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

BY

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DECLARATION
I declare that this project is my original work and has not been presented for an award of a degree in any other University.

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

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DEDICATION

This project is dedicated to my family and the School of Business University of Nairobi fraternity.
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LIST OF ABBREVIATIONS

BLR- Base Lending Rate

CBK-Central Bank of Kenya

CPI – Consumer Price Index
IDB –Islamic Development Bank

IMF –International Monetary Fund

Ksh – Kenya Shillings
MCos – Mudaraba Companies
OIC- Organization of Islamic Conference

PLS- Profit-and-loss-sharing

ROA - Return on Asset

ROE-Return on Equity

SCP – Structure Conduct Performance
ABSTRACT

Shariah compliant finance has become an accepted niche product and service in local financial transactions. It offers a fresh opportunity to emphasize the moral and ethical aspects of business and finance that reaches beyond the Islamic world to prompt a re-examination of the core values underlying all financial transactions. In the recent past in Kenya, there has been a substantial increase in the number of new initiatives to develop and improve the concept of Islamic financing. The main objective of this study was to investigate the effect of Islamic banking products on the financial performance of commercial banks in Kenya over a period of five years (2009 to 2013). Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables. Multiple regression analysis was carried out to investigate the nature of the relationship between the dependent and independent variables. Looking at the variables collectively, it’s evident that there was a strong positive significant relationship between bank performance and Bank size, Liquidity, Murabaha, Mudaraba and Tawarruq. Although Ijara had a positive relationship with return on assets it was not significant. From this we can conclude that an increase in either of the variables of interest is associated with an increase in Islamic bank performance. The ANOVA shows that the F value of 22.278 & P value <0.05 indicates that the overall regression model for the control variables is significant hence it has some explanatory value. Hence, there is a significant relationship between bank size, liquidity and bank performance. At 95 percent confidence interval i.e. P-value (p<0.05) it implies that both the control variables combined do influence Islamic banks performance. In addition, an F value of 16.475 & P value <0.05 indicates that the overall regression model constituting of both control and predictor variables have an influence on Islamic bank performance. Bank size is the most influential control variable since it had the most statistically significant coefficient as indicated by a t ratio of 4.652 and a beta coefficient of 0.346. Also there is a significant positive relationship between liquidity ratio and Islamic bank performance as indicated by (β=6.228, t=3.175 and p value < 0.05). In the full model constituting of predictors and the control variables Murabaha had the most statistically significant coefficient as indicated by the t-ratio of 3.461(β=7.20E-10, t=3.461, p value =3.461). It is important to note that all the available Islamic products available in Kenyan commercial banks had a positive significant relation with the exclusion of Ijara which had positive insignificant relationship. This implies that an increase in provision of Islamic banking services in Kenyan commercial banks will lead to increase in Banks performance.
CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

The Organization of Islamic Conference (OIC) defines an Islamic bank as a financial institution whose statutes, rules and procedures expressly state its commitment to the Principles of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations. Tayyebi (2008) describes Islamic Finance as any Finance that is compliant with the principles of Islamic Law.

Ariff (1988) described how the first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967, by which time there were nine such banks in the country. These banks neither charged nor paid interest, invested mostly in trade and industry, directly or in partnership with others, and shared profits with depositors. Thus, they functioned essentially as saving investment institutions rather than as commercial banks. The 1970s heralded the arrival of a new age in Islamic finance witnessing the establishment of the Nasir Social Bank in 1971, Philippine Amanah Bank in 1973, the Dubai Islamic Bank in 1975, the Kuwait Finance House, the Faisal Islamic Bank of Sudan, and the Faisal Islamic Bank of Egypt, all in 1977, the Bahrain Islamic Bank in 1979, and the Qatar Islamic Bank in 1981, to mention a few.

Siddiqi (1999) states that an increasing number of Western banks have established subsidiaries and/or specialist divisions to offer corporate finance and investment banking services for tapping the deposits of high net worth individuals. The list of these Western financial institutions includes such well known names as Citigroup, ANZ, Grindlays, JP Morgan, Deutsche Bank, ABN AMRO, Goldman Sachs, Chase Manhattan, NatWest, Societe General, and HSBC among others.
In Kenya, the first Islamic bank, Gulf African Bank started operations in 2008 (Source: CBK). Islamic banking is noted as the fastest growing segment of the credit market in Muslim countries that have Islamic banks and their market share has risen from 2 percent in the late 1970s to about 15 percent, as measured by assets in the banking system. And by some estimates, funds under Islamic management are increasing at the rate of 15-20 percent a year (The Banker 2000).

### 1.1.1 Islamic Banking Products

Generally, bank activities can be grouped into two activities. First is banking traditional activities and the second is banking non-traditional activities. Banking traditional activities refer to activities which are based on accepting deposits and offering loans (Moshirian & Lean, 1998) while banking non-traditional activities are activities that offer fee-producing activities (ranging from underwriting activities to cash management, custodial services and trading income (Sanep, Ismail and Shahida, 2005).

Musharaka (Partnership Finance) is a contract among two or more parties, each contributing some of their capital in a joint commercial venture. Profit ratios have to be specified in advance but in case of a loss, it must be shared in proportion to the capital sums contributed. There are differences of opinion in fiqhas to whether profit ratios can differ from ratios of capital contribution. Among the classical jurists, Malik and Shafi’i do not permit it; Ahmad makes it subject to free consent, while Abu Hanifah caps the share of a perpetual sleeping partner to no more than the proportion of his investment (Usmani, 2002).

Mudaraba (Trust Financing) is a contract in which the bank provides all the capital while the partner contributes commercial efforts, professional skills and experiences. Finally, the bank receives a predetermined proportion of the profits. In the case of a loss, the bank bears all the financial loss whilst the manufacturer goes unrewarded (Rob, 1992). It is concluded that this system encourage the individual to participate in financial activity and prove himself as an active part of society.
Murabaha (Cost-plus financing) is a particular type of sale (murabaha simply meaning ‘mark-up sale’) that Islamic jurisprudence considers as a trust contract, because the seller and the buyer do not negotiate the price, but rather agree on a certain profit margin added to the cost, as faithfully declared by the seller (Saadallah, 2007). Moreover, in classical Islam a murabaha transaction involving a sale for cash was the norm. The first step in converting the original murabaha into a vehicle for financing was to make the extension of credit an essential feature of the transaction. This was done by having the murabaha concluded on the basis of deferred payment instead of cash settlement.

Bai-mua’jjal (deferred payment sale) is a contract which is traded without additional costs. The parties agree to payment of the price at a time in the future. This contract is valid if the date of payment is set unambiguously, that is, with reference to a specific date or a specific period. However, the date of payment cannot be set with reference to a future event when the exact date of occurrence of that event is either unknown or uncertain. The deferred price could be set higher than the spot price as long as the price is set at the time of purchase. Hence, the price cannot be changed once the sale contract has been concluded (Usmani, 2006).

Ijara (Leasing) is a rent contract by which the owner of the good rents it to another party bidding it. After that the latter can purchase it and rent is reduced until the good become the possession of the client (Bellalah and Ellouz, 2004). Nowadays the Home Finance and Islamic mortgage are based on the concept of Ijara and it is very successful tool in Islamic financial system.

