EFFECT OF ISLAMIC FINANCE ON PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

I declare that this research dissertation is my original work and have not been previously published or submitted anywhere for the reward of a degree. I also declare that this contain no material written or published by other people except where due reference is made, and author duly acknowledged.

Name: Signature……

Reg. No.: 19/00596 Date……

I do hereby confirm I have examined the master's research dissertation of FREDRICK OKELLO AKONGO, Reg. No:19/00596

And have approved it for examination.

Signature…… Date……

Dr. Fatoki Lanre

DEDICATION

I dedicate this research project to the entire Akongo family especially my wife Hellen Magdalene and our children Andrew, Austin and Amelie for their moral support all through my studies.

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LIST OF ABBREVIATIONS AND ACRONYMS

GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
IFSB	Islamic Financial service Board
R**OE**	Return on Equity
ROI	Return on Investment
SACCOs	Savings and Credit Cooperatives
SPSS	Statistical Package for Social Sciences

DEFINITION OF TERMS

Financial Performance: Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues (Alkhazaleh & Al-Dwiry, 2018).

Ijara products: It is a contract between a customer and a financial institution whereby the financial institution purchases a real estate or equipment upon a request by the customer and then rents it to the customer (Alkhazaleh & Al-Dwiry, 2018).

Islamic Finance: Refers to the financing activities that are compliant with the sharia law as well as its application in the development of Islamic economics (Abduh & Omar, 2012).

Mudaraba contracts: Refers to a financial instrument, equivalent to trust-based financing, used to fund short-term as well as medium-term business engagements such as retail trade (Azkanar, 2016).

Musharakah contracts: Means partnership and is a project that is jointly held by the financial institution and the customer in which both the customer and the bank sign a partnership agreement under the product, in which both of them agree to finance the project (Asmadi, 2017).

Performance: Refers to the completion of a task having attained the preset objectives and goals (Zafar & Nor, 2019).

ABSTRACT

The main aim of this study was to establish the effect of Islamic finance on the performance of commercial banks in Kenya. The study was guided by three specific objectives which are to; establish the effect of Mudaraba loans on commercial banks' financial performance in Kenya, assess the effect of Ijara products on commercial banks' financial performance in Kenya and assess the effect of Murabaha contracts on commercial banks' financial performance in Kenya. This study used a descriptive research design. The study was undertaken in the two completely established Islamic commercial banks in Kenya as well as the 5 conservative banks offering partial Islamic commercial banking. 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 2015-2019. Descriptive statistics was utilized to organize Data. To scrutinize the data, descriptive analysis such as standard deviation, frequencies, mean, as well as percentages were utilized. Additionally, Pearson correlation as well as multiple regressions which are inferential statistics were utilized. So as to come up with a reliable model for this survey the researcher carried out appropriate diagnostic tests. The study established that Murabaha is the most common Islamic finance products though the Ijara was also significant. The findings also showed strong positive relationship between Murabaha and bank performance. From the study findings it was evident that there was a positive effect of Ijara on bank performance. Mudaraba had a positive insignificant effect on bank performance. Based on the findings, the study concluded that the Islamic finance affected bank performance with some having a positive significant effect and others insignificant effect. The study recommended that commercial banks in Kenya should sensitize its customers on the need to promote partnership through financing business ideas. Also among the most recommended measures put in place is by selecting key financial and other indicators to monitor programs based on the statutory requirements on Islamic banking products. Developing systems for managing future performance based on the statutory requirements is also highly recommended.

Key words: Financial Performance, Islamic finance, Mudaraba loans, Ijara products,

Commercial banks, Musharakah contracts.

CHAPTER ONE

INTRODUCTION

1.1 Background of Study

Islamic finance is well known for promoting the sharing of risk and rewards between the financers and the borrowers, by so the degree of sharing the risks varies by the type of contract agreed upon by the parties involved (Khrawish, 2015). The basic principles underlying Islamic financial transactions and which are the guidelines to all Islamic finance practices are that the financing purpose should avoid all activities prohibited by Sharia (Islamic Laws), should avoid gharar this involves; risks, uncertainty, and speculation activities and also must avoid Riba which involves; interest receiving and giving activities (Chatti, Kablan, & Yousfi, 2016). These principles and the other doctrines of Muslim faith are incorporated in Islamic finance to meet the growing global demand for sharia-compliant investment and financing.

Originally, Islamic finance came about as an intermediary for the Islamic people to access financial services that were in tandem with the Islamic laws. According to Henry and Wilson (2014), since its launch in Dubai in the years1975, Islamic finance has significantly grown with the number of clients increasing considerably. Islamic banking has thus come out as one of the fastest growing sectors during the last three decades. As Iqbal, Munawar and Molyneux (2015) sattes, it has been accepted by both Muslims and Non–Muslims thus spreading across the globe.

In many African countries Islamic banking and finance has become a showpiece and a number of market development and regulatory efforts have taken place in the recent years. Necessary legal and regulatory framework have been put in

place by countries to enable Islamic Banking and Finance services to be offered in their respective jurisdiction (Negara Malaysia, 2017). According to Malaysia World's Islamic Finance marketplace in their book Islamic finance in Africa (2017), in Africa, there is a clear set of potential for Islamic banking growth with intention to diversify their sources of funding.

