EFFECT OF ISLAMIC BANKS ON FINANCIAL DEEPENING AMONGST KENYAN MUSLIMS

BY

MUSTAFA ALI BORU

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION OF THE UNIVERSITY OF NAIROBI

NOVEMBER 2013

DECLARATION

I hereby declare that no portion of the work that appears in this study has been used in support of an application for another degree or qualification of this or any other University or institution of learning.

Signature:……………………………………….…**Date:** ……………..……..…….

Mustafa Ali Boru

D61/64241/2011

This research project has been submitted for examination with my approval as university supervisor.

Signature:……………………………………….…**Date:** ……………..……..…….

Joseph Barasa

Department of Finance and Accounting

School of Business, University of Nairobi

DEDICATION

To my lovely children

Rukia Mustafa

and

Boru Mustafa

(That you may excel beyond this)

ACKNOWLEDGEMENT

The long and challenging journey that has led to the successful completion of this MBA program would not have been without the incredible support and encouragement of many people I interacted with.

My mum Rukia Mericha for supporting and encouraging me to go through the program, my dad Ali Boru for challenging and pushing me to take up the program, my Uncle Mohamed Mericha for giving me words of wisdom and encouragement to enroll into the program. My dear friend Aziza Hassan for encouraging and supporting me all through the program and many times offering me technical support. The mother of my kids, Nasibo Wachu for taking great care of my children to enable me concentrate on my studies, My children could surely not wish for a better mother. My friends Daud Dida, Mohamed Noor Adan and Ann Mutiso for always checking that I am on course. I would like to record my special thanks and utmost gratitude to my supervisor, Joseph Barasa. Your professional guidance and wisdom throughout this project made it possible for me to successfully undertake the study.

ABSTRACT

This study sought to establish the effects of Islamic banks on financial deepening amongst Kenyan Muslims. This research adopted a descriptive research design where the population of interest in the Islamic field was visited. The target population for this study was the Muslims. The researcher intends to examine a sample of 384 Muslims drawn from the population of over 100,000. The researcher used a questionnaire as the primary data collection instrument. Content analysis and descriptive analysis were employed. Regression model was also used to establish the relationship between the variables. he study established that lack of access to financial information service affected the growth of Islamic banking. Lack of managerial training and experience affect the growth of small and medium financial institutions. The study identified that government policies and regulations affect the growth of small financial institutions. The study established that technological changes affect the growth of the financial institutions. The customers encounter problems of raising capital, accessing finance and accessing credit. The study recommends that there should be increased support for learning visits to improve the information flow, the government should come up with policies on training of business owners and managers especially on directing, staffing, deployment of finance resources and controlling activities, the government should seek to address the pertinent issues like complex licensing regime that has impeded economic development Islamic banking system in the country. The government should intercede in solving the problems of unawareness of new technology, unfamiliarity with new technologies and the new technology not being affordable by maybe subsidizing on the cost of adoption. The financial institutions should also adjust their tight regulations and credit policies and the means of determining the creditworthiness of their customers and the credit appraisal.

TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

ABBREVIATIONS

CBK	-	Central Bank of Kenya
GDP	-	Gross domestic product
FCB	-	First Community Bank
GAB	-	Gulf African Bank
KCSE	-	Kenya Certificate of Secondary Education
MFI	-	Micro Finance Institution
NGO	-	Non Governmental Organization
SPSS	-	Statistical Package for Social Services

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Globally, Islamic banks are growing at between 10% to 15% per annum with global asset in excess of one trillion dollars and operating within more than sixty countries across the world especially in the Middle Eastern and Asian region countries (El-Gamal, 2006).

The popularity and appreciation of Islamic banking by Muslims and non-Muslims in Muslim and non- Muslim countries has been evidenced by the spread of most Islamic banks within middle eastern and emerging countries and many universal banks in developed countries increased demand of Islamic financial products (Yudistira 2003).

The Islamic banking institutions' relative stability in the current recession has attracted a lot of attention even from the Vatican. The Vatican endorsed the Islamic finance rules as a way to restore confidence in the conventional financial system in response to the global economic crisis. As the result of the confidence in the Islamic financial systems during financial crisis it is estimated that Islamic banking would be growing at a rate of 10-15% per year and with signs of consistent future growth (Chapra, 2009).

Financial systems based on Islamic banking tenets are dedicated to elimination of the payment and receipt of interest in all forms. The fundamental sources of Islam are the holy Quran and the Sunnah, which is synonymous with the teachings and traditions authentic translation. Both of these sources treat interest as an act of exploitation and injustice and as such it is inconsistent with notions of fairness and property rights. Islamic banking thus derives its specific raison d'être from the fact that there is no place for the institution of interest in the Islamic order (Hassan & Lewis).

Shariah demands that borrowers and lenders share rewards and losses in an equitable fashion. The common Islamic banks' ways of raising revenue as an alternative to interest is through financial intermediation of profit sharing (Mudharabah), joint venture (Musharakah), cost plus (Mudharabah) and leasing (Ijarah) contracts (Ariff,1998).

As Islam forbids the receipt or payment of interest (the basis of most conventional Western banking), many Muslims have chosen not to use their products and services. The result is that many have no banking history, creating another potential barrier to accessing banking services in the future (Hanlon, 2005).

Financial leaders claim that the main reason for encouraging Islamic finance in Kenya is to combat financial exclusion among millions of Muslims who are either outside or are at the margins of the financial services industry due to their faith. The argument is that the availability of Shariah compliant financial products would increase the financial inclusiveness of Kenyan Muslims as the hurdle of Shariah incompatibility would be removed. An implied argument, though not necessarily a valid one is that by introducing and encouraging Islamic finance, the Kenyan government has tackled the financial exclusion of Kenyan Muslims. Another implied argument is that Kenyan Muslims would no longer have any excuse for remaining financially and socially excluded as they would now have access to financial products compatible with their faith. The implicit assumption here is that they would flock in large numbers to the institutions offering Shariah-compliant financial products for their financial services needs. However, the reality on the ground may be different as the consumer behaviour process of demanding and consuming financial products is rather more complex than that, and the above-mentioned predictions may turn out to be too simplistic and optimistic, if not unrealistic. Hence, it is the aim of this study to examine the above-mentioned assumptions in the light of the realities on the ground.

1.1.1 Islamic Banks

Islamic bank is a bank that by its own choice, opt to comply with two sets of laws: the law of the land; and the Islamic law (Shariah). This is why Islamic banks have two sets of counsel; traditional ‘lawyers’ and Shariah councils. Islamic banks deals with transactions which are limited to financial relationships involving entrepreneurial investment subject to the moral prohibition of:-

(i) Interest earnings or usury (riba)

(ii) Haram (sinful activity), such as direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment

(iii) Speculation, betting, and gambling (maisir), including the speculative trade or exchange of money for debt without an underlying asset transfer

(iv) The trading of the same object between buyer and seller (bay’ al inah)

(v) Preventable uncertainty (gharar) such as all financial derivative instruments, forwarding contracts, and future agreements.

These distinctive properties derive from two religious sources predicated on the creation of an equitable system of distributive justice and the promotion of permitted activities (halal) and public goods (maslaha): These sources include:

(i) The Shariah which comprises the Qur'an (literally, "the way")

(ii) the sayings and actions of prophet Mohammed(peace be upon him) recorded in a collection of books know as the sahih hadith,

Islamic Shariah explicitly prohibits interest (riba) in all its manifestations. Islamic Banking and Finance in modern times has grown out of the Muslims' desire to find out the ways and means to fulfill their financial requirements in view of prohibition of interest.

In Kenya, there are two Islamic banks: First Community Bank (FCB) and Gulf African Bank (GAB). Between them they have branches in Nairobi, Mombasa, Garissa and Wajir Counties.

1.1.2 Financial Deepening

Financial deepening refers to increased provision of financial services with a wider choice of services geared to all levels of society. Financial deepening play an important role in reducing risk and vulnerability for disadvantaged groups, and increasing the ability of individuals and households to access basic social services (Shaw, 1973). Direct access to financial services can improve individual livelihoods amongst the poor by enabling them to manage scarce resources more efficiently, thereby smoothing consumption and protecting against economic shocks.

