

**THE EFFECT OF THE ISLAMIC FINANCING MODES ON THE
PROFITABILITY OF COMMERCIAL BANKS IN KENYA**

BY

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DECLARATION

I declare that this research project is my original work and it has never been presented to any other college, institution or any university for any academic award other than University of Nairobi for academic credit.

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DEDICATION

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LIST OF ABBREVIATIONS

AU - Asset utilization

BITA- Bank income as percentage of Total Assets

CAGR-The Compound Annual Growth Rate

CB- Conventional Banking

CBK-Central Bank of Kenya

DJIM - Dow Jones Islamic Market Index

EVA - Economic value added

GCC-Gulf Cooperative Council

GDP- Gross Domestic Product

SAAAME - South America, Africa, Asia and Middle East

IBD's -Islamic Banking Divisions

IBS - Islamic Banking Scheme

NCO-Net charge-off

NOM - Net operating margin

OER - Operating efficiency ratio

PLS- Profit-and-loss-sharing

PM- Profit Margin

ROAA - Return on Average Assets

ROA - Return on asset

ROD - Return on deposit

ROE-Return on Equity

TITA- Total income as a percentage of total assets

ABSTRACT

The Islamic banking system has gained momentum worldwide. Islamic banking refers to financial services that meet the requirements of the Shari'ah or Islamic law. Also called Islamic finance or Islamic financial services, Islamic banking represents the practical application of modern Banking concepts within the overall development of Islamic Economics (Abdeen & Dale, 1984). The Shari'ah prohibits the payment of fees for the renting of money (Riba or Interest) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haraam) such as gambling, pornography, pork or alcohol. Since its introduction in Kenya in 2007, rapid growth has been seen in number of commercial banks offering Islamic financial services and efforts to demystify Islamic banking and improve it. The main objective of this study was to evaluate the effect of different Islamic financing modes on profitability of commercial banks in Kenya over a period of six five years (2008-2013). Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables. 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 an Islamic banks performance and different financing modes. 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 an F value of 3.776 and a P value < 0.05 indicating that the overall regression model for the control variables is significant hence it has some explanatory value. Hence, there is a significant relationship between return on assets and different financing modes. At 95 percent confidence interval P-value ($p < 0.05$) implying that the variables combined do influence Islamic banks performance. In the full model constituting of predictors and the control variables, Ijara had the most statistically significant coefficient as indicated by the t-ratio of 2.353 ($\beta = 7.58E-10$, $t = 2.353$, $p \text{ value} = 0.04$). It is important to note that all the available Islamic products available in Kenyan commercial banks had a positive significant relation with the return on assets implying that the diversification and introduction of more financing modes will enhance commercial banks performance offering Islamic financial services. However, there is no multi-Collinearity between the different financing modes. The study therefore recommends that more financing modes should be introduced and pursued to increase uptake of Islamic financial services. Central Bank of Kenya should also hasten the process of structuring regulations and markets for Islamic financial instruments such as Sukuk since Islamic banks are locked out of treasury bills and bonds which are considered non-compliant to Islamic banking and financing Shariah regulations.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

During the last decades, the financial systems have played an undisputed role in the development of the world economic growth (Chapra, 2008). However, an important contemporary issue for financial institutions and financial markets are Islamic financial services, which are rapidly growing worldwide. Islamic banking refers to financial services that meet the requirements of the Shari'ah or Islamic law. While designed to meet the specific religious requirements of Muslim customers, Islamic banking is not restricted to Muslims. Islamic banking represents the practical application of modern Banking concepts within the overall development of Islamic Economics (Abdeen & Dale, 1984). The Shari'ah prohibits the payment of fees for the renting of money (Riba or Interest) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haraam) such as gambling, pornography, pork or alcohol.

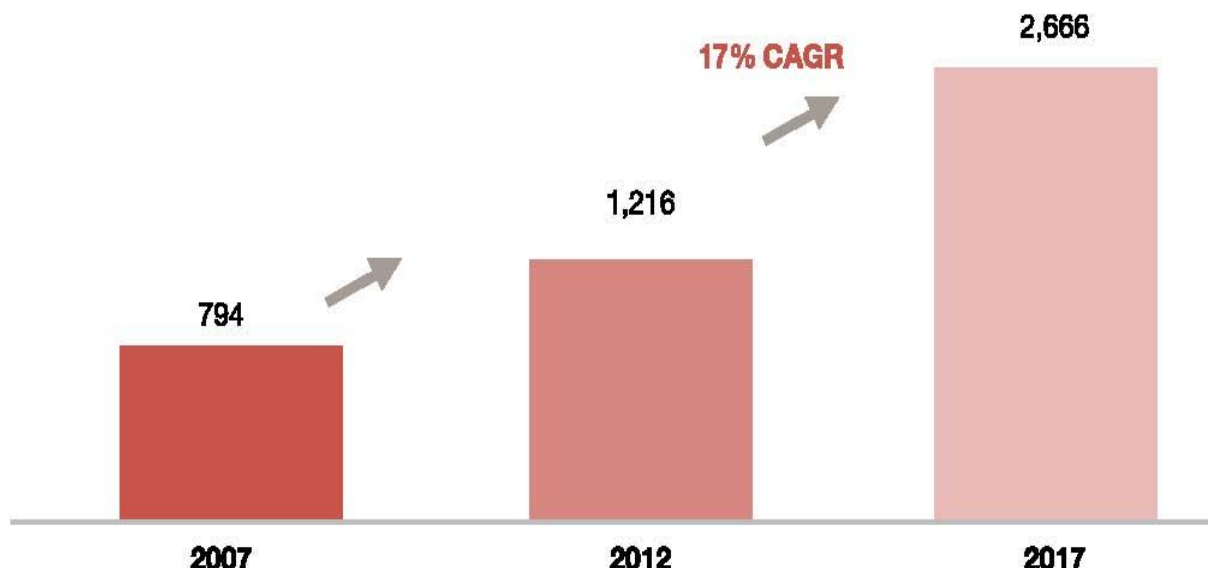
The idea of Islamic banking goes back to as early as the 7th century, but it was only commercially implemented in the last century (De Jonge, 1996). As the end of the colonial era approached, some of the newly formed and independent Muslim states re-assessed their economic policies on the basis of Shari'ah principles. This marked the beginning of the present-day revival of Islamic finance. Small scale limited scope interest-free institutions were unsuccessfully tried in the mid-1940s in Malaysia and 1950s in Pakistan (Gafoor, 1996). From 1946 onwards, research by Muslim scholars gradually produced principles for banking practices that were likely to be acceptable to the banking and Islamic communities.

The first successful application of Islamic finance was undertaken in 1963 by Egypt's Mit Ghamr Savings Bank, which earned its income from profit-sharing investments rather than from interest. By the 1970s, the push for Islamic finance had gained momentum (Algaoud & Lewis, 2001). In 1973 the conference of foreign ministers of Muslim countries decided to establish the Islamic Development Bank with the aim of fostering economic development and social progress of Muslim countries in accordance with the principles of Shariah. This marked the first major collective step taken by Muslim countries to promote Islamic finance (Saeed, 1996).

There has been large scale growth in the Islamic banking sector in many countries around the world during the last thirty years (from 1980's) as the performance growth is influenced by factors including the introduction of broad macroeconomic and structural reforms in financial systems, the liberalization of capital movements, privatization, the global integration of financial markets, and the introduction of innovative and new Islamic products. Islamic finance is now reaching new levels of sophistication (Cornelisse and Steffelaar, 2008).

In 2007, Islamic law (Shari'ah) compliant assets were estimated to have grown by 37% to \$729bn. They were expected to reach the \$2 trillion mark in 2013. A Price Water House Coopers report titled "*Islamic Finance: Creating value (2013)*" estimates the Islamic finance assets to grow to \$2.666 Trillion by 2017. The growth path over the years as envisaged is shown below;

Figure 1.1: Islamic Finance Growth



Source: PWC (Islamic Finance: Creating Value Report, 2013)

Ernest & Young's "*World Islamic Banking Competitiveness Report 2012-2013: Growing Beyond DNA of Successful Transformation - December 2012*" posits that Islamic banking assets with commercial banks globally grew to \$1.3 trillion in 2011, suggesting an average annual growth of 19% over past four years (2011: 24%). It further states that the Islamic banking growth story continues to be positive, growing 50% faster than the overall banking sector. The report further states that the Islamic banking assets are forecast to grow beyond the milestone of \$2 trillion by 2014. It is however a different story as per the report when it

comes to profitability. The industry's average ROE was 12% compared to 15% for conventional banks in 2011 as Islamic banks continue to grapple with multiple challenges relating to sub-scale operation, asset quality, negative operating income from core activities and a weak risk culture.

While many assets are based in countries such as Saudi Arabia, Malaysia or Kuwait, Western financial institutions and governments have also developed a strong interest in Islamic finance (Cihák and Hesse 2010; McKenzie 2009). The British government praises the UK as 'the leading centre for Islamic finance outside of the Gulf Cooperative Council (GCC) and Malaysia' and has defined clear policy objectives for its development (HM Treasury 2008). An Islamic banking and financial system exists to provide a variety of religiously acceptable financial services to the Muslim communities. In addition to this special function, the banking and financial institutions, like all other aspects of Islamic society, are expected to 'contribute richly to the achievement of the major socio-economic goals of Islam' (Chapra, 1985, p. 34). Despite the growing popularity of Islamic financial services, Islamic financing modes remain and understanding of such modes remains a challenge. In their study, Gerrard and Cunningham (1997) reported that Muslim respondents, though aware of basic conditions in Islam, were almost wholly ignorant of the sense of specific Islamic financial conditions like Mudaraba, Musharaka and Ijara.

1.1.1 Islamic Modes of Financing

Hassan and Lewis (2007) identify the following basic types of Islamic financial contracts in Islamic banking; Musharakah (partnership), Mudaraba (finance by way of trust), Murabaha (cost-plus financing), Ijara (leasing), Salam (advance purchase), Bai bi-thamin ajil (deferred payment financing), Istisnaa (commissioned manufacture) and Sukuk (participation securities).