Qard Hasan (welfare loan) is an instrument in Islamic financial system provided to the customers who are facing financial crises or unpredicted expenditure without paying any fees or interest. It is a loan that is returned at the end of the agreed period without any interest or share in the profit or loss of the business (Chapra, 1985).
1.1.2. Financial Performance

Islamic banking is phenomenally profitable because, although its underlying funding mechanism is the same as conventional banking, its default experience is better, and its charges higher and less transparent (Cook, 2006). Islamic banks had US$1.54 Trillion in Shariah compliant assets with commercial banks globally in 2012 and an average ROE of 12.6% for the top 20 Islamic banks, compared to comparable conventional average of 15% (Source: World Islamic banking competitive report 2013). Some reports suggest that assets held by Islamic financial institutions may rise five-fold to more than $5 trillion (Source: Moody’s Investor Service).

Samad (1999) studied the links between efficiency and performance of Islamic banks. Comparing the efficiency of conventional and Islamic banks, Samad found that Islamic banks tend to become inefficient when operating within the dual banking environment. Samad and Hassan (1998) also observed that in some aspects, Islamic banks out performed conventional banks. Hassan and Bashir (2003) studied the effects of controlled and uncontrolled variables on Islamic banks profitability. They found that while factors such as capital, overhead, gross domestic product and conventional interest rates were positively related to profitability; loan ratios, reserves taxes, and size were adversely related.

1.1.3. Effect of Islamic Banking Products on Financial Performance

In general, Islamic banks are performing better than conventional banks. Ayub (2002) observed that Islamic banks are well capitalized, profitable and stable due to their effective use of resources. In comparison to international standards in banking, Islamic banks are at par with them in terms of profitability ratios but their operations are not cost effective.

Campbell (2010) observed that at the onset of the global financial crisis of 2008, Islamic banks were seen as one type of financial institution that had fared well and they were viewed by some as a possible savior to fill the gap made by failed conventional banks. Islamic banking is grounded on the prohibition of being involved in interest-bearing
activities. Taken to its logical end, this prohibition means that Islamic banks cannot hold any securitised assets, interest related derivatives or other assets that led to the 2008 global financial crisis. Hasan and Dridi (2010) found that the Islamic banking business model shielded Islamic banks from adverse profit effects that befell many conventional banks in 2008.

Beck et al. (2010) found that many of the conventional products can be redrafted as Shariah compliant products, so that the differences are smaller than expected. There is also consistent evidence of higher capitalization of Islamic banks and this capital cushion plus higher liquidity reserves explains the relatively better performance of Islamic banks during the recent crisis.

1.1.4. Commercial Banks in Kenya

There are forty-three licensed commercial banks in Kenya. Among them, only two, the Gulf African bank and First Community bank are fully-fledged Islamic banks. The conventional commercial banks have set up Islamic windows offering Islamic products and services (Source: CBK). According to CBK annual Report 2013, The Kenyan Banking Sector recorded improved performance in the fiscal year 2012/13 with total assets standing at 15 percent higher in June 2013 compared to June 2012. The sector recorded enhanced performance with the size of assets standing at Ksh 2.5 trillion, loans and advances amounting to Ksh 1.5 trillion, while the deposit base stood at Ksh 1.9 trillion and profit before tax of Ksh 61.5 billion as at June 30, 2013. During the same period, the number of bank customer deposit and loan accounts stood at 18.9 million and 3.8 million, respectively. The banking sector gross loans and advances increased from Ksh 1.29 trillion in June 2012 to Ksh 1.45 trillion in June 2013 translating to a growth of 12.9 percent.

The sector registered improved capital levels in June 2013 with total capital which comprises core and supplementary capital, growing by 23.7 percent from Ksh 294.3 billion in June 2012 to Ksh 364.0 billion in June 2013. The shareholders’ funds increased by 25.2 percent from Ksh 315.1 billion in June 2012 to Ksh 394.4 billion in June 2013.
The ratios of total and core capital to total risk-weighted assets therefore increased from 20.3 percent and 17.7 percent to 23.3 percent and 20.2 percent, respectively. The banking sector registered Ksh 61.5 billion pre-tax profits during the period ending June 30, 2013, which was an increase of 15.6 percent from Ksh 53.2 billion as at June 2012. Total income stood at Ksh 177.3 billion, a marginal growth of 0.5 percent compared with Ksh 176.4 billion registered at the end of June 2012.

1.2. Research Problem

Shariah-compliant banks are inherently more stable than conventional peers. Speculation is forbidden, and because charging interest is prohibited under shariah law, returns are based on profit-sharing. Many factors have contributed to the development of Islamic finance and the spread of Islamic banking. (IMF, 2009) has investigated the determinants of the pattern of Islamic bank diffusion around the world using country-level data for 1992–2006. It was argued that the huge influx of petrodollars from the late 1970s, as well as the consistently high oil prices in international markets, has provided a strong impetus for the development of several Islamic banks in the Middle East. Islamic banking is spreading wherever there is a sizable Muslim community and is not restricted to Muslim countries.

The probability for Islamic banking to spread in a given country rises with the share of the Muslim population, income per capita, and whether the country is a net exporter of oil. Trading with the Middle East and economic stability are also conducive to the diffusion of Islamic banking. Proximity to Malaysia and Bahrain, the two Islamic financial centers, does matter. The interest rates’ decrease enhances the development of Islamic banking because they reduce the opportunity cost for less deeply religious individuals to put their money in a conventional bank.

Several formal critiques have been conducted to highlight, on the one hand, the main critical areas where the conventional economic system conflicted with Islamic values, and on the other to lay out alternatives to interest-based financial systems and banking
that have started to gain momentum in Muslim countries. The contributions of Qureshi and Siddiqi, were considered important in this regard. Their works focused on studying how Islam could propose an introduction to Islamic Finance and Islamic Banking framework to organize an economy and providing a formal definition of Riba, as well as explanations and rationales behind the prohibition of interest. The main studies proposed a comparison framework between the economies based on Islamic tenets, socialism and capitalism and emphasized the operational and organizational model of an Islamic bank.

Parallel to the research initiatives taken by Islamic international institutions such as the IDB and its research arm the Islamic Research and Training Institute established in 1981, the World Bank as well as the International Monetary fund were among the first conventional institutions to initiate research on understanding the macroeconomic efficiency and financial stability of an interest-free economic system as well as the financial implications of a loss and profit sharing mechanism (Khan 1987, Khan and Mirakhor 1990). There has also been an outpouring of continuous research on the nature and operation of interest free banks by Muslim economists such as Siddiqi, Bashir and Chapra.

By exploring the different Islamic contacts, these researches led to the laying out of alternatives to the conventional banking system. In fact, the main results of their efforts were to provide a framework to the early theoretical models of Islamic banking based on the concept of Profit and loss sharing through the Musharaka and Mudaraba contracts. The two-tier Mudaraba financial intermediary model was thus designed and its efficiency and performance assessed.

Chapra (1985) initiated discussions on corporate governance in Islamic financial institutions. He underlined that Shariah compliance in Islamic banks will lead to differences in governance mechanisms in Islamic banks compared to conventional banks. He also provided an overview of corporate governance from an Islamic perspective, focusing on the Islamic financial institution and presented a model defining stakeholders in Islamic banks. He argued that, in contrast with the conventional bank’s corporate
governance mechanism where the depositors’ interest does not receive much attention, Islamic banks’ corporate governance should give emphasis to protect depositors’ interest in their business.

As far as the asset liability management is concerned, interest toward the development of Sharia-compliant derivative, securitized and structured based instruments has gained momentum. Iqbal (1999) pointed out that the Islamic system of contracting allows for designing risk management solutions using the framework of financial derivative products. He analyzes and discusses the case of a specific Islamic contract, istijrar, and highlights its possible use in managing certain forms of risk. He also argued that Islamic finance provides the basic building blocks that can be used to construct more complex financial instruments that will enhance liquidity and offer risk management tools. The study thus seeks answers to the research question: What effect does Islamic banking products have on the financial performance of commercial banks?

