PROPOSED INTERVETION MEASURES TARGETED AT BOOSTING THE DEVELOPMENT OF ISLAMIC CAPITAL MARKETS IN KENYA

DECEMBER 2011

Research, Market Infrastructure and Product Development©

1.0 INTRODUCTION

Vision 2030 is Kenya's economic development blueprint covering the period 2008 to 2030. It aims to transform Kenya into a newly industrializing, "middle-income country providing a high quality life to all its citizens by the year 2030". The Vision is based on three "pillars": the *Economic, the Social and Political pillars.* The Economic Pillar identifies six priority sectors to drive growth towards realizing its key objective. These are *Tourism, Agriculture, Wholesale and Retail Trade, Manufacturing, BPO and* ***Financial services****.* The Financial Sector's main objective under Vision 2030 is to create a vibrant and globally competitive financial sector that will create jobs and promote high levels of savings to finance Kenya's overall investment needs and makes Kenya the regional financial services hub.

Over the last decade, the Kenyan capital market has witnessed a considerable amount of development, and has assumed an increasingly significant role within the overall financial sector. Much has been done to enhance market infrastructure and processes, and to strengthen the regulatory framework during this period, with the CMA itself having been at the forefront of such efforts. The capital market has seen significant growth, with a steady increase in the amount of funds raised.

While the capital market has played an important role in mobilizing funds and facilitating economic development in the past, the development financing requirements of our economy indicate that even greater demands will be placed on the capital market in the coming years in order to achieve our national aspirations. There is therefore the need to develop appropriate capital market structures and mechanisms to support the economic, financial and commercial goals of the country.

Niche markets where Kenya has a comparative and competitive advantage represent potentially significant areas where the domestic capital market can effectively position itself at the regional front, particularly where there is largely untapped potential for such development. Efforts must therefore be taken to improve on the segments of the Kenyan capital markets that have hitherto not developed in tandem with other areas of the market, and where the country has the natural strengths and potential to become a leading player. This will enlarge the breadth of the overall capital market beyond the borders of basic conventional products, and the positive implications for broader capital market activity will also contribute to the overall growth of the financial services industry.

The Islamic capital market is one such niche area. In recent years, Islamic finance has grown rapidly across the world, conservatively estimated at 10-15% annually. Kenya has ambitions of becoming the Islamic finance hub of East Africa and wants to leverage its first mover advantage in this niche market within the region. The country's access to a significant concentration of prospective consumers of Islamic financial products and services within Eastern Africa provides a potentially significant market for Kenyan products and services which conform to Islamic religious principles[1]. Given the availability of an established market infrastructure coupled with the nascent status of Islamic capital markets within the region compared to conventional markets, Kenya is well placed to carve its position as one of the key players for providing Islamic capital market services and products.

The Authority believes the foundations for the future development of Islamic finance in Kenya have been firmly laid. The Central Bank of Kenya (CBK) has already licensed two Islamic banks - Gulf African Bank (GAB) and First Community Bank (FCB), while various other banks are offering Shariah compliant services and products through “Islamic Windows”. The Capital Markets Authority has also licensed FCB Capital in 2009, which will offer Islamic asset management business and capital markets products. This is in addition to approving Genghis Capital’s Amana Fund in 2013, which is the first Islamic Collective Investment Scheme in Kenya. Similarly, FCB has been authorized to act as an Islamic insurance (Takaful) broker for general Takaful products the bank is structuring. In addition, Takaful Insurance of Africa, the first fully Shari’ah-compliant insurance company in Kenya, was licensed and launched in January 2011. Kenya Re is also in the final stages of rolling out Re-Takaful products and services. These developments have enabled the formerly unbanked Kenyans and specifically the Muslim communities in the marginal areas have access to financial services adding to the wealth creation in the economy.

From a broader perspective, the development of this niche market sector into a strong and viable component of the domestic financial services value chain will also provide an important starting point for the expansion of other key areas of comparative and competitive advantage in the capital market within the region or internationally.

2.0 PROPOSED STRATEGIC THRUSTS TOWARDS THE DEVELOPMENT OF ISLAMIC CAPITAL MARKETS IN KENYA

The Islamic capital Market in Kenya is currently at it very nascent stages. It is expected to function as a segment within the broader market for issuers and investors and play a complementary role to the Islamic banking and Takaful industry in broadening and deepening the Islamic financial sector. Within its mandate to foster the development of all aspects of the capital market, the Capital Markets Authority has focused its efforts on two fronts, namely: establishing the supporting institutional, policy and regulatory environment; and widening the product base.