In Kenya, according to Hussain, Shahmoradi and Turk, (2014), the financial regulatory agencies of Kenya are ready to allow Islamic finance and Banking to thrive and plans are there to make Kenya a hub of Islamic finance in the Eastern region. Currently Kenya is the leading in Islamic Banking regionally and by so it has to fully operating Islamic Banks and the third once currently being authoresses to operate in Kenya (Hussain, Shahmoradi, & Turk, 2014). Kenya also has an Islamic insurance company recognized as Takaful, a sharia- compliant mutual fund, and two Savings and Credit Cooperatives (SACCOs) namely, the Taqwa Sacco as well as Crescent Takaful Sacco. Additionally, it has been included to the Islamic Financial service Board (IFSB), a Malaysia based body that regulates and promotes transparent and sound Islamic finance services globally (Hussain, Shahmoradi, & Turk, 2014).

1.1.1 Islamic Finance

Islamic finance refers to how businesses and individuals raise capital in accordance with Sharia, or Islamic law (Abduh & Omar, 2012). It also refers to the types of investments that are permissible under this form of law. Islamic finance can be seen as a unique form of socially responsible investment. Asmadi (2017) states that there are multiple number of products in the Islamic finance. Most of these products are similar although they have different uses. Musharakah which means partnership in

Arabic is a project that is jointly held by the financial institution and the customer. It is a requirement that both the customer and the bank sign a partnership agreement under the product, in which both of them agree to finance the project. The parties in the Musharakah arrangement share the losses in the ratios of their financing in the project. Working capital can be provided to companies or joint ventures in sectors such as agriculture and real estate using Musharakah contracts. Asmadi (2017) states that this form of contracts is often used for funding long-term investment ventures.

Mudaraba is another financial instrument that Islamic financial institutions aggressively use. This instrument is used to fund short-term as well as medium-term business engagements such as retail trade. Naseem (2014) states that in the traditional financial structure, the Mudaraba contracts are equivalent to trust-based financing. The proceeds of the investment is shared between the financial institution and the business person in the ratios agreed upon at the contract signing stage. Naseem (2014) adds that the parties do not have a fixed amount of money that they share, but agree during the completion of the contract on the proportions of sharing the profits whereby 15 to 30% of the profits usually goes to the Islamic financial institution. In case losses occur, the financial institution bears them all and the trustee (the Mudarib) is not rewarded for its efforts. The trustee cannot source for funds elsewhere, neither can it use its own money for the project. Moreover, the Mudarib cannot utilize the finances for other projects not included in the contract without the client's authority.

Another Islamic financial product is Ijara which, in the traditional financial structure is equivalent to lease transactions. According to Asmadi (2017), Ijara is a contract between a customer and a financial institution whereby the financial

institution purchases a real estate or equipment upon a request by the customer and then rents it to the customer. The parties agree on the duration in which the lease will run as well as the rent fee which can either be time-varying or fixed. The Islamic financial institution, in the Murabaha contracts, offers trade financing. A contract of sale of goods goes along with Murabaha which is arranged between the customer and the bank at a price agreed upon by the parties. Upon the request of the customer, the bank purchases the merchandise such as component parts and raw materials. The bank then sells the goods to the customer and makes profit from selling the goods as well as charging for the availed services (Naseem, 2014). Once the contract has been signed, the bank avails to the customer in advance, the date as well as the place where the specified goods will be received and proceeds to deliver the goods to the customer. The Islamic financial institution endures all the damage and spoilage risks before availing the goods to the customer.

1.1.2 Performance

Performance refers to the completion of a task having attained the preset objectives and goals (Zafar & Nor, 2019). Performance evaluation enables the organization to assess its efficiency and effectiveness over a period of time by comparing with its objectives or with market leader to overcome its weaknesses. Researchers explored a number of indicators to measure organizational performance. It is reported that an organization can maximize the customer satisfaction for better profitability, increased sales volume that ultimately improves its performance for long term benefit (Badreldin, 2017). Generally, performance is assessed by the application of financial measures. Financial performance is a subjective measure of how well a firm can use

assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Badreldin, 2017). There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as loans and advances, deposits, total interest income, total interest expense, other costs and other indicators are used in measuring performance of a commercial bank. Rashid et al. (2016) measured firm's financial performance using the financial indicators such as return on assets, return on investments and current ratios. Financial ratios reflect the financial performance of the organization by an examination of financial statements as indicated by profitability, liquidity, leverage, asset utilization and growth ratios (Ho & Wu, 2016).

Return on Assets (ROA) is a ratio of Income to its total asset (Khrawish, 2017). It measures the ability of the bank management to generate income by utilizing company assets at their disposal; it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the management of a company in generating net income from all the resources of the institution (Khrawish, 2017). A higher ROA shows that the company is more efficient in using its resources (Wen, 2018). According to Parsa and Muwlazadeh (2016) Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. It reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet.

1.1.3 Commercial banks in Kenya

According to CBK (2018) Supervision Report as of December 2018 out of the 43 commercial banks 29 of them are domestically owned and 14 are foreign owned. In terms of asset holding, foreign banks account for about 34% of the banking assets as of 2018. The Kenyan financial system is dominated by commercial banks as financial intermediaries that act as conduits between the surplus economic units and the deficit economic units (Musyoki & Kadubo, 2018). According to Rose (2017), a commercial bank is simply a business corporation organized for the purpose of maximizing the value of the shareholders' wealth invested in the firm at an acceptable level of risk. Obtaining a positive net income is imperative for permanency and sustainability.

Commercial banks are licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued thereunder. They are the dominant players in the Kenyan Banking system and closer attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with the laws and regulations (Musyoki & Kadubo, 2018). The banking industry has been earmarked as a key pillar to the achievement of vision 2030 (a long-term strategy to achieve sustainable growth by year 2030) through increased savings, encouragement of Foreign Direct Investment (FDI), safeguarding the economy from external shocks as well as propelling Kenya to become a leading financial center in Eastern and Southern Africa.

