FACTORS INFLUENCING DEVELOPMENT OF ISLAMIC BANKING IN KENYA

BY

ADANO SALAD KADUBO

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (MBA), SCHOOL OF BUSINESS,

UNIVERSITY OF NAIROBI

OCTOBER, 2010

DECLARATION

This management research project is my original work and has not been submitted for a degree in any other University.

DATE *J I*

lMl.ll.1°.!..*

Adano.S. Kadubo

D61/70143/2009

This management research project has been submitted for examination with my approval as the University supervisor

SIGNEJ>—\ DATE

Dr. Josiah Aduda

Department of Accounting and Finance

School of Business

University of Nairobi

DEDICATION

To Asha my wife, the love of my life and bedrock of my family who encouraged me to complete this project. To my daughter Zulekha, My sons: Bilal and Abubakar for their love, psychological support and patience during this project.

ACKNOWLEDGEMENTS

At the outset, all praise be only to Allah (Almighty God), the omnipotent to accept this effort and to consider it for his sake only without whose grace this work would have not been accomplished.

I would like to express my profound thanks to Dr Josiah Aduda, the chairman of finance and accounting department at University of Nairobi, for patiently supervising the whole of the research work and frequently providing guidance throughout my period of study. I am deeply grateful for his invaluable assistance and encouragement during his supervision.

I wholeheartedly appreciate the entire teaching fraternity at University of Nairobi with whom I interacted with during my program of study. Their dedication, commitment and passion to learning have been truly inspirational. My heartfelt appreciation is extended to all the respondents and every one else who encouraged and helped me to complete this study specially my cousin Abdi Abudo who assisted in distribution and collection of the questionnaires.

I owe my greatest debts and thanks to my beloved wife Asha, my daughter Zulekha and my sons: Bilal and Abubakar for their truly extraordinary patience and emotional support during my study.

ABSTRACT

The purpose of the study was to investigate the factors influencing the development of Islamic banking in Kenya.

The research designed for study was a case study approach focusing on four Islamic compliant banks in Kenya. These are: - First Community Bank; Gulf African Bank; Dubai Bank; Kenya commercial Bank Ltd and Barclays Bank Ltd.

The population of the study consisted of 33 customers, who were the holders of accounts in the respective banks and 11 managers. Sample data collected by use of questionnaires administered by the researcher and a research assistant. Data analysis method used is based on the quantitative approach using descriptive statistics: mean, mode, and median. Frequency tabulations and cross tabulations were used to bring out the finding of the study.

The study revealed Islamic banking compliant was driven by religious compliance and customers need being met. It also revealed that continuous review and improvement of shari'ah compliant products together with diversifying market niche will lead to drastic development and marketing of Islamic banking products.

From the study the following conclusions were drawn: firstly, the factors that influence development of Islamic banking products in Kenya are purely religious compliance and customers need being met.

The study made recommendation as follows; firstly, though the uptake of Islamic banking products in Kenyan market was good, the rate of growth especially conventional

banking with Islamic window has been too slow and currently controls 0.8% of the market share. Further research is required to establish factors that contribute to this slow pace of growth of Islamic products in Kenyan market.

TABLE OF CONTENTS

/

LIST OF TABLES

LIST OF FIGURES

/

ABREVIATIONS

AAOIFI - Accounting and Auditing Organization of Islamic Financial Institutions

AMFI - Association of Micro Finance Institution

ANOVA - Analysis of Variance

CBK -Central Bank of Kenya

CGAP - Consultative Group to Assist the Poorest

CSR - Corporate Social Responsibility

FCB -First Community Bank

GCC - Gulf Cooperation Council

KBA -Kenya Bankers Association

KYC - Know Your Customer

MFI -Micro Finance Institution

PLS - Profit Loss Sharing

SPSS - Statistical Package for Social Sciences

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Study

There is no satisfactory definition of a bank and term bank, as such, may apply to an organization, a financial institution operated by an individual as sole proprietor, partnership, a corporation or other type of association, in modern use it is an establishment for the custody of money (Saddiqi, 1986).

One definition of an Islamic Bank is a bank that, by its own choice, opts to comply with two sets of law: the law of the Land (Jurisdiction); and the Islamic Law (Shari'ah). This is why Islamic bankers have two types of legal counsel: traditional "lawyers" and "Shari'ah Councils" (Al-Bahar, 1996). As Islamic finance is intertwined within its religion, the basis of the religion affects the finance in two important ways: "Islam aims at building a socio-economic order based on justice and considers economic activity as a means to an end and not an end in itself. It enjoins Muslims to harness natural resources, which are a trust from Allah(God) , for carrying out rightful activities; but abhors exploitation and man-made inequalities of income and wealth." "Islam is deeply concerned with the problem of economic development, but treats this as an important part of a wider problem, that of total human development. The primary function of Islam is to guide human development on correct lines and in the right direction. It deals with all aspects of economic development but always in the framework of total human development and never in a form divorced from this perspective" (Al-Harran, 1993).

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shari'ah, known as Fiqh al-Muamalat (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba (usury/interest). Common terms used in Islamic banking include; profit sharing (Mudharabah), safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijarah).In an Islamic mortgage transaction, instead of loaning the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the bank's profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. This arrangement is called Murabaha. Another approach is Eljara wa Elqtina, which is similar to real estate leasing. Islamic banks handle loans for vehicles in a similar way by selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid (Kahf, 2004).

An interest free Islamic bank in relation to its clients plays the role of partner, investor and trader. The interest free modes of operation designed by Islamic financial institution s satisfy the criteria 'God permits trading and forbid riba". Keeping in view of the Islamic injunctions against taking and giving of interest, the Islamic banks have organized their operations on the basis of profit /loss sharing which is permitted in Islam .Islamic banks accept demand deposits and time deposits. Demand deposit are fully repayable on demand and do not get any return, holder of time deposits are given a share in the profit earned by the bank according to a profit sharing rates made known in advance. Echoes in

favor of interest free banking are coming from religious proposals appeal on the basis of similarity in the fundamental economic teaching of Islam, Judaism and Christianity. Secular recommendations are based on soundness of interest free banking and anticipation of crisis in conventional banking system, no doubt interest is a source of increasing problems for governments, consumers, corporations, real estate owners, farmers and banks alike in the United States. Western has shown their confidence in the soundness and viability of interest free banking and its prospects (Anwar, 1989).

Unlike positive economics, the entire edifice of Islamic economy is built upon a set of objectives or maqasid. In other words, Islamic economics is normative in nature with the objective of the Shari'ah being to promote the well being of all mankind which lies in safeguarding their faith, their human self, their intellect, their posterity and their wealth. /

At the micro level, the precepts of profit maximization and utility maximization are retained intact but are supplemented by a set of interlinked objective functions. Islamic system tries to promote a balance between market, family, society and the state. It does so by promoting both the material and the spiritual urges of the human self, foster peace of mind, enhance family and social solidarity. Some western thinkers and anti-globalization activists decry the western economic model as being suppressive of collective human rights, community and social well being, disruptive of family values and too much focused on selfish individual interests. Behavioral economists were already challenging the assumption of rationality in the choices and preferences an individual makes in day-to-day life. The 2008-09 global financial crisis has put to serious question the rationality assumption that underpins the modern capitalist system. Thus, the merit of Islamic

economic model therefore lies not only in its extension but also in overcoming weaknesses and deficiencies of the western model in fundamental and beneficial ways. It introduces into the objective function an additional argument that keeps self-interest within the bounds of social interest by limiting individual preferences to conform to social priorities and eliminating or minimizing the use, of resources for purposes that frustrate the realization of the social vision. This may help promote harmony between self-interest and social interest and put at rest the current tension between individual utility maximization and achievement of collective good (Husain, 2010).

The major characteristics of the Islamic bank are: being part of a faith-based system, it is obligatory on Islamic banks that they do not pursue activities that are detrimental to the society and its moral values. Thus, Islamic banks are not allowed to invest in casinos, nightclubs etc. It is pertinent to note that casinos are one of the prime vehicles used for money laundering and dealing with them could expose the conventional banks to such risk. The second distinguishing feature of the Islamic banking is that in addition to the rules and regulations applicable to the conventional banks, the Islamic banks have to go through another test i.e. fulfill exhaustive requirements to be Shari'ah compliant. This requires that the clients of Islamic banking must have business that should be socially beneficial for the society creating real wealth and adding value to the economy rather than making paper transactions. Therefore, a stringent Know Your Customer (KYC) policy is inherently an inbuilt requirement for an Islamic bank since the Islamic bank has to know the customer and his business before getting into a socially responsible Shari'ah compliant transaction. KYC is the first line of defense against money laundering in any banking system. Third, by their very nature, Islamic mode of financing and deposit taking

discourages questionable/undisclosed means of wealth that form the basis of money laundering operations. The disclosure standards are stringent because the Islamic banks require the customers to divulge the origins of their funds in order to ensure that they are not derived from un-Islamic means e.g. drug trade, gambling, extortion, subversive activities or other criminal offences. On the financing side, the Islamic banks must ensure that funds are directed towards identifiable and acceptable productive activities. Most Islamic financing modes are asset backed, i.e. they are used to finance specific physical assets like machinery, inventory, equipment, etc. In addition to above, and the role of the bank is not limited to a passive financier concerned only with timely interest payments and loan recovery. The bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. In the case of loss in business, the Islamic financier has to share that loss. To avoid the loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele (Ilusain 2010).

Islamic banking started with personal initiative of the concerned Muslims to address the problem for riba. The pioneers included committed and resourceful individuals, professional bankers, Islamic economists and religious scholars. There was no initial working model to act upon, except the thought that interest-based banking might be replaced by banking on profit-and-loss sharing basis. This effort took place when the financial system at large, as also the regulatory environment, was riba based. Things changed in the late seventies and in the early eighties with recognition at the state level for the need to develop riba-free financial system in Iran, Sudan, Pakistan and Malaysia. In the meantime, Islamic bankers also organized themselves through international Association of Islamic Banks. This was soon followed by establishment of AAOIFI for

achieving standardization in Islamic banking practices. The current position is that there are more than 200 Islamic financial institutions all over the world; the annual growth rate of Islamic banking industry worldwide is more than 16%. In some Muslim countries, total or partial transformation has taken place in favor of Islamic banking. Islamic banking has also gained approval by international financial institutions, professional bankers and the academia. Central banks of several Muslim countries have jointed hands in order to give it an international standard. Some issues are identified here that may help consolidation and growth of Islamic banking (Sayyid, 2003)

The core belief of Islamic banking stems from a divine injunction against the acceptance of interest between buyers and sellers of capital resource. Such injunctions are based on compliance with Islamic jurisprudence or Shari'ah extracted from the holy Al-Qur'an and Al-Sunnah. The Shari'ah specifies, inter alia, rules that relate to the allocation of resources, property rights, production and consumption, and the distribution of income and wealth. These injunctions are historically and ethically linked, as interest creates social divisions between the rich and the poor and especially causes hardship to borrowers. This is so because the lender is seen to be exploiting other people's needs without actively using to advantage the productive nature of the capital in question. Islamic banking advances the following set of beliefs: interest as a reward for saving does not have any basis as a moral foundation. Abstinence from spending of present income does not deserve a financial reward; and to benefit from money is to transform the money into investments, conditioned to accept risks and bringing the knowledge of other factors of production together (Presley, 1988).