1.3. Research Objective
To establish the effect of Islamic banking products on the financial performance of commercial banks in Kenya.

1.4. Value of the Study
Islamic banking offers products based on the concept of risk-sharing which is a very important aspect of a financial product due to the numerous financial crises that emanate from today’s greedy financial advisors and gullible investors. Islamic banking products provide a fresh opportunity to emphasize the moral and ethical aspects of business and finance that reaches beyond the Islamic world to prompt a re-examination of the core values underlying all financial transactions. Kenya offers significant growth prospects for Islamic banking owing to its vast Muslim population. Hence, deepening Islamic finance could help Kenya attract investment from cash-rich Islamic funds in the Gulf and South-East Asia. This study seeks to research how the performance of Islamic products and
services has encouraged the growth of this niche sector in Kenya in order to tap into its growth and profitability.
CHAPTER TWO

LITERATURE REVIEW

2.1. Introduction

The extent of literature review covers the theoretical review, the determinants of Islamic banking performance and the empirical review.

2.2. Theoretical Review

This section covers three theories; Islam and the Theory of interest, Profit loss sharing theory and Mohsin theory, which serve to extend existing knowledge on the origin and basis of Islamic banking.

2.2.1. Islam and the Theory of Interest

A few visionary individuals, scholars, bankers, Islamic economists and Shariah scholars started Islamic banking system as a universal banking system in 1970.

Qureshi (1946) looked upon banking as a social service that should be government sponsored by like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any.

Uzair (1955) invoked the principle of mudaraba based on Shariah. His principal contribution lay in suggesting mudaraba as the main premise for ‘interestless banking’. Siddiqi (1983) thought that interest-free banking could operate successfully only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offence. He also thought it’s important to have Islamic laws enforced before interest-free banking could operate well. This view has not gained acceptance, as demonstrated by the many Islamic banks which operate profitably in 'hostile environments'.
2.2.2. Profit Loss Sharing Theory

Ahmad (1952) envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds. Uzair (1955) says that Islam emphasizes agreed ratios of profit sharing rather than fixed and predetermined percentages. Instead, the transactions should be on a profit and loss sharing basis.

2.2.3. Mohsin Theory

Mohsin (1982) model was designed to fit into a capitalist environment. Many of the activities listed certainly go beyond the realm of commercial finance and are so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. In addition, he stated that riba-free banks could coexist with interest-based banks.

Mohsin (1982) states that his model incorporates the characteristics of commercial, merchant, and development banks, blending them and adding various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by finance business alone.

2.3. Determinants of Commercial Bank Performance

Performance to banks refers to the capacity in generating sustainable profitability (Wild, Shaw & Chiappetta, 2009). A popular framework used by regulators is the CAMEL framework, which uses some financial ratios to help evaluate a bank’s performance. Fitch
(1990) states that CAMEL bank rating is used by bank’s management to evaluate financial health and performance.

The five CAMEL factors are Capital Adequacy, Asset Quality, Management Quality, Earnings and Liquidity. They indicate an increased likelihood of bank failure when any of these five factors prove inadequate. However, an Islamic bank could fail as much due to non-compliance with the Shariah as for financial imprudence. Therefore it should be ensured that all activities of an Islamic bank comply with Shariah principles (Al-Jarhi and Iqbal, 2001).

2.3.1. Islamic Banking Products

Idries et al. (2013) examined Mudaraba loans and found that Mudaraba loans have inverse relationship with various profitability indicators. The implications of this result is that Islamic banks who work in countries with Hybrid banking system (Islamic and conventional banks) face a serious problem with Mudaraba loans because the borrowers prefer to transact with conventional banks when they expect high return for their project while they prefer Islamic banks when they expect low return for their project.

Dar et al. (2011) argue that PLS features marginally in the practice of Islamic banking and finance. Whatever the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their businesses. Even specialized Islamic firms, such as Mudaraba Companies (MCos), which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a Mudaraba or Musharaka basis. Most Islamic banks and finance companies have so far been engaged in short term financing. Mudaraba and Musharaka, being long term financing instruments, have as a result been ignored. Hence, there is a need to innovate in designing short term PLS contracts, for example, to stage the financing, as is common in venture capital financing.

They cited several limitations of PLS contracts. First, PLS contracts are inherently vulnerable to agency problems, as entrepreneurs have disincentives to put in effort and
have incentives to report less profit compared to the self-financing owner-manager. This argument is based on the idea that parties to a business transaction will shirk if they are compensated less than their marginal contribution in the production process, and as this happens in the case of PLS, capitalists hesitate to invest on a PLS basis. The argument further goes back to a different worldview of ownership under PLS as compared to the capitalist worldview, which allows only those who own certain crucial means of production to be legitimate residual claimants in the production process. Entrepreneurs claim profit. Capitalists, on the other hand, put an emphasis on the productivity of capital and, hence, are reluctant to bear any losses incurred in production. Capitalists’ unwillingness to bear risk and entrepreneurs’ tendency to exclude others from sharing profits has resulted in a less favorable response to PLS from the financial and business community. Second, PLS contracts require well-defined property rights to function efficiently. Therefore, in countries where property rights are not properly defined or protected, PLS contracts are deemed to be less attractive or to fail if used. Third, Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive. Fourth, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense.

Also, the Mudaraba certificates issued by MCos do not give voting rights to certificate holders, and hence no AGM is called. Fifth, equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk. This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially markup to ensure a certain degree of liquidity. Sixth, unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing. Seventh, secondary markets for trading in Islamic financial instruments, particularly Mudaraba and
Musharaka, are non-existent. Consequently, they have so far failed to effectively mobilize financial resources. Hence, proponents of Islamic banking take the exclusion of PLS as a serious operational deficiency and face a challenging task ahead to innovate PLS-based products to make the asset side of banks more dependent on profit and risk-sharing.

Murabaha contracts for financing activities such as developments via fake invoices has been a real practice so far in the Iranian banks due to the lack of a strong surveillance mechanism. Habibi (2009) claimed that many of facilities offered by Iranian banks in forms of Islamic products such as Murabaha are doubtful for concluding riba. It represents that the Iranian banks are merely carrying Islamic labels not rather than dummy version of Islamic banks.

2.3.2. Capital Adequacy

Capital base of financial institutions facilitates depositors in forming their risk perception about the organization. Also, it is a significant structure for financial managers to maintain adequate levels of capitalization. Capital adequacy is very useful for a bank to conserve & protect shareholders confidence and prevent the bank from bankruptcy.

In the standard CAMEL framework, it is assessed according to: the volume of risky assets, the volume of marginal and inferior assets, bank growth experience, plans, and prospects; and the strength of management in relation to all the above factors (Sundarajan and Errico, 2002).

2.3.3. Asset Quality

Asset quality determines the healthiness of financial institutions against loss of value in the assets as asset impairment risks the solvency of the financial institutions.

In the standard CAMEL framework, asset quality is assessed according to: the level, distribution, and severity of classified assets, the level and composition of non-accrual
and reduced rate assets, the adequacy of valuation reserves; and the demonstrated ability to administer and collect problem credits (Sundarajan and Errico, 2002).

### 2.3.4. Management Quality

Management quality means adherence to set norms, ability to plan and be proactive in the dynamic environment, leadership, innovativeness and administrative competence of the bank.

