measures were to be taken to improve the reach and access of financial an appropriate model that is rooted in Islam and conforms to beliefs and cultures of the Muslim clients. (Mohammed Obaidullah, 2008).

Kenya has a significant population of Muslims. However, on the basis of the large proportion of the Kenyan population below the poverty line (estimated at 46% in the Medium Term Plan for Vision 2030), it could be postulated that the majority of these Muslims were in the lowest quintile of the socioeconomic segment and would immensely benefit from financial services that met their needs and improved their socioeconomic living standards. The potential for sharia compliant products in increasing financial access at that time was therefore large.

It was therefore critical to establish if the development of Islamic microfinance models in Kenya's financial services sector would have reduced the gap of the unbanked population in country.

1.3 General Research Objective

The general objective of this study was to explore the potential of Islamic microfinance in increasing financial access to Kenya's unbanked population.

1.3.1 Specific Research Objectives

1.3.1.1. To determine access to and demand for Islamic microfinance products by Kenya's microfinance clients.

1.3.1.2. To explore the supply of Islamic Finance products in Kenya's microfinance industry.

1.3.1.3. To assess the potential of Kenya's microfinance industry in supplying Islamic microfinance products.

1.3.2 Research Questions

1.3.2.1. Do Kenya's microfinance clients who require Islamic microfinance products have access to them? Is there demand for these products?

1.3.2.2. Does Kenya's microfinance Industry supply Shariah-compliant products as an option to its Muslim clients?

1.3.2.3. What is the potential for Kenya's Microfinance sector in supplying these products?

widening gap of the unbanked. In Kenya alone 38% of the population was unbanked as revealed by a survey conducted by FSD in 2007. (FSD Kenya, 2007).

Obaidullah (2008) recognizes that while some poor Muslims, devoid of options and hard-pressed for cash may avail of interest-bearing credit, many prefer to stay away. To address this problem Dr. Obaidullah suggests that microfinance can be offered using a variety of mechanisms that do not violate the Shariah. The lack of such mechanisms in Kenya's microfinance industry at the time provided the motive for this study.

1.5 Limitations of the Study

In spite of good intentions the study was limited by the following four issues:

- Islamic banking and finance was still a new concept in Kenya. It had been adopted largely by mainstream commercial banks and International Islamic banks. The few Kenyan banks that were known to practice Islamic Banking through 'Shariah windows' were the Kenya Commercial Bank (KCB) and Barclays Bank of Kenya. Others were Dubai Bank and Imperial Bank. However, First Community Bank and Gulf African Bank were the only known fully-fledged international Islamic Banks operating in Kenya at the time (Daily Nation, August 2008). It was even more difficult to gather information on Islamic microfinance since it was yet to be seen in Kenya. The study was therefore limited in finding answers where there were no previous practices and experiences.
- There was little literature on Islamic banking practices in Kenya and none (let alone) on Islamic microfinance. Much of the information was gathered from newspaper articles and the internet. The study was limited in using foreign experiences and tried to localize and customize these experiences to help in conceptualizing it to the Kenyan context. In a 2007 global survey on Islamic microfinance, CGAP collected information on over 125 institutions and contacted experts from 19 Muslim countries. Other global bodies like the IFC and UNCDF had also gathered case studies on institutions offering Islamic finance across the globe for comparative analysis. These types of studies had a wide scope and were subject to vast amount of resources – human, time and finances. Nevertheless this particular study was going to focus on the few institutions offering Islamic finance in Kenya and whose impact were similar to what was reported on the global scene. This was to be related to Islamic microfinance as an option for the poor and so there were some critical assumptions in fitting the study in to the Kenyan context.
- Classified as the *second revolution*, Islamic banking practices and Sharia-compliant financial products were developing very fast and taking different models. The findings

resulting out of this study were therefore to be limited to the context of the time of the study.

- Finally, the study was being conducted at a time when the Microfinance Act 2006 had just been enacted and many mainstream Kenyan MFIs were busy transforming by opening banking units in response to the opportunity for client deposit mobilization for capitalization as per the Act. Some declined to be interviewed since their Research and Development (R&D) departments that were critical in responding to the study questions were very busy developing products in line with the new Microfinance Act.

1.6 Operational definition of terms

Shariah The term Shariah refers to divine guidance as given by the Holy Qur'an and the Sunnah of Prophet Muhammad and embodies all aspects of Islamic faith, including beliefs and practice.

Riba An excess or increase. Technically, it means an increase over principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense in return to the other party; every increase which is without an equal counter value - in simple terms, 'interest'.

Ijara Letting on lease. Sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipments, buildings or other facilities to a client, against an agreed rental.

Takaful Takaful comes from the Arabic root-word 'kafala'- guarantee. It means mutual protection and joint guarantee. Operationally takaful refers to participants mutually contributing to a common fund with the purpose of having mutual indemnity in the case of peril or loss.

Murabahah Literally it means a sale on mutually agreed profit. Technically it is a contract of sale in which the seller declares his cost and the profit. This has been adopted by Islamic banks as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance.

Mudarabah A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while the loss is borne by the provider(s) of the capital.

Musharakah Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions

Gharar It means any element of absolute or excessive uncertainty in any business or a contract about the subject of contract or its price, or mere speculative risk. It leads to undue loss to a party and unjustified enrichment of the other, which is prohibited.

Hadith (Sunnah) Custom, habit, way of life. Technically it refers to the utterances of the Prophet Muhammad other than the Holy Qur'an, or his personal acts, or sayings of others, tacitly approved by the Prophet.

Haram/Haraam Anything prohibited by Shariah.

Microfinance clients Typical microfinance clients are poor and low-income people that do not have access to other formal financial institutions. Microfinance clients are usually self-employed, household-based entrepreneurs. Their diverse "microenterprises" include small retail shops, street vending, artisanal manufacture, and service provision. In rural areas, micro entrepreneurs often have small income-generating activities such as food processing and trade; some but far from all are farmers.

Chapter 2

LITERATURE REVIEW

1.1 Introduction

This chapter provides information gathered from selected literature and articles on Sharia-compliant banking, microfinance and related products in relation to increasing financial access to the untapped Muslim population as a market niche and the implications of rolling out such products in a microfinance context.

2.2 Related to the problem context

The First Medium Term Plan of the Vision 2030 (2008-2012) defines Kenya's Financial Services Sector (FSS) as comprising of Banking, Insurance, Capital Markets, Pension Schemes and Quasi-banking institutions such as: Savings and Credit Cooperative Societies (SACCOs); Microfinance Institutions (MFIs); Building Societies, Kenya Post Office Savings Bank (KPOSB); Development Finance Institutions (DFIs); and informal financial services such as Rotating Savings and Credit Associations (ROSCAs). The paper further asserted that a well-functioning financial system was critical in accelerating economic growth. It envisioned that such a system will also ensure macroeconomic stability as well as promote private sector development, which in turn will generate employment opportunities and reduce poverty. The paper then recognized that the Financial Services sector played a key role in mobilizing the savings and investments required to implement the Medium Term Plan. (GoK, 2008).