In their short period of existence, Islamic banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. Currently there are two Islamic banks operating in Kenya: Gulf African and First Community bank that had a loan portfolio of 4.9-billion shillings, deposits totaling 7.5billion shillings and 27270 deposit accounts. These indicators point to the tremendous potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population of 36-million (Muriri, 2009).

Ndung'u (2008) reported that Barclays' La Riba account was the first-ever Shari'ah-compliant account in Kenya. The account was set up in December 2005. However, Kenya's first Islamic bank. First Community Bank (FCB) was granted a banking license in May 2007. The bank started operations in November that year. Apart from FCB, Gulf African Bank is the other bank in Kenya with a licence to operate as a full Islamic bank. Both of these banks have large GCC shareholders. Other banks in Kenya are increasingly applying to include Islamic windows in their businesses. Three other banks have shown interest to open Islamic windows and the central bank is in discussions with them, he added.

CBK (2010) CBK is working on a framework that will eventually lead to the flotation of sharia compliant bonds and treasury bills in the local money market. The moves to entrench Sukuk bonds and the bills in the law are seen as a push by CBK to tap the increasing amount of cash flowing into Africa from the Gulf region. Sukuk bonds that are structured to be in compliance with Shari'ah law which bars payment of interest have

seen rapid uptake in recent years as more and more businesses and governments have used them to raise financing. These bonds has a maturity that is determined in advance and is backed by an asset which makes it possible for the investor to earn a return from the profits derived from the assets. Much of this activity has taken place in the Gulf and South East Asia so far, and analysts believe a government issue could be the key that Kenya needs to place it as the premier Islamic finance hub in the region.

1.2 Statement of the Problem

The study carried out by Gerrald in the year 1997 found that: Islamic religious belief and social responsibility are the two most important factors that determine bank selection. Cost benefit is the third most important factor considered in bank selection. Clients of conventional and Islamic banks share a number of motives, but they differ significantly on a few motives in relation to bank selection, the clients of Islamic banks are more familiar with the products/services that conform to the Shari'ah.

However, the study by Erol and El-Bdour (1989) contradict the findings of other studies and argue that religious motivation did not appear to play a primary role in bank selection. Significant number of customers would withdraw their deposits if an Islamic bank did not generate sufficient profit to make a distribution in any one year hence motivated by higher dividend payments instead.

Further, the results of the study by Oundo (2009) suggested that there was poor supply of SharPah-compliant products in Kenya's financial institution. The challenges in the supply side of Shari'ah compliant financial services was illustrated by one bank that wrote Cheques to suppliers for their Muslim clients who were uncomfortable with

receiving credit in cash against the Shari'ah. There was high demand for Islamic financial products against a negligible supply of the same meaning that Islamic finance clients had few options (if any) and financially neglected by the microfinance sector.

According to Ndungu (2010) Kenya was the first country in the East and Central African region to introduce Islamic banking in the year 2007. In this short period, two banks were licensed to exclusively offer Shari'ah-compliant products with many other conventional banks establishing a window specifically for Shari'ah-compliant products. He noted that the concept of shari'ah complaint banking has emerged as an alternative vehicle for mobilization and supply of finance. For example, the two banks have already contributed in development agenda of the country by participating in Shari'ah-compliant (Sukuks) components of infrastructure bonds issued by the Central Bank of Kenya on behalf of the Government of Kenya and "Structured Sukuk" is expected to cover the bonds and T-Bills / market in future. However, although the concept of Islamic Finance has generated a lot of interest and overwhelming support from both Muslim and non-Muslim population in Kenya, as a regulator, CBK has faced by certain challenges which need to be addressed.

In their short period of existence, Islamic banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. Currently there are two Islamic banks operating in Kenya: Gulf African and First Community bank, which had a loan portfolio of 4.9-billion shillings, deposits totaling 7.5billion shillings and 27270 deposit accounts. These indicators point to the tremendous potential of this market niche, which has been

previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population of 36-million (Muriri, 2009).

To address the above challenges highlighted by Central Bank of Kenya, this study seeks to establish factors influencing the development of Islamic banking in Kenya.

1.3 Objective of the Study

The purpose of the research was to investigate the factors influencing the development of Islamic banking in Kenya.

1.4 Significance of the Study

The study will create a better understanding on the main factors that highly contribute to success of Islamic banking in commercial Banks in Kenya. Therefore, this study will be of importance to commercial banks in Kenya in their endeavor to grow their Islamic banking portfolio hence increasing their profitability. To customers' who are in need of Islamic compliant products from banks , Government and regulatory institutions such as the Central Bank of Kenya (CBK), Kenya Bankers Association (KBA) and Association of Micro Finance Institutions in Kenya (AMFI) in understanding the operations of Islamic Banking requirements also the extent to which they can sustain the market segment and contribute to the literature of what is known about Islamic banking in Kenya.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter will first presents review of theoretical issues, practices and empirical studies underlying factors influencing development of Islamic banking. The chapter will finally conclude by providing theoretical solutions to the factors influencing development of Islamic banking.

2.2 Islamic banking instruments: theory and practice

The Islamic banking model primarily relies on the instruments of mudarabah (joint venture) and musharakah (equity participation) to eliminate interest from the financial sector and economy. Other interest-free instruments such as murabaha (deferred payment sale), ijarah (leasing), bai Salam (advance payment) and bai istisna (procurement engagement) are also used to enhance the practical scope, diversification and risk management capabilities of the Islamic banking system.

2.2.1 Profit and loss sharing (PLS) Theory

Islamic scholars treat PLS instruments, mudarabah and musharakah as a central pillar of the Islamic banking model. In mudarabah banking, the Islamic bank accepts funds from depositors under risk-sharing arrangements. The Islamic bank either directly invests these funds in profitable investments or extends them to entrepreneurs on a risk-sharing basis. The Islamic bank shares the profit or loss made on mudarabah ventures with its

depositors. In musharakah banking, the Islamic bank contributes the depositors' funds to a joint enterprise with the client (an entrepreneur). Generally, the Islamic bank allows the client to manage all the affairs of a Musharakah business. The Islamic bank and the client mutually share the profit or loss made on the Musharakah investment.

In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS, especially in case of Mudaraba that does not provide any control rights to the financier (the Islamic bank in this case). Fiqh literature on this issue is quite out-of-date and needs serious reconsideration. For example, Saleh (1986) lists three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower.

The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract. The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. There is a need for construction of standardized PLS contracts, or bylaws, in the light of the legal frameworks of Muslim

countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

2.2.2 Murabaha (deferred payment sale): theory and practice

Under the Murabaha arrangement, the client makes a promise to buy specified goods from the Islamic bank on a deferred payment basis. The Islamic bank purchases goods from the original supplier and sells them on to the client after adding its own profit margin. The legality of murabaha could not be established from the primary sources of Islamic Shari'ah, i.e. the holy Quran and Sunnah. The early Islamic jurists, such as Imam Malik (796) and Imam Shafi (820), approved murabaha sales but they did not refer to the increase in price in the case of deferred payment. Subsequently, certain other Islamic jurists, such as Sarakhsi (1091), Marghinani (1197) and Nawawi (1277), allowed the seller to charge a higher price in the deferred payment sale by characterizing it as a normal trade practice (Saadullah, 1994; Vogel and Hayes, 1998). Contemporary Islamic scholars have mixed opinions about the murabaha banking system. The majority of them have strong reservations about it because of its close resemblance to conventional banking practice.

The practice of murabaha financing grossly violates Shari'ah principles. Islamic banks insure murabaha goods against the risks of damage, destruction and theft, and impose all such costs on their clients (Bashir, 1999; Warde, 2000). They use interest rates to fix

returns on murabaha contracts. They assign higher returns on murabaha contracts with longer periods, just as conventional banking does. They follow the rule: pay now, pay less principal. They recover fines and additional charges from clients who delay murabaha loan repayments. Furthermore, they unlawfully recover losses from clients who breach their promises to buy murabaha goods. Thus, Islamic banks earn almost risk-free returns on their murabaha investments (Khan & Bhatti, 2008).

2.2.3 Ijarah (lease financing): theory and practice

The features of Ijarah financing are very similar to those of conventional lease financing. However, unlike in the conventional lease contract, Shari'ah holds the leaser responsible for all damage, repairs, insurance and depreciation of the leased asset. The leaser should also bear the risk of uncertainty attached to the useful life of the leased asset. Islamic financial institutions mostly rely on leasing, known as Ijarah wa iqtina, for meeting financing needs in the real estate, retail, industry and manufacturing sectors. Leasing enjoys strong support from Shari'ah scholars and bears a close resemblance to conventional leasing (Iqbal, 2000).

2.2.4 Bai Salam (advance payment) and bai istisna (procurement engagement)

Bai salam and bai istisna are forward sale contracts in which the seller pays in advance the price of goods that are to be delivered to him at a specified future date. Bai salam was widely practiced in the Arabian agricultural sector long before the dawn of Islam. These instruments are best suited to meet the financing needs of the farming and manufacturing industries in the Islamic economy. Shari'ah stipulates that the terms and conditions of bai

salam and bai istisna contracts, such as price, quantity and quality of goods, should be clearly determined without involving any features of interest, gharar (speculation) or dubious sale (Iqbal, 2000).

2.3 Empirical Studies:

Amin,(2008) carried out study to investigate the choice criteria for Islamic home financing in Malaysian Islamic banks. Most importantly, this study considers establishing a specific rank of choice criteria for Islamic home financing. Moreover, these choice criteria will also be ranked according to the selected demographic elements such as gender, marital status and age range. He used a quantitative study similar to what was employed by previous researchers. The study presents primary data collected by self-administered questionnaires involving a sample of 150 Malaysian bank customers in Labuan, Malaysia. Of these, 141 questionnaires were returned with a response rate equivalent to 94 per cent. The Islamic home financing choice criteria as perceived by the Malaysian bank customers are analyzed using frequencies, independent samples t-test and ANOVA.

The above study results suggest that "Shari'ah principle", "lower monthly payment", "transparency practice", "interest-free practice" and "100 per cent financing" are the first five decision criteria considered as being very important. The least preferred criteria, among others, are "recommendation", "longer financing period", "product range" and "branch location". Results also suggested that a small number of significant differences are apparent in the importance of choice criteria with respect to gender, marital status and age range.

According to Khan & Bhatti (2008), Islamic banking has made unprecedented progress over recent years. The Middle East, South Asia and the Indian Subcontinent have emerged as hubs of Islamic banking. Western conventional regulators and investors and other agents have also shown a greater interest in and a receptive attitude towards Islamic banking. Despite all this, Islamic banking has been facing some core problems and challenges that will have deep Impact on its future growth and development

The research limitation was that it dealt with concepts, information and other facts on Islamic banking that are not supported by any statistical analysis and empirical evidence. Thus, the research may be regarded as being subjective in its real essence.

