THE EFFECT OF ISLAMIC BANKING PRODUCTS ON FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN KENYA

BY

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DECLARATION

This research proposal is my original work and has not been presented for a degree in any other university.

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This research proposal has been submitted for examinations with my approval as the university supervisor.

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DEDICATION

I dedicate this project to my family and friends for unfailing encouragement and love. For this I say thank you and God bless.

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I wish to thank most sincerely all those whose contributions have made this project a success. To my supervisor Dr. Kennedy Okiro for his assistance and advice all through making this project a success. To my wonderful family for their moral support. Most of all I thank God for the gift of wisdom and strength to complete this project.

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LIST OF ABBREVIATION AND ACRONYMS

EAC East African Community

FDI Foreign Direct Investment

GAB Gulf African Bank

GDP Gross Domestic Product

IMF International Monetary Fund

KCB Kenya Commercial Bank

SPSS Statistical Package for Social Sciences

USD United States Dollars

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ABSTRACT

Establishing the effect of Islamic banking products on financial performance of Islamic banks in Kenya was the objective of the study. This study used a case study and adopted a descriptive research design. The study collected data from Gulf African Bank and First Community Bank. This study utilized secondary data. Secondary data as analyzed using inferential statistics, descriptive statistics, regression analysis and correlation. Secondary data was gathered from financial statements of the Islamic bank. Inferential statistics such as multiple regressions and Pearson correlation was used. In establishing the link between Islamic banking products financial performance in Islamic banks in Kenya and the significance /fitness of the model and descriptive and inferential statistics were employed specifically using correlation, regression and ANOVA. The study found a positive correlation between financial performance of IFIs and Islamic financial instruments which include Musharakah financing, Mudaraba financing, Murabaha financing and Ijara financing, Thus the study concludes that all the Islamic financial instruments had a positive impact on the performance of commercial Banks in Kenya. The study concludes that Islamic banking products lead to improved financial performance of Islamic banks Kenya. Financial performance is the most significant challenge to Islamic banks since other commercial banks have since been licensed to offer Islamic banking products.

CHAPTER ONE

INTRODUCTION

1.1Background of the Study

In the last two decades, the banking sector has witnessed the rise and development of a new financial product: Islamic banking, which is based on the Islamic law (Shariah). The Islamic banking has developed as a focused and reasonable substitute for conventional banking. Islamic banking has grown generously and has ended up as one of the world's quickest developing financial divisions (Godana, 2016). Emergence of Islamic banking products has increased the level of competition in the banking sector since the products act as a substitute to the existing products in the market. Competition entails striving against others in order to be victorious. (Pettinger & Richard, 1996). Increased competition led to the introduction of Islamic banking products. These products are expected improve the banks financial performance.

Islamic banking is a system of banking characterized by exclusion of utilization of loan cost and that depends on a hidden idea of justice in which both profits and risks are shared. Islamic banking has greatly gained momentum in Kenya. In 2005, Barclays introduced a window for Islamic banking. First Community Bank Limited was the first commercial bank operating entirely under Islamic Shariah principles to be licensed to operate in Kenya. In January 2008, Gulf African Bank commenced its operations in Kenya as the first fully fledged Islamic bank to operate in Kenya (Daily Nation, 2008). Conventional banks have not been left behind in offering Islamic banking products. These banks include KCB, Standard Chartered, Barclays Bank Kenya, National Bank Kenya, Equity bank and Chase Bank. (Ismail, 2010).

Islamic banks in Kenya are subjected to the same regulations as conventional banks for lack of specially tailored frameworks to regulate them. The perception of the market that it is for Muslims and lack of adequate information on this system of banking, have limited its customer base. With Islamic banking investments are limited to non-profit making ventures and this causes excess competitiveness of Islamic in Kenya. Although, facing challenges with regulation, wrong perception, and excess ROA for Islamic banks in Kenya Islamic banking has resulted in declining financial performance in banking sector. There is need to alleviate these challenges in order to foster but the full importance of Islamic banking can only be understood after understanding it's the extent of its impact on financial performance. This study therefore seeks to determine the extent of the effect of Islamic banking on financial performance of Islamic banks in Kenya.

1.1.1 Islamic Banking Products

A financial organization that works the intention of implementing and materializing the banking industry's Islam economic and financial standard (Godana, 2016). According to the Islamic Development Bank (2007) these banks are characterized as financial and social establishments whose destinations and operations as well as standards and practices must conform to the ethics of Islam Shariah (jurisprudence) and which must maintain the interest from any enthusiasm for any of their operations. The Islamic bank is an establishment whose principle action, prone to routine bank, is the activation of funds from bankers and these funds offer to the specialists having a shortage and lead all banking exercises without the utilization of financing cost (Goaied, 2015). Banks are grouped into traditional and

nontraditional. According to Moshirian and Lean (1998) banking traditional activities are activities which founded on acceptance of deposits.

A leasing contract whereby a good owner rents it to another bidding party is called Ijara. Afterwards, the bidder can buy it, the rent is then lowered untill when it becomes the possession of the client (Bellalah & Ellouz, 2004). Islamic mortgage and home Finance are founded on the idea of Ijara. This has been used as a tool for success in the Islamic Financial System.

Mudaraba (Trust Financing) is a contract whereby a bank grants all the funds as the partner's inputs are professional skills, experience and commercial efforts. A predetermined profit proportion is received by the bank. When there is an occurrence of a loss, the bank takes all the financial loss while the manufactures are not rewarded (Rob, 1992). The conclusion about this system is that it encourages individuals to partake in financial activities and show themselves as active in the society.