1.1.3 Islamic Banks and Financial Deepening

Islamic banks aim to have all financial transactions be based on real economic activity; and prohibit investment in sectors such as tobacco, alcohol, gambling and armaments. They provide an increasingly broad range of many financial services, such as fund mobilization, asset allocation, payment and exchange settlement services, and risk transformation and mitigation. These specialized financial intermediaries perform transactions using financial instruments that comply with Shariah principles. The main reason for emergence of Islamic banks in Kenya is the strong demand from a large number of Muslims for Shariah compliant financial services and transactions.

Financial products that comply with Islamic Shariah would improve access of financial services by Muslims who would otherwise not have benefited from those services due to the restrictions imposed by their faith.

1.2 Statement of the problem

A study carried out by Gerald in 1997 found that Islamic religious belief and social responsibility are the two major important factors that determine banks selection.

An Islamic finance system can play vital role in the economic development of Islamic and non Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest based financial channels and facilitating the development of capital markets (Zaher and Hassan, 2001).

Islamic financial market are operating far below their potential because the customers are not fully convinced about the compliance of the products offered by Islamic banks, whether they comply to the requirement of Islamic Shariahh. While some products like Profit sharing (mudharabah) and joint venture (musharakah) seems to fully comply with Islamic Shariahh, others like cost-plus tend to have the interest component which has explicitly forbidden in Islam through Quran and hadith of the prophet Muhammad (peace be upon him). There is concern that some products offered by Islamic banks in Kenya have interest component but only the word interest changed to be called profit. While appreciating the fact that interest is strongly prohibited in Islam, there is concern not to be alarmed where there is no interest involved.

Muslims in Kenya are disadvantaged in many aspects like all other ethnic minority groups, but they also suffer from some additional problems specific to them due to their faith. Muslim community suffers from significant poverty which is very complex and multifaceted. The researcher is of the opinion that lack of access to financial services has greatly exacerbated the plight of this community and the availability of suitable financial products would greatly enhance the economic power as well as their social status. The outcome of this research was valuable to all parties concerned with the predicament facing this community, including the providers of Shariah compliant financial services, the policy makers and Muslim social organizations. The good news though is that this matter is gaining recognition in Kenya's financial services industry. The authorization of the Islamic Banks by the Central bank of Kenya was an important step towards financial inclusion as the newly-established Islamic banks and other conventional banks with windows of Islamic products could serve the Muslims with financial services consistent with their faith. Shariah-compliant banks and other institutions providing similar products would play a big role in boosting financial inclusion among Muslims. Indeed, there was a general belief across the board by a large number of Muslims, which the availability of such products would substantially translate to financial Deepening. The general consensus among the Muslim community too is that they would fully engage in the financial services sector if an authentic and competitive Shariah-compliant alternative was provided for them. However, one of the objectives of this thesis is to establish whether the Shariah-compliant financial products currently on offer in Kenya have met the expectations of this community as far as accessing financial products is concerned.

1.3 General Objective

The purpose of this study is to evaluate the products offered by Islamic banks and compare it with requirements of Islamic Shariahh. It is also intended to look at the extent to which Muslims in Kenya enjoy or benefit from financial offered by these banks. The purpose of the study is therefore to find out if the introduction of Shariah-compliant financial products in Kenya has significantly improved the financial inclusion level of Kenyans.

1.4 Specific Objectives

(i) To find out if the introduction of Shariah-compliant financial products in Kenya has significantly improved the financial inclusion level of Kenyans.

(ii) To understand the overall socio-economic structures as well as the banking behaviour of Muslim community and their access to conventional finance prior to the introduction of Islamic finance Kenya

(iii) To understand banking and other micro-financial services and home-financing facilities employed by these communities.

1.5 Significance of the Study

The study was to evaluate whether the introduction of Islamic finance in Kenya has enhanced the financial inclusiveness of Muslim community. Many Muslim community leaders and commentators are of the opinion that the genuine, competitive Shariah-compliant financial products play a critical role in the financial inclusion of Kenyan Muslims. Further, these commentators assert that many Muslims are particularly excluded from the main conventional financial products such as mortgages, personal, business and investment accounts due to the prohibition of riba (interest) in Shariah the study was therefore be of importance to the customers of Islamic banks, management of the banks, the Shariah supervisory board, the shareholders of the bank and the academicians. The findings were to guide the customers and the potential customers in evaluating the products offered and align them with the Islamic Shariah. The customers would have the confidence to benefit from various financial services offered by the banks without fear of going against the teachings of their religion.

Managers of Islamic banks and other conventional banks offering Islamic products would be interested to know how their products impact on its customers. The study was significant to the bank managers in enabling them to know how their products are perceived by other people and have more in-depth understanding on people's expectations. This enabled the management of Islamic banks to come up with products that would enhance financial deepening amongst Muslims.

The findings of this study could also be used by the policy makers especially the Ministry of Finance. It would help regulators understand the banking behavior of a portion of Kenya's population and know the micro-financial services used by this group. This insight could help the Central Bank in drafting regulatory framework for guiding Islamic banks.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews present theoretical issues and looks at two theories upon which this study is hitched. Various empirical studies are reviewed and finally conclude on the effect of Islamic banks on financial deepening amongst Muslims.

2.2 Monetary and Macro Theory

Until the middle of the twentieth century, most economists found no fault with the fact that the present banking and financial system is interest based. In the mid-sixties of the last century, some economists noticed that the current macroeconomic theory is devoid of any satisfactory and acceptable rationale for holding money. As a result of this realization, attempts were made to introduce money explicitly into theory, while building the micro foundations of macroeconomics. During such process, it was natural to look into the issue of optimal monetary policies. Only then, they stumbled on the Friedman's monetary rule that a zero nominal interest rate is a necessary and sufficient condition for optimal a locative efficiency. Imposing a positive price on the use of money would lead traders to economize on its use, by using real resources. However, when the rate of interest is zero, traders had no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment. These results imply that the long forgotten Christian and Jewish teachings as well as those of Islam and Hinduism that prohibit the charge of interest on loans are not an aberration.

In a conventional market economy the rate of interest can be brought down to zero only through deflating the economy at a rate equal to the real rate of interest, which can be attained by steadily contracting the money supply at a rate equal to the representative household time preference. Such policy rule clearly implies that central bankers should implement a long-run policy of deflation, something that they would never accept (Friedman, Milton, 1969).

With deflating the economy, some economists would worry about the existence of a liquidity trap when the rate of interest is zero (Uhlig, Harald, 2000). Others point out that monetary authorities would have less leeway with adjusting the interest rate downwards in the face of recession if the rate of interest is very low. Certainly, deflation has efficiency problems parallel to those of inflation, even at very low interest rates. While many economists believe that problems involved with zero interest rates are all surmountable, monetary authorities are not yet impressed.

The fact that Islamic banking and finance avoids the use of interest-based lending has significant implications to monetary policy. In managing the money supply, the monetary authority would monitor the real rate of growth and set the rate of monetary expansion to the level consistent with prices stability and expected real growth. Some Islamic economists propose a 100per cent required reserve ratio in order to give the authorities absolute control of the money supply and to appropriate all seignior age resulting from monetary expansion to the government instead of banks' shareholders (Al-Jarhi, Mabid Ali, 2003).

The fact that the economy is as close as possible to price stability implies that the rate of monetary growth is optimal, and there is no need to divert real resources to monetary use. Therefore, Pareto optimality is assured without problematic deflationary policies. Meanwhile, people can use their cash balances to carry out spot purchases. Those with insufficient cash balances for their current purchases of assets and/or commodities can revert to finance. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources.

In case of profit sharing modes of Islamic finance, focus would be on the profitability and rate of return of the concerned investment. Financial resources would be directed to the most productive investments. This would increase the efficiency of the financing process and also reinforce efficiency in the real sectors. In credit-purchase and leasing modes of Islamic finance, money is not given outright, but rather commodities are given in return for debt obligations. Credit expansion in the face of increasing credit-purchase of assets and commodities would be tied directly to higher demand for assets and commodities, which would have a direct bearing on aggregate supply. Consequently, credit finance under Islamic finance would be less inflationary in comparison to conventional banking and finance.

2.2.1 Behavior of Credit Markets

An important part of macro theory relates to the behavior of credit markets. In conventional finance, present money is traded against future money either in integrated debt or in bond markets, where huge sums of debt are traded daily. Debt markets act as an easy conduit to move short-term funds from one country to another, more often than not, in reaction to factors that are only nebulously related to economic fundamentals. Such flows threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call “contagion.”