Khan & Bhatti (2006) carried out a study to understand the reasons why Islamic banking failed in Pakistan despite lots of efforts being made to implement in contrast to its success in other parts of the world. The study provides a longitudinal view of the issue of replacing the interest-based financial system in Pakistan with an interest-free system by taking the religious, socio-economic and political factors of the country. They found that piecemeal solutions to eliminate interest from the financial sector of Pakistan could never succeed and concluded that all intellectual, practical, political, constitutional and legal efforts undertaken in Pakistan to enforce an interest-free system were not meant in earnest and therefore they inflicted serious damage to the cause of Islam as well as Islamic banking. Interest is prohibited in Islam for its exploitative nature. In case of Pakistan, interest institution is not only deep-rooted, but also strongly interlinked with other exploitative tools that are prevalent in the hands of some selected people to keep their control over political, economic and social spheres of Pakistan. The practical success of interest-free banking and finance movement in Pakistan could not be

materialized unless the state and polity of Pakistan are not convinced seriously to discover the paradigm of their personal and State institution based on Islamic guidance and principles.

The study provides a broader perspective over the issue of eliminating interest from the national economy and financial sector of Pakistan. The study reflects some serious social-political, micro and macro economic constraints that should first be sorted to pave the way for any viable strategy to succeed in replacing the existing system with risk-sharing and alternative interest-free mechanisms. However, the contents of the study woven around normative and social disciplines and therefore, it is not possible to devise any statistical model to empirically test the contribution of these socio-economic factors in a failure of interest-free banking and finance movement for future research and any identified limitations in the research process.

The study by Alexakis and Tsikouras (2009) provides an overview of the regulatory framework and key regulatory institutions and industry associations in Islamic finance today and highlight areas that merit increased attention, a wide range of bibliography was reviewed, with particular focus on the standards published by the Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions. Regulatory topics of particular interest in the Islamic financial world are reviewed. An overview of the main Islamic regulatory institutions is provided. The study ends with a set of hypotheses requiring further research and found that the growth of the Islamic finance sector may be impacted by the: increased involvement in Islamic finance

by Western regulators, as well as credit rating agencies; existence of sound accounting procedures; increased protection of stakeholders of Islamic Financial Institutions.

The distinction between trade and Riba is worth noting as found in the verse as God has allowed trade and prohibited Riba (Qur'an 2:275). From an economic point of view, the exchange between the buyer and the seller is viewed as just. This is because the profit arising out of the trade is equal to the labor and time that the buyer spent in securing the commodity to the seller. On the other hand, interest is deemed unjust because the lender is legally assured of his capital and premium at the time of expiration of the loan without executing any labor or being subject to any risk. From an Islamic moral point of view, the use of interest is burdensome to the borrower in the event of project failure or economic catastrophe. In the context of modern financial economics, Riba al-nasi'ah can be defined as a risk-free return from an investment vehicle or strategy (Ebrahim, 1999). This is because the income stream assigned to the lender is independent of the future value of the project. Regardless of the risk inherent, conventional lenders assume the right to the capital and interest, whether the employed capital yields positively or negatively. The real danger lies when shocks are introduced into the economy, as experienced in South East Asian countries.

The extraction and outward flow of funds by creditors in a herd-like fashion caused markets to crash with high volatility in the region (Kaminsky and Reinhart, 1998; Miller, 1998). As markets have become more integrated than ever, the panics are felt elsewhere. Thus, solutions based on ribawi (conventional) finance have failed to resolve these problems. Gharar is implied as "deception based on the absence of knowledge or the

unlikelihood of delivery with the prospect of causing harm" (Thomas, 1995). In conventional banking, the actual returns on the bank's portfolio of loans are unknown, although the bank commits itself to paying depositors a predefined rate of income. Maysir entails speculative elements in a contract where expected gains are not clearly defined at the initiation of the contract. Ibn Taymiyah clarifies the distinction of Gharar-and Maysir by saying that: 'Gharar is something the consequence of which is unknown (majhul al-'aqiba), selling it involves Maysir, which is gambling (qimar). Gharar is of three types: either what does not exist like habal al-habala or that which cannot be delivered, like the horse that has escaped; or third, that which is unknown in an absolute sense (majhul mutlaq), or the object that is identified but remains unknown in its genus or its quantity.' '(Ebrahim, 2001).

Both the theory of Islamic banking and the rapid expansion of Islamic banks in recent years have demonstrated the viability and feasibility of non-interest-based operations. This must be surprising to those who believed that banks and financial systems could not operate in a modern economy without reliance on an interest rate mechanism. Indeed, experience has shown that Islamic banks are powerful means of mobilizing resources. Operationally, however, both the Islamic financial systems in the countries that have adopted it as well as individual Islamic banks face challenges that need to be addressed. The most important among these challenges is the fact that, while it has been relatively easy to create a system in which deposits do not pay interest, the asset portfolios of Islamic banks do not contain sufficiently strong components that are based on profit sharing. The main reasons for this are lack of a legal and institutional framework to

facilitate appropriate contracts as well as mechanisms to enforce them; lack of appropriate menus containing a broad range and a variety of maturity structures of financial instruments. Consequently, a relatively strong risk perception has become associated with profit-sharing methods in particular and Islamic banking in general. This, in turn, has led to concentration and asset portfolios of the Islamic banks in short-term and trade-related assets with inimical effects on investment and economic development. The problem is exacerbated by the fact that Muslim countries, as is the case in much of the developing world, suffer from a lack of deep and efficient capital and money markets that can provide the needed liquidity and safety for existing assets. Lack of short-term financial instrument to provide liquidity is due to absence of suitable long-term instruments to support capital formation (Mirakhor, 1997).

Siddiqi (2006) noted that Muslims have the same orientation and motivation in finance as everybody else, they will end up having the system that has resulted from other people's choices, the one we call conventional financial system. A genuinely distinctive system can emerge only out of a genuinely distinct orientation and motivation, a different set of norms. If Muslims do not have one, they do not need a different financial system. If they have one, we need research on what it is and how can it can be translated into behavioral patterns and institutions. This is quite appropriate as Muslims themselves feel that their current motivations may not be what they ought to be. Where as Sudin and Wan (2008) study investigating the impact of selected economic variables on deposits level in the Islamic and conventional banking systems in Malaysia found recent econometric rates of profit of Islamic bank, rates of interest on deposits of conventional bank, base lending

rate, Kuala Lumpur composite index, consumer price index, money supply and gross domestic product have different impact on deposits at both Islamic and conventional banking systems. In most cases, customers of conventional system behave in conformity with the savings behaviour theories. In contrast, most of these theories are not applicable to Islamic banking customers. Therefore, there is a possibility that religious belief plays an important role in the banking decisions of Muslim customers.

Kumar, Kee & Charles (2010) The overall service quality gap for Islamic banks is significantly higher than that of conventional banks mainly as a result of relatively high expectation of customers on the service of Islamic bank. The expectations on the factors competence and convenience are significantly higher in Islamic banks compared with conventional banks. On the other hand, the perception on the factors tangibility and convenience are significantly higher in conventional banks compared with Islamic banks. This results in service quality gap on each individual factor, except that the factor reliability is significantly higher in Islamic banks. The application of dominance analysis to predict the service quality gap indicates that the difference between the two types of banks is in terms of degree and not in terms of pattern. The competence and convenience are found to be the relatively more dominating critical factors in both types of banks. These two dimensions together can help to close up the overall service quality gaps to an extent of more than 70 per cent and 80 per cent respectively in conventional and Islamic banks. These dimensions are very much related with human factors such as the ability for banks to understand and give individualised attention, willingness to help customers and provide prompt services.

Islamic Banking prohibits interests, which mean that Islamic banks cannot incur or earn interest in any of their financial transactions. Hence, Islamic banks are not in the business of lending money to the public or borrowing from it. Rather, these banks mobilize funds on bases that are quite different from those of traditional commercial banks and use distinct financial instruments in their uses of funds. Shareholders' funds are the only source of equity funds raised by the bank through the sale of common shares to the public. They also include any reserves accumulated by the bank over the years. Shareholders have sole control over the management of the bank. No preferred shares are issued by Islamic banks because holders of these shares are paid a fixed dividend, which is prohibited by Shari'a. (Rifaat, 1996)

Study on Islamic banking carried out by Gerrald (1997) establishes that, in Singapore a country that has a minority of Muslims in its population, both Muslims and non-Muslims are generally unaware of the culture of Islamic banking. In addition, the two separate groups have different attitudes towards the Islamic banking movement, with the degree of difference depending on the nature of the respective factors put to them. For example, when asked what they would do if an Islamic bank did not make sufficient profits to make a distribution in any one year, 62.1 per cent of Muslims said they would keep their deposits within the Islamic banking movement, while 66.5 per cent of non-Muslims said they would withdraw their deposits. In relation to bank selection criteria, there was general accord as between Muslims and non-Muslims on the rating of the various criteria. Five significant differences were noted, the most relating to "being paid higher interest on savings".

The desire to be paid higher interest was far stronger with non-Muslims. *

Overall, after people have been exposed to the culture of Islamic banking, it would be expected that people's awareness of what Islamic banking involves would increase and their attitude towards this form of banking should change. The shift would be expected to be much greater with Muslims. Likewise with the ranking of the various bank section criteria. Shifts would be expected, more particularly with Muslims banking and it's potential. Equivalent studies could be conducted in other countries which have minorities of Muslims in their population.

In his study Oundo (2009) noted that many mainstream banking clients who demand Shari'ah-compliant products, are the many poor people who insist on these products. (CGAP, 2008). The emergence of Islamic banks in Kenya had been an outcome of the demand by mainstream banking clients for Shari'ah-compliant products. Whereas the mainstream banking sector had options for their Muslim clients, poor micro-entrepreneurs had no option of Islamic Microfinance products. The study reveals that due to lack of options most respondents accessed loans from the available institutions as a coping strategy. The study also assessed the knowledge of the respondents on the existence of a Kenyan MFI that provided Shari'ah-compliant products. All respondents said they had no knowledge of any Islamic MFI in the country and had never heard of one. Asked whether they would switch over to Islamic MFIs if given the option, all respondents responded in the affirmative. This confirmed the existing market niche.

2.4 Summary of Literature Review

Prior studies have sought to establish that Islamic banking is an expression of practical terms and application of part of Islamic religious conduct that encompasses every sphere of the economy, honesty, social and private lives and its absence from an Islamic community in developed world is reflection of an imperfect execution of Muslim duty unto almighty who had prescribed a religion for Muslim that is economically related as well.

However other studies establish that competence and convenience is dominating in both conventional and Islamic banking system although in term of degree it has high significance in Islamic banking. These relate to human factors such as the ability for banks to understand the customer's requirements and tailor their products and services to meet the customer need.

Other study established that profit of Islamic bank, rate of interest on deposits of conventional bank, base lending rate, country composite index; consumer price index, money supply and gross domestic product have different impact on deposits at both Islamic and conventional banking system since customers of conventional system mostly behave in conformity with the savings behavior theories.

