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

By

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DECLARATION

This project is my original work and has not been submitted to any institution or university for examination.

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This research has been submitted for the examination with my approval as the candidates's supervisor.

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DEDICATION

I dedicate this research project to my family for their continued moral support and willingness to support me during my studies.

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ABBREVIATIONS

AITAB	Alijarah Thumma Albai
BBA	Bai Bithaman Ajil
CBK	Central Bank of Kenya
FCB	First Community Bank
GAB	Gulf African Bank
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
NIM	Net Interest Margin
PLS	Profit and Loss Sharing
ROA	Return on Assets
ROCE	Return on Capital Employed
ROE	Return on Equity

ABSTRACT

This study was carried out to examine the effect of Islamic banking contracts on finanncial peformance of Islamic commercial banks.The purpose of the study was therefore to examine the extent to which Islamic contracts affected finanncial performance with the aim of establishing the extent to which islamic contracts related with financial performance of Islamic commerical banks. The study relied on secondary data to adress the research objective.The study findings was expected to provide recommendation on the possible challenges facing Islamic commercial banks as well as possible policy recommendations. A descriptive and diagonistic survey design was used. The target population for the study was two Islamic banks. A five year data for five Islamic products as well as financial performance based on these products was used. Both descriptive and inferential statitistics was used for data analysis. Descriptive statistics generated the amount of various Islamic products and trends in financial performance while inferential statistics provided a correlation and regression analysis between Islamic contracts and financial performance of Islamic commercial banks.The study findings indicated a notabale offer of Islamic contracts within the periods 2009-2013. The amount of Islamic contracts fluctuated from one year to to another with murabaha contract being the highest and showing steady levels of uptake among the customers. Uptake of Islamic contract was based on the nature of the product and extent of compliance with shariah. Strong postive correlation coefficients of 0.617 was obtained between financial performance and murabaha while, Tawarruq showed a weak positive correlation of 0.159, Mudaraba had a weak correlation of 0.038 while injara showed a moderately weak correlation of 0.397. A variation of 73.6 % on financial performance due to changes in Islamic contracts murabaha, musharaka, Tawarruq, mudaraha and ijara at 95% confidence level was obtained. A strong positive correlation of 0.858 exists between Islamic contracts and financial performance. A unit increase in the amount of Islamic contracts would lead to an increase in financial performance by coefficient factors 1.442, 0.739, 0.656, 0.56 and 0.114 respectively. The study recommended an uptake of Islamic products by all other banks as a financial innovation in the sector, suitable policy to profile Islamic contracts based on their uptake and the government to ease licensing process for Islamic banking. The study was limited to the few Islamic products available among Islamic commerial banks. Further study should be carried out on the factors affecting uptake of Islamic contracts in Kenya and regulatory procedures and their effect of ease of doing business for Kenya’s Islamic banks.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

For many years, Islamic banks have witnessed double digit growth rates, surpassing their conventional peers. According to Kearney (2014), at first it seemed all well for Islamic banking industry.There was ample room for growth as Islamic banking rarely exceeds a third of total market share. Several potential markets with large muslim populations remain largely untapped. Such include, india and the common wealth of independent state countries, made up of former soviet republics. In addition, overall banking penetration in many of country’s core markets is still low, with low banking penetration levels in many core industry markets. At the same time, several new markets have opened up for Islamic banking even on more horizons. This said, a closer look at the Islamic banking industry reveales a changing market dynamics. Among the key indicators of the changing dynamics is growth rate and profitability.

According to Kearney (2014), after years of rapid growth in which islamic banks outpaced conventional banking in most markets, outgrowth is waning in key geographical regions, including Saudi Arabia and the United Arab Emirates, soon growth in Islamic banking could match the general market suggesting that Islamic banks may have exhausted their natural share. As far as profitability is concerned, Islamic banks generally outperformed conventional banking in terms of growth over the past decade, they have consistently outperformed them in terms of profitability. However, several small Islamic banks have been struggling for years to turn profitable, others have been badly affected by regional economic crisis.

More importantly, some major islamic banks such as those in Gulf Cooperation Council (GCC), have witnessed declining profits over the past five years. To sustain profitable growth a more sophisticated leveraging of Islamic potential much has not yet been exploited. A continous examination of Islamic banking contracts and their effects of financial performance therefore comes in to play an important role in adressing the changing business dynamics for Islamic banks.

1.1.1 Islamic Financial Contracts

Various forms of commercial contract in Islam can be identified in the Quran (Ajlouni, 2012). Islamic contracts of relevance to commercial and financial activity are widely recognized as contracts of exchange, contracts of charity and contracts of investment and partnership. According to Ahmed and Zakaria (2011), it is generally agreed that commercial transaction should be concluded at a price that is agreed mutually and not under duress, with the parties involved being sane and old enough to understand the implication of their actions without uncertainty or deception, with regard to quality and ability of the service provider to deliver.

Islam generally permits trade and commerce thereofore civil contracts can be used in Islamic banking and finance. Brown (2003), defines the concept of Islamic banking and finance and mobilization of deposits through contracts by shariah and application of funds through contracts permissible by the shariah. According to Chachi (2005), the concept of Islamic banking was developed in late 1940s, based on the norms and standards of Sharia law. Islamic financial contracts are the basis for the operations of Islamic banks and it also has the same importance to the conventional banks which offer shariah compliant products (Faraq, 2010).

There are certain basic types of financial contracts, which have been approved for being compliant with the islamic finance principles. Musharaka (partnership) which according to Gamal (2006), is often perceived to be the preferred Islamic mode of financing, because it adheres most closely to the principle of profit and loss sharing. Partners contribute capital to a project and share its risks and rewards. Profits are shared between partners on a preagreed ratio, but losses are shared in exact proportion to the capital invested by each party.

Mudaraba (finance by way of trust) is a form of partnership in which one partner (rabb al-mal) finances the project, while the other party (mudarib) manages it (Gamal, 2006). According to Gamal, Mudaraba though similar to musharaka, has a financing mode financing, does not require that a company be created, the financial institution provides all of the capital and the customer is responsible for the management of the project. Profits from the investment are distributed according to a fixed, pre-determined ratio. Another main financial contract by the Islamic banks is murabaha (Cost-plus Financing). In Murabaha contract, the bank agrees to buy an asset or goods from a third party, and then resells the goods to its client with a mark-up (Iqbal, 2011). The client purchases the goods against either immediate or deferred payment. There is also Ijara(leasing) contract, like a conventional lease, ijara is the sale of manfa'a (the right to use goods) for a specific period. In Muslim countries, leasing originated as a trading activity and later on became a mode of finance. Ijara is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee (Hassan & Mervyn, 2009). Salam (Advance Purchase) contract is also offered by Islamic banks. Salam is purchase of specified goods for forward payment. This contract is regularly used for financing agricultural production (Hassan & Mervyn, 2009).

Bai bi-thamin ajil (deferred payment financing) contract is an islamic banking contract which involves a credit sale of goods on a deferred payment basis (Iqbal, 2011). At the request of its customer, the bank purchases an existing contract to buy certain goods on a deferred payment schedule, and then sells the goods back to the customer at an agreed price. The bank pays the original supplier upon delivery of the goods, while the bank's customer can repay in a lump sum or make instalment payments over an agreed period. Istisnaa (commissioned manufacture), although similar to bai bi-thamin ajil transactions, istisnaa offers greater future structuring possibilities for trading and financing (Mohammad & Melvis, 2015).

