EVALUATION OF ISLAMIC BANKING PRODUCTS AND FINANCIAL PERFOMANCE OF ISLAMIC BANKS IN KENYA
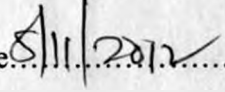
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DECLARATION

This Research Project is my original work and has not been submited to any University or college for academic credit. All information from other sources has been duly acknowleged.
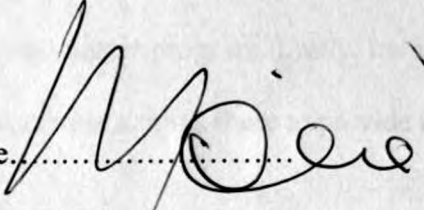
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Mirie Mwangi, Lecturer.

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Thank you all

DEDICATION

I dedicate this project report to my parents for their financial and moral supports throughout my day in school, May Allah bless them and sustain their help to reap the fruit of their labour. I also dedicate this work to my dear wife for her full support and patience, and my brothers and sisters for their word of encouragement in my studies.

ABSTRACT

The objective of this study was to evaluate the effects of Islamic banking products on the profitability of Islamic banks in Kenya. Annual financial statements of two Kenyan fully fledged Islamic banks from 2008 to 2011 were obtained from the CBK and Banks annual report. The data was analyzed using linear regressions method to measure the performance of key financial performance variables and financing contracts.

This study made use of secondary data in analyzing the relationship between Islamic banking product and financial performance of the 2 fully fledged Islamic banks licensed by CBK. The secondary data was obtained basically from published annual reports of the selected banks and data collection form for individual product data for items not appearing on the financial statements.A set of statistical techniques, Multiple R F-value, determination (R^2) and significance level, by researcher to analyze the relationship between dependent and independent variable.

The results indicate a strong positive relationship between product size and amount and financial performance of Islamic bank in Kenya F-value and significance level of less than 0.5, regression relationship between Islamic bank products and profit before tax is statistically significant. As a result, any change in the size of Islamic banks product will have an effect of the earnings of the bank.

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ABBREVIATIONS

ATM   -   Automated Teller Machine

BBK   -   Barclays Bank

BSReport -   Bank Supervision Report

BTP   -   Before-Tax Profit over Total Assets

CBK   -   Central Bank of Kenya

FCB   -   First Community Bank

GAB   -   Gulf African Bank

KCB   -   Kenya Commercial Bank

MARG   -   Net Interest Margin

NIM   -   Interest Income

PAT   -   Profit After Tax

ROA   -   Return on Asset

TA   -   Total Asset

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

1.1.1 The Concept of Islamic Banking

The core concept of Islamic banking is to provide services to its customers free from interest and the giving and taking of interest (riba) is prohibited in all transactions (Lewis & Algaoud, 2001). Prohibition of interest (riba) makes Islamic banking system differ from conventional banking system. In other words, the main difference between Islamic and conventional banks is the use of money. In conventional banks, money is used as a commodity that is bought and sold through the interest's usage according to Alkassim (2005).

The five main Shariah principles that are permanent include the prohibition of riba, application of al-bay' (trade and commerce), avoidance of gharar (ambiguities) in contractual agreements, the prohibition of maisir (gambling), and prohibition from conducting business involving prohibited commodities such as pork, liquor, illicit sex, and pornography. The forbidden actions are called Haram while the legal, permitted, and admissible actions are referred to as Halal (Rosly, 2005).

Many studies have been conducted to investigate the profitability determinants of conventional banks. Since the pioneering work of Hester and Zoellner (1966), which measured the relationship between items in the balance sheet and earnings of banks in the US, studies of bank profitability have expanded to the international

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level (Short, 1979). In the Islamic banking literature, the empirical work of Haron (1996a) was the first attempt to investigate factors that contributed towards the profitability of Islamic banks. However, most of the research used multiple regression analysis in measuring the relationship between thedetermining factors and profitability ratios. In contrast to other studies, Chirwa (2003) applied time-series techniques of cointegration and error-correction methods to test the structure-conduct-performance hypothesis and determine whether a long-run relationship exists between the profits of commercial banks and concentration in the banking industry.

1.1.2 Bank Financial Performance

There are several criteria to evaluate the performance of banks for successful survival in the era of globalization and competition. Multiple aspects like profitability, liquidity, management performance, leverage, market share, productivity, innovation, quality of products, human resources and sales volume etc. can evaluate any organization. Inception of Islamic banks necessitated the importance of performance evaluation to compete with conventional banks in Kenya. Performance evaluation enables the organization to assess its efficiency and effectiveness over a period of time by comparing with its objectives or with market leader to overcome its weaknesses. Researchers explored a number of indicators to measure organizational performance (Dess & Robinson, 1984).

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It is reported that an organization can maximize the customer satisfaction for better profitability, increased sales volume that ultimately improves its performance for long term benefit (Baker & Sinkula, 1999). Generally, performance is assessed by the application of financial measures. Rashid et al. (2003) measured firm's financial performance using the financial indicators such as return on assets, return on investments and current ratios. Financial ratios reflect the financial performance of the organization by an examination of financial statements as indicated by profitability, liquidity, leverage, asset utilization and growth ratios (Ho & Wu, 2006).

1.1.4 The Relationship between Product and Financial Performance

A product focus should lead to higher growth and profitability. Porter (1980) argues unless a focus strategy is used to target a neglected market, it usually involves a trade-off between profitability and sales volume, that is, focus may limit expansion opportunities thereby constraining the overall market share achievable. For banks to survive and deliver consistent financial performance, customers have to be satisfied with their products.

