

**THE RELATIONSHIP BETWEEN FINANCING CONTRACTS AND
FINANCIAL PERFORMANCE OF ISLAMIC BANKING IN KENYA**

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DECLARATION

I declare that this is my original work and has not been presented in any other University or college for examination or academic purposes.

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

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DEDICATION

I would like to take this opportunity to thank God for making this study possible.

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TABLE OF CONTENTS

DECLARATION.....	ii
ACKNOWLEDGEMENTS.....	iii
DEDICATION.....	iv
TABLE OF CONTENTS.....	v
LIST OF TABLES.....	viii
LIST OF ACRONYMS AND ABBREVIATIONS.....	ix
ABSTRACT.....	x
CHAPTER ONE: INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.1.1 Financing Contracts.....	2
1.1.2 Financial Performance.....	5
1.1.3 Financing Contracts and Profitability.....	6
1.1.4 Islamic Banking in Kenya.....	7
1.2 Research Problem.....	9
1.3 Objectives of the Study.....	11
1.4 Value of the Study.....	11
CHAPTER TWO: LITERATURE REVIEW.....	15
2.1 Introduction.....	15
2.2 Theoretical Framework.....	15
2.2.1 Structure Conduct Performance Theory.....	15
2.2.2 Efficiency Structure Theory.....	16
2.2.3 Balanced Portfolio Theory.....	16
2.2.4 Signaling Theory.....	17
2.2.5 Risk-return Theory.....	17
2.2.6 Risk Aversion Theory.....	18
2.3 Determinants of Bank Performance.....	18
2.3.1 Internal Factors	18

2.3.1.1 Capital Adequacy.....	18
2.3.1.2 Asset Quality.....	19
2.3.1.3 Management Efficiency.....	19
2.3.1.4 Earning Ability.....	19
2.3.1.5 Liquidity Management.....	20
2.3.2 External Factors.....	20
2.4 Empirical Review.....	21
2.4.1 International Studies.....	21
2.4.2 Local Studies.....	23
2.5 Summary of Literature Review.....	24
CHAPTER THREE: RESEARCH METHODOLOGY.....	26
3.1 Introduction.....	26
3.2 Research Design.....	26
3.3 Population.....	27
3.4 Data Collection.....	27
3.5 Data Analysis.....	28
3.6 Test of Significance.....	29
CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION.....	30
4.1 Introduction.....	30
4.2 Response Rate.....	30
4.3 Data Validity.....	30
4.4 Descriptive Statistics.....	31
4.5 Correlation Analysis.....	33
4.6 Regression Analysis.....	33
4.7 Discussion of Research Findings.....	35

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECCOMENDATIONS.....	36
5.1 Introduction.....	36
5.2 Summary of Findings.....	36
5.3 Conclusion.....	36
5.4 Policy Recommendations.....	37
5.5 Limitations of the Study.....	38
5.6 Suggestions for Further Research.....	38
REFERENCES.....	39
APPENDICES.....	43
APPENDIX I – List of Commercial Banks Offering Islamic Banking.....	43
APPENDIX II – Data Collection Table.....	44

LIST OF TABLES

Table 4.1: Descriptive Statistics.....	31
Table 4.2: Pearson Correlation.....	33
Table 4.3: Regression Analysis.....	33
Table 4.4: Analysis of Variance (ANOVA).....	34
Table 4.5: Regression Coefficients.....	34

LIST OF ACRONYMS AND ABBREVIATIONS

ANOVA – Analysis of Variances

ASEAN – Association of Southeast Asian Nations

BBK – Barclays Bank of Kenya

CBK – Central Bank of Kenya

FCB – First Community Bank

GDP – Gross domestic product

GTG – Get through guides

IT – Information Technology

KCB – Kenya Commercial Bank

NBK – National Bank of Kenya

NFI – Net Financing Income

NIM – Net interest margin

ROA – Return on assets

ROE – Return on equity

SCP – Structure-conduct-performance theory

ABSTRACT

The objective of this research study was to establish whether a relationship exists between financing contracts and financial performance of Islamic banking in Kenya. The study targeted seven (7) commercial banks that operate Islamic banking in Kenya. It covered the period between 2010 and 2014. Specifically, the study sought to establish the relationship between Islamic financing contracts and banking financial performance. The return on Assets (ROA) was used to measure financial performance. The financing contracts discussed in the study include; Murabaha (cost plus mark up), Mudharaba (profit sharing), Musharaka (profit-loss sharing/joint venture), Ijara (leasing), and Tawaruq (reverse Murabaha). The data for this study was collected using questionnaires for primary data study and secondary data was obtained from the Central Bank of Kenya annual reports and individual bank statements for unlisted banks. Out of the seven banks targeted, six responded which represented a response rate of 85.7%. A regression analysis was performed. From the results it was noted that there is a relationship between the financing contracts and performance of Islamic banking. The key indicator supporting this theory is the p value being < 0.05 . The analysis on the financing contracts produced a coefficient of determination of 85.9% which shows how well the model used fits the data available. This coefficient of determination also shows the percentage of variations in bank financial performance explained by financing contracts. Based on the summary of the findings, the study concluded that if Islamic banking is to have meaningful contribution to profits such banks should adopt a larger proportion of murabaha and musharaka in their financing portfolio. Given that the relationship of the model is positive, increasing proportion of financing contracts offered would affect a bank's financial performance positively. Similarly, a decline would decrease a bank's performance. The moderate relationship (moderate correlation) between financing contracts and financial performance implies that there are other factors which affect a bank's financial performance and not only the financing contracts. The study recommended that banks offering Shariah compliant financial services should pay key attention to the contracts they offer and capitalize on those with greater yields. This would significantly improve financial performance.

CHAPTER ONE: INTRODUCTION

I.1 Background of the Study

Islamic banking is faith based banking; which means that it is influenced by the Islam faith, unlike conventional banking which is not. According to the Institute of Islamic Banking & Insurance (which was founded in 1990), Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Sharia'h (Islamic rulings) and its practical application through the development of Islamic Economics.

According to Al Baraka Banking Group (a licensed wholesale bank by the Central Bank of Bahrain founded in 1984), an Islamic bank is an institution that mobilizes financial resources and invests them in an attempt to achieve predetermined Islamically-acceptable social and financial objectives. Both mobilization and investment of funds should be conducted in accordance with the principles of the Islamic Sharia'h.

The origin of the Islamic banking concept dates back as far as 1963. The first Islamic bank was founded in Egypt and its main principle was profit sharing based on the non-interest philosophy of Islamic Sharia'h. In 1974, the organization of Islamic countries (OIC) established the first Islamic bank called the Islamic Development Bank or IDB. The business model was to provide financial assistance and support on profit sharing.