One party buys the goods and the other party undertakes to manufacture them, according to agreed specifications. Islamic banks frequently use istisnaa to finance construction and manufacturing projects. Sukuk (participation securities) were introduced recently for the same reasons that led to the establishment of interest-free banking, which was to meet the requirements of those investors who wanted to invest their savings in shari'a-compliant financial instruments (Mohammad & Melvis, 2015).

Islamic financing is uniquely based on the principles of Islamic law (Alkassim (2005). It differ substantially the conventional finance and is in the broadest sense establsihed to pursue wider objectives of sharia which is establishment of justice for mand kind in area of business and finance. While of particular interest to Muslim community, Islamic financing and Islamic finance products are available to all regardless of their faith. It has become more accessible through establishment of Islamic financial institutions (IFIs) banks whose constitutional documents comply with sharia as well as local laws. Islamic banks have played a signifincant and active role in finanancing techniques as well as generating interest in Islamic finance products beyond traditional Islamic finance markets. According Bashir (2000), despite its rapid growth, the islamic finance industry contrast to its conventioanl counterpart is still relatively new as Islamic financing techniques are still evolving. Against, this, scholar and practitioners are developing methods to comply with sharia law while examimining ways in which islamic banks can establish health financial standing.

1.1.2 Financial Performance

Firm performance is a multidimensional construct that consists of four elements (Alam, Raza, & Akram, 2011). According to Chachi, (2005), The soundness of a bank depends on its ability to meet its obligations in a crisis situation. This is usually measured by the capital–assets ratio. There are three major reasons for a bank to monitor its capital–assets ratio. Chachi (2005) noted that, First, regulatory authorities require a minimum amount of bank capital. Second, the size of the bank capital has some safety implications as it provides some cushioning, albeit limited, against the possibility that the bank cannot satisfy its obligations to its creditors. Third, the amount of capital affects the rate of return to the bank equity holders. There is a trade-off between the return to the owners and the safety of the bank; given return on assets, the smaller the bank capital, the higher the rate of return to the owners of the bank. Therefore, the owners of the bank have a natural tendency to keep lower capital–asset ratios. However, the lower capital–asset ratios increase the risk of bank failures (Chachi, 2005).

There are several ratios that are typically used to measure the profitability of firms. The two most often used are the rate of return on assets (ROA) and the rate of return on equity (ROE). Both measures are closely tied to the key item in the income statement; net income. ROA shows the profit earned per dollar of assets and most importantly, reflects the management ability to utilize the bank's financial and real investment resources to generate profits. ROE, on the other hand, reflects how effectively a bank management is using shareholders funds. A bank's ROE is affected by its ROA as well as by the bank's degree of financial leverage (equity/ asset). Since returns on assets tend to be lower for financial intermediaries, most banks utilize financial leverage heavily to increase return on equity to a competitive level (Chachi, 2005).

1.1.3 Islamic Banking Contracts and Financial performance

The Agency theory in banks and financial intermediation theory, both predicts the quality of bank assets is important determinant of profitability and performance of banks (Alkassim, 2005). McDonell and Rubin (1991) also found that sales of deposit and lending products as one of critical factors to success of banks. Islamic banks profitability equals the difference between income derived from investment of depositors and shareholder funds and income attributable to depositors and operating expense (Alkassim, 2005).

Therefore, Islamic banking income of financing income, dealing income, and operating income (fee and commission and other income), Where Muddep is an income attributable to Mudarabah deposits. Earnings assets in Islamic bank consists of several Financing contracts but most common ones are Murabaha, Bia bithaman ajil, Al-ijaraha thumma al-bai. These contracts are divided into debt base financing and equity base financing. These financing incomes may derive from sales mark up price or profit and loss sharing methods (Alkassim, 2005).

1.1.4 Islamic Commercial Banks in Kenya

Islamic banking is a system of conducting trade and banking activities in line with the principles of Islamic Shari'ah while avoiding all the prohibited activities such as interest or Riba, Gharar, financing of haram trade and businesses (Brown, 2003).

Brown further notes that Islamic banking is not banking which is based on pricing money and earning interest as conventional interest-based banks do but it is a system of trade where goods and services are sold and capital is invested by taking risk to earn halal profits. Interest free banking is a subset of Islamic banking concept (Iqbal, 2011).

While conventional banks earn their money by charging interest and fees for services, Islamic banks earn their money by profit and loss sharing, trading, leasing, charging fee for services rendered and using shariah contracts of exchange (Arif,2001). Islamic commercial banks are basically meant to promote and encourage Islamic principles while earning money (Alkassim,2005). The banks operate based on Islamic business law for their basic transactions. They also follow the financial laws and regulations of the countries which they operate. The value of money in Islamic banking is based on increment on projects that money has been invested in (Ajlouni, 2012). While debtor and creditor relationship does exist at times in Islamic banking, the relationship between customer and Islamic bank is based in the Islamic contract in question (Ajlouni, 2012). On investment, although the customer deposits the money in order to earn extra income, for savings, the principal return is not guaranteed, in case the Islamic bank losses money because of unexpected business failure, the bank isn't liable to pay money to its customers (Alkassim,2005). In Kenya, banks that are conventionally non-Muslim are offering niche services and products to meet the needs of diverse customer base (CBK, 2014).

Islamic commercial banks therefore offer Shariah compliant or Islamic banking. In Kenya, Islamic banking industry accounts for 2% of the country's banking business in under than five years. According to Wokabi (2014), Gulf and first community banks purely Islamic banks in Kenya, with Barclays, Standard Chartered, Kenya commercial bank and national bank offering Islamic banking products. Islamic banking sector in Kenya is still at its infant stage and emerging financial innovation because of the worldwide trend towards Islamic banking. Shariah compliant banks are already increasing the scope of their customers and posing a competitive threat to other financial banks (Mang'eni, 2009).

The two Islamic banks, that is the gulf African bank and First community bank have created a strong appeal not only to Kenya's 8 million Muslim populations, but to the rest of the conventional customers as witnessed by number of conventional clients who switched to Islamic products (Mang'eni, 2008). The first commercial bank operating entirely under Islamic Shariah Principles was first community bank. Gulf African bank commenced its operation in Kenya as a fully fledged Islamic bank to operate in Kenya (Republic of Kenya, 2011). Entry of shariah compliant products is perhaps one of the most critical developments in Kenya's financial sector given the key role the sector plays in the economic growth of the country (Karin, 2008). Despite, this important observation, the sector is still under exploration and therefore the need to establish how Islamic products related with financial performance still remain eminent. It is therefore on the basis of this background that this study will be undertaken.

1.2 Research Problem

Islamic banking contracts are the backbone to the Islamic banks' products and services. Every product or service must apply at least one Islamic contract to support and to validate the transaction. These contracts represent the contracts of sale, leasing, partnership, deposits, fees, agency, transferring of debt, gift, collateral and others

(Munawar & Philip, 2005). However, There has been changing market dynamics within the isalmic banking sector, as a result, reports have indicated declining growth rates and profitabity with suggestions for Islamic banks to revisit their strategies being put forth (Kearney, 2014).

Among the issues that Islamic banking sector has to content within their business environment include; size of the banks many islamic banks are considerably smaller than their conventional competitors in their domestic markets, there is growing competition as the number of islamic banks and financial services is growing in the midst of slowed market growth, Further, standardization and regulation present ongoing challenges for Islamc bank. In addition, most islamic banks have not been consistently profitable due to global financial associated with the structural factors as far as nature of Islamic banking prodcuts is concerned (Kearney, 2014).

