ISLAMIC BANKING FINANCE TO SMALL ENTREPRENEURS: A CASE OF KENYA

(An Institutional Network Approach)

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ABSTRACT

Purpose: The purpose of this paper is to delineate Islamic banking finance and its impact on SMEs (Small and Medium Enterprises) and micro entrepreneurs in a particular country context.

Design/methodology/approach: An Institutional Network theoretical frame of references is used to study this particular phenomenon. The research methodology applied in the study is of a ***qualitative nature***. A multiple explanatory case study is adopted as a research strategy in order to focus on contemporary phenomenon within the real life context of SMEs and micro entrepreneurs.

Findings: Among others, the findings include the extent to which interest free financing by Islamic banks contributes to developing network relationships between the lenders and the borrowers and other related economic

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actors in a society. The findings also reveal the impact of societal sector institutions in accelerating the Islamic financing activities in a particular socio-cultural environment.

Research limitations/implications: The study mainly relates the Islamic banking finance to SMEs and micro entrepreneurs by the First Community Bank, the leading sharia-based bank in Kenya.

Practical implications: Since lending organisations under the Islamic Financing System (IFS) renders services to their clientele without interest, the lender-borrower relationships are featured by a close supervision of their borrowed funds. While lending funds to its customers, the Islamic banks invest funds under different investment modes of funding such as the *Mudaraba*, *Musharaka*, *Murabaha* and *Bai-Muajjal*.

Originality/value: The study is based on the socio-cultural context of Kenya where the paper premised on its theoretical perspective and 'Institutional-Network Approach' in the field of Islamic finance towards SMEs and micro entrepreneurs.

***Keywords*:** SMEs; Micro Entrepreneurs; First Community Bank; Kenya; Institutions; Network Relationships; Lender-borrower relationships; Islamic Banking; *Mudaraba*; *Musharaka*; *Murabaha*

INTRODUCTION

The Republic of Kenya, a country with an area of 581,309 km^2 (224,445 sq. miles), and a population of approximately 45 million people, is East Africa's industrial nerve-centre. Most businesses are in private hands, with foreign investments supporting the agricultural and mining sectors. The SMEs and micro-entrepreneurs in Kenya contribute greatly towards enhancing economic growth by generating employment opportunities for poverty stricken people. It is revealed from the study that financing to SMEs and rural-based micro-entrepreneurs in many developing nations not only creates job facilities for the rural poor, but also plays a predominant role in enhancing well established network relationships between lenders and borrowers, as well as among various economic actors in a society (Alam 2002; 2008).

In Kenya, even though the SMEs and micro entrepreneurs contribute greatly to the country's economy, similar to other developing nations, these sectors of the economy face multidimensional problems. These problems ultimately affect their growth and profitability and, hence, diminish their ability to contribute effectively to sustainable development. As observed by Wanjohi and Mugure (2008) and Wanjohi (2009), lack of access to credit facilities is almost universally indicated as a key problem for SMEs and micro entrepreneurs. In some circumstances, even where credit is available, the entrepreneur may lack freedom of choice due to the lending conditions, possibly forcing the purchase of heavy, immovable equipment that can serve as collateral for the loan. In this regard, Kihimbo et al. (2012) in their study observed that less than half of SMEs consider formal financing as a source of capital for their operations; more than 90% of SMEs who sought formal financing succeeded. These results showed that formal financing was significant in keeping SMEs' businesses operational in localities such as the Kakamega Municipality.

An overlap between various sources was observed, indicating that multiple sources of capital are adopted by a variety of the SMEs; these include loans from micro-finance institutions and private sources. This bottleneck forces entrepreneurs to rely on self-financing or borrowing from friends or relatives. Lack of access to long-term credit for small enterprises forces them to rely on high cost short-term finance. Normally, SMEs and micro entrepreneurs in Kenya experience various other financial challenges such as the high cost of credit, high bank charges and fees. Taking advantage of such crucial situations, numerous moneylenders, using so-called Pyramid schemes, appeared, promising hope among the 'little investors', that they can make it to the financial freedom through soft borrowing.

Thus, financial constraint remains a major challenge facing SMEs in Kenya (Wanjohi and Mugure, 2008; Kimani and Kombo, 2010). In recent years an Islamic bank called The First Community Bank (FCB) started giving loans without interest to its clientele in different parts of the country. The main objective of this paper is to see how and to what extent the FCB, the first Islamic bank in Kenya, contributes to promoting small entrepreneurs by providing interest free loans in different sectors. The paper also aims to find how the Islamic banking principles work in a non-Islamic country. The study of Islamic finance to SMEs and micro-entrepreneurs is based on the socio-cultural context of Kenya.

LITERATURE REVIEW

SMEs and micro entrepreneurs play significant roles in eradicating the unemployment problem, which remains a serious impediment to a nation's economic growth. Although large-scale industries are involved in mass-production and invest large amounts of capital, these industries are mostly urban based. Consequently, large-scale industries fail to play a significant role in solving unemployment problems related to the rural population. This is exactly where SMEs and micro entrepreneurs succeed better (Anderson and Khambata, 1985; Macuja, 1981). In their studies, a number of researchers (Cosslett and Ashe, 1989; Little, 1988) have observed the issue as to how and to what extent MEs (Medium Enterprises) contribute towards the development of a nation's economy. It is shown in one of the reports published by the United Nations Development Program (UNDP, 1993, p. 41) that in the sub-Sahara region, the SMEs and micro entrepreneurs in the informal sector expanded by 6.7% a year between 1980 and 1989. In this regard, Cosslett and Ashe (1989) observe that:

> "In rural areas, in addition to the legion of subsistence and small farmers, there is a growing percentage of individuals whose primary source of income is trading, cottage industries and a wide range of services, generally categorised as off-farm activities: the figure ranges from 19 to 23 per cent in countries like India, Sierra Leone and Colombia, from 28 to 38 per cent in Indonesia, Pakistan, Kenya and Philippines, and as high as 49 per cent in Malaysia" (Cosslett and Ashe, 1989, p. 17).

Due to various problems, such as the lack of sufficient funds caused by inadequate infrastructural and institutional arrangements and shortcomings in the area of marketing and distribution, the growth of SMEs and micro entrepreneurs in rural areas is less pronounced than could be expected. The slow growth of these sectors of the economy, in turn, results in the migration of manpower from rural to urban areas; this ultimately increases problems, such as overcrowding, increased competition for fewer jobs, etc., in the urban areas. Moreover, due to the limited job opportunities, such urbanisation additionally hampers the nation's economy (Myrdal, 1968, p. 527). Almost all previous studies carried out by various authors have analysed the problems of SMEs and micro entrepreneurs within various national contexts. However, the concept of interest free financing by Islamic banks is new in the financial market, and studies are required to see how and to what extent this special financing system contributes to the promotion of SMEs and micro entrepreneurs by eliminating various hindrances in different socio-cultural, environment and country context. Based on the above discussion, the main research questions posed are:

1. How and to what extent does First Security Bank (FSB), succeeded in implementing the *Shariah* based Islamic banking finance among different rural-based small entrepreneurs in Kenya?
2. How do different Islamic modes of financing contribute to the promotion of lender-borrower network relationships?
3. To what extent do societal sector institutions like the country culture, religion, family/clan, political systems, legal systems and government influence the Islamic banking activities?