Musharakah (partnership) is often perceived to be the preferred Islamic mode of financing, because it adheres most closely to the principle of profit and loss sharing. Partners contribute capital to a project and share its risks and rewards. Profits are shared between partners on a pre-agreed ratio, but losses are shared in exact proportion to the capital invested by each party. In Musharakah, all partners have the right but not the obligation to participate in the management of the project, which explains why the profit-sharing ratio is mutually agreed

upon and may be different from the investment in the total capital (Hassan and Lewis, 2007).

Mudaraba (finance by way of trust) is a form of partnership in which one partner (rabb al-mal) finances the project, while the other party (mudarib) manages it. Although similar to a Musharakah, this mode of financing does not require that a company be created; the financial institution provides all of the capital and the customer is responsible for the management of the project. Profits from the investment are distributed according to a fixed, predetermined ratio. The rabb al-mal has possession of the assets, but the mudarib has the option to buy out the rabb al-mal's investment. Mudaraba may be concluded between an Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee of their funds, and its business-owner clients. In the latter case, the bank acts as a mudarib for a fee. The bank also acts as a mudarib in relation to its depositors, as it invests the deposits in various schemes (Hassan and Lewis, 2007).

In a Murabaha (cost-plus financing) contract, the bank agrees to buy an asset or goods from a third party, and then resells the goods to its client with a mark-up. The client purchases the goods against either immediate or deferred payment. Some observers see this mode of Islamic finance to be very close to a conventional interest-based lending operation. However, a major difference between Murabaha and interest-based lending is that the mark-up in Murabaha is for the services the bank provides (for example, seeking and purchasing the required goods at the best price) and the mark-up is not stipulated in terms of a time period. Thus, if the client fails to make a deferred payment on time, the mark-up does not increase from the agreed price owing to delay. Also the bank owns the goods between the two sales, which mean it carries the associated risks (Hassan and Lewis, 2007).

Like a conventional lease, Ijara is the sale of manfa'a (the right to use goods) for a specific period. In Muslim countries, leasing originated as a trading activity and later on became a mode of finance. Ijara is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. Responsibility for maintenance/insurance rests with the lessor. During a pre-determined period, the ownership of the asset remains with the lessor (that is, the bank) who is responsible for its maintenance, which means that it assumes the risk of ownership. Under an Ijara contract, the lessor has the right to renegotiate

the terms of the lease payment at agreed intervals. This is to ensure that the rental remains in line with market leasing rates and the residual value of the leased asset. Under this contract, the lessee (that is, the client) does not have the option to purchase the asset during or at the end of the lease term. However this objective may be achieved through a similar type of contract, Ijarawa iqtina (hire-purchase). In Ijarawa iqtina, the lessee commits himself to buying the asset at the end of the rental period, at an agreed price (Hassan and Lewis, 2007).

Salam (advance purchase) is the purchase of specified goods for forward payment. This contract is regularly used for financing agricultural production. However, Bai bi-thamin ajil (deferred payment financing) involves a credit sale of goods on a deferred payment basis. At the request of its customer, the bank purchases an existing contract to buy certain goods on a deferred payment schedule, and then sells the goods back to the customer at an agreed price. The bank pays the original supplier upon delivery of the goods, while the bank's customer can repay in a lump sum or make installment payments over an agreed period. Istisnaa (commissioned manufacture) although similar to bai bi-thamin ajil transactions, istisnaa offers greater future structuring possibilities for trading and financing. One party buys the goods and the other party undertakes to manufacture them, according to agreed specifications. Islamic banks frequently use istisnaa to finance construction and manufacturing projects(Hassan and Lewis, 2007).

Sukuk (participation securities) were introduced recently for the same reasons that led to the establishment of interest-free banking, which was to meet the requirements of those investors who wanted to invest their savings in Shari'ah-compliant financial instruments. As mentioned earlier, interest-based transactions and certain unlawful business activities (such as trading in alcoholic beverages) are ruled out in the Islamic mode of financing. However, this does not mean that the possibility of bond issuance is forbidden in Islamic finance as well. Recognizing that trading in bonds is an important element of the modern financial system, Muslim jurists and economists have focused on developing Islamic alternatives, and the Sukuk have generated the most attention amongst these financial innovations. The basic difference between conventional bonds and Sukuk lies in the way they are structured and floated. In the conventional system of bond issue and trading, the interest rate is at the core of all transactions. In contrast, the Islamic Sukuk are structured in such a way that the issue is based on the exchange of an approved asset (for example, the underlying assets could include buildings, hire cars, oil and gas pipelines and other infrastructure components) for a specified

financial consideration. In other words, Sukuk are based on an exchange of an underlying asset but with the provision that they are Shari'ah-compliant; that is, the financial transaction is based on the application of various Islamic commercial contracts (Hassan and Lewis, 2007).

1.1.2 Profitability

Profitability is excess of income over expenditure, income from an investment or transaction or an advantage or benefit derived from an activity. Aburime (2009) observed that the importance of bank profitability can be appraised at the micro and macro levels of the economy. At the micro level, profit is the essential prerequisite of a competitive banking institution and the cheapest source of funds. It is not merely a result, but also a necessity for successful banking in a period of growing competition on financial markets. Hence the basic aim of every bank management is to maximize profit, as an essential requirement for conducting business. At the macro level, a sound and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system. Bank profits provide an important source of equity especially if re-invested into the business. This should lead to safe banks, and as such high profits could promote financial stability (Flaminiet al. 2009).

However, too high profitability is not necessarily good. Garcia-Herrero et al. (2007) observed that too high profitability could be indicative of market power, especially by large banks. This may hamper financial intermediation because banks exercising strong market power may offer lower returns on deposit but charge high interest rates on loans. Too low profitability, in turn, might discourage private agents (depositors and shareholders) from conducting banking activities thus resulting in banks failing to attract enough capital to operate. Furthermore, this could imply that only poorly capitalized banks intermediate savings with the corresponding costs for sustainable economic growth.

1.1.3 Commercial Banks in Kenya

The Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK), govern the Banking industry in Kenya. The CBK, which falls under the Minister for Finance's docket, is responsible for formulating and implementing monetary policy and fostering the liquidity,

solvency and proper functioning of the financial system. The CBK publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. Banks in Kenya have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks' interests and addresses issues affecting its members. The banking system in Kenya is highly segmented by size and ownership factors. The four segments comprise of foreign owned banks, state owned banks, large private owned banks and small private owned banks (Qin, 2012). The financial institutions in Kenya essentially consist of forty three (43) licensed commercial banks and one Mortgage Finance Institution. Out of the 44 institutions, 31 are locally owned and 13 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the Government and State Corporations, 27 commercial banks and 1 mortgage finance institution (Central Bank of Kenya website).

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 (CBK annual Report 2013).

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 (CBK annual Report 2013).

1.1.4 Effects of Islamic Modes of Financing on Profitability

The degree of awareness in Islamic financing modes remains a challenge to uptake of Islamic financial services and consequently profitability of Islamic banks. In their study, Gerrard and Cunningham (1997) reported that Muslim respondents, though aware of basic conditions in Islam, were almost wholly ignorant of the sense of specific Islamic financial conditions like Mudaraba, Musharaka and Ijara.

Sami (1994) in his paper “Progress of Islamic Banking: The Aspirations and The Realities” asserts that there is excessive resort to the murabahah mode and the neglect of the other legitimate modes of financing by Islamic Commercial Banks. He further posits that the criticism is repeatedly levelled against Islamic banks and although it is valid, yet, it is not a violation of the injunctions of Shari’ah as long as the murabahah contract is correct from the Shari’ah point of view and is free from intentional or nominal deception. He suggests that It would, however, have been much better, if Islamic banks were able to distribute their investments over various possible forms such as Mudarabah, Musharakah, Salaam, advance-sale and leasing. This would have been optimum from the viewpoint of the soundness of the work and dealings.

Sami (1994) further asserts that many critics blame Islamic banks for utilizing the interest rate as a criterion for fixing the profit margin in the murabahah sales. As a matter of fact there is no known way of avoiding the link up with this criterion as long as Islamic banks are operating within an environment where they coexist with traditional banks. But, what is required of Islamic banks is to avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods which some of them employ, which involve calculation of the absolute profit rate while paying no consideration to the installments paid during the year.

Most professional and training courses in banking tend to be geared toward conventional banking rather than Islamic banking. In reality, a limited number of institutions offer training for Islamic institutions. Hence, the lack of professional courses and training tailored for Islamic banking has resulted in a lack of qualified staff. Rammaland Zurbruegg (2007) believe that the absence of the required trained staff has made Islamic banks resort to the next best alternative recruiting staff from conventional banks. With the vastly different concepts of

the two systems, it is not rare to see such staff having difficulty adjusting to the Islamic banking system. Faizul (2000) indicated that the lack of trained staff partly contributed to the slow innovation of the Islamic banks products and instruments. In addition, Meenai (1998) thinks that the lack of trained staff affects relations with central banks due to the inability to clarify and explain various issues to them.

Islamic banks have had a fairly large degree of “monopoly” over the financial resources of the Islamically motivated public. This situation is changing fast. Islamic banks are now facing ever increasing competition (Azizul, 1999). Therefore competition is challenge to Islamic banking. Azizul (1999) also note that problem caused by the predominance of debt based modes of financing is that it is difficult to transform these financial modes into negotiable financial instruments. Once a debt has been created, it cannot be transferred to anyone else except at par value. This renders the whole structure of Islamic financial market highly illiquid. This is one of the major obstacles in the development of secondary markets in Islamic financial instruments. Unless equity based modes become more popular or other negotiable instruments are developed Islamic financial markets will remain undeveloped.