The diffusion of financial innovation also affects saving rates. If banks offer non-traditional products or new technological services, consumers benefit from these innovations and allocate their savings towards these new products and services and banks diversify their sources of income so that they can afford lower interest margins (Berger, Hasan & Klapper, 2005).

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An in-depth profitability and risk analysis is usually needed if a comprehensive evaluation of bank's performance is required. This is so because 'investigating the risk and profitability measures is expected to indicate how the depositors' and shareholders' funds are used. For example, the profitability measures determine the bank's market valuation and its ability to get funded in the deposit and equity markets. Generally speaking, higher returns are both necessary and sufficient for attracting additional deposits.

The effect of bank size (measured in terms of the value of total assets) on its performance measures is documented in many recent papers (Boyd and Runkle, 1993; Keeley 1990). The conventional wisdom is that, a small-sized bank has a higher return on assets and a higher capital-asset ratio. A higher capital ratio means a lower leverage multiplier, and hence a lower return on equity. On the other hand, large banks have lower returns on assets and lower capital-asset ratios. This exposes them to higher leverage and higher returns on equity. Meanwhile, different banks' sizes have different policy implications. First, small banks are usually exposed to high risks as indicated by their rates of return on assets. Small banks should, therefore, be forced to hold higher percentage of equity to assets. Second, large banks tend to use more arbitrage transactions than small banks. The extensive use of arbitrage increases size but reduces returns on assets, and lowers capital ratio.11 finally; bank regulators perceive that small banks have less diversified portfolios than large banks. Henceforth, adherence to certain capital adequacy requirements is essential to limit banks' risk-taking behavior.

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The proponents of large scale raise many points in favor of large bank size. They argue that large size promotes efficiency by inducing economies of scale. Large banks are expected to take advantage of the economies of scale and reduce the costs of gathering and processing information. Large size is also anticipated to enable the bank to be more diversified.A diversified institution is expected to mobilize more funds and, hence, generate high returns to its depositors and equity holders. Furthermore, large institutions are apt to finance a large number of profitable investment opportunities. Finally, because banks have superior access to investment activities, factors affecting their sizes and efficiencies will have an impact on the aggregate economy.

1.1.5 Islamic Banking in Kenya

The concept of Sharia-compliant financial institutions in Kenya was introduced in 2007 through a change in the Banking Act, under Cap 488, which saw the establishment of two fully-fledged Islamic banks — FCB and GAB. FCB is the first Bank approved by the Central Bank of Kenya (CBK).The bank received its approval from the Central Bank of Kenya (CBK) on May 29th 2007 thereby opening the door for Sharia Compliant banking not only in Kenya but indeed in the entire East and Central African region.

(GAB) establishment can be traced back to 2005, when a group of motivated Kenyans envisioned establishing an Islamic bank as an alternative to conventional

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banking in the country. This opened up competition for Muslim clientele in Kenya thereby attracting convention banks such as Barclays, Chase Bank and Fidelity Bank to offer Shariah compliant product. Equity Bank, the largest local bank by consumer base, plans to start offering shariah compliant products and services by the end of the year 2012.

1.2 Statement of the Problem

McDonnell and Rubin (1991) indicates that sales of deposit and lending products as one critical succes dimensions in the performance of banks.However no research have been undertaken to investigate which Islamic bank product is the most contributor to the financial performance of a bank. Friedman (1969) suggested that a nominal zero interest rate is necessary condition for optimal allocation of resource. It was found that zero interest rate is required and sufficient for allocative efficiency by investigation within general equilibrium models (Wilson, 1979).

The basic aim of the Islamic banking is to perform interest-free activities. While in conventional banking investors are guaranteed a predetermined rate of interest and it aims to maximize the return even at the cost of society or other stakeholder. Financial sector reflects the overall trend of the economy and banking institutions are the main component of it. In Pakistan, there are a number of conventional banks that are providing a variety of products to their customers but most of the products are riba (interest) based which are contradictory to the principles of Sharia'h.Literature also supported that interest-free (profit and loss sharing) system is viable and superior to an interest-based system (Chapra, 1985).

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Islamic banks deal in equity based (profit/loss) contracts that are more suitable for the economy as compared to interest-oriented conventional banks. Similarly, both banking streams provide a set of products and services that requires a comparative study to assess their performance on the basis of service quality and customers' satisfaction. Banks earnings come from its investments accounts; financing and other financial services.Banks earn profit from financing products, investment accounts and other financial services.

Consumers' deposits are important as a source of funds and to channel it to investors, business firms and goverments who would use this funds effeciently in productive projects and investments.Thus, financing and deposit products would contribute to banks earnings. MacDonald and Rubin (1991) also agrees that sales of deposit and lending products as one critical success dimensions in the perfomance of banks.However it is yet to be proven which financing contaract is the most contributor to the banks earnings in kenya.

1.3 Objective of the Study

To determine the relationship between Islamic banking products and financial performance of Islamic banks in Kenya.

1.4 Value of the Study

Evaluation of bank's products performance is important for all parties which are known as bank stakeholders.In a competitive financial market banks product performance provide signal to stakeholders whether to borrow or withdraw funds

from bank.Similarly , It flashes direction to bank managers whether to improve its deposit services or financing services or both in order to improve banks earnings.

The central bank will find this study very important as it continuous to effectively play its regulatory role of safeguarding the soundness of the industry through ensuring that banking registered to offer Islamic banking products come up with sheria compliant product that are profitable to the company to safe guard its going concern. Finally, the research will also be of help to researchers and academicians in their quest to understand Islamic banking products and their effect on the banks financial performance.