By the end of 1970, several Islamic banking systems had been established throughout the Muslim world including the first private commercial bank in Dubai (1975), the Bahrain Islamic bank (1979), and the Faisal Islamic bank of Sudan (1977), (Otit, 2011).

According to Get Through Guides (2012), Sharia'h compliant banks are influenced by; the Quran and its practices, the Sunnah (which is the way of life prescribed as normative in Islam based on the teachings of Prophet Muhammad), and the consensus of the Jurist and the interpreters of Islamic laws.

There are several principles associated with Islamic finance. The first principle states that no investment is made in contradiction to the Sharia'h rules. Thus, all investments must be made in line with the Sharia'h.

The second principle refers to the prohibitions under Sharia'h. The investments made under Islamic finance must not deal with terms that are deemed undesirable and prohibited under Sharia'h which include but are not limited to riba (which is taking or receiving interest), maysir (which includes speculation or gambling), gharar (which is the uncertainty regarding the subject matter or terms of a contract-this prohibition extends to trading the things one does not own), and investments involving alcohol, drugs and money laundering activities.

The third principle is on risk sharing. Risk relating to any transaction must be shared between at least two parties. This ensures that parties investing funds and the parties managing the funds share the business risk in return for a share in profit (GTG, 2012).

I.1.1 Financing Contracts

Islamic finance does not recognize money as a commodity but rather as a means to carry out a transaction. The financing facilities offered by Islamic banking are in the form of contracts. These contracts are entered into by the bank and the recipient of funds. These contracts do not involve the charging of interest but rather are profit/loss sharing contracts. The most commonly

used financing contracts are; murabaha, musharaka, mudharaba, istisna, Ijara, salam and tawaruq.

Monzer (1975) explains that murabaha is the equivalent to asset financing in conventional banking. It is a cost plus mark up contract. The parties to this contract are the Islamic bank and the borrower. The borrower will approach the bank to buy an asset on their behalf from a supplier at a predetermined price upfront. The bank will then carry out its own due diligence before agreeing to take up the contract.

Once the contract is approved, the bank will purchase the asset and the borrower will be given a period of time to pay the bank for the asset at a price which will include the asset price plus a markup profit for the bank. This mark up is determined before the asset is bought and the borrower is made aware. The assets can be used as collateral for the transaction or the borrower can provide another form of collateral. The borrower can pay in predetermined installments the whole amount owed (cost plus mark up).

Mudharaba is equivalent to equity financing in conventional banking. It is a profit sharing contract that is entered between the Islamic bank and the investor. The bank is the funds owner while the borrower (investor) will be the working partner.

The borrower will approach the bank with a trading venture in which they will require a certain amount of investment. The bank therefore provides principle capital into the venture while the borrower takes full charge of managing this venture for the purpose of maximizing its profit and to liquidate all its properties by its closing date.

The bank has the full right to inspect accounts, books and records of the venture at any time and place a reservation on any managerial acts it sees unfit in the best interest of the venture. This

input is important since the bank is taking all the risk. The profits are shared at a predetermined ratio whereas any losses made are borne by the bank. Losses incurred due to indiscretions by the borrower will be borne by the borrower and not the bank (Monzer, 1975).

Musharaka is also an example of equity financing. Unlike Mudharaba, this contract is a joint venture in which the bank and investor share in both the profits and losses from the venture. The parties to this contract are the Islamic bank and the borrower.

The borrower approaches the bank to go into partnership with them on a trading activity. The bank provides a certain amount of capital and the borrower also contributes a certain amount of capital. The borrower will assume all managerial responsibilities but unlike in Mudharaba, the bank has the right to appoint an employee as a representative in the partnership.

The profits and/or losses that come about as a result of the partnership are shared according to a predetermined ratio. The borrower will put under full authority of the bank their securities, assets as a guarantee to be used only in the case of damage caused by neglect or transgression by the second partner (Monzer, 1975).

Monzer (1975) explains ijara as a leasing contract. The bank purchases goods then leases them to the clients for specified rentals for a fixed period of time. Further arrangements can be made if the client wants to purchase the goods. In this contract, the Islamic bank is the lessor and the bank client is the lessee. The contract outlines the description of the asset to be leased, the amount of rentals charged for leasing the asset, the due date of submitting rentals and the whole period of the rent.

The lessor is responsible for major maintenance that restores the leased asset to normal use in case of any deficiency; defect, unless such defect is caused by improper use by the lessee. The

lessor is also responsible for insurance on the asset itself. The lessee is responsible for regular operational maintenance and for any defect caused by harsh, and/or abnormal use of the asset.

At the end of the rent period, the lessee shall return the leased asset to the lessor. In the case where the lessee is willing to purchase the asset after the rent period lapses, the contract parameters change slightly in that, in addition to paying rentals monthly, the lessee will also pay a certain amount that will contribute into the total price for the asset. Thus, the lessee will be saving up towards buying the asset. This amount is agreed at the onset of the contract.

Istisna is a contract to manufacture goods, assemble or process them, or build a house or other structure according to the exact specifications and in a fixed timeline. Payments are made as work on property is finished. Financing Istisna can only be done by means of two parallel contracts whose subjects are exactly similar: first contract is between the financier and the party that needs contracted things. The second contract is between the financier and the contractor who actually manufactures, constructs or builds the contracted things.

The client approaches the bank to finance the manufacture of an asset. The bank then approaches a contractor to carry out the manufacturing. The bank pays the contractor after delivery of manufactured goods. The full price paid out plus a markup profit are added up and submitted to the client. The client pays the bank back in installments. The client delivers assets to be held as collateral until full repayment (Monzer, 1975).

Salam is a post delivery or forward transaction similar to a future or forward purchase contract. Through this system the bank provides necessary funds required to meet the working capital needs of a customer of a productive sector of the economy. A client approaches the bank to purchase in advance goods which will be delivered at a future date. The bank agrees to buy the

merchandise described to pay the price in cash now. The client will provide security to guarantee the contract till delivery of the merchandise.

The bank will undertake to enter into a parallel salam contract in which the bank sells similar quantity with same specification and delivery date to another party. The difference between the prices of the two parties of the two contracts is the bank's profit (Monzer, 1975).

Tawaruq is the mode through which some Islamic banks provide personal financing to facilitate the supply of cash to their customers. It is the equivalent to an overdraft in conventional banking (United Arab Bank website, 2015).