In most countries including Kenya, Islamic banks are put under the supervision of the central bank of the country and are given the same treatment as given to normal commercial banks. There are only a few instances where special Islamic banking legislation was approved to define a new relationship between Islamic banks and the central bank. Most Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with Islamic banks (Azizul, 1999).The central banks subject Islamic banks to the same controls, conditions, and regulations that they apply to interest based banks. Azizul (1999) notes that there are certain factors, however, that requires that Islamic banks be treated on a different footing. A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the rather inappropriate policies of central banks toward Islamic banks. Although most Islamic banks function under the supervision of a central bank, they cannot benefit from central bank facilities such as lending and interest on deposits held as reserve requirements because funds are usually provided on the basis of interest. Qadeeruddin (2005) notes that Islamic Banks operating within existing legal and regulatory framework will be a great challenge. Qadeeruddin (2005) also noted that so much attention has been given to conventional banking industry in Kenya but no research has explored the factors affecting performance of Islamic Banking in Kenya.

1.2 Research Problem

Dridi (2010) analyzed the performances of 120 conventional and Islamic banks after the global financial crisis. The study found out that global financial crisis of 2007-2008 did not adversely affect the economies of the Muslim countries practicing Islamic banking and financial system as much as it affected the Western economies. In the face of the crisis Islamic banks appeared to be more resilient to the effects of global economic downturn and international financial crisis than the conventional because Islamic banks tended to avoid speculative investments such as derivatives that many analysts believe led to the financial crisis. Islamic banks also avoided sub-prime crisis due to the fact that they must balance their books, and so did not lend to sub-prime borrowers.

While many Islamic finance assets are based in countries such as Saudi Arabia, Malaysia or Kuwait, Western financial institutions and governments have also developed a strong interest in Islamic finance (Cihák and Hesse 2010; McKenzie 2009). The popularity of the Islamic banking system is not limited to the Islamic banks only. Increasingly large international conventional banks are showing interest in the Islamic banking system as well. (Naser and Moutinho, 1997). The Islamic finance assets are estimated to grow to \$2.666 Trillion by 2017 according to Price Water House Coopers report titled "*Islamic Finance: Creating value (2013)*". The same report indicates that the Demand for Islamic finance services is increasing due to growing Muslim populations in SAAAME countries especially in Asia and Africa, which currently account for over 95% of the world's Islamic population and which are projected to grow 35% by 2030. SAAAME countries also contain large unbanked populations, which can be harnessed by Islamic banking models.

Profitability is a prerequisite of a competitive banking industry. In order for banks (whether privately or publicly owned) to continue to prosper, there is need for its earnings to be relatively stable for its expansion and growth over time. (Goddard, Molyneux, & Wilson, 2004). Similarly, profitability remains a critical factor for Islamic banking growth and sustainability. A study by Musa (2007) showed that several conventional banks have introduced Shariah compliant deposit products while two fully fledged Islamic banks have been licensed by the Central Bank of Kenya in 2007. It is necessary that Muslims are able to access financial services that do not violate their principles and beliefs. The study reports that the Central Bank of Kenya licensed First Community Bank and Gulf African Bank as Islamic

banks that offer Shariah compliant products. Gulf African Bank did break even exactly just after two years whereas First Community Bank stated attaining profits three years after its launch as per published financial statements and reports of the two banks.

Most research work done have categorized determinants of a bank's profitability into three indicators: bank-specific, industry-specific and macroeconomic indicators. Cornett and Tehania (1992), Mercia, et al. (2002), Toddard, et al. (2004), Guru et al.(2001)and Panayiotis et al.(2006) show that bank profitability is a function of internal and external factors. Internal factors include bank-specific; while external factors include both industry-specific and macroeconomic factors. Internal factors include capital ratio, bank size, liquidity, expenses management and asset quality. These factors are referring to the factors that can be managed by the management of a bank. External factors include gross domestic product (GDP), inflation, money supply and competition where all these factors considered beyond the control of a bank's management. It is mostly the macroeconomic factors.

Schoon(2008) indicates that one of the major challenges facing Islamic banking is the fact that it is considered by most of non-Muslim customers as a faith based banking practice. This might lead to others having perception of Islamic finance being tainted with terrorist funding and home of anti-money laundering. Secondly, Most Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with Islamic banks. (Azizul, 1999). Islamic Banks also face challenges of operating within existing legal and regulatory framework (Qadeeruddin, 2005).Only few professionals exist in Kenya with a firm understanding of Islamic banking and finance processes. These banks are now facing ever increasing competition (Azizul, 1999).

This study aims at performing comparative studies on amounts and risks of different modes of financing and their respective contribution to commercial banks profitability. Most studies done by Cornett and Tehania (1992), Mercia et al. (2002), Toddard et al. (2004), Guru et al.(2001)and Panayiotis et al.(2006)done have categorized determinants of a bank's profitability into three indicators: bank-specific, industry-specific and macroeconomic indicators. This study intends to establish how different financing modes affect commercial banks profitability hence the research question; what is the effect of the Islamic Financing Modes on profitability of Commercial Banks in Kenya?

1.3 Objective of the Study

To investigate the effect of the Islamic Financing Modes on the Profitability of Commercial Banks in Kenya.

1.4 Value of the Study

This study is meant to create awareness on modes of financing deployed by Islamic banks in their operations and the effect of the same on their loan products uptake and profitability. The study will help customers, investors and other stakeholders understand both profit sharing and non-profit sharing modes of Islamic banking. The study is also useful for academicians who wish to do further studies on the systems and principles applied by Islamic banks. It will contribute to existing theory on Islamic banks performance and more specifically from the dimension of different financing modes. Islamic Banks can also use the findings at a policy level to enhance their approaches to financing thereby leading to better uptake of their finances and services in general. The study will be more useful to Kenyan commercial banks who can use the results of the study to allocate their financing amounts to different financing modes in order of contribution to profitability and risk exposure.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In this chapter, a review of literature related to the study is discussed under the following themes: theoretical reviews done on the subject area, empirical reviews and determinants of bank profitability. The later sections of the chapter provides the conceptual framework upon which the study is based and a critical review of the literature. The chapter ends with a summary of literature review and identifies the research gaps to be addressed by the current study.

2.2 Theoretical Review

What can be characterized as the theory of Islamic finance was, till the end of the nineteen-seventies, largely a plea for replacing interest in bank lending by profit sharing. This would change the nature of financial intermediation, making the fund owners as well as the financial intermediaries share the risks of enterprise with the fund users. It was also argued that most, though not all, the other problems of capitalism were rooted in the practice of lending on interest. Among these problems was unemployment, inflation, poverty amidst plenty, increasing inequality and recurrent business cycles (Uzair, 1955; Maududi, 1961, Ahmad, 1972, Hameedullah, 1970 & Hameedullah, 1936). These problems could be solved by abolishing interest and replacing it by profit sharing. It was not until the next decade that Islamic economists were able to fortify these claims by sophisticated economic analysis, especially at the macroeconomic level. Some of the theories include Islam and Theory of Interest, Chapra Model of Islamic Finance and Profit and Loss Sharing (PLS) Theory.

2.2.1 Islam and the Theory of Interest

The early contributions on the subject of Islamic finance were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on Islam and the Theory of Interest (Qureshi, 1946) looked upon finance as a social service that should be sponsored by the government 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. No mention was made of profit-sharing.

Ahmad (1952) in his book *Economics of Islam* 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. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was not 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.

The principle of *mudaraba* based on Shariah was invoked systematically by Uzair (1955). His principal contribution lay in suggesting *mudaraba* as the main premise for 'interest less finance'. However, his argument that the bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical. Al-Arabi (1966) envisaged a finance system with *mudaraba* as the main pivot. He was actually advancing the idea of a two-tier *mudaraba* which would enable the bank to mobilize savings on a *mudaraba* basis, allocating the funds so mobilized also on a *mudaraba* basis.

A pioneering attempt at providing a fairly detailed outline of Islamic finance was made in Urdu by Siddiqi in 1968. (The English version was not published until 1983.) His Islamic finance model was based on *mudaraba* and *shirka* (partnership or *musharaka* as it is now usually called). His model was essentially one based on a two-tier *mudaraba* financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of *mudaraba* and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

2.2.2 Chapra Model of Islamic Finance

Chapra's model of Islamic finance, (Chapra, 1982), was based on the *mudaraba* principle. His main concern, however, centered on the role of artificial purchasing power through credit creation. He even suggested that 'seigniorage' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. Chapra was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. He therefore preferred medium sized banks which are neither so large as to wield excessive power nor so small as to be uneconomical. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Al-Jarhi (1983) went so far as to favour the imposition of a 100 per cent reserve requirement on commercial banks. Mohsin (1982) has presented a detailed and elaborate framework of Islamic finance in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds 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. Many of the activities listed certainly go beyond the realm of commercial finance and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development.

Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that *riba*-free banks could coexist with interest-based banks. The point that there is more to Islamic finance than mere abolition of interest was driven home strongly by Chapra (1985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of *riba*, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-maximizing role. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers.

Unlike conventional banks which depend heavily on the crutches of collateral and of non-participation in risk, Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional finance.

Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic finance, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges.

2.2.3 Profit and Loss Sharing Theory

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

The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower. The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract. The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities.

There is a need for construction of standardized PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

2.3 Determinants of Banks Performance

In theory, determinants of a bank's profitability are categorized into three indicators: bank-specific, industry-specific and macroeconomic. Cornett and Tehania (1992), Mercia, et al. (2002), Toddard, et al. (2004), Guru et al.(2001)and Panayiotis et al.(2006) show that bank profitability is a function of internal and external factors. Internal factors include bank-specific; while external factors include both industry-specific and macroeconomic factors. Internal factors include capital ratio, bank size, liquidity, expenses management and asset quality. These factors are referring to the factors that can be managed by the management of a bank. External factors include gross domestic product (GDP), inflation, money supply and competition where all these factors considered beyond the control of a bank's management. It is mostly the macroeconomic factors.