In contrast, debt is created in Islamic finance through selling goods and services on credit, which by itself is not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines an equilibrium mark-up rate. Such credit markets would be fully segmented. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion would therefore be remote and there would be no pressing need to choke capital movements with restrictions. Institutional participants in conventional credit markets carry out huge speculative transactions which most often turn out to a major source of instability. In contrast, Islamic banking and financial institutions are strictly prevented from carrying out such gambling activities. Thus, it seems reasonable to deduce that destabilizing speculative activity would significantly be curtailed in Islamic financial markets. Speculative activities related to interest rate expectations would become out of place. Change in spending would be reflected directly on change in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces.

2.2.2 Risk-sharing

Another important aspect of micro theory is that of risk-sharing. Conventional finance can be likened to a spectator’s game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic finance, meanwhile, is similar to participatory sports, where everyone is playing and no one is merely watching. In addition, there is a moral side to Islamic finance that seems to be in the back of everyone's mind. Risk is known to be one of the most important ingredients of making investment. In Islamic finance, those who finance investment share a good part of the risk with those who carry out actual investment activities.

Conventional finance leaves risk to be borne by specialists and traded among them. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves shielded from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only. Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it was. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions.

The banks and financial institutions can also share the decision-making process as their representatives sit on the boards of directors of firms receiving funds. It, therefore, may be noticed that risk as well as the responsibility for decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for involvement of a wider section of entrepreneur and investors in economic activities, so that people would eventually feel they are partners rather than spectators. The benefit of wider involvement goes beyond the feeling of involvement. It adds to the stability of banks. Investment depositors share risk indirectly with firms, while relying on banks for monitoring. Having the proxy vote of depositors and other investors, Islamic banks, would be capable of influencing the corporate governance of firms in a way that reduces the risks of failure and promotes profits. In other words, the stability of the banking system would reinforce and be reinforced by the stability of the real sector. The main results of this would be a higher integrity of the whole economic system.

2.2.3 Equity Consideration

An important aspect of macro theory is equity. Islamic financial system is basically viewed as private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they might contribute to the efforts taken by the whole society in that direction. *Zakah* proceeds are known to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of working and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor enough productive assets, to make them more productive, which in turn contribute to economic development. Islamic banks can help by acting as custodians of and participants in the disbursement of the zakah proceeds. Government and nongovernmental organizations (NGOs) collecting zakah can deposit part of the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they may also add a proportion of zakah due on their shareholders' equity. They might even accept direct payments of zakah and other donations on behalf of *zakah* paying individuals and philanthropic institutions.

As to income maintenance, Islamic banks can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturely liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial Institutions in project financing should come in handy in reducing poverty and increasing equity through proper use of zakah proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit sharing basis would be more concerned with profitability and rate of return than with collateral and guarantees. In an Islamic financial system those who are not wealthy, but have worthy investment projects, may also have appropriate access to finance.

2.3 Banking Theory

Let us first look at the liabilities of Islamic banks of which only demand deposits, placed on the basis of profit and loss sharing, are guaranteed. When such banks face macroeconomic or bank-specific crises, investment depositors automatically share the risk. The bank is less likely to fall bankrupt as bank run is least probable. It can, therefore, be said that an Islamic banking system is relatively more stable than conventional banking (Khan, Mohsin S. 1986).

Banking theory studies finance as a process that runs among three parties: a principal, an agent and an intermediary, where both the principal and the agent jointly finance a project which is managed by the agent and partly financed by the principal (Ennis, Huberto M. 2000).

The success of the project depends on the agent putting a minimum effort. Information asymmetry exists between the agent and the principal, and the latter cannot perfectly monitor the former. An intermediary performing monitoring on behalf of the principal would ameliorate the principal-agent problem, Holmstrom, B. and J. Tirole (1997). Islamic banking and finance relates to banking theory in two aspects. First, Islamic banks perform the function of intermediation between fund owners and firms. Banking theory can justify this role in fashion similar to the role of commercial banking, which intermediates between borrowers and lenders. It conclude that an efficient solution to the monitoring problem can be obtained when an agent pools deposits to finance investment projects (Diamond,D. 1984).

Second, Islamic banks are supposed to practice equity finance simultaneously with credit purchase and leasing finance. This implies that they are some kind of kin of universal rather than of commercial banks. Banking theory comes again to show that such a role brings extra advantages to Islamic banking. Models that provide rationale for relationship banking postulate a positive relationship between the severity of asymmetric information between banks and fund users on the one hand and informational distance on the other. When conclusions of such models are applied to Islamic banks, if unencumbered with constricting regulations, they would tend to build relationships in their core markets. Such retrenchment permits them to fend off the competitive threat to their captive market. Outside their core segment, they offer credit purchase and leasing finance, which bear some similarity to transactional loans. In equilibrium, both forms of relationship and transactional finance compete with each other but Islamic banks would be expected to specialize in a core market with relationship or universal banking (Hauswald, Robert and Robert Marquez, 2000).

Islamic banks should, therefore, function as universal banks, which are “large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters.” (Calomiris, Charles W. 2000).

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

Obviously, adverse selection can be avoided by careful screening of finance seekers. When a bank provides equity and debt finance simultaneously, it had more access to information than in a situation when only debt finance is provided. It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking. Reducing possibilities of moral hazard requires monitoring of the firm obtaining finance (Aoki, Masahiko 1994).

Equity finance provides the bank with access to information necessary to practice continuous monitoring. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, assist in order to protect its investment.

In summary, banking theory indicates that Islamic banks should operate as universal banks, and when they do, they would be exposed to lower levels of moral hazard and adverse selection. Universal banking has recently attracted much writings from both proponents and antagonists. Meanwhile, the arguments leveled against it created much discussion in the beginning but proved unfounded at the end. It has been credited with encouraging industrialization in pre-war Belgium, Germany, Italy and Japan. This confirms Gerschenkron's and Schumpeter's opinions that such form of banking spurs economic growth and helps backward countries to catch up with the developed one (Al-Jarhi, Mabid Ali (2003).

More recently, Da Rin and Hellmann (2001) have introduced financial intermediation into the big push model which has two Pareto-rank able equilibriums. They showed that universal banks can induce an economy to move from low to high equilibrium if they are sufficiently large to invest in a critical mass of firms. The costs of mobilizing the critical mass are reduced, if banks are allowed to own equity that allows them a share in the value they help create by mobilizing the critical mass. This means that universal banks found it easier to promote investments in new industries. While providing a sophisticated analytical framework for the behavior of universal banking, Da Rin and Hellmann's model is a good step towards building a macro theory of banking.

Universal banks have been accused of altering the corporate capital structure in favor of debt and against equity, inefficiently combining banking with trade, of concentration to a degree that produces anti-competitive behavior (what came to be known as the organ bank hypothesis). They have also been accused of benefiting from the inside information about the firms they lend while exercising monopolistic power over access to external finance, leading to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights. None of such accusations was found credible (Fohlin, Caroline, 2000).

2.4 Empirical Study

A study carried out by Amin (2008) 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, this choice criterion was also ranked according to the selected demographic elements such as gender, marital status and age range. He used a qualitative 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 questioners were returned with a response rate equivalent to 94 percent. The Islamic home financing choice criteria was perceived by the Malaysian bank customers were analyzed using frequencies and independent sample t-test. This study suggest that “Shariah principle” “lower monthly payment” “transparency practice, interest free practice and 100 percent financing were the first five decision criteria considered as most important. The least preferred criteria among others are recommendation, longer financing period product range and branch location. This study shows that a significant number of Muslims would opt to stay away from conventional banking if it conflict with their religion.

According to Khan & Bhatti (2008) Islamic banking has made unprecedented progress over recent years. The Middle East, South Asia and India sub continent have emerged as hubs of Islamic banking. Western conventional regulators and investors and other agents have also shown a great interest in and a receptive attitude towards Islamic banking. Despite all these Islamic banking has been facing some core problems and challenges that have deep impact on its future growth and development. The research limitations 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 and 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 series 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 interlined 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 political class of Pakistan are convinced 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 macroeconomic contrasts that should first be sorted to pave the way for any viable strategy to succeed in replacing the existing system with risk sharing and attractive interest free mechanisms. Moreover, the contents of the study woven around normative and social disciples and therefore, it is not possible to devise any statistical model to empirically test the contribution of these social economic factors in a failure of interest free banking and finance movement for future research and any identified limitations in the research process. This study shows the need to have Kenyan financial regulators and the Ministry of Finance to be looped in development of Islamic financial instruments.