The United Arab Bank defines tawaruq as a Sharia'h compliant financing solution that is designed to provide one with liquid assets as per their needs. The bank explains the two stages of tawaruq as follows: the Murabaha stage; where the bank and customer enter into a commodity Murabaha contract that is governed by the Murabaha rules of the Sharia'h supervisory board. The customer will own either physically or constructively the assets subject of the Murabaha contract.

The second stage is the asset liquidation stage. During this stage the customers can choose either to sell/liquidate the commodity directly in the market on their own or through an agency agreement with the bank (United Arab Bank website, 2015).

I.1.2 Financial Performance

Like all businesses, banks profit by earning more money than what they pay in expenses. Conventionally, bank profits are majorly made of fees charged on bank services and the interest the bank earns on its assets, whereas the major liability is the interest paid on its liabilities.

The performance of commercial banks can be affected by internal and external factors (Al-Tamini, 2010; Aburime, 2005). Profit is the ultimate goal of commercial banking (Ongore & Kusa, 2013). It is important to measure the financial performance of a bank as a means of knowing the progress of the bank and the managers and shareholders are able to tell how the bank is doing.

To achieve this, banks rely on the use of financial ratios. To measure profitability of commercial banks, a variety of profitability ratios are used of which, return on equity (ROE), return on assets (ROA), and net interest margin (NIM) are the major ones (Murthy & Sree, 2003, Alexandru et al., 2008). These ratios are some of the bank performance indicators.

The ROE is a measure of the efficiency with which a company employs owner's capital (Khrawish, 2011). ROE is a financial ratio that refers to how much profit a company earned compared to the total amount of shareholder equity invested or found in the balance sheet (Ongore & Kusa, 2013). It is calculated as follows; $\text{Net income} / \text{Bank capital}$. The better the ROE the higher the profitability of the bank and the more effective management is utilizing shareholder capital.

The ROA is a ratio of income to its total assets (Khrawish, 2011). It measures the ability of bank management to generate income by utilizing company assets at their disposal (Ongore & Kusa, 2013). ROA is measured by; $\text{Net income} / \text{Bank assets}$. Wen (2010), states that a higher ROA shows that the company is more efficient in using its resources.

The two ratios, ROE and ROA, can be used when measuring the profitability of Islamic banks. The third ratio (net interest margin) however, cannot be used since Islamic bank principles prohibit the charging and receiving of interest.

The NIM is the difference between the interest income generated by banks and the amount of interest paid out to their lenders (for instance, on deposits) relative to the amount of their interest earning assets (Ongore & Kusa, 2013). NIM ratio is measured by; $\text{Net interest income} / \text{Total earning assets}$. The higher the NIM ratio the higher the banks profit and the more stable the bank is. However, a higher NIM could reflect riskier financing practices associated with substantial loan loss provisions (Khrawish, 2011).

The NIM can be used for Islamic finance performance measurement by changing it into net financing income (NFI). It will be measured by; $(\text{Financing income} - \text{cost of deposits}) / \text{Total earning assets}$.

1.1.3 Financing Contracts and Financial Performance

The largest asset item in the financial statements of an Islamic bank, as it is with conventional banks is financing activities. Financing contracts form a substantial portion of the financing activities of the Islamic bank. Thus, the more returns a bank makes from the contracts offered, the more profits the bank makes.

These contracts are agreements entered into by both parties whereby no interest is charged but the bank gains financially by charging a mark up or rentals (in the case of leasing). The bank does not lend the customer money directly but rather indirectly. This is in line with Islamic financing philosophy that money is a medium of exchange and not a commodity, its sale and purchase is prohibited in Islam (Bokhari, 2010).

With the ROE indicator, Islamic banks will calculate it using $\text{net income} / \text{bank capital}$ just like conventional banks. The bank capital refers to the shareholder equity. The only disparity comes

into when computing the net income. A large component of net income for conventional banks is interest income.

For Islamic banks, the net income does not include interest income but rather income realized from financing activities (deals), other operating income and non-operating income. Income from financing activities refers to the mark up charged when offering financing contracts and the profit gained from equity contracts. The bank's assets in this case majorly include the financing activities of the Islamic bank, unlike loans for conventional banks.

Each financing contract the bank offers contributes to the profit of the bank. The contract can either increase profitability or decrease profitability depending on their proportion to the overall financing activities of the bank.

1.1.4 Islamic Banking in Kenya

Sharia'h compliant banking is viewed by many as the fastest growing segment of the banking sector in the world. In Africa, Islamic banking is a fast growing financial sector attracting all customers even of different religious orientation. The uptake of Islamic banking is projected to grow exponentially in sub-Saharan Africa. Kenya is among other African countries that are taking up the lead in Sharia'h compliant banking services (Ndung'u, 2011).

Kenya was the first country in Eastern and Central Africa to amend the banking laws to accommodate Islamic finance. In the 2010-2011 Kenyan budget, former prime minister proposed further amendment to the banking act and the Central bank laws to facilitate the flourishing of Islamic transactions in the country (Shariff, 2013).

In Kenya, there are 2 fully fledged Sharia'h compliant banks. Additionally, the Central Bank has granted some conventional banks licenses to operate Islamic banking windows as part of their operations. First Community Bank (FCB) was the first fully fledged Sharia'h based bank licensed to operate in Kenya. It began operations in 2008 after receiving a commercial banking license and authorization to establish a Sharia'h bank from the Central Bank under Cap 488 of Banking Act to operate as a fully fledged Sharia'h compliant institution. (CBK Act, 2007) Gulf Africa Bank began operations in 2008 and became the second commercial bank in Kenya to receive authorization to practice Sharia'h banking, after FCB.

Barclays Bank of Kenya was the first bank to provide Islamic banking services in Kenya. This was back in 2005. The then managing director, Adan Mohamed (2005), said his bank became the first one to launch Islamic banking products in Kenya, targeting thousands of its muslim customers who profess the Muslim faith. Barclays Bank stepped in to respond not only to the needs of about 8 million Kenyan muslims who had no access to such a product but also to allow a global trend that has taken off in Britain, Canada and the United States. (Panapress, 2005)

National Bank of Kenya first introduced Al-mumin in 2009 which was rebranded in April 2013 to National Amanah to offer a wider range of banking products and services that are Sharia'h compliant. National Amanah adheres to the guidance of Sharia'h supervisory board with respect to all matters relating to interpretation and application of Sharia'h to the accounts and investments. (NBK website) Standard Chartered bank launched Islamic banking services in Kenya, the first foray of its 'Saadiq' brand into Africa in March 2014. (Vizcaino, 2014)

Chase bank of Kenya introduced Islamic banking services in May, 2009. They offer both account based and loan based services. They have incorporated a Sharia'h board, like First Community bank and Gulf Africa bank.