In the standard CAMEL framework, management is evaluated according to: technical competence, leadership, and administrative ability; compliance with banking regulations and statutes; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; tendencies toward self-dealing; and demonstrated willingness to serve the legitimate needs of the community (Sundarajan and Errico, 2002).

### 2.3.5. Earnings

Capacity and functions of the Shariah Supervisory Boards should also be reviewed. Given the complexity of many Islamic banks’ operations, involving the monitoring of investment projects, managing commodity inventories at times, legal uncertainties relating to Shariah litigation systems, and similar problems, establishing adequate internal systems and controls for managing risks and validation of transactions play a particularly crucial role in the effective management and containment of operational risks (Sundarajan and Errico, 2002).

The quality of earnings represents the sustainability and growth of future earnings, value of a banks’ lucrativeness and its competency to maintain quality and earn consistently. The single best indicator used to gauge earning is the Return on Assets (ROA). However, for this study in addition to the ROA, we shall also use the Return on Equity (ROE) ratio.
In the standard CAMEL framework, earnings are assessed according to: the ability to cover losses and provide for adequate capital; earnings trend; peer group comparisons; and quality and composition of net income (Sundarajan and Errico, 2002).

The criteria set for earnings and profitability in the standard CAMEL rating framework are generally applicable to the Islamic banks as well. According to Sundararajan and Errico, economic losses would first result in a depreciation of the value of the depositor’s wealth and then affect the bank’s equity position in the event that it had also used its own resources to finance the loss making investment project (e.g., through a Musharaka arrangement). Also, such risks to deposits, if they materialize, might result in reputational damage and loss of depositor base, leading to liquidity and, possibly, solvency problems (Sundarajan and Errico, 2002).

2.3.6. Liquidity

In case of an adequate liquidity position, the institution can obtain sufficient funds, either by increasing liabilities or by converting its assets to cash quickly at a reasonable cost.

In the standard CAMEL framework, liquidity is assessed according to: volatility of deposits; reliance on interest-sensitive funds; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to inter-bank markets or other sources of cash, including lender-of-last-resort (LOLR) facilities at the central bank (Sundarajan and Errico, 2002).

2.4 Empirical Review

This section covers the international evidence and local evidence.

2.4.1. International Evidence

Hassan and Bashir (2003) researched the determinants of Islamic Banking profitability between 1994 and 2001 for 21 countries. They used the regression model whereby a variety of internal and external banking characteristics were used to predict profitability and efficiency. Their results show that Islamic Banks have a better capital asset ratio
compared to conventional banks. Surprisingly, they document a negative relationship between total assets and profitability, which means that smaller banks are more profitable. In addition, during an economic boom, bank profitability seems to improve because there are fewer nonperforming loans. Inflation, on the other hand, does not have any effect on Islamic Bank profitability.

Haron (2004) researched the impact of internal and external variables on the profitability of Islamic Banks in selected countries from 1984 to 2002. The data used are panel data and it is assumed that all behavioral differences between individual banks are captured by the intercept. A dummy variable approach is applied. He found that liquidity, funds deposited into current accounts, total capital and reserves, assets structure, inflation and money supply have a significant long-run relationship with the profitability of Islamic Banks. Also, the percentage of profit-sharing between bank and depositors positively influence the profitability of Islamic Banks. The results also show that interest rates, inflation and size have significant positive impact on the profits of Islamic Banks.

Samad (2004) researched the comparison between the performance of Islamic Banks and conventional banks in Bahrain after the Gulf War of 1990. The study applies Student’s t-test to financial ratios for Islamic and conventional commercial banks in Bahrain for the period 1991-2001The results indicate that there is no significant difference, in terms of profitability and liquidity, between Islamic Banks and conventional banks. Moreover, Islamic Banks are exposed to less credit risk than conventional banks.

Ali (2004) researched on the Islamic modes of finance and associated liquidity risks. He found that in case of Islamic banks the nature of shariah compatible contracts are an additional source of liquidity risk, particularly if the conventional financial infrastructure is maintained. In the case of a murabaha contract the bank buys the commodity for a client and sells it to him on a markup price to be paid later. However, in this contract the ordering client has the right to refuse acceptance of the delivery for some reasons. If he rejects and refuses to receive the commodity the bank is stuck with it until another buyer is found. Also if the buyer is unable to pay the due amount on time this can also give rise to liquidity risk for the bank. Liquidity risk comes in an ijara contract when the bank has
to pay the price of the asset upfront to acquire the asset before it can lease it to its customer. The liquidity risk depends upon whether or not the asset is readily resell-able in the market. This risk is however less than that is found in murabahā contract because murabahā is not re-sellable and re-price-able. Salam is an advance payment commodity sales contract where the delivery of the commodity is deferred. When a bank signs to purchase a commodity on salam, liquidity risk exposure occurs when the bank requires cash but is unable to exit the salam contract by selling it to a third party before maturity because of the shariah restriction of “do not sell what is not in your possession.” Thus there cannot be a secondary market for trade in salam contracts. Also, even if the commodity becomes available it may not have an active market. Istisna is a manufacture to order contract for yet to be manufactured good on payment of an advance price either in full or in installments. The primary liquidity risk arises in the same way as in salam contract, since debt cannot be sold. However, the liquidity risk in istisna is lower than that of salam because in salam full upfront payment is necessary.

Chong and Liu (2009) researched on whether Islamic banks are indeed interest-free, using Malaysian experiences as a case study. Their findings suggest that profit- and loss-sharing schemes are indeed the distinguishing feature of Islamic banking although they tend not to be as important as a mode of financing on the assets side of the balance sheet. While the financing structure on the deposit-side is theoretically a profit- and loss-sharing contract, pay-outs tend to be closely pegged to rates on conventional deposits. They also found that there is little difference in substance between Islamic and conventional banks. And like conventional banks, Islamic banks do earn fees and commissions relating to services beyond traditional deposit and loan financing activities.

2.4.2. Local evidence
Ongore (2011) researched the influence of ownership identity on the performance of commercial banks. He used linear multiple regression model and Generalized Least Square on panel data to estimate the parameters. He observed that the risk-taking behaviour and investment orientation of shareholders have great influence on the decisions of managers in the day-to-day affairs of firms. The management decision, in
turn, is affected by the interests of the owners which is determined by their investment preferences and risk appetite.

Wako et al. (2014) conducted a study that sought to determine the challenges affecting the performance of Islamic banks in Kenya. The research was carried out through descriptive survey design and it involved gathering of facts opinions and views of staffs on the challenge that affect the performance of Islamic banks. The target population for this research study included 250 Islamic banking staff in Nairobi County. The sampling frame for this study was Islamic bank staff in Nairobi County. This study adopted random sampling method. In relation to internal/bank specific challenges it was concluded that risk asset management, weak corporate governance and poor human resource practices, influence the performance of Islamic banks. In addition one of the most serious problems being faced by Islamic banks is the lack of proper legal framework to deal with cases of delayed payments and bad loans expeditiously. Since Islamic banks cannot charge interest on the delayed debts, they face a bigger risk of default as well as loss in income. These considerations, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. Also, as far as management quality is concerned, it was found that there is a serious shortage of scholars who possess even a working knowledge of both Islamic fiqh and modern economics and finance. Similarly, most of the managers of Islamic banks are not very well trained in the use of Islamic modes of finance. An institution is what its employees make it. Therefore, it is extremely important to have the people with the right kind of skills and commitment to run the Islamic banks.