Sharia- compliant or Islamic commercial banking is a quickly developing fragment of financial sector in Kenya, since its inception. The impact of Islamic finance sent strong signals to Kenya's financial services sector to the point of being

highlighted in the latest amendments to the Finance Act (2008), which was amended to include a requirement by all institutions to pay revenue on all investment accounts operated and kept as per the Islamic law. The change applied to organizations offering Islamic finance products which did not allow payment of interest (CBK, 2019). The totally Sharia complaint banks, First Community Bank and Gulf African Bank, have made a solid advance to the 8 million Muslim in Kenya, as well as to the rest of the conventional customers as witnessed by the numbers of conventional bank clients who switched over to these Islamic institutions.

First Community Bank Limited was the first commercial bank operating entirely under Islamic Sharia principles to be licensed to operate in Kenya (Othman, Maji, & Rahman, 2017). In January 2008, Gulf African Bank commenced its operations in Kenya as the first fully fledged Islamic Commercial Banks to operate in Kenya. Conventional banks have not been left behind in offering Islamic commercial banking products. These banks include KCB, Standard Chartered, Barclays Bank Kenya, National Bank Kenya, Equity bank and Chase Bank.

1.2 Statement of the Problem

The Kenyan banking sector is one of the fastest growing and competitive market in Sub-Saharan Africa with high returns which has eventually led to a lot of creativity and changes in the banking sector (KBA, 2018). The operational modes of most banks have changed in order to meet the market demands in a special and quick banking system. Islamic banking is one of the new services offered in both Islamic commercial and conventional banks in Kenya but not all convectional commercial banks offers this services (KBA, 2018). In Africa, there is a clear set of potential for Islamic

finance growth with intention to diversify their sources of funding. Islamic financial services have a strong demand in the current Africa due to the demographics. With the emerging of proper financial inclusion, Islamic finance stands a chance to offer a better solution in Africa.

Although Islamic finance has expanded so much beyond traditional boarders, the global environment has become increasingly challenging; an environment that is subject to powerful forces of demand from Muslim population in the country, unstable market conditions, misconceptions against Islamic finance, heightened competition, documentary complexity, lack of qualified and skilled personnel in Islamic finance, rising cost-to-income ratio and brand recognition (Adano, 2016). These challenges may have a negative effect on the financial performance of commercial banks. In Kenya Islamic banks are not separately defined in the Banking Act. All banks including those operating pursuant to Islamic Banking principles are subject to the requirements of the Banking Act. There is high demand for Islamic financial products against a negligible supply of the same (Ndung'u, 2017).

There was a gap in Islamic finance related literature with regard to the financial performance studies. Local studies done on Islamic finance included; Halkano (2017) who in his study on performance of Islamic and conventional commercial banks in Kenya, which was a comparative case study, indicated that on the whole, the conventional commercial banks performed better than the Islamic banks during the period under review. Ahmednoor (2012) also carried out a study on evaluation of Islamic finance products and financial performance of Islamic banks in Kenya. The study focused on profit as well as financial performance and it was

centered on Islamic banks performance in Kenya. However, the study concentrated only on the banks (commercial) that were fully Islamic banks. Jafar (2016) did a study on how Islamic finance impacted upon the conventional banks' financial performance in banks providing products of Islamic banking in Kenya. Conventional banks providing Islamic products were the sole focus of the survey. Many studies have been conducted on Islamic finance and its affects commercial banks' financial performance in other countries like Malaysia, Pakistan and Indonesia. Conversely only few studies had been conducted in Kenya and the few that had been done focused on either the fully Islamic banks or the conventional banks offering Islamic products. The study sought to bridge this gap by investigating the effect of Islamic finance on the performance of both the Islamic and conventional commercial banks in Kenya.

1.3 Objectives

1.3.1 Broad Objective

The main aim of this study was to establish the effect of Islamic finance on the performance of commercial banks in Kenya.

1.3.2 Specific Objectives

The study was guided by the following specific objectives:-

i). To establish the effect of Mudaraba loans on commercial banks' financial performance in Kenya

ii). To assess the effect of Ijara products on commercial banks' financial performance in Kenya

iii). To evaluate the effect of Murabaha contracts on commercial banks' financial performance in Kenya

1.4 Research Questions

2 What is the effect of Mudaraba loans on commercial banks' financial performance in Kenya?

3 What is the effect of Ijara products on commercial banks' financial performance in Kenya?

4 What is the effect of Murabaha contracts on commercial banks' financial performance in Kenya?

1.5 Significance of the Study

The study might be important to the bank management in identifying banking system weaknesses in an effort to improve on service delivery and offer more satisfaction to customers. The study might also be important to other stakeholders in the banking industry as it might provide insights into how Shariah-compliant banks in Kenya sustain Islamic financing, and the challenges and/or opportunities that are encountered. In addition, the study might inform policymakers in the formulation of relevant and effective policies aimed at streamlining the Islamic banking system.

Additionally, the study made contributions to the current pool of knowledge in the Islamic financing area. It might also act as a basis for further research. The findings might benefit future research intended at filling the existing gaps in literature and scholarly work. The final report will be placed in libraries where academicians and researchers can access it and use it as a reference document. The academicians and researchers can use the findings to add knowledge and do comparative studies.