But in spite of the significance of the Financial Services Sector as demonstrated by the government paper, access to financial services in Kenya remained one of the biggest challenges in achieving the mid-term goals of vision 2030. According to an FSD study *(Financial Access Survey)* conducted in 2007, the banking sector served only 19 per cent of Kenya's bankable population with 8 per cent being served by other financial services providers such as MFIs and SACCOs. 35 per cent relied on informal financial services providers such as the ROSCAs and ASCAs while 38 per cent were totally excluded, that is, they did not use any financial products for whatever reasons. The survey inferred that access to financial services outside the main cities still remained limited. (FSD Kenya, 2007). But among the reasons proffered in the FSD study none touched on limited financial access emanating from the absence of financial products that endeared to the clients' socio-cultural and religious values such as sharia-compliant finance products for the sensitive Moslem clients. Studies, however, revealed that Islamic societies were characterized by high and rising levels of poverty and financial exclusion. This financial exclusion was aggravated by failure on the part of conventional microfinance programs to give due importance to the religious sensitivities of Muslims. (Mohammed Obaidullah, 2008). This was especially true for Kenya where Islamic finance in the mainstream banking sector was gradually taking root but with no evidence of its counterpart, Islamic Microfinance, following cue in the microfinance sector.

It was suggested that Islamic banking was emerging as a second line of defence for the International Commercial Banking "offering *Halal* products" and bringing in new untapped markets to the "fold". But unfortunately Islamic banking, like its conventional counterpart, was fast becoming "banking of the rich, by the rich, for the rich". (Mohammed Obaidullah, 2008). This offered another reason why, in spite of the advent of Islamic banking in Kenya, there was need to develop Islamic microfinance products to increase financial access to the Moslem poor at the bottom of the financial pyramid. These were to be adopted easily by Islamic banks that already had expertise and experience in Islamic finance principles and practices. It did however require more investment in time and resources to adopt the same by the inexperienced microfinance institutions of Kenya.

2.3 Related to the methodology

According to UNCDF's Special Unit on Microfinance (SUM), many people in Islamic countries do not use conventional banking services for religious and cultural reasons. Making Islamic banking products more easily available in these countries could help people at the bottom of the economic pyramid and promote economic growth.

Islamic financial practices are founded on the belief that money is not an earning asset in and of itself and therefore cannot earn interest. Islamic religious law, that is, *Sharia,* emphasizes ethical, moral, social and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the banking system. (UNCDF, 2001).

UNCDF also notes that the prohibition of interest has been interpreted differently by the scholars of *Sharia* and there are various schools of thought on the topic. By no means do all Muslims or Muslim countries practice any form of Islamic banking. Like CGAP UNCDF also noted that there are three widely used Islamic banking methods:

Musharaka: Financial transactions in which the investment made is based on equity participation. All partners have a financial stake in the company and the right to a pre-determined percent of the profits. Investment is not required to be paid back at a predetermined date and the bank remains a partner in the operation.

Mudaraba: Owner of the capital is the bank or moneylender *(Hawala)*, who is able to determine a percent of profit. Like Musharaka, the actual return is unclear as it depends upon the final profit. The major difference between Mudaraba and Musharaka, is that in the case of Mudaraba the entrepreneur is not required to invest his/her own capital and the total loan is paid back at a predetermined date (along with any profit). The partnership is then closed.

Murabaha: Financial product, similar to trade finance in the context of working capital loans and to leasing in the context of a fixed capital loan. The institution buys goods and resells them to entrepreneurs for the cost of the goods plus a fixed mark-up for administration cost. The financing entity owns the goods until the last installment is paid.

When profit sharing is the source of return as in the first two methods, the lender is actually an investor, taking on a portion of the business risk of the enterprise. Additionally, profit sharing adds a distinct complexity as accurate and valid books need to be available and maintained.

Given the nature of microfinance clients the book keeping complexities associated with Musharaka and Mudaraba financial products make it unsuitable options as microfinance products.

In the third method, murabaha, the financing entity takes on more of a lending role, with a fixed amount of risk and fixed amount of return, although the success of the business is integral to the eventual repayment of the financed amount (as in any financing), it does not determine the total return to the financing institution.

UNCDF concludes that Murabaha is a more suitable financial product to adapt to the needs of the typical microfinance client. It does not require conventional collateral for credit (the commodity or asset being financed serves as collateral). Nor does it require accounting records, something not readily available from clientele in areas where the literacy rates are low as in the coastal areas of Kenya where also the Muslim population is relatively high. However, its use does manifest challenges for a microfinance institution. To better elaborate on these challenges, UNCDF uses Hodeidah Microfinance Program (HMFP), an MFI located in Hodeidah City on the coast of Yemen in the Arab peninsula. The program follows conservative Islamic banking tenets and uses the murabaha method adapted for its target clientele.

From the Hodeidah case study the microfinance model used is fundamentally similar to the group methodology in use by Kenyan MFIs. The only difference is the use of *Murabaha* which could easily be rolled out by Kenyan MFIs operating in Muslim-prone regions. From the HMFP case study UNCDF highlighted the following issues that offered significant lessons to traditional microfinance practitioners.

2.3.1. Lessons from Hodeidah microfinance program – Yemen

a. Market access and participation

Target group

The project may lend to anyone in the target group who is poor, lives in the districts of operation and has an economic activity. The project also focuses on start up activities but to a lesser percentage. Typically the female clients are involved in different activities such as selling grocery items, selling fish, making bread, sewing and serving as middle-women. Most women who participate are widows with children. Women form lending groups mostly with other women. Although women have smaller loan sizes on average than men, as is typical of much MFI lending, their performance relative to men is similar in terms of repayment.

Perception and Acceptance

The program was developed based upon an extensive market survey during which potential clients were interviewed to determine their preference for the type of credit. In spite of this survey, when the program was first introduced, some clients were afraid to take the loan due to their religious beliefs. Others (not always clients) felt that since the program targets the poor, it should give soft loans because the implied service charge rate is higher than what commercial banks charge. Some religious/mosque speakers announced that the project practices *riba* (charging of interest) which is prohibited in Islam. However, when the project management described details of the transaction, most of these speakers felt the product did adhere to the murabaha methodology and retracted their statements. Although traditional banking products have been available in Yemen for many years (and are still the predominant type of finance), many people, especially the poor, have been reluctant to take credit, in part due to religious beliefs. However, openness to credit varies from region to region. In Aden, a less conservative city, people are less reluctant to take credit, even the traditional form of credit. Some clients were able to get supplier credit from wholesalers in the past. In such cases a client would have an introduction from another member of the community. Clients fortunate enough to have supplier credit often had to pay more for credit than if payment was made in cash (from the buy-sell transaction). Most borrowers prefer to use HMFP as the suppliers did not always give sufficient credit to fill demand, nor would they sell on credit if they had brisk demand for the product. From this finding it may be adduced that other factors such as perception and acceptance can affect microfinance outreach even with the introduction of Sharia-compliant products. Areas with risk-averse clients may still avoid credit even if the model fits in to their religious and cultural systems.