2.5. Summary of the Literature Review
In Islam and the Theory of Interest, (Qureshi, 1946) proposed an interest–free financial system where by Muslims are prohibited from taking or giving interest regardless of the purpose. However, some commodities are discretely charging interest on their products by pegging the profit-margin of a product on an underlying interest rate. Alsayyed (2010) researched on the uses and misuses of commodity murabaha. He found that Commodity murabaha is one of the most commonly used financing contracts in Islamic banking. It is
flexible enough to facilitate many structures for financing, hedging, and currency exchanging. However, it has many potential avenues for outwitting the shariah objectives and spirit. It is not the permissibility of murabaha contracts per se but their indiscreet use and faulty structuring, that in many cases guarantees not only a fixed profit rate benchmarked on interest but also the return of the principal through buy-back provisions - which is fueling the perception that from Islamic banks interest is out but interest is in; it only walks in an Islamic cloak.

In addition, it was expected that Islamic banks would progress in time to genuine operations based on the objectives of an Islamic economic system and that they would distance themselves from what resembled interest based enterprises. However, what is currently happening is the opposite, namely, Islamic financial institutions have now begun competing to present themselves with all the same characteristics of the conventional banks. Like mainstream banks, they too are diverting the savings of those at the lower rungs of society to the richer classes. Researches in the direction of the uses of funds may prove unrewarding. In addition the distribution of earnings between the owners of banks and the depositors especially the smaller ones, may be found much skewed in favor of the former.

Amin and Chong (2007) researched on whether inflation and deflation affect Islamic home financing in Malaysian Islamic banks. Their main objective was to explain Islamic home financing and its performance in relation to the economic situation such as in inflation and deflation. Islamic home financing carries fixed/flat rate, which does not change according to the market rate, and is more secure than conventional home loans. Inflation does not increase the cost of financing of Islamic home financing, since the government cannot impose the base lending rate (BLR) which is riba and uncertain from Islamic point of view. Hence, this causes Islamic home financing to be stable due to the flat rate imposed on the facility.

It is advantageous to the customer because he will consistently pay the fixed monthly payment or installment from the beginning of the payment period to the final settlement by the customer. Evidently, the monthly payment will remain the same. However, the
country faces inflation because of the increment in the average price of the goods in the market. In order to reduce the pressure of inflation the government through the Central Bank announces to increase the interest rates imposed by conventional banks in the country. Consequently, conventional banks tend to increase their interest rates as well as to re-examine the interest rate offers for the existing home loan offers to the customer. On the contrary, Islamic home financing tends to be uncertainty-free because it does not have any relationship with inflation control by the government.

Because the Islamic financial system ignores inflation and deflation effects on the economy of a country, the flat rate imposed by Islamic banks benefit individuals more as compared to the banking institutions. Hence, pricing for Islamic home financing which is based on the flat rate system does not price financing equitably. Therefore, some adjustments are needed to reduce the gap between both the customers of the banks and the Islamic banks.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction
This section describes the research design of this study, states the target population, highlights the data collection method used and analyses the data collected.

3.2. Research Design
Nachmias and Nachmias (1996) describes a research design as the blueprint that enables the investigator to develop solutions to the research problems and guides him in the various stages of the research. Descriptive study was undertaken in order to ascertain reliability of data collected so as to be able to describe the characteristics of the study’s variables and answer the research question.

Best and Kahn (2005) state that descriptive research is aimed at describing characteristics of variables in a situation and is concerned with conditions or relationships that exist, opinion that are held, processes that are going on, effects that are evident or trends that are developing.

3.3. Target Population of the Study
Target population refers to the total number of subjects or the total environment of interest to the researcher (Oso and Onen, 2009). Secondary data was used to analyze the effect of Islamic banking products on financial performance of commercial banks in Kenya. 6 commercial banks were used for purposes of the study (APPENDIX 1)

3.4. Data Collection
Secondary data on Islamic banking products for the financial years 2009-2013 was obtained from the financial statements of commercial banks that offer Islamic banking
products. In the event that they were not published, the researcher wrote to individual banks requesting for the information.

3.5. Data Analysis

Data analysis refers to examining what has been collected in a survey or experiment and making deductions and inferences (Kombo & Tromp, 2006). Data was organized by use of descriptive statistics. Descriptive analysis such as mean, standard deviation, frequencies and percentages was used to analyze data.

Inferential statistics such as Pearson correlation and multiple regressions was used. Multiple regression is a statistical technique used to examine the way a number of independent variables relate to one dependent variable. The Multiple Regression Analysis was used to determine the nature of relationship between independent variables and the dependent variable.

The analytical model for this research, was developed and justified in the literature review, and represents how the various Islamic banking products affect the financial performance of commercial banks. The required assumptions of this multiple regression model are that:

a) The error variable (ε) is normally distributed,

b) The mean value of the error variable is zero,

c) The variance of the error variable is a fixed but unknown value,

d) The values of the error variable are independent of one another, and

e) Relationship between financial performance of commercial banks and variables of financial products is linear.

3.5.1. Analytical Model

The regression model expressed in mathematical notation is as follows:

\[
Y = \alpha + \text{Mus} \beta_1 + \text{Mud} \beta_2 + \text{Mur} \beta_3 + \text{Ija} \beta_4 + \text{Sal} \beta_5 + \text{Bba} \beta_6 + \text{Ist} \beta_7 + \text{AQ} \beta_8 + \text{LQ} \beta_9 + \text{BS} \beta_{10} + \varepsilon
\]
Where:

\[ Y = \text{Return on Assets} \]

\[ \alpha = \text{constant term (The Y intercept)} \]

Beta (\( \beta \)) = Beta coefficients

\( \varepsilon = \text{Error term.} \)

Mus = Musharaka (partnership) financing as measured by the natural logarithm of amount invested.

Mud = Mudaraba (finance by way of trust) financing as measured by the natural logarithm of amount invested.

Mur = Murabaha (cost-plus financing) financing as measured by the natural logarithm of amount invested.

Ija = Ijara (leasing) financing as measured by the natural logarithm of amount invested.

Sal = Salam (advance purchase) financing as measured by the natural logarithm of amount invested.

Bba = Bai bi-thaman Ajil (deferred payment financing) financing as measured by the natural logarithm of amount invested.

Ist = Istisnaa (commissioned manufacture) financing as measured by the natural logarithm of amount invested.

AQ = Asset Quality as indicated by the ratio of total non-performing loans to overall loan portfolio

LQ = Liquidity as indicated by short term investments of the bank in relation to total assets

BS = Bank Size as measured by the natural logarithm of the book value of assets.
3.5.2. Test of Significance
The coefficient of determination, denoted as $R^2$ was used to indicate how well data fit into the statistical model. F-statistics (also known as fixation indices) were used to undertake further analysis. Analysis of variance (ANOVA) tests were used in the analysis of experimental data to test the variables for statistical significance.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1. Introduction
The current chapter presents the study findings as per the formulated objectives. The conceptual framework as described in chapter one will be tested. In the first section descriptive statistics will be presented and in part two Pearson correlation coefficient and regression analysis will be presented and interpreted. The conceptual model will be tested for fitness using p values and t statistics value. Currently there are seven commercial banks offering Islamic banking services in Kenya. Among the seven banks offering Islamic Banking services i managed to collect the required data from only four commercial banks which constituted almost 60%. According to Kothari (2004) a response rate of 60% and above is appropriate for social sciences, therefore, in the current study the response rate was appropriate.