1.6 Scope of the Study

The study sought to investigate the effect of Islamic finance on the commercial banks' performance in Kenya. The study was located in Gulf African bank as well as First

Community Bank Limited which are the two completely established Islamic commercial banks in Nairobi as well as the Standard Chartered Bank of Kenya, National Bank of Kenya, Barclays bank of Kenya, Kenya Commercial Bank and Diamond Trust Bank of Kenya which are the 5 conventional banks offering partial Islamic commercial banking. Comparisons were done between theories and works done by various authors in the same field, as well as in practice, using interviews, so as to generate reliable information fit for this study.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In this chapter, literature related to the effect of Islamic finance on the commercial banks' performance was reviewed from the past 5 years between 2015 and 2019. Specifically, the study sought out for information on what other authors have found out about Mudaraba loans, Ijara products and Murabaha contracts and how they affect commercial banks' performance. This literature was reviewed in a bid to identify the gaps that exists in literature and which the present survey will seek to seal. The review identified the existing gaps in both context and methodology used by the different scholars. The review also highlighted what other nations have done in order improve the performance of commercial banks.

2.2 Theoretical Framework

The purpose of theoretical review was to concretely examine the corpus of theory that had accumulated in regard to the concept of Islamic banking. The theoretical review helps to establish what theories already exist, the relationships between them, to what degree the existing theories have been investigated, and to develop new hypotheses to be tested. This study was anchored on the agency theory, Chapra theory of Islamic banking and the theory of Islamic banking.

2.2.1 Agency Theory

Alchian and Demsetz (1972) as well as Jensen and Meckling (1976) are the originators of the agency theory. The theory as defined by Jensen and Meckling (1976) is the relationship that exists between stockholders that they refer to as the

principals and the business managers and executives who they refer to as the agents. The theory appreciates the contractual outlook of the firm. Therefore, the agency problem comes about in the bid of separating the company's management from the company's financiers. Melyoki (2005) postulates that the relationship that exists between the principal and the agent is valuable allows the shareholders to participate as the bearers of risks (principal) who employs and keeps the agent who is capable and knowledgeable and has certain talents necessary for increasing the value of the investment of the principal by efficiently allocating resources. In this principal-agent relationship the agent only enjoys a part of the outcomes of his efforts.

The theory is based on the assumption of goal conflict between the principal and the agent (Jensen & 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). Therefore, the agency theory advocates for closely checking up on the agents because they are prone to working for their interests as opposed to working for the interests of the financiers (principals). The close checking ends up with agency costs that are incurred in the alignment of the shareholders' interests with those of the executive and reducing the inefficiencies that might arise internally. 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.

In the financial field, commercial banks act as intermediaries (agents) between lenders (depositors) and borrowers (investors). According to this theory, two parties have an agency relationship when they cooperate and engage in an association where in one party (the principal) delegates decisions and /or work to another (the agent) to act on its behalf, (Boatright, 2010; Zu & Kaynak, 2012). Agency theory submits that agents tend to engage in self-serving, opportunistic behavior when opportunities arise. The theory resides on the mismatch of goals, risk and information between agents and principals, and that both agents and principals act in their own self-interest. Zu and Kaynak (2017) further asserts that the agency theory is premised on five major assumptions, i.e. potential goal conflicts exists between principals and agents; each party acts in its own self-interest; information asymmetry frequently exists between principal and agents; agents are more risk averse than the principal; and efficiency is the effectiveness criterion. Rowe (1982) criticized this theory and argued that all these are caused by human actions and that some humans may subjugate their self-interests and act in the broader interest of the organization. Thus, the philosophy of incompatibility of interests does not always hold.

The assumptions and prescriptions of the agency theory fit well with bank financial performance determining factors, which was the main objective of this study. Islamic ethical values and moral code contribute to good agency relationships. The agency theory will help managers build a close bank-customer relationship, customer-centric solutions, that will increase customer loyalty by management providing early feedback of potential agency problems perceived by customers and investors (Zu & Kaynak, 2012).

Agency theory predicts that incentive pay should be tied to performance relative to comparable firms, not absolute performance. And indeed, early studies found that changes in CEO cash compensation were negatively related to industry and market performance, but positively related to firm performance. The theory was relevant in this study in explicating the agency problems that exist under the Mudaraba contracts. According to Shaikh (2015) the fact that Rabb-ul-Maal is the only one who shoulders all the financial losses is one of the key challenges in using Mudaraba for financing. Consequently, if in the Mudaraba contract the Islamic bank has become a party as a Rabb-ul-Maal, all the losses emanating from the contract will be borne by the bank. Even if he bears the sole authority of transacting the business affairs, the fund manager (Mudarib) shoulders no loss. According to Shaikh (2015) unlike in venture capitals where the investor has the freeway of including some clauses to deal with the agency problem, hire and fire the board of directors as well as the board of management, the Rabb-ul-Maal has no room for taking part in the day to day operations of the business. The Mudarib behaves like an employee of the organization whenever a loss comes about, but when the company makes profits he shares in them as if he is the only one who made it possible.

2.2.2 Chapra Theory of Islamic Banking

The Chapra theory of banking was advanced by Chapra (1982). The main argument behind this model was based on the assumption that purchasing power of parties to financial transaction agreements was founded on credit advancement. Furthermore, the argument is advanced that if justice and equity is seen to be served then every time the bank accrues any interest this should be bequeathed to the

government. This model was interested in equity financing espoused by private financial institutions where profit making often seems to be the overriding aim for their operations (Mokhtar, Abdullah, & Alhabshi, 2008). Emphasis was laid on medium-sized banks which did not wield so much power or were too small to be economical.