Musharaka, also known as Partnership Finance is a more than one party contracts each contributing capital into a joint venture. The ratios of profits are established beforehand but in case of a loss, it is shared in proportion with contributed sums. Opinion differences occur infiqhas as to whether profit ratios vary from ratios of capital contribution. Malik and Shafi'iare among the classical jurist who do not permit it, the limit of perpetual sleeping partner's share is limited to the amount of his investment Abu Hanifa while Ahmad makes it subject to free consent (Usmani, 2002).

Murabaha (Cost-plus financing) is a specific kind of sale considered as a trust contract by the Islamic jurisprudence, since there is no price negotiation between the seller and the buyer, but instead, an agreement on a specific margin of the profit included in the cost and declared faithfully by the seller (Saadallah, 2007). In the early Islam, murahaba transaction entailing a sale for cash was normal.s

1.1.2 Financial Performance

Generally, in measuring the overall financial health, financial performance is normally over a particular period of time. It is used for comparison between similar firms or industries in aggregation. Financial performance can be measures in diverse ways, however, all measures need to be taken in total. Line items such as loans and advances, deposits, total interest income, total interest expense, other costs and other indicators are used in measuring performance of a commercial bank.

Operational performance is one of the relevant issues in Islamic banking is. Efficiency performance and profitability are normally used in substitute of each other so as to indicate the different measures utilized in assessing banking operation. Corporate entities are primarily formed to generate profits. Islamic bank which is one of the corporate entities offers a huge number of services and products for profit. To measure organizational performance, scholars investigated various indicaters (Dess & Robinson, 1984). Profitability, productivity, management performance, liquidity, innovation and quality of products are among the diverse criterias of evaluating performance of banks.

According to Wheelen and Hunger (1998) organizations and their objectives appropriate are the major determinants of the performance measures. This can be seen in terms of market share, profitability, and cost reduction. Moreover, financial indicator such as earning per share (EPS) return on investment (ROI) and return on equity (ROE) are frequently used by various corporate entities to measure performance. Given that today's world is so competitive, banks have to improve their services together with products so at to meet the ever-changing clients' demands which in turn improves their financial performance. Islamic banks use the above performance measures to evaluate their progress.

1.1.3 Islamic Banking Products and Financial Performance

Islamic finance and the products of finance that are the basis of Islamic banking are among the fastest growing sectors of the finance industry, running over 300 institutions in 75 countries (Celebi, Hassan, & Zirek, 2015). Despite the difficulty in isolating banking as an exogenous variable, trials have been fruitful in yielding results that indicate financial performance of Islamic banks is enhanced by its products enhance Banks can establish a firm that is creditworthy, leverage savings, ROA for Islamic banks in Kenya provision, and transaction facilitations and pooling of risks, all of which facilitate growth of the economy. Banks also change savings allotment to different firms through loans and impact on growth by increasing the rates of domestic savings and attract foreign capital (Johnson, 2013).

The relationship between Islamic banking products financial performance is evident in the study findings of Hasan and Dridi (2010) where they found that Islamic banking business structure protect them from adverse profit effects that of 2008 financial crisis. Iran and Zaman (2014) conducted a study on Islamic bank product efficiency in South Asian

Countries and found that Islamic banking products' return on asset was 91% and 77% for net income ration. Performance of Islamic banking products are also considered superior to that of conventional banks due to its profitability, stability and its well capitalized (Ayub, 2002).

1.1.4 Islamic Banking in Kenya

Since 1970 when modern Islamic banking was born in Egypt, it has broaden rapidly across the globe in mostly, but not exclusively, countries that have larger Muslim populations. Many banks have expanded to establish Islamic windows that offer Islamic banking. This has expanded the industry from an insignificant beginning to over USD 1.6 trillion in assets in 2012 with an expectation of growth to reach USD 6.1 trillion by the end of the decade (Imam & Kpodar, 2015). Kenya has not been left out in providing Islamic banking services. Conventional banking institutions have embraced Islamic banking through opening up of banking windows that offer Shariah compliant banking services targeting both Muslim and non-Muslim customers.

The emergence of Islamic banking was a result of the launch of Islamic banking products by Barclays in Kenya in December 2005. Two years later there was introduction of the First Community Bank in 2007 then the Gulf African Bank (GAB) in 2008. The growth trend continued with other conventional banks such as Kenya Commercial Bank offering products that are compliant with Shariah through special Islamic windows. Through the Finance Act of 2010 (Ndung'u, 2011). The Islamic banking window was introduced by Standard Chartered in Kenya in 2013. As of the end of 2013, Islamic banking accounted for 2% of the total banking business in Kenya (IMF, 2014).

These banks target both Muslim and non-Muslim customers. According to Kenya institute of bankers' newsletter, June 2009, in Kenya there are possible profitable markets for Islamic banking products among the business community in Nairobi, Mombasa and other towns with sizeable Muslim communities (Mutua, 2017). Islamic banking products, however, like any other new venture faces challenges. In Kenya, there are no unique frameworks by the government to regulate Islamic banking leaving it to be regulated as conventional banking. The problem of excess ROA for Islamic banks products in Kenya is also a challenge which results from the inability of Islamic banks to invest in any profit generating ventures such as government securities as other conventional banks do.

1.2 Research Problem

Islamic finance and the Shariah compliant financial products that form the base of Islamic banking are now a fast growing sector of the financial markets industry, running in over 300 institutions in 75 states (Johnson, 2013). Islamic banking through mobilization of deposits and proper allocation of the collected resources can foster financial performance. The risk-sharing model applied in Islamic banking where risks are not transferred through financial markets may be more efficient than the borrower-risk model applied in conventional banking. While it is necessary for Islamic banks to practice more carefulness in lending because they bear more burden of risk, this system could probably result in a more economically favorable ROA for Islamic banks in Kenya distribution.