4.2. Descriptive Statistics
Table 4.1 shows the descriptive statistics for the dependent variable, independent and control variables used in the present study. The mean average return on assets was 17.5% and standard deviation of 1% indicate that banks offering Islamic banking have almost the same performance. Murabaha was the most common Islamic financial product averaging 1,628,090,647 per annum among the four banks. Musharaka had a mean of 1,428,939,639, followed by Ijara, Mudaraba and Tawarruq. Among the control variables the average size of Islamic banks was 20.9 and their liquidity was 31.22%.
Table 4.1: Overall Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return of Assets</td>
<td>0.1749946</td>
<td>1.00342952</td>
</tr>
<tr>
<td>Murabaha</td>
<td>1628090647</td>
<td>1548426222</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1428939639</td>
<td>1655556932</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>27300000</td>
<td>12536221.21</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>153000000</td>
<td>80097966.33</td>
</tr>
<tr>
<td>Ijara</td>
<td>140572562.5</td>
<td>90933036.62</td>
</tr>
<tr>
<td>Bank size</td>
<td>20.9</td>
<td>1.97884</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.31222</td>
<td>0.06817</td>
</tr>
</tbody>
</table>

*Source: Research Findings*

Since the study was carried from 2009 to 2013. Descriptive statistics was carried out for different years as shown below. Table 4.2 shows that despite the presence of Islamic finance, commercial banks offering the services had an average loss of (70%), a factor that can be attributed to unfamiliarity of Islamic financial services in the Kenyan economy, even though the bank liquidity was 25.5% and Murabaha had the highest average.

Table 4.2: Year 2009 Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>-0.7002368</td>
<td>0.13738571</td>
</tr>
<tr>
<td>Murabaha</td>
<td>1908519140</td>
<td>578345239.7</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1502264135</td>
<td>236685243.5</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>27300000</td>
<td>.0000</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>153000000</td>
<td>.0000</td>
</tr>
<tr>
<td>Ijara</td>
<td>181210188</td>
<td>92409875</td>
</tr>
<tr>
<td>Bank size</td>
<td>21.0552</td>
<td>2.62134</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.25525</td>
<td>0.019414</td>
</tr>
</tbody>
</table>

*Source: Research Findings*

Table 4.3 shows an improvement of Islamic banks performance in the year 2010 since banks had an average loss of (19.7%) which shows a great improvement from the previous year. This can be attributed to sensitization and awareness of the customers in regard to Islamic financial services. Murabaha and Ijara were the most common Islamic financial products since they had the highest average. Since the standard deviations of
Mudaraha and Tawarruq were 0 it implies that all the banks experienced equal demand for the two products.

**Table 4.3: Year 2010 Descriptive Statistics**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>-0.1970826</td>
<td>0.77282394</td>
</tr>
<tr>
<td>Murabaha</td>
<td>2030140640</td>
<td>821588239.7</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1649288635</td>
<td>530734243.5</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>27300000</td>
<td>.0000</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>153000000</td>
<td>.0000</td>
</tr>
<tr>
<td>Ijara</td>
<td>202818437.5</td>
<td>135626375</td>
</tr>
<tr>
<td>Bank size</td>
<td>21.1644</td>
<td>2.55936</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.30425</td>
<td>0.070178</td>
</tr>
</tbody>
</table>

*Source: Research Findings*

Table 4.4 shows that in the year 2011 commercial banks had an average return on assets of 31.9% and the Islamic financial products had very high averages. A closer scrutiny of the bank size depicted that there was a persistent upward trend in the bank size which implies that the bank’s assets base increased with increase in commercial banks performance. The banks liquidity in the year 2011 averaged at 32.4% which showed an upward trend. Thus, the management should ensure that their commercial banks adhere to the minimum required liquidity ratios.

**Table 4.4: Year 2011 Descriptive Statistics**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.3196531</td>
<td>0.78584471</td>
</tr>
<tr>
<td>Murabaha</td>
<td>964023170.7</td>
<td>1656536423</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1078798047</td>
<td>2042931496</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>24975000</td>
<td>4650000</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>116000000</td>
<td>74000000</td>
</tr>
<tr>
<td>Ijara</td>
<td>83805562.5</td>
<td>39615647.55</td>
</tr>
<tr>
<td>Bank size</td>
<td>21.2729</td>
<td>2.01286</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.324</td>
<td>0.103228</td>
</tr>
</tbody>
</table>

*Source: Research Findings*
Table 4.5 shows that during the year 2012 commercial banks offering Islamic banking had the highest return on assets which averaged at 71.1% and the liquidity ratio was 32.8% while the banks had an average size of 21.7. This shows that the bank returns on assets was highest in the year 2012 as compared to the other years. Murabaha was still the most common Islamic financial product while the demand for Mudaraba remained at constant level of 153 million per annum.

Table 4.5: Year 2012 Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.711213</td>
<td>1.38750449</td>
</tr>
<tr>
<td>Murabaha</td>
<td>1498452617</td>
<td>2408100139</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1214572654</td>
<td>2168069412</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>21850000</td>
<td>10900000</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>153000000</td>
<td>.000</td>
</tr>
<tr>
<td>Ijara</td>
<td>72005062.5</td>
<td>42904143.74</td>
</tr>
<tr>
<td>Bank size</td>
<td>21.6949</td>
<td>1.91503</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.32808</td>
<td>0.06645</td>
</tr>
</tbody>
</table>

*Source: Research Findings*

Table 4.6 shows that there was a decline on the return on assets among the banks offering Islamic financial services to 52.26% while their liquidity increased to 34.95%, the decline can be attributed to the electioneering period since the general election was held on March 2013. Owing to the history of the year 2007 investors may have shied off to minimize the chances of experiencing political risk.

Table 4.6: Year 2013 Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.5226185</td>
<td>1.16860917</td>
</tr>
<tr>
<td>Murabaha</td>
<td>1739317664</td>
<td>2164517873</td>
</tr>
<tr>
<td>Musharaka</td>
<td>1699774723</td>
<td>2784348596</td>
</tr>
<tr>
<td>Tawarruq</td>
<td>35075000</td>
<td>26971883.51</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>190000000</td>
<td>177499295.8</td>
</tr>
<tr>
<td>Ijara</td>
<td>163023562.5</td>
<td>58477077.35</td>
</tr>
<tr>
<td>Bank size</td>
<td>22.3124</td>
<td>1.65134</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.3495</td>
<td>0.047676</td>
</tr>
</tbody>
</table>

*Source: Research Findings*
4.3. Inferential Statistics
Having carried out the descriptive statistics the study employed inferential statistics so as to draw conclusions and recommendations. Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables and since all the variables were in ratio scale Pearson Moment correlation coefficient was used. Multi regression analysis was carried out to investigate the nature of the relationship between the dependent and independent variables.