Microenterprise vs. Small Enterprise

HMFP's primary market is the microenterprise. Some financed micro-businesses have grown to a larger size and when this occurs, and the lending cap is reached, the program refers the client to a bank. As murabaha is not an Islamic banking product which requires profit-sharing, its use eliminates the need for written records, often unavailable at the microenterprise level, or if available (20 percent of HMFP clients keep books), the client may be unwilling to share them. Additionally, as financing is not based on profit sharing, the return to the institution is based on a well-defined contract, with pre-defined amounts. Therefore there is no opportunity for abuse on the part of the client through inaccurate or false record-keeping. Finally a fixed contract and absence of profit sharing implies a less complicated process and thus a lower cost to the institution to implement. Murabaha can be used for both working capital and fixed asset financing, thus widening the appeal of the product, especially as a client develops economically. In either case the lender "owns" the financed goods/assets, until the loan is paid in full. Thirty percent of all loans are for fixed asset financing. The observation from the above study implies that the absence of written records reduces the costs of operations since MFIs do not provide clients with pass books as is the case currently. This again appeals to the illiterate clients who are largely found in the rural areas especially at the coastal region of Kenya where, again, the Muslim population is relatively high. This, therefore, creates the possibility of widening outreach to the underserved market.

2.3.2 Challenges

Accounting and Financial Issues

HMFP has two elements of accounting/finance, which differ from most microfinance organizations. Both have implications for content of financial statements. The first is capitalization of the service charge expected upon disbursement, which affects the balance sheet. The second is the absence of the "principle of interest" on outstanding loan balances affecting yield on the portfolio and thus income earned.

Amortization of Service Charge/Principal

As interest (the concept of paying for the time value of money) is not considered in murabaha, the question of amortization does not exist. The contract between the borrower and institution is for a fixed amount to be paid in equal installments. Installment amounts are calculated in advance and include both the initial amount extended as well as a service charge. The service charge is nominally based on the amount loaned as well as the term in which installments are to be paid back. HMFP collects installments primarily on a monthly basis, although shorter installment periods also take place. The "service charge" or agreed cost of the buy-sell service is a fixed amount based on the expected term of the loan and frequency of installments. At HMFP it is based on a 2 percent flat monthly charge.

Table 1 Sample Loan Installments

Period	Principal from (to) Client	Fees/Service Charge	Net Cash Flow
0	(20,000)	50	(19,950)
1	3,750		3,750
2	3,750		3,750
3	3,750		3,750
4	3,750		3,750
5	3,750		3,750
6	1,250	2,400	3,650

Periods/Year = 12

Periods in Loan = 6

The six installments are essentially equal. The first five installments are principal only. The final installment (or more depending on the term of the loan) is the service charge plus remaining principal. In a traditional MFI, the installments are equal, but usually the client pays a portion of the principal and interest in each installment (either through amortization or a fixed split between interest and principal). This is essentially the same.

Implications:

From an accounting perspective, disbursement involves a disbursement of both principal receivable and service charge receivable. Thus service charge is "capitalized" on the balance sheet through the lifespan of the loan and normally included in the portfolio outstanding account. This receivable is only reduced as the service charge comes in (at the end of the loan term). For example, in the loan noted above, the expected service charge of 2400 YR is posted to "client account" (which includes both service charge receivable and portfolio outstanding) upon disbursement.

The loan portfolio, and thus balance sheet, at any one time, is overstated in terms of assets, and depending on the season and balance sheet composition. This kind of scenario poses a slight technical challenge to the traditional MFI's accounts. But this can be sorted out with a good accounts software program.

Income Earned

A major tenet of the murabaha methodology is the existence of a fixed contract for the service. This contrasts with conventional microfinance, where the client enters into a contract while the cost for the service could change depending on repayment performance. When a murabaha loan is issued, the service charge is based on a fixed loan term and fixed installment schedule. When these parameters are violated, there is no recourse in terms of penalty to compensate for the fact that the loan is outstanding longer than expected or that the loan installment is late. In a traditional MFI, late fees and penalty interest is a critical motivation for repayment. However, in addition to the operational implications this has in terms of the importance of effecting prompt repayment, it also has implications for the income statement. The service charge is received at the end of the loan period, thus, murabaha income is credited only at the end of the loan, and not over the life of the loan. Posting income at the end of the loan is highly conservative, as the period over which it was earned has passed. However, HMFP is reluctant to accrue income over the life of the installments, as it appears then to be similar to the concept of interest. However, there has been no discussion as to why HMFP does not take in the service charge initially as a prepaid fee, except that it would not adhere to conservative accounting principles. The implication of receiving the murabaha income/service charge at the end of the loan term is that it can lead to wide swings in income depending on the seasonality of the portfolio. This contrasts to more traditional MFIs, where even if there is seasonality and varied disbursement patterns of the portfolio, interest income is accrued on a regular basis. Thus swings in income are not so pronounced. This is another digression that traditional MFIs should consider in the designing of Sharia-compliant products. The option would be to take the service charge upfront from the loan amount rather than wait up to the end of the term, though this may make the product appear to be more costly for the client. Once again the foregone observations prove that the concept of service charge between Murabaha and conventional microfinance is fundamentally the same except that there are no late payment penalties which may adversely affect portfolio performance.

Operational Issues

Monitoring and Risk Management

Portfolio quality and the eventual recovery of the loan are determined by the credit process ranging from promotion, screening, application, analysis, approval (pre-loan), through post-disbursement management such as collection, delinquency follow-up, and qualification for additional loans. These elements are as integrated into the murabaha product as they are in "standard" microfinance products. However, the borrower or murabaha client incurs no penalty for late payment (except for fees and transportation costs charged for legal follow-up)—one of the principal motives for on-time repayment. Nonetheless, other incentives for repayment remain in place:

- attraction of the possibility of additional, larger loan
- program is rigorous about going after delinquent borrowers
- regular equal installments enforce discipline among borrowers

Control

A significant operational difference separating the murabaha system from the conventional microfinance system is the disbursement transaction. The client does not handle cash at disbursement: instead, the transaction is between the institution (represented by the field officer) and the purveyor of the commodity or fixed asset. As such, the institution bears the risk of this transaction. The transaction is normally done on a cash basis. Consequently the field officer may carry large amounts of cash to suppliers or markets, and the institution is susceptible to risk of theft by an outside party or even its own staff. To minimize the impact of these concerns, certain levels of cash disbursement require more than one field officer present or he or she restricts the disbursements to a small number of clients, thereby carrying only cash for three to four transactions. Each of these restrictions/controls imply additional costs, not generally incurred in many MFIs where the clients come directly to the institution to obtain their disbursement and are thus the ones to take the risk. These additional control issues have caused HMFP to consider creating an internal auditor position. Although recommended in best practices of microfinance, an internal auditor position is usually a luxury found only in a larger MFI. Management believes that the nature of the transactions, and the risks which they pose to the institution, require further review. Presently an external auditor serves this purpose in a limited way. This is one of the greatest challenges posed for Kenyan MFIs that may want to go the Islamic microfinance way since the level of exposure is extremely high. The controls adopted by HMFP may not address this problem in its entirety in Kenya's MFI sector. This may raise further questions on the feasibility of Islamic microfinance in general and its viability in the Kenyan context in particular.

Performance

Efficiency

The nature of murabaha financing is such that, although much of the other costs of lending and follow-up are incurred as in conventional microfinance, the additional cost of the buy-sell mechanism clearly adds to the program's operating costs. Credit officers are required to prepare a detailed feasibility study in every loan case, which then serves as the basis for murabaha financing. They are also required to go to the market to purchase the commodity or fixed asset and exchange cash for it.

