

Factors Influencing Sharia Banking Integration by Microfinance Institutions in Kenya

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Abstract

The growing global prominence of Islamic finance has generated increasing interest in the integration of Sharia-compliant financial services within conventional financial systems. While significant progress has been made in the development of Islamic banking, the adoption of Sharia-compliant financial models within microfinance institutions (MFIs) remains relatively underexplored, particularly in emerging economies such as Kenya. This study examines the factors influencing the integration of Sharia banking within MFIs in Kenya through a desk review of existing theoretical and empirical literature. Using thematic content analysis, the study synthesizes scholarly and institutional publications to identify the key determinants shaping the adoption of Islamic microfinance practices. The findings reveal that the integration of Sharia banking within MFIs is primarily influenced by three interrelated factors: conventional interest rate structures, operational costs associated with Sharia compliance, and the regulatory and institutional framework governing financial institutions. Interest rate dynamics affect the competitiveness of Islamic financial products relative to conventional lending mechanisms, while the operational requirements of Sharia governance, product restructuring, and compliance with standards such as those of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) create additional institutional costs. The study concludes that successful integration of Sharia banking within MFIs requires coordinated institutional, financial, and regulatory adjustments. Strengthening regulatory support, enhancing institutional capacity, and increasing awareness of Islamic financial products can significantly promote the development of Islamic microfinance. By highlighting the determinants of Sharia banking integration, the study contributes to the growing body of knowledge on ethical finance and provides policy-relevant insights for advancing financial inclusion in Kenya and other emerging markets.

Keywords: Sharia banking, Islamic Finance, Microfinance Institutions, Financial Inclusion, Ethical Finance, Regulatory Framework, Operational Costs, Kenya

1. Background of the study

The global financial landscape has undergone a profound transformation over the past few decades, characterized by the remarkable expansion of Sharia banking, commonly referred to as Islamic finance. Governed by the ethical and jurisprudential principles of Islamic law (Sharia), this distinctive financial system prohibits the charging or payment of interest (riba), excessive uncertainty or speculation (gharar), and investment in industries considered unethical, such as alcohol and gambling (Hassan, 2021; Grassa et al., 2021). Unlike conventional interest-based financial models, Islamic finance promotes risk-sharing, asset-backed transactions, equitable profit-and-loss distribution, and a broader commitment to social justice and ethical wealth creation (Abdeldayem and Aldulaimi, 2020). Financial instruments such as Murabahah (cost-plus financing), Ijara (leasing), Mudarabah (profit-sharing partnership), and Musharakah (joint venture) form the operational foundation of Islamic financial systems, distinguishing them significantly from traditional lending and investment mechanisms (Hassan et al., 2022).

Globally, the Islamic finance industry has demonstrated remarkable resilience and sustained growth, with total assets projected to surpass USD 4 trillion by 2023, reflecting a compound annual growth rate that has consistently exceeded 10 percent in recent years (Islamic Financial Services Board, 2024; Refinitiv, 2023). This expansion has been driven primarily by increasing demand from the global Muslim population for faith-compliant financial services, as well as a growing interest among non-Muslim investors seeking ethical, socially responsible, and sustainable investment alternatives.

The contemporary development of Islamic finance can be traced to the mid-twentieth century, gaining significant momentum during the 1970s with the establishment of specialized Islamic financial institutions in the Middle East and Southeast Asia. Notably, the resilience demonstrated by Islamic financial institutions during global financial crises—largely attributed to their emphasis on real economic activities and asset-backed financing—has enhanced their credibility and attracted increasing attention from regulators, policymakers, and conventional financial stakeholders worldwide (Hassan, 2021). As a result, the expansion of Islamic finance has extended beyond traditional Muslim-majority regions into emerging markets, including Africa, where substantial Muslim populations and the need for inclusive financial systems provide fertile ground for growth (Mroua and Trabelsi, 2020).

In Kenya, a key economic hub in East Africa, the financial sector plays a critical role in facilitating economic growth and development through commercial banks, microfinance institutions (MFIs), and other non-bank financial intermediaries. While conventional financial models have historically dominated the Kenyan financial system, the integration of Islamic finance principles began to emerge in the early 2000s. This development has been driven largely by Kenya's Muslim population—estimated at approximately 11 percent of the total population—as well as a growing demand for financial services that comply with Sharia principles. The Central Bank of Kenya (CBK) has supported this growth by licensing fully-fledged Islamic banks and permitting conventional banks to establish Islamic banking windows, recognizing the potential of Sharia-compliant finance to promote financial inclusion and diversify the financial sector (Wachira, 2021).