THEORETICAL AND METHODICAL REVIEW

The concept of an *Institutional-Network* theoretical frame of reference (Alam, 2002) is used in this study; it was developed based on Whitley's (1992a) *Business System* institutional approach and Jansson's (2002) *Network Institutional Model*. The business systems approach is an institutional approach used by Whitley (1992b) to study business organisations, *inter alia* in Asian countries. In Whitley's (1992b) comparative study of business systems in East Asian countries (e.g. Chinese family business units

(CFB) in Taiwan and Hong Kong, Japanese Kaisha and Korean chaebol), the author tried to find how firms are constituted as relatively distinct economic actors in different market societies, and how they organise economic activities in the form of dominant hierarchy-market configurations. The comparative analysis of business systems, as Whitley (1992b) observed, is the study of these configurations. In this regard, the author argued that a key task concerning the comparative study of business systems is to analyse how distinctive patterns of economic organisations become established and effective in different societies, and how they change in relation to their institutional context. In his study, Whitley (1992a) also observed that these patterns concern the nature of economic activities that are coordinated through managerial hierarchies and how these hierarchies organise their cooperative and competitive relationships through markets.

To study the impact and influence of Islamic finance on SMEs and micro entrepreneurs, based on Whitley's business system (BS) model, the author (*ibid.*) developed the concept of four components of different SME and ME systems and financing systems. These components, for example, are the nature of an organisation, market organisation, employment systems, and authority and control systems. According to Whitley (1992b), a comparative analysis of the business system is the systematic study of these configurations and how they become established in markets. Like Whitley's (1992b) business systems, the Islamic financing system (IFS) is seen as a 'financing business system of its own, with a foundation based on religion, having its own rules governed by the Islamic laws' (Alam, 2002; 2009). These rules differ from those of other financial systems. Different financial systems, for example, market-based financing systems (MBFS) such as conventional banks, cooperative financing systems (CFS), and traditional money lending systems (TMLS), are viewed as particular arrangements of hierarchy-market relationships that become institutionalised and relatively successful in a particular context. A similar arrangement is also done to institutionalise different SMEs and micro entrepreneurs. Entrepreneurs of similar nature are thus, grouped in different SCI systems. Different financing organisations and small and cottage industries under different financing systems, as well as SCI Systems, are regarded as economic actors acting within these organisational fields.

Since one of the objectives of the research relates to finding how the interest-free micro-credit by Islamic banks contributes to the establishment of lender-borrower network relationships, apart from Whitley's (1992a, 1992b) institutional concept in the Institutional-Network theoretical framework, the author (*ibid.*) also used the network concepts of Jansson's (2002) networks institutions model, where the author integrated networks with institutions and viewed the network from an institutional perspective. According to Jansson (2002), institutions also concern different types of habitual or recognised behaviour, such as habits, rules, and procedures. This implies that institutions are characterised by a rule-like or governing nature, an ability to facilitate and constrain inter-human and inter-social relationships, and by predictive behaviour. Veblen (1919, p. 239) observed that institutions themselves are comprised of settled habits of thought common to the generality of men. In order to study the relationships between Multinational Corporations (MNCs) and their commercial partners, the author used a network approach and developed a theory to analyse such linkages. In order to study the network relationships between and within organisations belonging to the two focused institutions, for example, SMEs and Micro-Enterprise Systems (MEs) and Major Financing Systems (MFS) and their relationships with other economic actors in the organisational fields, the author used the concept of Jansson's (2002) and Jansson et al.'s (1995) trans-organisational network theory while developing my analytical framework.