2.3.1 Capital Ratio

Capital ratio is a valuable tool for assessing safety and soundness of banks. Some of the researchers explain that when a bank has high capital ratio or more equity capital, it shows the bank is safer and is an advantage to get higher profitability (Vong and Chan, 2009). Vong and Chan proved that capital will positively affect profitability with their statistically done research. This result is consistent with Abreu and Mendes (2002) which also found a positive relationship between capital and profitability. In the study, Abreu and Mendes proposed that a well-capitalized bank faces lower expected bankruptcy costs and show profit later. A study by Bashir (2000) also found the same result with a measure of capital by using the equity to total asset ratio for Islamic banks. Even most studies found there are significant positive relationships between the capital ratio and profitability but Athanasoglou, Delis and Staikouras (2006) and Athanasoglou, Delis and Staikouras (2005) found that capital is negatively related to banks' profitability for conventional banks. Wasiuzzaman and Tarmizi (2010) and Pramato and Ismail (2006) found that the relationship between capital and Islamic bank profitability is negative in Malaysia. Hassan and Bashir (2003) found the same result

which is found a statistically significant negative relationship between the capital and profitability i.e high capital ratio reduces the profitability of a bank.

2.3.2 Bank Size

Bank size is one of the variables that determine banks' profitability. Boyd and Runkle (1993) showed that size of a bank is also associated with the concept of economies of scale. Referring to Idris et al (2011) and Bahsir (2003), they found that the bank size is a very strong variable that will positively influence the level of profitability. Idris et al believed that larger banks would have an advantage in negotiating the price of input, and it can reduce bank's average cost. Therefore, the bank is able to enjoy the economics of scale and improve its profitability. However, Wasiuzzaman and Tarmizi (2010) and Athanasoglou, Brissimis and Delis (2005) found size of Islamic banks is insignificant and it is not important to affect banks' profitability. Wasiuzzaman and Tarmizi (2010) discovered that the bank size is highly correlated to the capital ratio and concluded that the profitability of Islamic banks in Malaysia is not influenced by the bank size.

2.3.3 Liquidity

Studies have been done on the relationship of liquidity of bank and its profitability on conventional banks as well as Islamic banks. Kosmidou, Tanna and Pasiours (2005) did a research on UK commercial banks and revealed a negative sign of liquidity on NIM. However, it is only significant in the presence of external factors. Bourke (1989) and Sufian and Habibullah (2010), among others; found a positive significant result between the level of liquidity and profitability with the proxy of liquid assets to total assets and loans to total assets. It indicates the higher liquidity of a bank, the higher profitability of the bank. Nevertheless, with the proxy of liquid assets to total assets and loans to total assets, Molyneux and Thornton (1992) and Francis (n.d.) has found a negative and significant relationship of liquidity in relation to profitability with the argument that low levels of bank liquidity improve bank profitability and high levels of liquidity declines bank profitability.. On the studies of Islamic banks, the result is mixed and various. Most studies such as Haron and Azmi (2004) and Wasiuzzaman and Tarmizi (2010) found a positive and significant relationship of liquidity and profitability. It argued that Islamic banks have the opposite signs with conventional banks due to the profit and loss sharing basis. However, a study on Indonesia's bank (Izhar and Asutay, 2007) contradicts the result with a negative sign and

significant relationship. A recent study by Idris et al. (2011) showed that liquidity does not meet the requirement of significance and hence it is not an absolute determinant to affect the profitability of Islamic banks in Malaysia.

2.3.4 Asset Quality

Besides liquidity, asset quality is also an important determinant that can have impact a bank's profitability because a poor asset quality may cause credit risk and lead to bank failure. Most studies expect the relationship of asset quality and profitability to be negative as bad loans may lower the profitability of a bank. Therefore, asset quality also known as loan quality should be concerned in order to provide good earnings. Awan (2009) has done a comparison of asset quality between conventional banks and Islamic banks. Hassan conducted a comparison by using a ratio of loan-loss reserve to gross loans, impaired loan over total loans and the percentage of net charge-off (NCO) to gross loans. On another hand, Awan used the indicators such as non-performing loans (NPLs), ratio of NPL to advances/ financing, ratio of provisions to NPLs and ratio of NPLs to deposits. Finally, a result showed that Islamic banks have more productive and efficient asset quality than conventional banks since Islamic banks have low default rate and healthier balance sheet. Athanasoglou, Delis and Staikouras (2005), Vong and Hoi (2009), Wasiuzzaman and Tarmizi (2010) and Ramadan, Kilani and Kaddumi (2011) found a significant and inverse relationship of asset quality and profitability for both commercial banks and Islamic banks. An inverse relationship reflecting the increase in exposure to credit risk may lower the bank's profit. Among others, Kosmidou, Tanna and Pasiours (2005), Sufian and Habibullah (2010) and Francis (n.d.) found a contradicting result, which is positive relationship of asset quality in relation to bank profitability. Kosmidou et al. used a proxy of loan loss reserves to gross loans to show a positive and significant effect of asset quality on NIM; however, it is insignificant on ROAA. Kosmidou et al. conclude that high risks may result in high returns. Francis measured asset quality by using total growth in bank deposit indicator and explained that high interest rate margin may increase the profits.

2.3.5 Expenses Management

Expenses management also appears to be one of the important determinants of bank's profitability. A poor expenses management contributes to poor profitability, and an efficiency expenses raises a bank's profit. A bank's expense includes the total amount of wages and salaries and the costs of running branch office facilities. The expenses management indicators

are expected to be negatively related to profitability as lower the usage of operational costs may help to increase the profit of a bank. However, there are some studies that suggested the positive relationship of expenses and profitability because higher payroll expenditures could contribute to require more productive human capital. Later, Athanasoglou, Delis and Staikouras (2005), Kosmidou, Tanna and Pasiours (2005) and Sufian and Habibullah (2010) also found the negative and statistically significant relationship on expenses with the proxies of cost to income ratio and operating expenses to total assets. Another study done by Ramadan, Kilani and Kaddumi (2011) showed there is a negative significant effect on Return on asset. However, it is statistically insignificant on Return on equity. Similarly, Hassan (2003) who conducted a study on Islamic banks profitability revealed a significant effect on Net Interest Margin (NIM) but does not have any significant coefficients on Return on Assets (ROA) and Return on Equity (ROE). On the contrary, Molyneux and Thornton (1992), Bashir (2003) and Haron (2004) found that the expenses affect bank profitability positively. It indicates high expenses or operating costs could generate higher profit for banks. Although most of the studies show a significant result of expenses impact on bank profitability, Izhar and Asutay (2007) asserted insignificant and positive relationship with profitability indicators in the study on Islamic banks. It suggests that the more profitable the bank the higher salary expenses will be.

2.3.6 Gross Domestic Product

The Gross Domestic Product (GDP) is a measurement of total economic activity within an economy. It is considered as an external determinant of banks' profitability given the positive relationship between the growth of the economy and the well-being of the banking sector (Levine and Zevros, 1998). Many have studied the effect of economic growth on banks' profitability. For instance, a single country study for assessing the impact of financial crisis on bank performance in Indonesia by Sufian and Habibullah (2010) was done. In their studies, they found that there is a positive association between banking sector performance and economic growth. This further confirms the findings of Pasiouras and Kosmidou (2007) in which the macroeconomic condition such as economic growth is statistically significant and positively related to both domestic and foreign banks operating in 15 European countries. Wasiuzzaman and Tarmizi (2010) also found a positive relationship by explaining high economy growth leads to improvement in credit quality and thus increases banks' profitability. Another single country study on Tunisian banking industry which analyzes the

impact of financial structure, macroeconomic indicators and banks' characteristics on banks' net interest margins, and profitability has been done by Ben Naceur and Goaid (2006). Ben Naceur and Goaid found that the macroeconomic indicators such as GDP have no impact on banks' interest margin and profitability. Another study done by Athanasoglou, Delis and Staikouras (2005) in South Eastern European region also found that GDP does not present any significant effect on banks' profitability.

2.3.7 Inflation

Inflation rate is one of the important determinants of banks' profitability. Revell (1980) believed that inflation could be a factor that influences banks' profitability. This hypothesis was empirically tested by Boyd, Levine and Smith (2000). The authors used various regression techniques in their studies and found that there is a strong non-linear relationship between inflation and financial sector performance. Boyd et al (2000) concluded that inflation is statistically significant and negatively related to the financial sector performance. Izhar and Asutay (2007) and Haron and Azmi (2004) used the Consumer Price Index as a proxy for inflation in their studies of banks' profitability. However, they found that the inflation is positively related to the profitability measures, and this further confirmed the work of Haron (1996) and Molyneux and Thornton (1992). In the study of Heggested (1977), the author tried to measure the impact of inflation on profitability indirectly. Instead of using Consumer Price Index as a proxy for inflation, Heggested used per capita income as an independent variable. However, Heggested found that there is no relationship between per capita income and banks' profitability. Ben Naceur (2003) used regression analysis (panel data with random effects) to investigate the banks' profitability determinants of the Tunisian banking industry performance. Ben Naceur suggested that growth rate are insignificant and have no impact on banks' profitability and interest margin. In addition, the study by Perry (1992) and Wasiuzzaman and Tarmizi (2010) found very different findings in which the effect of inflation on banks' profitability depends on whether the inflation is anticipated or unanticipated. If the inflation is anticipated, the bank can adjust the interest rate accordingly. Thus, the bank's revenue will increase faster than costs and eventually increase the banks' profitability. On the other hand, if the inflation is unanticipated and the banks are most probably not able to adjusting their interest rate promptly, this will eventually affect the banks' profitability adversely as the bank costs may increase faster than bank revenues. Vong and Chan (2009) believed that macroeconomic variable like the inflation rate will affect the

banks' profitability. In their study, they found that the inflation rate had a strong impact on the banks' Return on Assets. The bank management has to anticipate the inflation rate and react accordingly in order to be profitable in inflationary environments.