The Chapra model of banking further outlawed riba (interest), maintaining that it is essential for the Islamic banks to emphasize on the common customer's interests, without singling out group or individual preferences (Chapra, 1982). According to this model, Islamic banks are viewed on the basis of a middle ground between conventional banks in the mainstream financing market and small banking institutions where the shift focuses more on the interest of the customers as opposed to those of the financiers. This is as opposed to orthodox banks which depend heavily on collaterals as a way for mitigating risks (Mohamed, Abdulle, & Salina, 2012).

Chapra (2008) was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. He therefore preferred medium-sized banks which are neither so long as to wield excessive power nor so small as to be uneconomical. Chapra (2008) scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Haron (2004) has presented a detailed and elaborate framework of Islamic banking in a modem setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It

adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone (Rashid, Sambasivan & Johari, 2003). Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Haron (2004) model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that riba-free banks could coexist with interest-based banks.

Unlike conventional banks which depend heavily on the crutches of collateral and of non-participation in risk, Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing (Siddiqui, 2008). Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges (Chapra, 2008).

Chapra (2008) and others have held the view that the collateral itself is wide-open to a valuation risk and also stated that collateral value could be lessened by the same reason that decreases the debtor's capability to pay back. The Muslim academics support shari’ah law compliance and have the view of using profit and loss sharing

system and which may reduce this problem (Sufian & Chong, 2008). They maintain that without this system of profit and loss sharing, banking institutions will not always commence a thorough assessment of the collateral and the customer's credit worthiness and will spread financing for any purpose (Chapra, 2008).

This theory further envisioned a scenario where, given that there is no emphasis on profit and loss making in unconventional banking otherwise called Islamic banking, the relationship between the customer and the financial is more enhanced than in the case of conventional banking (Muhammad, 2011). Essentially, due to the ban on interest in the Islamic banking, the question of mortgage financing needs a different approach if it has to make much sense to the customers and the public in general. This is due to the fact that there is no possibility of resorting for any assistance from the exchequer in the event that there are any suspected bad deeds by either of the parties involved in the financial agreement (Mervyn & Lewis, 2010).

The theory was relevant in explaining the Ijara products. According to Chapra (1982), there are always other ways of raising money by the banking institutions without necessarily turning to the central bank for assistance whenever they feel that their existence is threatened. This suggestion negates the craving for interests by banks as almost the only sure way of making an extra coin.

2.2.3 The Theory of Islamic Banking

It was not until 1970s that the theory of Islamic banking came into existence. This was done majorly due to the plea of replacing bank lending interest by sharing of profit. This changed the concept of money related intermediation, making various players to share enterprise risk with the store clients (Ismail, 2010). Fairness was the

primary attention by early researchers. It was seen to be unjust for end-user businessman to endure all the business risks while permitting financier and bank guarantee a foreordained profit. The manner in which profitable endeavors were led did not guarantee a positive return. Therefore, regardless of the consequences of big business, there existed no security for cash investment guaranteeing a positive yield.

Muslim economists have pointed out that it is a historical accident that interest has become the kingpin of modern banking (Abdus, Norman, Gardner, & Bradley, 2005). The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Muslim scholars recognize the important role banks play in the economy of a country in modern times. Banking institutions act as financial intermediaries between savers and investors. They can be of significant help in assisting the process of capital formation and development (Ayub, 2002). The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental teachings of the Qur'an and the Sunnah. Since banks perform a useful service of financial intermediation, they are wholly acceptable in a Muslim society.

Theoretical work by Muslim scholars has sought to demonstrate that it is possible to run an economy without interest even in modern times. Replacement of interest based banking by interest-free banking has received the greatest attention in this endeavor (Bessis, 2008). The basic postulate that has guided all theoretical work on Islamic banking is that while interest is forbidden in Islam, trade and profit is permissible. Muslim scholars have developed a radically different model of banking which does not make use of interest. It relies instead on profit/loss sharing for

purposes of financial intermediation (Sadaqat, Akhtar & Ali, 2011). The earliest references to the reorganization of banking on the basis of profit/loss sharing are found in the writings of certain Muslim scholars in the late forties and early and mid-fifties of this century. The sixties and seventies saw more elaborate formulations of the concept of Islamic interest free banking. The subsequent period has witnessed further refinements in the theory of Islamic banking (DeYoung & Rice, 2004).

Theoretical work on Islamic banking encompasses several aspects related both to the operating procedures of Islamic banks and the possible socioeconomic consequences of the adoption of the new system (Hassan, Mohamad & Bader, 2009). The theoretical underpinnings of Islamic banking rests on equity, fairness and making allowable monetary gains through risk-taking, trade and asset usage. In its purest form, Islamic banking distinguishes itself from conventional banking by using profit and loss-sharing schemes as a means of dispensing financial capital (Gerrad & Cunningham, 2007).

Sheikh (2009) contended that most, though not all, problems of private enterprises were encountered in the act of loaning on interest. Among these issues was joblessness, expansion, increasing inequality and erratic business cycles. By revoking interest and replacing it with benefit sharing, these issues could be solved. Islamic financial analysts could not brace these cases by complex monetary investigation until the next decade. In addition to other things, this time attention was to a major extent on pointing out the inadequacies of free enterprise and connecting them to the interest formation (Ismail, 2010). With this went the contentions demonstrating that it was conceivable to have custody of money without premium and that it would not

unfavorably influence reserve funds and venture. Some contended that getting rid of interest would support investments prompting expanded production.