The internal and external factors may significantly affect the Islamic banks' profitability. The study can be used as a reference for Islamic banks to focus and control over the variables that bring negative effects to its profitability.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter reviews the literature that forms the basis of this study. It will highlight the theoretical framework that underpins the Islamic finance and overall banking performance, review the grounding theories of the study and analyse some empirical literatures done by various scholars.

2.2 Theory of Islamic Banking

The early contributions on the subject of Islamic banking 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 banking 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) 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

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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 'interestless banking'. 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 banking 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. In other words the bank would act as a mudarib in so far as the depositors were concerned, while the 'borrowers' would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.

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Irshad (1964) also spoke of mudaraba as the basis of Islamic banking, but his concept of mudaraba was quite different from the traditional one in that he thought of capital and labour (including entrepreneurship) as having equal shares in output, thus sharing the losses and profits equally. This actually means that the owner of capital and the entrepreneur have a fifty-fifty share in the profit or loss as the case may be, which runs counter to the Shariah position. Irshad envisaged two kinds of deposit accounts.

The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund which would absorb all losses so that no depositor would have to bear any loss. According to Irshad, all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968. His Islamic banking 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

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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.

Chapra's model of Islamic banking (Chapra 1982), like Siddiqi's, was based on the mudaraba principle. His main concern, however, centred 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. Al-Jarhi (1983) went so far as to favour the imposition of a 100 per cent reserve requirement on commercial banks.

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 mediumsized 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.

Mohsin (1982) has presented a detailed and elaborate framework of Islamic banking 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 banking business

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alone. Many of the activities listed certainly go beyond the realm of commercial banking 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 banking 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 banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, 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 (Chapra, 1985).

2.3 Factors Influencing Bank Profitability

To identify the relevant factors influencing bank profitability in Kenya, CAMEL framework and market structural factors; ownership and market concentration will be used for evaluating bank performance. CAMEL stands for Capital adequacy, Asset quality, Management efficiency, Earnings performance and Liquidity.Bashir (2003) identified the determinants of profitability in Islamic Banks. They study focused on cross-country analysis and collected income statements of 14 Islamic banks in 8 countries for the period of 1993 to 1998. Using return on asset (ROA) and return on equity (ROE) as dependent variables the regression reported that profitability indicators positively react to boost in loan ratios and capital.

Al-Tamimi (2005) studied the determinants of UAE commercial banks through a contrast between National and Foreign banks for the period 1987-2002. Using results of two regression models the study suggested that the bank portfolio combination and bank size were found to have highly significant relation with return on assets and return on equity for the National banks performance.

Despite the fact that the majority of Islamic Banks were established within the promising and/or Middle East states, many banks in developed countries have

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started to value the enormous demand for financial products of Islamic Banks (Sufian, 2007). Mokhtar, Abdullah and Alhabshi (2008) while studying Malaysia banks for the period 1997 to 2003 discovered that, even though the fully functional Islamic banks were more efficient and well-organized in contrast to the Islamic windows, still they were less efficient than the conventional banks.

Siddiqui (2008) analyzed behavior of Islamic styles of finance and scrutinize their risk characteristics. Comparing two fully Islamic licensed banks of Pakistan (Meezan Bank and Al-Baraqa Bank) study contrasted a range of earning, liquidity, and profitability and capital adequacy ratios and contrasted with scheduled banks ratios. The study found reported Islamic banks in Pakistan were more inclined in the direction of employing projects with long= term financing and found to had enhanced profitability than conventional banks. Sadaqat, Akhtar and Ali (2011) reported the superior performance of conventional banks than Islamic banks in boosting their profitability and risk management practices.

Sufian and Parman (2009) studied the profitability of non-commercial banks financial institutes (NCBFIs) of Malaysia with the macroeconomic and bank-specific factors that influenced their profitability for the period of 2000-2004. Using ordinary least square model, the study found NCBFI with high credit risk and loan intensity tend to show lesser profitability level and NCBFI with high operational expenses and level of capitalization tend to show higher profitability level. Sufian and Noor (2009) found that the Islamic banks have been administratively incompetent in taking advantage of their resources to the optimum

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extent. Sufian (2007); Choi, Stefanou, and Stokes (2007); Koutsomanoli-Filippaki, Margaritis, & Staikouras (2009) observed significant variation and diverse prototypes in inefficiency levels across banking systems. Additionally he found small and home private banks emerge to be the utmost efficient.

Hassan, Mohamad and Bader (2009) stated that on average, banks are more competent in utilizing their resources in contrast to their capability to produce profits and revenues while studying on a cross-country level in 11 Organization of Islamic Conference (OIC) nations for the period 1990-2005. Sufian and Habibullah (2010) empirically studied the efficiency of the banking sector of Thailand for period 1999-2008. Using DEA model and multivariate regression analysis founds that superior efficiency levels are revealed by banks with superior capitalization and higher loans intensity. Conversely, empirical findings propose topical global financial crunch to be negative exercising on the efficiency for banks of Thailand.

Akhtar, Ali and Sadaqat (2011) reported the significance of size and networking capital while studying the risk management practices of Islamic banks. Ali, Akhtar and Ahmed (2011) studied the bank-specific and macroeconomic determinants of profitability for commercial banks of Pakistan. Using four years data the study found significant affect of capital adequacy ratio, credit risk, asset management, GDP and consumer price index with profitability when measure with return on assets (ROA) and significant relation of operating efficiency, asset management and GDP with profitability when measured with return on equity (ROE).

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2.3.1 The Effect of Bank-Specific Factors on Bank Profitability

Bank-specific factors are those factors within the direct control of managers and can be best explained by the CAMEL framework, while external factors include industry-specific and macroeconomic factors.