Finally the success of Islamic banking lays in the amalgamation of all necessary financial, economical, social, political, managerial and other skills in a manner that conform to Islamic principles in order to attempt to preserve man's perpetual happiness in the hereafter.

This study seeks to contribute to existing literature by establishing factors influencing development of Islamic banking in Kenya.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides a discussion of the research methodology which will be used in the study. It discussed the research design identifying the population of study, sample and data collection methods as well as data analysis and data presentation methods employed in the study.

3.2 Research Design

A research design is an arrangement of conditions for the collection and analysis of data in a format that combines their relationship with the purpose of the study to the economy of procedures (Chandran, 2004). According to Bryman (2001), there are three main types of study designs, these are: exploratory, causal and descriptive or diagnostic study designs. Descriptive studies lead to a profile development of a situation or a group of people by acquiring complete and possible accurate information while a descriptive research reports the way circumstances are by describing elements such as possible behavior, attitudes, values and characteristics (Bryman, 2001).Descriptive data are collected through questionnaire survey, interviews and observations (Chadran, 2004).

The research design employed in this study was descriptive in nature in form of a survey. According to Chadran, (2004) a descriptive design enables the researcher to collect in depth information about the population being studied. Study by Gerrald (1997) have

used a similar research design where five significant factors were noted, the most relating to non Muslim being the desire to be paid higher interest on their savings.

3.3 Population & Sample

3.3.1 Population

Mugenda and Mugenda (2003); Peil (2005), describe a population as "the entire group of people, individuals, events or objects that have a common observable characteristic. The population of this study was all five commercial banks in Kenya, which rolled out Islamic banking products and all its customers (Ndungu, 2008/

3.3.2 Sample

The study employed a combination of census and probability sampling. The census method was used to include all managers in the banks whose customers were sampled. The probability sampling was used to sample the customers; it was on a walk in basis. It was assumed that since the bank customers walk in at random, interviewing all willing customers was random enough. According to Kothari (2004), a sample is a representative group of the accessible population that is selected using various sampling methods. The sample size for the managers was 11 and that of the customers was 33.

3.4 Data Collection Methods

Data collection involves contacting members of the population the researcher has sampled in order to collect the required information about the study (Mingala, 2002). This study employed use of primary data, and obtained from bank employees and bank customers, by use of questionnaire. The use of questionnaire was justified because they

provide an effective way of collecting information from a large literate sample in a short period of time and at a reduced cost than other methods. Moreover, questionnaires facilitate easier coding and analysis of data collected.

3.4.1 Validity and reliability of the instruments

The researcher with the help of one research assistant who was trained on communication and interviewing respondents personally administered the questionnaires. This method of administration is justified since it results in higher response rate than drop and picks method of administration. The questionnaires were pilot tested and modified for all categories of respondents to improve further their reliability and validity.

3.5 Data Analysis

Data is a collection of facts and figures relating to a particular activity under study (Mingala, 2002). Mingala (2002) also acknowledged that for data to be useful, it has to provide answers to the research questions. Data analysis is defined as the whole process, which starts immediately after data collection and ends at the point of interpretation and processing of results (Cooper and Schindler, 2000).

In respect of the data collected using questionnaires, the likert scale was used. The likert scale was used because it is simple to construct, easy to read and infer, and is likely to produce a highly reliable scale. Data was captured and analysed using SPSS version 17, descriptive statistics test such as mean, mode, median, percentage and factor Analysis was used to analyze the questionnaire and important factors in Islamic banking

development highlighted. The numerical data collected were presented graphically using tables, pie chart and graphs for easy interpretation.

CHAPTER FOUR

4.0 DATA ANALYSIS AND RESULTS

4.1 Introduction

This chapter presents the results and findings of the study based on the research objectives. The results were presented in form of frequency tables, charts, and graphs. Various statistical techniques were used to analyse the survey data to answer research objectives.

4.2 Characteristics of the Sample (Customers)

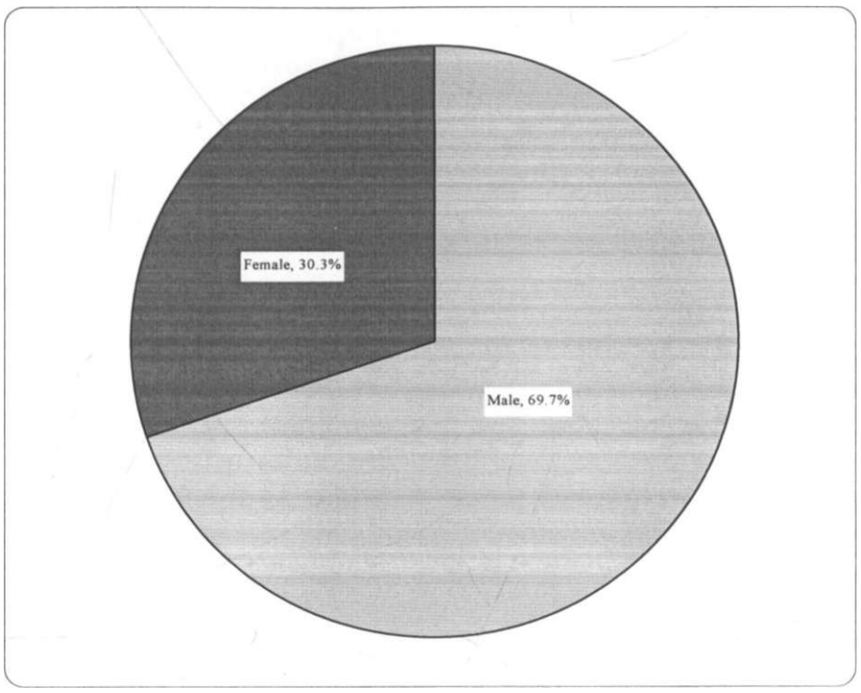
This section describes the basic characteristics of the sample for customers who participated in the survey; the section intends to demonstrate that the customers sample distribution was unbiased and that the sampling design had taken into account most of the important sample characteristics.

The characteristics of the respondents who responded to the customers' questionnaire include the gender of the respondents, age, religious affiliation, length of time with an account in the bank and the length of time the bank has offered Islamic compliant banking.

Table 4.2.1 Distribution of Respondents by Gender

	Frequency	**Percent**
Male	23	69.7
Female	10	30.3
Total	33	100

Figure 1. Pie chart of Respondents by Gender

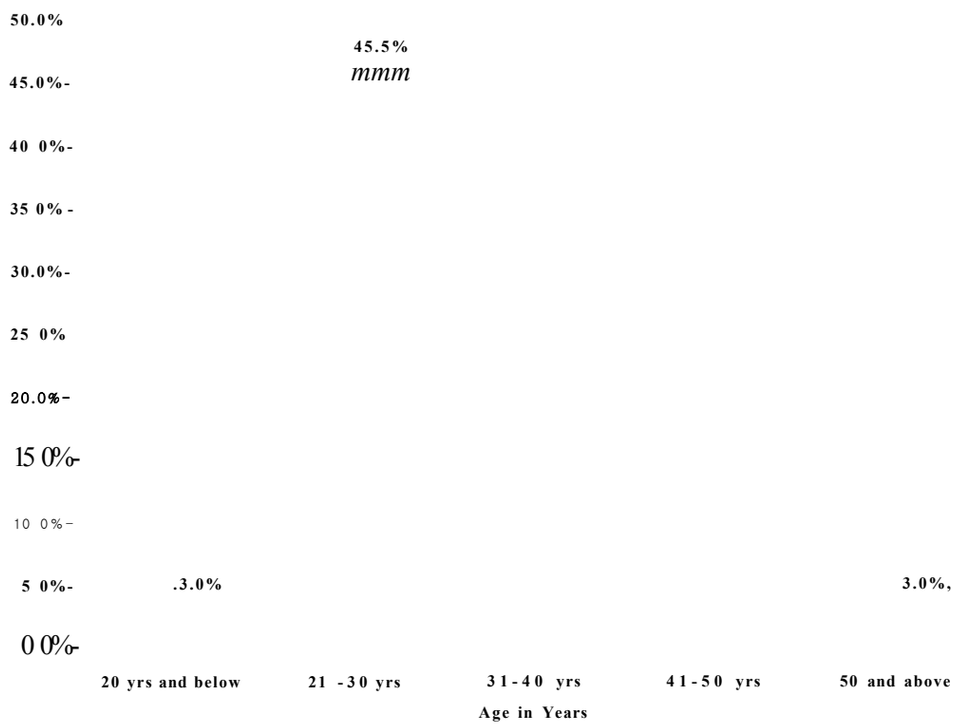


The finding above shows that the sample was comprised of 69.7% male customers and 30.3% female customers.

Table 4.2.2 Distribution of Respondents by Age

	Frequency	**Percent**
20 yrs and below	1	3
21 -30 yrs	15	45.5
31 -40 yrs	13	39.4
41 -50 yrs	3	9.1
50 and above	1	3
Total	33	100

Figure 2. Histogram showing Respondents Age

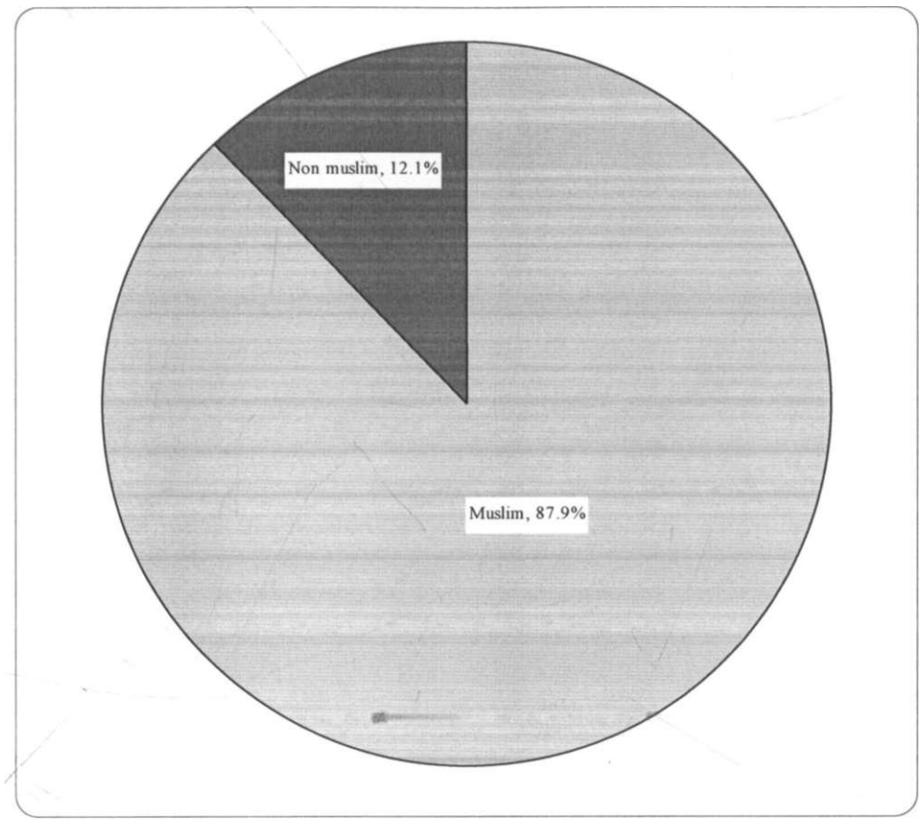


According to the age distribution table above, 45.5% of the respondents were between 21 and 30 years of age, 39.4% were between 31 and 40 years, 9.1% were between 41 and 50 years.