Despite these developments within the formal banking sector, the integration of Islamic finance within the microfinance sector in Kenya remains relatively limited. Microfinance institutions play a crucial role in promoting financial inclusion by providing credit and financial services to low-income households, micro-entrepreneurs, and underserved communities. However, the majority of MFIs continue to rely on conventional interest-based lending models, which may conflict with the religious and ethical preferences of Muslim clients, particularly in regions with significant Muslim populations such as the coastal counties of Kenya.

The potential for Sharia-compliant financial services within the microfinance sector is therefore substantial. Islamic microfinance has the capacity to expand financial access by offering ethically compliant financing mechanisms that align with the religious beliefs of Muslim entrepreneurs while simultaneously promoting equitable and socially responsible financial practices. However, the transition from conventional interest-based microfinance operations to Sharia-compliant financial models presents several structural and institutional challenges.

One key challenge relates to the transition from conventional financial reporting frameworks governed by International Financial Reporting Standards (IFRS) to Sharia-compliant accounting practices guided by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Such a transition requires significant institutional adaptation, including modifications to accounting systems, governance structures, product design, and operational procedures. Furthermore, microfinance institutions must establish robust Sharia governance mechanisms to ensure compliance with Islamic jurisprudential requirements while maintaining operational efficiency.

In addition, MFIs must navigate several structural constraints, including limited regulatory guidance, operational restructuring costs, and the need to redesign financial products that align with Sharia principles while remaining commercially viable. Without careful institutional restructuring, attempts to introduce Sharia-compliant products risk becoming superficial or symbolic, thereby undermining both operational effectiveness and the credibility of Islamic financial services (Khattak and Hussain, 2019).

Against this background, understanding the key determinants that influence the integration of Sharia banking principles within microfinance institutions in Kenya becomes critically important. In particular, interest rate dynamics within the conventional financial system, the operational costs associated with implementing Sharia-compliant financial products, and the adequacy of the regulatory and policy framework represent crucial factors that may either facilitate or hinder the successful adoption of Islamic finance within the microfinance sector. This study therefore seeks to examine these factors in order to provide deeper insights into the institutional and operational conditions necessary for effective integration of Sharia banking principles within MFIs in Kenya, thereby contributing to the broader agenda of ethical finance and inclusive economic development.

1.2 Statement of the Problem

The integration of Sharia banking principles into traditional microfinance institutions (MFIs) in developing economies such as Kenya remains a relatively underexplored area of scholarly inquiry. While substantial research has examined the operations and performance of fully-fledged Islamic banks, limited attention has been devoted to the unique processes and institutional challenges involved in transitioning conventional microfinance institutions—particularly those that rely heavily on interest-based lending models—toward Sharia-compliant financial systems (Ali and Naysary, 2022). This gap is significant given the critical role played by MFIs in promoting financial inclusion among low-income populations and micro-entrepreneurs.

The transition toward Sharia-compliant microfinance represents a complex and multidimensional institutional

transformation. Microfinance institutions seeking to integrate Islamic finance principles must fundamentally restructure their operational frameworks by replacing conventional interest-based lending with alternative financing mechanisms such as profit-sharing arrangements, leasing structures, and asset-backed financing contracts. Additionally, such institutions must establish effective Sharia governance systems, adapt financial reporting frameworks, and provide adequate training for employees to manage new operational procedures (Abdeldayem and Aldulaimi, 2020; Grassa et al., 2021).

Another major challenge relates to the regulatory environment governing Islamic finance in Kenya. While the regulatory framework supports Islamic banking within the commercial banking sector, there remains a lack of specific regulatory guidelines tailored to microfinance institutions seeking to adopt Sharia-compliant financial practices. This regulatory ambiguity creates uncertainty regarding licensing procedures, compliance requirements, and supervisory oversight for MFIs attempting to integrate Islamic finance into their operations.

Furthermore, several critical determinants of Sharia banking integration within MFIs remain insufficiently investigated. These include the influence of prevailing conventional interest rates on the competitiveness of Islamic financial products, the potentially high operational costs associated with implementing Sharia-compliant governance and financial systems, and the adequacy of the regulatory environment in facilitating institutional transformation. Existing studies have acknowledged these challenges but have rarely examined them empirically within the context of microfinance institutions operating in emerging economies (Khattak and Hussain, 2019).