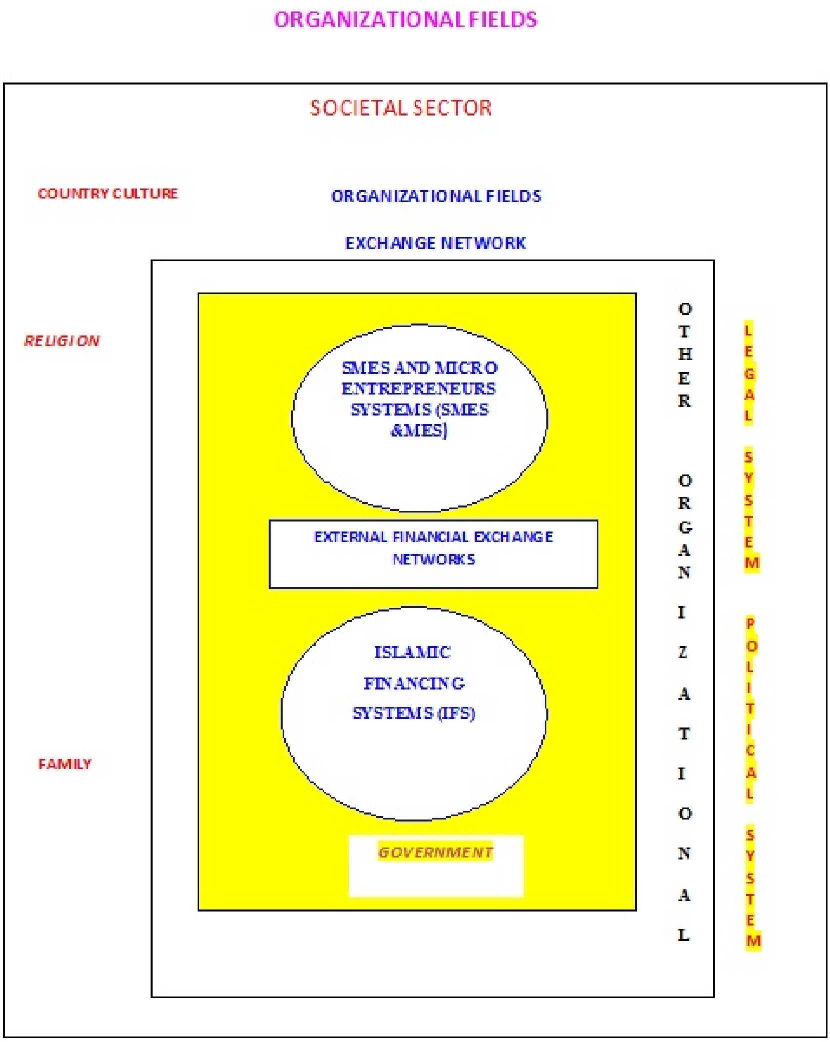

Figure 1 Institutional-Network Framework

Source: Adopted from Alam, 2002

Figure 1 consists of two major fields: the financial market and other organisational fields. Since the focus of the present study is concentrated towards the study of the financing of SMEs and micro-entrepreneurs by Islamic banks within the IFS system, and its relationships with different SMEs and micro-entrepreneur systems, this field is divided into two sub fields: the SMEs and MEs, and the IFS. Therefore, these issues are viewed under the organisational fields in the first rectangle. SMEs, MEs and IFS are viewed as two different institutions in the organisational fields. The second box or major field consists of different actors in the other organisation fields. These actors are, for example, customers, intermediaries (local leaders, seniors), competitors, and suppliers. They are related to the product and service exchange networks, influencing the major organisational field of the financial market in the first rectangle. The external financial exchange network between SMEs and MEs and IFS shown in the framework is meant for studying the exchange network relationships between and within different organisational units belonging to these two systems in the financing market of the major organisational fields. Since the exchange activities and network relationships of different actors in the organisation fields are influenced by societal sector institutions, such as country, culture, religion, family/clan, political system, legal system and government, these institutions are placed in the outer rectangle. These macro institutions surround the major institutions in the first and the second organisational fields. They are shown in the outer rectangle in order to study their influences on the exchange functions with regards to Islamic financing between SMEs, MEs and IFS, and other institutions within and between these organisational fields.

RESEARCH METHODOLOGY

The research methodology applied in this study is of a qualitative nature (Jick, 1979; Merriam, 1998; Sherman and Webb, 1988; Patton, 1985). A qualitative type of research is characterised by a collection of data directly from respondents in the field. This is because the entire research programme is based on facts acquired from the material world, that is, the practical field of study. The study of lender-borrower network relationships between rural-based MEs and Islamic banks was conducted through in-depth interviews with respondents under review.

Based on Merriam's (1998) Interview Structure Continuum idea, while interviewing respondents, highly structured, semi-structured and unstructured interviews were used to suit whatever situation arose. A case study (Yin, 1994) method was adopted as a research strategy in order to focus on contemporary phenomenon within the real-life context of different rural-based micro entrepreneurs under various ME systems, and their relationships with financing organisations within Islamic Financing Systems.

In order to collect required data, the author travelled to Nairobi in 2014 and 2017. In 2014 different senior officials of the First Community Bank (FCB) were interviewed;

this is the only Islamic Financing Bank in Kenya. In 2017, an observation was made and some community people and small entrepreneurs were interviewed in order to know their views and ideas on Islamic banking activities in Kenya.

While interviewing, the following structures were observed:

- face-to-face interviews with senior bank officials of the First Community Bank in Nairobi were conducted;
- questions were asked to respondents based on questionnaires;
- while conducting the interviews, different questions were asked regarding:
  - the nature of SMEs and micro entrepreneurs to whom loans are given;
  - the procedure for lending funds;
  - follow-up activities;
  - the Islamic Financing Mode the bank used while funding;
  - influence of a socio-cultural environment in implementing Islamic Financing where the majority are non-Muslims;
  - influence of religion, culture, legal systems, political systems and government in implementing *Sharia*-based financing;
  - responses of customers in this specific financing system;
  - bank-clientele relations;
  - loan recovery rate;
- a tape recorder was used to record respondent's answers;
- subsequent to the interview, the recorded tape was replayed and data recorded in detail for the purpose of analysis;
- in order to interview bank officials, the bank was visited a few times within the timeframe of two weeks; each interview lasted 2—3 hours. Data were also collected from other sources such as the bank's Annual Report, etc.

THE BASIC CONCEPT OF THE ISLAMIC BANKING SYSTEM

The Islamic bank operates its financial activities without charging interest on loans. Regarding interest in Islamic economics, Ahmad (1994) argued that the elimination of interest does not mean zero-return on capital; rather Islam forbids a fixed predetermined return for a certain factor of production, i.e. one party having assured return and the whole risk of an entrepreneurship to be shared by others (Ahmad, 1994; Chapra, 1992). The authors also observed that it is the capital entrepreneurship that shares both the real contribution and the real profitability. The Islamic bank follows the principle of *equity-based investment*. The Islamic banking system also proposes that resources can be contracted on the basis of venture capital and risk sharing deals.

The introduction of Islamic banking in the modern world is based on the principles of Islamic economics. Molla et al. (1988) and Chapra (1992, 1985) observe that the aim of Islamic economics is not only the elimination of interest-based transactions and the introduction of the *zakat* (contribution to poor) system, but also the establishment of a just and balanced social order free from all kinds of exploitation. The Islamic bank plays a vital role in achieving this balanced social order and establishing ideal Islamic societies in Muslim countries. An Islamic bank may be defined as a financial intermediary whose objectives and operations, as well as principles and practices, must conform to the principles of Islamic Law (*Sharia*). Consequently, it is conditioned to operate all its activities without interest (Alam, 2011). In many ways, Islamic banks are similar to other privately owned formal financial intermediaries. The main difference is that an Islamic bank neither accepts deposits nor invests funds to its customers on interest. Instead, the bank shares the profit or loss (Nienhaus, 1983, 1988, 1993).

The Islamic Financing System (IFS) includes different financing organisations that are guided by *sharia* (Islamic law) based financing principles. These organisations use different financing techniques and lending procedures from those in other financing systems. The IFS is a mix of market-based and non-market-based financing systems. Although many exchange functions in organisations within the IFS are similar to those of western inspired commercial banks, they are also based on non-market rules and regulations, which are purely based on religious ethics. The organisations in the IFS function beyond the market-based economy, since the exchange relationships of this system are mainly ethics-based, originating from religious beliefs, trust and faith (Alam, 2002). There are several Islamic financing modes used by banks while lending funds to their customers. These are for example, *Mudaraba* (Capital Financing), *Musharaka* (Partnership Financing), *Murabaha* (Cost-Plus Profit Based Financing) and *Bai-Muajjal* (Cost Plus Sale Under Deferred Payment). The bank mostly uses *Musharaka*, *Murabaha* and *Bai-Muajjal* modes of financing while lending funds to small entrepreneurs.

THE FIRST COMMUNITY BANK IN KENYA (FCB): AN EMPIRICAL REVIEW

This section of the article includes an empirical review regarding the First Security Bank and its SMEs and micro finance activities. The qualitative data were collected through direct interviews with senior officials of the bank in Nairobi.

A BRIEF BANK HISTORY

In recent years, Kenya has experienced the presence of interest-free financing in different economic sectors introduced by the country's pioneer Islamic bank, known as the First Community Bank (FCB). This bank is the first operating a *Sharia* compliant banking institution.