This theory was relevant in explaining the Murabaha contracts variable. The entry and multiplication of Murabaha or cost-plus financing was a noteworthy improvement in the late nineteenth century. The product required, purchased by the bank at demand, was what the representative was given by the Islamic bank. This was with the guarantee to buy it from the bank at a greater cost than its price tag and it was to be paid after a timeframe (Abduh & Omar, 2012). Each Murabaha exchange made an obligation. Resources put into Murabaha exchanges were protected. This was contrasted with stores provided on a benefit sharing premise. Murabaha overwhelmed the scene of Islamic finance after few years of presentation in late nineteen seventies, it.

2.3 Empirical Review

This section presents the findings of other authors in relation to the three variables, mudaraba loans, Ijarah products and Murabaha contracts. A literature review summarizes and discusses previous publications on a topic. It consists of books and scholarly journals that provide research examples of populations or settings similar to the researcher’s own, as well as community resources to document the need for the proposed research.

2.3.1 Mudaraba Loans

The Mudarabah is a profit or loss sharing model used by tradesmen in Mecca before the advent of Islam. It is believed that Prophet Muhammad employed Mudarabah with a rich woman named Khadijah, who was to become his wife about

fifteen years prior to the establishment of Islam (Al-Jahri & Munawar, 2017). Mudaraba, is a mode of financing through which the bank, the owner of the capital or rabb-al-mal, provides capital finance for a specific venture indicated by the customer; the entrepreneur or mudarib (Hamid & El-Ghazali, 2018). In other words, Mudarabah is a contract between two parties: an investor; individual or bank that provides a second party, the entrepreneur, with financial resources to finance a particular enterprise. Profits are then shared between the two parties, rabb-al-mal and mudarib, according to some pre-agreed ratio. The investor bears all financial losses and the entrepreneur the operating losses; principally the opportunity cost of their own efforts.

Distribution of profits and losses is an equitable approach that conforms to Islamic Shari'ah. In a financial intermediation form, the rabb-al-mal is a customer who deposits capital in a bank, representing the mudarib, to invest according to Mudarabah. Mudarabah deposits could be compounded in a public pool for investment, which is a permissible way for the bank to mix Mudarabah deposits with its own funds (Al-Jahri & Munawar, 2017). The profits would then be distributed according to an agreed formula, but losses once again remain the liability of the capital providers. This is an extension of what is essentially a trade practice into formal banking environment. It can be argued that the profit sharing Mudarabah was practiced in Arabia when the labour or management owner or the mudarib has the idea and skills of business but no capital of his own.

Working capital financing is a cornerstone of all financial systems. Although there are religious and cultural differences between different nations, financial institutions throughout modern civilizations face similar business challenges. These

include maintaining adequate capital ratios, financing inventories, fixed assets, and extending credit sales (Sudin & Shanmugam, 2016). A study of Islamic finance usually necessitates an analysis of what implications the religious rulings have on the operations of functioning financial institutions.

Murabahah product of Islamic finance was well articulated by Khan (2017) who established that Murabahah contracts have three basic conditions; first, tangible commodity must exist at the time of the deal, second, the commodity must be owned by the seller and thirdly, price should be agreed by both parties. This means that instead of an Islamic bank issuing loans, the borrower would have to state in explicit terms the purpose and specification of the item to be financed. The bank buys the item and sells it to the buyer at an agreed price. Murabahah products are interest free but based on fixed return (Khrawish, 2017). Through a critical analysis of the existing literature, it was established that IFI use different terms to make their practices Islamic such as; terms of trade (loan), profit (interest) and fine (opportunity cost and time value of money). The study further ascertained that for Islamic banks to grow their customer base, they must design the interest free products according to the spirit of Islam instead of altering names of different transactions.

Habiba and Yusoff (2019) conducted a survey on the effcet of Mudarabah financing on performance of commercial banks in Tanzania. This investigation used a qualitative technique through case study method. Data in this research were primary data and secondary data obtained from informants through interviews. The study used interactive data modeling techniques. The study established that Mudarabah financing had a positive significant effect on performance of commercial banks.

Abdirizak (2016) did a study in Kenya effect of mudaraba loans on the financial performance of Islamic commercial banks. A descriptive and diagnostic 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 statistics was used for data analysis. The study established that mudarabah loans had a positive significant effect on financial performance of Islamic commercial banks.

Zafar and Nor (2019) did a study on the determinants of return on investment in Mudarabah and Musharakah contracts in Pakistan. The data for this study were collected from annual reports of twenty-three Mudarabah companies in Pakistan, listed in Pakistan Stock Exchange, during the period 2011- 2015. Panel data techniques were utilized to analyze the effect of the independent variables on ROI. The results of panel data analysis indicated that for both Mudarabah and Musharakah contracts, agency cost showed a major as well as positive impact on ROI while monitoring cost had a substantial and negative relationship with ROI.

Idries, et al., (2018) carried out a study on the influence of Mudarabah loans on the profitability of the Islamic banks in Jordan. The study was based on primary data collected through a questionnaire survey among the policy makers, executives and customers of Islamic banks in Jordan. The study used purposive random sampling method. The study revealed that a converse correlation exists between Mudaraba loans and a variety of profitability indicators. The findings indicate that there exists a grave problem with offering Mudarabah loans for Islamic banks with operations in countries that have a banking structure that is hybrid, that is, countries with

conventional and Islamic banks. This problem emanates from the fact that when borrowers anticipate high returns from investment, they have preference for conventional banks but run to Islamic banks when they anticipate low returns.