Without rigorous empirical investigation into how these factors influence the integration of Sharia banking within MFIs, institutions may face strategic uncertainty, operational inefficiencies, and missed opportunities to serve the growing demand for ethical and faith-based financial services. Consequently, there remains a critical need for context-specific research that examines the determinants of Sharia banking integration within microfinance institutions in Kenya. This study seeks to address this gap by providing empirical evidence on how interest rate dynamics, operational costs, and regulatory support influence the successful adoption of Sharia-compliant financial practices within the Kenyan microfinance sector.

2. Literature Review

This chapter reviews scholarly literature on the integration of Sharia banking within conventional financial institutions, with a focus on microfinance institutions (MFIs) in Kenya. It begins by examining theoretical foundations that explain the principles of Islamic finance and its interaction with conventional financial systems, providing insight into the institutional and operational dynamics of adopting Sharia-compliant financial practices. The chapter then discusses the key variables guiding the study—conventional interest rate structures, operational costs of Sharia banking implementation, and the regulatory framework—and analyzes how they influence Islamic finance integration in microfinance models. It further presents an empirical review of previous studies on Islamic finance and Islamic microfinance, highlighting their findings, methodologies, and limitations while identifying gaps in existing research. The chapter concludes by synthesizing the main insights from the literature and outlining the research gaps that the study aims to address.

2.1 Theoretical Review

This section examines the major theoretical perspectives that provide an analytical framework for understanding the integration of Islamic finance within conventional financial institutions. These theories help explain the motivations, operational mechanisms, and institutional challenges associated with transitioning from conventional interest-based financial systems to Sharia-compliant financial models.

Islamic Economic Theory

Islamic economic theory provides an alternative economic paradigm grounded in the ethical and jurisprudential principles of Sharia. Unlike conventional economic systems that prioritize profit maximization, Islamic economic thought emphasizes social justice, fairness, and ethical economic conduct (Ayub, 2007). Central to this framework is the prohibition of *riba* (interest), which is considered exploitative and capable of promoting economic inequality and financial instability.

Instead of interest-based financial transactions, Islamic finance requires that financial activities be linked to real economic activity and supported by tangible assets (Alshater et al., 2021). The system also prohibits excessive uncertainty (*gharar*) and speculative behavior resembling gambling (*maysir*), thereby encouraging transparency, fairness, and responsible risk management in financial transactions.

Islamic economic theory promotes risk-sharing financial arrangements such as *Mudarabah* and *Musharakah*, where financiers and entrepreneurs share profits and losses according to predetermined agreements. These arrangements align incentives between investors and entrepreneurs while ensuring that financial returns are directly linked to the performance of real economic activities (Hassan et al., 2022).

Beyond financial transactions, Islamic economic principles incorporate broader socio-economic objectives aimed at promoting equitable wealth distribution and social welfare. Instruments such as *Zakat* facilitate wealth redistribution, while ethical investment screening ensures that financial resources are not directed toward harmful or socially undesirable industries.

This dual emphasis on financial sustainability and social justice makes Islamic economic theory particularly relevant to microfinance institutions, which often aim to promote inclusive economic development while maintaining financial

viability.

Theory of Financial Intermediation

The theory of financial intermediation explains the role of financial institutions in facilitating the efficient allocation of financial resources between savers and borrowers. In conventional financial systems, financial intermediaries collect deposits and convert them into interest-bearing loans, generating profits from the spread between borrowing and lending rates while managing credit and liquidity risks.

Islamic financial intermediation fundamentally transforms this traditional model by replacing interest-based lending with asset-backed and risk-sharing contractual arrangements. Under Islamic finance, financial institutions function not merely as lenders but also as partners, traders, or asset managers engaging in transactions such as Murabaha (cost-plus sale), Ijarah (leasing), Mudarabah (profit-sharing partnership), and Musharakah (joint venture).

In these arrangements, financial returns are not predetermined through fixed interest payments but instead depend on the performance of the underlying economic activities. Consequently, Islamic financial intermediaries assume greater exposure to asset risk and entrepreneurial outcomes rather than relying solely on credit risk.

For conventional microfinance institutions in Kenya, the adoption of Islamic financial intermediation would require significant operational restructuring. Institutions would need to move beyond traditional lending practices and develop capabilities in asset acquisition, trade financing, profit-sharing arrangements, and Sharia compliance monitoring. This transition would also require enhanced institutional capacity, including specialized expertise in Islamic financial products and governance frameworks.