Table 4.2.3 Distribution by Religion of the Respondents

	Frequency	**Percent**
Muslim	29	87.9
Non Muslim	4	12.1
Total	33	100

Figure 3. Pie Chart Showing Religion of the Respondents

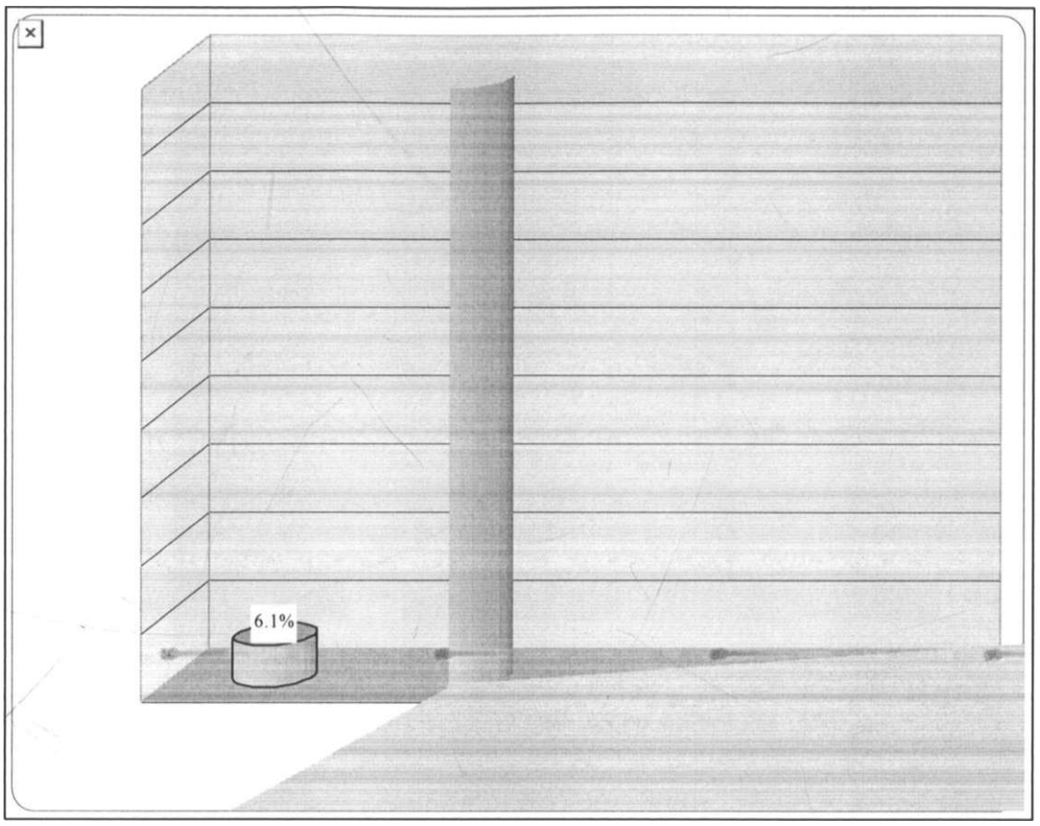


The findings also found out that 87.9% of the respondents were Muslims and only 12.1% were non-Muslims.

Table 4.2.4 Distribution by Length of Time with the Account in the Bank

	Frequency	**Percent**
Less than 1 yr	2	6.1
1 - 5 yrs	29	87.9
6 - 10 yrs	1	3
More than 10 yrs	1	3
Total	33	100

Figure 4. Histogram showing respondent Length of Time with the Account in the Bank

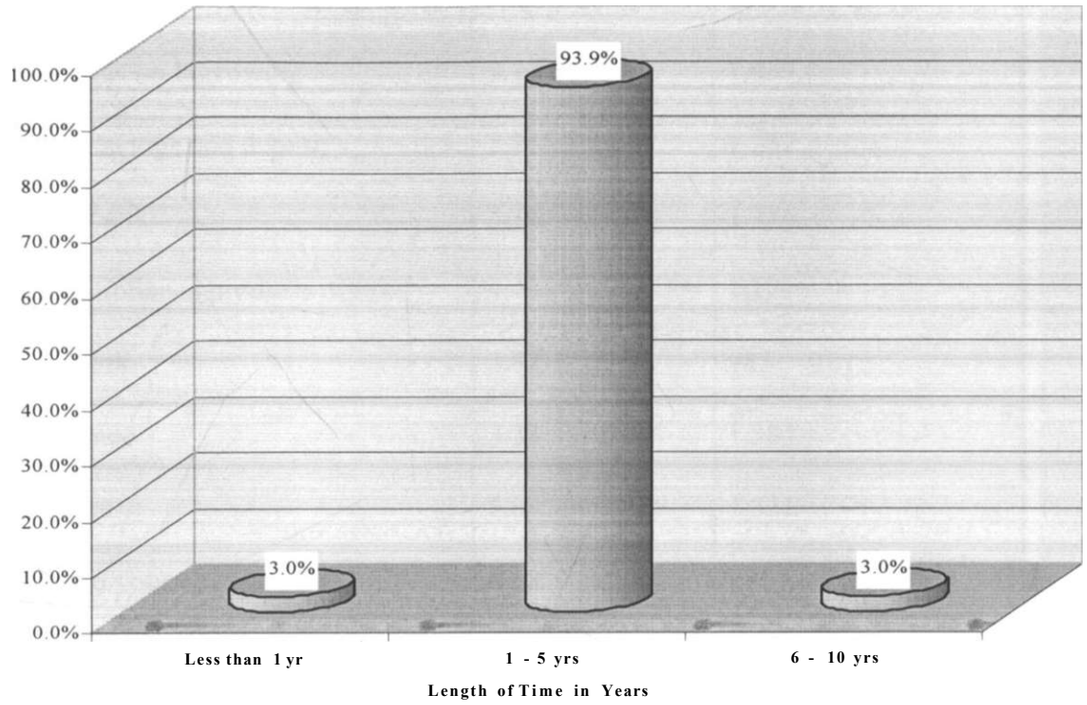


The table above shows that 87.9% of the respondents have had an account with the bank for between one to five years, 6.1% have maintained an account with the bank for less than one year

Table 4.2.5 Length of Time the Bank has been involved in offering Islamic banking compliant products/services

	Frequency	**Percent**
Less than 1 yr	1	3
1 - 5 yrs	31	93.9
More than 10 yrs	1	3
Total	33	100

Figure 5: Histogram showing Length of Time the Bank has been involved in offering Islamic banking compliant products/services



The table above also shows that the banks have been offering Islamic compliant banking for between one and five years, three percent of the banks have had Islamic compliant products for less than six months and another three percent have had the products for more than 10 years.

Table 4.2.6 Factors that Influenced Respondents to Open an Account with Current Bank

	Mean	**Std. Dev**
Interest/charges on borrowing	3.15	1.439
Earnings on savings and deposit	2.7	1.237
Profit of the bank	3.18	1.286
Religious compliance products offered	4.48	1.121
Branch network	3.82	983
Friend influence	3.33	1.384
Advertisement	3.09	1.331
Responsive to your need	4.58	751
Minimum requirement to open account	3.79	1.166
Service efficiency and convenience	4.42	936

To establish the factors that influenced the respondents to open a bank account with the current bank, the respondents were asked questions rated on a five point likert scale where one represented not at all influenced and five represented influenced by the factor to a very large extent. Charges on borrowing had a mean score of 3.15, this was equivalent to not sure on the likert scale, and this means that the customers were not sure whether charges on borrowing had any influence on their decision to open an account with the bank. Other factors which were also rated the same were: Earnings on savings and deposits with a mean score of 2.7, Profit of the bank with mean score of 3.18, Friends influence with a score of 3.33, and Advertisement with a score of 3.09. The major factors

found to have influenced the respondents to a large extent are: religious compliance products offered with a mean score of 4.48; branch network with a mean score of 3.82; responsive to customer need with a mean score of 4.58; minimum requirement to open account with a means score of 3.79 and service efficiency and convenience with a mean of 4.42. This therefore means that the later factors are the major drivers.

Table 4.2.7 Factors that Influenced the Respondents to borrow or Save in the Current Bank

	Mean	**Std. Dev**
Borrowing cost	3.36	1.22
Compliance to Islamic Shariah	4.76	708
Cost/Charges	3.82	1.044
Repayment period	3.7	1.132
Security/Collateral requirement	3.73	1.098
Risk of borrowing	4.12	992
Earning on Savings	3.52	1.253

To determine factors that influenced the respondents to borrow or save in the current bank, the respondents were asked questions rated on a five point likert scale where one represented a strong level of disagreement with the statement and five represented a strong level of agreement. According to the statistics in the table above, borrowing cost had a mean score of 3.36, meaning the respondents are not sure about whether the cost of borrowing had an influence of not. On the other hand, all the other factors had means

cores above 3.5 meaning the respondents either agree or strongly agree with the statements as factors that influenced them to borrow or save in the current bank. The findings show that Compliance to Islamic Shari'ah had the highest mean score of 4.76, which is equivalent to the highest level of agreement. This means that compliance to Islamic shari'ah is the most important factor. The following are the other important factors: Cost/Charges with mean score of 3.82, Repayment period with mean of 3.7, Security/Collateral requirement with mean score of 3.73, Risk of borrowing with mean of 4.12 and Earning on Savings with a mean of 3.52.

4.3 Characteristics of the Sample (Managers)

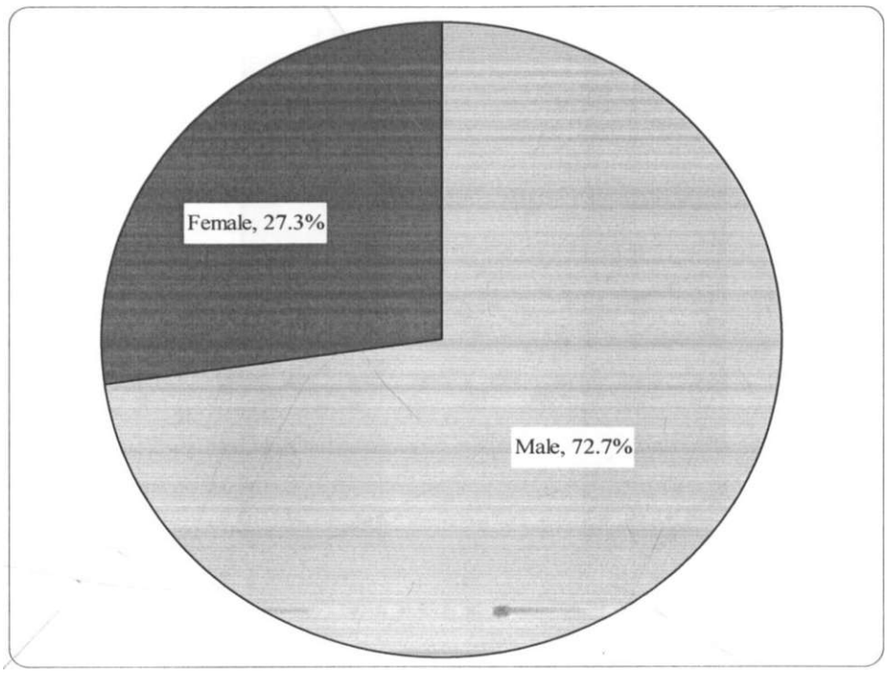
This section describes the basic characteristics of the sample for managers who participated in the survey; the section intends to demonstrate that the managers sample distribution was unbiased and that the sampling design had taken into account most of the important sample characteristics.