Kenya’s Islamic banks have not been exempted from the current business challenges affecting islamic banking sector. According to Kinyanjui (2013) on challenges facing Isalmic banks, providing a blend between religion complaint and meeting of financial needs for target customers was found to affect market development for Islamic banks. Oundo (2009) indicated that there was poor supply of Shari’ah compliant products in Kenya’s financial institutions. Ndung'u (2010), underscored the concept of Islamic banking describing it an emerging and alternative vehicle for mobilization and supply of finance in Kenya, he however noted that despite the overwhelming interests, challenges facing the concept need to be addressed.

The aforementioned studies reveal that Islamic banking as an important concept that is addressing a special market niche of clients. This notwithstanding, it is notable the changing market dynamics may be threatening the performance of Islamic banks. This is particularly true for their financial performance whose dismay is expressed in reduced growth for the banks and profitability. The aforementioned studies have majorly focussed on the development of Islamic banking concepts, the changing market dynamics and challenges facing the sector. Little if any has been done to address the effect of the Islamic banking products and financial performance. It is therefore on this basis that this study will be carried out. The study seeks to answer the question, to what extent do Islamic banking contracts affect financial performance of Islamic commercial banks?

1.3. Research Objectives

The objective of this study is to assess the effect of Islamic banking contracts on the financial performance of Islamic commercial banks.

1.4 Value of the Study

The study findings will prove to be important to commercial banks in Kenya particularly Islamic banks, policy makers in banking and financial services and in scholarship. This study will add more knowledge on the concept of Islamic banks and give more empirical findings on the relationship between Islamic financial contracts and performance. This will provide more literally material which will be of value to scholars, students and researchers. This study can also be used as a basis of further research and also in academics in the area Islamic banking.

This study will provide more insight on the effect of islamic financial contracts on performance, not only in the banking industry but other financial financial institutions like Islamic Insurances which apply the same principles as that of the Islamic banking. This will provide management of commercial banks and firms in financial services with more insight on the importance of Islamic financial Contracts and not only to the banks's performance but also assist on financial innovation.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

In this chapter, a review of literature related to the study is disccussed. The chapter starts with theoretical reviews of the islamic bank literature followed by review of empirical studies. The Chapter ends with a summary of Literature review and identifies the research gaps to be addressed by the current study.

2.2. Theoretical Review

The study will be guided by profit loss sharing theory, agency theory and stewardship theories.

2.2.1 Profit and Loss Sharing Theory

The profit and loss sharing instruments mudarabah and musharakah are considered central pillar of the Islamic banking model (Faraq, 2010). In mudarabah banking, the Islamic bank accepts funds from depositors under risk-sharing arrangements. The Islamic bank either directly invests these funds in profitable investments or extends them to entrepreneurs on a risk-sharing basis. The Islamic bank shares the profit or loss made on mudarabah ventures with its depositors (Gamal, 2006).

In musharakah banking, the Islamic bank contributes the depositors' funds to a joint enterprise with the client (an entrepreneur). Generally, the Islamic bank allows the client to manage all the affairs of a Musharakah business (Hassan & Mervyn, 2009). The Islamic bank and the client mutually share the profit or loss made on the Musharakah investment. In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. The profit and loss sharing theory has been faulted as a result of lack of proper monitoring mechanisms especially in case of Mudarabah that does not provide any control rights to the financier (Iqbal, 2011).

Literature of the Profit and Loss sharing dates back in 1986. According to Saleh (1986), there are three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower. Rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract.

The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. Studies by Okpara (2009) indicate a need for construction of standardized PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

2.2.2 Agency Theory

The origin of Agency theory is Alchian & Demsetz (1972) and Jensen & Meckling (1976). Agency theory re-establishes the importance of incentives and self interest in organizational thinking (Perrow,1986) . In agency theory information is regarded as a commodity which has a cost and can be purchased which then makes it possible for organizations to invest in formal information systems such as budgeting, MBO and Board of Directors. Informal systems include managerial supervision. All these investment is geared to control agent opportunism. Agency theory extends organizational thinking by pushing the ramifications of outcome uncertainty to the implications of creating risk. This implies therefore that outcome uncertainty coupled with differences in willingness to accept risk is likely to influence the contracts between principal and agent.

Jensen and Meckling (1976) defined Agency theory as the relationship between shareholders who they termed as the principals and the company executives and managers who they see as the agents. Agency theory is an appreciation of the contractual view of the firm. Agency problem therefore arises in the need to separate the suppliers of finance from the management of the firm. The principal-agent relationship is beneficial in that it creates room for the shareholders to specialize as risk bearers, the principal, who hires and retains the agent who is endowed with specific talents, knowledge and capabilities to increase the value of the asset through efficient allocation of resources (Melyoki, 2005). In this principal-agent relationship the agent only enjoys a part of the outcomes of his efforts (Denise and McConnell, 2003).

The theory is based on the assumption of goal conflict between the principal and the agent (Jensen and Meckling, 1976). Due to the human opportunistic behaviour, the agent may make decisions that are incongruent to the best interest of the principals (Padilla, 2002). Agency theory therefore calls for close monitoring of the agents due to the prospect that they serve their own interest rather than of those of the owner principal.

The monitoring results to agency costs that are meant to align the interests of the shareholders to that of the executive and reduce internal inefficiencies. According to Jensen and Meckling (1976) the agency cost comprises of three different components: monitoring costs, bonding cost and residual cost. Monitoring costs are meant to cushion the principal from the devious behaviour of the agent. Bonding cost are meant to encourage the agent to make decisions that are beneficial to the principal while residual loss is the cost borne by the principal when the monitoring cost and bonding cost fail to contain the devious behaviour of the executive.

The delegation of management rights by the principal to the agent creates a situation where the agent has more information about the outcomes of his efforts (Hart, 1995). The ensuing information asymmetry where the agent has more information on the outcomes than the principal implies that the principal cannot fully measure the outcomes of the agents (Melyoki, 2005). This therefore means agency costs can only be minimized but not eliminated (Hart, 1995).Agency problems exhibit itself in two forms: the failure of managerial competence and the failure of managerial integrity (Moldoveanu & Martin, 2001). Failure of managerial competence arises from ignorant mistakes made in executing managerial responsibilities. These can occur due a situation where the principal cannot adequately ascertain the agent's ability to execute the responsibilities for which he is hired or paid for. On the other hand, failure of managerial integrity arises from moral hazards and relates to the wilful behaviour on the part of the managers that reduces the value of firm's asset (Melyoki, 2005).

The monitoring solution by shareholders, especially major ones constitutes an important mechanism for encouraging managers not to deviate from shareholders interest. In cases where ownership is fragmented, the board of directors is viewed as an alternative mechanism (Jensen, 1993 and Denise, 2001).Agency theory has a basic conclusion that value of a firm cannot be maximized as managers normally hold executive power which allows them to expropriate value for their own interest (Turnbull,1997).However despite the claim that the conflicts between the principal and the agent cannot be eliminated Agency theory provides a broad analytical framework to examine how managers can optimally invest for orgranizations.

2.2.3 Stewardship Theory

Stewardship theory is a theory that rejects the assumptions of agency theory (Davis et al, 1997). Stewardship theory has its roots in the socio-psychological model of human behaviour, with the main assumption that manager's behaviour is pro-organizational and collectivistic, achieving higher utility by serving an organization than working to satisfy personal goals (Tipuric,2008).Gay (2002) on the other hand, looks at stewardship theory as having been derived from economic model of human behaviour which McGregor classified as Theory Y, whose main assumption is that people are inherently motivated to work and perform a good job. In this theory managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis 1991). According to Smallman (2004) when the wealth of the shareholders is maximized, the steward's utilities are maximized too, because organizational success will serve most expectations and the stewards will have a clear mission.