First Community Bank was established in 2007 operating according to *Sharia* law by private investors in Kuwait, Kenya and Tanzania. The bank received a Kenyan commercial banking license the same year, and started operations in June 2008. The FCB is the first Kenya-based bank to operate according to the laws of *Sharia*. Since the founding of First Community Bank, another *Sharia* bank, the Gulf African Bank, has also received a commercial license from the Central Bank of Kenya. It is the first bank approved by the Central Bank of Kenya (CBK) under Cap 488 of the Banking Act to operate as a full-fledged *Sharia* Compliant banking institution. The bank received its formal approval from the Central Bank of Kenya (CBK) on 29 May 2007, thereby opening the door for *Sharia* Compliant banking, not only in Kenya but also in the entire East and Central African region.

The bank has a dedicated team of employees who are well trained to deliver the highest levels of service to its clientele. As a committed Kenyan Bank, FCB's motive is to take its alternative form of banking to as many places as possible within the country. As a pioneer *Sharia* compliant banking institution, FCB, in addition to its core banking business, is also in the final stages of bringing a number of other innovative *Sharia* compliant products such as Islamic Insurance (Takaful), Islamic Bonds (Sukuk), Sharia Compliant Mutual Funds and shares trading to Kenya. All FCB products and services are offered on a fully *Sharia* compliant basis as approved by the *Sharia* Advisory Board, which is comprised of prominent Islamic scholars both from inside and outside Kenya. First Community Bank has been selected as one of the four banks in the country to work with the Youth Enterprise Development Fund. The FCB aims at succeeding as an institution and enlist the trust of people about the viability of Islamic finance as an alternative financing system.

Driven by ethics, the FCB is a bank:

- that provides *Sharia* compliant financial services and solutions to meet the needs of its clientele;
- progressive for all, irrespective of their religion, race, gender or creed;
- with a focus aspiring to the highest standard of business ethics, good governance, financial stability and regulatory compliance;
- where clients are regarded as partners in business;
- that stands for growth and prosperity of its partners;
- with an ambition to achieve the highest possible level of contribution to the socio-economic development of Kenya and East Africa;
- with big ideas but small enough to care;
- promoted, managed and staffed by Kenyans with diverse experience and expertise to offer world class financial solutions to all its stakeholders.

Vision Mission and the Core Value of the FCB

The fundamental vision of the FCB is to be the preferred *Sharia* compliant financial service partner in all places the bank chooses to operate. While the mission of the bank is to operate as a responsible corporate citizen, foster growth for bank customers, employees, shareholders and the community through the provision of innovative *Sharia* compliant financial solutions. The core values of the bank are acronymic in the word FIRST, which also means a journey to a new frontier of financial services and solutions. The word *Fairness* indicates that bank will work with its stakeholders in a fair and honest manner. It will create partnerships that lead to win-win situations with all those who transact with it. *Innovation* stands for embracing changes, flexibility and continuously adapting to the rapidly evolving world. The bank strives to continuously perpetuate excellence and provide innovative *Sharia* compliant banking solutions. In response to the dynamic needs of its clientele, the bank will look for creative, new and better ways to provide its expertise in all dimensions of business. *Responsibility* denotes that the bank will conduct its business with the highest standards of ethics, adherence to the law, doing what is right, and exercising the highest level of responsibility in managing the financial affairs of all its stakeholders. *Sharia Compliance* is the essence of the FCB's existence, and remains a commitment beyond banking for the bank. The bank is extremely vigilant in this regard. *Teamwork* denotes that the banks are committed to supporting each other, taking collective ownership and responsibility for all the banks and winning together as team (Corporate Profile, FCB).

Products of the FCB

The First Community Bank uses different financing techniques based on Islamic *Sharia* while accepting deposits and investing funds. These financing modes were explained by senior officials during interviews, as explained below.

Different Deposit Accounts Maintained by FCB

The First Community Bank maintains the following deposit accounts while accepting deposits from clients.

- Current Account;
- Transactional Accounts;
- Savings Account; and
- Fixed Maturity Accounts.

Current Account or Demand Deposit Accounts

The FCB accepts deposits from customers on current accounts in the same way as conventional banks. This account is also known as the Demand Deposit Account as the deposited amount is payable to customers on demand without any notice. As banks use current account deposits at their own risk, the depositors of this type of account are not entitled to any share in the profit earned by the bank. The bank's current account services enable customers to make the most of daily banking needs without compromising any benefits. All of the bank's current accounts are based on the Islamic contract of *Qard Hasan* (free loan) in which the depositor grants the bank permission to utilise the deposited funds for *Sharia* compliant activities, while the bank in return guarantees the value of the deposit in full demand.

Transactional Accounts

These are tailored savings accounts with the flexibility of current accounts.

Savings Accounts

The FCB accepts saving deposits from customers under *Al-Wadia* and *Al-Mudaraba Sharia* principles. The word *Al-Wadia* means Trusteeship. In this case, banks act as trustees for its customers. In savings accounts under the *Al-Wadia* principle, the bank is given authorisation by depositors to use the funds at the bank's own risk. In this mode of deposit, the bank allocates the funds received from customers to a deposit pool, which is used to invest in *Sharia* compliant trade and business transactions. Profits generated from the funds are shared with clients accordingly.

Different Investment Modes Used by the First Community Bank

Personal Finance

Under personal finance, individual clients are able to purchase goods and household items required by them, as well as pay for services such as education, medical, *Hajj*, weddings and holidays in a *Sharia* compliant manner. The bank uses the *Murabaha* mode of *Sharia* compliant contract while lending funds under personal financing.

Business Corporate Finance

In business corporate finance, the FCB teams of business bankers assist corporate clients in financial structuring of a wide range of solutions such as working capital finance, assets finance, leasing, project and construction finance, forward contract finance and equity finance. Under business corporate finance, the bank uses *Investment Musharaka* and *Mudaraba* modes of the *Sharia* compliant contract.

Equity Finance

Under equity financing, the bank supports professionals such as medical doctors, lawyers, engineers and other entrepreneurs to establish as well as grow their business. This is done through the use of *Musharak* and *Mudaraba Sharia* compliant instruments.

Trade Services

The trade services of the FCB relates to all forms of local and international trade. These services include opening and managing letters of credit – transferable, revolving standby – and is a core function of the bank's trade finance department, while letters of guarantee are in operation to cover key business areas such as bid bonds, performance bonds, advance payment bonds and custom bonds. The bank uses the Service *Ijara* mode of *Sharia* complaint contract for the different trade services.

Different SMEs Funded by the FCB

As reported by the respondent, among SMEs about 60% of loans are given to the manufacturing sector, 30% to the trading sector and 20% to the service industry sector.