The characteristics described include the gender of the respondents, age, religious affiliation, length of time in the bank and the length of time the bank has offered Islamic compliant banking.

Table 4.3.1 Distribution of Respondents by Gender

Gender	Frequency	Percent
Male	8	72.7
Female	3	27.3
Total	11	100

Figure 6: Pie chart of Respondents by Gender

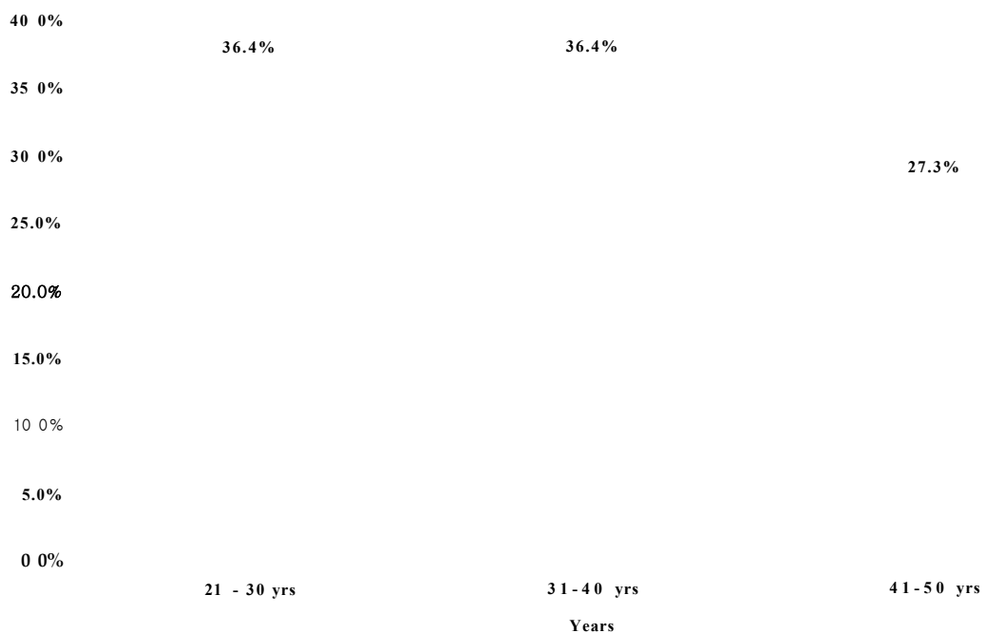


The table shows that the sample comprised of 72.7% male and 27.3% female.

Table 4.3.2 Distribution of Respondents by Age

Age	Frequency	Percent
21 -30 yrs	4	36.4
31 -40 yrs	4	36.4
41 -50 yrs	3	27.3
Total	11	100

Figure 7: Histogram of Respondents by Age



/

The table above shows that 36.4% of the managers were between 21 years and 30 years, another 36.4% of the managers were between 31 years and 40 years. It also indicates that 27.3% of the managers were between 41 to 50 years.

Table 4.3.3 Distribution of Respondents by Job Description.

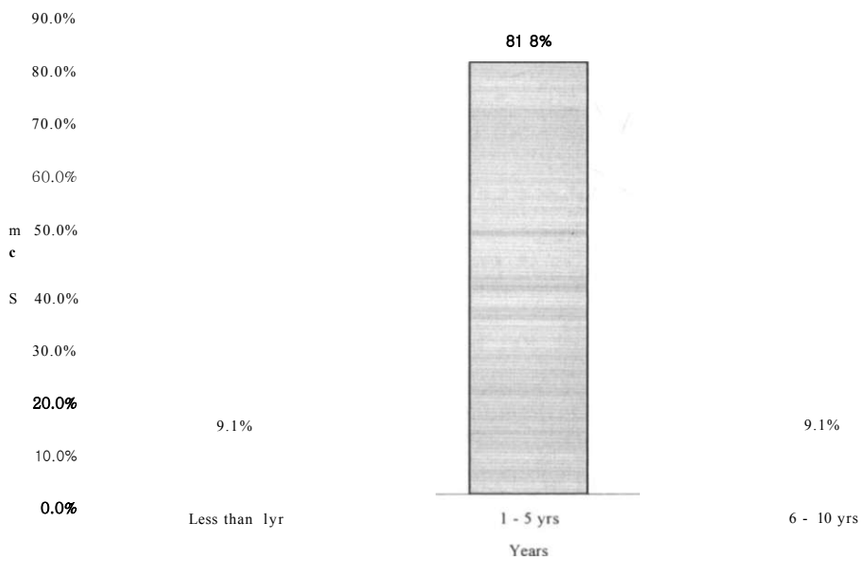
Job Description	Frequency	Percent
Product development manager	4	36.4
Marketing manager	7	63.6
Total	11	100

The findings shows that 36.4% of t le managers were product development managers anc 63.6% were marketing managers.

Table 4.3.4 Distribution of respondents by length of time with the bank.

Factors	Frequency	Percent
Less than 1 yr	1	9.1
1 - 5 yrs	9	81.8
6 - 10 yrs	1	9.1
Total	11	100

Figure 8 . Histogram of respondents by length of time with the bank.



The findings also shows that 9.1% of the managers had worked with the banks for less than one year, 81.8% of them had worked with the same bank for between one and five years and another 9.1% had worked with the bank for between six and ten years. On the other hand, all the managers interviewed reported that their respective banks had been involved in offering Islamic banking compliant products and services.

Table 4.3.5 Factors influencing Bank's Entry in to the Shari'ah Compliant Products / Services

Factors	Mean	Std. Dev
Increased competition in the traditional bank market	3.27	1.272
Potential huge profit from Islamic banking	3.73	1.009
Service quality gap	3.91	0.831
As corporate social responsibility (CSR) activity driven by public concern	2.36	0.924
High bank liquidity requiring investments	1.82	1.079
Diversification to cushion the risk of corporate borrowing	2.18	0.982
Staff aggressiveness and commitment	2.64	1.206
Conducive government regulations and support	3.18	1.401

To determine the factors that influenced the banks to start providing shariah compliant products and services, they were asked to rate the above factors on a five point likert /

scale where one represent no influence and five represent influence to a great extent. The findings shows that the managers were not sure about the influence from increased competition, Staff aggressiveness and commitment and having a conducive government regulations and support, all with a mean score of about three.

The findings show that potential huge profit from Islamic banking and Service quality gap were the two major factors influencing entry. On the other hand corporate social responsibility (CSR), activity driven by public concern and high bank liquidity requiring investments, and diversification to cushion the risk of corporate borrowing does not have any influence.

Table 43.6. Factors that influence the sustainability of Shari'ah compliant product/services for Commercial Banks

Factors	Mean	Std. Dev
Laid down institutional policies and procedures to regulate Islamic products	3.45	1.293
Increased number of customers	4	0.816
Support from senior management and board	4.18	1.168
Aligned Islamic banking products policy to the overall strategy of the bank	4.55	0.688
Well versed shari'ah board members	4.45	0.82
Management and staff who understand Islamic Banking Market dynamics	4.27	0.467
Good customers services	3.82	0.603
Training and workshops for customers to understand shari'ah compliant products	3.45	1.036
Separation of the funds between Islamic and Conventional funds	2.27	1.555
Establishment of Accounting that comply to Islamic Shari'ah	3.73	1.489

The statistics in the table above shows that the managers are not sure with laying down institutional policies and procedures to regulate Islamic products as a away of ensuring sustainability of Shari'ah compliant product/services for Commercial Banks. The managers also disagreed that separation of the funds between Islamic and Conventional funds could lead to sustainability of the Islamic compliant product or services. On the other hand, the managers agreed that the following were the factors that lead to sustainability of the products: increased number of customers; support from senior management and board; aligned Islamic banking products policy to the overall strategy of the bank; well versed shari'ah Board members; management and staff who understand

Islamic Banking Market dynamics; good customers services and establishment of Accounting that comply to Islamic Shari'ah.

Table 4.3.7 Factors affecting the development and marketing of Shariah compliant products in your bank.

Factors	Mean	Std. Dev
Lowering bank charges	2.82	1.168
Increasing earning on deposit & savings	2.09	1.136
Relaxing the collateral requirement during lending	2.91	1.044
Diversifying Islamic banking product	4.64	0.505
Continues review and improvement of shari'ah compliant products	4.55	0.522
Bonus to marketing staff	2.73	1.555
Interest free lending	4.73	0.905
Profit loss sharing approach	4.64	0.505

The managers were also not sure about the following factors influencing the development and marketing of the products: Lowering bank charges, relaxing the collateral requirement during lending, and Bonus to marketing staff. According to the managers, the major factors that lead to development and marketing of Islamic compliant products were: diversifying Islamic banking product; continues review and improvement of shari'ah compliant products; interest free lending; profit loss sharing approach