In Kenya, Islamic banking has developed since 2005 when the first window of Islamic banking was established. Fully fledged Islamic banks have also been opened: First

Community Bank and Gulf African Bank. More banks including Kenya Commercial bank have continued to open windows that offer Islamic banking services to their customers. While grappling with challenges in regulation, wrong perception by customers and excess ROA for Islamic banks in Kenya Islamic banking has expanded and resulted in a positive impact on the economy. There is need however to fully evaluate the impact of Islamic banking products on financial performance Kenya.

On the area of Islamic banking, various studies have been done. Globally, Irfan and Zaman (2014) did a study on performance and efficiency of Islamic banking in South Asian countries. The study found that Islamic banking efficiency is about 98.19% in term of return on asset ratio; about 91.4% regarding return on equity ratio and 77.03% as for net profit ratio. Imam and Kpodar (2015) sought to examine whether Islamic banking is good for growth. From the study it was noted that financial development is widely convenient for the economy growth and the research then sought to determine whether the same would be said for Islamic banking. Despite the result of the studies, it is comparably small in size in comparison with the economy and the general size of the financial system, Islamic banking is related positively to economic growth even after control of different determinants inclusive of the financial depth level.

Locally, Bintiomari (2010) studied response strategies by Islamic banks to competition in the commercial banking sector in Kenya. The study adopted a case study. Primary data was collected through an interview guide that was conducted by the researcher. Ahmednoor (2012) evaluated Islamic banking products and financial performance of Islamic banks in Kenya. The study utilized secondary data from published annual reports of the selected banks. Ogola (2016) studied the impact financial development on growth of the economy

in Kenya. From the study financial development, mainly involving the banking sector affects the construction, retail and wholesale, information and communication, and finance and insurance sectors. This showed a positive correlation between financial development and economic growth. From the studies above it can be noted that no study has been done to determine the extent of the effect of Islamic banking products on financial performance of Islamic banks in Kenya. This creates a knowledge gap which this study wishes to fill through answering the research question: what is the effect of Islamic banking products on financial performance of Islamic banks in Kenya?

1.3 Objectives of the Study

To establish the effect of Islamic banking products on financial performance of Islamic banks in Kenya.

1.4 Value of the Study

To the management and employees of Islamic banks, the results of this study can be used to understand the effects of the banks and their extent on the growth of the economy in Kenya. This understanding is of great help in decision making in these banks in regard to formulation of strategy and day-to-day operations. An understanding of the effect the Islamic banking products have on the financial performance of the banks will encourage better decisions in the banks.

Policy makers are guided by research findings that attempt to demystify certain concepts that they are concerned with. The findings of this research may therefore be used by policy

makers in the formulation of more informed policies and mechanisms that will help foster the financial performance among banks in Kenya.

To the scholarly field this study adds to the literature available on Islamic banking products and its financial performance of Islamic Banks. The study's findings may be used by scholars and academicians to understand Islamic banking and the extent of its impact on financial performance of Islamic Banks. The findings of this study may also be used by other researchers as a basis for their research or to identify areas for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In this chapter, there is a review of literature relating to the subject of banking, more specifically Islamic banking products, and financial performance as presented by various researchers. This includes a theoretical review of various financial theories of banking, a look at the determinants of financial performance and a review of related empirical studies. The materials are obtained from various sources related closely to the topic and aims of this research.

2.2 Theoretical Review

There exist various financial theories of banking explaining the role of banking and the financial performance. This study is guided by the Financial Intermediation Theory of Banking, the Fractional Reserve Theory and the Neoclassical Theory: Exogenous growth theory theories.

2.2.1 Financial Intermediation Theory of Banking

The financial theory of intermediation states the banks are just monetary connections, indifferent from other non-bank institutions of finance; they collect deposits and lend them out. Banks, therefore borrow from depositors who have short maturities and lend to long maturity borrowers. This theory has been highly publicized by well-known economists and high ranking economics journals. The initial promoters of this theory are Von Mises (1912), Tobin (1963), Sealey and Lindley (1977) and Riordan (1993).

The writings of Von Mises states that the bank negotiators activities of credit is illustrated by other people's lending of borrowed money and that bankers are only those that lend money of those; those lending their own money are capitalists and not bankers. Mises believes that this only among the banks' functions; the argument of Keynes (1936) is that savings need to be gathered first for investments to occur. Harrod (1939) and Domar (1947) have mirrored this in the Keynesian model which are based on the financial banking intermediation theory though not modeling banks explicitly. The conclusions by Harrod and Domar have had a considerable impact in the policy of economy in the era before war and their work has been understood to the impact that developing nations could be assisted by global banks that could avail the lacking domestic savings via loaning from abroad so as to finance growth of the economy. This logic has led to increased foreign borrowing by underdeveloped countries from the time of the World War II. According to Riordan (1993) depositors lend to banks who in turn lend to investors. Investors have inadequate equity to fund their projects fully and as a result seek loans to finish the funding. Hence banks gather the deposits to make loans.

The financial intermediation theory of banking explains that banks play a crucial part in the economy, directing funds from units in excess to units in need. Islamic banking is seen to clearly play this role through accumulation of deposits and lending of this money to borrowers for purposes of investment though at no interest. This theory is relevant to the study in that it tends to explained the influence Islamic products have on financial performance.

2.2.2 The Theory of Islamic Banking

It was until 1970s that the theory of Islamic banking came to existence. This was done majorly due to the plea of replacing bank lending interest by sharing of profit. This changed the concept of money related intermediation, making various players to share enterprise risk with the store clients (Ismail, 2002). Fairness was the main primary accentuation by early researchers. It was seen to be unjust for end-user entrepreneur to bear all the business risks while and permitting fund owner and bank guarantee a foreordained return. The manner by which profitable endeavor were led did not surety a positive return. Therefore, regardless of the consequences of big business, there was no defense for cash capital guaranteeing a positive return (Hasan, 2005).