Despite these challenges, Islamic financial intermediation offers the potential to align financial returns with real economic productivity while promoting ethical wealth distribution and supporting the financing needs of micro-entrepreneurs within a Sharia-compliant framework.

Institutional Theory

Institutional theory provides valuable insights into how organizations respond to external pressures within their operating environments. According to this theory, organizational practices are shaped by coercive, mimetic, and normative pressures arising from regulatory frameworks, competitive dynamics, and societal expectations.

Within the context of Islamic finance, the integration of Sharia-compliant financial practices by microfinance institutions in Kenya can be interpreted as an institutional response to evolving financial, regulatory, and socio-cultural environments. Coercive pressures arise from the formal recognition of Islamic finance by regulatory authorities such as the Central Bank of Kenya. Mimetic pressures occur when institutions adopt practices observed in successful organizations operating within similar markets. Normative pressures emerge from societal expectations, particularly from Muslim communities seeking financial services that comply with Sharia principles.

By adopting Sharia-compliant financial practices, MFIs may enhance their institutional legitimacy, strengthen their social license to operate, and align themselves with emerging global standards in ethical finance, including those promoted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

However, the integration of Islamic finance within conventional financial institutions introduces significant institutional complexity. MFIs must simultaneously comply with conventional financial regulations while ensuring adherence to Sharia governance requirements. Successfully navigating this dual regulatory environment requires the establishment of internal Sharia governance frameworks, alignment of reporting systems with IFRS and AAOIFI standards, and transparent communication with stakeholders.

Stakeholder Theory

Stakeholder theory emphasizes that organizations must balance the interests of multiple stakeholders in order to achieve sustainable success. In the context of Sharia banking integration within microfinance institutions, a diverse range of stakeholders influences the adoption and implementation of Islamic financial practices.

Key stakeholders include Muslim micro-entrepreneurs seeking Sharia-compliant financial services, shareholders expecting sustainable profitability, employees responsible for implementing operational changes, and regulatory authorities responsible for overseeing financial sector compliance. In addition, Sharia supervisory boards play a crucial role in ensuring religious compliance and maintaining the credibility of Islamic financial products.

External stakeholders such as competitors, financial markets, and the broader society also influence institutional behavior by shaping competitive standards, ethical expectations, and public perceptions regarding financial practices.

Failure to effectively balance these stakeholder interests may lead to operational inefficiencies, reputational risks, and reduced institutional performance. Therefore, successful integration of Sharia-compliant financial services requires effective stakeholder engagement, transparent governance structures, and responsive product development strategies.

2.2 Empirical Review of Literature

Empirical studies on Islamic finance have documented its rapid global expansion across both dedicated Islamic financial institutions and conventional banks offering Sharia-compliant financial services. Research consistently highlights the resilience of Islamic financial institutions, particularly during periods of financial instability, due largely to their emphasis on asset-backed financing and risk-sharing mechanisms.

Several studies have also identified significant demand for Sharia-compliant microfinance services in regions with substantial Muslim populations. Surveys conducted in these contexts demonstrate that religious beliefs and ethical considerations play an important role in shaping financial service preferences.

However, despite the growing body of research on Islamic finance, significant gaps remain regarding the integration of Sharia-compliant practices within conventional microfinance institutions. Existing studies, including those by Khattak and Hussain (2019), highlight key challenges such as the absence of clear regulatory frameworks for Islamic microfinance, difficulties in transitioning to Sharia-compliant accounting standards, the high operational costs associated with restructuring financial operations, and the complexities involved in establishing effective Sharia supervisory boards.

Nevertheless, much of the existing empirical literature remains limited in scope. Many studies focus on individual institutional cases or specific geographic contexts, resulting in limited generalizable insights regarding the broader process of integrating Islamic finance into conventional microfinance systems.

In particular, there is limited empirical evidence examining the influence of conventional interest rate environments on the pricing and competitiveness of Islamic microfinance products. Similarly, there is insufficient data on the operational costs associated with implementing Sharia-compliant financial systems, including governance structures, staff training, and technological adjustments.

Furthermore, comparative empirical research examining regulatory frameworks governing Islamic microfinance—particularly in emerging economies such as Kenya—remains underdeveloped. Consequently, there is limited understanding of how licensing procedures, taxation policies, and supervisory structures influence the ability of microfinance institutions to transition toward Sharia-compliant financial models.