Stewardship theory sees a strong relationship between managers and the success of an orgranization, and therefore the stewards protect and maximize shareholder wealth through firm performance. A steward, who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups have interests that are well served by increasing organizational wealth (Davis, Schoorman & Donaldson, 1997). Where the CEO couples as the chairman the fate of the organization and the power to come up with a strategy becomes the power of an individual (Kumudini, 2011). The focus of stewardship theory therefore becomes structures that facilitate and empower rather than monitor and control (Davis,1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of the chairman and CEO, and supports appointment of a single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke, 2004).

2.3 Determinants of Commerical Bank Financial Performance

The financial performance of commercial banks is determined by different factors. According to Almajali et al, (2012), the following are determinants of various measures of financial performance.

2.3.1 Liquidity

Liquidity measures the extent to which a firm has cash to meet immediate and short term obligations or assets that can be quickly converted to do this. Accordig to Matz (2011), liquidity is characterized by high level trading activity, in which assets can easily be bought or sold. It denotes the ability of an aseet to convert into cash quickly.

Proper management of working capital components helps in reducing the costs of the firm and this highly contributes in reducing the liquidity risk of the firm and thus mitigating any financial losses that might be attributed to lack of finances to take advantage of profitable investments. Other theoretical models in which liquidity is viewed include; for example Evans and Jovanovic (1989) in their theoretical model which suggested that a moderate amount of liquidity may propel entrepreneurial performance, but that an abundance of liquidity may do more harm than good. Therefore, the effect of liquidity on firms' financial performance is ambiguous.

2.3.2 Financial Leverage

Financial leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity (Gibson 2010). It can be aptly described as the extent to which a business is using the borrowed money. Business companies with high leverage are considered to be at risk of bankruptcy if, in case, they are not able to repay the debts, it might lead to difficulties in getting new lenders in future. According to Gibson, the more debt financing a company uses, the higher it’s financial leverage. A high degree of financial leverage means high interest payments, which negatively affect the company's bottom-line earnings per share. Financial risk is the risk to the stockholders that is caused by an increase in debt and preferred equities in a company's capital structure. Ketz (2003) indicated that the financing or leverage decision is a significant managerial decision because it influences the shareholder’s return and risk and the market value of the firm.The ratio of debt-equity has implications for the shareholders’ dividends and risk, this affect the cost of capital and the market value of the firm that may significantly affects its financial performance (Zenious 2010).

2.3.3 Customer Deposit

According to Zenious (2010), best performing financial institutions are those who have maintained high level of deposit accounts relative to their assets. Increasing the ratio of total deposits to total assets means increasing the funds available to use by the institution in different profitable ways such as investments and lending activities.

2.3.4 Size of banking institution

The size of any firm is said to be an important determinant of it's financial performance. According to Zenious (2000), size of a bank has a postive effect on financial performance. Zenous notes that larger firms leverage their size to obtain better deals in financial as well as product or other factor markets. Large organizations often get access to cheaper financial resources, as well. These effects are more pervasive in institutional contexts of incomplete or imperfect markets that are more likely to be the case in developing economies such as India.

2.3.5 Age of banking institution

A firms age is siad to influence its financial performance. According to Matz (2011), organizational inertia operating in old firms tend to make them inflexible and unable to appreciate changes in the environment. Newer and smaller firms, as a result, take away market share in spite of disadvantages like lack of capital, brand names and corporate reputation with older firms. Newly established banking institutions are not particularly profitable (if at all profitable) in their first years of operation, as they place greater emphasis on increasing their market share, rather than on improving profitability.

2.4 Empirical Studies

Several studies have been undertaken by different scholars to seek answer to the problem faced by every increasing demand for Islamic banking since its inception in 1970s.

2.4.1 International Evidence

The performance of Islamic baking is of main importance to many stakeholders in the banking Industry. Bashir (2001) tried to identify the underlying determinants of Islamic bank performance. It his study he applied regression analysis in order to establish the relationship between the profit of the banks and some internal bank variables. The study found that the profit of Islamic banks is generated from overheads, customer short-term financing and non-interest earning assets.

Ahmed &Zakaria (2001) in their research on the performance of Islamic banking contracts and its sensitivity to Islamic bank profit examined the financing contracts of 17 banks both local and foreign in Malaysia. The research analyzed the financial data of banks size, customer deposits, financing contracts collected from the bank annual financial reports from 2000 to 2010. The research applied Regression analysis to identify the contribution of financing contracts to the profitability of the banks. The main variables used in the research were profit before tax as the independent and the dependent variables were deposit contracts and financing contracts.

The deposit contracts studied by Ahmed & Zakaria (2011) were divided into two main categories: Mudarabaha deposits and Non-Mudarabaha deposits. Furthermore, Financing contracts were divided into four main categories which are: bai’ bithaman ajil (deferred payment financing), al-ijarah thumma al-bai (Hire purchase financing), murabahah(cost-plus financing) and other financing. The Study found out that bank's profit is positive and statistically significant with financing contracts and mudharabah deposit contract against assets. This paper concludes that bai' bithaman ajil (BBA) and alijarah thumma albai' (AITAB) are the most financing contracts consumed by banks' customers. The empirical results also show that AITAB is statistically significant to the bank's profitability.

Another study by Zulkifli (2007) which has also examined the performance of Islamic products found that Islamic contracts of Al-Bai are the most contributors in terms of profit and growth of the Islamic banks in Malaysia. Further study by Bashir (2003) examined the determinants of eighteen Islamic banks performance across eight Middle Eastern countries- namely Egypt, Bahrain, Jordan, Kuwait, Qatar, Sudan, Turkey and United Arab Emirates- from 1993 through 1998. The study used four measures of performance net non-interest margin (NIM), before tax profit to total assets (BTP/TA), ROE, and ROA. Meanwhile, seven bank's characteristics are used as internal determinants of performance which are equity to assets ratio, loan to assets ratio, non-interest earning assets to total assets ratio, short-term funding to total assets, overhead to total asset ratio, total liabilities to total assets, and ownership in addition to bank's size. Moreover, the study used external variables such as macroeconomic environment, regulation and financial markets. The regression analysis showed that there is a positive relationship between Islamic banks performance and capital to assets and loan to assets ratios. The higher the ratio, the more profitable the bank will be. The results also indicate the foreign-owned banks are more profitable than their domestic counterparts. Taxes effect negatively on bank's performance, while favorable macroeconomic condition impact bank's profitability positively. Furthermore, Bashir (2001) claims that since deposits in Islamic banks are treated as shares, reserves held by banks exert negative impacts such as reducing the amount of funds available for investment.

Brown (2003), also examined the Islamic banks efficiency of serveral banking systems across countries descripitvely from Middle east, North Africa and Asia over the period 1998-2001. The finding of the study indicated that Profitability, which measured by ROA and ROE, vary among countries for each year. The most liquid market, measured by liquid assets divided by customer and sort term funding, is in the Bahamas. Finally, when the cost efficiency scores are compared with the standard ratio cost efficiency measurement, cost to income, the correlations are not significant (Brown 2003).

Similar study that encomposed several variables in quest to examine the profitability of islamic banks as well as conventional banks was Alkassim (2005). By the use of regression analaysis Alkassim (2005) in the paper used three profitablity measure: return on equity (ROE), Return on Assets (ROA), and Interest margi, the paper also used six bank characteristics: banks's size, total equity to total assets, total loans to total assets, deposits to total assets, total expense to total assets, and non-interest expense to total expense. Results show that deposits have a positive relationship with conventional banks, but negative relationship with Islamic banks. 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).