Mauudi (1961) contended that most, however not all, alternate issues of private enterprise were established in the act of loaning on interest. Among these issues was joblessness, expansion, expanding disparity and intermittent business cycles. Through canceling interest and supplanting it by benefit sharing, these issues could be illuminated. Islamic financial analysts could not brace these cases by complex monetary investigation until the next decade. In addition to other things, this stage concentration was to a major extent on pointing out the inadequacies of free enterprise and connecting them to the enthusiasm establishment. With this went the contentions demonstrating that it was conceivable to have keeping money without premium and that it would not unfavorably influence reserve funds and venture. Some contended that getting rid of interest would support investments prompting expanded production (Mannan, 1999).

The coming and multiplication of murabahah or cost-plus financing was a noteworthy improvement amid the late nineteenth century. The commodity required purchased by the bank at demand was what the representative got from the Islamic bank. This was with the guarantee to buy it from the bank at a greater cost than its price tag and it was to be paid after a timeframe (Archer and Karim, 2002). Each murabahah exchange made an obligation. Resources put into murabahah exchanges were protected. This was contrasted with stores provided on a benefit sharing premise. Murabahah vanquished the scene of Islamic finance after few years of presentation in late nineteen seventies, it. (Hasan, 2005).

2.3 Determinants of Financial Performance

Various studies have researched on the elements essential to financial performance. These studies have emphasized on different explanatory parameter set by use of varying conceptual and methodological points of view and given shaded various lights on financial performance. Determinants of financial performance include: capital adequacy, liquidity management, asset quality, management efficiency.

2.3.1. Capital Adequacy

Funds available in supporting the business of a bank are termed as capital (Athanasoglou et al. 2005). In adverse situation it also acts as a cushion Diamond (2000). Given the fact that deposits are normally fragile and prone to bank runs, liquidity is normally created. According to Dang (2011) capital adequacy ratio (CAR) decides capital adequacy. CAR is directly proportional to the resilience of the bank to crisis situations. According to Sangmi and Nazir, (2010) through determining bank's growth to risky but profitable ventures or areas, it has a direct effect on the profitability of banks.

2.3.2. Asset Quality

Credit portfolio, fixed asset, current asset, and other investments comprises the bank asset. Banks need income to survive, they majorly earn income through provision of loans. Through loan, commercial banks generate income making it a major asset. Bank's profitability is determined by the quality of loan portfolio. Losses derived from delinquent loans are the highest risk facing a bank (Dang, 2011). Every commercial bank strives to maintaining the level of nonperforming loan lower. Portfolio good health is shown when the ratio of nonperforming loans to total loans is low. (Sangmi and Nazir, 2010).

2.3.3. Management Efficiency

Various financial ratios are used to represent management efficiency. They include: earnings growth rate, loan growth rate and total asset growth. The management efficiency other ratio is the operational proficiency which deals with the working costs. Some financial ratios go about as management efficiency proxy. Financial ratios can be used to measure the ability of the administration to convey its assets proficiently, wage expansion and decreasing working expenses. operating profit to income ratio is normally used to gauge management qaulity (Rahman et al. In Ilhomovich, 2009; Sangmi and Nazir, 2010). The operating profit to total income is higher and the efficient management tends to have a positive relationship. This is in aspects income generation and operational efficiency. According to Athanasoglou et al. (2005). Operating expenses to total asset ratio and profitability have negative relationship.

2.3.4. Liquidity Management

Liquidity alludes to the capacity of the bank to satisfy its obligations, basically of depositors. Profitability of a bank is related to adequate liquidity level (Dang, 2011). The

most well-known financial ratio that mirrors the liquidity position of a bank are total loan to customer deposits and customer deposit to total asset. Different researchers utilize distinctive financial ratio to gauge liquidity. For example, Ilhomovich (2009) utilized cash to deposit ratio to quantify the liquidity level of banks in Malaysia. In any case, the research led in China and Malaysia found that liquidity level of banks has no association with banks performance (Said and Tumin, 2011).

2.3.5. External Factors/ Macroeconomic Factors

The macroeconomic policy stability, Inflation, Gross Domestic Product, Political instability and Interest Rate are a portion of the macroeconomic factors that influence banks perfomance. For instance, Gross domestic product pattern influences the interest for resource of a bank. Amid Gross domestic product development declining, the interest for credit falls which thusly contrarily influence banks profitability. According to Athanasoglou et al., (2005) amid blast the interest for credit is high contrasted with recession. Similar creators state in connection to the Greek circumstance that the connection between level of inflation and bank profitability is stayed to be far from being obviously true. The course of the relationship isn't clear (Vong and Chan, 2009).

2.4 Empirical Studies

Empirical literature on Islamic products and financial performance literature has addressed banking and other financial issues as well as financial development and its indicators and how they relate to and affect financial performance. Globally, Imam and Kpodar(2015) sought to answer the question: is Islamic banking good for financial performance? From the study it was noted that financial development is widely favorable for financial performance and the research then sought to determine whether the same would be said for

Islamic banking. The findings of the research were that despite its comparably small size, Islamic banking products is linked with the financial performance positively even after managing several determinants like level of financial depth.