Overall, while the demand for Islamic financial services and the theoretical foundations of Islamic finance are well documented, empirical evidence on the operational and institutional challenges faced by conventional microfinance institutions integrating Sharia banking remains limited.

2.3 Critique of the Literature

Despite the extensive literature on Islamic finance, several significant research gaps remain, particularly with regard to the integration of Sharia-compliant financial practices within conventional microfinance institutions.

First, much of the existing research focuses on large commercial banks and fully-fledged Islamic financial institutions, providing limited insights into the operational realities of non-deposit-taking microfinance institutions. These institutions operate under different business models, serve smaller-scale clients, and face distinct regulatory and operational constraints.

Second, existing studies rarely provide detailed empirical analysis of the organizational transformation required for conventional microfinance institutions to adopt Sharia-compliant financial models (Khattak and Hussain, 2019). While conceptual differences between conventional and Islamic finance are widely discussed, practical challenges—such as redesigning financial products, training employees, and adapting accounting systems from IFRS to AAOIFI standards—are less frequently examined.

Third, although operational costs are commonly identified as a potential barrier to integration, few studies provide detailed empirical estimates of the specific costs associated with implementing Sharia governance structures, upgrading information systems, and conducting staff training programs. This lack of cost-related data makes it difficult for MFIs to effectively plan for institutional transformation.

Additionally, the regulatory environment governing Islamic microfinance remains inadequately explored. Although Kenya has established a regulatory framework that accommodates Islamic banking within the commercial banking sector, there are currently no specific regulatory guidelines tailored to microfinance institutions seeking to implement Sharia-compliant financial services. This regulatory gap creates uncertainty regarding licensing requirements, taxation treatment, and supervisory oversight.

Finally, the existing literature often examines the determinants of Islamic finance adoption in isolation rather than considering the dynamic interaction among multiple variables such as interest rates, operational costs, and regulatory frameworks.

Consequently, there remains a significant knowledge gap regarding the practical, financial, and regulatory complexities associated with integrating Sharia banking principles into conventional microfinance institutions. Addressing these gaps requires context-specific empirical research capable of providing detailed insights into the institutional transformation process.

2.4 Summary

This chapter reviewed the theoretical and empirical literature relevant to the integration of Sharia banking principles within conventional microfinance institutions. The theoretical review examined Islamic economic theory, financial intermediation theory, institutional theory, and stakeholder theory, each of which provides valuable insights into the operational and institutional dynamics of Islamic finance integration.

The review highlighted that integrating Sharia-compliant financial practices requires a fundamental shift from traditional interest-based lending toward asset-backed and risk-sharing financial models. Such a transformation is influenced by multiple factors, including prevailing interest rate structures, operational costs associated with implementing Sharia-compliant systems, and the regulatory framework governing financial institutions.

Although existing literature documents the global growth and resilience of Islamic finance, it reveals a critical research gap regarding the supply-side integration of Sharia banking within conventional microfinance institutions. In particular, limited empirical research exists on the operational, financial, and regulatory challenges faced by MFIs attempting to adopt Islamic financial practices.

This gap underscores the importance of conducting empirical research that provides context-specific insights into the factors influencing Sharia banking integration within microfinance institutions in Kenya. The findings of this study are therefore expected to contribute to both academic knowledge and policy discussions concerning the development of inclusive and ethically grounded financial systems.

3 Methodology

This study adopted a desk review methodology, relying on the systematic examination and synthesis of existing scholarly literature and secondary data sources related to Sharia banking and microfinance. The approach was appropriate because the study sought to analyze existing theoretical and empirical knowledge on the factors influencing the integration of Sharia banking within microfinance institutions (MFIs) in Kenya. A desk review allows researchers to consolidate insights from diverse academic works, policy documents, and industry reports in order to develop a comprehensive understanding of a research problem.

The study utilized secondary data obtained from peer-reviewed journal articles, academic books, policy papers, and reports from reputable institutions involved in Islamic finance and financial sector development. Key sources included publications from international bodies such as the Islamic Financial Services Board and other scholarly databases including Google Scholar, ScienceDirect, and ResearchGate. These sources were selected because they provide credible and authoritative information on Islamic finance, financial intermediation, regulatory frameworks, and financial inclusion.

The selection of literature was guided by relevance to the research topic, scholarly credibility, and recency of publication. Preference was given to peer-reviewed academic studies and institutional reports addressing Islamic banking, Islamic microfinance, and regulatory frameworks affecting financial institutions in emerging markets. Studies focusing on Africa and developing economies were particularly prioritized due to their contextual relevance to Kenya.