2.3.1.1 Capital Adequacy and its Effect on Profitability

Beckmann (2007) argue that high capital lead leads to low profits since banks with a high capital ratio are risk-averse, they ignore potential [risky] investment opportunities and, as a result, investors demand a lower return on their capital in exchange for lower risk.Thus well capitalized banks should be profitable than lowly capitalized banks.The banking sector in Kenya provides an interesting case to examine the impact of capital because the minimum statutory requirement has been upgraded to Ksh. 1billion in 2012.

2.3.1.2 Assets Quality and its Effect on Profitability

The CBK measures asset quality by the ratio of net non-performing loans to gross loans. Kosmidou (2008) applied a linear regression model on Greece 23 commercial banks data for 1990 to 2002, using ROA and the ratio of loan loss reserve to gross loans to proxy profitability and asset quality respectively. The results showed a negative significant impact of asset quality to bank profitability. This was in line with the theory that increased exposure to credit risk is normally associated with decreased firm profitability.

2.3.1.3 Liquidity Management and its Effect on Profitability

The trade-offs that generally exist between return and liquidity risk are demonstrated by observing that a shift from short term securities to long term securities or loans raises a bank"s return but also increases its liquidity risks and the inverse in is true. Thus a high liquidity ratio indicates a less risky and less profitable bank (Hempel et al, 1994).

In Kenya the statutory minimum liquidity requirement is 20%. However, according to CBK Bank Supervision Annual Report (2011), the average liquidity ratio for the sector was 37 percent as at December 2011 compared to 44.5 percent registered in 2010, and way above the minimum requirements. The reduced liquidity ratio is attributable to increased loans and advances in 2011 as indicated by the increase in gross loans to gross deposits ratio from 74 percent in 2010 to 80 percent in 2011.

Kimingi (2010) did a study on the effects of technological innovations and financial performance of banks and depicted that depicted that technological inovations affect financial perfomance through increased sales and competitive positioning. Also, a study on determinants of financial innovation and its effects on banks performance concluded that technological innovations influence the structural aspects of banks in Kenya. Use of various aspects of technological innovations is thus expected to have great effects of financial performance of an organisation (Kihumba, 2008).

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2.4 Products under Islamic Banking System

Islamic banks have five product categories which are deposits, investements, financing, trade financiang, and card services.However, Kenyan Islamic banks have two major products, that is, customer deposits and loan or financing.

2.4.1 Customer Deposits

2.4.1.2 Al-Wadia

Islamic banking accepts saving deposits from customers unders al-Wadia (trusteeship) with sheria principles.In saving accounts under the Al Wadia,the bank is given authority by depositers to use the fund at the bank's own risk.This type of deposit is similar to a current account or demand deposit except that the bank gurantees its customers the fullreturn of deposited funds with any profit.The profit or loss from the use of such deposit is shared between the banks and the depositors at an agreed ratio between both parties (Ahmed, Rahman, & Ahmed, 2006 ; Ali & Saker 1996)

2.4.2 Loan/Product Financing

2.4.2.1 Mudharabah Financing

Capital Financing is a contract between at least two parties in which the bank will act as the investor who supplies the entire capital of the business formng the relationship between suplier of capital and the user of capital.These two parties work togather and share profits and losses.The main advantage with this type of partnership is that it combines the efforts of human beings and their skills with the capital,which contributes towards the development activities in a society and also

helps to solve unemployment.When the venture ends ,the manager of capital ,that is,the entreprenuer pays the entire capital back to the bank ,along with an agreed proprtion of profit.If there is any loss,it is borne by the bank (Ahmed, Rahman & Ahmed, 2006)

2.4.2.2 Musharaka

The word Musharaka means a profit sharing joint venture ,designed to limit production or commercila activities for long run.In this case , the bank and the customer contribute capital jointly.They also contribute mamnagerial expertise and other essential services at agreed proprtion .Profit or losses are shared according to the written contract (Ahmed, Rahman & Ahmed, 2006)

2.4.2.3 Murabaha –Cost plus Profit

The word 'Murabaha' means cost plus profit .In the system the bank agrees to purchase a good for a clientwho will then reimburse the bank in a stated time period at an agreed upon profit margin.The mark-up price that the bank and the buyer agrees to is mainly based on the market price of commodity.Thus the bank earns profit without bearing any risk (Ahmed, Rahman & Ahmed, 2006)

2.4.2.4 Ijara

The word Ijara indicates leasing.The leasing purchase is another technique adopted by Islamic banks in financ ing equipements and instruments for customers.This system is also similar to leasing activity offered by conventional banking.Leasing is a contract between bank (lessor) and the customer(lessee) to use particular assets and pays rent (Zeneldin,1990). The leasing agreement is basedon profit sharing in

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which the bank buys the movable or immovable property and lease it to one of its client for an agreed sum by installements and for a limited a period of time into a saving account held with same bank. The contract is called ijara-wa-iqtina that is, leasing purchase, when the ownership of the asset transfered to the client after the completion of leasing contracts. (Ahmed, Rahman & Ahmed, 2006)

2.4.2.5 Qard ul Hassan-Interest Free Loan

It means free interest free loan.It is .normally given to needy students, small producers, farmers, entreprenuers and economically deprived segments of the society.The main aim of this loan is to help needy people to be self sufficient and to raise their income and standards of living (Zeneldin, 1990).

2.5 Measures of Performance

Evaluating bank performance is a complex process that involves assessing interaction between the environment, internal operations and external activities. In general, a number of financial ratios are usually used to assess the performance of financial intermediaries. The primary method of evaluating internal performance is by analyzing accounting data. Financial ratios usually provide a broader understanding of the bank's financial condition since they are constructed from accounting data contained on the bank's balance sheet and financial statement. (Kidwell, Peterson & Blackwell, 2000).