The distinction between trade and Riba is worth noting as found in the Quran as God has allowed trade and prohibited Riba (Quran 2:275). From an economic point of view the exchange between buyer and seller is viewed as just, this is because the profit arising out of trade is equal to the labour and time that the sellers spend in securing the commodity to the buyer. 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 labour 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 project failure or economic catastrophe. In the context of modern financial economics, Riba al Nasiah can be defined as a risk free return form an investment vehicle or strategy (Ebrahim, 2001). 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 outflow of funds by creditors in a herd like fashion caused market to crash with high volatility in the region (Kaminsky and Reinhart, 1998; Miller 1998). As markets become more integrated the panics are felt elsewhere. The solutions based on conventional finance have failed to resolve these problems. Ghana 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 pre-defined 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 *Maysi*r by saying that "*Gharar* is something consequence of which is unknown; selling it involves 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 operators. This must be surprising to those who believe 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 does not pay interest the asset portfolios of Islamic banks do not contain sufficiently strong components that are based on profit sharing. The main reason for this is lack of a legal and institutional framework to facilitate appropriate contacts as well as mechanisms to enforce them. 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 bank 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 in 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's to provide liquidity is due to absence of suitable long term instruments to support capital formation (Mirakhor 1997).

Siddigi (2006) noted that Muslims have the same organization and motivation in finance as everybody else, they end up having a 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 any they do not need a different financial system. If they have one, we need research on what it is and how can it 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.

2.5 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 regimes conduct that encompass every sphere of the economy, honesty, social and private lives. Absence of Islamic finance in an Islamic society is a reflection of an imperfect execution of Muslim duty unto the Almighty who had described a religion for Muslims that is economically related as well.

According to the theories discussed, Islamic finance give more focus to real resources and economic activity rather than hoarding and speculating on money. Banks expected to participate in economic activities, productivity, enhancement of corporate governance fort its customers and risk sharing. While Islamic banks in Kenya and other banks who have a window of Islamic products have issued various financial products in trying to reach to financially excluded Muslim population, some of these products are looked at suspiciously by the Muslims. Being guided by the theories and empirical studies discussed, the study has an in-depth look at Islamic products and compares it with simple teachings Islamic Shariahh. An interpretation of various rules of Islamic Shariah was sought from Muslim scholars, the Muslim populace and the Islamic bankers.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

Like any other researcher, I am very concerned about the reliability, completeness and the clarity of my research findings and results and therefore have to employ the most appropriate methods and devices to achieve the desired outcome. The chapter outlines the research design to be used in this study. The sections included in the chapter are the population of the study, the sample selected for study and the data collection process. It has been concluded with the data analysis methods.

3.2 Research design

Generally speaking, research methodology refers to the method or methods of collecting; analyzing and reporting data. In other words, it is the framework in which the researcher works to collect, analyze and interpret information in order to find satisfactory findings of the study. Generally speaking, a research methodology that combines two or more research methods gives better interpretation as the information missed by one method might be captured by the other and thus an enhanced and integrated result may emerge from the analysis. Mixed research is therefore the most suitable method for my research and the two most relevant methodologies are survey questionnaires and semi-structured interviews.

3.3 Population and Sample

3.3.1 Population

Population is a group of people, individuals, events or objects that have common observable characteristics (Mugenda and Mugenda 2003, Peil 2005). The population of this study comprise of the entire Muslim population in Kenya, two Islamic banks which rolled out Islamic banking products, other conventional banks that provide Islamic products and Islamic finance scholars.

3.3.2 Sample

The concept of sampling is an integral part of most research and mine is not an exception. Sampling has been defined as a small representation of the larger whole (Rao 1994). Sampling is usually done as covering the entire population is costly and time-consuming. Instead of testing the population, you can choose a representative sample so that you can generalize the findings to the population (Keller & Warrack 2002).

The objective is to use small representations to draw conclusions from the whole, known as the 'population', the chosen sample has certain characteristics and it is the duty of the researcher to consider the following:

1. Relevant population and parameters, which refers to the population from which the sample should be selected. In this case, residents of Garissa town represent my population and a representative sample had to be selected from this population.

2. Sample size, which is very important as the size of the sample has a direct impact on the overall acceptability and the generalizability of the findings. I took many things into account in deciding the appropriate sample size including:

1. The overall economically active population in Garissa.
2. Existing literature on the subject of sampling and deciding on the most appropriate sample size.
3. The confidence level which in this case was estimated to be 0.95
4. Any statistical tools that could assist me in determining the right sample size.

The sample size was determined by adopting the standard formula, that is, $N=Z^2pqD/d^2$ as used by Cochran, 1998.

n = the minimum sample size (if the target population is greater than 10,000)

Z = the standard normal deviate at the required confidence level 1.96 which corresponds to 95

p = Proportion of the target population estimated to have characteristics being measured.

q = $1 - p$

d = the level of statistical significance or degree of freedom which is 0.05

D = Degree of accuracy = 1

Thus: $$N = \frac{(1.96)^2 \times 0.5 \times 0.5 \times 1}{(0.05)^2}$$

N = 384 Respondents

Therefore, the study used a sample size of 384 members of the 2 Islamic Banks in Garissa

3.4 Data collection process

Data collection process involves contacting members of the population. The researchers sampled in order to collect the required information about the study through survey questioners. These tools were to be administered to bank customers, Muslim scholars and potential bank customers in Garissa. The target participant was randomly found in mosques, hotels, market places and banks.

3.5 Data analysis

Data is collection of facts and figures relating to a particular activity under study Minjala(2002). Minjala (2002) also acknowledged that for the 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 the data collection and end at the point of interpretation and process of the result, Cooper and Schindler (2000). The SPSS statistical package was selected by the researcher to analyze data for its obvious appealing features. However, the fact that the majority of our data is in nominal form means that the amount of relevant inferential statistical analysis is limited. However, all the possible and relevant descriptive and inferential statistical analysis was explored and utilized as practically as possible using graphs, charts and percentages.

3.5.1 Research analytical model

The linear regression model for this study was:-

$$y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_n X_n ....\varepsilon$$

Y = financial inclusion

α = constant term (other factors that influence financial inclusion apart from the

Islamic banks)

X_1 = measured the number of people banking with Islamic banks but would not have banked with other covenant banks

X_2 = measures the number of people banking with conventional banks that have Islamic windows

X_3 = Number of people who have taken loans with Islamic banks and would not have take such loans from conventional banks

β_1, β_2 β_3 β_4 = Beta coefficient indicating various levels o importance (Wright of each factor)

Statistical tools will be used to analyze the data in order to provide for meaningful distribution of scores for this purpose SPSS will be used.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETITION

4.1 Introduction

This chapter presents analysis and findings of the study as set out in the research methodology. The results are presented on effect of Islamic banks on financial deepening amongst Kenyan Muslims. The data was gathered exclusively from questionnaire as the research instrument. The questionnaire was designed in line with the objectives of the study. To enhance quality of data obtained, Likert type questions were included whereby respondents indicated the extent to which the variables were practiced in a five point Likerts scale.

4.1.1 Response Rate

The study targeted to sample 384 respondents in collecting data with regard to the effect of Islamic banks on financial deepening amongst Kenyan Muslims. From the study, 105 out of 384 sampled respondents filled in and returned the questionnaire contributing to 72%. This commendable response rate was made a reality after the researcher made personal visits to remind the respondent to fill-in and return the questionnaires.