The implication of additional operational costs makes Islamic microfinance unattractive to the conventional microfinance industry which is also heavily subsidized and may not incur additional costs for the sake of religion. This may call for modifications to address the issue of costs incurred under the buy-sell mechanism.

2.3.3 Conclusion

The UNCDF case study concludes that Islamic Finance principles applied to microfinance pose several operational and financial challenges to an MFI. Throughout the study the differences between the practices and processes of a traditional MFI and that of an MFI applying Islamic banking principles to microfinance have been highlighted. The tables below sum up these differences.

Table 2 Principles of financially viable lending to poor entrepreneurs

Principle	Murabaha adaptation	Common to MFIs and HMFP
Offer services that fit the preferences of poor entrepreneurs	• Product and process do not allow relatively unrestricted use of funds. • Product requires more extensive application including cash flow. • Fixed asset and working capital loans offered	• Short-term loans • Repeat loans • Small loans • Outlets close to customer • Loan installments compatible with cash flow of business
Streamline operations to reduce unit costs	• Application form can be lengthy • Potentially lower productivity per staff due to application	• Standardized process • Inexpensive offices • Staff selected from local communities

	process • Disbursement is through buy-sell mechanism	
Motivate clients to repay loans	• No additional service charge on late installments	• Joint liability groups • Access to further loans, increasing loan sizes • Staff credit culture
Charge full-cost interest rates and fees		• Fees and service charge to cover full costs of lending

Table 3 Other comparisons with traditional microfinance operations

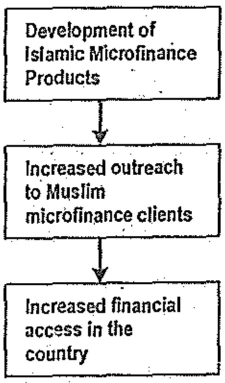
Element	Murabaha/HMFP	Traditional MFI
Accounting	• No amortization of service charge over life of loan • Lump sum at end • Capitalization of service charge, overstatement of assets	• Amortization or equal split of interest over life of loan • No capitalization of interest
Patterns of Disbursements	• Significant impact of seasonality on income	• Some impact of seasonality on income
Planning/Analysis	• Does not fit into typical forecasting models • Data needs to be adjusted for standard analytical formats	
Control/Risk	• Field officers handle disbursement • Early consideration of the post of internal auditor	• Client bears risk after receiving disbursement • Internal auditor post usually comes with advanced size of the institution

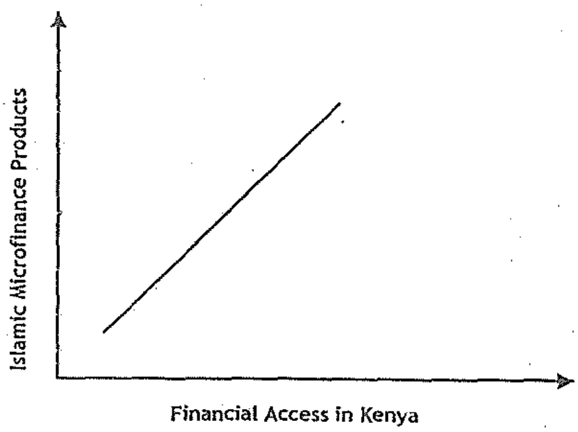
2.4 Summary and existing gaps

After microfinance, the advent of Islamic finance (Sharia-compliant banking) was the next big thing that took the financial world by storm. Previously silent and relegated to the Gulf banks and the Arab world, Islamic banking was taking a steady trend in shaping up the western world and sub-Saharan Africa. Most economies in these regions were positioning themselves in preparation for the next level of competition as conventional banks prepared to fight it out with fully-fledged Islamic financial institutions for the same market but with more 'competitive' rates. It was for this reason that CGAP occasioned a global survey in 2007 to assess the extent of outreach of Islamic banking in the world financial markets. Sharia-compliant banking at the time was still nascent in Kenya (less than 3 years old) and emerging practices were still being observed. But Islamic Microfinance, on the other hand, was yet to take root in Kenya's financial services sector though there were indications that demand for Islamic microfinance products was real but untapped. With regards to the foregone observations it was the purpose of this study to investigate the actual existence of demand for Islamic microfinance and its viability in Kenya.

2.5 Conceptual Framework

The study looked at the relationship between two concepts. The concept of *Islamic Microfinance* was the independent variable while the concept of *Financial Access* was the dependent variable. It proposed that the development of Sharia-compliant products in Kenya's microfinance industry would lead to increased financial access to Kenya's unbanked population since it would have provided financial options to the unbanked Muslims. This is illustrated by the following framework of relationships:





Chapter 3

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the strategy that was used in gathering data and information for addressing the research problem and objectives. The chapter also describes where the primary research was to be conducted, the targeted institutions and individuals and the data collection methods that were employed in carrying out the research.

The researcher visited the selected institutions and clients to administer the instruments of data collection besides reviewing all the available and relevant literature.

3.2 Research Design

A research design is a definite plan determined before any data are collected, for obtaining a study sample from any given population. The study design most appropriate for this study was a cross sectional survey design. The survey is a non-experimental, descriptive research method.

3.3 Target Population

The research was carried out in Nairobi, the capital and commercial city of Kenya which serves as the Headquarters of most MFIs and commercial banks operating in Kenya. The target population was the Muslim population and institutions operating in areas where there was a considerable Muslim presence both within and outside Nairobi.

3.4 Sample Design

The sampling design that best suited the study was stratified random sampling. The sampling frame was to be constructed from Muslim small-scale businessmen and women in the Eastleigh area and Makina and Kambi Muru villages of Kibera slums of Nairobi. A sample of 30 interviewees was drawn for the individual study while 8 institutions were sampled from the MFIs and Banks operating in Nairobi and with branches in regions with considerable Muslim presence.

3.4.1 Construction of the Sample frame

Part of the sampling frame was drawn out of the institutions listed in the Microfinance Directory (AMFI, 2008) and commercial banks operating in Kenya as listed in the website (Wikipedia). Organizations whose headquarters and/or operations were out of Nairobi were deliberately left out of the sample frame. The 'city-bias' was based on the fact that most financial institutions operating in the country have their Head Offices in Nairobi.

3.4.2 Sample size determination

5 out 11 MFIs and 5 out of 46 commercial banks were selected from the sample frame for this study for purposes of institutional respondents. 30 individual respondents were also selected for the study on individual clients.

3.4.3 Sampling procedure

The sample frame contained categories of MFIs, conventional commercial banks, Islamic Financial institutions, Mortgages, wholesale microfinance institutions and the Association of Microfinance Institutions of Kenya (AMFI-K). The sample size was determined through stratified random sampling method.

3.5 Data Collection

3.5.1 Data collection instruments

The data was collected by use of questionnaires and interviews administered directly to the selected institutions and individual clients by the researcher.

3.5.2 Validity and reliability of the instruments

The tools were designed in a structured systematic way that revealed standard issues of concern from the respondents in terms of the research objective/questions. There were modifications for all categories of respondents as per the nature of institutions, i.e. MFIs or Banks. The tools were also pilot tested to further improve their reliability and validity.