The collected literature was analyzed using thematic content analysis, which involved identifying and synthesizing key themes emerging from the reviewed studies. The analysis focused on themes related to interest rate structures, operational costs associated with Sharia-compliant financial systems, and regulatory frameworks influencing the integration of Islamic finance within microfinance institutions. Through this process, the study was able to identify common patterns, theoretical insights, and existing research gaps relevant to Sharia banking integration.

Throughout the study, ethical academic practices were maintained by ensuring that all sources of information were properly acknowledged through appropriate citation and referencing. The desk review approach therefore provided a reliable and systematic means of synthesizing existing knowledge and identifying key determinants influencing the integration of Sharia banking within MFIs in Kenya.

4 Findings and Interpretation

4.1 Introduction

The findings of this study are derived from the desk review and thematic analysis of existing literature on Islamic finance and microfinance integration. The analysis synthesized theoretical perspectives and empirical evidence from previous studies to identify the key determinants influencing the integration of Sharia banking within microfinance institutions (MFIs) in Kenya. Consistent themes emerging across the literature include interest rate structures, operational costs associated with Sharia compliance, and the regulatory framework governing Islamic finance. These factors collectively shape the feasibility, institutional readiness, and sustainability of Sharia banking adoption within MFIs (Khattak and Hussain, 2019; Hassan et al., 2022; Wachira, 2021).

The literature further suggests that the successful integration of Islamic finance requires a systemic alignment between financial incentives, institutional capacity, and regulatory support. When these conditions interact positively, they create an enabling environment for the adoption of Sharia-compliant financial products. Conversely, weaknesses in any of these areas may constrain integration efforts and limit the ability of MFIs to offer Islamic financial services.

Based on the thematic synthesis of the reviewed literature, this study proposes an Integrated Model of Sharia Banking Adoption in Microfinance Institutions. The model illustrates how three key determinants—interest rate structures, operational costs of Sharia compliance, and regulatory frameworks—interact to influence the successful integration of Islamic finance within MFIs.

The model suggests that interest rate dynamics shape the market competitiveness of Islamic financial products relative to conventional lending mechanisms. Operational costs influence the institutional capacity of MFIs to restructure their financial operations, while regulatory frameworks determine the legal and institutional feasibility of implementing Sharia-compliant financial services.

Together, these determinants form a multidimensional system that affects the strategic decision-making process of MFIs

seeking to integrate Islamic finance.

4.2 Influence of Conventional Interest Rate Structures

The literature reviewed indicates that conventional interest rate structures significantly affect the attractiveness and competitiveness of Islamic financial products. In conventional microfinance systems, lending operations rely heavily on interest-based returns, which represent the primary source of institutional income.

However, Islamic finance prohibits interest (*riba*) and instead promotes risk-sharing financial arrangements, including *Murabaha*, *Musharakah*, *Mudarabah*, and *Ijara* contracts (Hassan et al., 2022). These financial instruments link returns to real economic transactions rather than predetermined interest payments.

Empirical studies suggest that when conventional interest rates are relatively high, Sharia-compliant financial products may become more attractive to borrowers because profit-sharing or asset-based financing mechanisms can offer competitive pricing while aligning with ethical and religious principles (Hassan, 2021). Conversely, when interest rates in conventional financial markets decline, Islamic financial products may face pricing disadvantages due to the additional operational costs associated with asset-based transactions.

The literature therefore indicates that the prevailing interest rate environment plays a critical role in shaping the financial viability of Islamic microfinance services.

4.3 Operational Costs of Sharia Compliance

Another dominant theme emerging from the literature concerns the institutional and operational costs associated with implementing Sharia-compliant financial systems. The transition from conventional microfinance to Islamic financial models requires substantial institutional restructuring.

Several operational requirements contribute to increased implementation costs. These include the establishment of Sharia supervisory boards, training of employees in Islamic financial principles, modification of accounting systems to comply with AAOIFI standards, and the development of new financial products that eliminate interest-based structures (Khattak and Hussain, 2019).

In addition, Islamic financial transactions often involve trade-based or asset-backed financing mechanisms, which require more complex contractual arrangements and monitoring procedures compared to conventional lending models. These operational requirements increase administrative costs and require specialized institutional expertise.