Said &Tumin (2011) also conducted a study on the relatinonship between peformance and financial ratios of commerical banks. The aim of the study was to extablish the relatinoship betwen between the banks' internal factors and its financial performance, their results suggest that credit risk and operating expenses affect negatively the performance of banks in both countries in the case of return on asset (ROA), however, this is different in the case of return on equity (ROE). Therefore, in this case, credit risk and operating expenses have respectively a negative impact on Malaysian and Chinese banks performance. In addition, this study shows that bank performance in both countries is not affected by bank size and liquidity. Among researchers who also made contribution and studied internal determinants of bank performance are Bourke (1989), Sufian (2007), Al-Tamimi (2010), Said and Tumin (2010).

According to Sufian (2007), liquidity proved to be a significant factor of higher bank efficiency especially during the period of unstable macroeconomic conditions in Malaysia. Further, Sufian and Noor (2009) confirmed positive relationship between bank efficiency and level of capitalization in Islamic banks of Middle East, North Africa and Asian countries Rasiah and Devi Naga (2002) used liquidity as one of the independent variables of profitability of commercial banks in Malaysia and Singapore. Beck, Demirguc-Kunt and Merrouche (2010) measured financial stability of Islamic and conventional banks. As a result, they provided an evidence of higher capitalization and higher liquidity reserves of Islamic banks.

Similarly, Hassan and Bashir (2003) confirmed that higher level of capital of Islamic banks with results in higher level of profitability.Ahmednoor Hassan(2013) conducted a research titled evaluation of islamic banking products and financial performance of islamic banks in kenya, the study used linear regression to to measure the performance of key financial variables and financing contracts. The study indicated regression relationshiop between Islamic bank products and profit before tax is statistically significant. As a result, any change in the size of islamic banks produc will have effect on the earnings of the banks.

2.4.2 Local Evidence

Various local studies have also been undertaken to examine the effect of Islamic banking on financial performance. Kinyanjui (2013) undertook a study to investigate the challenges facing development of Islamic banking in Kenya. He adopted a case study approach focussing on four Islamic compliant banks in Kenya that included, First Community Bank; Gulf African Bank; Dubai Bank; Kenya commercial Bank Ltd and Barclays Bank Ltd. The population of the study consisted of 33 customers, who were the holders of accounts in the respective banks and 11 managers. Sample data collected by use of questionnaires administered by the researcher and a research assistant.

Data analysis method used is based on the quantitative approach using descriptive statistics: mean, mode, and median. Frequency tabulations and cross tabulations were used to bring out the finding of the study. The study revealed Islamic banking compliant was driven by religious compliance and customers need being met. It also revealed that continuous review and improvement of shariah compliant products together with diversifying market niche will lead to drastic development and marketing of Islamic banking products. The study concluded that the factors that influenced development of Islamic banking products in Kenya were purely religious compliance and customers need being met.

Kasmani (2013) did a study to examine the growth of Islamic banks in Kenya. The study adopted a descriptive research design with simple random technique used to indentify100 respondents to participate. The study findings indicated that religious, considerations represented one of the main reasons the respondents offered for opening an account with an Islamic bank. Muslims constitute the majority of the bank‘s customers with non-Muslims appearing to be underrepresented. The majority of the respondents were self-employed which is in line with contemporary thinking within the Islamic banking sector. Better product portfolio was another reason offered by the respondents for opening an account with Islamic banks.

Kadubo (2010) undertook a study to investigate the factors influencing the development Islamic banking in Kenya. The research adopted a case study design with the population consisting of 33 customers, who were the holders of accounts in the respective banks and 11 managers. Quantitative approach was used in data analysis. The study found religion as a key driver towards Islamic bank products, with diversification of products considered key in development of Islamic products. The study recommended a further research is required to establish factors that contribute to this slow pace of growth of Islamic products in Kenyan market.

2.5 Summary of Literature Review

The literature on Islamic banking has a long hsistory that spans from 1980s (Saleh 1986). Islamic banking practices are governed by theory and pracctices behing profit and loss sharing, murabaha, ijarah, and Bai Salam (Iqbal, 2000). Financial performance for banking institutions is influenced by factors broadly categoried as external and internal (Fredrcik, 2014 and Obamunyi (2013).

Various empirical studies on Islamic anking have been undertaken at both international and local spheres. From the international scope, the most relevant to this study include performance of Islamic banking contracts and sensitiveity to bank profits in Malaysia(Zulkifli (2007) and the relationship between perforamnce and financial ratios for Malaysia and chinese banks (Said and Tunin ,2011). Locally, similar studies sought to establish the challenges facing development of Islamic banks in Kenya (Kinyanjui, 2013), The gowth of Islamic banks in Kenya (Kasman 2013) and factors affecting the development of Islamic banking (Kadubo , 2010). While all the aforementioned studies provide acknowldgeable efforts that have been done in the area of Islamic banking, it is imporrtant to underscore that there has been limited efforts to link islamic banking contratcs and financial performance. It is thus on this basis that this study seeks to fill in this gap by examining the effect of Islamic banking constracts and financial performance for Islamic banks in Kenya.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents a detailed description of the research methodology adopted by the researcher in this study. The components of the methodology in this chapter include the research design, target population, sampling procedure and design, data collection instrument and procedures and data analysis.

3.2 Research Design

A research design is the structure of research. It is the glue that holds all the elements in a research process project together. A design is used to structure the research, to show how all of the major parts of the research project work together to try to address the central research questions. This study employed descriptive and diagnostic research design in order to explain the relationship between the variables under study. According to (Mugenda 1999) a descriptive study is undertaken in order to certain and be able to describe the characteristics of the variables of interest in a situation.

3.3 Target Population

According to Mugenda and Mugenda (2010), a target population is one that the researcher wants to generalize the result of the study while Burns and Grove (2003) describe population as all the elements that meet the criteria for inclusion in a study. The population of this study is Islamic commercial banks in Kenya which offer Islamic banking products. This study target two fully-fledged Islamic banks in Kenya, that offer Islamic banking products.

3.4 Sampling

Kothari (2004) defines a sample as a definite plan for obtaining a sample from a given population. Sampling is a procedure by which some elements of the population are selected as representatives of the total population through the use of probability to acquire a representative degree of reliability in the selected area. Two banks offering islamic financial products were studied in this study.

3.5 Data Collection Instrument and Procedure

Secondary data was used for this study. This means that the data used was quantitative in nature. The researcher used financial performance data for the years 2009 -2013. Data was obtained from financial statements, income statements, balance sheets and bank reports as well as data from internal sources.

3.6 Data Analysis

Bailey (1984) defined data analysis "as the process of packaging collected information, evaluating it, putting it into order and structuring its main component in a way that the findings can be easily and effectively communicated. In analyzing, the data was first edited, coded, tabulated and interpreted to check for clarity, completion and consistency of the information in relation to the research objectives. The analysis of quantitative data was carried out using SPSS (statistical package for social Science).

Regression analysis is applied to identify the contribution of the Islamic banking contracts to the Islamic banks earnings. The dependent variable is profit before tax and the independent variables composed of deposits contracts and financing. In order to determine reliability of the performance measure, ordinary least square estimation will be used to identify the beta and the t-values. The measure of the total exposure of the bank's earnings is by estimating the following linear equation:

$$Y_{it} = \alpha_i + \beta_i X_i + e_{it}$$

Where:

Y it = represents the return on assets for bank i in year t,

Xi = represents bank variables of financing contracts and bank consumer short term deposits, Where;

X1= The amount of Musharakah (partnership) Financing contracts

X2 = The amoount of Murabaha (Cost Plus Financing) Financing contracts

X3 = The amount of Mudaraba (finance by way of trust) Financing Contracts

X4= The amount of Ijara (Leasing) Financing contracts.