3.5.3 Administration of the instruments

Primary data was gathered through structured questionnaires and interviews from the selected institutions and individuals. Secondary data was gathered from internet sources, books, newspaper articles and papers by authorities in the area of Islamic Microfinance. Pilot testing of the tools for conducting primary data was done prior to the eventual roll out of the research. The researcher carried out the research by himself with the assistance of a guide through Makina and Kámbi Muru villages of Kibera.

3.8 Data Analysis

Raw data was coded and analyzed using Ms Excel spreadsheet.

3.7 Reliability of the Research

In spite of the challenges experienced in the field the data gathered through this research was reliable and generated information that was instrumental in meeting the objectives of the research.

3.9 Presentation of Findings

Findings of the study were presented in percentages, charts and graphs besides descriptive information.

Chapter 4

DATA ANALYSIS AND PRESENTATION OF FINDINGS

4.1 Introduction

This chapter presents the data analysis and the findings from the primary research. The first section of this chapter describes the site of the research and the challenges encountered while conducting the study. The data analysis and the findings have been divided into two sub-sections. The first sub-section discusses the findings from the perspective of individual respondents while the second sub-section discusses findings from the perspective of the institutional respondents.

4.1.1 Site of the research

The research was conducted in Eastleigh area of Nairobi and Makina and Kambi Muru villages of Kibera slums. Eastleigh area is known for the large presence of a close knit, almost clandestine, agile business community of Somali residents (Kenyan and foreign). It has actually been baptized as a *small* Somalia within Kenya. The Somali are largely Muslim and are known for their strict adherence to Islamic law (the Shariah). To most Kenyans the Somali people in Eastleigh have a reputation of astute businessmen and women who supply virtually everything under the sun at very affordable (almost questionable) prices. Most businesses in Nairobi's Central Business District (CBD) and other parts of the country get their supply from Eastleigh area of Nairobi. While the financial services sector of the Somalis operating in Eastleigh is so covert it is common knowledge that they use *Hawalas* (informal money-lenders) to finance their businesses. This has been one of their coping strategies for the lack of Sharia-compliant products in Kenya's microfinance industry and the banking sector. It is also common knowledge that most of them do not have national identity cards and so cannot meet some of the requirements set by Kenya's formal financial services providers. Eastleigh area therefore provided an ideal site for the study.

Makina and Kambi Muru villages of Kibera slum are known as the Muslim centres of Kibera. Most of the residents of this area are Muslims with many micro and small enterprises (MSEs) and Small and Medium Enterprises (SMEs) making them suitable candidates for MFIs.

They too provided ideal respondents for this study.

4.1.2 Challenges in data collection

The research was conducted over a period of one week and it targeted clients from Eastleigh and Kibera areas of Nairobi. The sample size was 30 clients who had to be Muslims. The study also targeted institutional respondents which were MFIs and Commercial Banks operating in Nairobi's CBD and Eastleigh area. The researcher used probability sampling – Stratified Random Sampling to get a list of institutions for his study. A list of banks and MFIs operating in Nairobi was derived from the internet and the Microfinance directory respectively. 5 banks and 5 MFIs were selected randomly. Out of these 1 MFI and 1 bank declined due to their tight schedule. For the individual respondents, out of the 30 who were randomly selected the researcher managed to get 28 clients. This was largely due to the time constraint of the study.

All the individual respondents hailed from Makina and Kambi Muru villages of Kibera since respondents from Eastleigh were very suspicious (as expected) and literally refused to cooperate by saying that they did not understand or speak Swahili properly.

Out of the 5 banks surveyed 2 were Islamic Banks. 2 of the conventional banks were also offering microfinance services.

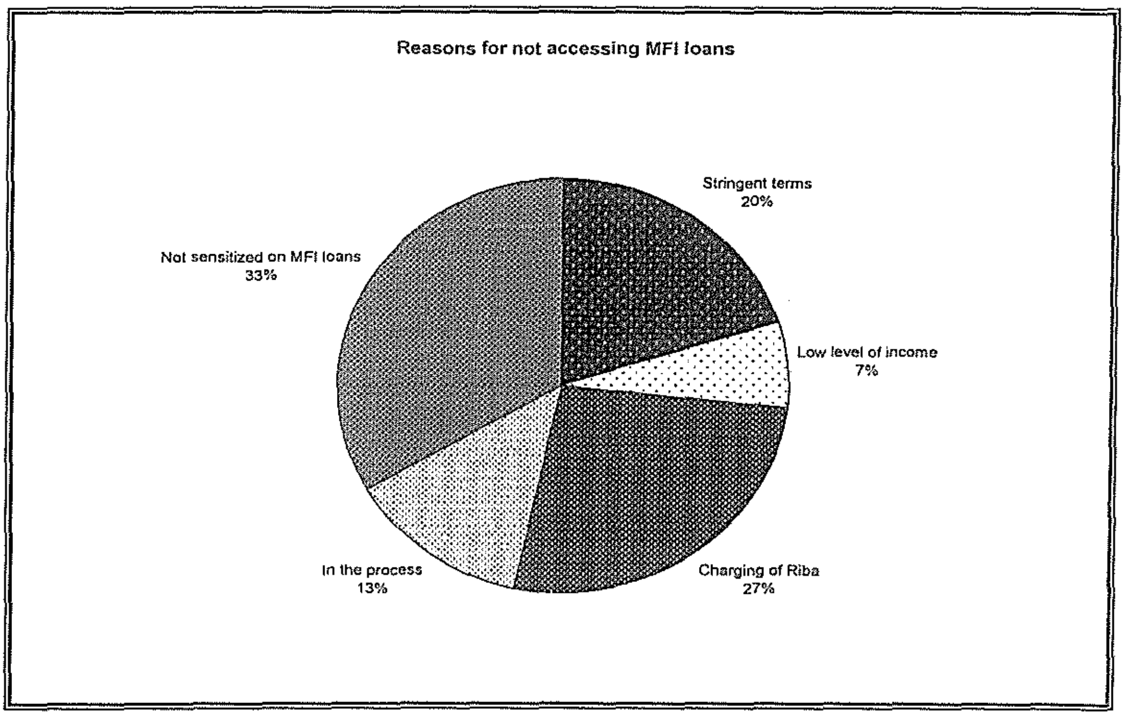
The profile of both the institutional and individual respondents provided ideal characteristics to make the results of this study valid and reliable.

4.2 Data analysis and Presentation of findings – Individual respondents

4.2.1 Accessibility to loans by Muslim clients

50% of the clients surveyed said that they did not access MFI loans for a variety of reasons. 33% of those who did not access MFI loans said that they had not been adequately sensitized on MFI products and procedures of accessing loans; 20% cited stringent terms by MFIs; 7% said it was due to their low levels of income; 13% said it was a matter of time as they were in the process; but 27% cited the charging of *Riba* against the Shariah as a discouragement to them against accessing MFI loans. The charging of *Riba* (interest) was therefore among the main reasons for financial exclusion among the Muslim clients.