4.3.1. Correlation Analysis
Table 4.7 reports the study correlation matrix. There was a strong positive significant relationship between bank performance and bank size (Pearson correlation = 0.755). Liquidity had a significant positive relationship with return on assets (Pearson correlation = 0.615). Murabaha had the strongest positive significant relationship with return on assets amongst the Islamic products by Islamic banks in Kenya (Pearson correlation = 0.617). Although, Ijara had a positive relationship with return on assets it was not significant (Pearson correlation = 0.397). Tawarruq had a positive significant relationship with return on assets (Pearson correlation = 0.159). Mudaraba had a positive significant relationship with return on assets (Pearson correlation 0.038). Therefore, it can be deduced that an increase in either of the variables of interest is associated with an increase in Islamic bank performance.
Table 4.7: Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>Bank size</th>
<th>Liquidity</th>
<th>Murabaha</th>
<th>Tawarruq</th>
<th>Mudaraba</th>
<th>Ijara</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>P value</td>
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<tr>
<td>N</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Pearson</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Bank size</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.755**</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
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<td>20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.615**</td>
<td>-0.183</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>0.005</td>
<td>0.44</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>N</td>
<td>20</td>
<td>20</td>
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<tr>
<td>Murabaha</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.617**</td>
<td>0.715**</td>
<td>-0.031</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>0.005</td>
<td>0.00</td>
<td>0.896</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tawarruq</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.159**</td>
<td>0.065</td>
<td>0.019</td>
<td>-0.001</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>0.516</td>
<td>0.785</td>
<td>0.936</td>
<td>0.998</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>N</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Mudaraba</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.038*</td>
<td>0.047</td>
<td>-0.031</td>
<td>-0.004</td>
<td>0.882**</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>0.878</td>
<td>0.845</td>
<td>0.897</td>
<td>0.987</td>
<td>0</td>
<td></td>
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<td>N</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Ijara</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Correlation</td>
<td>0.397</td>
<td>0.416</td>
<td>-0.215</td>
<td>0.422</td>
<td>0.005</td>
<td>-0.024</td>
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<tr>
<td>Sig. (2-tailed)</td>
<td>0.093</td>
<td>0.068</td>
<td>0.362</td>
<td>0.064</td>
<td>0.982</td>
<td>0.921</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>

** Correlation is significant at the 0.01 level (2-tailed). * Significant at the 0.05 level (2-tailed).

Source: Research Findings

4.3.2. Regression Analysis

The section below presents the results of regression analysis. Table 4.8 shows the model summary for both the control variables and the full model. The control variable R squared (coefficient of determination) showed that 73.6% of the Islamic banks performance was contributed by the bank size and liquidity. Further, the study showed that 85.8% of Islamic banks performance can be attributed to bank size, liquidity, Mudaraba, Ijara, Musharaka, Tawarruq and Murabaha. The Islamic products offered by
commercial banks in Kenya accounted for 17.7% of the commercial banks performance as accounted for by a significant R squared change (R squared change =0.177 & p value =0.018).

**Table 4.8: Model Summary**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R²</th>
<th>Adj R²</th>
<th>Std. Error</th>
<th>Change Statistics</th>
<th>R²</th>
<th>F Change</th>
<th>df1</th>
<th>df2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.858a</td>
<td>0.736</td>
<td>0.703</td>
<td>0.54707</td>
<td>0.736</td>
<td>22.278</td>
<td>2</td>
<td>16</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>.955b</td>
<td>0.913</td>
<td>0.858</td>
<td>0.378771</td>
<td>0.177</td>
<td>4.475</td>
<td>5</td>
<td>11</td>
<td>0.018</td>
<td></td>
</tr>
</tbody>
</table>

*a Predictors: (Constant), Liquidity, Bank size
b Predictors: (Constant), Liquidity, Bank size, Mudaraba, Ijara, Musharaka, Tawarruq, Murabaha

**Source: Research Findings**

Table 4.9 shows the ANOVA (Analysis of Variance) which is meant to test the model goodness of fit. The F value of 22.278 & P value <0.05 indicates that the overall regression model for the control variables is significant hence it has some explanatory value. This depicts there is a significant relationship between bank size, liquidity and bank performance. At 95 percent confidence interval i.e. P-value (p<0.05) it implies that all the two control variables combined do influence Islamic banks performance. In addition, an F value of 16.475 & P value <0.05 indicates that the overall regression model constituting of both control and predictor variables have an influence on Islamic bank performance.
<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>13.335</td>
<td>2</td>
<td>6.668</td>
<td>22.278</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>4.789</td>
<td>16</td>
<td>0.299</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>18.124</td>
<td>18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Regression</td>
<td>16.546</td>
<td>7</td>
<td>2.364</td>
<td>16.475</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>1.578</td>
<td>11</td>
<td>0.143</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>18.124</td>
<td>18</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a Dependent Variable: ROA
b Predictors: (Constant), Liquidity, Bank size
c Predictors: (Constant), Liquidity, Bank size, Mudaraba, Ijara, Musharaka, Tawarruq, Murabaha

**Source: Research Findings**

From Table 4.10 below bank size is the most influential control variable since it had the most statistically significant coefficient as indicated by a t ratio of 4.652. Bank size had a beta coefficient of 0.346 which implies that a unit change in the bank performance is associated with an increase of 0.346 in bank size. Also there is a significant positive relationship between liquidity ratio and Islamic bank performance as indicated by (β=6.228, t=3.175 and p value < 0.05), this implies that a unit change in Islamic bank performance is associated with 6.228% increase in liquidity.

In the full model constituting of predictors and the control variables Murabaha had the most statistically significant coefficient as indicated by the t-ratio of 3.461(β=7.20E-10, t=3.461, p value =3.461). This implies that a unit increase in the bank performance is associated with 7.20E-10 increase in Murabaha. It is important to note that all the available Islamic products available in Kenyan commercial banks had a positive significant relation with exclusion of Ijara which had positive insignificant relationship. This implies that an increase in provision of Islamic banking services in Kenyan commercial banks will lead to increase in Banks performance.
Table 4.10: Regression Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>5.504</td>
<td>1.853</td>
<td>2.971</td>
</tr>
<tr>
<td></td>
<td>Bank size</td>
<td>0.346</td>
<td>0.074</td>
<td>0.627</td>
</tr>
<tr>
<td></td>
<td>Liquidity</td>
<td>6.228</td>
<td>1.962</td>
<td>0.428</td>
</tr>
<tr>
<td>2</td>
<td>(Constant)</td>
<td>1.307</td>
<td>2.067</td>
<td>0.632</td>
</tr>
<tr>
<td></td>
<td>Bank size</td>
<td>0.139</td>
<td>0.094</td>
<td>0.253</td>
</tr>
<tr>
<td></td>
<td>Liquidity</td>
<td>8.05</td>
<td>1.494</td>
<td>0.553</td>
</tr>
<tr>
<td></td>
<td>Murabaha</td>
<td>7.20E-10</td>
<td>.000</td>
<td>1.142</td>
</tr>
<tr>
<td></td>
<td>Musharaka</td>
<td>4.36E-10</td>
<td>.000</td>
<td>0.739</td>
</tr>
<tr>
<td></td>
<td>Tawarruq</td>
<td>5.11E-08</td>
<td>.000</td>
<td>0.656</td>
</tr>
<tr>
<td></td>
<td>Mudaraba</td>
<td>6.83E-09</td>
<td>.000</td>
<td>0.56</td>
</tr>
<tr>
<td></td>
<td>Ijara</td>
<td>1.22E-09</td>
<td>.000</td>
<td>0.114</td>
</tr>
</tbody>
</table>

*Dependent Variable: ROA

Source: Research Findings

4.4. Interpretation of the Findings

Therefore, we can conclude that all the independent variables influence commercial banks performance in Kenya. The study findings were similar to (Bashir, 2001) who investigated the determinants of Islamic banks performance and found out that there is a positive significant relationship between Islamic products and bank performance. Similar findings were found in United Arab Emirates whereby banks offering both Islamic and conventional banking services registered high profitability ratios as compared to the others offering conventional banking services only (Sammad & Hassan, 1998).

The most significant control variable is bank size since it had the most statistically significant coefficient as indicated by a t ratio of 4.652. Therefore, commercial banks offering Islamic banking services in Kenya should increase their size by acquiring more assets.