Four measures of performance are used in this study: the net non-interest margin (NIM), profit margin (BTP/TA), returns on assets (ROA), and returns on equity

(ROE). The NIM is defined as the net income accruing to the bank from non-interest activities (including fees, service charges, foreign exchange, and direct investment) divided by total assets. Non-interest income is growing in importance as a source of revenue for conventional banks in the 1990s. Some of the fastest growing non-interest income items include ATM surcharges, credit-card fees, and fees from the sale of mutual funds and annuities (Kidwell, Peterson & Blackwell, 2000).

For Islamic banks, non-interest income, NIM, makes up the lion's share of total operating income and captures the bank's ability to reduce the risk of insolvency. Moreover, since the returns on Islamic banks' deposits are contingent on the outcomes of the projects that banks finance, then NIM reflects the management's ability to generate positive returns on deposits. If banks were able to engage in successful non-loan activities and offer new services, non-interest income will increase overtime (Madura, 2000). Goldberg and Rai (1996) used the net non-interest return as a rough proxy of bank efficiency.

The bank's before-tax profit over total assets (BTP/TA) is used as a measure of the bank's profit margin. This measure is computed from the bank's income statement as the sum of noninterest income over total assets minus overhead over total assets minus loan loss provision over total assets minus other operating income. BTP/TA reflects the banks' ability to generate higher profits by diversifying their portfolios. Since large size (scale) enables banks to offer a large menu of financial services at

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lower costs, then positive relationships between BTP/TA and the explanatory variables in equation (1) will give support to the efficient-structure hypothesis (Smirlock, 1985).

2.6 Review of Empirical Evidence

Islamic banking system is thirty years old and is considered a part of banking industry. Islamic banking is also known as interest-free banking or profit-loss sharing (Alkassim 2005). Thus, it is a necessary to provide firstly a brief explanation of what Islamic banking is. Then, the section introduces history of Islamic banking and how it evolves, core concept and principles that Islamic banking should follow, and finally some examples of Islamic lending models.

Alkassim (2005) studied the profitability of sixteen Islamic and eighteen conventional banks in GCCs over the period 1997-2004 by using multiple regression. The paper used nine variables; three of them are used as profitability measures return on equity (ROE), return onassets (ROA), and net interest margin (NIM), and six variables are used as bank's characteristics; bank's size, total equity to total assets (TE/TA), total loans to total assets (TL/TA), deposits tototal assets, total expenses to total asset, and non-interest expense to total expense. Results showthat, first, bank's size reacts negatively with conventional banks' profitability, but positively with Islamic banks.

Second, total equity has a positive relationship with Islamic banks performance, but a negative relationship with conventional banks. Third, total loans have positive relationship with both banks. Forth. deposits have a positive relationship with conventional banks. but negative relationship with Islamic banks. Fifth, Total Expenses for conventional banks impact profitability negatively whereas Total Expenses for Islamic banks help profitability. Finally, Non-Interest Expense (overhead) assists both Islamic and conventional banking profitability (Alkassim 2005).

Gaddam. AlKhathlan. and Abdul Malik (2009) studied the financial performance analysis of Saudi banks for the selected period (2003-2007) by using simple regression analysis. The sample of their study contains six commercial banks. Financial performance, measured by ROA and NIM, is considered to be the dependent variables. The independent variables used in their paper such as assets utilization, operational efficiency, and bank's size were measured to examine their impacts on financial performance. Results show that there are positive correlation between financial performance and asset size, asset utilization and operational efficiency.

Further, the regression analysis also confirmed that the financial performance of the banks is greatly influenced by the operational efficiency, asset utilization and asset size (Gaddam, AlKhathlan, and Abdul Malik 2009). This study did not show the ratios used to calculate the assets utilization and operational efficiency. It is shown

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only the correlation between financial performance (ROA and NIM) and assets size, assets utilization, and operational efficiency.

Spathis, Kosmidou, and Doumpos (2002) studied the profitability determinants in Greek banking systems. The paper measures the effectiveness and efficiency based on banks' size (small and large banks) in Greece by using several ratios of profitability such as return on assets (ROA), return on equity (ROE), and Net Interest Margin (MARG). The study covered seven banks as large and sixteen banks as small banks over the period (1990-1999) by using panel data.

The study incudes ratios to assess banks' performance such as current asset to loans (CA/TL) to measure short-term investment, loans to deposits (L/D) to measure liquidity, and total assets to total equity (TA/TE) to measure capital adequacy. The evidence indicates that the large banks are more efficient than small banks. However, small banks are characterized by high capital yield (ROE), high interest rate yield (MARG), high financial leverage (TA/TE), and high capital adequacy (TE/TA). On the other hand, large banks are characterized by high assets yield (ROA), and low capital and interest rate yield (Spathis, Kosmidou & Doumpos 2002).

2.7 Summary of Literature Review
The review of literature has revealed that bank profitability can be influenced by bank-specific factors and external factors. Bank-specific factors are those factors within the direct control of managers Sand can be best explained by the CAMEL

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framework, while external factors include industry-specific and macroeconomic factors. The review of literature also revealed that the multiple linear regressions method is the most used in modeling the relationship between bank profitability and its factors.

Finally, it is clear from the reviewed literature that few local studies have been dedicated on this particular area of bank performance and that studies that have attempted to do so have tended to study each factor of performance to the exclusion of other factors.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The main objective of this chapter is to describe the research design, population, and sampling design, the data collection method and the data analysis that will be used in determining and evaluating the effects of products on the profitability of Islamic banks in Kenya. This section will also include research tools that will be employed to collect data and in carrying out the data analysis

3.2 Research Design

In this study ex-post-facto design will be used. Kerlinger (1983) states that ex post facto is a systematic, empirical inquiry in which the researcher does not have direct control of independent variables because their manifestations have already occurred. In this study the banking products and financial performance of Islamic banks had occurred by the time the research was being carried out. The researchers' analysis will therefore be limited to the data that is available.