A Sharia'h board is the governing board of all products offered by Islamic financing. The board sits to vet and approve all products offered by the bank/ window. The board functions like a normal bank board but includes members with in depth knowledge of the Sharia'h law.

Islamic finance is not limited only to the banking sector. The Islamic oriented investments are being practiced in Kenya by the large Muslim population engaged in active economic activity. Islamic finance in Kenya comprises two types of institutions: banking institutions, which fall under the banking law, and financial cooperatives.

There are three levels of Islamic banking institutions in Kenya, of which the first two fall into the legal category of commercial banks; Full-fledged Islamic commercial banks, Islamic banking units of commercial banks and Islamic Co-operative Societies like Muslim operated and run SACCOs. (Sheikh, 2009)

1.2 Research Problem

Several researches have been carried out on Islamic banking innovation, profitability, and their performance in the financial sector. Masika (2011) researched on the relationship between financial innovation and growth in profitability of Islamic banking in Kenya. Haron (1997) reviewed the determinants of Islamic bank profitability while citing some evidence. Sheikh (2009) researched on the factors that led to the emergence of Islamic banking in Kenya and the regulatory challenges facing the industry. Wako, Kamaria, and Kimani (2014) researched on the challenges affecting performance of Islamic banks in Kenya.

Other researchers have concentrated mainly on bank profitability. Munyambonera (2012) researched on the determinants of commercial banks' profitability in sub-Saharan Africa. Staikouras (2004) researched on the determinants of European bank profitability. The determinants were categorized into internal and external factors.

The internal factors include; capital adequacy, asset quality, management efficiency, earnings ability, and liquidity management. These factors are bank specific and can be managed by the bank management. The external factors include, gross domestic product (GDP), inflation, interest rates, and political instability. These factors are considered to be out of the control of the bank's management. They are mostly macroeconomic factors. The banks are forced to adapt to their changes.

Islamic banking unlike conventional banking is guided by several principles. The key being adherence to Sharia'h laws in all banking practices. Equally important is the prohibition of interest charging. Lastly Islamic banking advocates for risk sharing between the bank and the customers.

A review of several international studies shows that most researchers favored studies on profitability of Islamic banking and comparative studies of Islamic and conventional banking. Haron (1997) researched on the determinants of Islamic bank profitability. Hassan and Bashir (2004) also researched on the determinants of Islamic banking profitability.

Wahidudin et al (2012) carried out a study on the determinants of profitability focusing on a comparative analysis of Islamic banks and conventional banks in the ASEAN countries. Hanif, Tariq, Tahir & Momeneen (2012) conducted a research on the comparative performance of

conventional and Islamic banking in Pakistan to find out which banking stream was performing better than the other.

Local studies on Islamic banking practices were more varied. Sheikh (2009) conducted a research on the factors that led to the emergence of Islamic banking in Kenya and the regulatory challenges facing the industry. Masika (2013) conducted a study on the relationship between financial innovation and growth in profitability of Islamic banking in Kenya. Guyo & Adan (2013) conducted a study on the determinants of retail consumer choice of Islamic banking in Kenya. Wako, Kamaria and Kimani (2014) carried out a study on the challenges affecting performance of Islamic banks in Kenya.

To the knowledge of the researcher, there are no researches carried out on the relationship between financing contracts and financial performance of Islamic banks in Kenya. This research intends to establish whether financing contracts affect the performance of Islamic banks hence the research question; what is the relationship between financing contracts and the financial performance of Islamic banks in Kenya?

1.3 Objectives

To determine the effect of financing contracts on financial performance of Islamic banks in Kenya.

1.4 Value of the study

This study will benefit many stakeholders of the financial sector in Kenya and those from other countries who will be willing to invest in Kenya in the future. This study will help current and potential investors assess the future prospects of the Islamic banking in Kenya and guide them in

their investments, financing and savings decisions. The investors would be made more aware of the financing contracts available in Islamic banking.

Potential commercial banks looking to venture into Islamic banking could use this study to better understand the viability of future investments in Islamic banking. This study will delve into the financing contracts offered by Islamic banks and the findings will hopefully reveal a positive relationship between the two variables (financing contracts and financial performance). This study will assist regulatory authorities such as Kenya Bankers' Association and the Central Bank of Kenya to continue to pursue policies that will enable the sector to grow and flourish further in the economy.

Existing Islamic banks and Islamic banking windows will also benefit from this study. The findings from this study will hopefully help them improve their overall profitability by investing a bulk of their finances on the more profitable financing contracts that they offer. Lastly, this study fills the gap left by lack of research in this particular area of study. It will serve as a base point for future researches in this area.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter explores the concept of bank financial performance through a review of theories on financial performance and also theories related to Islamic bank performance. Additionally, a review of bank profitability determinants has been carried out. Lastly, a review of empirical studies carried out on Islamic bank financial performance has also been made.

2.2 Theoretical Framework

There have been several theories developed to explain the financial performance of companies, even banks. The ones under review in this study relate to bank performance. They include the structure-conduct-performance (SCP) theory which is also referred to as the market power theory, efficiency structure theory, balanced portfolio theory, signaling theory, risk aversion theory and the risk-return theory.

2.2.1 The Structure-Conduct-Performance Theory

The structure-conduct-performance (SCP) theory is based on the proposition that market concentration fosters collusion among firms in the industry (Haron, 1997). The assumption of this theory is that the degree of concentration in a market exerts a direct influence on the degree of competition among its firms (Haron, 1997).

In banking, the SCP theory was first used to measure the performance and concentration of deposits among banks in the local market area (Haron, 1997). Among the pioneer researchers who measure the effect of concentration on interest rates were Schweiger and McGee (1961),

Edwards (1964), Meyer (1967), Brucker (1970), among others. Although their findings supported the SCP theory, there were also some limitations (Haron, 1997). Benston (1973) noted that most of these studies had serious conceptual and statistical shortcomings that undermined the value of their findings (Haron, 1997).

2.2.2 The Efficiency Structure Theory

The efficiency structure theory suggests that enhanced managerial and scale efficiency leads to a higher concentration and then to higher profitability (Berger, 1995). Smirlock (1985) was the first researcher to test this hypothesis in banking context. He believed that as a result of the efficiency firms will obtain bigger market share and increase their profitability (Haron, 1997).