The bank uses different modes of financing such as *Murabaha*, Investment *Musharaka*, and *Bai-Muajjal* modes of financing, while lending funds to different SMEs and micro entrepreneurs. The bank uses the *Bai-Muajjal* (Cost plus Profit) mode of financing while lending funds to the agricultural sector. For example, once a customer applies for a loan to buy seeds, the bank purchases the seeds on the customer's behalf and then resells the same to the customer together with profit. In any newly established business venture, the bank invests funds under Investment *Musharaka* mode of financing. The capital is equally contributed by the bank and the customer, who share profits or losses equally. As with new ventures, the bank uses Investment *Musharaka* in the manufacturing sector. The bank uses both *Musharaka* and *Murabaha* modes of financing in both service and trading sectors. It is reported by the respondents that the bank uses a major portion of their funds in the *Musharaka* mode of financing.

It is also reported that the bank did not succeed in investing funds under the *Mudaraba* (Capital Financing), mode of financing. At the initial stage, the bank started giving loans for certain projects under this mode but ended up with negative results. In such an investing mode, the financing authority is the bank while the clients give their expertise and time, and both parties share profits or losses in an agreed proportion. It is reported that the success of such types of investment are based on the honesty and integrity of the customers. Unfortunately, the bank failed to find dedicated and honest customers, and they were compelled to stop funds in this specific mode.

SMEs and Micro-financing by the FCB

The FCB introduced its funding to different SMEs and micro entrepreneurs in different parts of the country. The majority of the bank's financing consists of SME projects and micro enterprises. The bank has 17 branches in different parts of the country and, until 2012, records showed that the bank had invested more than 5,000 million Ksh., in different SMEs and micro entrepreneurs.

SMEs and Micro Entrepreneurs as Defined by the FCB

The bank defines SMEs and micro entrepreneurs from the perspective of loans given to them. SMEs are those firms where loans range from US$15,000 to US$20,000. On the other hand, micro entrepreneurs are those businesses that are offered a loan of a maximum of US$1,000.

Procedures Followed by FCB While Giving Loans

Interested borrowers from FCB normally contact their local branch where the preliminary activities of loans initiate. The customers are required to submit their project proposal for which they are eager to borrow funds. The bank officer is responsible for project evaluation, undertaking a feasibility study of the proposal, and seeing that *Sharia* law allows the project. There are trained personnel in the bank having knowledge in different kinds of business who normally evaluate and study a particular project proposal submitted by the customer. Once the project is found appropriate, the bank asks the client for the necessary documents relating to the business. In some cases, to have proper evaluation the bank officials pay visits to the customers' business premises. The finance department examines the total financial needs. Prior to giving loans, the bank investigates the following matters about a prospective customer:

- prospect of the proposed business in the society;
- prior business experiences of the customer, if any;
- customer's reputation in the society;
- records of any loan default case.

Loan Approval Certificate from Sharia Board

Once the project has been studied, the preliminary report prepared and the required documents are obtained from the client, the project report, together with the financial plan, is passed to the *Sharia* board; the *Sharia* board consists of five members. As a rule of the bank, the *Sharia* board must approve each project loan. The board examines the project and related documents and finally approves the project: they are the loan approving authority for a particular project. The board is also responsible for ensuring that the project activities are in compliance with the Islamic *Sharia*. Once the *Sharia* board certifies the project and approves the loan, the bank starts processing loan agreements with the customer. The entire process of approving loans is done within a short span of time in order to avoid delays in sanctioning the loan.

Need for a Guarantor

Once the loan for a particular project is approved, the customer is required to produce a letter from an influential local leader who acts as a guarantor for the client.

The branch manager normally helps a customer select a local influential person from the locality. The guarantor's certificate must contain that he personally knows the customer and the bank may continue financial deals without any difficulties. The guarantor thus acts as a security for the bank on behalf of the customer. In addition, the bank asks for documents of landed property from the customers as a security in order to lend funds.

Direct Contact by Customer

The customer must contact the bank officials directly for to obtain a loan: the bank does not allow any middlemen to work on the customers' behalf. In order to encourage customers' direct contact, every branch is equipped with local staff that can communicate easily and explain the basics of Islamic Financing Systems, and different financing modes of funding the bank use while lending funds for a particular project to the clients.

Branch Managers' are Authorised to Pay Loans

Once the *Sharia* board approves the loan for a particular project, the file is sent directly to the branch manager. The branch manager does not need to wait for the approval from the head office to release the funds. Every branch manager is authorised to release funds up to a certain limit.

Financing to Micro Entrepreneurs

As reported by the senior officials of the FCB, the bank invested very few funds towards micro-entrepreneurs. While lending funds to micro entrepreneurs, the bank gives loans to both at the group and the individual level. In a group loan, the group associates are held responsible for the default of the others in the group. The bank gives loans to micro entrepreneurs on an Investment *Musharaka* or a partnership basis. The profits or losses of the business are shared according to the agreed proportions.

Religious Beliefs of the Customers of FCB

While asked questions about the religious beliefs of customers to whom loans are given, the respondent of the FCB reported as:

> An Islamic bank does not require the customer to be a Muslim. Even though the fundamental idea of lending funds without interest is based on Islamic *Sharia*, it does not mean that a borrower of funds from the bank must be a Muslim. We lend funds to every customer regardless of their religion, cast or creed. In Kenya, the majority of people are non-Muslims. Our customers

belong to different religious practices. Surprisingly, more than 60% of customers of our bank are non-Muslims. In many branches among all customers, only a few are Muslim. We found that non-Muslims are doing very well and they are honest in financial dealings. In comparison to Muslim customers, it is noted that the FCB is having more non-Muslim investors. Muslim customers show less interest in investing funds to the bank or borrowing from the bank.

Customers' Visit to the Bank

Since the FCB does not allow any middlemen to negotiate between the borrower and the lender, customers are encouraged to contact bank officials directly. The bank officers help customers to accomplish the necessary formalities from beginning to end; from the opening of an account to the approval of loans. In some cases the bank helps prospective customers to prepare their project proposals. In many cases, bank officials visit customers' premises in order to investigate and evaluate their position. Once the officer thinks it is appropriate, he/she recommends for the consideration of sanctioning loans. The bank officials in charge of certain projects continue their visit to customers after the loan is sanctioned. The bank follows up with the clients business activities in order to be sure that the customer is using the borrowed funds appropriately.

Co-operation from the Government

As mentioned earlier, the FCB is the first bank approved by the Central Bank of Kenya (CBK) under Cap 488 of the Banking Act to operate as a full-fledged *Sharia* compliant banking institution. It is said by a respondent that the FCB was one of the first *Sharia* based banks receiving all sorts of cooperation from the government. There are no complications from any legal aspects, or from any other government mechanism. The government encourages the FCB operations and it is recognised by the Central Bank.