3.3 Target Population

The population of this study comprised of all licensed commercial banks in Kenya. As at 31 December 2011, there were 43 registered commercial banks (Appendix 1).

3.4 Sample Design

Sample of study is two fully fledged Islamic banks in Kenya. They are First Community Bank and Gulf African Bank. The period of study would cover three years from 2009 to 2011 because banks offering Islamic windows do not cover the

period of study as they are less than two years old in offering Islamic banking products

3.4 Data Collection

The sources of data to be used by the researcher will be secondary in nature. This is because the study involves evaluation of historical data. The financial data will be taken from the two banks annual report data collection form for individual product data for items not appearing on the financial statements.

3.5 Data Analysis

The researcher shall use PAT (profit after Tax) in measuring the financial performance of the selected banks. In order to determine reliability of performance measure, simple linear regression will be used to identify the coefficient and t-values .Linear regression is widely used in researches and produces good results (Bourke, 2009).The measure of the total exposure of banks earnings is estimated in the following linear equation

$$Y_{it} = \beta_0 + \beta_1 x_1 + \beta_1 x_2 + \varepsilon_{it}$$

Where: Y_{it} = represents the return on assets for bank i in year t

β_0 = the constant

β_i are co-efficient where $i = 1, 2,$

X_1 represents Lending in terms of amount of financing

contracts   (Murabaha, Mudarabah and musharaka).

X_2 represents the Consumer Short Term Deposit in terms of

amount of liability of savings deposit, current deposits and

investment deposits

ε = **error term**

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For Islamic banks, loan consists of profit generated from various banking activities including; financing such as equity-financings (*mudarabah & musharakah*), debt financings (bay' bi thaman ajil, murabahah and ijarah); participation in direct investment (investment securities and dealing securities);

Consumer short term funds include savings deposits, current deposits and investment deposits. The deposits are liability to the bank and holding this liability is an expense to the bank. Thus the ratio of consumer short term funds to total assets is expected to show negative correlation with bank profitability. Financing refers to total gross financing and financing contracts in banks portfolio. In this case, they include Murabaha, Ijara, Mudaraba ad Musharaka and other term financing.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

In this chapter the results of the data analysis are presented. The data were collected and then processed in response to the problems posed in chapter 1. One fundamental goal drove the collection of the data and the subsequent data analysis. The goal was to determine the relationship between Islamic banking products and financial performance of Islamic banks. The findings presented in this chapter demonstrate the relationship between Islamic banking products and financial performance of Islamic banks.

4.2 Data Analysis and Findings

As at the financial year ended December 31, 2011 the two banks collectively commanded a market share of 0.9% of the banking sector with gross assets of Ksh.21.67 bn, net loans and advances of Ksh.11.7bn, which increased by 417% in 2011 compared to 2008.The financing is contributed by major products such as musharaka, murabaha and mudarabaha. Deposits stood at Ksh.18.7bn, an increase of 338% since 2008 with 74,157 deposit accounts – in 4 years of operation. The combined loss resulted from the cost of running new business but has shown a tremendous reducing the loss from Kshs 689 million to a profit of Kshs 267 million within four years.

Table 1.0: Key Financial Performance: Combined Islamic Banks

Year	Lending Kshs "Millions"	Deposits Kshs "Millions"	PBT Kshs "Millions"
2008	2,800	8,428	(689)
2009	7,240	10,067	(314)
2010	9,254	13,773	(113)
2011	11,697	18,677	267

Source: Data survey

The study of Islamic Bank products for the two Islamic banks in Kenya is concertrated on the financing and deposit products. According to CBK supervision report, GAB and FCB as small bank with a market size index of 0.6% and 0.41% respectively. (CBKsupervision report, 2011).

The tables below shows key financial performance of Gulf African Bank and First Community Bank.

Table 1.1 : Key Financial Performance, GAB in millions

Year	Lending Kshs "Millions"	Deposits Kshs "Millions"	Assets Kshs "Millions"
2008	1,932	3,428	5,000
2009	4,950	6,425	7,749
2010	6,271	8,163	9,594
2011	7,440	10,865	12,915

Source: CBKsupervision report

GAB is therefore ranked as the largest Islamic bank service provider in Kenya. As the end of financial year GAB had a total asset of kes. 10.92 billion showing a steady growth from kshs.5 billion in 2008.The financing of the growth of GAB is partly financed by deposit available from customer. These deposits generate funds and revenue to the bank. Total deposits of GAB are Kshs. 10.9 billion which is 3 times more than its deposit of kshs.3.4 billion in 2008.These funds is sufficient to

finance lending where total financing is kshs.7.4 billion and 4 times more than its figure of kshs. 1.9 billion in 2008.

Table 1.2 : Key Financial Performance, FCB in millions

Year	Lending Kshs "Millions''	Deposits Kshs "Millions''	Assets Kshs "Millions''
2008	868	2,091	3,189
2009	2,290	3,642	4,457
2010	2,984	5,611	6,380
2011	4,258	7,812	8,740

Source: CBKsupervision report

The table above shows the performance of FCB. FCB has a total asset of kes.8.7 billion which is 3 times more than its asset in 2008.Total deposits are kshs.7.8 billion which is 4 times than that of 2008, its figure of Kshs. 2 billion. Banks total deposit is sufficient to cover its financing need. Total financing is kshs.4.3 billion which is 5 times more than 2008's figure of ksh 0.9 billion.