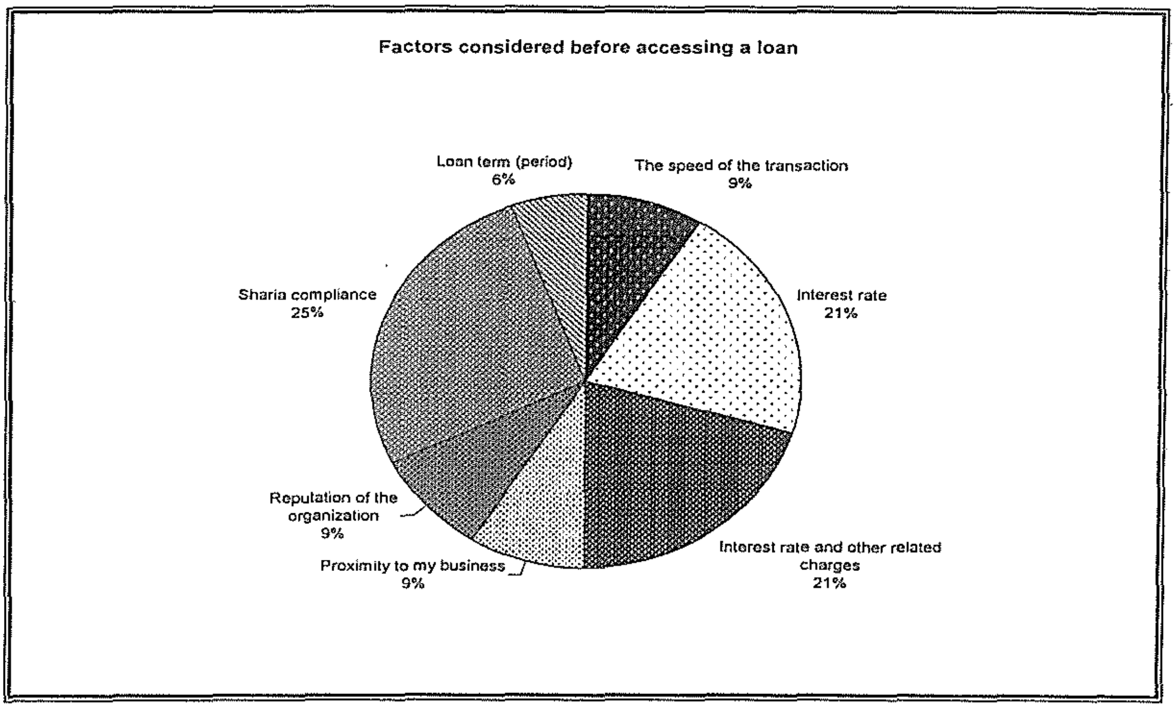
The diagram below is a graphic representation of the responses.



4.2.2 Factors considered before accessing loans

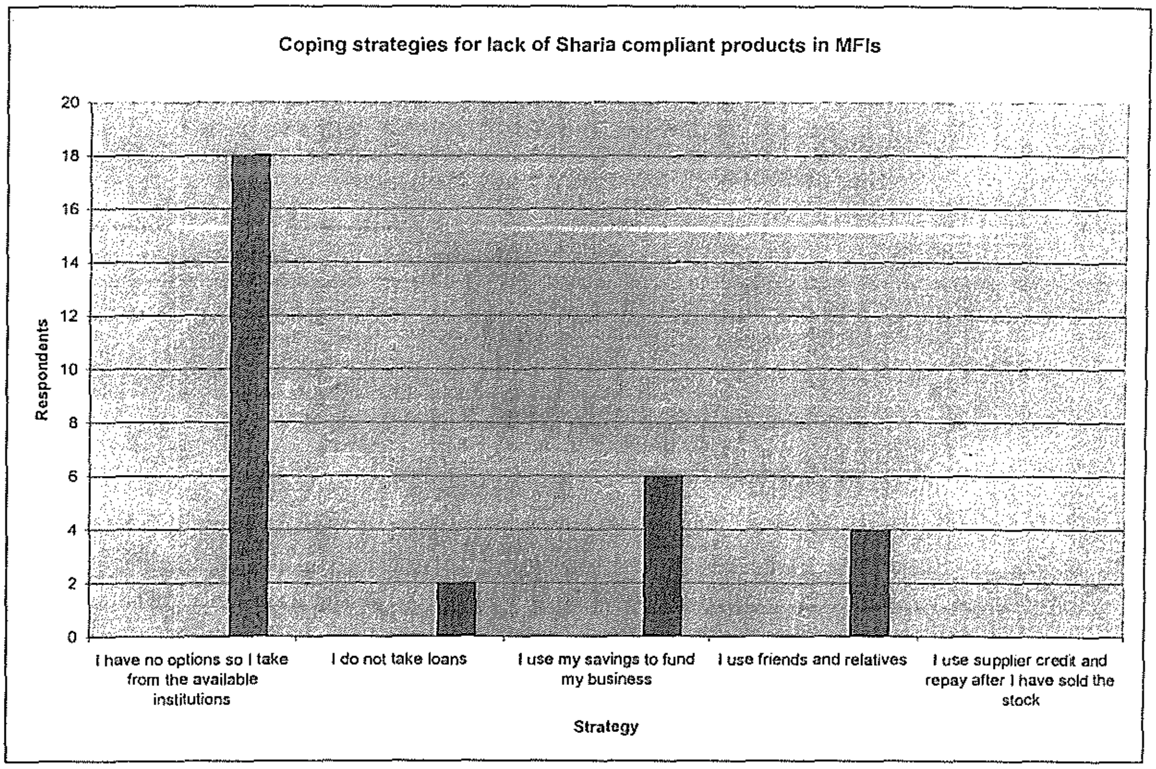
All respondents were asked about factors they considered before (thinking of) applying for a loan. This question was put forward to all the clients despite their loan status (those who had ever applied for loans and those who had never). Among the reasons given 25% said they would consider if the institution's products were Sharia-compliant; 21% revealed that they would look at interest rate and other related charges; while 9% said the reputation of the organization was paramount another 9% said they would consider the speed of transaction; another 9% said they would look at the proximity of the institution to their business; and finally 6% thought that the loan term (repayment period) was critical in making a decision before taking a loan.

While the highest percentage was from clients who said that they considered Shariah-compliance important a CGAP survey on Islamic microfinance cautions from its anecdotal evidence that some survey respondents may verbally express a preference for Islamic products simply to demonstrate piety or (when given a choice in practice) will opt for lower priced conventional product. (CGAP, 2008). In deed, on further probing as to why most respondents preferred Shariah-compliant products the researcher discovered that the reasons given were out of the respondent's perception that Shariah-compliant products were cheaper than conventional products since they prohibited *Riba.* There is a general perception that Islamic banking is '*interest free*' and so clients think it is 'costless'. This is a fallacy. The diagram below illustrates the above factors.



4.2.3 Coping strategies by respondents in addressing the lack of Shariah-compliant products in Kenya's MF industry

While there are many mainstream banking clients who demand Shariah-compliant products, studies reveal that there are also many poor people who insist on these products. (CGAP, 2008). The emergence of Islamic banks in Kenya had been an outcome of the demand by mainstream banking clients for Shariah-compliant products. Whereas the mainstream banking sector had options for their Muslim clients, poor micro-entrepreneurs had no option of Islamic Microfinance products. The researcher wanted to know some of the coping strategies the respondents used in addressing the lack of Shariah-compliant products in Kenya's microfinance industry. Due to lack of options most respondents accessed loans from the available institutions as a coping strategy. The results are illustrated in the diagram below.