Celebi, Hassan and Zirek (2015) examined the correlation between size of Islamic banking, Islamic investment, Islamic banking deposit and economic growth in member states of Organization of Islamic Cooperation. The study used a balanced panel comprising of 16 nations with 13 years of annual data in the panel. Fixed impacts managing for autocorrelation and heteroscedasticity was applied to see the contemporary impact of Islamic banking variables on real GDP growth rate. Islamic deposit, Islamic investment and Islamic size variables were found to positively and considerably explain real GDP growth rate at 1% considerable rate. Impulse response functions and variance decomposition were identified as to show the extent and importance of this impact in the long run.

Abduh and Omar (2012) studied Islamic banking and financial performance in Indonesia. The study purposed to assess the long-run and short run correlation between economic growth and Islamic banking development in the case of Indonesia. The study found a considerable correlation between Islamic banking and financial performance. This relationship was established to be two way with Islamic banking positively influencing financial performance in the short-run and financial performance having a positive effect on Islamic banking in long-run. The relations between Islamic banking and financial performance according to this study is bi-directional.

Ogola(2016) studied the impact of financial development on financial performance in Kenya. From the study financial development, mainly involving the banking sector affects the construction, retail and wholesale, information and communication, and finance and insurance sectors. The study examined the effect of financial development on financial performance and also investigated the direction of causality between the two. The study used Pooled OLS, Fixed Effect random effect model. The study used panel data for the period 2007 to 2015, that was retreived from the Central Bank of Kenya. The results suggested presence of a relationship from financial development to financial performance. Financial development is seen to promote economic growth but financial performance has no effect on financial development. The study also found that policies enhancing the financial development can help promote financial performance.

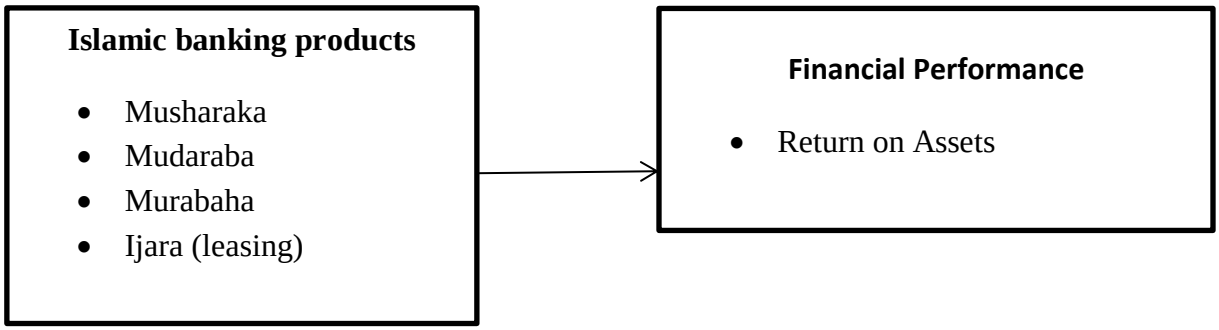
Olonje (2014) evaluated the correlation between financial market development and financial performance in the East African community. The population under study was the five official members of EAC: Kenya, Uganda, Tanzania, Rwanda and Burundi for a six year period between 2008 and 2013. According to the study, higher financial development mobilizes higher savings mobilization and the allotment to return high projects. Secondary data for the 6-year period was collected and data analyzed using SPSS Version 20 whereby multiple regressions were employed. The findings suggested that 19.4% of variations in economic growth in EAC are explained by variations in the five financial development indicators under study. The findings indicate positive relationships between market capitalization, money growth and economic growth and negative relationships between ratio of credit to private sector to GDP levels, levels of nonperforming loans and interest rate spreads to GDP.

2.5 Conceptual Framework

Through assessing the literature review, conceptual framework aiding in understanding the connection between the examination variables can be developed. The independent variable was studied in terms of Islamic banking products. On the other side, the dependent variable was majorly discussed in terms of Return on Assets.

Figure 1: Conceptual Framework

Independent variable



2.6 Summary of Literature Review

This chapter has reviewed three theories that relate Islamic banking products and financial performance. The financial intermediation theory explains how Islamic banking through provision of capital for investments in terms of loans is beneficial to financial performance of banks. This is the same case with the fractional reserve theory but this theory goes further to explain the effect of the banking system as a whole on financial performance through creation of money.

The neoclassical theory, though gives other factors that affect economic growth does not leave out the need for capital accumulation in fostering economic growth. The chapter goes ahead to explain other determinants of economic growth. Empirical studies on financial development indicators among them banking and economic data have also been reviewed. These studies do not however agree on the causality of Islamic banking and financial performance.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section details research procedure utilized by researcher to conduct research. The research methodology includes the design of research, target populace and design, data collection and analysis instrument and procedures.

3.2 Research Design

Research design is normally seen as the fabric that grasps all factors in the process of research project. A design is utilized in structuring the research, showing the research project's major parts work together and tackle the primary research questions. Every item being considered in any inquiry field makes up the 'universe' or 'population'.

This study used a case study and adopted a descriptive research design. In order to meet this study objective, case study was used which enabled the researcher to collect in-depth secondary data that enabled the researcher meet the objectives of the study. A case study was chosen due to its emphasis on detail (Cooper, 1995).

3.3 Population of the Study

A complete individual, case or objects set with some common features is referred to as a population (Mugenda & Mugenda, 2003). The study collected data from two fully developed Islamic banks in Kenya, that is, First Community Bank Limited and the Gulf African Bank.

3.4 Data Collection

The study utilized secondary data which was gathered from financial statements of the Islamic banks indicated above. Islamic banking was introduced in Kenya in 2008. Secondary data covered a period of five years from 2012-2016.