In the full model constituting of predictors and the control variables Murabaha had the most statistically significant coefficient. Therefore, commercial banks should promote and market the Murabaha products among its customers so as to foster bank performance. This was followed by Musharaka, Tawarruq and Mudaraba, all with a significant positive
relationship with bank performance. Although Ijara has a positive relationship with commercial banks performance it was not significant.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Introduction
This section covers the summary, conclusion, recommendations for policy, limitations of the study and suggestions for further research.

5.2. Summary
The main objective of the study was to investigate the influence of Islamic products on commercial banks financial performance in Kenya. To achieve this objective data was collected from commercial banks operating in Kenya which are currently offering Islamic products. Data collected was then analyzed using both descriptive and inferential statistics. Correlation design was adopted to explain the causal relationship between Islamic banks products and banks financial performance. Descriptive statistics depicted that Murabaha is the most common Islamic banks products though the others are gaining popularity as period elapses. Further, in the earlier years such as 2009 Islamic banks products had negative influences on commercial banks performance as reported by negative return on assets. In the recent periods such as in the year 2012, Shariah compliant banking services had positive influence on commercial banks financial performance as depicted by positive return on assets.

The inferential statistics used such as correlation coefficients showed strong positive relationship between bank size and commercial banks performance. Therefore, it can be implied that the larger the bank’s assets total the higher the influence on commercial banks performance. All the Islamic banking products currently offered by commercial banks in Kenya depicted positive relationship with commercial banks performance.

5.3. Conclusion
Overall the analysis shows commercial banks performance in Kenya is influenced by Islamic banking products offered such as Murabaha, Musharaka, Tawarruq, Mudaraba and Ijara as well as control variables such bank size and liquidity ratio. Although the
control variables explain 73.6%, it means there are other control factors which explain commercial banks financial performance. Both control variables and predictors had a combined explanatory power of 91.3% which means the remaining percentage is explained by other factors excluded from the model. A close scrutiny of the commercial banks return on assets depicts that the average return on assets declined in year 2013, thus economic and political stability will also play a greater role in promoting the use of Islamic banking products in Kenya. Since most of the products are business oriented, investors may not be willing to invest when the political temperature is high. Another factor which can influence the presence of Islamic banking products in Kenya is customer’s awareness of their existence therefore commercial banks should sensitize members of the public on Islamic banking products. This is mainly because many deserving cases of financial resources are unaware of the existence of banking products which are compliant with Shariah law.

Islamic banking products are vital banking services in the rapid economic growth of the capital markets. Lack of access to cheap and affordable capital especially loan capital or working capital for startup has been identified as a major constraint to economic growth and development of many countries and since commercial banks are key pillars of economic development through financial intermediation. Islamic financial products such as Musharaka (partnership finance) may promote sharing of financial knowledge especially to investors who may be having inadequate financial training.

5.4. Recommendations for Policy

On the basis of the findings the following recommendations arose. The survey showed that Murabaha is the most influential Islamic banking product on commercial banks performance. Therefore, commercial banks in Kenya should sensitize its customers on the need to promote partnership through financing business ideas. Also among the most recommended measures put in place is by selecting key financial and other indicators to monitor programs based on the statutory requirements on Islamic banking products. Developing systems for managing future performance based on the statutory requirements is also highly recommended.
Since access to finances is a vital tool for economic development there is need for the development faith based financial products which can be used by investors at different stages of investment such as seed, start-up, expansion, development or bridge finance and working capital finances. Commercial banks should diversify and increase their Islamic banking products since currently there are very few Shariah compliant products. Also commercial banks should set up education platforms geared towards making its customers aware of the benefits and costs associated with Islamic banking products.

5.5. Limitations of the Study

There are a few Islamic products available in the commercial banks in Kenya. This is in comparison with the vast number of Islamic financing products that currently exist in the Gulf countries.

Islamic banking is still relatively new in the Kenyan market with just about six years since inception. Hence, the results are representative of a banking sector that is still in the growth stage. Therefore, we cannot compare the results we are getting for the Islamic banking sector and the conventional banking sector because one is in the growth stage while the other is in the mature stage.

There is no regulatory body in Kenya tasked with ensuring that in as much as the Islamic banks are performing well, they are also Shariah compliant in all their business transactions.

5.6. Suggestions for Further Research

The effect that operating in the conventional set up is posing on overall Islamic banking performance and Shariah non-compliance risks that are being experienced as a result. This is because the Islamic banking system has placed many restrictions on the way all transactions are to be handled. Hence, it would be important to know if the restrictions are being fully implemented or they only exist on paper.
The role of Islamic banking on economic development should be researched. It would be important to know if the presence of banking that is consistent with faith has encouraged those that had shunned away from the conventional banking system to join the Islamic banking system and therefore have access to all the financial services that joining a bank affords.

Factors that are unique to Islamic banking performance is an area that deserves further research. For instance, due to the ban on acceptance or issuance of interest, how well are they dealing with market factors like inflation and other financial risks without having to transact with interest charges. Also, in their transactions with commercial banks in the conventional system or the Central Bank, how does the ban on issuing or receiving interest payments affect the way they transact with them.
REFERENCES


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APPENDICES
APPENDIX 1: COMMERCIAL BANKS OFFERING ISLAMIC BANKING SERVICES AS AT 31ST DECEMBER 2013

1. Gulf African Bank (K) Ltd
   P.O. Box 43683-00100
   Nairobi, Kenya

2. First Community Bank
   P.O. Box 26219-00100
   Nairobi, Kenya

3. Chase Bank
   P.O. Box 66015-00800
   Nairobi, Kenya

4. Barclays Bank
   P.O. Box 30120-00100
   Nairobi, Kenya

5. Standard Chartered Bank
   P.O. Box 30003-00100
   Nairobi, Kenya

   Corporateaffairs@nationalbank.co.ke
   Source: CBK
APPENDIX 2: DATA COLLECTION FORM

A. BANK PROFILE

1. Year of Establishment of Islamic Banking

2. Nature of Islamic Bank’s operation in Kenya (tick as appropriate)
   - An Islamic Window within conventional bank
   - A Fully fledged Islamic Bank

B. ISLAMIC BANKING FINANCING PRODUCTS AND FINANCIAL PERFORMANCE OF THE ISLAMIC BANKING PORTFOLIO IN THE LAST FIVE YEARS.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>FINANCIAL PERFORMANCE MEASURE</td>
<td>Amount of Musharaka financing made</td>
<td>Amount of Mudaraba financing made</td>
<td>Amount of Murabaha financing made</td>
<td>Amount of Ijara financing made</td>
<td>Amount of Salam financing made</td>
</tr>
</tbody>
</table>

45
<table>
<thead>
<tr>
<th>Liquidity ratio</th>
<th></th>
<th></th>
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</thead>
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<tr>
<td>Bank Size</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount of Short-term investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book value of Assets</td>
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</tr>
</tbody>
</table>
APPENDIX 3: INTRODUCTORY LETTER

DIANA KIRIGO THOMI,
REG NO. D61/78812/2012.

THE FINANCE MANAGER,
_________ BANK LTD,
NAIROBI, KENYA.

RE: REQUEST FOR RESEARCH DATA

I am a University of Nairobi MBA (Finance) student and am currently researching on the effect of Islamic banking products on financial performance of commercial banks. I am hereby requesting you to provide me with Audited financial statements & disclosures and Amount of financing made by your bank through the various Islamic banking products for the five (5) year period from 2009 to 2013.

The data will be used purely for academic purposes. I shall share the report with you upon request.

Your assistance is highly appreciated.

Regards,

Diana K. Thomi