A study on the Development of Islamic Capital Markets in Kenya conducted by RMIPD department coupled with IFSI stakeholder consultations revealed several challenges and gaps

[1] East Africa, including Ethiopia, has a sizeable Muslim population of between 25 million to 45 million. In Kenya, despite the fact that the country has a Muslim population of approximately 10 million[1], Islamic banking is growing at a steady rate, not only servicing the needs of Muslims but also anyone of any institution interested in ethical and socially-responsible financing. In addition, some parts of Kenya have a large expatriate Somali community as a result of the civil war in neighboring Somalia

that needed to be addressed. Nevertheless, some initiatives to develop the sector are already in place in the banking industry aimed at spurring growth in this market segment. Specifically, the amendment of the CBK Act to recognize these products as innovative banking products and as such afford them tax neutrality. However, discussions are still ongoing with the KRA to progress implementation.

The further development of the Islamic capital market in Kenya will add to the depth and diversity of the overall capital market as well as provide a significant contribution to the overall growth of the financial services industry. Development efforts, like those for the conventional market, must necessarily adopt a comprehensive, multi pronged approach to enhance the competitive position of Kenya's Islamic capital market. To this end, the following strategic initiatives have been identified and will need to be undertaken to achieve this objective;

i. Facilitating the development of products and services related to the Islamic capital market

ii. Creating a viable market for the effective mobilization of Islamic funds

iii. Ensuring that there is an appropriate institutional, policy and regulatory framework for the Islamic capital market

iv. Enhance the profile of the Islamic capital market domestically

2.1 STRATEGIC INITIATIVES

i. Facilitating the development of products and services related to the Islamic capital market

To build an Islamic Capital market that is competitive and attractive to issuers and investors, there needs to be coordinated efforts to develop a variety of Islamic securities instruments. The range of products available should be adequate to meet the investment; capital raising and risk management needs that form the basic structure of any segment of the capital market.

Developing a wide range of competitive products and services entails developing the range and quality of local expertise in Islamic securities through comprehensive training and education efforts. In view of this, there needs to be measures to facilitate industry and academic efforts to develop appropriate Islamic securities products. Efforts in this respect will include measures to assist in the promotion of Islamic collective investment schemes and sukuk. To this end, there will be joint efforts by the CMA, qualified training providers and other relevant institutions to promote the development of human capital in this area. In addition, the entry of suitable foreign financial institutions and professionals with expertise in financial advisory services and investment to provide advice and the transferable of knowledge to their Kenyan counterparts will be facilitated and encouraged where such expertise is not available locally.

ii. Creating a viable market for the effective mobilization of Islamic funds

The Islamic capital market should be liquid and efficient enough to provide the Islamic banking, takaful and investment management industries with competitive investment avenues that facilitate the more efficient mobilization of these funds. The participation of institutions managing Islamic funds in the capital markets has been limited, a fact attributable to a combination of structural impediments and insufficient product depth. In view of this, the identification and development of new avenues and instruments in which Islamic funds can be invested will need to be more actively pursued.

iii. Ensuring that there is an appropriate institutional, policy and regulatory framework for the Islamic capital market

The domestic regulatory and business climate should be characterized by a well defined and widely accepted accounting, tax, policy and regulatory framework for the Islamic capital market. Such a framework should be benchmarked against international standards, specifically Malaysia and Gulf Corporation Council (GCC) states[2], and should effectively facilitate informed decision making by market participants as well as foster market integrity through the timely disclosure of relevant and reliable information.

Thus efforts will be made to establish a facilitative environment for encouraging innovation and efficiency in Islamic securities dealings, in compliance with strong Shariah principles. There is the clear need for the establishment of a single Shariah Advisory Council (SAC), with sufficiently wide industry representation, to enhance the consistent application of Shariah rulings within the capital markets. The SAC should be in position to establish standardized Shariah guidelines and decisions to guide the appropriate treatment of instruments in Kenya's Islamic capital markets.

From the accounting perspective, the CMA, ICPAK and industry stakeholders will collaborate to ensure that the Kenyan Islamic accounting framework is consistent with international best practices in order to ensure consistent reporting and user certainty as well as enhancing the quality of published accounting information relating to Islamic financial products and services.

The need for tax harmonization policies is also well recognized. Tax disparities will need to be addressed in order to create a level playing field between Islamic and conventional products and services. This will allow consistent opportunities for development across both these markets. Therefore, to ensure neutrality in the current tax regime governing Islamic securities transactions, the CMA will collaborate with the KRA to accelerate the process of addressing current tax provisions that may be potentially inhibiting the development of the Islamic capital market.