Table 4:1: Response Rate

Response	Frequency	Percentage
Responded	110	28
Not responded	279	72
Total	384	100

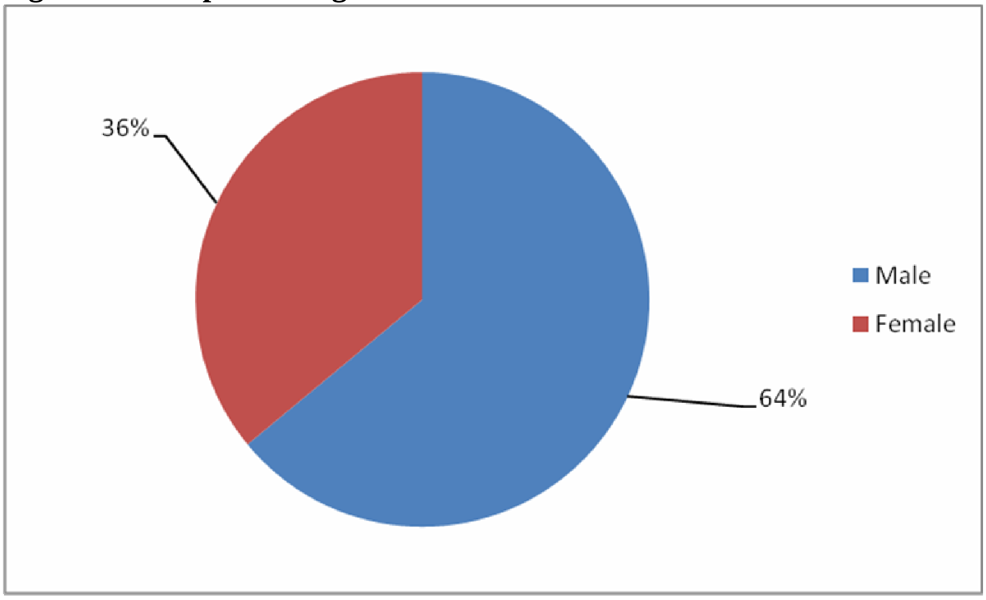
Source: Researcher (2013)

4.2 Respondents Information

4.2.1 Respondents Gender

From the figure below majority of the respondents were male with 64% and 36%of females.

Figure 4.1: Respondents gender



Source: Researcher (2013)

4.2.2 Distribution of Respondents by Age

The highest number of respondents was 47% age group 35-49 years, while a further 44% of the age group was 25 to 34 years, 8% consisted of respondents above 65years, as the table below illustrates.

Table 4.2 Respondents age

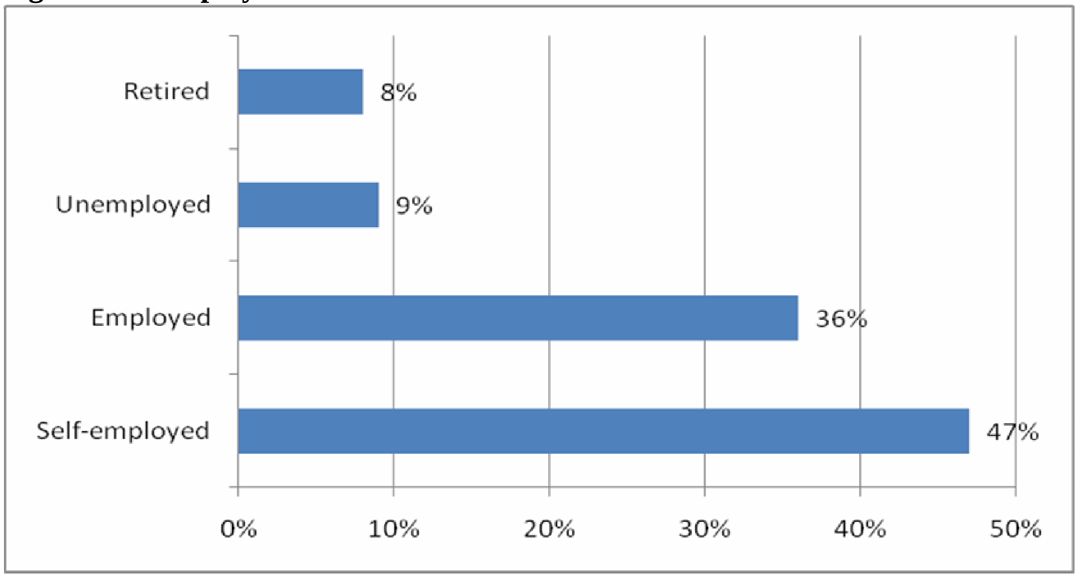
	Frequency	**Percent**
25-34	49	44
35-49	52	47
65+	9	8
Total	**110**	**100**

Source: Researcher (2013)

4.2.3 Current Employment

The figure below illustrates that majority of the respondents with 47% were self employed while those employed had a percentage of 36%, those unemployed were only 9%and 8% retired.

Figure 4.2: Employment details



Source: Researcher (2013)

4.2.4 Respondents Educational Qualifications

The highest number of respondents as the table below indicates had a diploma level with 30% of education whilst a further 36%were degree holders; a 8%of them had a secondary school education and others had masters degree as the table shows.

Table 4.3: Respondents education

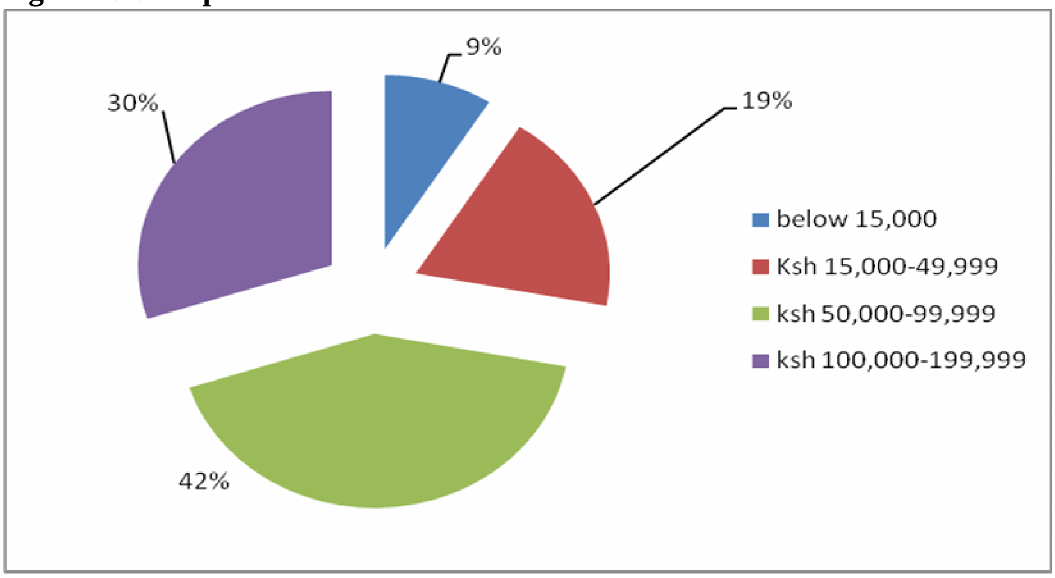
	Frequency	**Percent**
KCSE	30	27
Diploma	31	28
Degree	29	27
Masters	20	18
Total	**110**	**100**

Source: Researcher (2013)

4.2.5 Monthly Income

The respondents' monthly income with the highest percentage had income between ksh 50,000-99, 999; the least had an income of below ksh 15,000, as the figure below illustrates.

Figure 4.3: Respondents income



Source: Researcher (2013)

9% of the respondents had a monthly income of below Kshs15,000, 30% had income between Kshs. 15,000 to kshs. 50,000, while those between kshs. 50,000 to kshs. 100,000 were 42%. 19% of the respondents had earnings above Kshs. 100,000.

4.3 Conventional Financial Services

This section is intended to collect and analyze data on whether the respondents have financial products offered by conventional banks.

4.3.1 Access to Conventional Financial Services

Majority of the respondents had a current account with the highest percentage of 43% followed by savings account with a percentage of 32%, 25% did not have account.

4.3.2 Financial Products From Conventional Bank

The following financial products from conventional bank were used by the respondents 20% personal loan, 16% as business loan and 64% have not taken any loan**.**

Table 4.4: Respondents financial products

	Frequency	**Percent**
Personal loan	22	20
Business loan	18	16
None	70	64
Total	**110**	**100**

Source: Researcher (2013)

4.3.3 Financial Products from Islamic Bank

82% of the respondents had not taken any loan with any Islamic bank before, as the table below shows.