The study also assessed the knowledge of the respondents on the existence of a Kenyan MFI that provided Shariah-compliant products. All respondents said they had no knowledge of any Islamic MFI in the country and had never heard of one. Asked whether they would switch over to Islamic MFIs if given the option, all respondents responded in the affirmative. This confirmed the existing market niche.

4.3 Presentation and analysis of data – Institutional respondents

4.3.1 Level of awareness about the Islamic Microfinance concept

To assess the level of awareness of the Islamic Microfinance concept in Kenya's financial services sector the study found out that 5 out of the 8 institutions surveyed were not aware of the Islamic Microfinance concept as much as they knew of its counterpart, the Islamic Banking. Ironically, all the respondents who showed lack of knowledge on Islamic microfinance were actually MFIs. Interestingly when asked if they saw the need to introduce Islamic Microfinance to address the needs of their Muslim microfinance clients 6 out of 8 respondents thought it was necessary. For respondents who thought it was necessary but did not offer Islamic Microfinance products a variety of reasons were offered as illustrated below.

Reasons for not having Islamic Microfinance products	No. of respondents	Explanation
We see no need since Sharia-compliant products are the same as conventional microfinance products.	1	
It is not in our mission to offer Islamic Microfinance	2	Christian-based
We have no expertise or experience in the area Islamic Microfinance	1	
It is a matter of time before we start offering	1	
There is no sufficient demand to warrant product development in that area.	1	

4.3.2 Viability of Islamic Microfinance in Kenya

To address the question of viability the study sought the opinions of respondents on the effect of rolling out Sharia-compliant products in the microfinance industry. 5 out of 7 respondents felt that this would actually increase their market segments since it was a market niche that was yet to be exploited by Kenyan MFIs then. The respondents felt that rolling out Islamic microfinance products would also have given them a competitive edge in the market.

All respondents felt that there were opportunities that made Islamic microfinance viable in Kenya. There was a perception that the growing interest in Islamic Banking in Kenya's mainstream banking industry at that time also meant that there was demand at the low end segment of the market. Respondents felt that Islamic microfinance invests in viable businesses just like conventional microfinance and so it is viable too. The Islamic Banks added that there was a large number of Muslims in the country that was underserved. This was besides the revelation that most clients in conventional banks were disillusioned with conventional banking practices that were largely considered exploitative and unethical.

4.3.3 Factors hindering Kenya's Microfinance sector from venturing into Islamic Microfinance

The following responses emerged from the respondents in explaining the lack of Shariah-compliant products in Kenya's microfinance industry in spite of the existing demand. Most respondents felt they had no expertise and experience in the area of microfinance. The diagram below is a summary of the responses.

Factors	Responses
Lack of expertise and experience	4
Lack of sufficient demand	2
Apathy (no interest in the concept)	1

It is the next big thing in Microfinance (it is a matter of time)	2
Operational costs related to Islamic Microfinance.	1
Lack of a regulatory environment	2

4.3.4 Evidence of existing opportunities (existing potential) for Islamic Microfinance in Kenya

In analyzing the institutional awareness of the existing market niche for Shariah-compliant products in Kenya's microfinance sector, the study sought the opinions of the respondents on the existing opportunities in the market. The following were the findings.

Responses	Respondents
There is rapid growth of Islamic banking which also implies that there could be demand for Microfinance services at the low end market.	6
There are willing donors from the Gulf countries to fund Islamic microfinance initiatives.	1
There are many Muslim microfinance clients who have been left out by the conventional MFIs.	4

4.3.5 Regulation of Islamic Microfinance

The study also sought to find out from the respondents if they thought that Sharia-compliant products were subject to regulation by the government. 6 respondents said that Islamic Finance was not subject to any regulations while 1 respondent did not have knowledge about the regulation of Shariah-compliant products in Kenya.

Chapter 5

DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.0 Discussions and Conclusions

5.1 Introduction

The first three sections of this chapter present the conclusions from the findings of this study. The conclusions have been aligned to provide answers to the research questions and objectives of the study. The last section is on recommendations and has three sub-sections.

5.2 Islamic Microfinance – an existing market niche

The first specific research objective set out to determine access to and demand for Islamic microfinance products by Kenya's microfinance clients. The findings from this study suggested that there was an existing market niche for Islamic Microfinance products in Kenya's financial services sector. The findings also indicated that Kenya's microfinance clients (a substantial number) who demanded Islamic microfinance products did not have access to them since there was no institutional respondent that offered Shariah-compliant products while no individual respondent had knowledge of any MFI providing Islamic microfinance products. The findings of the study indicated categorically that 50% of the respondents were denied access to loans for the mere reason that the products were not Shariah compliant. This finding compared favourably with the CGAP study which revealed that in Syria 43 percent of the respondents considered religious reasons to be the largest obstacle to obtaining micro-credit. In addition, 46 percent of respondents who had never applied for a loan stated that religious reasons were the primary reason they had never applied. And nearly 5 percent of current borrowers said they would not apply for another loan for religious reasons. (CGAP, 2008).

5.3 Supply of Islamic Finance Products in Kenya's microfinance industry

The second specific research objective set out to explore the supply of Islamic Finance products in Kenya's microfinance industry. The results of the study suggested that there was poor supply of Shariah-compliant products in Kenya's microfinance industry (probably too insignificant to reach the lowest segments of the socio-economic profile). The challenges in the supply side of Sharia compliant financial services was illustrated by one bank that wrote Cheques to suppliers for their Muslim clients who were uncomfortable with receiving credit in cash against the Shariah. There was high demand for Islamic Microfinance products against a negligible supply of the same meaning that Muslim microfinance clients had few options (if any) and were financially excluded by the microfinance sector.

5.4 Potential Supply of Shariah Compliant Microfinance Products

The third specific research objective set out to assess the potential of Kenya's microfinance industry in supplying Islamic microfinance products. The study findings suggested that there was a high potential for Kenya's microfinance industry to grow and supply shariah compliant products. There were existing structures and adequate institutional framework in the MFIs that were at the time offering conventional microfinance products. Literature review and anecdotal evidence established that there was little difference in terms of product design between Islamic Finance (microfinance) and the conventional products.

5.5 The Potential of Microfinance in Increasing Financial Access in Kenya.

The overall research objective of the study was to explore the potential of Islamic microfinance in increasing financial access to Kenya's unbanked population. The study findings indicated that there was demand for Sharia compliant microfinance services, that the supply then was too insignificant to meet the large demand and that the infrastructure in the microfinance industry favourably positioned the industry to grow into this niche. It was therefore concluded that the microfinance industry was on the verge of propelling the nation into the second financial revolution and was to increase formal financial access to a significant proportion of Kenya's unbanked population.

6.0 Recommendations

6.1 Sensitization and knowledge creation on the concept of Islamic Microfinance

Microfinance stakeholders like AMFI – K and universities offering microfinance studies like Strathmore University need to seize the opportunity and sensitize the microfinance community (practitioners, researchers and investors) of the newest concept in microfinance – Islamic microfinance.