X5= The amount of Tawarruq

α_i = constant

$\beta_{i\ =}$ Coefficient

e_{it} = Error Term

This regression relationship will show the extent to which independent variables (Islamic contracts) influenced the dependent variable (Financial performance).This was be shown by the coefficient of the independent variable in each case. A correlation analysis was performed to find how variables related to each other in the model.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter provides an analytical presentation of the study the effects of Islamic banking contracts and financial performance of Islamic commercial banks. The findings have been presented as set out in the research methodology. The results include; a descriptive analysis of the two Islamic banks in Kenya, that is the first community bank and the Gulf African bank, profitability trends for the Islamic banks, and the relationship between the Islamic products and profitability. The data used in the survey was gathered exclusively from the selected banks websites as well as other relevant sources such as published central bank of Kenya and Kenya National Bureau of statistics reports.

4.2 Results and Discussions

The results and discussion section has been subdivided into background information of Islamic banks in Kenya, descriptive statistics of the amount of Islamic banking product, financial performance trend as measured in return on Assets, and inferential statistics on Islamic products in relation to financial performance.

4.2.1 Background information of Islamic Banks

Kenya has two main Islamic commercial banks, namely the first community bank and the Gulf African Bank. The first community bank is a commercial bank in Kenya and the largest in the economy of East Africa. The bank is licensed by the Central Bank of Kenya and national banking regulator. First Community Bank was established in 2007 according to Shariah law by private Muslim investors in Kuwait, Kenya and Tanzania. The bank has been in operation since 2008. According to CBK (2014), the banks total assets were valued at about US$130.85 million (KES 11.305 billion), with shareholders' equity of about US$14 million (KES 1.21 billion), and customer deposits of US$115 million (KES 9.932 billion). The Gulf African Bank (GAB) is a commercial bank in Kenya and licensed under the central bank of Kenya. As of December 2014, the Gulf African Bank was mid-sized financial services provider in Kenya. Gulf African Bank started operations in Kenya after receiving a commercial banking licence and authorization to establish a shariah bank from central bank of Kenya. It is the second commercial bank in Kenya to receive authorization to practice sharia banking after First Community Bank.

4.2.2 Descriptive statistics of the amount of Islamic banking products per year

The study provided an analysis of various Islamic banking products from the year 2009 to 2013. The Islamic products examined included; murahaba, musharaka, mudaraba tawarruq and Ijara. Table 4.1 to 4.5 indicate the amount of each of these products in different years.

Table 4.1 Amount of Islamic products in the year 2009

Islamic Contract	**Amount is billion (Ksh)**
Murabaha	1.91
Musharaka	1.5
Tawarruq	0.027
Mudaraba	0.153
Ijara	1.81

Source: Researcher 2015

In the year 2009, Murabaha was the highest amount of Islamic contract offered, while Tawarruq was the least offered product. The finding indicate that Ijara was also a common Islamic product though, compared to Musharaka and Mudaraba.

Table 4.2 Amount of Islamic products in the year 2010

Islamic Contract	Amount is billion (Ksh)
Murabaha	2.03
Musharaka	1.64
Tawarruq	0.027
Mudaraba	0.153
Ijara	2.03

Source: Researcher 2015

In the year 2010, murabaha amount was 2.03 billion compared to 1.91 billion in the year 2009, this recorded a growth of 6.2% of the product. Ijara recorded the highest growth of 12.1% with growth of Ksh 1.81 billion to ksh 2.03 billion. There was no growth recorded for Tawarruque and mudaraba products.

Table 4.3 Amount of Islamic products in the year 2011

Islamic Contract	Amount is billion (Ksh)
Murabaha	1.96
Musharaka	1.27
Tawarruq	1.07
Mudaraba	0.429
Ijara	0.83

Source: Researcher 2015

In the year 2011, murabaha amount was ksh 1.96 billion compared to 2.03 billion in the year 2010; this recorded a decrease of 3.45% on the amount of the product. Musharaka was ksh 1.27 billion, while tawarruq and mudaraba was ksh 1.07 and 0.429 billion respectively. A growth was recorded for tawarruq and mudaraba products while a decrease was recorded from Ijara contract.

Table 4.4 Amount of Islamic products in the year 2012

Islamic Contract	**Amount is billion (Ksh)**
Murabaha	1.49
Musharaka	1.21
Tawarruq	0.218
Mudaraba	0.153
Ijara	0.072

Source: Researcher 2015

In the year 2012, murabaha amount was ksh 1.49 billion compared to 1.96 billion in the year 2011; this recorded a decrease of 23% on the amount of the product. Musharaka was ksh 1.21 billion, while tawarruq and mudaraba was ksh 0.218 and 0.153 billion respectively. Ijara was ksh 0.072 billion.

Table 4.5 Amount of Islamic products in the year 2013

Islamic Contract	**Amount is billion (Ksh)**
Murabaha	1.73
Musharaka	1.70
Tawarruq	0.035
Mudaraba	0.190

Ijara	0.163

Source: Researcher 2015

In the year 2013, murabaha amount was ksh 1.73billion compared to 1.49 billion in 2012; this recorded an increase of 16% on the amount of the product. Musharaka was ksh 1.70 billion, tawarruque was ksh 0.035, mudaraba was 0.19, and Ijara was 0.163.

4.2.3 Trend in the amount of Islamic products in the period 2009-2013

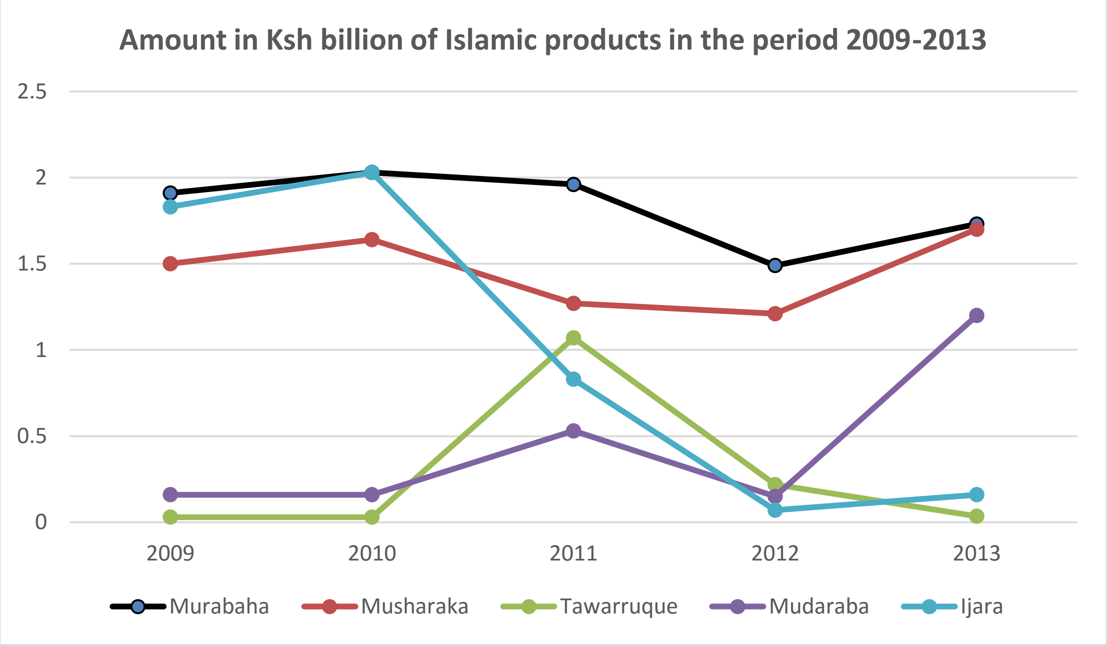

Figure 4.1: Trend in the amount of Islamic products in billion (Kshs) in the period 2009- 2013 (*Source: Researcher, 2015)*

Within the period 2009 -2013, it is notable murabaha product was the highest among all the islamic contracts offered. There is notable and unpredicatble fluctuations among the islamic products across the years. Musharaka and mudaraba indicated a steady level of growth.