Table 4.5: Respondents Islamic bank products

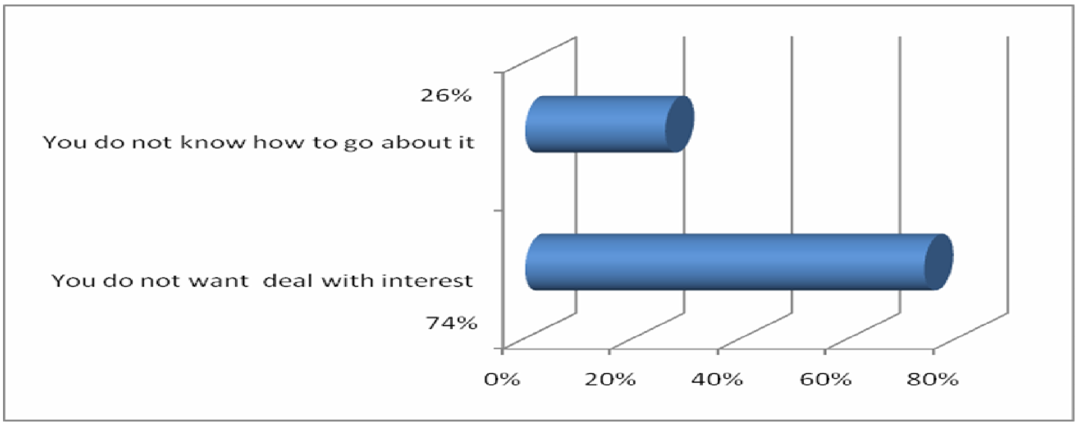
	Frequency	**Percent**
Personal loan	5	5
Business loan	15	14
None	90	82
Total	**110**	**100**

Source: Researcher (2013)

4.3.4 Reasons Not Having Financial Products

Majority of the participants with 74% did not want any deals with interests, 26%of them did not know how to go about it, as the figure below illustrates.

Figure 4.5: Reasons not having financial products



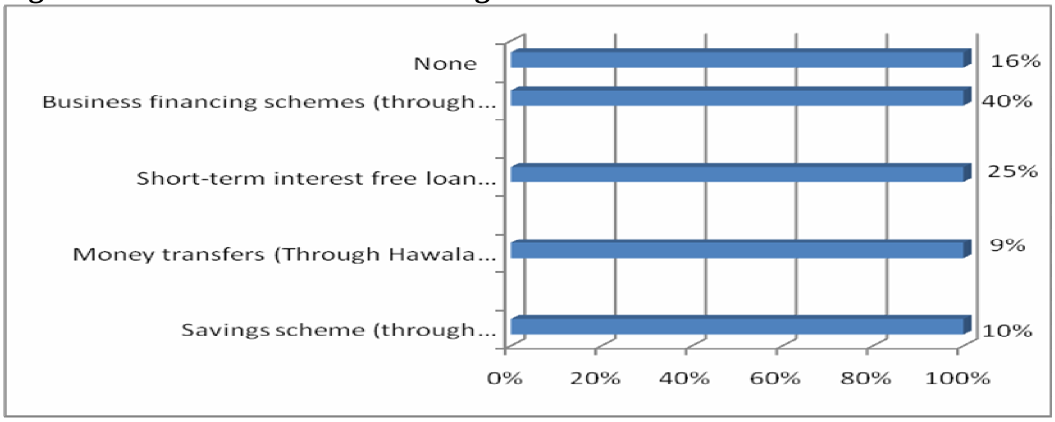
Source: Researcher (2013)

26% of the respondents said they do not know how to go about the processes of getting loans from Islamic banks while 74% said they did not want to deal with interest. They feel that Islamic banks offer nothing different from conventional banks in terms of dealing with interests.

4.3.5 Financial Products with High Demand

Business financing schemes was the most important financial service needed on day to-day basis, as the figure below shows with 40% while Short-term interest free loan had a 25% response money transfers had a response of 9%, while savings scheme had 10% as the figure below shows

Figure 4.6: Financial Product on High Demand



Source: Researcher (2013)

4.4 Existing Shariah compliant financial products

This section is intended to collect and analyze data on whether the respondents have financial products offered by Islamic banks.

4.4.1 Shariah compliant Information knowledge

All the participant had information about the existing Shariah compliant financial products in Kenya before as the below table shows;

Table 4.6: Respondents knowledge on Shariah compliant

	Frequency	Percent
Yes	110	100

Source: Researcher (2013)

β_1 A percentage of 59% had a bank account with the institutions offering Shariah compliant financial products while 41 percent do not as the table shows.

Table 4.7: Respondents with Shariah compliant bank accounts

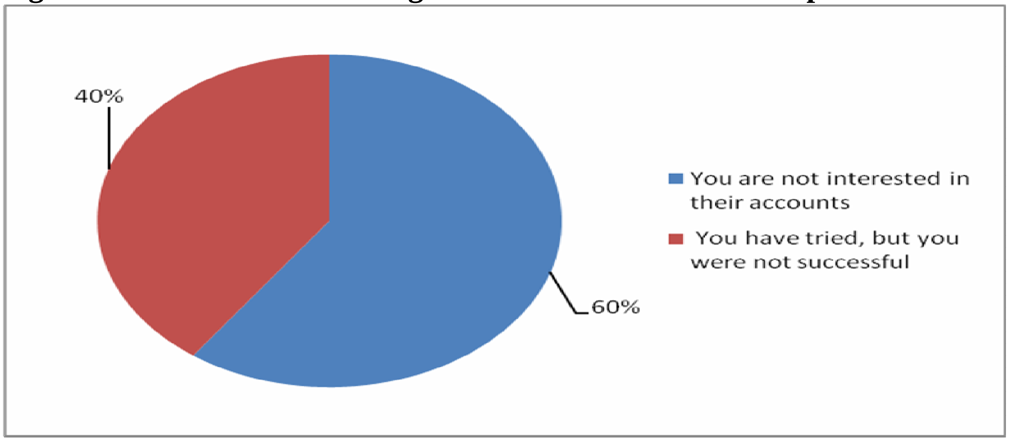
	Frequency	Percent
Yes	65	59
No	45	41
Total	**110**	**100**

Source: Researcher (2013)

4.4.2 Reasons Not Having Accounts with Shariah Compliant

The main reason why the respondents did not have an account with any of the institutions providing Shariah compliant financial products was 40% who said they are not interested in their accounts, 60% said they think they are not any different from the conventional banks

Figure 4.7: Reasons Not Having Accounts with Shariah Compliant



Source: Researcher (2013)

4.3.3 Respondents Residence

Of the 110 respondents, 75% live in rented property while 25% of them live in owned property as the table shows.

Table 4.7: Respondents residence

	Frequency	**Percent**
Rented property	83	75
Owned property	27	25
Total	**110**	**100**

Source: Researcher (2013)

4.4.4 Mortgages Taken

In the table; out of the 110 respondents 20% took a conventional mortgage to purchase property while 80% of them did not as the table illustrates.

Table 4.8 Mortgages taken

	Frequency	**Percent**
Yes	12	11
No	98	89
Total	**110**	**100**

Source: Researcher (2013)

4.5 Expectation from the introduction of Islamic finance in Kenya

4.5.1 Respondents owning Businesses

The respondents who were not in business had 34% of the respondents, while 66% were in business as the table below illustrates.

Table 4.9: Respondents owning businesses

	Frequency	Percent
No	37	34
Yes	73	66
Total	**110**	**100**

Source: Researcher (2013)

4.5.2 Business Loan for Startup Business

From the table below 64% of the respondents did not take out a loan from any bank or any other institution when starting up the business.34% of the respondents took a loan.

Table 4.11: Business loan for startup

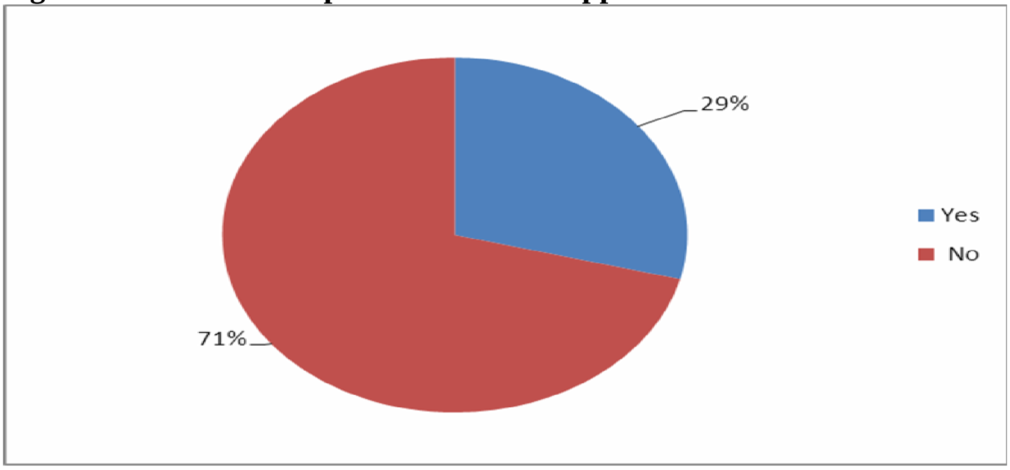
	Frequency	Percent
No	73	66
Yes	37	34
Total	**110**	**100**

Source: Researcher (2013)

4.5.3 Shariah Compliant Institutions Approached

The figure below illustrates that 71% did not approach any of the institutions offering Shariah compliant financial products for raising finance for their business and a total of 29% approached Islamic banks.