AMFI – K as an umbrella body and knowledge sharing forum needs to start sensitizing its members on the existing market niche (Islamic microfinance) so as to address the issue of financial exclusion of the Muslim clients thereby reducing the widening gap of Kenya's unbanked population (38%).

Strathmore University should take lead in sensitizing microfinance students on emerging issues such as Islamic microfinance. This can be included as a topic (or more boldly, a unit) under Module One under the *Microfinance Scenario* unit (or a separate unit – Islamic Microfinance). This will position microfinance students favourably in the industry and therefore give them an edge in the job market and research/policy institutions.

6.2 Research and Development in Shariah-compliant products

Kenya's microfinance practitioners should spend time, effort and resources in conducting more research on the area of Islamic microfinance. The nature of Islamic microfinance needs to be explored further to assess its viability in the Kenyan context. There is also need to conduct research on the nature and extent of demand for Shariah-compliant products in Kenya's microfinance industry. This was identified as a research agenda by the CGAP survey at the global arena. (CGAP, 2008).

Research findings in these areas will help the Research and Development departments of Kenyan MFIs make more informed and relevant decisions on whether to venture into this interesting area of Islamic microfinance.

6.3 The role of the government

From the study it was clear that the institutional respondents were not sure of the regulations governing Shariah-compliant banking. In fact, in its most recent amendment, the Central Bank of Kenya recognized the presence of Islamic banks in the country by highlighting an article to recognize the aspect of '*returns*' by Islamic banks. (CBK, 2009).

The Microfinance Act 2006 was not formulated in a day. It took a lot of lobbying and advocacy by practitioners through AMFI – K to have the Kenyan government recognize the influence of microfinance in Kenya and see the need for regulation. Again, Islamic microfinance is knocking at the Kenya microfinance door yet there seems to be little effort to position the regulators in supervising the aspect of Islamic microfinance which is both unique in nature and form.

It is the recommendation of this study that AMFI – K and the government should start putting in place a framework to address the possible (and almost sure) integration of Islamic microfinance into the Kenyan microfinance space. Afterall the impact of Islamic Finance had already been felt in the mainstream banking in spite of initial reluctance by CBK.

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WORK PLAN

NO.	Activity	Jan	Feb	Mar	Apr	May
1	Purchasing stationeries	X				
2	Writing proposal	X	X			
3	Questionnaire preparation			X		
	Proposal presentation			X		
	Check list preparation			X		
	Familiarization with area leaders in study area.				X	
	Questionnaire pre- testing				X	
	The beginning of the research up to the end				X	
	Data collection, processing and analysis					X
	Report writing					X

BUDGET

	Activity	Responsible person (s)	Costs	Total
	Purchase stationeries	Researcher and government officials	3 Reams paper @10,000 1 Flash disc 40,000 50 pens@500	30,000 40,000 25,000
	Transport hiring	Researcher	300 km@1000	300,000
	Familiarization with study area residents	Researchers and target population and area leaders.	Refreshment 20,000	20,000
	Questionnaire pre- testing	Researchers and Leaders.	Refreshment 20,000	20,000
	Report printing and photocopying	Researcher	100 copies x 100 Printing 10,000	10,000 10,000
	Data collection	Researchers, Leaders.	Perdiem 30 days x 30,000 Refreshment (various 150,000	900,000 150,000
	Data processing and analysis	Researcher	Perdiem 3 days x 45,000	135,000
	Report writing and presentation.	Researcher	Perdiem 5 days x 45,000	255,000
	Report printing and binding	Researcher	2 copies@ x 60,000	120,000
			Grand total	2 005 000

QUESTIONNAIRE

CONSENT FORM

Good morning/afternoon/evening. My name Mbaya Mercy Kanana from Kampala International University. I am conducting a survey on the place/role Islamic Microfinance in Kenya's Microfinance industry. All your opinions will be treated confidentially and used for research purposes only, that is, details of your institution will not be released or shared with anybody. I will not quote any individuals by name in my report.

I request your permission, therefore, to carry out the interview which will take about 30 minutes.

Interviewer sign to indicate consent ______________________Date _________________________

NAME OF INSTITUTION -------------------------------------

LOCATION ---

POSITION OF RESPONDENT -------------------------------------

INTERVIEWER VISITS --

1

2

3

DATE OF INTERVIEW

Result Codes

1.Completed

2.Declined

3.Not available after 3 call backs

4.Other (Specify) --

1. Are you aware of the Islamic Microfinance concept? YES /NO

If YES, what do you consider as fundamental differences between Islamic Microfinance and conventional microfinance?

a. No difference

b. Focus on Muslim clients only

c. Charging of interest rate

d. Operational strategy

e. Others (specify)

2. Do you consider Sharia-compliant products necessary in meeting the needs of your Muslim clients? YES NO

a. If YES but no Sharia-compliant products on offer, what are the factors that have made your organization not to venture in to Islamic microfinance?

i. We see no need since Sharia-compliant products are the same as conventional microfinance products.

ii. It is not in our mission to offer Islamic Microfinance

iii. We have no expertise or experience in the area Islamic Microfinance

iv. Islamic microfinance will increase the risks and operational costs

v. There is no sufficient demand to warrant product development in that area.

vi. Other reasons (specify)

3. Do you consider microfinance products developed in consideration with the Sharia laws will increase the outreach of your organization, and microfinance in general, by having Muslim clients joining the program?

YES/ NO .If YES, how?

4. Do you think having Sharia-compliant products will give your organization a competitive edge in the market? YES/ NO

a. If YES, why don't you have Sharia-compliant products?

i. We see no need since Sharia-compliant products are the same as conventional microfinance products.

ii. It is not in our mission to offer Islamic Microfinance

iii. We have no expertise or experience in the area Islamic Microfinance

iv. Islamic microfinance will increase the risks and operational costs

v. There is no sufficient demand to warrant product development in that area.

vi. Other reasons (specify)

5. What do you think has kept Kenya's microfinance industry from venturing in to Islamic Microfinance?

a. Lack of expertise and experience

b. Lack of sufficient demand

c. Donor demands

d. It is the next big thing in Microfinance (it is a matter of time)

e. Operational costs related to Islamic Microfinance.

f. Other reasons (specify)

6. Is your market strategy reflective of the religious values of your clients in different regions of the country? YES/ NO .If YES, how?

7. What evidence is there to indicate that there are opportunities in Sharia-compliant banking for Kenya's microfinance industry?

a. There is no evidence.

b. There is rapid growth of Islamic banking which also implies that there could be demand for Microfinance services at the low end market.

c. There are willing donors from the Gulf countries to fund Islamic microfinance initiatives.

d. There are many Muslim microfinance clients who have been left out by the conventional MFIs.

e. Other reasons (specify)

8. Are Sharia-compliant products exempt from regulatory issues unlike conventional products? YES/ NO .If YES, why?

9. How are Islamic banks managing Sharia-compliant products in spite of feasibility concerns?

a. Depend on heavy subsidies from donors

b. Islamic banking is just as feasible as conventional banking

c. Other reasons (specify)

10. Are all your products strictly for Muslim clients? YES/ NO .Why

11. What are some the concerns expressed by clients who come for your products that make them not to go for conventional financial products?

a. Lack of Sharia-compliant products and services from other banks