The Cultural Values of Customers

Kenyan society is oriented by different cultures and traditions. It brings harmony among people of same tribe. The bank finds it secure to lend funds where people have respect for their own culture.

Family/Clan in Manufacturing Concerns

It has been reported that customers who borrowed funds for manufacturing concerns work together alongside family members. As the tradition of the different tribes, the elders of the house are respected as the chief of the house: all family members are loyal to the head. While lending funds, all members of the family share the responsibilities and work together for the project.

Challenges of the FCB

It is reported by the senior officials that the First Community Bank, as the first Islamic bank in the country, is facing many challenges. The fundamental problem is the awareness of the bank among the general mass population. Local Muslims think of the bank as one of the charitable institutions as giving loans on *Qarze Hasan* (a voluntary loan repayable on condition). Non-Muslims in general, assume that it is a bank for Muslims only. In order to promote public awareness, the bank started the propagation of its different financing activities through advertisement on television, radio programmes, neon signs, etc. In addition, the bank is working together with local traditional banks to render services to their customers. The FCB maintains a window in many local commercial banks. Clients of the FCB in rural Kenya, where no FCB branch exists, may carry on financial transactions in the window branch. The FCB gives commission to the traditional banks for maintaining window branches and rendering services to their customers. The bank is experiencing satisfactory progress in their propagation, and clients are increasing gradually.

Recovery of Loans from Customers

It is reported by the respondents that the recovery rate of the loans is satisfactory: there are very few default cases. In any default case, the bank studies the situation of the client's business and, if needed, refinances the client to overcome the crisis. Customers are encouraged to discuss their grievances directly with the concerned officers. Once the officer who provides the loan finds the default case to be genuine, the client is given further assistance.

RESEARCH FINDINGS

It is revealed from the study that the FCB gave almost 60% of its loans to the manufacturing sector, and uses Investment *Musharaka* (Investment Partnership) as a mode of *Sharia* based financing. This specific financing mode helps the bank ensure that the borrowed funds are used by the customer solely for the purpose for which they are borrowed. Using this specific financing system, FCB makes sure that the clients make proper use of their borrowed funds. It is also learned from the study that the bank does not give the *Murabaha* (Cost Plus Profit) mode of finance to customers who stay far from the bank. This is due to the fact that the bank may not have good control over the customers' activities and the realisation of loans may be difficult. *Sharia* based financing is also regarded as a supervisory loan. For that reason, and before lending funds, the bank ensures that they may supervise customers' activities and realise their expected returns from the investment. It is also known from the study that the *Mudaraba* (Capital Financing) mode of financing, being one of the most important

Sharia based lending modes of the FCB, did not work well in the Kenyan money market. This was due to the fact that, under this mode of financing, the bank provides the funds for the business and the borrowers give their time and expertise: they share profits at an agreed proportion. However, if any loss occurs, the bank bears the entire burden of losses. For that reason, the FCB finds that this lending mode is one of the riskiest modes of finance. It needs an honest and sincere partnership, which the FCB has difficulty in finding.

Network Relationships between the Bank and Customers

It is noted from the study that once various formalities regarding lending funds to a customer end, the FCB enters into a partnership agreement with the customer. As the loan is given on a participating mode of financing, the bank agrees with customers about the percentage of profit or loss to be shared with them. Thus, the bank establishes direct contact with customers. In order to supervise SMEs, senior staff responsible for particular projects pay regular visits to the customers' business premises. The manager observes the customer's progress of work and gives necessary advice when needed. The study also reveals that customers are encouraged to directly contact the senior bank officials and branch manager to discuss different issues of their business. This in turn enhances the bank-customer relationships and strengthens the *personal network* between the bank and the clients.

Easy Access of Customers to the Bank

The bank staff of the FCB encourage their clients and welcome them to discuss various issues of their business concerns. In every branch of the FCB there are separate sections within the bank premises where bank staff voluntarily assist their customers in observing various formalities to obtain loans. In addition, the bank staff brief every customer about the various modes of Islamic financing. They also explain to them how the Islamic financing system works alongside a traditional banking system. Since Islamic banking is a new concept in Kenyan society, they find it difficult to differentiate between traditional bank funding and Islamic bank funding. The FCB officials encourage customers to come to the bank premises and discuss various issues about the bank functions. There is no need to observe any formalities to meet a senior official of the bank. This welcoming mentality and easy access of customers to the bank is an added advantage for the FCB to attract customers from different sectors of the economy.

A Unique Administration of Borrowed Funds

For the loan giving procedures, it may also be noted that the loan administration tendency of the FCB is unique. The bank staff are assigned the duty of contacting customers and observing their activities. The staff have this responsibility in order to be sure that they are using their borrowed funds appropriately and are willing to repay the loan on time.

Guarantor Acting as Security to Borrow Funds

The FCB normally does not impose any burden of securities on its customers. Due to the partnership mode of financing, a close supervision of loans is given more importance than the collateral for loans. As a requirement, every customer must provide the bank with a certificate from a local reputed person who agrees to act as a guarantor for the customer in case of any default.

Serving the Clients' Interest

The study reveals that officials of the FCB are very much concerned about the welfare of customers and their interests. The Public Relations Department (PRD) is responsible for dealing with customers' affairs. The bank management is very concerned with the fact that every individual customer receives proper attention from the officers dealing with them. In order to develop public relations, banks give training to their staff.

No Interference from Middlemen

As FCB officials assist clients at various levels, they do not need any assistance from middlemen. Thus, direct assistance to customers by the FCB staff reduces the possibilities of interference from any middleman. The FCB staff assists a customer to observe different formalities in obtaining loans. It has been mentioned earlier that bank officials responsible for a particular project make frequent visits to the customer's business site. The officer investigates progress of the clients' business and helps to maintain their accounts. Due to the direct bank-customer relationships, the interference of the middlemen is completely absent, and thus borrowers are able to save a lion's share of their borrowed funds.

Priority of Rural Female Micro Entrepreneurs

It is reported by bank officials that the FCB gives micro credit to the rural-based poor women in the society. Although the percentage of investment in this sector is negligible, the FCB has special arrangements in the bank for women customers. The bank officer reported that female micro entrepreneurs are found to be more organised and active than male customers. Most of the projects that are run by female customers are found to be successful. They arrange their work jointly with other members of the group. They are found most sincere and utilise their time and money in a proper way. The bank has increased various facilities for women, and the manager of the bank tries to ensure that there is no gender inequality present in relation to the bank officer.