Odongo and Muchelule (2019) also carried out a study on the effect of Mudarabah loans on financial performance of commercial banks in Nairobi City County. The research was carried out in ten commercial banks which were operational in Nairobi City County. The target population was the 195 employees in the ten commercial banks in Nairobi City County. The sample size was 129 employees. The employees were divided into two strata, the middle level and lower cadre staff. Stratified random sampling was used to determine the group that was to be issued with questionnaires'. The study adopted the descriptive survey design. The research instrument that was used during the study was a questionnaire. Both qualitative and quantitative data was collected and analyzed using inferential and descriptive statistics with the aid of Statistical Package for Social Science (SPSS) version 20. The study concluded that Mudarabah loans had a negative and insignificant effect on financial performance of commercial banks in Nairobi City County.

Sheikh (2019) also carried out a study on the effect of Mudarabah financing on profitability of Islamic banks in Kenya. This study adopted the descriptive research design and sampled 45 respondents by Census survey technique. Data was collected by use of a structured questionnaire and analyzed both by descriptive and inferential statistics. The study established that there was a positive correlation between Mudarabah financing and profitability in Islamic banks. The R square was 0.609

indicating that 60.9% of variance in profitability in Islamic banking could be explained by Mudarabah financing.

Entissar (2016) also did a study assessing the influence of Mudarabah loans on the financial performance of Sudanese Commercial Banks. The study used secondary data sourced from twenty-seven Sudanese Islamic banks' financial statements, particularly the balance sheet and the profit and loss statement, during the period from 2005 to 2013. The sample represented the major Sudanese banks that had consistently published their financial statements over the study period. This data were collected either from the bank websites or as hard copies directly from the banks' headquarters and branches. The study used the panel estimate approach, which is used in financial modelling when the data has both time series and cross-sectional elements: such data are often referred to as longitudinal data. The study established that Mudarabah loans had a negative insignificant influence on the financial performance of Sudanese Commercial Banks.

Mohammad (2019) also carried out a study on the influence of Mudaraba contracts on financial performance of commercial banks in the United Kingdom. The study employed a descriptive survey research design and incorporated elements of both qualitative and quantitative approaches in terms of instruments and data analysis. The study population was the two fully fledged Islamic commercial banks. The respondents were 185 senior and junior staff working in the headquarters of these banks. The study used stratified random sampling to select the sample. This method is appropriate because the sample represents the target population and eliminates sampling bias. The study used primary data. The study used mean and percentages in

this study. The study used Statistical Package for Social Sciences (SPSS) to generate the descriptive statistics and also to generate inferential results. Inferential included both correlations and regression. The study found that there was a negative influence of Mudaraba contracts on financial performance of commercial banks in the United Kingdom.

Sutrisno (2018) also carried out a study on the influence of Mudaraba contracts on financial performance of commercial banks in Indonesia. The population in this study was 13 Islamic commercial banks operating in Indonesia with a sample of 8 Islamic commercial banks taken by pur-posive sampling method. To test the hypotheses, multiple regression analysis tools were used at a significance level of 0.05. The results showed that Mudaraba contracts had no significant influence on financial performance of commercial banks in Indonesia.

2.3.2 Ijarah Products

Ijarah is the proceeds from a rental contract between two parties, where the lessor leases capital asset to the lessee. Ijarah literally means to give something on rent (Abdirizak, 2016). There are two forms of leasing in Islamic Finance. Direct leasing finance (Ijarah), is whereby the lessor allows the lessee to use capital assets owned by the lessor for a specified period of time ranging from a few days to years depending on the type of asset. In return, the lessee pays the rental fee monthly or annually. However, the ownership of the capital assets cannot transfer to the lessee in this type of leasing and insurance on the capital assets remains the responsibility of the lessor (Hamid & El-Ghazali, 2018).

In contemporary Islamic banking, Ijarah has been adapted to provide a form of hire purchase (Ijarah wa-Iqtina), whereby an institution or individual customer requests the bank to purchase equipment with the intention of leasing it to the customer (Badreldin, 2017). In turn, the Islamic bank rents the asset to the client who pays a certain fixed rent and promises to purchase the asset within a specified period to transfer ownership from the bank to the customer (Al-Jahri & Munawar, 2017). Furthermore, this could be transformed as a decreasing-value lease that allows the client to pay an installment of the value of the asset plus its rent each period to reduce the lessor's share of ownership until the lessee becomes the owner (Lewis & Algoud, 2016).

Omar (2018) carried out a study effect of Injara products on the financial performance of conventional banks offering islamic banking products in Kenya. The study adopted a descriptive research design. The study comprised of 6 conventional banks offering Islamic banking products. Secondary data on Islamic banking products for the financial years 2009-2015 was obtained from the financial statements of conventional banks that provide Islamic banking data and products was analyzed using Statistical Program for Social Sciences form (SPSS) and excel as the fundamental computer strategy for data analysis. The study established that Injara products had positive and significant impact on the financial performance of the conventional banks in Kenya.

Alkhazaleh and Al-Dwiry (2018) did a survey on which extent the Jordanian Islamic banks' financial performance was impacted by Ijara contracts during the financial period 2010-2016. Secondary data was collected from annual reports and

accounts of all the local Islamic banks that were engaged in lease financing that is Jordan Islamic Bank, Jordan Dubai Islamic Bank and Arab Islamic International Bank. So as to realize the aims, the study relied on testing the hypotheses through regression analysis. Ijara contracts, as the results of the study indicated, had significant impact on the return on assets and return on equity as measures of financial performance.

Szczepanowicz (2016) effect of Ijara products on financial perfromance of commercial banks in the USA. The survey was done on the basis of quantitative approach by utilizing cross sectional data context examination. The descriptive methodology was used to obtain the necessary data and information with regards to the measure of performance and growth of the Islamic finance and banks institutions Six banks formed the population from which the data was gathered for the period running from 2012-2015. The study established a significant correlation between Ijara products and financial performance of the commercial banks.