4.2.4 Financial performance for the period 2009-2013 as measured by ROA

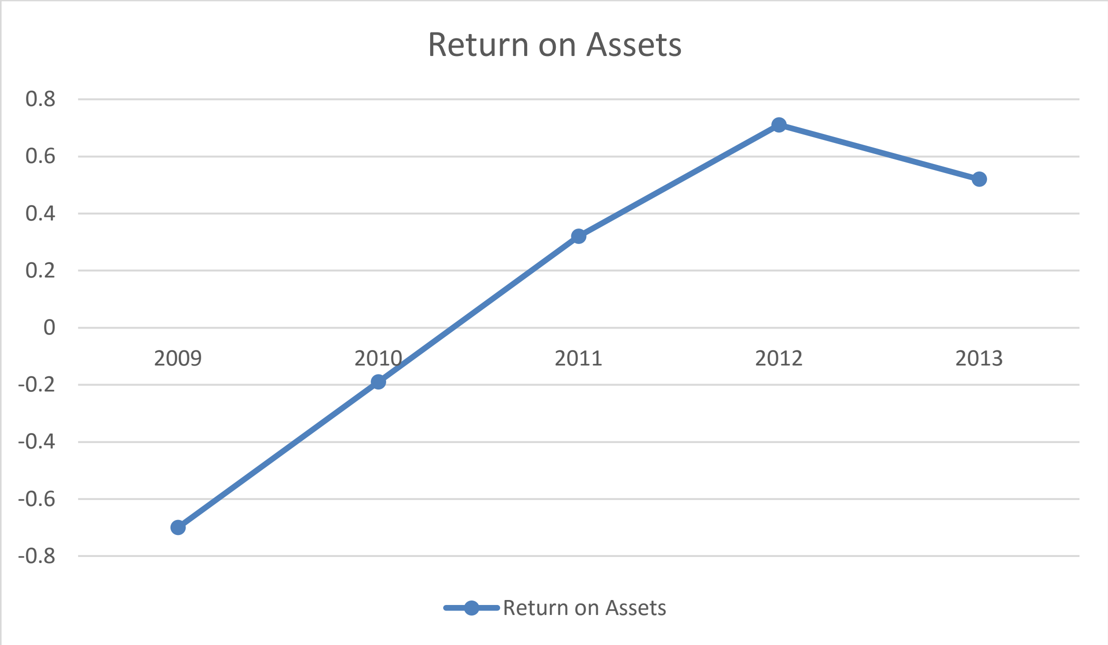

Figure 4.2: Financial performance trend for Islamic banks in the period 2009 -2013

The financial trend for Islamic banks offering financial contract has been on an increasing trend from a negative value in 2009, to a positive growth across 2011 and 2012. There was however a slump in the year 2013; a negative growth that could be associated with Kenya's 2008 and 2013 general elections.

4.3 Inferential Statistics

In order to draw inferences on the effect of Islamic contracts on financial performance of Islamic banks, further analysis to generate inferential statistics was undertaken. In determining the direction and nature of relationship between islamic banking products and financial performance , correlation analysis was undertaken to establish the nature and the direction of the relationship. In order to examine the strength of relationship, a multiple regression analysis was undertaken between financial performance (measured as return on investment) and islamic contracts.

4.3.1 Correlation Analysis

Table 4.6 : Correlation matrix between Islamic products and return on assets

	Financial Performance (ROA)	**Murabaha**	**Tawarruq**	**Mudaraba**	**Ijara**
Financial Performance (ROA)	1				
Murabaha	0.617**	1			
Tawarruq	0.159**				
Mudaraba	0.038*	0.176	-0.186	1	
Ijara	0.397	-0.312	-0.202	-0.441*	1

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

The correlation analysis of the study findings indicated that there was a positive correlation between various islamic products and financial performance as measured in return on Assets. For instance, Murabaha showed a strong positive correlation of 0.617, while Tawarruq showed a weak positive correlation of 0.159, Mudaraba had a week correlation of 0.038 while ijara showed a moderately weak correlation of 0.397. There was also a notably strong significant relationship between murabaha and retun on assets. This could be an indicator that murabaha is the most commonly sought islamic contract compared to other contracts. It can thus be deduced that increase in the islamic products is likely to increase the financial performance for Islamic banks.

4.3.2 Regression Analysis

In order to examine the strengh of relationship between Islamic products and financial performance of Islamic commercial banks, a regression analysis was undertaken.The regression relationship showed the extent to which each independent variable (Islamic contracts) influenced the dependent variable. This was shown by coefficient of the independent variable in each case.

Table 4.7: Summary of the regression model

Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**	**F change**	**Sig. F change**
1	858	0.736	0.736	0.54707	16.475	0.00

The Adjusted R is the coefficient of determination which tells the variation in the dependent variable (Financial performance) due to changes in the independent variables (Islamic contracts). From the findings on table 4.7 the value of R squared was 0.736 and indication that there was a variation of 73.6 % on financial performance due to changes in Islamic contracts murabaha, musharaka, Tawarruq, mudaraha and Ijara at 95% confidence level. R is the coefficient which shows the relationship between study variables. From the findings shown, in the table above, a strong positive relationship exists between the study variables as shown by an R of 0.858.

Table 4.7: Anova

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	16.546	2	2.364	16.475	.000
	Residual	1.578	23	0.143		
	Total	18.124	25			

From the Anova Statistics in table above, the processed data which is the population parameter, had a significance level of 0.00 which shows that the data is ideal for making a conclusion on the population parameters as the value of significance (value) is less than 5% **.**

Table 4.9 Regression Coefficients

Model		Unstandardized coefficients		Standardised Coefficients	t	Sig.
1		B	Std. Error	Beta		
	(Constant)	1.307	2.067			
	Murabaha	7.20-10	0.000	1.142	3.461	0.005
	Musharaka	4.36-10	0.000	0.739	2.582	0.026
	Tawarruq	5.11-08	0.000	0.656	3.413	0.006
	Mudaraba	6.83-09	0.000	0.56	2.929	0.014
	Ijara	1.22-09	0.000	0.114	1.067	0.309

Dependent Variable is the Financial Performance (measured by return on investment)

The established regression equation was $Y = 1.307 + 1.142X_1 + 0.739\ X_2 + 0.656\ X_3 + 0.56\ X_4 + 0.114\ X_5$. From the above regression equation, it was revealed that financial performance holding Islamic contracts to a constant, the financial performance for Islamic banks would stand at 1.307. A unit increase in the amount of Islamic contracts would lead to an increase in financial performance by coefficient factors 1.442, 0.739, 0.656, 0.56 and 0.114 respectively. The study found that all Islamic contracts examined had significant influence on financial performance of Islamic Banks. The

P- value for all independent variables was found to be less than 0.05 indicating that the variables were statistically significant.