Nevertheless, the literature suggests that although operational costs may initially present a barrier to adoption, these costs tend to decline over time as institutions gain experience, develop internal expertise, and achieve economies of scale in Islamic financial operations.

4.4 Regulatory and Institutional Framework

The regulatory environment is identified as a critical enabling factor in the integration of Sharia banking within financial systems. Effective regulatory frameworks provide legal clarity, institutional legitimacy, and supervisory oversight necessary for the development of Islamic finance.

In Kenya, the regulatory environment has increasingly recognized the importance of Islamic finance. The Central Bank of Kenya (CBK) has licensed fully-fledged Islamic banks and permitted conventional banks to establish Islamic banking windows, thereby facilitating the growth of Sharia-compliant financial services (Wachira, 2021).

However, the literature highlights that regulatory frameworks specifically tailored to Islamic microfinance remain underdeveloped. While commercial Islamic banking has received regulatory recognition, there is limited regulatory guidance addressing how microfinance institutions can integrate Sharia-compliant financial practices.

This regulatory gap creates uncertainty regarding licensing requirements, taxation treatment, and supervisory mechanisms for MFIs seeking to adopt Islamic financial services. As a result, the absence of clear regulatory frameworks may discourage institutional investment in Islamic microfinance despite growing market demand.

The literature therefore emphasizes that strengthening regulatory frameworks for Islamic microfinance could significantly accelerate the integration of Sharia banking within MFIs in Kenya.

4.5 Synthesis of Findings

The thematic analysis of the literature reveals that the integration of Sharia banking within microfinance institutions is a complex institutional transformation influenced by financial, operational, and regulatory factors.

Three major findings emerge from the desk review. First, interest rate structures influence the pricing competitiveness and market attractiveness of Islamic financial products relative to conventional lending mechanisms (Hassan et al., 2022). Second, operational costs associated with implementing Sharia-compliant governance, accounting systems, and financial products present short-term institutional barriers but may decline as institutional capacity improves (Khattak and Hussain, 2019). Third, regulatory frameworks play a critical enabling role in facilitating institutional adoption of Islamic finance, and the absence of clear regulatory guidelines for Islamic microfinance remains a key constraint within the Kenyan financial system (Wachira, 2021).

Overall, the findings suggest that successful integration of Sharia banking within MFIs requires coordinated adjustments across financial markets, institutional governance structures, and regulatory policy frameworks. Where these elements are aligned, Islamic microfinance has the potential to significantly expand financial inclusion while promoting ethical and

socially responsible financial practices.

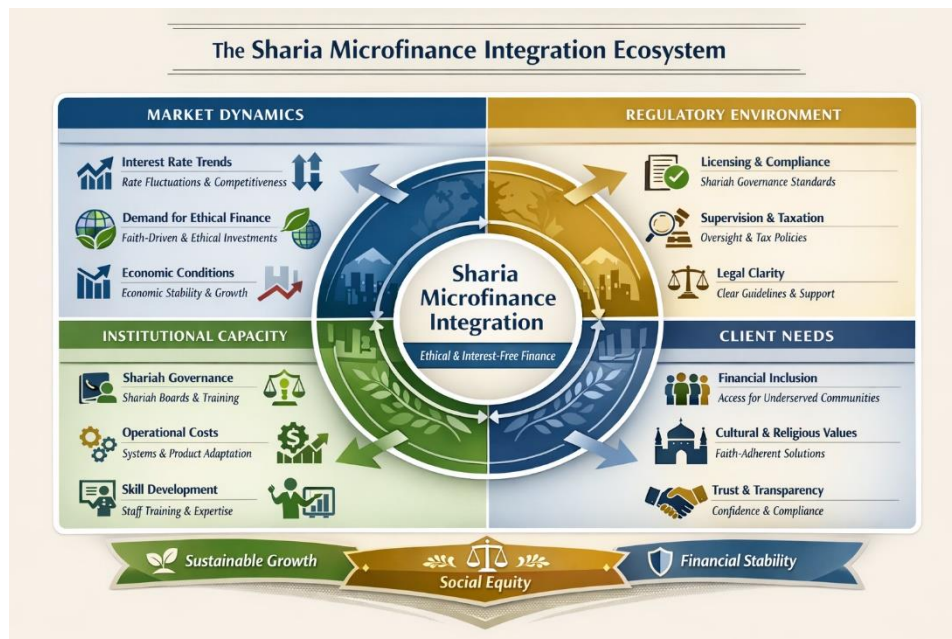


Figure 1: The Sharia Microfinance Integration Ecosystem
(Developed with aid of AI)