Table 4.3.8 Factor Analysis

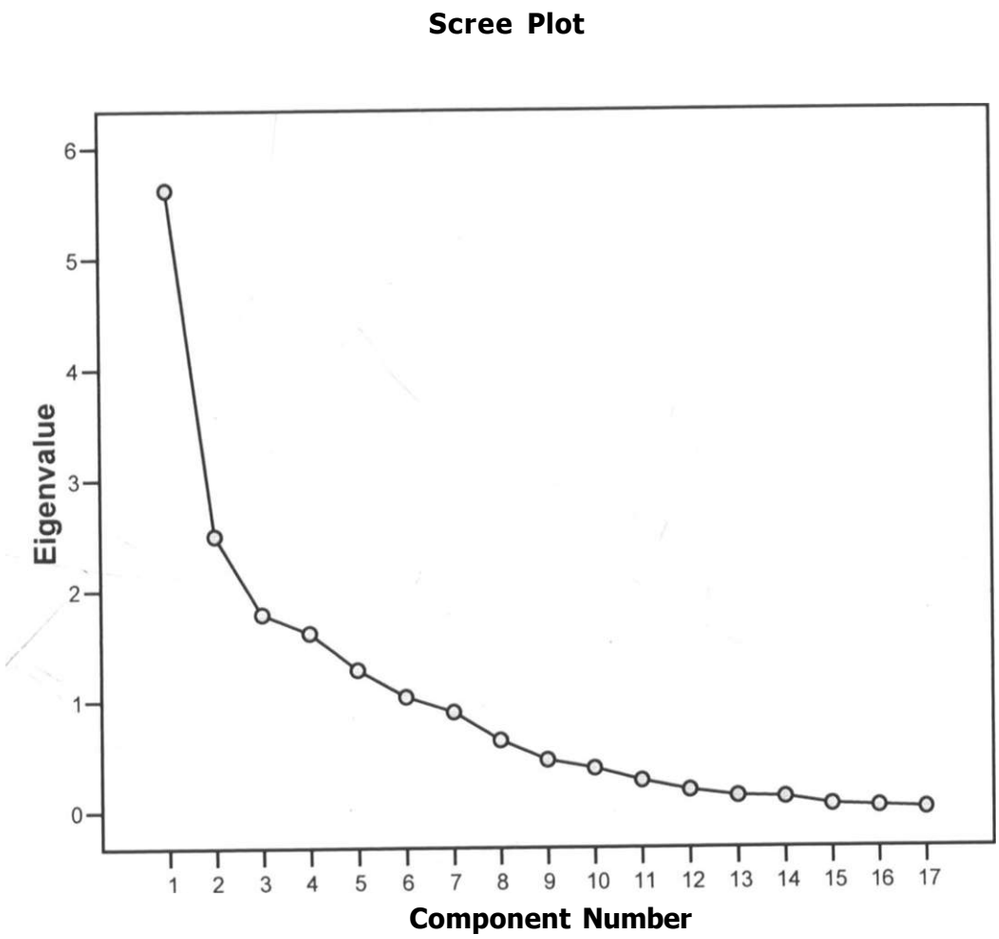
Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumul-ative %	Total	% of Variance	Cumulative %
1	5.62	33.05	33.05	5.62	33.05	33.05	3.51	20.62	20.62
2	2.49	14.66	47.71	2.49	14.66	47.71	2.95	17.37	37.99
3	1.78	10.50	58.21	1.78	10.50	58.21	2.19	12.90	50.88
4	1.61	9.49	67.70	1.61	9.49	67.70	1.96	11.52	62.40
5	1.28	7.52	75.22	1.28	7.52	75.22	1.91	11.23	73.63
6	1.03	6.08	81.30	1.03	6.08	81.30	1.30	7.67	81.30
7	0.90	5.26	86.57						
8	0.64	3.75	90.32						
,9	0.46	2.71	93.03						
10	0.38	2.26	95.29						
11	0.27	1.61	96.89						
12	0.18	1.08	97.98						
13	0.13	0.76	98.74						
14	0.12	0.69	99.43						
15	0.05	0.29	99.72						
16	0.03	0.19	99.91						
17	0.02	0.09	100.00						

Extraction Method: Principal Component Analysis.

The eigenvalues in the table of communalities above shows that six components have been extracted, and the total variance explained by the six components is 81.3%. The scree plot below shows the number of components extracted.

Figure 9.Line graph of Scree plot.



Rotated Component Matrix (a)

	Component					
	I	2	3	4	5	6
Interest/charges on borrowing	-0.01	-0.37	0.053	-0.09	**0.792**	0.1
Earnings on savings and deposit	0.468	0.415	-0.17	-0.15	**0.619**	-0.06
Profit of the bank	**0.689**	0.41	-0.08	-0.13	0.207	0.178
religious compliance products offered	-0.12	-0.17	-0.07	**0.935**	-0.16	0.016
Branch network	-0.06	-0.11	-0	-0.01	-0.01	**0.96**
Friend influence	0.103	**0.728**	-0.16	-0.27	-0.23	0.212
Advertisement	-0.09	**0.917**	0.103	0.004	-0.04	-0.24
Responsive to your need	-0.19	-0.08	**0.847**	-0.17	0.121	0.063
Minimum requirement to open account	**0.665**	0.068	0.316	-0.13	0.191	0.395
Service efficiency and convenience	0.345	0.216	**0.814**	-0.04	0.125	-0.01
Borrowing cost	0.196	0.016	0.246	-0.05	**0.813**	-0.05
Compliance to Islamic Shariah	-0.15	-0.03	-0.15	**0.932**	-0.03	-0.04
Cost/Charges	**0.863**	-0.15	0.082	-0.06	0.203	-0.12
Repayment period	**0.904**	0.178	0.015	-0.16	-0.05	-0.16
Security/Collateral requirement	0.43	**0.633**	0.445	-0.11	-0.01	-0.13
Risk of borrowing	0.338	**0.518**	0.469	-0.07	-0.02	-0.13
Earning on Savings	**0.501**	**0.53**	0.353	-0.02	0.058	0.017

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization. Rotation converged in 6 iterations.

The rotated component matrix above shows the factor loadings of each variable by the component. The factor loadings were grouped based on the variables. It shows that factor/component number one contains the following variables; Minimum requirement to open account, Profit of the bank, Cost/Charges, and Repayment period. Component number two contained the following variables; Friend influence, Advertisement, Security/Collateral requirement, and Risk of borrowing. However, earning on savings loads on two components, therefore it was dropped out. Variables in component number three; Responsive to customer need, and Service efficiency and convenience. Component number four contains Compliance to Islamic Shari'ah.

4.4 Summary and interpretations

From the data that has been collected and analysed, the following findings were made from the customers' point of view. Most of the customers were driven by religious compliance and customers needs being met; that is 4.48 and 4.58 respectively on a five point likert scale.

When we look at religious affiliation, around 87.9% of those who responded were Muslims. Therefore it is crystal clear that Muslims want to safeguard their faith, their human self and their wealth according to the ways stipulated in the Quran i.e. shari'ah. Above all, they want their need to be met also, like others. This is why most of the Muslims and Non-Muslims responded positively to factors like service efficiency and minimum requirement to open an account overwhelmingly.

However, some of the factors like advertisement with a score of 3.09; charges on borrowing with a mean score of 3.15; earnings on savings and deposits with a mean score of 2.7, had no or minimal influence on the customers choice of the bank. We can therefore say that these are not the primary things in the choice of the bank. The factors in the previous paragraphs were given an upper hand over these.

From the findings, we found out that around 87% of the customers had an account in the bank for less than five years. This can be attributed to the shorter period the bank has started offering the Islamic compliant products in Kenya. It shows that there is potentiality of these products in future, as more people will start rushing for it. The percentage of aged people stood at 3%.

The managers' findings conform to that of the customers. They agreed that continuous review and improvement of shari'ah compliant products and diversifying Islamic banking product leads to development and marketing of Islamic compliant products.

From the findings, around 81.8% of the managers were with the bank for a period less than five years. Therefore, there are likelihood of most of them gaining experience and enhancing there marketing skills in marketing Islamic compliant products.

In addition, the study found that factors like increased competitions; staff aggressiveness; having government conducive regulations and support were not a major issue to them. Most of the interviewed managers rated this as not sure. This shows that those factors were not a cause of downfall or spread for Islamic compliant banking products.

According to the statistics, strengthening the shari'ah board and putting the customers priorities at forefront, will lead to spread and strengthening of Islamic banking in Kenya. Lastly, the research also found out that borrowing cost stands at a mean score of 3.36%.These shows that the respondents were not sure whether the cost of borrowing had an influence on them. These contrast other conventional bank where this issue is a determining factor for most of the customers.

/

CHAPTER FIVE

5.0 SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

The purpose of this study was to establish factors that influence development of Islamic banking in Kenya. The research design adopted was a descriptive survey in form of census. The population identified the banks to study as: Gulf African Bank, First Community Bank (FCB), Dubai bank and Barclays bank. From the above listed banks the sample of 33 customers and 11 managers were drawn.

Data was collected through self-administered questionnaire and the data analysis method was quantitative in nature. Descriptive statics' based on mean, mode, median and factor analysis was used to analyse the data and make comparisons among desired variables. The findings were presented using tables and graphs.

The study concluded that the following are the key factors that influence respondents to keep an account with their current respective banks: religious compliance products offered, branch network, responsiveness to the needs of the clients, minimum requirement to open an account, service efficiency and convenience to the clients.

The study also concluded that the following were the major factors that influenced the respondents to borrow or save money in the same banks, key among them is compliance are Islamic sharfah,cost/charges of borrowing/saving, repayment period, security / collateral requirement for the loans, risks of borrowing and earning on savings.

5.2 Conclusions

Based on the findings discussed above the following conclusions were drawn from the study: firstly, the factors that influence development of Islamic banking in Kenya are purely shari'ah compliance. Both internal and external environments may drive these factors. That is, strong and effective shari'ah board can do a great effort in coming up with Islamic compliant products. In addition, the religious leaders can woo a great number of clients for Islamic banks by confirming its shari'ah compliancy.

Other than providing Islamic compliant products and services, factors such as: offering product and services that meet the customers' needs, reduced borrowing cost, minimum requirements to open an account and service efficiency influences the development of Islamic banking. The Islamic banks should put these priorities at forefront and strengthening it. By doing so, they can also win a great number of customers from both Muslims and non-Muslims community. Above all, they should invest in branch expansion thus enabling the marketing Islamic banking products at the grassroots' level.

Lastly, the research concluded that there are future market potentialities for the Islamic banking products. Many younger generations were seen going for these products and services. For this banking, system to develop and grow the banks should create awareness through seminars, workshops, and advertisement and prayer sermons quoting verses from Quran and sayings of the prophet (hadith) that concern Islamic Banking system.

5.3 Policy Recommendations

In Kenya, all banks offering Islamic banking have established their own separate Shari'ah Board to supervise and offer guidance to their respective banks on Islamic banking system. In principle, Shari'ah Boards have the authority to impose their viewpoint, but logistic considerations do not permit timely vetting and/or monitoring of all banking operations. In view of these, I recommend CBK to put in place a policy to establish a universal Shari'ah Boards to oversee Islamic banking operation in Kenya.

Conventional banking system in Kenya are compelled to have a uniform financial reporting standard thus mixing their funds that are both conventional and Islamic compliant. In view of this, Muslim customers are discouraged to bank with such conventional banks, as it is not acceptable in terms of shari'ah. Therefore, I recommend CBK to allow such conventional bank to have separate financial reporting standards.

Lack of qualified Islamic banking personnel is another major bottleneck in Kenya. Further training and Islamic finance education should be given to bank personnel to up skill them to offer quality service and appropriate advise to bank customers. I recommend banks to organize regular training and work shops by inviting well-versed Islamic scholars to educate bank personnel about Islamic banking and financing.

5.4 Limitations of the study

The study contains three limitations. The first limitation was based on the sample area of the study. The area of the study is only limited to Kenya. It could be better if the area of study were extended over a range of countries, the best of all being different countries of different continent.

Secondly, this study was restricted to the use of analysis method since the data did not allow for aggregation. More than two method of data collection could have been employed thus overcoming any limitation.

Thirdly, this study was unable to perform ANOVA for religion differences as the sample consisted largely of Muslims. This could have been overcome by doing the same research in other conventional banks, thus cross-checking both sides.

5.5 Suggestions for future research

Various factors influences customers choice of their banks; further research should be done to find out whether those factors influencing Muslims have the same impact on the non-Muslims customers.