Group-wise Loan makes Micro Entrepreneurs Well Organised

It is known from the bank officials that most of the micro entrepreneur clients of the FCB are not well educated and consist of rural poor individuals. They need guidance to utilise the little savings that they have in a productive way. The micro-credit policy of the FCB is not only to educate them regarding interest free loans, but also to organise their activities by close supervision so that they might contribute to the society. In addition, the entire lending activities of the banks are organised in such a way that borrowers benefit from the beginning to the final stage of their projects.

Credit In-Kind Rather than Cash

It has been mentioned in an earlier section that the FCB does not extend credit to their clients belonging to agriculture in cash but paid in merchandise of a kind. Since the *Murabaha* mode does not allow customers to borrow funds in cash, they are bound to present pro-forma invoices for seeds and other agricultural products that they intend to buy. The bank purchases these their behalf and resells the merchandise to the customer at a profit. The application of the “in-kind” (for example: loan in material rather than cash) lending principle shows that the loan’s recovery rate of the FCB from agricultural loans is higher than other financing organisations. It makes proper use of borrowed funds.

Establishment of a Strong Lender-Borrowers Network Relationship

It is observed from the study that the long-term lending policy of the organisations in the Islamic financing system increases the interdependency between exchange partners. This results in the deepening of lender-borrower relationships, and helps exchange partners to get to know each other better. A continuous and long-term exchange relationship contributes in the development of trustful financial ties between the lenders and borrowers. When the long-term lending policy increases interdependency, the commitment to exchange partners also increases.

Influence of Societal Sector Institutions

It has been mentioned in earlier sections that different societal sector institutions always influence the lending and borrowing activities of financial organisations. These institutions comprise of country culture, political systems or the government, religious beliefs and habits, etc. Influences of these institutions on financial activities differ from country to country (Alam, 2002). In this section, a brief description is given as to how the FCB financing is influenced by different societal sector institutions.

Political Systems and the Government

The government supports the FCB's financing activities. The Central Bank of Kenya has received approval for the operation of the FCB as a full-fledged *Sharia* Compliant banking institution under Cap 488 of the Banking Act. This was a welcoming gesture to the introduction of the country's first Islamic bank. As informed by the respondent, the bank does not face any conflict from the government. The only problem the bank faces are the country's political unrest and unstable political systems. Many of their clients in certain areas sometimes suffer due to tribal disturbances and political unrest in the country. This hampers the investment process and, in many cases, customers suffer losses. Being a *Sharia* based banking institution the bank has to bear losses in such situations. Political unrest and uncertainties have grown in an alarming way in recent years due to the conflicts with the neighbouring country of Somalia.

Country Culture and Norms and Habits

Kenya is a country that has many tribes and a multicultural presence: there are more than 40 ethnic groups in the country. The largest of these is the Kikuyu, representing 22% of the population, 14% are Luhya, 13% are Luo, 12% are Kalenjin, 11% are Kamba, 6% are Kisii, and 6% are Meru. Others comprise approximately 15% of the population, including the Somalis and the Turkana in the north and the Kalenjin in the Great Rift Valley. These ethnic categories are further broken down into subgroups. Of the total population, 1% is non-African, mostly of Indian and European descent.

The idea of Islamic banking is a new innovation in the country's money market. People in different tribes are not aware of the financing systems that are followed by Islamic banks. Because of this, the bank faces problems in implementing *Sharia* based investments. However, the bank has taken the initiative to educate people and promote Islamic banking activities in both urban and rural areas. It has been reported by an FCB respondent that the concept of Islamic banking is gradually being understood by the general masses. At the initial stage, the bank found it difficult to divert customers from their cultural beliefs and norms, which are not beneficial in any way and rather consume time, money and energy. It was also noted that the customs of people, such as food, clothing, accommodation, etc., influences the activities of both lenders and borrowers. Due to the changes in habit of people in different seasons, the demand for certain SME products increases, and MEs find these projects profitable.

Religious Faith and Beliefs

Kenya's most recent religious compositions as shown by the *Kenya Information Guide* are 45% Christian-Protestant, 33% Roman Catholic, 10% Muslim, 10% indigenous religions, and 2% others. It is evident from the study that the religions or religious faiths do not have any negative impact on Islamic financing. As informed by the FCB's officer, the majority of the customers are non-Muslim. The people in general are very simple and hard working. They are concerned about an honest lender who may save them from the burden of local money lenders who take a high rate of interest for their borrowed funds. The FCB not only finances but also acts as a guide to the clients. This attitude of the bank is highly appreciated by customers in different localities. Since the FCB's financing activities have nothing to do with people's religious faith, the main aim is to assist customers in their business activities. Consequently, the FCB has attained its reputation in the Kenyan money market. The majority of the Kenyan population being non-Muslim, there are no conflicts in carrying on their banking activities from the perspective of Islamic *Sharia*.

Progress in Financing Activities

The FCB has shown good progress with regards to the bank's deposit, investment and profit margins. A brief description of the bank progress is given below in Table 1.

Table 1 Total Deposit from Customers

Year	*Customer Deposit*
	Ksh. Million
2008	2090
2009	3642
2010	5611
2011	7812
2012	8833

Source: Corporate profile FCB www.firstcommunitybank.co.ke

It is apparent from the above table that, at the beginning, the bank showed an increase of its deposit of Ksh. 1,552 million in 2009 compared to 2008, which is an almost 74% increase. This figure doubled in 2010. The table shows a gradual increase in deposits each year. Compared to 2008, the total deposits in 2012 increased by Ksh. 6,743 million, which is more than 300%, a significant success in customer deposits.

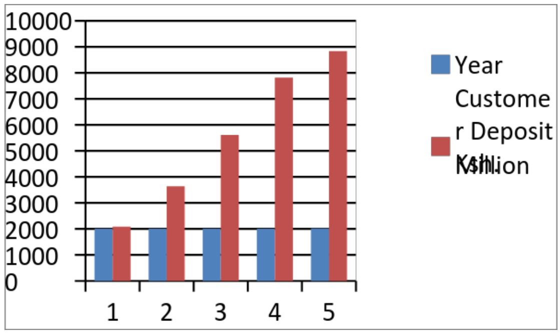

Figure 2 Total Deposits from Customers

Source: Corporate profile FCB www.firstcommunitybank.co.ke

These figures are illustrated in the graph below.
From Figure 2 it is noted that the deposit curve, even though showing an upward ten-

Table 2 Total Investment of the Bank

Year	*Investment*
	Ksh. Million
2008	868
2009	2,290
2010	2,984
2011	5,452
2012	5,471

Source: Corporate profile FCB www.firstcommunitybank.co.ke

dency in years 4 and 5, it is not as high as years 1 to 3.
Table 2 shows that the bank succeeded in increasing its investment from Ksh. 1,422 million from 2008 to 2009, which shows an approximate increase of 164% in a year. The increase in investment from year 1 to year 5 as shown by the above table is almost Ksh. 4,603 million. Being a newly established bank, the increase in investment