Figure 1 presents the Sharia Microfinance Integration Ecosystem, illustrating the interconnected factors that influence the successful integration of Sharia-compliant financial services within microfinance institutions (MFIs). The model shows that Sharia microfinance integration is shaped by four major interacting domains: market dynamics, regulatory environment, institutional capacity, and client needs. Market dynamics include factors such as interest rate trends, demand for ethical finance, and broader economic conditions that affect the competitiveness of Islamic financial products (Hassan, 2021; Hassan et al., 2022). The regulatory environment encompasses licensing requirements, supervisory mechanisms, and legal clarity necessary to support Sharia-compliant financial operations (Wachira, 2021). Institutional capacity reflects the internal readiness of MFIs to adopt Islamic finance through Sharia governance structures, operational systems, and staff expertise (Khattak and Hussain, 2019). Finally, client needs represent the demand for financial inclusion, culturally appropriate financial services, and transparency among Muslim and ethically motivated clients. The model suggests that effective interaction among these ecosystem components facilitates sustainable Sharia microfinance integration, ultimately contributing to financial stability, social equity, and inclusive economic growth.

5 Conclusions and Recommendation

5.1 Conclusion

This study examined the factors influencing the integration of Sharia banking within microfinance institutions (MFIs) in Kenya through a desk review of existing literature. The analysis revealed that the integration of Islamic finance into conventional microfinance systems is influenced by a combination of financial, institutional, and regulatory factors. Specifically, conventional interest rate structures, operational costs associated with Sharia compliance, and the regulatory framework were identified as the key determinants shaping the adoption and sustainability of Sharia-compliant financial services. The findings indicate that while Islamic finance presents significant opportunities for expanding financial inclusion and promoting ethical financial practices, its successful integration within MFIs requires substantial institutional adaptation and supportive policy environments.

The review further highlights that interest rate dynamics within conventional financial markets affect the competitiveness of Sharia-compliant financial products. At the same time, the operational requirements associated with Sharia governance, staff training, and compliance with standards such as those developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) create additional institutional costs that may initially discourage adoption. In addition, the absence of clear regulatory frameworks specifically addressing Islamic microfinance in Kenya creates uncertainty for MFIs seeking to introduce Sharia-compliant financial services. Despite these challenges, the growing demand for ethical and faith-based financial products suggests significant potential for Islamic microfinance to contribute to inclusive and socially responsible financial systems. Therefore, the integration of Sharia banking within MFIs represents not only a financial innovation but also a strategic opportunity to expand access to financial services among underserved populations.

5.2 Recommendations

Based on the findings of this study, several recommendations can be made to facilitate the successful integration of Sharia banking within microfinance institutions in Kenya. First, regulatory authorities should consider developing clear and comprehensive regulatory frameworks specifically tailored to Islamic microfinance. Such frameworks would provide legal clarity regarding licensing, supervision, taxation, and Sharia governance requirements, thereby reducing institutional uncertainty and encouraging MFIs to adopt Sharia-compliant financial models.

Second, microfinance institutions should invest in institutional capacity building to support the implementation of Islamic financial services. This includes establishing effective Sharia governance structures, providing specialized training for staff in Islamic financial principles, and upgrading operational systems to accommodate Sharia-compliant financial products. Strengthening internal institutional capacity will enhance the ability of MFIs to design and manage Islamic financial products effectively.

Third, policymakers and financial institutions should promote public awareness and financial literacy regarding Islamic finance, particularly in regions with significant Muslim populations. Increasing awareness of Sharia-compliant financial services can stimulate demand and improve the acceptance of Islamic microfinance products among potential clients.

Finally, further research should be conducted to provide empirical evidence on the operational and financial performance of Islamic microfinance institutions in Kenya. Future studies could employ quantitative or mixed-method approaches to examine the practical outcomes of Sharia banking integration within MFIs, thereby contributing to more informed policy development and institutional decision-making.

Overall, strengthening regulatory support, institutional capacity, and public awareness will be critical in enabling the successful integration of Sharia banking within the Kenyan microfinance sector and in advancing the broader goals of financial inclusion and ethical finance.

Declaration of Competing Interests

The authors declare that they are not aware of any competing financial interests or personal relationships that may have influenced the work described in this document.

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Ethical considerations

The article followed all ethical standards appropriate for this kind of research.

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