Though the uptake of Islamic banking products in Kenyan market was good, the rate of growth especially in conventional banking with Islamic window has been too slow, currently controlling only 0.8% of the market share. Therefore, further research is

required to establish factors that contribute to this slow pace of growth of Islamic products in Kenyan market.

Another area that requires further research is to investigate whether common factors influences customers to make choice between various Islamic products such deposits and borrowing. The research also recommends similar research carried out in Muslim populated countries and compared with less populated Muslim countries in order to compare and establish whether factors influencing Muslim also influences non-Muslim to make banking decisions.

REFERENCES

Alexakis, C.&,Tsikouras, A, (2009). Islamic finance regulatory framework : *challenges lying ahead*, International Journal of Islamic and Middle Eastern Finance and Management, Vol. 2 Iss: 2, pp.90 - 104

Al-Harran, S.A.S. (1993). Islamic Finance: *Partnership Financing,* Pelanduk Publications, Malaysia, pp. 15-157.

Amin, H. (2008).*Determination of choice criteria in Malaysia's Retail Banking.* Kuala Terrengganu.Malaysia.

Anwar, M. (1989). *Modeling interest free economy;* Genuine publication. West, New Dhephi.

Bryman, C. (2001).Improving Internal Control: *A Practical Guide for Microfinance Institutions.* Microfinance Network with GTZ, Technical Guide No. 1

CBK. (2010). *Targets Gulf cash with compliance bonds*: Business daily news. Nairobi. Kenya.

Chandran, E. (2004). *Research methods: A quantitative approach with illustrations from Christian ministries.* Day star University, Nairobi.

Cooper, D., & Schindler, P. (2000). *Business research methods.* (8lh edn) New Delhi, Tata Mc Graw Hill.

Ebrahim, M.S,(2001*).Islamic banking in Brunei Darussalam. University of Brunei* Darussalam/National University of Singapore, Singapore, and Tan Kai Joo Kemuda.

Erol, C. & El-Bdour, R. (1989). "*Attitudes, behaviour and patronage factors of bank customers towards Islamic banks".* International Journal of Bank Marketing, Vol. 7 No. 6, p. 31.

Gerrald, P. *(1991).Division of Banking and Finance, Anyang business school.*Nyanyang Technology University. ". *International Journal of Bank Marketing; 15/16 pp204-216.*

Husain, I.(2010).Keynote address delivered at the Conference on Islamic banking and Finance : *Islam and the Future of Economics* .Karachi .

Iqbal, M. ed. 2000. *Islamic Banking and Finance: Current Developments in Theory and Practice.*Islamic Foundation and IAIE.

Kahf, M. *(2W4).Success factor of Islamic Banks*, Symposium on Islamic Banking and Finance. Brunei.

Khan, M. M. & Bhatti,M. I., (2008) Development in Islamic banking: *a financial risk-allocation approach.* VOL. 1 PP 40-51.

Khan, M. M., & Bhatti ,M. I. (2006). *Why interest-free banking and finance movement failed in Pakista.Humanomics Vol 22, 3 pp 145-161.* Australia.

Kothari, C.R. (2004). *Research methodology,* methods & techniques. New Delhi: New age international (P) limited publishers.

Kumar,M., Kee, F. T., & Charles .V. *International Journal of Quality & Reliability Management*, Volume 27, Number 3, 2010, pp. 352-378(27).Emerald Group Publishing Limited.

Mingala, M. S. (2002). *Financial Markets and Institutions.* Addison Wesley, New York.

Mirakhor, A. (1997). *Progress and Challenges of Islamic Banking* .International Monetary Fund.

Miriri, D. (2009). Islamic banks carve niche in crowded Kenyan market. Gulf African Bank .Peoples daily, Nairobi, Kenya.

Mugenda,O.M., & Mugenda,A.G. (2003*).Research Methods.* Lab Graphics Services. Nairobi.

Ndung'u, N. (2008. Issue of Money works. *Gulf African Bank Annual East & Central Africa Islamic conference.* Nairobi, Kenya

Ndung'u, N. (2010). *Islamic finance:* the African experience2nd gulf bank annual east and central Africa Islamic conference.Nairobi.Kenya.

Oundo, M. A. (2009). *The potential of Islamic Microfinance in increasing financial access to Kenya's unbankedpopulation.* Nairobi, Kenya.

Peil, E, (2005). *Finance, for Small Enterprises in Ghana.* Washington DC, A World Bank publication.

Presley, J.R. (1988). *Directory of Islamic Financial Institutions,Croom* Helm, Beckenham, London.pp. 68-9.

Rifaat, A. A. K. (1996). *"The impact of the Basle capital adequacy ratio regulation on the financial and marketing strategies of Islamic banks",* International Journal of Bank Marketing, Vol. 14 Iss: 7, pp.32 - 44.

Siddiqi ,M. N. (2006). *Islamic Banking and Finance in theory and practice.* A survey of state of the art Islamic economic studies vol. 13.2, Pakistan.

Siddiqi, M.N. (1986). *Model of Islamic banking.* Kazi publication, Lahore, Pakistan.

APPENDICES

APPENDIX I: COVER LETTER AND SURVEY QUESTIONNAIRE

Dear Respondent

I am a post-graduate student studying towards my MBA (Masters in Business Administration) at the University of Nairobi. The aim of my study is to investigate factors influencing development of Islamic banking in Kenya.

You are part of our selected sample of respondents whose views we seek on the above-mentioned matter. We would therefore appreciate it if you could answer a few questions. It should not take more than ten minutes of your time to fill in the questionnaire.

There are no correct or incorrect answers. Please answer the questions as accurately as possible. For each statement, tick (with a cross **X)** the number which best describes your experience or perception. For example, if you strongly agree with the statement, tick the number 5. If you strongly disagree with the statement, tick the number 1. Similarly, if you believe a stated variable is very important strongly, tick the number 5 and if you believe the stated variable is not important, tick the number 1. **Tick only one answer for each statement and answer all questions please. I guarantee that all information will be handled with the STRICTEST CONFIDENTIALITY.**

Thank you very much.

Adano Salad Kadubo

APPENDIX II: FOR BANK CUSTOMERS

Name (optional)

SECTION I: Background Information (Please tick one)

1. Gender

( ) Male

( ) Female

2. Age

( ) 20 years and below

( ) 21-30 years

( ) 31-40 years

( ) 41-50 years

( ) 50 years and above

3. Details of your Banker?

a. Institution (Bank)

b. Branch

c. How long have you banked with the above Bank?

( ) Less than one year

( ) Between 1 and 5 years

( ) Between 6 and 10 years

( ) More than 10 years

5. How long has your bank been involved in offering Islamic banking?

( ) Less than one year

( ) Between 1 and 5 years

( ) Between 6 and 10 years

( ) More than 10 years

SECTION II

Please indicate the extent to which the following factors have influenced you to bank with your current Banker.

Factors	**Not at all Influenced (1)**	**Small Extent (2)**	**Not sure (3)**	**Large extent (4)**	**Very Large Extent (5)**
Interest rate /Charges on Borrowing					
Earnings on savings and deposits					
Profit of the Bank					
Religious Compliance product					
Bank operate Internationally					
Number of Branches					
Types of Products					
Friend influence					

Advertisement					
Responsive to your need					
Minimum requirement to open account					

Others (please explain)

SECTION III

Please indicate the extent to which you agree or disagree with the following factors that influence you to borrow or save with your current Banker.

Factors	**Strongly Disagree (1)**	**Disagree (2)**	**Not Sure (3)**	**Agree (4)**	**Strongly Agree (5)**
Interest rate/borrowings cost					
Compliance to Islamic Shari'ah					
Cost/Charges					
Repayment Period					
Security/Col lateral requirement					
Low Risk Of borrowing					
Earnings on Savings					

Others (please explain)

SECTION IV

Please indicate the extent to which you agree or disagree with the following factors that influence you to remain with your current Banker.

Factors	**Strongly Disagree (1)**	**Disagree (2)**	**Not Sure (3)**	**Agree (4)**	**Strongly Agree (5)**
Customized products					
Service Efficiency and Convenience					
Staff Knowledge					
Inter-branch banking					
Customer Categorization					
Minimum Balance					
Specialized service offered					

Others (please explain)

APPENDIX III: For Product Development and Marketing Managers

Name of the Institution (optional)

SECTION I Background Information (Please tick one)

1. Gender

( ) Male

( ) Female

Factors	**Not at all Influenced (1)**	**Small Extent (2)**	**Not sure (3)**	**Large extent (4)**	**Very Large Extent (5)**
Increased competition in the traditional bank market					
Huge profits noted from the Islamic Banking					
Need to establish a niche market					
As corporate social responsibility (CSR) activity driven by public concern					
High bank liquidity requiring investment					
Existing infrastructure suitable for Islamic banking operation					
Diversification to cushion the risk of corporate borrowing					
Top management and organizational culture orientation					
Staff aggressiveness and commitment					
Conducive government regulations and support.					

2. Age

( ) 20 years and below

( ) 21-30 years

( ) 31 -40 years

( ) 41-50 years

( ) 50 years and above

3. What is your job description?

( ) Product Development Manager

( ) Marketing Manager

4. How long have you worked in the bank?

( ) Less than one year

( ) Between 1 and 5 years

( ) Between 6 and 10 years

( ) More than 10 years

6. How long has your bank been involved in offering Islamic Compliant products/services to customers?

( ) Less than one year

( ) Between 1 and 5 years

( ) Between 6 and 10 years

( ) More than 10 years

7. Please indicate the extent to which the following factors have influenced your bank's entry in to the Shari'ah Compliant Products/Services.

Others (please explain)

8. Please indicate the extent to which you agree or disagree with the following factors that influence the sustainability of Shari'ah compliant product/services for Commercial Banks.

Factors	**Strongly Disagree (1)**	**Disagree (2)**	**Not Sure (3)**	**Agree (4)**	**Strongly Agree (5)**
Laid down Institutional policies and procedures to regulate Islamic products					
Customized products to suit customer preferences					
Increased number of customers					
Product segmentation					
Aligned Islamic banking product's policy to the overall strategy of the bank					
Well versed Shari'ah board members					
Management and staff who understand Islamic Banking Market dynamics.					
Good Customer Service Mechanism					
Organize training and workshops for					

customers to understand Shari'ah compliant products					
Separate of the funds between Islamic and Conventional funds (avoid mixing funds)					
Establishment of Accounting that comply to Islamic Shari'ah					

Others (please explain) others (please explain)

9. Please indicate the importance that you attach to the following factors with regard to development and marketing of Shari'ah compliant products in your bank.

Factors	**Not Important (1)**	**Moderately Important (2)**	**Not Sure (3)**	**Important (4)**	**Very Important (5)**
Lowering bank charges					
Increasing earning on deposit & savings					
Relaxing the collateral requirements during lending					
Diversifying Islamic banking products					

Continues review and improvement of Shari'ah compliant products.					
Bonus to marketing staff					
Interest free lending					
Profit Loss sharing approach					

Others (please explain)