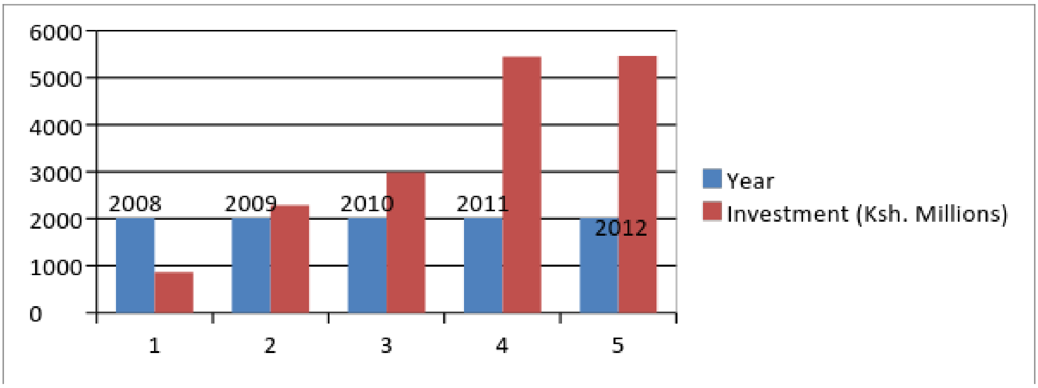

Figure 3 Investment Trend of FCB

Source: Corporate profile FCB www.firstcommunitybank.co.ke

may be labelled a significant one. The trend in the increase of the investment position of the FCB is illustrated in the following graph.

Figure 3 shows the trend of a slow increase in investment from year 2 to year 3, which is only 30%. This is worse between year 4 and year 5, where the increase is only

Table 3 Profit after Tax

Year	*Profit after tax* (Ksh. Thousands)
2008	−307,202
2009	−112,429
2010	−97,506
2011	241,305
2012	271,403

Source: Corporate profile FCB www.firstcommunitybank.co.ke

0.35%: this is a very negligible increase in investment. The graph shows that, although in total there is an increase in investment, there is a slow year-wise growth.

It is observed from Table 3 that the company could not earn any profit in the first three years; however, there was a gradual decrease in the loss figure in every year. Compared to the losses in 2008, the losses in 2010 decreased by Ksh. 209,696 thousand, which is almost a 68% decrease. However, the bank regained its position in year

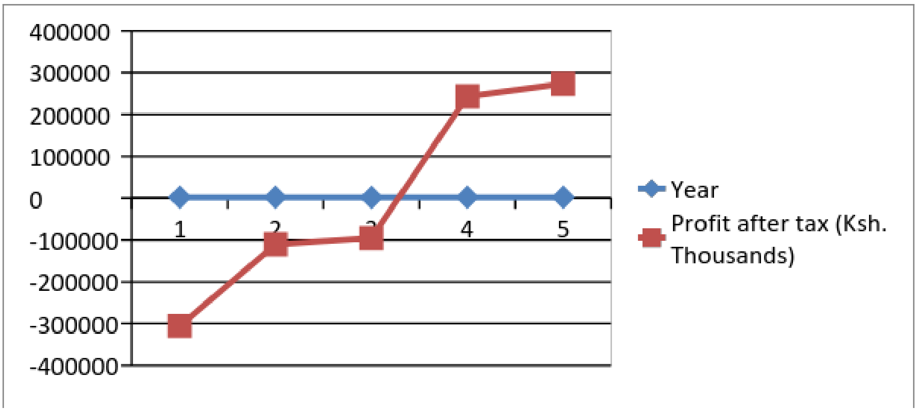

Figure 4 Profit after Tax

Source: Corporate profile FCB www.firstcommunitybank.co.ke

2011 and showed an increase in its profit position in the year 2012. The profit after tax is shown by the following graph:

Figure 4 shows that there is a big jump in the profit and loss trend from year 3 to year 4. In year 4 the bank earned profits of over Ksh. 240,000. However, the growth trend did not progress much from year 4 to year 5, which shows only a 12% increase in profits.

CONCLUSIONS

Based on the detailed discussions above, it may be concluded that being a newly established Islamic Bank, the FCB is doing well in Kenya's money market of Kenya. Since the bank maintains a close contact with customers and supervises the borrowed funds, the entire financing activities are characterised by unique lender-borrower relationships. It may also be concluded from the study that the general masses accepted the concept of the FCB as a financing institution and nothing directly related to the religion of Islam. This in turn facilitated the bank to work more effectively in the Kenyan society where the majority of people are non-Muslims. Since the bank not only shares profits or losses with their customers, but also takes part in the management and the supervision of the activities of borrowers, it has created a positive impact on banking functions.

It may also be concluded that in certain cases such as the agricultural sector, the

FCB gives loans on a *Murabaha* mode of financing, where credits are given in-kind rather than cash. This system assures the bank about the proper utilisation of borrowed funds. With the intention of expanding its investing activities, the FCB takes interest in the future to invest a good portion of their savings in different sectors of Kenya's economy. In this case it will not only eliminate poverty but also be successful in establishing a just and balanced social order, free from all kinds of exploitations in the society.

It is apparent from the study that the FCB has shown remarkable progress in its banking activities such as accepting deposits and investing funds since its inception. It is also noted from the study that the FCB was able to reach many of its customers who are mainly non-Muslims. As reported by the bank officials, the bank faced no problems in operating their financing activities with non-Muslim customers. Even though Kenya is a nation where the majority of its people are non-Muslim, the FCB noted positive impacts on its financing activities towards small entrepreneurs from different societal sector institutions, such as country, culture, religion, clan, legal systems, political systems and government. The bank is progressing with its renewed vigour in enhancing its financing activities among rural based small entrepreneurs in Kenya, which may be a good example for other East African nations like Uganda and Tanzania.

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BIOGRAPHY

Dr Mohammed Nurul Alam is a Faculty of BBA (Accounting) Yorkville University, Canada. He holds a Ph.D. in Islamic Finance from Lund University, Sweden, and a Masters in Accounting from the University of Chittagong, Bangladesh. He is the author of two books, and many articles in peer-reviewed journals. His interests are mainly concerned with the study of the activities of Islamic banking finance towards micro-entrepreneurs and SMEs. Dr. Alam has undertaken extensive research on micro-entrepreneurs and SME finance by Islamic Banks in Indonesia, UK, USA, Sudan, Turkey, Cyprus, Kenya, Pakistan and Bangladesh. He has more than 40 years of teaching experience in the field of accounting and other commerce-related subjects, and has taught graduate and postgraduate students in many countries in Africa, Europe, Asia, North America, and the Middle East.

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