With regard to the legal framework, there is scope to develop regulations and/or guidelines to cater to the needs of the Islamic capital market. This development will also enhance the legal

[2] The GCC consists of Oman, Bahrain, Kuwait, Qatar, Saudi Arabia and the UAE. Jordan and Morocco have also been invited to join the council. Yemen is currently in negotiations for membership.

process for cases related to such transactions with due consideration of the relevant Islamic concepts and contracts.

iv. Enhance the profile of the Islamic capital market domestically

Despite the nascent nature of Kenya's Islamic capital market and IFSI in general, it is relatively developed within the EAC context in terms of products and expertise available. There is substantial scope for Kenya to capitalize on its comparative advantage and establish itself as a regional Islamic capital market hub. This calls for a bold approach towards raising the profile of the IFSI with the ultimate aim of enhancing the overall IFSI capacity to draw funds into the domestic capital market for Islamic products.

A vital element of this approach is to galvanize local industry participants to develop and exploit opportunities arising from the specialized needs of this consumer base. In view of this, the CMA will work closely with the MoF and CBK to assess the viability of issuing Islamic Bonds or sukuk. This will not only serve to enhance the profile but also the competitiveness of Kenya's Islamic capital market.

Investor education and public awareness efforts are also needed to achieve the desired goals. The CMA will play an active role in efforts to enhance the awareness of the market and will develop a comprehensive educational and promotional program with industry participants aimed at enhancing general awareness among issuers and investors keen to participate in the Kenyan capital market.

3.0 RECOMMENDATIONS

3.1 Efforts to introduce Islamic financial products and services

In developing new products, there are essentially two methods which can be employed. The first is by identifying existing conventional capital market instruments that are acceptable to Islam. This approach facilitates product development efforts and offers a lower risk of non-acceptability by market participants since the products actually originate from the conventional market, with little or no modification. It is therefore recommended that;

In the short term;

i. The Authority commission an Islamic Finance expert/scholar to undertake a preliminary screening of stocks listed at the NSE as well as the structure of Infrastructure Bonds to determine their level of Shariah compliance in order to assess their viability as enablers[3] of ICM product development in Kenya.

In the medium term;

[3] It is expected that this development will be a major enabler of the introduction of Shariah indices as well as Islamic CIS's

ii. Development of a Shariah screening criteria by the Capital Markets Shariah Advisory Council/Board

iii. Introduction of Shariah approved securities, endorsed by the Shariah Advisory Council and approved by the CMA. Also, and in consultation with the NSE, the viability of introducing a Shariah Board and Islamic Index could be explored.

The second method involves product origination and innovation based on various Islamic concepts. This entails a detailed understanding of the various types of Islamic contracts and an appreciation of the contemporary needs of the issuers, investors and intermediaries in the market. The products structured must not only satisfy Shariah but also be consistent with the commercial and legal systems of Kenya.

The area in which the Islamic capital market could develop aggressively is the market for long-dated securities that represent asset-based obligations i.e. Sukuk. The S*ukuk* market provides a functional equivalent to the conventional government and corporate bond market. It is therefore recommended that;

In the short term:

iv. Allocate a target share of publicly issued Infrastructure bonds to Islamic Financial Institutions (IFIs) structured as Sukuk.

In the medium term:

v. Commission a study to ascertain the depth of capital accumulation as well as investment patterns, opportunities and challenges within the IFSI in Kenya. The objective will be to explore the viability of issuing a Sukuk benchmark infrastructure bond in Kenya's capital market. The possibility of hiring a consultant to structure a deal at this stage could be considered

In the Long Term:

vi. The Government integrates Sukuk issuance within the national public debt management framework. This is also expected to spur growth within the corporate sector's issuance of sukuk

3.2 Efforts to Increase Islamic capital markets expertise through training, education and co-operation

Human capital represents an extremely important dimension in supporting the objective of positioning Kenya as an Islamic capital market center. A knowledgeable and skilled workforce is they key to sustaining a competitive advantage. It is therefore necessary to develop local expertise to ensure the availability of a pool of skilled professionals who are well versed in Shariah matters and are able to provide a range of relevant, high quality, value-added advisory and intermediation services. It is therefore recommended that:

In the short term:

vii. A study tour of the Malaysian and/or the UAE Islamic capital markets be undertaken by a delegation consisting of Authority staff and market operators to provide a practical understanding of the development and operations of Islamic capital markets so as to be better informed when developing a policy and regulatory framework

viii. The Authority request for technical assistance from Malaysia for a resource person to conduct capacity building workshops for stakeholders within the IFSI in Kenya

In the medium term;

ix. The Authority sponsor members of staff to undertake specialized training on Islamic Financial Products and services. The Malaysian Islamic Financial Center (MIFC) and the Securities Industry Development Corporation (SIDC) are well placed to offer these programs. On the other hand, a resident advisor can perform this role.