2.3.8 Money supply

Money supply is a measure of the total amount and value of money in an economy. There are various ways of calculating the money supply. The most conservative includes only currency in circulation and instruments that can be converted to currency on demand (e.g. the amount in a checking account). Most of the studies found that money supply has a positive relationship with banks' profitability. For instances, Bourke (1989) and Molyneux and Thornton (1992) found that money supply is significantly and positively related to banks' profitability. In the study of Bourke (1989), the market expansion is represented by annual growth in the money supply. The study by Haron and Azmi (2004) is the first using time series techniques of co-integration and error-correction mechanism to analyze the strength of influence between both internal and external determinants and Islamic banks' profitability. They found that there is a significant long-run relationship between the banks' profitability and its determinants such as money supply, inflation, and deposit items and so on. Haron and Azmi suggested that money supply is positively related to the profitability measures of Islamic banks such as bank's portion of income as percentage of total assets (BITA) and total income as a percentage of total assets (TITA).

2.3.9 Competition

Rasiah (2010) found that the increasing competition was actually caused by the deregulation of the banking industry where new financial institutions can enter the banking industry. Studies have been done on the effect of competition on bank profitability and there are different results showed. Theoretically, competition will reduce the profit of a bank as the profit now is shared when competitors increase. Emery (1971) who is the first researcher who studied on the impact of competition on bank profitability found out that there was no significant impact on bank's profit. Besides, Rhoades (1980) also found that there was no relationship between new entry of banks and competition. In a study earlier, Whalen (1988) found that competition does not have a significant impact on bank profits if the banking industry was already competitive. This indicates that the new entry of new banks or new branches will not affect the profit of the existing banks if the existing banks are competitive.

Lindley, James T., James A., James E. and Benton (1992) found there was a negative and insignificant relationship between competition and new entry. Haron (1996) also found that Islamic banks bring more benefit to the depositors compared to conventional banks. Likewise, there was a negative and insignificant relationship between competition and bank's operations (as cited Hassan and Bahsir, 2003). Nevertheless, Demirguc-Kunt and Huizinga (2001) found that competition has a negative and significant impact on the banks' performance. The result indicated that the bank's profit is reduced due to the stronger competition. Besides, Hassan and Bahsir (2003) also found that the competition brings a negative impact on bank's performance in their study. In their study, they used number of banks to represent the competition in order to determine the impact of competition on the Islamic bank's profit. Results showed that there is a negative impact but insignificant on the bank profitability except for the net non-interest margin. However, Heggsted and Mingo (1976) who used the market share as a measurement of competition found a positive relationship. It indicated that the degree of monopoly and power of market share could give a bank greater control on the prices and service.

2.4 Empirical Evidence

Pickett (2006) defines empirical evidence as a source of knowledge acquired by means of observation or experimentation. This section highlights both international and local evidence of research done on banking performance and factors incidental thereto.

2.4.1 International Evidence

A large number of empirical studies have been conducted about determinants of bank performance. One of the early studies that attempted to find out the major determinants of bank performance and profitability was carried by Short (1979) and Brouke (1989). Since then many studies have been conducted by other researchers.

Ahmed and Khababa (1999) examined the determinants of the banking sector in Saudi Arabia. They used the ROA, ROE, and the percentage of change in earnings per share as profitability measures. They found that business risk and bank size are the main determinants of the Saudi banks' performance. Guru et al. (2002) provided evidence from Malaysia. They investigated the factors that affect banks performance and profitability for seventeen Malaysian commercial banks, over the period 1986-1995. They used capital adequacy,

liquidity and management expenses as internal factors. Firm size, ownership and external economic conditions were used as external determinants. The results indicated that management expenses had a significant positive impact on bank's profitability. The results also suggested that high interest results in low bank profitability. Contrary to that, inflation had a positive impact on bank performance.

Staikouras and Wood (2004) constructed the OLS and fixed effect models to examine the determinants of European bank profitability from 1994 – 1998. The authors found that the profitability of European banks is influenced not only by factors related to their management decisions but also to changes in the external macroeconomic environment. Athanasoglou et al. (2005) studied the effect of bank-specific, industry-specific and macroeconomic determinants of bank profitability, using an empirical framework that incorporates the traditional Structure-Conduct-Performance (SCP) hypothesis. The results indicated that all bank-specific determinants, with the exception of size, affect bank profitability significantly in the anticipated way.

Bashir and Hassan (2004) studied the determinants of Islamic banking profitability between 1994 and 2001 for 21 countries. They used internal and external banks characteristics to determine profitability as well as economic measures, financial structure variables, and country variables. They used, Net-non Interest Margin (NIM), which is non-interest income to the bank such as, bank fees, service charges and foreign exchange to identify profitability. Other profitability indicators adopted were Before Tax Profit divided by total assets (BTP/TA), Return on Assets (ROA), and Return on Equity (ROE). They studied 43 Islamic banks. Their findings show that Islamic banks have a better capital asset ratio as compared to commercial banks which means that Islamic banks are well capitalized.

Kosmidou (2008) studied the determinants of performance for 23 Greek banks during the period 1990-2002. In his study, the return on average assets (ROAA) is used as bank performance measure. Cost-to-income ratio, equity to total assets, bank's loans to customer and short-term funding, loan loss reserves to gross loans, and the bank's total assets were used as internal determinants. On the other hand, he used the annual change in GDP, inflation rate, growth of money supply, stock market capitalization to total assets, total assets to GDP, and concentration as external determinants of performance. The results suggest that ROAA is

associated with well-capitalized banks and with lower cost-to-income ratios. Also, both size and the growth of GDP were positively related to banks performance, while inflation had a negative impact on banks performance.

Saona (2011) examined the determinants of the profitability of the US banks during the period 1995-2007. The empirical analysis combined bank specific (endogenous) and macroeconomic (exogenous) variables through the GMM system estimator. He found a negative link between the capital ratio and the profitability, which supports the notion that banks are operating over-cautiously and ignoring potentially profitable trading opportunities.

Akhtar et al. (2011) used a sample of Islamic banks in Pakistan over the period 2006-2009 to investigate the effect of bank-specific factors on bank's profitability using a multivariate regression models. They found that gearing and capital adequacy ratios had a significant positive impact on bank performance.

Habtamu (2012) examined determinants of bank profitability for the period 2002 to 2011 using balanced panel data of sixty seven observations from seven private commercial banks and analysed the same using multiple linear regressions method. The study concluded that managerial efficiency, bank size, level of GDP, and capital adequacy have significant impact on ROA. The study also found out that managerial efficiency, liquidity, bank size and GDP had significant influence on ROE. These variables also had positive relationship with profitability of private banks Capital adequacy, asset quality and GDP was also found out to have considerable relationship with NIM. All these variables have a negative correlation with profitability except level of GDP.

2.4.2 Local Evidence

Muthini (2005) conducted a study on the determinants of banks profitability in Kenya by empirically evaluating the link between internal and external determinants over profitability over a period of ten years (2002 to 2012) using descriptive analysis and inferential analysis. The study indicates that that banks profitability performance is affected by Capital Adequacy, Bank Size, Liquidity, Asset Quality, Expenses Management, Operational Inefficiency, Credit Deposit Ratio, Credit Risks, Liquidity Risks, Efficiency and Productivity, Age, Cost Per Borrower, Cost Income Ratio and Operating Expenses to Loan Portfolio, Ownership,

Concentration, Interbank rate, Market share and Banking system reform, Real GDP Growth Rate, Treasury bills rate, Spread, Inflation rate and Market Capitalization on profitability measures.

Olweny and Shipho (2011) evaluated the effects of banking sectoral-factors on the profitability of commercial banks in Kenya, using panel data from 2002 to 2008 of 38 commercial banks. The authors concluded that the bank-specific factors are more significant factors influencing the profitability of commercial banks in Kenya than market factors. The study revealed that profitable commercial banks are those that strive to improve their capital bases, reduce operational costs, improve assets quality by reducing the rate of non-performing loans, employ revenue diversification strategies as opposed to focused strategies and keep the right amount of liquid assets.

Ongore and Gemechu (2013) conducted by a study on determinants of financial performance of commercial banks in Kenya covering 37 commercial banks using multiple linear regression model and t-statistic to determine the relative importance (sensitivity) of each explanatory variable in affecting the performance of banks. The study concluded that capital adequacy, asset quality and management efficiency significantly affect the performance of commercial banks in Kenya. However, the effect of liquidity on the performance of commercial banks is not strong. The relationship between bank performance and capital adequacy and management efficiency was found to be positive and for asset quality the relationship was negative. Findings of the study on the direction and effect of macroeconomic variables on the performance of commercial banks in Kenya was inconclusive.

Wako et al. (2014) evaluated challenges affecting performance of Islamic banks in Kenya. The study was carried out through descriptive survey design that involves 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. It found out that global economy changes, advancement in information technology, the difficulties of legal and institutional framework, weak risk assessment and management, weak corporate governance standards and poor human resource practices were major factors affecting Islamic commercial banks performance in Kenya.

2.5 Summary of the Literature Review.

The literature review indicates that Islamic banking despite being nascent in many countries it was founded many years ago. There has been continuous growth and emergence of new Islamic financing modes. It brings to the fore such development, the multipurpose nature of Islamic banking and its growth and survival in modern economic settings. The review shows that banks profitability performance is affected by Capital Adequacy, Bank Size, Liquidity, Asset Quality, Expenses Management, Operational Inefficiency, Credit Deposit Ratio, Credit Risks, Liquidity Risks, Efficiency and Productivity, Age, Cost Per Borrower, Cost Income Ratio and Operating Expenses to Loan Portfolio, Ownership, Concentration, Interbank rate, Market share and Banking system reform, Real GDP Growth Rate, Treasury bills rate, Spread, Inflation rate and Market Capitalization on profitability measures.

A significant positive relationship has been noted between the bank's profitability in terms of return on equity (ROE) and government ownership, bank concentration and the level of interest rate. Other factors affecting commercial banks performance are noted as global economy changes, advancement in information technology, the difficulties of legal and institutional framework, weak risk assessment and management, weak corporate governance standards and poor human resource practices. Of major importance is that the review shows similar factors affecting banks in international space are same factors affecting performance of local commercial banks.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

In this chapter, the research design, target population, data collection and data analysis are discussed.

3.2 Research Design

A research design is regarded as an arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance with research purpose (Kombo & Tromp, 2006). It constitutes the blueprint for collection, measurement and analysis of data (Kothari, 2004). Nachmias and Nachmias (1996) describe 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.