In his study Smirlock (1985) found that market share and not concentration (further disproving the SCP theory) had a significant and positive impact on bank rates (Haron, 1997). This is one of the more modern theories of bank profitability. It emphasizes on management and employee efficiency as the major contributor to bank profits.

2.2.3 The Balanced Portfolio Theory

This theory is also referred to as the modern portfolio theory. It was invented by Harry Markowitz in 1952. According to Olweny and Shipho (2011) the balanced portfolio theory also added additional dimension into the study of bank performance. This theory states that portfolio composition of the bank, its profit and the return to the shareholders is the result of the decisions made by management and the overall policy decisions (Ongore & Kusa, 2013).

This theory is adopted by management that is not too risky and not against taking risks either. The policy applied is well balanced to ensure minimum losses incurred as a result of maximum risk taken.

2.2.4 The Signaling Theory

Signaling theory suggest that a higher capital is a positive signal to the market of the value of a bank (Ommeren, 2011). Michael Spence in 1973 wrote an article titled 'Job Market Signalling'. This is when the signaling theory was born.

Berger (1995) and Trujillo (2012) observe under signaling theory, bank management signals private information that future prospects are good by increasing capital. Thus, a lower leverage indicates that banks perform better than their competitors who cannot raise their equity without further deteriorating profitability (Ommeren, 2011). This theory is witnessed in banks that do not rely heavily on leverage but rather equity capital.

2.2.5 The Risk-Return Theory

The risk-return theory argues that capital and bank profitability are negatively associated (Ommeren, 2011). This theory argues that increasing risks by increasing leverage of the bank leads to higher expected returns. This theory was first put forward by Harry Markowitz in 1952 under the Markowitz efficient portfolio theory.

It suggests that if a bank intends to increase profits by increasing leverage, the equity-asset ratio (capital) has to be reduced (Ommeren, 2011). This theory is mostly adopted by risk taking managers who are willing to take up more risk with the hopes of higher returns.

2.2.6 The Risk Aversion Theory

The risk aversion theory was first developed by Galbraith in 1967 and later expanded by Cave in 1970. It states that uncertainty avoidance by large firms vary directly with the degree of market that these firms possess.

Edwards and Heggsted (1973) tested this hypothesis in banking and believed that banks with monopoly power may choose to forego some of the potential profits by choosing safer portfolios than other banks in more competitive markets (Haron, 1997). Bourke (1989) also conducted a similar study on banks and proved the existence of this theory (Haron, 1997).

2.3 Determinants of Bank Performance

Determinants of bank performance can be classified into bank specific (internal) and macroeconomic (external) factors (Al-Tamimi, 2010; Aburime, 2005).

2.3.1 Internal Factors

These are also referred to as the bank specific factors. Scholars use the CAMEL framework to proxy these factors (Dang, 2011). CAMEL stands for capital adequacy, asset quality, management efficiency, earnings ability, and liquidity management. These factors are within the scope of the bank to manipulate and differ from bank to bank (Ongore & Kusa, 2013).

2.3.1.1 Capital Adequacy

Capital is the amount of own fund available to support the bank's business and act as a buffer in case of adverse situation (Athanasoglou et al, 2005). According to Dang (2011), the adequacy of capital is judged on the basis of capital adequacy ratio. This ratio shows the internal strength

of the bank to withstand losses during crisis. It has also a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas (Sangmi & Nazir, 2010).

2.3.1.2 Asset Quality

Bank asset includes among others current asset (cash), credit portfolio, fixed asset, and other investments. Financing activities (like loans and financing contracts) are the major asset of a commercial bank from which they generate income. The quality of financing portfolio determines the profitability of banks.

The highest risk facing a bank is the losses derived from delinquent loans (Dang, 2011). Thus, non performing loan ratios are the best proxies for asset quality (Ongore & Kusa, 2013). The lower the ratio, the better the bank is performing (Sangmi & Nazir, 2010).

2.3.1.3 Management Efficiency

This factor is represented by different financial ratios like total asset growth, loan growth rate and earnings growth rate (Ongore & Kusa, 2013). Management efficiency affects profitability directly. When operational expenses are efficiently managed an increase in profits is noted. Thus, if management carries out their duties to the bank efficiently, the bank in turn will perform well.

2.3.1.4 Earnings Ability

The earnings ability of a firm directly impacts on its profitability. Negative earnings growth will result in lower profits made by the bank. On the other hand, positive earnings growth will result

in increased bank profitability. Thus the bank has to ensure an increased earnings ability to ensure increased profitability thus improved performance overall.

2.3.1.5 Liquidity Management

Liquidity refers to the bank's ability to meet its obligations as and when they fall due, mainly of depositors. According to Dang (2011) adequate levels of liquidity is positively related with bank profitability. A bank that is posting profits but is illiquid is said to be performing poorly. Thus a bank must ensure it is liquid and making profits to be seen to be performing well.

2.3.2 External Factors

These are also referred to as macroeconomic factors. They include but are not limited to, macroeconomic policy stability, gross domestic product (GDP), inflation, interest rates, and political instability.

The trend of the GDP affects the demand for bank assets (Ongore & Kusa, 2013). Declining GDP growth results into a fall in demand for credit which will negatively impact profitability of banks (Athanasoglou et al, 2005).

Political instability in a country will result in reduced bank profitability. The unrest in the country will lead to reduced business in the country and this will thus mean reduced profits. This was evidenced during the post election violence in Kenya of 2007-2008.

The bank lending rate is expected to have a positive impact on bank profitability. This is because interest rate directly impacts bank interest income and expenses, and the net result that further affects profitability (Obamunyi, 2013).

Inflation refers to a sustained increase in the general price level of goods and services in an economy over a period of time. When the country begins to experience a period of high inflation, it means that goods and services will be more expensive whereas a period of low inflation means that goods and services will be relatively cheaper. High inflation period will also result in lending facilities being more expensive. This will result into fewer people being able to afford to borrow thus the bank profitability will go down.

2.4 Empirical Review

2.4.1 International Studies

Haron (1997) researched on the determinants of Islamic bank profitability. The data for this study were based on the 10 year financial statements from twelve (12) banks. The study found that while most independent variables such as capital ratio, liquidity, interest rates, money supply, inflation and total expenses have a similar impact on both Islamic and conventional banks, the market share variable produced a different result. In the case of profitability theories, evidence was found to support risk aversion theory but the existence of the efficient structure theory and the expense preference theory in Islamic banks was not supported.