4.4 Discussion of the Findings

The study was aimed at examining the effect of Islamic contracts on financial performance for Islamic commercial banks in Kenya. The study focussed on five Islamic contracts that is Murabaha, Musharaka , Twawarruq Mudaraba and Ijara. Data on the amount of these islamic contracts was measured compared to financial performance in the period 2009 to 2013. The findings indicated a fluctuating trend as far as Islamic contracts were concerned. These trend could however be associated with other factors outside Islamic banks such as Kenya's general elections. There is an indicative uptake of Islamic products with murabaha being the most offered and sought for Islamic contract. Uptake of Islamic contracts is a religious driven exercise and therefore Islamic banks have to tie the products they offer with compliance with shariah. These findings consur with Kinyanjui (2013) findings that indicated that Islamic banking was driven by religious compliance and customers needs being met.It thus confirms Kinyanjui's observations that factors affecting Islamic banking in Kenya is purely religious.

Various products have different uptake among customers. This probably explains why murabaha and mudaraba had relatively high uptake compared to other Islamic product. This observation concur with Kasmani (2013) who indicated that product fortfolio was a reason why customers open accounts with Islamic banks. Islamic banks play a key role in influencing financial performance of Islamic commercial banks. Based on the findings in this study, all Islamic contracts examined yielded a positive correlation with banks financial performance as measured in return on assets.

These findings consur with Kadubi (2012) who indicated that the key drive towards Islamic bank products was diversification of products considered key in development of Islamic products.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter provides a discussion on the effect of Islamic banking contracts on financial performance for Islamic banks in Kenya.The chapter has been sectioned into; summary, conclusions and recommendations.

5.2 Summary of the Finding

The findings on Islamic commercial banks was derived from the two Islamic commercial banks in Kenya. There is notabale offer of Islamic contracts within the periods 2009-2013. The amount of Islamic contracts fluctuated from one year to to another with murabaha contract being the highest and showing steady levels of uptake among the customers. Uptake of Islamic contract was based on the nature of the product and extent of compliance with shariah.

There is observable increase in the financial performance for the banks offering Islamic contracts. Strong postive correlation coefficients of 0.617 was obtained between financial performance and murabaha while, Tawarruq showed a weak positie correlation of 0.159, Mudaraba had a weak correlation of 0.038 while injara showed a moderately weak correlation of 0.397.

There is a variation of 73.6 % on financial performance due to changes in Islamic contracts murabaha, musharaka, Tawarruq, mudaraha and ijara at 95% confidence level. A strong positive correlation of 0.858 exists between Islamic contracts and financial performance for Islamic banks. From the study findings, financial performance as a function of Islamic contracts could be expressed as; $Y = 1.307 + 1.142X_1 + 0.739 X_2 + 0.656 X_3 + 0.56 X_4 + 0.114 X_5$. This means that from a constant of 1.307, a unit increase in the amount of Islamic contracts would lead to an increase in financial performance by coefficient factors 1.442, 0.739, 0.656, 0.56 and 0.114 respectively.

5.3. Conclusion

The study concludes that the performance of Islamic commercial banks is influenced by Islamic banking contracts that includes Murabaha, Musharaka, Tawarruq, mudaraba and Ijara. A variation of 73.6% of the financial perforamance as a result of Islamic contracts indicates that this may not be the only factor that determine the finanncial perfomance of these banks. There might be other factors in place that could probably be considered during further analysis of this area of study. Of importance to note in this study was the low financial performance for the years 2009 and 2013, this could probably be explained by the country's state of political stability during this periods. This would imply that most investors are willing to sign into Islamic contracts when the political situation is stable enough for favourable investments.

Different Islamic contracts have different uptake among customers. This could probably explain why murabaha has highest amount across 2009 to 2013 compared to other products. It could also explain the products that customers find rewarding in terms of returns on investsment. For growth and increased performance of Islamic commerical banks, the product mix become an important factor in determining how fast and profitable the institution could grow as a result of Islamic banking products.

5.4. Recommendations for Policy

After successful completion of the effects of Islamic contracts on financial performance for Islamic banks in Kenya , the following recommendations for policy were made. Islamic banking is an upcoming financial innvovation and therefore an important adoption not only for Islamic banks but also all other banks. It is thus recommended that the management of other non islamic banks in Kenya that have not yet adopted Islamic banking to consider adoption of shariah compliant banking policies.

Some Islamic contracts have higher uptake among customers compared to others. A policy by the management of commerical banks to profile Islamic products based on their uptake would be important. This would act as a guiding tools towards investing in products that could probably provide high returns and also reducing the costs incurred in products that are less consumed. The governement should easen the licensing process for Islamic banking products. This will make it easy for banks wishing to provide Islamic banking to adopt the Islamic banking products and reach out to many customers.

5.5. Limitations of the Study

The study was limited to the few Islamic products available among Islamic commerial banks. Kenya has only two banks offering fully-fledged islamic banking. This means that information provided in this study was only limited to this study. The nature of data used in this survey was secondary and thus the researcher was faced by the limitations associated with secondary data.

The secondary data used in this study was not collected to ansswer the specific research question and therefore it was hard for the researcher to get particular information specific to this study. The variables collected were defined and categorized differently from what the researcher would have chosen. For instance, data availabe was categorised interms of volumes of islamic products upto the year

2013 rather than 2014. The data available was also difficult for the researcher to access and therefore it took more than expected time.

The researcher did not participate in the planning and execution of the data collection process and therefore does not know exactly how the data was done. The reseacher was therefore not able to take into account all the aspects of validating data in the data collection process. The secondary data set obtained by the respondent did not provide information on data documentation process or collection procedure, response rate, and other technical information during data collection process.

5.6. Suggestions for Further Research

The study established fluctuating trends as far as the uptake of Islamic banking contracts is concerned. It is therefore important to carry out a further study on the factors affecting uptake of Islamic contracts in Kenya. Financial performance of Islamic commerical banks may be influenced by other factors not examined in this study, it is thereore important to examine other factors affecting financial perfoamnce of Islamic commercial banks other than Islamic contracts.

The fact, that only two commercial banks offer full fledged Islamic product could be an indicator of the unexploited potential as far as the Islamic banking is concerned. Further study should therefore be undertaken on regulatory procedures and their effect of ease of doing business for Kenya's Islamic banks. Operating in a conventional set up is posing performance and non Shariah compliance risk. This is associated with many restrictions in the way all transactions are to be handled. A further study on the extent of implementation of islamic banking restrictions shoould therefore be carried out.

The study found out that islamic banking play a critical role in some segment of the economy. As such it is important to carry out a study on the the potentail for islamic banking in enhacing economic growth. Is there a difference between conventional banking and islamic banking in terms of how they are affected by ban or accepance of issuance of interest ? to what extent are islamic banking dealing with factors such as inflation and other fiancial risk without interest charges?

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APPENDICES

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

1.Gulf African Bank Limited

2.First Community Bank Limited

3. Kenya Commercial Bank Limited

4. National Bank Limited (National Amanah)

5. Barclays Bank of Kenya Limited (La Riba)

6. Standard Charted Bank Limitied (Saadiq)

7. Chase Bank Limited (Chase Iman)

8. Dubai Bank Kenya

9. Middle East Bank Kenya

Source: CBK 2014

APPENDIX II: LIST OF FULLY FLEDGED ISLAMIC BANKS IN KENYA

1. First Community Bank Limited
2. Gulf African Bank Limited

Source: CBK (2014)

APPENDIX III : DATA COLLECTION SCHEDULE

1. Bank Profile...
2. Year of Establishment ....

ISLAMIC CONRACTS AND FINANCIAL PERFORMANCE

	2009	2010	2011	2012	2013
Financial performance in terms of (ROA)					
Amount of Musharaka					
Amount of Mudaraba					
Amount of Murabaha					
Amount of Injara					
Amount of Tawarruq					