The study adopted descriptive research design. Best and Khan (2009) posit that descriptive research is aimed of 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. Descriptive studies are not only restricted to fact findings, but also may result in formulation of important principles of knowledge and solution to significant problems (Kombo & Tromp, 2006).

The descriptive research design was adopted to explore how Islamic financing modes influence commercial banks profitability. 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

3.3 Target Population

Population is a complete set of individuals, cases or objects with some common observable characteristics (Mugenda & Mugenda, 2003). Target population refers to the total number of subjects or the total environment of interest to the researcher (Oso & Onen, 2009). The population of this study comprised all institutions providing Islamic Banking Services and registered with Central Bank of Kenya. Secondary financial statements data on loan book held, profitability and different financing modes portfolios will be used to analyze the effect of Islamic financing modes on profitability of commercial banks in Kenya. The entire

population comprising of 7 commercial banks will be used for purposes of the study.

3.4 Data Collection

Secondary data on Islamic financing modes volumes for the period 2008-2013 was obtained from financial statements of commercial banks that form the target population. Critical information for the study will be amount of financing made per financing mode, risk classification and grading of each financing mode and after tax profits generated by each financing mode. Where the same are not published in financial statements of respective banks, the researcher will write 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 will be organized by use of descriptive statistics such as frequency distribution tables and percentages. The data collected for the purpose of the study will be adopted and coded for completeness and accuracy. Descriptive analysis such as mean, standard deviation, frequencies and percentages will be used to analyze data.

Inferential statistics such as Pearson correlation and multiple regressions was used. Multiple regressions as a statistical technique was used to examine the way a number of independent variables relate to one dependent variable. The Multiple Regressions Analysis will be used to determine the nature of relationship between predictor variables and variable. The coefficient of multiple correlations is symbolized by the correlation R which indicates the strength of the correlation between the combination of the predictor variables and criteria variables.

The analytical model for this research, was developed and justified in the literature review, and which ultimately, provides structure to the empirical analysis. This analytical schema represents the model of the how different Islamic Modes of Finance affect the performance of commercial banks. The required assumptions of this multiple regression model are; the error variable (ϵ) is normally distributed, the mean value of the error variable is zero, the variance of the error variable is a fixed but unknown value, the values of the error variable are independent of one another, and relationship between profits of commercial banks and variables of financing modes is linear

3.5.1 Analytical model

The regression model expressed in mathematical notation is as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + \varepsilon$$

Where:

Y= Return on Assets measured by Total Comprehensive Incomes divided by the Total Assets

α = Constant Term (The Y-Intercept)

Beta (β) = Beta coefficients of the regression model+

ε = Error term.

X_1 = Amount of Musharakah (partnership) financing made

X_2 = Amount of Mudaraba (finance by way of trust) financing made

X_3 = Amount of Murabaha (cost-plus financing) financing made

X_4 = Amount of Ijara (leasing) financing made

X_5 = Amount of Salam (advance purchase) financing made

X_6 = Amount of Bai bi-thamin ajil (deferred payment financing) financing made

X_7 = Amount of Istisnaa (commissioned manufacture) financing made

X_8 = Amount of Sukuk (participation securities) financing made

X_9 = Size of the Bank-Natural Logarithm of book value of assets

X_{10} = Bank's Asset Quality- Ratio of NPL to Total Financing.

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) was used to test the expected level of heteroscedasticity in the target population. Analysis of variance (ANOVA) was used in the analysis of experimental data to test the variables for statistical significance.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

In this chapter, the study provides descriptive analysis and inferential analysis, results and discussion done on the data gathered. The descriptive analysis helps the study to describe the relevant aspects of the phenomena under consideration and provide detailed information about each relevant variable. For the inferential analysis, the study used the Pearson correlation, the panel data regression analysis and the f-test statistics. While the Pearson correlation measures the degree of association between variables under consideration, the regression estimates the relationship between the Islamic financing modes and profitability of commercial banks in Kenya.

4.2 Data analysis and findings

Primary and secondary data on 7 commercial banks offering Islamic financial services was considered in the analysis for the period 2008-2013. 8 different Islamic financing modes formed independent variables under study. The analysis is discussed hereunder;

4.2.1 Descriptive statistics

The mean and the standard deviation of different financing modes i.e Murabaha, Musharaka, Mudaraba, Tawaruq and Ijara for the period under consideration returned the following results;

Table 4.1: Descriptive Statistics Overall

Financing Mode	Mean	Std. Deviation
Murabaha	1,619,346,521	1,407,850,112
Musharaka	1,383,921,513	1,516,971,978
Tawaruq	27,300,000	11,394,086.95
Mudaraba	153,000,000	72,800,501.67
Ijara	135,005,250	86,004,401.45

Source: Research Findings

The table 4.1 show the results of summary statistics of all the taken variables in the analysis. The mean lending under Murabaha during the period was the largest standing at Ksh. 1,619,346,521 with a standard deviation of 1,407,850,112. Musharaka was the second largest with Ksh. 1,383,921,513 and a standard deviation of 1,516,971,978. Tawaruq returned the smallest mean of Ksh. 27,300,000 with a standard deviation of 11,394,086.95. Mudaraba and Ijara slightly formed a bigger part of the portfolio than Tawaruq returning a mean of Ksh 153,000,000 and 135,005,250 and a standard deviation of 72,800,501.67 and 86,004,401.45 respectively. The results observe that all the determinant variables have an influence on profitability of commercial banks as indicated by their positive mean values and their standard deviation.

The descriptive statistics for each of the bank was further analysed as per the table below. Identity of each bank is kept confidential and the banks named A, B, C and D.

Table 4.2 : Descriptive Statistics per Bank

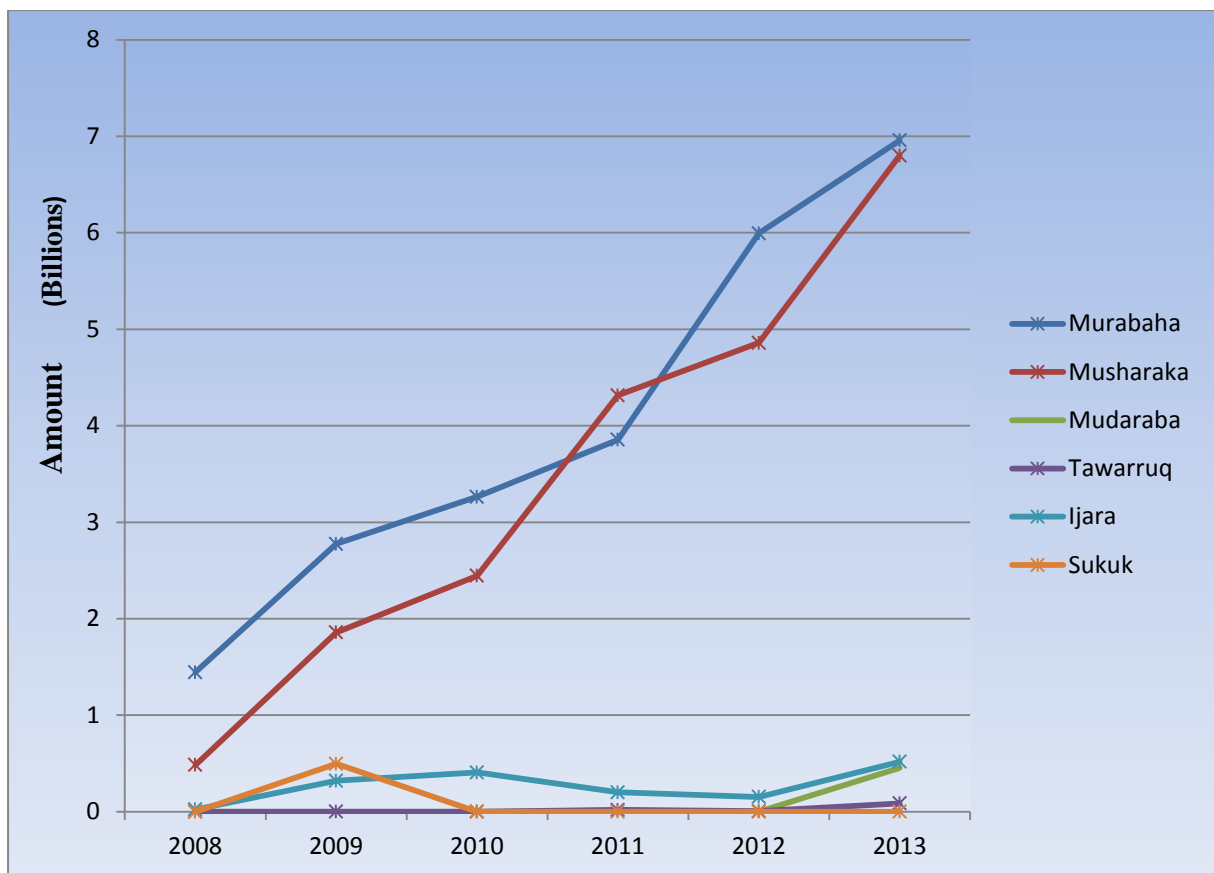
Bank	Financing Mode	Mean	Std. Deviation
A	Murabaha	1,335,576,728	629398673
	Musharaka	838,993,039.1	626977278
	Tawaruq	27,300,000	0
	Mudaraba	153,000,000	0
	Ijara	135,005,250	0
B	Murabaha	852,723,260.3	841634362
	Musharaka	738,394,089.8	707168160
	Tawaruq	19,516,666.67	9397960.8
	Mudaraba	105,500,000	73668854
	Ijara	115,985,958.3	50143010
C	Murabaha	3,448,979,500	1317000000
	Musharaka	3,209,483,167	1966000000
	Tawaruq	27,300,000	0
	Mudaraba	153,000,000	0
	Ijara	188,893,833.3	155776848
D	Murabaha	840,106,593.6	854297383
	Musharaka	748,815,756.5	697675633
	Tawaruq	35,083,333.33	19065195
	Mudaraba	200,500,000	116350763
	Ijara	100,135,958.3	43202295

Source: Research Findings

Murabaha returned the largest mean and standard deviation for all the banks considered followed by Musharaka. Tawaruq returned the smallest mean and standard deviation. The analysis is consistent with our findings in table 4.1 above.