In the long term:

x. That Islamic Finance training programs be developed and integrated within the SITI curriculum for building capacity within market intermediaries

It is also incumbent upon the CMA to continue to explore and identify common areas for the purposes of developing products, services and ways of working together in addition to providing many new opportunities for furthering the growth of Islamic capital markets on a larger scale. In furtherance of this objective, it is recommended that;

xi. The Authority seeks synergistic strategic alliances with other major Islamic capital markets. A logical first step would be to consider establishing a strategic relationship with a member of the GCC as we already have one with Malaysia. In addition, membership to AAOIFI and IFSB could be explored.

Given the embryonic nature of this segment of the capital market, strategic alliances will provide invaluable opportunities for Kenya to build critical mass.

3.3 Efforts to establish a single Shariah Advisory Council for the Islamic capital markets sector

In order to be deemed as *Shariah*-compliant, Islamic capital market products and services need to undergo a pre-defined vetting and approval process by *Shariah* advisers. Literature reveals that the *Shariah* approval process or certification process is carried out through two different methods. The first, which is currently the practice in Kenya, is through a market approach whereby financial institutions have their own in-house independent *Shariah* advisory bodies that screen and endorse their Islamic capital market products and services. This process is driven by private sector-led initiatives, and is not mandated by any specific regulatory or policy requirement. The second method takes an approach whereby the regulatory authority assesses *Shariah* compliance and issues the appropriate *Shariah* certification for all Islamic capital market products and services under its purview. *Shariah* compliance issues are taken into consideration in the regulator's functions such as product approval, eligibility criteria for intermediaries, reporting requirements of regulated entities, and enforcement of regulatory requirements.

We feel that an apex Shariah Advisory Council for the sector would be beneficial to the ICM in Kenya as this would help in the standardization of interpretation thus providing some certainty in the market over the long run rather than have compartmentalization (as it is currently) leading to confusion in the market. Never-the-less, regulatory focus should be on the interplay between the private Shariah boards and the National board, by ensuring that interaction is open and transparent so as to avoid a monologue type of situation. It is recommended that;

In the Short term:

xii. The Authority continues to rely on existing Shariah Audit Boards to assure on product and /or service compliance. However, promoters must ensure that these products/services are marketed as such.

In the medium term:

xiii. A Shariah Advisory Council is established as the apex advisor on Shariah compliance of Islamic Capital Market products and services. This council will have representation from academics, professionals as well as nominees from existing Shariah Boards within the industry and will be gazetted by the Minister of Finance. This council should also be empowered to publish a set of standardized Shariah guidelines and decisions to guide the appropriate treatment of services and products within Kenya's Islamic capital markets. The guidelines should be regarded as binding national Shariah rulings. The SAC should also provide a centralized and systematic screening facility.

In the long term:

xiv. The CMA builds internal Shariah regulatory capacity with the aim of establishing a Shariah Unit that will handle all aspects relating to supervision, inspection, regulatory and compliance operations of Islamic Capital Markets products and services

3.4 A facilitative tax, accounting and legal framework should be established for the Islamic capital market

The development cycle of the IFSI in Kenya is in its nascent stages and as such, comprehensive policy and regulatory intervention at this juncture may be premature. Sufficing to note that while the need for separate regulations is recognized for Islamic Financial Services in many countries the Islamic capital market products are regulated using same set of regulations that exist for capital markets. However, particular attention must be given to ensuring that the Islamic capital market operates at a level playing field as the conventional market.

The tax treatment of certain Islamic financial transactions has not always been consistent with that of comparable transactions in the conventional market, resulting in the former bearing an additional tax burden. Although some progress has been made to address this problem, there is scope for more comprehensive measures to remove tax disparities of this nature, in order to allow consistent opportunities for development across both the Islamic and conventional markets. It is therefore recommended that;

In the short term:

xv. The Islamic capital market is regulated within the framework of the conventional capital market. However, this will be reinforced by mandating that Islamic Capital Markets go through a Shariah Compliance vetting process by existing Shariah Boards of Market Players and affected products marketed as such.