Figure 4.9: Shariah compliant institutions approached



Source: Researcher (2013)

4.5.4 Reasons Not Approaching Shariah Compliant Institutions

The reason why the respondents did not approach the institutions had a total of 29% who did not need their help, 19% did not know about Shariah compliant, 50% think they are not different from conventional banks while 31% gave reasons like strict policies in giving out their loans.

Table 4.12: Reasons not approaching the Shariah compliant institutions

	Frequency	**Percent**
You did not need their help	21	19
You think they are not different from conventional banks	55	50
Other	34	31
Total	**110**	**100**

Source: Researcher (2013)

4.5.5. Shariah Compliant Institution Instructions

The availability of suitable Shariah compliant business finance would help mostly in the expansion of the business with a response of 55% another 20% said it would help to improve lives of many muslims16% said it would result in wealth creation among Muslims 11%of the respondents needed to get the meaning of Shariah compliant as the table shows.

Table 4.13: Importance of Shariah compliant institutions

	Frequency	**Percent**
Expand business, leads to more profits	65	59
Improve lives of many Muslims	20	18
Result in wealth creation among Muslims	25	23
Total	**110**	**100**

Source: Researcher (2013)

CHAPTER FIVE

SUMMARY OF FINDINGS CONCLUSIONS AND RECOMMENDATIONS

5.1Introduction

This chapter provides the summary of the findings from chapter four, and also it gives the conclusions and recommendations of the study based on the objectives of the study. The objectives of this study were to determine the effects of Islamic banks on financial deepening amongst Kenyan Muslims, to understand the overall socio-economic structures as well as the banking behaviour of Muslim community and their access to conventional finance prior to the introduction of Islamic finance Kenya, To understand banking and other micro-financial services and home-financing facilities employed by these communities.

5.2 Summary of the Findings

The findings and the results of the research have been presented in a more technical and analytical way in the chapters. This section summarizes the main research findings intending to present some policy recommendations. The main research findings related with research objectives here is worth mentioning that form part of my own empirical results.

The Islamic banking and finance in Kenya is a community based banking driven by the financial needs of the customers from the Muslim community and is intended to meet the financial needs of the community which have diverse financial needs like any other segment of the market in terms of bank accounts and financial products like housing, personal and business finance. The Islamic banking and finance system is an alternative and not a replacement of the traditional banking and financial system in Kenya or anywhere else and its proportion is very small as compared to the traditional counterpart. The growth of Islamic banking in Kenya, in spite of all the supportive policies of the government and regulators, has not been very effective in terms of attracting a larger segment of the Muslim audience in the market and producing some socio-economic changes in the living conditions and business and economic activities of the Muslim community. According to this research, 82% of the respondents have not taken any loan from the Islamic banks, majority (74%) thought they are not different from other conventional banks and that they did not want to deal in interest. Others gave other reasons like bureaucracy and strict policies and requirements in giving out loans; others said the Islamic banks have poor marketing strategies in informing customers about their products. Majority (59%) of the respondents has a bank account with the Islamic banks or banks offering Islamic products but they have not benefitted from any of their products.

5.3 Conclusions

Islamic banking is continuing to grow as a viable financial institution in areas with Muslim populations across the world, yet its effect on economic growth and the deepening of financial systems was previously undetermined. This paper attempted to add to the literature on Islamic banks by investigating effect of Islamic banks on financial deepening amongst Kenyan Muslims. Furthermore, the effect of Islamic banks on financial deepening amongst Kenyan Muslims was tested. Confirming past research on the topic, the most significant indicator of the diffusion of Islamic banks is the presence of a Muslim population. This finding is supported by previous evidence that Islamic banking appears to be a complement to, rather than a substitute for, conventional banks.

Muslims in Kenya appreciate the need to have financial products that comply with their faith; they have strong need for financial support which is yet to be satisfied by the available Islamic banks in Kenya. There is also a need to come up with or revise existing financial regulations in Kenya to enable these Islamic banks fully comply with Shariah.

5.4 Recommendations

Based on the revealed facts previously mentioned in the section of research findings, a suggestion of some basic and significant recommendations to improve the performance of Islamic banking and finance institutions,. Here it is worth mentioning that the performance of Islamic banking and finance from a socio-economic perspective is a multifaceted and complicated issue with many reasons working behind as it has previously been mentioned. Among these reasons are; skepticism, availability of small range of the products, extra marginal cost of the products, less access of the customers to these products, little knowledge and less awareness of the people about Islamic finance and these products, low credit worthiness of the less affluent and financially excluded segment of the market etc. Therefore it requires more sophisticated and comprehensive solution rather than suggesting one single solution as magic stick to improve the situation overnight. The study further recommends change in financial regulations by Central bank, like allowing the banks to have joint venture with borrowers, allow the banks to share in profits and loss of borrowers' businesses that they finance.

5.5 Suggestions for Further Research

Some further research areas where future researcher can work to improve the results contribute to bring a positive change and the correlation between financial and social performance of Islamic banks can further be, studied with more specific areas and wider resources for research. Although we have very limited research discussing the financial and economic aspect of Islamic banking Kenya, but the social role of this newly banking system has almost been neglected and needs to be explored in more specific way. The regression analysis between social and economic and financial performance of the Islamic banks in Kenya and correlation between business and economic activity of the less affluent and provision of Islamic microfinance in Kenya, Dealing with social problems like extremism and radicalization through providing Islamic banking and financial services to the unemployed Muslim youth in Kenya, the financial inclusivity and pluralism and Islamic microfinance in Kenya

REFERENCES

Al-Jarhi, M. (2003), “Islamic Banks & Universal Banks: Need for leveled playing field”, A paper presented to the International Seminar on Islamic Banking: Risk Management, Regulation and Supervision, organized by the Ministry Finance Indonesia, the Central Bank Indonesia and the Islamic Research and Training Institute, Jakarta, Indonesia, September 30.

Alexakis C. & Tsikouras, A. (2009), Islamic finance regulatory framework: Challenges lying ahead International Journal of Islamic and Middle Eastern Finance and Management.

Amin, H. (2008), Determination of choice criteria in Malaysia’s retail banking. Kyala Terrenganu. Malaysia.

Aoki, M (1994), “Monitoring Characteristics of the Main Banking System: An Analytical and Developmental View” in The Japanese Main Bank System, edited by M. Aoki and H. Patrick. New York: the Oxford University Press, 1994.

Ariff, M. (1988), ‘Islamic banking’, Asian-pacific Economic literature, vol.2 No.2 pp 46-62).

Calomiris, D. and Charles W. (2000), “Universal Banking and the Financing of Industrial Development” in Gerard Caprio, Jr. and DimitriVittas, Eds, Reforming Finance: Some Lessons from History.

Chapra, M. (2009), the global financial crisis: Can Islamic finance help? Retrieved April 01 2009 from new horizon Islamic banking; http://www.new horizon-Islamic banking.com/index.

Cooper, D. and Schindler M. (2000).Business research method 8th Edn New Delhi tata ma Graws Hill).

Da Rin, M. and Thomas H. (2001), “Banks as Catalysts for Industrialization”, William Davidson Working Paper Number 443 October.

Diamond, D. (1984), “Financial Intermediation and Delegated Monitoring”, Review of Economic Studies, 51, 393-414.

Ebrahim, M. (2001), Islamic banking in Brunei, Drarussalum. University of Brunei Darussalam /National university of Singapore, Singapore and Tankai JOO Kemuda.

El-Gamal, M. (2006), Overview of Islamic Finance.