Further analysis was done to determine growth pattern of each financing mode as detailed in the figure 4.3 below;

Figure 4.2: Growth Pattern of Financing Modes

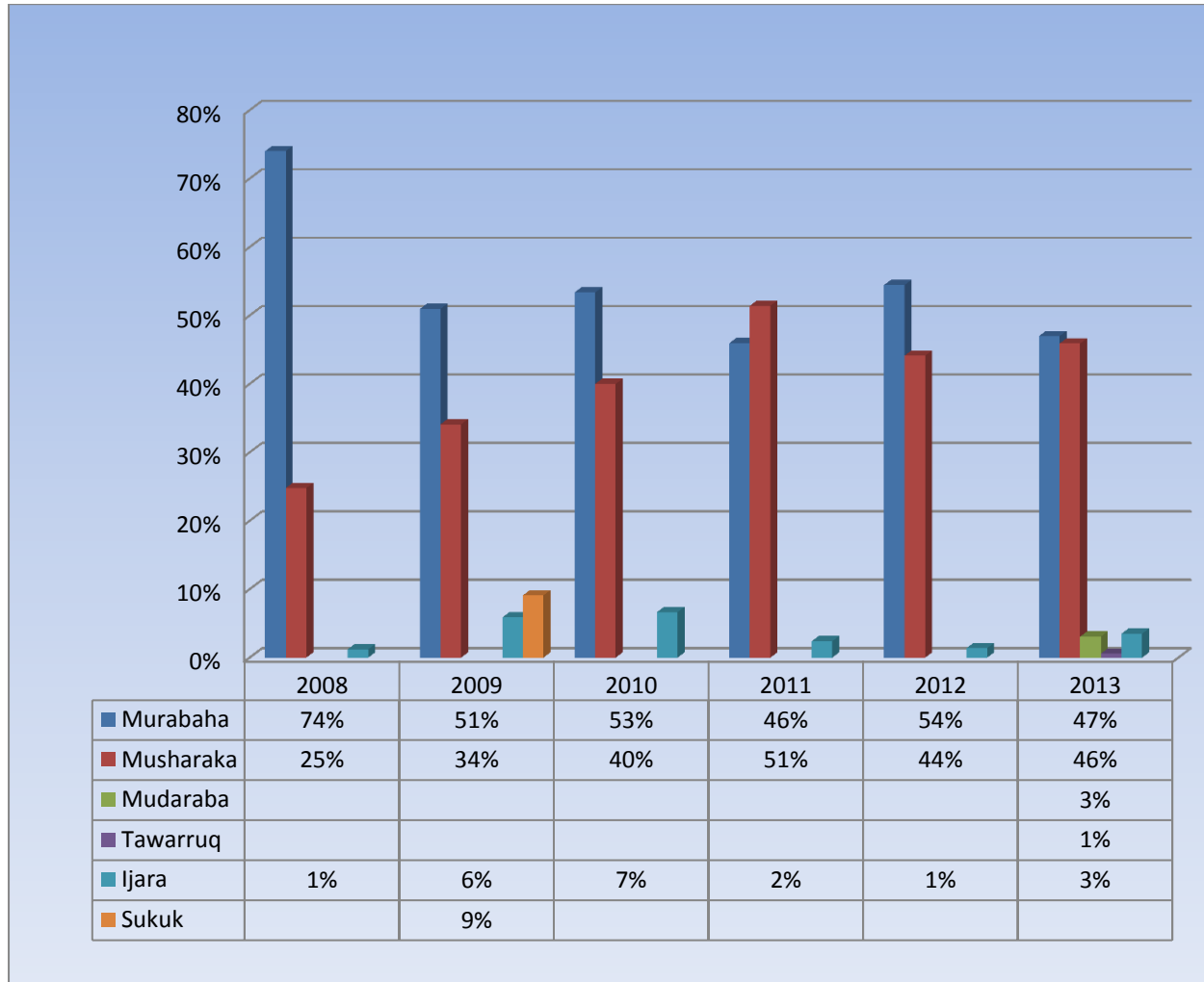


Source: *Research Findings*

Figure 4.2 indicates that Murabaha is the highest growing in the Islamic banking portfolio followed closely by Musharaka. Mudaraba, Tawaruq and Ijara are growing at a very small rate and constitute a small percentage of the portfolio of the period under study. Mudaraba, Tawaruq and Ijara are almost growing at the same rate hence Murabaha and Musharaka dominating overtime. Sukuk was only issued once in Kenya (2008) and hence its growth trajectory could not be reliably determined.

The portfolio composition of an Islamic banking asset book for each financing mode over the years was also determined and results documented in figure 4.2 below;

Figure 4.3 : Product Composition



Source: Research Findings

Figure 4.3 indicates that Murabaha has been declining overtime with Musharaka and other modes increasing. Murabaha composition in the total portfolio fall from 74% in 2008 to 47% in 2013. Musharaka increased from 25% in 2008 to 46% in 2013. The other financing modes i.e Mudaraba, Ijara, Tawaruq and Sukuk have seen limited growth over the period under consideration. However, Murabaha still remains the biggest contributor to an Islamic banking portfolio in Kenya.

4.2.2 Panel Data Regression coefficients

Panel data regression between the Islamic financing modes and return on assets of an Islamic banking portfolio was done. The results were as per table 4.3 below;

Table 4.3 : Regression Analysis

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.715a	0.512	0.376	0.789735	1.463
Predictors: (Constant), Ijara, Tawarruq, Musharaka, Mudaraba, Murabaha					
Dependent Variable: ROA					

Source: Research Findings

R-squared is a statistical measure of how close the data are to the fitted regression line. R-Squared measures the coefficient of determination and it states the model explanatory power. In general, the higher the R-squared, the better the model fits the data. The coefficient of determination as per table 4.3 above is 0.512 showing that the data fits very well into the regression model.

Table 4.4 : ANOVA (Analysis of Variance)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11.774	5	2.355	3.776	.016b
	Residual	11.226	18	0.624	-	-
	Total	23	23	-	-	-
Dependent Variable: ROA						
Predictors: (Constant), Ijara, Tawaruq, Musharaka, Mudaraba, Murabaha						

Source: Research Findings

From the table 4.4, since the P value < 0.05 as indicated in the analysis of variances (Sig) then there is a significant relationship between the dependent and independent variables. This means there is a significant relationship between Islamic financing modes and return on assets for the Islamic banking portfolio of a commercial bank. Similarly, the P-value is a meaningful addition to the model because changes in the predictor's value are related to changes in the response variable as per the outcome.

The regression coefficients for the model are as follows in table 4.5 below;

Table 4.5 : Regression Coefficients

Financing Mode	Unstandardized Coefficients		Standardized Coefficients	t	P value	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	1.154	0.51	-	2.265	0.036	-	-
Murabaha	1.16E-09	0.000	1.629	3.185	0.005	0.104	9.652
Musharaka	7.31E-10	0.000	1.109	2.249	0.000	0.111	8.97
Tawaruq	4.54E-08	.000	0.517	2.478	0.000	0.222	4.51
Mudaraba	5.52E-09	.000	0.401	1.948	0.036	0.222	4.513
Ijara	7.58E-10	.000	0.065	2.353	0.04	0.795	1.258

Source: *Research Findings*

In the table 4.5, There is a significant relationship between all the independent variables and dependent variable as they all have a P value of <0.05. Any change in Ijara financing with a B of 7.58 is likely to highly affect the ROA of a commercial bank offering Islamic financing services. Musharaka with a B of 7.31 is also likely to significantly affect ROA with a B of 7.31 followed closely by Mudaraba by a B of 5.52. Increase in Murabaha is not likely to significantly affect the ROA as it has a B of 1.16. The alpha of 1.154 with a standard error of 0.51 indicates some portion of ROA of bank may not be related to any assets and this may include other charges, commissions and commitment fees on financing made. Multi-Collinearity between the different financing modes is measured. Multi-Collinearity tolerance is indicated by 1/VIF. Multi-Collinearity will be present if VIF is greater than 10 or tolerance is < 0.1. From the analysis, the different financing modes don't share multi-Collinearity and therefore don't relate statistically.

The Pearson correlation coefficient is a measure of the strength of the linear relationship between two variables. It is referred to as Pearson's correlation or simply as the correlation coefficient. The Pearson correlation analysis for the data is as per table 4.6 below;

Table 4.6 : Pearson Correlation

Pearson Correlations							
		ROA	Murabaha	Musharaka	Tawarruq	Mudaraba	Ijara
ROA	Pearson Correlation	1					
	Sig. (2-tailed)						
	N	24					
Murabaha	Pearson Correlation	0.561	1				
	Sig. (2-tailed)	0.004					
	N	24	24	24			
Musharaka	Pearson Correlation	0.403	0.94	1			
	Sig. (2-tailed)	0.001	0				
	N	24	24	24			
Tawarruq	Pearson Correlation	0.147	-0.001	0.013	1		
	Sig. (2-tailed)	0.004	0.998	0.95			
	N	24	24	24	24		
Mudaraba	Pearson Correlation	0.035	-0.004	0.013	0.882	1	
	Sig. (2-tailed)	0.001	0.985	0.952	.000		
	N	24	24	24	24	24	
Ijara	Pearson Correlation	0.256	0.413	0.328	0.005	0.023	1
	Sig. (2-tailed)	0.001	0.045	0.118	0.981	0.916	
	N	24	24	24	24	24	24

Source: *Research Findings*

The Pearson correlation for the data as per table 4.6 indicates that there is a linear relationship between most of the variables of the study. The P value is <0.05 between most variables indicating a strong relationship between the variables under study. Murabaha has the most

significant relationship with ROA having an r value of 0.561. Murabaha relates strongly with Musharaka with an r value of 0.94 whereas Mudaraba relates strongly with Tawaruq with an r value of 0.882. There is a negative relationship between Murabaha viz-a-viz Mudaraba and Tawaruq as the analysis returns a negative value of -0.004 and -0.001 respectively.