In the medium term:

xvi. Review taxation framework with the aim of achieving tax neutrality for ICM products and services. This process could be supported by introduction of an advance ruling procedure embedded within CMA's approval process to determine the tax profile of newly introduced transactions and products.

xvii. Promulgation of a Shariah Regulatory Framework through issuance of Guidelines be implemented

3.5 Efforts to enhance Investor Education

A strengthening of the information infrastructure for Islamic finance should be part of the broader policy strategy needed to develop efficient and liquid capital markets for these financial instruments and securities, as well as to enhance public access to a wide range of capital markets products and services. Investor education is critical to improving investor activism as well as enhancing investor protection and scrutiny of Islamic capital market activities**.** It is recommended that;

In the short term:

xviii. Investor Education and public awareness on Islamic Finance be integrated into the current IE&PA strategy of the CMA for implementation.

In the medium term:

xix. Educational materials on Islamic Finance be designed

In the long term:

xx. An extensive catalytic role be played by the public sector in developing more explicit recognition of the position of Islamic finance in the Kenyan economy, so that the unique operational features of Islamic finance can be recognized and an enabling environment can be provided for product innovations and enhanced access, while safeguarding stability through effective education and awareness programmes.

This objective will typically involve the cooperation of the all the Financial services sector regulators and the Ministry for Finance as well as other relevant public agencies such as the Kenya Revenue Authority.

3.6 Incentives to encourage the entry of foreign professionals with expertise in Islamic capital market related business should be provided

Efforts will be made to facilitate the entry of trained professionals to work in Islamic capital market related business, particularly in areas where the critical skills are not available locally, such as Islamic corporate finance and investment management services. This will enable a wider array of more sophisticated Islamic capital market services to be offered and raise the quality of services provided, bringing greater depth and breadth to the market. These measures could include the allocation of specific tax incentives as well as relaxation of foreign ownership restrictions and immigration rules where necessary. In view of this, the CMA will work closely with other relevant authorities to identify and implement appropriate measures to encourage the entry of such intermediaries/professionals.

3.7 INTERVENTION SUMMARY MATRIX

ISLAMIC CAPITAL MARKETS DEVELOPMENT ACTION PLAN RECOMMENDED INTERVENTIONS			
OBJECTIVE	**Short Term (Within the next 1 year)**	**Medium Term (2-3 year period)**	**Long Term (3-5 year period)**
Introduction of Islamic financial products and services	Commissioning of an Islamic Finance expert/scholar to undertake: i. a preliminary screening of stocks listed at the NSE ii. Examine current legal framework to establish impeding provisions to issuance of SUKUK as well as Islamic CIS's iii. Make recommendations on regulatory and tax framework iv. Explore the viability of issuing a Sukuk benchmark infrastructure bond in Kenya's capital market. The possibility of the consultant structuring a deal at this stage could be considered	i. Development of a Shariah screening criteria by the SAC ii. Development of SUKUK issuance guidelines iii. Development of Islamic CIS guidelines iv. Development of legal and regulatory framework for Islamic Capital Markets in Kenya	i. Integration of Sukuk issuance within the national public debt management framework. ii. Central Bank to consider being a member of the International Islamic Liquidity Management Corp, to enhance liquidity management for Islamic Banks

	Allocate a target share of publicly issued Infrastructure bonds to Islamic Financial Institutions (IFIs) structured as Sukuk.		
	Develop industry consultation paper soliciting for views on key institutional, policy and regulatory impediments currently existing and recommending appropriate interventions (A press statement and advert can be issued to enhance awareness).		
Increase Islamic capital markets expertise through training, education and co-operation	A study tour of the Malaysian and/or the UAE Islamic capital markets	Staff members to undertake specialized training on Islamic Financial Products and services.	Integration of Islamic Finance training programs within the SITI curriculum
	Request for funding for capacity building and technical assistance from development partners	Seek synergistic strategic alliances with other major Islamic capital markets and institutions.	Kenya to consider being a member of the Islamic Development Bank as it is offering substantial concessional lending opportunities through shariah compliant investment vehicles for infrastructure financing
Establishment of a single Shariah Advisory Council for the Islamic capital markets sector	Continue to rely on existing Shariah Audit Boards to assure on product and /or service compliance.	Establishment of a Shariah Advisory Council as the sole advisor on Islamic financial products and services.	Building of internal Shariah regulatory capacity with the aim of establishing a Shariah Unit within the Authority

	Organize stakeholders workshop to moderate on the criteria of establishment and appointment of SAC		
Establishment of a facilitative tax, accounting and legal framework	Regulation of Islamic capital market within conventional capital market framework.	Submit policy proposals on review taxation framework with the aim of achieving tax neutrality for ICM products and services.	
Enhance Investor Education	Investor Education and public awareness on Islamic Finance be integrated into the current IE&PA strategy of the CMA for implementation.	Educational materials on Islamic Finance be designed	An extensive catalytic role be played by the public sector in developing more explicit recognition of the position of Islamic finance in the Kenyan economy