Hassan & Bashir (2004) researched on the determinants of Islamic banking profitability. Utilizing bank level data, the study examined the performance indicators of Islamic banks' worldwide during 1994-2001. The study found that Islamic bank's profitability measures respond positively to the increase in capital and negatively to loan ratios. It indicates that adequate capital ratios play a weak empirical role in explaining the performance of Islamic banks. The study also found that favorable macroeconomic environment seems to stimulate higher profits.

The study further concluded that size of banking system has a negative impact on the profitability except net non interest margin. Lastly the study found an indication to the importance of consumer and short term funding, non interest earning asset and overhead in promoting bank profits.

Wahidudin et al (2012) carried out a study on the determinants of profitability focusing on a comparative analysis of Islamic banks and conventional banks in ASEAN countries. The study found that capital was important in explaining bank profitability in both types of banks. While operating expenses are negatively and strongly linked to it, showing that cost decisions of bank management are instrumental in influencing bank performance. The estimated effect of size does not provide evidence of economies of scale in banking.

Hanif, Tariq, Tahir & Momeneen (2012) conducted a research on the comparative performance of conventional and Islamic banking in Pakistan to find out which banking stream was performing better than the other. They used a sample of 22 conventional banks and 5 Islamic banks. The study covered a five year period (2005-09).

From the results it was concluded that in terms of profitability and liquidity management, conventional banking stream was performing better than the Islamic banking stream. However, under credit risk management and solvency maintenance, performance of Islamic banking was better than of the conventional banking sector, which showed the strength and soundness of the Islamic banking stream.

2.4.2 Local Studies

Sheikh (2009) conducted a research on the factors that led to the emergence of Islamic banking in Kenya and the regulatory challenges facing the industry. From the study it was deduced that demand for Islamic banking products, worldwide trend towards Islamic banking, shareholder's need for returns and amendments to the Banking Act are the main factors that led to the emergence of Islamic banking in Kenya.

Masika, (2013) conducted a study on the relationship between financial innovation and growth in profitability of Islamic banking in Kenya. This study concluded that bank innovations have a moderate influence on profitability of Islamic banks in Kenya. The summary of the study's findings concluded that if Islamic banking is to have meaningful contribution to profits such banks should adopt a composite of financial innovation.

Guyo & Adan (2013) conducted a study on the determinants of retail consumer choice of Islamic banking in Kenya. The study sought to identify the factors that influence the choice of the customers for Islamic banks operating in a dual-banking environment like Kenya. The study revealed that customers of Islamic banks view the industry much more favorably by the social and ethical goals that it serves, rather than the mechanics of its operationalization and functions. The various financing options on the menu of the bank played a critical role of attracting most of the customers since it is based on the unique pillars of Islamic Sharia'h but offered a better investment option compared to the conventional banking.

Wako, Kamaria and Kimani (2014) carried out a study on the challenges affecting performance of Islamic banks in Kenya. The target population for this research included 250 Islamic banking staff in Nairobi County. Findings under macro environmental challenges indicated that

institutional framework, IT, and global economy were factors influencing the performance of Islamic banking in Kenya. Findings under industry specific challenges indicated that bad loans, substitute products and supplier IT systems were factors affecting Islamic banking performance in Kenya.

Findings under bank specific challenges indicated risk asset management, weak corporate governance and poor human resource practices were identified as the major hindrance towards performance of Islamic banking in Kenya.

Lastly the study also identified the need by Kenyan banking regulators to enact some laws to facilitate the operation of a mixed banking system (conventional and Islamic) in the country. This is because the study concluded that the most serious problem faced by Islamic banks is the lack of a proper legal framework to deal with cases of delayed payments and bad loans expeditiously. Islamic banks cannot charge interest on delayed debts; they face a bigger risk of default as well as a loss of income which negatively affects their performance.

2.5 Summary of the Literature Review

Literature on bank performance has been available for the better part of the last century. This is evidenced by the increasing number of theories on bank performance. Recent studies show the emergence of theories centered on the performance of Islamic banks. This is due to the recent interest in Islamic banking practices being adopted more internationally and not just in Islamic states. Scholars are trying to make sense of how these banks are making profits despite not charging or receiving interest (riba).

Studies on bank performance determinants are extensive especially on conventional banking. The review identifies the bank performance determinants as, capital adequacy, asset quality,

management efficiency, earnings ability, liquidity management and a range of macroeconomic factors. Most of these determinants can be adopted by Islamic banking. Furthermore, researchers are coming up with determinants tailored to suit the principles of Islamic banking and better explain what determines their performance.

Lastly, a review of the empirical studies showed a growing interest in Islamic banking performance determinants and on their profitability and also on the challenges faced pursuant to their good performance. However there is a narrow focus, if any, on the impact of financing contracts on the bank's profitability.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodology and procedures that were used for collecting and analyzing data in the study. The chapter provides the research design used, the target population, the type of data used and data collection process and instruments used are also explained. The method used to analyze this data is explained lastly.

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). The study adopted a descriptive research design. Kombo & Tromp (2006) define descriptive statistics as not being only restricted to fact findings, but also may result in the formulation of important principles of knowledge and solution to significant problems.

The descriptive research design was adopted to explore the extent to which Islamic financing contracts affect the bank's financial performance. It was used because provided simple summaries about the sample and the measures; making the collected data more reliable and easier to describe characteristics of the study's variables.

Quantitative approach was used to establish proportions of the financing contracts used by banks offering Sharia'h compliant banking from 2010 to 2014 and in the determination of the Islamic bank's financial performance and the Islamic windows of conventional bank through the computation of the ROA. The ROA indicator was used as a measure of the financial performance of Islamic banks.

3.3 Population

Cooper & Schindler (2008), define a population as the total of the elements upon which inferences can be made. In this study the target population comprised of all licensed commercial banks in Kenya that offer Sharia'h compliant banking; whether fully fledged or conventional banks with Islamic windows.

The number of banks offering Sharia'h compliant banking is small thus sampling will not be required. The population size was seven commercial banks operating Islamic banking in Kenya as presented in appendix 1. The banks were selected because they operate Islamic banking windows except two which are fully fledged Islamic banks.

3.4 Data Collection Methods

The study used both primary and secondary data. The primary data for this study was the percentage contribution of each contract to the bank's overall financing book. This data was collected through data collection tables as presented in appendix 2. The respondents targeted were financing/credit managers of the banks. The study also used secondary data in the form of annual financial reports of the banks from 2010-2014. Information on the variables to compute ROA was sourced from the published financial statements of the banks.

Information relating to Islamic windows of commercial banks was sourced directly from the records of the window. These windows operate as bank branches and thus prepare separate financial reports for purposes of performance review of the individual branch. These individual records are then assimilated to prepare financial reports for the bank as a whole.