Table 2.1 FCB- Product Size in Terms of Amount of Financing

Year	Murabaha	Mudarabaha	Musharaka	Ijara	Tawaruq
2009	2.3 Billion	Nil	1.15 Billion	890 Million	300 Million
2010	3.8 Billion	Nil	3.1 Billion	1.2 Billion	450 Million
2011	5.5 Billion	Nil	4.9 Bbillion	2.3 Billion	800 Million

Table 2.2 GAB: Product Size in Terms of Number of Financing

Year	Murabaha	Mudarabaha	Musharaka	Ijara	Tawaruq
2009	180	Nil	105	30	15
2010	300	Nil	165	54	20
2011	435	Nil	220	72	32

The study of Islamic banking products shows that GAB is the largest Islamic banking product provider in kenya.Table 1.0 and 1.1 shows key financial

performance of GAB from 2007 to 2011.GAB has 4 different financing contracts in its portfolio.the contracts are Murabaha, Musharakah, Ijara and Tawaruq. Table 1.1 shows that only three are contributors to GABs gross financing.Murabaha contibutes 43.46% ,Musharaka contributes 34.28%   , Ijara contibutes 16.45% and Tawaruq contributes 5.81% during the period of study 2008-2011.In terms of busines growth, 3 contracts show a major growth,that is, Musharaka ,murabaha and Ijara.They grew by almost double the amount from 2010 to 2011. The statstics clearly indicates that GAB maintains a an image of the bank as a core provider of murabaha and musharaka.In terms of number of products murabaha and musharaka still leads in the list with 435 and 220 facilities being serviced in the year ended 2011.

Table 2.3: FCB- Product Size in Terms of Amount of Financing

FCB- Product Size in Terms of Amount of Financing			
Year	Murabaha	Mudarabah	Musharaka	Ijara
2009	400 Million	1 Billion	600 Million	50 Million
2010	550 Million	1.2 Billion	900 Million	100 Million
2011	800 Million	1.5 Billion	1.2 Billion	200 Million

Table 2.4: FCB- Product Size in Terms of Number of Financing

FCB- Product Size in Terms of Number of Financing			
Year	Murabaha	Mudarabah	Musharaka	Ijara
2009	400	200	400	100
2010	600	300	650	180
2011	1100	350	1000	350

FCB financing is divided into four main products murabaha, mudarabah, musharaka and Ijara.The table below shows an interesting fact in terms of financing

growth.Murabaha grew by 100%, mudarabah by 67%, musharakah by 100% and Ijara grew by 33%. In terms on numbers musharaka and murabaha leads in size by 1000 and 1100 facilities respectively and this implies thata FCB has focused on murabaha and musharaka and the most contributors to its financial performance.

4.2.1 Regression Analysis

In this section, we used the historical data regression analysis to investigate the impact of Islamic banking products on Islamic banks' financial performance proxied by profit before tax.

Table no. 3.1:Regression Statistics	
Multiple R	0.997858143
R Square	0.995720873
Adjusted R Square	0.987162618
Standard Error	45.18774741
Observations	4

Table no. 4 shows the model summary about goodness of fit of model. As co-efficient of determination or R square is 0.997, so we can say that our model is 99.7% accurate. As we know that ANOVA test is used to analysis of variances or comparison of two or more variables.

Table no 3.2
:ANOVA

	Df	SS	MS	F	Significance F
Regression	2	475142.4026	237571.2	116.3463	0.065415039
Residual	1	2041.932516	2041.933		
Total	3	477184.3351			

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As table no. 5 shows that, the p- value = 0.0654, that is, p is greater than 0.05 results in accepting null hypothesis. It may be inferred based on the analysis that there is no significant relationship in the movement of PBT and product. The p value is being less than 0.05 so we reject null hypothesis (Ho) and accept alternative hypothesis (H1) as shown above table.

Table 3.3: Coeficient of regression analysis

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	(1,158.437)	85.319	(13.578)	0.047	(2,242.519)	(74.355)
Lending	0.067	0.019	3.611	0.172	(0.169)	0.302
Deposits	0.034	0.015	2.187	0.273	(0.162)	0.229

Table no. 6 shows coefficients of regression model which has prepared above. This table shows the values of betas to include in equation or model. Thus by putting values, we get:

Profit after Tax= -1.158.437+ 0.067 (Lending) + (0.034) (Deposits)

The above equation shows that amount number of lending and deposits have positive relation. It means that if Kshs.1 increase in lending can generate Kshs. 0.067 Profits. Likewise, Kshs.1 increase in deposit can generate Kshs. 0.034 Profit.

4.3 Summary of Findings and Interpretations

This study made use of secondary data in analyzing the relationship between Islamic banking product and financial performance of the 2 fully fledged Islamic

banks licensed by CBK. The secondary data was obtained basically from published annual reports of the selected banks. The model, the F-value which is significant at 1% level indicates that the model do not suffer from specification bias. However, the coefficient of determination (R^2) indicates that a change in profit before tax is accounted for by the explanatory variables while the adjusted R-squared further justifies this effect. This invariably means that the profit before tax goes up as product size increases.

In addition, Multiple R value for the model is 0.99818589 showing that there is a strong relationship between Islamic banks product and financial performance of the Islamic banks in Kenya. As a result any change in the volume of the product will have a great impact on the level of product. This is attributed to various product factors such as size of the product and quality of the product among other factors.