3.5 Data Analysis

Once data is collected, secondary data was analyzed using descriptive analysis. Descriptive analysis was employed. The Statistical Program for Social Sciences adaptation (SPSS) and excel were used as the fundamental computer technique in analyzing the data. To summarize the data, descriptive statistics was largely put to use. This included frequencies and percentages. Diagrams such as tables and pie diagrams were used where suitable to present the collected data for simplicity of analysis and understanding. Inferential statistics such as multiple regressions and Pearson correlation was used. To determine the nature of relationship between independent variables and the dependent variable, multiple regressions was used

3.5.1 Analytical Model

$Y = \alpha + X_1\beta_1 + X_2\beta_2 + X_3\beta_3 + X_4\beta_4 + \varepsilon$

Where: Y= Financial Performance was Measured by (Return on Assets)

α= constant term (The Y intercept)

Beta (β) = Beta coefficients

ε= Error term.

X_1 = The amount of Musharakah (partnership) used in Financing contracts

X_2 = The amount of Murabaha (Cost Plus Financing) used in Financing contracts

X_3 = The amount of Mudaraba (finance by way of trust) used in Financing Contracts

X_4 = The amount of Ijara (Leasing) used in Financing contracts

3.5.2 Diagnostic Tests

The F test was used to test the statistical significance.This was done so as to the overall importance of the model. In testing the importance of the coefficients at 5% level of significance level, t – test was used.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

The analyses and presentation of the study as set out in the research methodology. are documented in this chapter. This section is in line with the study objective. This study covered a period of five years 2012 to 2016.

4.2 Descriptive Statistics

Measurement of the study variables was done through ccorrelation analysis between the study independent variables financial indicators which include growth in Musharakah (partnership) Financing contracts, Murabaha (Cost Plus Financing) Financing contracts, Mudaraba (finance by way of trust) Financing Contracts and Ijara (Leasing). Consequently, descriptive statistics of the collected data was analyzed using excel analysis tool Pack and the summary of the findings is presented in the in table 4.1 below

The amount of Musharakah (partnership) used in Financing contracts

X_2 = The amount of Murabaha (Cost Plus Financing) used in Financing contracts

X_3 = The amount of Mudaraba (finance by way of trust) used in Financing Contracts

X_4 = The amount of Ijara (Leasing) used in Financing contracts

4.2.1 Musharakah (partnership) Financing contracts

The researcher examined the amount of Musharakah financing contracts from the year 2012 to 2015. The findings are shown in the table below.

Table 4.1 Total amount of Musharakah Financing

	Mean	Std deviation
2012	2,717,324	0.078
2013	3,986,940	0.124
2014	6,487,347	0.118
2015	6,778,249	0.091
2016	7,236,051	0.086

Source: Research findings

From the findings the year 2012 recorded the least value of Musharakah used in financing contracts as shown by 2,7717.324 while 2016 recorded the highest amount of Musharakah value used in financing contracts as shown by 7,236,051, in addition, values for standard deviation depicts variability in amount of Musharakah used in financing during the five year period with the highest deviation of 0.124 in the year 2013 and the lowest at 0.078 in the year 2012, the findings revealed that there has been a significant increase in the amount of Musharakah used in financing during the five -year period.

4.2.2 Murabaha (Cost Plus Financing) used in Financing contracts

Table 4.2 Murabaha used in Financing contracts

	Mean	Std deviation
2012	3,457,637	0.325
2013	12,227,433	0.052
2014	19,414,513	0.018
2015	21,341,050	0.051
2016	253,172,326	0.323

The findings revealed that the year 2012 recorded the least amount of Murabaha used in financing contracts at 3,457,637, in the year 2016 the highest amount of 253,172,326 was used to finance Murabaha. In addition, standard deviation values reflect variability in amount of Murabaha used in financing during the five year period with the highest deviation of 0.325 in the year 2012 and the lowest at 0.018 in the year 2014, the findings revealed that there has been a significant increase in the amount of Murabaha used in financing during the five year period.

4.2.3 Mudaraba (finance by way of trust) used in Financing Contracts

Information on Mudaraba consumed between the year 2012 was sought and the findings presented in the table below.

Table 4.3: Mudaraba financing Years

	Mean	Std deviation
2012	4,397,334	1.260
2013	5,251,978	0.071
2014	6,646,754	0.0360
2015	7,681,379	0.0330
2016	7,987,178	0.0081

Table 4.3 shows the amount Mudaraba financing from 2012 to 2016. The table shows the lowest amount of Mudaraba recorded was 4,397,334 in the year 2012, while the highest amount recorded was 7,987,178 in year 2016. The values of standard deviation show variation of Mudaraba consumed by financing contracting. The highest level of variation recorded at 1.260 in the year 2012, while the lowest variation was 0.0081 in the year 2016. The findings reveal that there has been a steady rise in the amount of Mudaraba used in

financing during the five year period.

4.2.4 Ijara (Leasing) used in Financing contracts

Table 4.4: Ijara financing Years

	Mean	Std deviation
2012	99,439	0.233
2013	109,238	0.022
2014	147,433	0.0131
2015	165,497	0.271
2016	244,868	0.079

From the findings, it was revealed the years 2012 recorded the lowest amount of Ijara used in financing as shown by 99,439 while 2016 recorded the highest amount of Ijara used in financing contracts as shown by 244, 868, in addition, values for standard deviation depicts variability in amount of Ijara used in financing in the five year period with highest deviation witnessed in year 2015 and the lowest being in year 2013 at 0.022. The findings revealed that there has been a significant increase in the amount of Ijara used in financing during the five year period.