3.5 Data Analysis Method

Regression analysis was used to test the relationship between financial contracts and profitability of Islamic banking in Kenya. The regression model used was as follows;

$$BP_1 = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + e_1$$

Where:

BP_1 – is the Islamic bank's profitability represented by the ROA. This is the dependent variable of the equation.

a – is the Y-intercept

$\beta_1 - \beta_{10}$ – denotes the slope co-efficient.

e_1 – refers to the error term.

X_1 – Percentage of Murabaha financing made

X_2 – Percentage of Mudharaba financing made

X_3 – Percentage of Musharaka financing made

X_4 – Percentage of Istisna financing made

X_5 – Percentage of Ijara financing made

X_6 – Percentage of Salam financing made

X_7 – Percentage of Tawaruq financing made

X_8 – Bank's asset quality (ratio of non-performing loans to total financing)

X₉ – Bank’s liquidity (liquidity ratio)

X₁₀ – Management efficiency (loan growth rate)

3.6 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 was used to test the expected level of heteroscedasticity in the target population. Analysis of variance (ANOVA) was also 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 statistics, results and discussion on the data gathered. The descriptive analysis helps the study provide detailed information about each relevant variable. Additionally, correlation measures the degree of association between the variables under consideration while the regression analysis estimates the relationship between the financing contracts and profitability of Islamic banking in Kenya.

4.2 Response Rate

The study targeted 7 commercial banks which offered Islamic banking services in Kenya. 2 are fully fledged Islamic banks while the other 5 are commercial banks that operate Islamic banking windows. Out of the 7, only 6 participated in the study. The 7th declined with their reasoning being that their window began operations in 2014 and thus do not have the required data.

The 6 banks represented about 85.7% of the total population and thus an adequate response rate for the data analysis.

4.3 Data Validity

Primary and secondary data was considered in the analysis for the period 2010-2014. 5 different financing contracts and 3 control variables formed the independent variables under study. The dependent variable was represented by the banks' ROA.

The secondary data was sourced from the individual banks financial statements while the primary data was collected by aid of data collection tables filled by qualified managers in each of the participating firms. All the gathered information proved valid and reliable.

4.4 Descriptive Statistics

The mean and standard deviation of the financing contracts i.e. murabaha, musharaka, mudharaba, ijara, and tawaruq for the period under consideration returned the following statistics:

Table 4.1: Descriptive Statistics

	Col A (ROA)	Col B (MURABAHA)	Col C (MUDHARABA)	Col D (MUSHARAKA)	Col E (IJARA)	Col F (TAWARUQ)
Data size (n)	24	24	24	24	24	24
Mean	0.025	0.306	0.044	0.140	0.040	0.021
Error	0.003	0.048	0.010	0.027	0.021	0.013
Standard deviation	0.015	0.234	0.051	0.134	0.102	0.062
C.I. (95%) of mean	± 0.006	± 0.099	± 0.022	± 0.056	± 0.043	± 0.026
Lower range	0.019	0.207	0.022	0.084	-0.004	-0.005
Upper range	0.032	0.405	0.066	0.197	0.083	0.047
Coefficient of variation [%]	57.702	76.494	116.395	95.292	258.868	295.525
Skewness	0.923	0.515	0.525	1.351	4.274	4.401
Kurtosis	-0.021	-1.480	-1.412	2.490	19.607	20.452
Anderson-Darling test						
p value	0.2387	0.0931	0.0292	0.4609	0.0024	0.0011
Pass normality test (p>0.05)?	Yes	Yes	No	Yes	No	No

The mean financing under murabaha was the largest during the period standing at 30.6% with a standard deviation of 0.234. Tawaruq returned the smallest mean of 2.1% with a standard

deviation of 0.062. Musharaka was second with a mean of 14% and a standard deviation of 0.134. Mudharaba was third and ijara fourth with means of 4.4% and 4% respectively and standard deviations of 0.051 and 0.102 respectively.

Skewness indicates asymmetry and deviation from a normal distribution. When the value is greater than 0, then most values of that variable are concentrated on the left of the mean. This is a right skewed distribution. When the value is less than 0 then most values of that variable are concentrated on the right of the mean. This is a left skewed distribution.

The above analysis shows that ROA, murabaha and mudharaba have a right skewed distribution while musharaka, Ijara and tawaruq have a left skewed distribution. Kurtosis is an indicator used to describe whether a variable's distribution is flat or has a peak. The values in the analysis greater than 3 indicate that the values are concentrated around the mean with thicker tails. This indicates a peak in distribution. The values less than 3 indicate a flatter and wider peak. The values are wider spread around the mean.

The p value is used to test for normality. In the analysis, mudharaba, ijara and tawaruq failed the test with p values which were $p < 0.05$. This indicates that their values were not normally distributed.

4.5 Correlation Analysis

Table 4.2 Pearson Correlation

	ROA	MURABAHA	MUDHARABA	MUSHARAKA	IJARA	TAWARUQ
ROA	1					
MURABAHA	-0.60796	1				
MUDHARABA	-0.52133	0.877469	1			
MUSHARAKA	-0.54667	0.635162	0.53413	1		
IJARA	-0.09571	0.378991	0.479063	0.458271	1	
TAWARUQ	-0.1826	0.409274	0.417833	0.189728	0.058637	1

There is a negative relationship between each of the financing contracts and the ROA. This implies that the financing contracts and the ROA are moving in different directions. On the other hand, the contracts have positive relationships amongst each other. The Pearson correlation shows the presence of a linear relationship between the variables.

4.6 Regression Analysis

Regression analysis between the financing contracts and financial performance was done. The results were as per the following tables:

Table 4.3 Regression Analysis

Regression Statistics	
Multiple R	0.926565846
R Square	0.858524267
Adjusted R Square	0.783070543
Standard Error	0.006839708
Observations	24

R-squared measures how close the data is to the fitted regression line. It measures the coefficient of determination. The higher the R-squared, the better the model fits the data. The R-squared according to table 4.3 is 0.859 showing that the data fits very well in the model.

Table 4.4 Analysis of Variance (ANOVA)

	df	SS	MS	F	Significance F
Regression	8	0.004258	0.000532	11.37815628	4.05E-05
Residual	15	0.000702	4.68E-05		
Total	23	0.00496			

From the ANOVA summary in table 4.4, the P value (significance F) < 0.05. Its value is 0.0000404524668687766. This denotes a significant relationship between the dependent and independent variables. Thus proving a relationship exists between financing contracts and financial performance of Islamic banking in Kenya.