4.3 Interpretation of the Findings

The analysis indicates that Murabaha and Musharaka are the biggest contributors to an Islamic banking portfolio. Other financing modes are still lagging behind and despite their growth overtime, their contribution in the portfolio is minimal. There is a significant relationship between return on assets and different Islamic financing modes. The results of the study also observe that all the determinant variables have an influence on profitability of commercial banks as indicated by their positive mean values and their standard deviation. Therefore, the different financing modes play a critical role in profitability of commercial banks offering Islamic financial services.

The results show that the data fits very well into the regression model. The coefficient of determination of 0.512 is indicative of the same. There is a significant relationship between Islamic financing modes and return on assets for the Islamic banking portfolio of a commercial bank as indicated by the P (sig) value of 0.16b in the analysis of variances. The P value (sig) also indicates how changes in the predictor's value are related to changes in the response variable. The results show that any change in any financing mode will have an effect on the ROA.

Despite most commercial banks relying on loans to make profits, there is a portion of income that does not rely on loans. This includes fees, commissions and other charges that bank earns from offering services such as withdrawal fees, bankers cheque fees and monthly ledger fees amongst others classes of bank tariffs not related to financing. Our regression analysis indicates the same given that the constant value of 1.154. Standardized Beta Coefficients give a measure of the contribution of each variable to the model. A large value indicates that a unit change in this predictor variable has a large effect on the criterion variable. The t and Sig (p) values give a rough indication of the impact of each predictor variable – a big absolute t value and small p value suggests that a predictor variable is having a large impact on the criterion

variable. From the results it is evident that there is a significant relationship between different financing modes and the return on assets of a commercial bank offering Islamic financial services as they all have a P value of <0.05 . The results indicate the need for commercial banks offering Islamic financial services to evaluate the different financing modes it is using to offer its financings and critically analyze how it affects their ROA and overall profitability.

From the results, there is no indication of multi-Collinearity between different financing modes showing that they don't relate statistically. This could partly be due to different approach each mode is offering and different Shariah requirements put in place to given each financing mode.

The Pearson correlation for the data indicates that there is a linear relationship between most of the variables of the study. The P value is <0.05 between most variables indicating a strong relationship between the variables under study. The strong relationship between Murabaha and the ROA is indicating how any change in murabaha financing affects ROA. Murabaha relates strongly with Musharaka with whereas Mudaraba relates strongly with Tawaruq. This could indicate the specific attributes that this financing modes share despite having being different. The results also indicate there is a negative relationship between Murabaha viz-a-viz Mudaraba and Tawaruq respectively showing the extent of difference between this financing modes.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Analysis of the results makes it possible to shade light on the findings and draw some conclusions. Since the inception of Islamic banking in 2008 in Kenya; different Islamic financing modes have been introduced in line with Shariah requirements of different commercial banks. Murabaha constituted the largest portfolio in 2008 with other financing modes being only Musharaka and Ijara then. However, overtime, Mudaraba and Tawaruq have also been developing albeit at a slow rate as a component of Islamic banking portfolio and a financing mode. Sukuk was only issued once (2008) and has never been issued again due to lack of regulatory structure of Islamic financial instruments in Kenya.

A strong relationship has been noted between Islamic financing modes and profitability of commercial banks. Therefore, it can be reliably said that any commercial bank offering Islamic financial services must pay key attention to different Islamic financing modes it is to deploy in offering its services. No significant relationship has been noted between the different Islamic financing modes. However, there is a strong relationship between variables under study showing each combined has an effect on return on assets of different commercial banks.

5.2 Conclusion

The results show that banks profitability performance is affected by different Islamic financing modes for an Islamic banking portfolio held by any commercial bank. All the financing modes under study are positively correlated to return on income.

According to the regression equation established, taking all factors into the consideration, including different financing modes and the bank size, Standardized Beta Coefficients give a measure of the contribution of each variable to the model. A large value indicates that a unit change in this predictor variable has a large effect on the criterion variable. As per table 4.7, murabaha is the biggest contributor with a standardized coefficient of 1.629 followed by Musharaka with a standardized coefficient of 1.109.

The t and Sig (p) values give a rough indication of the impact of each predictor variable – a big absolute t value and small P value suggests that a predictor variable is having a large impact on the criterion variable. From table 4.5, it is clearly evident that the different Islamic financing modes have a significant effect on profitability given a P value of most of them is <0.05.

5.3 Policy Recommendations

The study found out that there is a significant relationship between the different financing modes and return on assets. Therefore, each commercial bank must always evaluate its Islamic financing modes availability, uptake and contribution to its profits. All Islamic banks channel their loans through any of the modes under study and this underpins the significance of the different modes to profitability of commercial banks. Some financing modes have never been offered or practised in Kenya. These include Salam Bai bi-thamin ajil and Istisnaa. Sukuk was only offered once (2008). There is a need for commercial banks to consider introduction this financing modes to avail customer's variety in choosing financing modes for their facilities. The Central Bank of Kenya (CBK) should consider putting regulations in place in consultation with different Shariah and Islamic banking practitioners that will enable issuance of Sukuks and trading in Kenya.

5.4 Limitations of the Study

The study covered a period of only six years. However, some commercial banks within the sample introduced Islamic banking in 2011 and thereafter making data availability limited for the period under consideration (2008-2013). Some banks only offer Murabaha as an Islamic financing mode which indicates preference for some modes hence affected the analysis. A number of commercial banks operating Islamic banking windows are yet to do segmental reporting for Islamic banking portfolio therefore rendering data unavailable for such a window. One of the commercial banks in the population which introduced Islamic banking in 2013 completely refused to share its data per financing mode and performance of its Islamic banking window. This distorts the analysis done due to inadequate data available for Islamic banking.

5.5 Suggestion for Further Research

For future studies, as time goes by, when there will be more Islamic banks to study and for longer period of time, a similar study would generate better insight on the performance of Islamic and contribution of each financing mode and provide solid evidence. A future study could also consider large samples and carry out performance comparison using a combination of models. Other areas of study would include the concept of Profit and Loss Sharing (PLS) in Islamic banking, other Islamic financing modes not used in Kenya such as Salam Bai bi-thamin ajil and Istisnaa and how to come up with innovative Islamic financing products or modes. Of interest may also be how to regulate Islamic banks in a conventional environment in compliance with Shariah.

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APPENDICES

APPENDIX 1: LIST OF BANKS PROVIDING ISLAMIC BANKING SERVICES IN KENYA

Bank	Address
Gulf African Bank Limited	Geminia Insurance Plaza P.O. Box 43683 -00100 Nairobi.
First Community Bank Limited	Prudential Building, 1st floor, Wing A, Wabera Street, P.O. Box 26219-00100, Nairobi Kenya, Banks in Kenya.
Chase Bank Limited (Chase Iman)	Riverside Mews, Junction of Ring Road Riverside and Riverside Westlane along Riverside Drive, P.O. Box 66015 - 00800, Nairobi.
National Bank Limited (National Amanah)	National Bank Building, Harambee Avenue, Nairobi Tel: 020-2828000, Fax: 020-311444/222304 E-Mail: corporateaffairs@nationalbank.co.ke
Barclays Bank of Kenya Limited (La riba)	Barclays Bank of Kenya Ltd, Barclays West End Building, Off Waiyaki Way, PO Box 30120 – 00100Nairobi, Kenya.
Standard Chartered Bank Limited (Saadiq)	48 Westlands Road, Nairobi, Kenya, P.O. Box 30003 – 00100 GPO, Nairobi
Kenya Commercial Bank Limited	Kenya Commercial Bank Limited, Kencom Building, P.O Box 48400-00100 Nairobi, Kenya.

Source: Central Bank of Kenya (CBK)

APPENDIX 2: INTRODUCTION LETTER

Roba Adan Abdi Boyante,

P.O. Box 47087-00100

Nairobi.

Date.....

The Head,

Shariah Compliance/Credit Administration

Company Name and address-----

Dear Sir/ Madam,

RE: REQUEST FOR RESEARCH DATA

I am a Master of Business Administration (Finance) student at the University of Nairobi undertaking a Research Project on the ‘The Effect of Islamic Financing Modes on the Profitability of Commercial Banks in Kenya’.

The research is being carried out as part of the requirements of obtaining the degree. Your bank has been selected to form part of this study and is kindly requested to assist in data collection by availing data required by the researcher on Islamic financing modes volumes, risk profiles and profitability contribution at your esteemed organization. The information provided will exclusively be used for academic purposes only and will be treated with utmost confidence. As a participant, you are free to request for a soft copy which can be sent to you via email.

Your cooperation and assistance will be highly appreciated.

Yours faithfully,

Roba Adan Abdi Boyante
(MBA Student)

Mr. Herick Ondigo
(Supervisor)

APPENDIX 3 -DATA COLLECTION FORM

BANK PROFILE

Name of the Bank.....

Year of Establishment.....

Mode of Islamic financial services operation at the bank (tick as appropriate)

An Islamic Banking Subsidiary

An Islamic Window within conventional bank

A fully fledged Islamic Bank

FINANCIAL PERFORMANCE AND MODES OF FINANCING DISTRIBUTION OF THE ISLAMIC BANKING PORTFOLIO OVER THE LAST SIX YEARS

Year/ Performance Measure	2008	2009	2010	2011	2012	2013
Net Income						
Net Assets						
Total Islamic Non-Performing Loans						
Amount of Musharaka financing						
Amount of Murabaha financing						
Amount of Mudaraba financing						
Amount of Ijara financing						
Amount of Salam financing						

Amount of Bai bi-thamin ajil financing						
Amount of Istisnaa financing						
Amount of Sukuk financing						
Total Islamic Non- Performing Loans						
Bank Classification according to CBK						