4.3 Inferential Statistics

4.3.1 The Effect of Islamic Bank Products on Financial Performance

Table 4.5 Correlation Analysis

	ROA	partnership	Cost Plus	finance by trust	Leasing
ROA	1				
Musharaka	0.378	1			
Murahaba	0.479	0.254	1		
Mudaraba	0.354	0.281	0.467	1	
Ijara	0.483	0.294	0.418	0.314	1

Findings in the table above indicate that there was a strong positive correlation between ROA for Islamic banks in Kenya and Mishawaka financing (partnership). There was a strong positive correlation between ROA for Islamic banks in Kenya and Mudaraba financing (Cost plus Financing). There was a strong positive correlation between ROA for Islamic banks in Kenya and Murabaha financing (finance by way of trust). There was a strong positive correlation between ROA for Islamic banks in Kenya and Ijara financing (Leasing). This is an indication of a strong correlation an indication that Islamic bank products lead to improved business financial performance.

4.3.2 Regression Analysis

To test the effect among predictor variables, multiple regression analysis was conducted. The dependent variable is ROA for Islamic banks in Kenya while the independent variable

is Islamic financial products. In order to code, enter and compute the measurements of the multiple regressions, statistical package for social sciences (SPSS V 21.0) was used.

$$Y = \alpha + X_1\beta_1 + X_2\beta_2 + X_3\beta_3 + X_4\beta_4 + \varepsilon$$

Where: Y= Financial Performance was Measured by (Return on Assets)

α= constant term (The Y intercept)

Beta (β) = Beta coefficients

ε= Error term.

X_1 = The amount of Musharakah (partnership) Financing contracts

X_2 = The amount of Murabaha (Cost Plus Financing) Financing contracts

X_3 = The amount of Mudaraba (finance by way of trust) Financing Contracts

X_4 = The amount of Ijara (Leasing) Financing contracts

α = Constant

$\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$ = Regression coefficients or change included in Y by each X value

ϵ = error term

The dependent variable is ROA for Islamic banks in Kenya ratio of the banks whereas the independent variables are the Islamic financial products.

Table 4.6: Model Summary

Relation between Islamic banking products and ROA for Islamic banks in Kenya

Regression Statistics	
Multiple R	0.374583
R Square	0.439888
Adjusted R Square	0.457697
Standard Error	0.004509
Observations	4

Through Coefficient of determination, the extent to which changes in the dependent variable can be explained by the change in the independent variables is expressed. It also explains the percentage of variation in the dependent variable. This is explained by all the four independent variables.

To evaluate model fit, R-Squared is a commonly used statistic. R-square is 1 minus the ratio of residual variability. The adjusted R^2 entails the percent of the variance in the dependent explained uniquely or jointly by the independent variables. 46% of the ROA for Islamic banks in Kenya in could be attributed to the combined effect of the predictor variables.

Table 4.7 Summary of One-Way ANOVA

	Df	SS	MS	F	Significance F
Regression	1	0.00095	2.39E-05	3.920	0.3356
Residual	5	0.00059	2.11E-05		
Total	6	0.00154			

To establish the significance of the regression model, One-way ANOVA was used from which a probability value of 0.3356 was recorded. This indicates that the regression relationship was highly significant in predicting how adoption of Islamic banking products affects financial performance of Islamic Kenya. The F calculated at 5% level of significance was 3.920. Since F calculated is greater than the F critical; this shows that the overall model was significant.

Table 4.8 Regression Coefficients results

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	-0.6194	0.1065	5.8177	0.0000	0.4013	0.8374
Musharaka	0.0720	0.0953	-0.7551	0.4565	-0.2672	0.1233
Murahaba	0.0693	0.0434	-1.5968	0.1215	-0.1581	0.0196
Mudaraba	0.0297	0.0676	-0.4393	0.6638	-0.1681	0.1088
Ijara	0.0048	0.6887	-0.2161	0.8304	-1.5595	1.2618

The established regression equation was;

$$Y= -0.6194 +0.072X1+0.069X2+0.03X3+0.004X4 +e$$

The regression equation above has established that holding all other factors constant (no implementation of Islamic financial products) ROA for Islamic banks in Kenya of ROA for Islamic banks in Kenya would be -0.62. The findings presented also show that taking all other independent variables at zero, a unit increase of Musharakah (partnership) Financing contracts would lead to an increase in ROA for Islamic banks in Kenya by 0.072. A unit increase in Murabaha (Cost plus Financing) financing contracts would lead to an increase in ROA for Islamic banks in Kenya by 0 .06972.

A unit increases in Mudaraba (finance by way of trust) Financing Contracts would lead to an increase in ROA for Islamic banks in Kenya by 0.03. A unit increase in of Ijara (Leasing) Financing contracts would lead to an increase in ROA for Islamic banks in Kenya by 0.004. This therefore implies that ROA for Islamic banks in Kenya is positively correlated to financial performance and therefore we conclude that a Islamic banking products enhances financial performance of Islamic Kenya.

4.4 Interpretation of the Findings

The study found out that adoption of Islamic banking products enhances the financial performance of Islamic banks. This was achieved through the regression model. The independent variables that were studied explain a substantial 46% of ROA for Islamic banks in Kenya of as represented by adjusted R^2 (0.46). This therefore means that the independent variables contributes 46% of the ROA for Islamic banks in Kenya while other factors and random variations not studied in this research contributes 54% of the ROA for Islamic banks in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

In this chapter, summarizes and conclusions are comprehensively detailed. The researcher further provides recommendations in line with the study findings and provides limitations from the study. Lastly suggestions for further research is provided.

5.2 Summary and Findings

Using correlation, regression and ANOVA, Inferential and Descriptive statistics were utilized. This were used so as to establish the significance /fitness of the model and also to establish the link between the study dependent and independent variables. The research findings indicate that that Islamic banking product enhances business financial performance of Islamic banks in Kenya.