The regression coefficients for the model are as follows:

Table 4.5 Regression Coefficients

	Coefficients	Standard Error	t Stat	P-value
INTERCEPT	0.058695775	0.007778	7.546361	1.75381E-06
MURABAHA	-0.046755404	0.015061	-3.10435	0.007252425
MUDHARABA	0.035816358	0.06527	0.548743	0.591256751
MUSHARAKA	-0.014185527	0.015466	-0.91719	0.373556826
IJARA	0.009922256	0.018116	0.5477	0.591955136
TAWARUQ	0.001970929	0.026268	0.075032	0.941180592

From the above summary in table 4.5, the formula coefficients have been determined. The intercept is 0.0587. Murabaha and musharaka have negative coefficients. This implies that when proportion of financing in either of the two contracts increases; it will result in a reduction of the overall ROA. The remaining financing contracts have positive coefficients. An increase in either will result in an increase in the ROA.

4.7 Discussion of Research Findings

The analysis indicates that murabaha is the biggest contributor to an Islamic banking financing portfolio. It is followed by musharaka. The other three seem not to be as popular with the public as their contributions are minimal. The results also show that all the financing contracts have an influence on the banks' performance as indicated by their positive means and positive standard deviations.

The results show that the data fits well into the regression model. The coefficient of determination of 0.859 is indicative of that. There is a significant relationship between the financing contracts and the ROA for the Islamic banking portfolios indicated by the significance of F value of 0.00004 in the ANOVA. The results show that any changes in any financing contract will have an effect on the ROA.

According to the Pearson correlation, all of the independent variables move in opposite direction with the dependent variable. This is evidenced by the negative correlation value for each when related with the dependent value (table 4.2). The contracts have positive relationships amongst themselves but at different degrees. The different degrees denote the extent to which each variable moves with another.

The regression analysis came up with the coefficients for each variable and the intercept. The intercept was calculated as 0.059. The negative coefficients calculated for murabaha and musharaka imply that there is negative relationship between the two and ROA. For every unit increase in murabaha, ROA will decrease by 0.0467. Similarly, every unit increase of musharaka will decrease the ROA by 0.0142.

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter reviews the findings outlined in chapter 4. A summary of the findings is discussed then a conclusion following the research is outlined. Some policy recommendations are also discussed followed by the limitations of the study carried out. Finally the researcher provides suggestions for further research.

5.2 Summary of findings

From the results it can be noted that there is a relationship between the financing contracts and performance of Islamic banking. The key indicator supporting this position is the p value being < 0.05 . Further analysis showed that the variables are negatively correlated with the dependent variable. This shows that although they move in different directions, they move together.

The financing contracts are all positively correlated with each other. This implies that they all move in the same direction. Some are more correlated than others. Those more closely correlated show similar attributes compared to those not so closely correlated. For instance, murabaha is close correlated with mudharaba and musharaka. This could be due to the similarities in their contractual make up.

5.3 Conclusion

The results show that Islamic banking financial performance is affected by different financing contracts. All the contracts are positively correlated to return an income. Therefore, it can be

reliably said than any commercial bank offering Islamic financing contracts must pay key attention to the contracts they offer and capitalize on those with greater yields.

The regression analysis output established a measure of the contribution of each variable to the model. As per the output, murabaha is the biggest contributor followed by musharaka. The t-statistics and p values give a rough indication of the impact of each predictor variable-a big t value and small p value suggests that a predictor variable is having a large impact on the dependent variable.

5.4 Policy Recommendations

The study found that a significant relationship exists between the different financing contracts and financial performance. Therefore each commercial bank offering these contracts must evaluate its contracts availability, uptake and returns. All banks which offer Islamic banking services have these contracts as part of their financing portfolio. This fact alone summarizes the significance of these contracts to financial performance.

These are not the only contracts available under Islamic financing. Some of the contracts that are offered internationally are not offered locally. These include istisna and salam. Commercial banks should consider introducing more Islamic financing contracts into the market to enhance variety for customers and thus increase their on profitability.

The CBK should consider putting regulations in place which will improve Sharia'h based financial services platform. Conventional banking has monopolized the market and if more Sharia'h based services can also successfully penetrate the market, competition will ensue. This competition will result in better pricing on loans and a wider variety of services for customers. Better regulations tailored towards Sharia'h based banking will enable this.

5.5 Limitations of the Study

The study covered a period of five years (2010-2014). However, some of the commercial banks within the sample introduced Islamic banking in 2013 and thereby making data availability limited for the period under consideration. Some banks only offer murabaha while others only offered murabaha and musharaka. This affected the analysis as not all contracts were equally represented.

One of the banks which started offering Islamic banking services in 2014 declined to take part in the study citing that their data was not enough to satisfy the requirements of the study. Another refused to share proportions of the contracts they offer. These two instances distorted the analysis done due to inadequate data made available for analysis.

5.6 Suggestion for Further Research

Future studies on this topic can be carried out when more commercial banks offer Islamic financial services thus more data will be available. The study then will provide better insight into the relationship between the financing contracts and bank financial performance.

A future study could also be done on the relationship between murabaha and profitability. This is because it has been proved to be the most sought after Islamic financing contract. The study could discuss it better and give more insight into the contract. The study could result in other banks and even customers to understand its appeal.

A more apt study could be on how best to regulate Sharia'h based banking in a conventional environment. This study could help speed up regulation of the sector in the market.

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APPENDICES

Appendix I: List of Commercial Banks offering Islamic Banking

Barclays Bank of Kenya

Chase Bank of Kenya

First Community Bank

Gulf Africa Bank

Kenya Commercial Bank

National Bank of Kenya

Standard Chartered Bank

Appendix II: Data Collection Table

Section 1

Name of Organization:

Name of Respondent:

Position of Respondent in the Bank:

Date of Incorporation of the Bank:

Fully fledged Islamic bank/window:

Commencement of Islamic Banking:

Commencement of financing under Islamic contracts:

Do you have a Sharia'h Board?

Section 2

1. Please tick which financing contracts were offered by your bank in the period 2010-2014

	2010	2011	2012	2013	2014
Murabaha					
Mudharaba					
Musharaka					
Istisna					
Ijara					
Salam					
Tawaruq					
Other (Please specify)					

2. Please indicate the % contribution of each contract towards the overall financing activities of the bank in the period 2010-2014

	2010	2011	2012	2013	2014
Murabaha					
Mudharaba					
Musharaka					
Istisna					
Ijara					
Salam					
Tawaruq					
Other (Please specify)					

Thank you.