Ennis, N. Huberto M. (2000), "Loanable Funds, Monitoring and Banking", Seminar, Department of Economics, Cornell University.

Friedman, M. (1969), "The optimum quantity of money", in The optimum quantity of money ad other essays, pp. 1–50. Chicago: Aldine.

Gerald, P. (1997), Division of banking and finance, Anyang Business school. Nyanyang technology university' International journal of bank marketing, 15/16 pp. 204-206.

Hanlon, M. (2005) Islamic Bank of Britain Offers Helping Hand to the Financially Excluded. The Islamic Bank of Britain Press Release Archives.

Hassan, M & Lewis M (2007) Islamic banking: An introduction and overview in MK Hassan and MK Lewis Handbook of Islamic banking (pp 1-17). Massachusetts Edward Elgar Publishing limited.

Holmstrom, B. and Tirole J (1997), "Financial Intermediation, Loanable Funds and the Real Sector", Quarterly Journal of Economics, 62, 663-691.

Holy Qur'an, Al-rayan Publishers, Saudi Arabia.

Iqbal, Z. & Abbas M. (2007), An Introduction to Islamic Finance. Singapore: John Wiley and Sons.

Khan, P. & Mohsin S. (1986), "Islamic Interest-Free Banking", IMF Staff Papers, March.

Khan, M. & Bhatti, M. (2008) Development in Islamic banking: A financial risk allocation approach.

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

Keller, G. and Warrack, B. (2002) Statistics for Management and Economics (5th edition). Duxbury: Thompson Learning.

Lewis N, Mervyn K., and Latifa M. (2001), Islamic Banking. Cheltenham: Edward Elgar Publishing Ltd.

Rao, K. (1994), Research Methodology in Commerce and Management. New Delhi: Sterling Publishers Private.

Shaw, E, (1973), Financial Deepening in Economic Development. Oxford University Press.

Uhlig, H. (2000), “Should We Be Afraid of Friedman’s Rule”, Humboldt University, Berlin, June.

Yudistira D. (2003), ‘Efficiency of Islamic banks; an empirical analysis of 18 banks’, finance no. 0406007, Econ UPA.

APPENDICES

Appendix I: Questionnaire

Name (Optional)………………………………………………………

Phone Number…………………………………………………………

PART A: I**nstructions**: Please tick the appropriate box

Personal profile

1. Gender
    - o Male
    - o Female

1. Age group
    - o 16-24
    - o 25-34
    - o 35-49
    - o 50-64
    - o 65+

3. Employment status
    - o Self-employed
    - o Employed
    - o Unemployed
    - o Retired
    - o Other, Please specify---

4 Educational qualifications

- None
- KCSE
- A-level
- Diploma
- Degree
- Other Please give details--
  -

4. Household Monthly Income

- Below 15,000
- Ksh 15,000-49,999
- Ksh 50,000-99,999
- Ksh 100,000-199,999
- Ksh200,000 and over

PART B: Instructions: Please tick the appropriate box

Your access to conventional financial services

6. Which of the following types of accounts do you or anybody in your household have?
   - Current account
   - Savings accounts
   - Others, please specify--
   - None

7. Which of the following financial products with a conventional bank do you have or ever had?
   - Mortgages
   - Persona
     l loan
   - Busines
     s loan
   - Interest earning savings account
   - Other, please specify ---
   - None
8. Which of the following financial products with an Islamic bank do you have or ever had?
   - Mortgages
   - Persona
     l loan
   - Busines
     s loan
   - Interest earning savings account
   - Other, please specify ---
   - None
9. If you do not have any of the products with conventional banks,
   what is main the reason?
   - You do not want deal with interest
   - You do not need to borrow
   - You are too poor to get these
     facilities
   - You do not know how to go about it
   - You tried, but did not succeed
   - Other reason-Please specify--

10. Some of the important financial services that you need on day to-day basis, but you cannot find in your conventional bank and access from elsewhere includes:
    - Savings scheme (through family/friends credit unions)
    - Money transfers (Through Hawala companies)
    - Short-term interest free loan (Through family and friends credit unions)
    - Business financing schemes (through Family/friends credit unions).
    - None
    - Other, Please specify---

PART C: I**nstructions**: Please tick the appropriate box

Your knowledge of the existing Shariah compliant financial products and how they influence your access to financial services in Kenya

10. Have you heard about the existing Shariah compliant financial products in Kenya?
    - No
    - Yes Please explain what you know about them------------------------------
11. Do you have a bank account with any of the institutions offering Shariah compliant financial products?
    - Yes
    - No
12. If you said No to the above question, the main reason you do not have an account with any of the institutions providing Shariah compliant financial products is because:
    - You are not interested in their accounts as you believe they are not that different from conventional banks.
    - You think they do not provide good service
    - You have tried, but you were not successful
    - Other, please specify---

13. Do you live in?

- o Rented property
- o Owned property
- o Council/Government house/flat
- o Other, Please specify---

14. Did you take out a conventional mortgage to purchase your property?

- o Yes
- o No

15. If you had a mortgage, before the introduction of Shariah compliant mortgages. Did you switch your conventional mortgage to a Shariah compliant one?

- o Yes
- o No, Please explain why? ---

PART D: I**nstructions**: Please tick the appropriate box

Your expectation from the introduction of Islamic finance in Kenya (For Muslim SMEs)

16. Are you in business?

- o No
- o Yes, Please explain the type of business and the method of financing it----------

----

17. Did you take out a loan from any bank or any other institution when you were starting up the business?

- o No
- o Yes, Please explain the nature of the loan and from which institution----

----

18. Did you approach any of the institutions offering Shariah compliant financial products for raising finance for your business?

- o Yes, Please explain what the outcome was-----------------------------------
- o No

19. If No to the above question, the main reason of not approaching these institutions is:
    - You did not need their help
    - You did not know about them
    - You think they are more expensive than their conventional counterparts
    - You have advised not to approach they as they are not for small man
    - Other, please specify--

20. In your opinion, how would the availability of suitable Shariah compliant business finance impact on your business strategy? ---

PART E:

Your attitudes towards the Shariah compliant financial products on offer in Kenya

21. Islamic mortgages are more expensive than conventional counterparts.

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

22. The availability of Shariah compliant products will enhance Muslims' access to financial services such as home financing.

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

23. There are many Muslims in Kenya who are not accessing financial products such as basic banking and home financing due to their faith and would do so if they had an Islamically acceptable alternative

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

24. The Shariah compliant financial products on offer in Kenya, such as home-financing products, are not different from the conventional ones, but it is a matter of inserting Arabic terms to suggest Shariah compliance

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

25. A large number of Kenyan Muslims should switch their banking and home-financing services to Shariah compliant products even if they have to pay more

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

26. The majority of Muslims think that the institutions providing Shariah compliant products are not as profiteering and aggressive than their conventional counterparts.

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

27. The Shariah compliant products on offer are very selective and cater only for the rich who are just a minority in Muslim population.

1	2	3	4	5
Strongly Disagree	Disagree	Neutral	Agree	Strongly agree

Interview questions for the Islamic bankers

1. What Shariah compliant products do you offer in Kenya? -------------------------------

2. How long have you been providing these financial products? ----------------------

----

3. What percentage of your current customers has not been accessing conventional banking services due to their faith? ---

4. Could you briefly explain the steps, if any, your organization has taken to enhance financial deepening and what has been achieved so far? -----------------------------------

5.According to your records, how many Muslims have switched their mortgage and bank accounts to yourselves after learning about your Shariah compliant products?-----

----

6.Some people argue that the reason why the Shariah compliant products on offer in Kenya are not very popular with many is because they believe that these products are not technically different from their conventional counterparts and more expensive, what is your response to this argument?--- -------------

Questions for the Islamic Finance and Banking scholars

1. In your opinion, how popular are the Shariah compliant products with their target customers? ---

2. In your opinion, what role should Islamic financial products play in enhancing financial deepening and is it doing that? --

----

3.A large number of Muslims are skeptical about the existing Shariah compliant products on the basis that they are not substantially different from their conventional counterparts, how justified is this skepticism in your opinion?

----

4. What do think is the future of Islamic banking and what are the challenges it should overcome to succeed? --

Appendix II: Time Plan

Phase	Description	Number of weeks										
		1	2	3	4	5	6	7	8	9	10	11
1	Data collection											
2	Data analysis											
3	Data interpretation											
4	Report writing											
5	Compilation and presentation											