The research investigated the relationship between amount used in Musharakah by Islamic financial institutions and ROA. The research findings showed an evidence of positive correlation between Musharaka financing and the performance of Islamic financial institutions. The coefficient of variation revealed that any further investments by Islamic financial institutions on Musharakah financing would lead to increase in return on assets by a factor of 0.072. The study also established that clients preferred Musharaka, because each partner has a privilege to participate in the management.

The study established a strong relationship between Mudaraba means of financing and financial performance of Islamic banking institutions. The coefficient of variation showed

that a unit increase in Mudaraba financing by IFI, would lead to an increase in Return on Assets by a factor of 0.069. In a mudaraba transaction, while the Entrepreneur only provides his labor, the capital owner (Rabb-ul Mal) provides all finance needed. At the end of transaction; in case of profit, profit is shred to parties according to the ratio that was. In case of a loss; the loss is only bore by the capital owner bears, entrepreneur pays nothing. The findings are in line with the call by Usmani (1998) in the process of Islamization of the economy, instrument should be used as a transitory step taken.

The study found a positive correlation between return on assets and Murabaha financing as shown by correlation coefficient of 0.354, the study revealed that further investments in unit change in Murabaha financing by IFI would lead to an increase in return on assets by a factor of 0.03.

The study found that there was positive correlation coefficient between return on assets and Ijara financing, as shown by correlation factor of 0.483, the research also established that a unit change in Ijara financing, while holding the other factors constant would lead to an increase in Return on Assets by a factor of 0.004. Further it was revealed that Ijarah should be Shariah-compliant and does not involve interest bearing contracts. Islamic leasing is suitable for some sectors of the economy given that it provides a major potential fpr securitization. This is evident in both the the public sector and consumers sector. It takes care of projects related to infrastructure building in the public sector, e.g., airports, roads, irrigation systems, schools, bridges and hospitals, etc. Further the study established that Lease finance has good features of debt finance. No agency relationship between the lessee and lessor exists, as evident in mudarabah (profit sharing).

5.3 Conclusion

The study concludes that Islamic banking products lead to improved financial performance of Islamic banks Kenya. Financial performance is the most significant challenge to Islamic banks since other commercial banks have since been licensed to offer Islamic banking products. The study found a positive correlation between financial performance of IFIs and Islamic financial instruments which include Musharakah financing, Mudaraba financing, Murabaha financing and Ijara financing, Thus the study concludes that all the Islamic financial instruments had a positive impact on the performance of commercial Banks in Kenya.

5.4 Recommendations for Policy and Practice

In line with the objectives of this study, the following recommendations can be deduced from the conclusions of the research: In order to aid the development of Islamic Banking in Kenya and reap the most benefit for the country, a legislative framework should be put in place to enhance the regulation of the industry. This means both the Central Bank Act as well as Banking Act should be amended to incorporate Islamic Banking concepts.

The study recommends that organizations should focus on adopting Islamic banking products so as to improve organizational performance through increasing customer base, asset quality, quality of service and increased market share. The study recommended that strategies on Islamic banking adoption should be formulated so as to achieve organization goals. There should be effective strategies focusing on Islamic banking products that cater for the organization goals, clients' needs and changes in the environment.

Given that customers are key assets in the success of organization, the study recommends that they should be treated well. Organization strategies should focus on quality of service. Organization strategies should be flexible to changes in the external environment and should be continually evaluated through frequent competitor analysis, SWOT analysis, stakeholder opinion polls and ensuring adherence to corporate governance practices if business financial performance is to be continually enhanced.

A National Shari'ah Supervisory Board should be constituted to guide a process of Ijtihad led standardization and convergence of products, set qualification and certification of Banks' Shari'ah Board members and set rules for Shari'ah control. The Central Bank should constitute a Shari'ah Advisory Board that will add value to its regulatory relationship with the Islamic Banking industry. Active restructuring of the government public debt to include sukkuk components in order to allow for active participation of Islamic Banking industry in Kenya.

5.5 Limitation of the Study

Data collection was extremely tedious and time consuming. Given the limited study duration, Comprehensive and exhaustive exhaustive research could not be carried out. The study, however, minimized these by conducting in-depth analysis that significantly covers the shortcomings of the study. Further, the data was tedious to collect and compute as it was in very raw form. Further the presentation of the data was varied which made the data computation even harder.

The researcher did not overlook the major limitation of descriptive research design which is that the design makes it difficult to explain phenomena that occur over time, hence the study's findings are only applicable to the study's time frame. This makes it difficult to explain phenomena that occur over time, hence the study's findings are only applicable to the study's time frame. It was difficult to access secondary data due to strict confidentiality exhibited by most banks. The annual financial statements are also prepared under the fundamental assumptions and concepts which are subjective and therefore not be uniformly applied especially in terms of provisions and estimates.

Lastly, given that financial statements are disclosed in the preceding years, material misstatement may occur. This provides an opportunity window for prior year's adjustments and can be brought to public attention. This therefore signifies the pattern depicted may affect the relationship established.

5.6 Suggestion for Further Research

This study concentrated on the effect of Islamic banking products on financial performance in Islamic banks in Kenya. The findings cannot be generalized because other banks and sectors face varied challenges such a political interference, government legislations, currency fluctuations in the international market. There is therefore need to do more research in other sectors in order to get a broader view. The research therefore should be replicated in other conventional banks that have opened Islamic windows in order to meet the requirements of the consumers and to retain their customers such as Barclays bank, Chase bank and consistency need to be determined through comparison of results.

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Appendix I: Data Collection Schedule

	Amount invested '000'				
Year/ Performance measure	2016	2015	2014	2013	2012
Net assets					
Net income					
Amount of Musharaka financing					
Amount of Mudaraba financing					
Amounting of Murabaha financing					
Amount of Ijara financing					