On the basis of F-value and significance level of less than 0.5, regression relationship between Islamic bank products and profit before tax is statistically significant. The implication of the findings is that Islamic banks' product has a significant impact on profit before tax of the bank. As a result, any change in the size of Islamic banks product will have an effect of the earnings of the bank.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.0   Introduction

The objective of this chapter is to discuss the findings, reach conclusion and make necessary recommendations from all the qualitative and quantitative analysis presented in chapter four. The chapter is structured into five sections as follows: section 5.1 Conclusion and Recommendation, section 5.2 Limitations and 5.3 covers the sections for recommendations and suggestions for further study.

5.1 Conclusions and Recommendations

Islamic banks in Kenya have huge growth in terms of assets, deposits and financing contracts.FCB financing contracts is hugely attributed to murabaha and musharaka. The regression analsysis reveals that financing contract is a major determinant variable that affects profitability.Higher deposits means enough funds available for financing contracts.

The slope of the regression equation is negative and this is as a result of inverse relationship between loss and product .that is an increase in product leads to a reduction in loss that resulted from new business loss and vice versa.However, the study could not determine individual products contribution to the banks earning

5.2 Limitations

The study focuses only on one area that affects performance and therefore other factors should only be Islamic banking product. This study is limited to only fully fleged Islamic banks a small sample of the population of commercial banks in Kenya, further study should be done on all banks offering Islamic product, that is, inclusive of conventional banks with Islamic windows. Secondly, the study was conducted within a limited period of time. This paper also did not include for instance, the effects size of banks, financial structure, as well as taxation variables on the profitability of Islamic banks.

5.3 Sugestions for Further Research

The limitations of the study have prompted suggestions for further research. This study is limited to only fully fleged Islamic banks a small sample of the population of commercial banks in Kenya, further study should be done on all banks offering Islamic product, that is, inclusive of conventional banks with Islamic windows

The period of study for this research is three years i.e. (2008-2011). This limitation was imposed by period of operation by the two banks which are very new in the market. The non availability of enough data pertaining to the reviewed banks was also a limitation. However, further research can consider more time frame based on the availability of the annual reports.

This research has gone some way to exploring how different products affect perfomance of Islamic banks in a narrow context. Further research could explore the relationship in narrower context for example, product quality, product interest/profit rates, non performing loans and individual product risk and return.

A study on the relationship between sheria principles and the value of a firm can also be carried out to measure its effect on financial performance of Islami Banks in Kenya. The inclusion of sheria principle factor could also result in additional edge-worth combinations of the internal corporate governance mechanism while other performance measures can also be introduced.

A comparison between Islamic banking products and conventinal banks products could be studied and this could address the similarities and differences of the product and performance in different in Islamic Banks and Conventional Banks.

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APPENDICES

Appendix 1: Commercial Banks in Kenya

1 Kenya Commercial Bank Ltd

2 Standard Chartered Bank Ltd

3 Barclays Bank of Kenya Ltd

4 Co-operative Bank of Kenya Ltd

5 CFCStanbic Bank Ltd

6 Equity Bank Ltd.

7 Bank of India

8 Bank of Baroda Ltd

9 Commercial Bank of Africa Ltd

10 Prime Bank Ltd

11 National Bank of Kenya Ltd

12 Citibank N.A.

13 Bank of Africa Kenya Ltd

14 Chase Bank Ltd

15 Imperial Bank Ltd

16 N I CBank Ltd

17 Ecobank Ltd

18 I & M Bank Ltd

19 Diamond Trust Bank Kenya Ltd

20 Family Bank Ltd

21 Habib Bank Ltd

22 Oriental Commercial Bank Ltd

23 Habib A.G. Zurich

24 Middle East Bank Ltd

25 Dubai Bank Ltd

26 Consolidated Bank of Kenya Ltd

27 Credit Bank Ltd

28 Transnational Bank Ltd

29 African Banking Corporation Ltd

30 Giro Commercial Bank Ltd

31 Equatorial Bank Ltd

32 Paramount Universal Bank Ltd

33 Jamii Bora Bank Ltd

34 Fina Bank Ltd

35 Victoria Commercial Bank Ltd

36 Guardian Bank Ltd

37 Development Bank of Kenya Ltd

38 Fidelity Commercial Bank Ltd

39 Charterhouse Bank Ltd

40 K-Rep Bank Ltd

41 GulfAfrican Bank Ltd

42 First Community Bank Ltd

43 UBA Bank Ltd

Appendix 2: Letter of Introduction

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Telegra

Dear Sir/Madam,

RE: **Request of Participation in MBA Research Project**

The bearer of this lette, Ahmednoor Hassan, is a Postgraduate Student undertaking a Master of Business Administartion (MBA) degree at the school of Business,University of Nairobi.He is majoring in Finance.As part of his course work assessement,he is required to submit a research project report on evaluation of different islamic banks products in Kenya to financial perfomance of Islamic banks.

Kindly, assist him by completing the attached table.We assure you that the information provided is purely for academic purposes only and will be treated with utmost confidentiality.

Should you be intersted in the findings of the research,a copy w ill be availed to you on request.In addition a copy will be also be availed at the university Library.

Your assistance will be highly appreciated

Mr. Mirie Mwangi   Ahmednoor Hassan
Lecturer, School of Business   MBA student
Supervisor   0720974512
0722726050
02 4184160

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Appendix 3: Data Collection Form

Kindly, indicate, for each period, the facility amount in kes. of the products below

Year	Product Component Kshs 'Million'					
	Murabaha	Mudarabah	Musharaka	Ijara	Ististana	Other
2009						
2010						
2011						

Kindly, indicate, for each period, the number of facility of the products below e.g

1450,500 e.t.c

Year	Product Component 00			
	Murabaha	Mudaraba	Musharaka	Ijara
2009				
2010				
2011				