Muatuz, (2017) did a study on effect of Injara products on the financial performance of conventional banks in Finland. The purpose of this research was to determine how the implementation of sharia compliance Ijarah contracts affected the banks financial performance. This research used primary data through interviews and questionnaire with a population of 100 respondents. The study used purposive sampling technique to come up with 80 respondents. The results of the study indicated that Ijarah contract had a positive significant effect on financial performance of the commercial banks.

Chepchirchir, Bogonko and Osodo (2019) investigated on the relationship between Ijarah financial product and financial performance of selected commercial banks in Kenya. The study adopted a correlational research design. The study targeted management employees in 2 banks that is First Community Bank and Gulf Africa Bank commercial banks. Census approach was employed. Document analysis was used to collect data. Content and face validity was used to validate the research instruments. Test-retest technique through a pilot study was adopted to validate the research instruments. Descriptive statistics were analyzed in form of means and standard deviation. Pearson correlation analysis and multiple regression analysis was employed to test the hypotheses. The regression coefficients showed that there was no significant relationship between Ijarah products and financial performance of the commercial banks.

Ahmed (2015) conducted a study to investigate the effect of Ijarah products on the financial performance of Islamic commercial banks in Uganda. A descriptive and diagnostic 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 statistics was used for data analysis. Descriptive statistics generated the amount of Ijarah products and trends in financial performance while inferential statistics provided a correlation and regression analysis between Ijarah products and financial performance of Islamic commercial banks. The study findings indicated a notable offer of Ijarah products within the periods 2009-2013. The amount of Ijarah products fluctuated from one year to another. Strong positive correlation coefficients of 0.617 was obtained between financial performance and Ijarah products.

Ibrahim (2015) conducted a study to investigate the relationship between Ijarah products and financial performance of Islamic banking in United Arab Emirates in 2010-2014. The study targeted seven (7) commercial banks that operate Islamic banking in United Arab Emirates. The data for this study was collected using questionnaires for primary data study and secondary data was obtained from the Central Bank annual reports and individual bank statements for unlisted banks. A regression analysis was performed. From the results it was noted that there is a negative relationship between the Ijarah products and performance of Islamic banking.

Dalimunthe, et al., (2019) also carried out a study on the influence of Ijarah contract on the financial performance of commercial banks in the USA. The research was conducted in the form of a descriptive study. This design was adopted as the suitable research design because it identifies patterns or trends in a situation. The target population were existing customers of Islamic Banking. A simple random sampling technique was used to identify the 100 sample size elements. Questionnaires were used to collect the primary data from the respondents. The collected data was first coded statistically and then analyzed using the Statistical Package for Social Scientists (SPSS). SPSS and Microsoft Excel enabled the researcher to compute descriptive statistics such as percentages, frequencies, and ranges. The study found that Ijarah contract had no significant influence on the financial performance of commercial banks in the USA.

Bakhita and Szczepanowicz (2019) also carried out a study on the influence of Ijara contracts on financial performance of commercial banks in Azerbaijan. Positivism philosophy, longitudinal and explanatory non–experimental research

designs were used. The target population was all the 40 commercial banks in Azerbaijan. The study used secondary data collected from annual reports of the Central Bank of Azerbaijan and commercial banks audited published financial statements for the period between2007 and 2015. Data was analyzed using descriptive statistics and panel multiple regression analysis. The results indicated that Ijara contracts had no significant influence on financial performance of commercial banks in Azerbaijan.

Almanaseer and AlSlehat (2016) also carried out a study on the influence of Ijarah contracts on financial performance of commercial banks in Jordan. The study depended on the analytical method through doing the statistical analysis of the independent variables on the dependent variable related to the subject of the study in order to cover the analytical part of the study, in addition to the descriptive method through relying on books, periodicals, previous studies and financial reports of the banks of the study' sample, whether the direct or the indirect ones, to cover the theoretical part. The study population consisted of Islamic banks operated in the Jordan. The study sample that were chosen purposively included (2) banks namely Jordan Islamic Bank for Finance and Investment as well as the Islamic International Arab Bank. From the results, the study established that Ijarah contracts had no significant influence on financial performance of commercial banks in Jordan.

Quan, Ramasamy, Devinaga and Shalini (2019) also did a study on the influence of Ijara contracts on financial performance of commercial banks in Malaysia. A positivist philosophy was adopted with the research design that included a thematic analysis. The results helped finalize the conceptual framework of the primary study, which was in form of a secondary data collection sheet. The study

adopted descriptive research design. Census technique was used to select the sample size. Primary data was collected by use of Questionnaires while in the collection of secondary data secondary collection sheet was used. Using collected data, then univariate tests were carried out to provide a deep insight for both parametric (t-test) and non-parametric test (Pearson correlation coefficient). In multivariate analysis, hierarchical multiple regression analysis models were used to determine the type of the relationship that existed between the independent and dependent variables. Data was edited, cleaned, codded and categorized. Quantitative analysis featuring the inferential and descriptive statistics was applied in analyzing data and thereafter, interpretation was done followed by data presentation using graphs and tables with relevant inferences, frequencies and percentages being used to describe and summarize relevant findings. On the other hand inferential statistics used included a regression model, correlation analysis, ANOVA and chi square respectively. The study established that Ijarah contracts had no significant influence on financial performance of commercial banks.

2.3.3 Murabaha Contracts

This is an Islamic instrument for buying and reselling the purchase or import of capital goods and other commodities by institutions, including banks and firms (Lewis & Algoud, 2016). In Murabaha arrangement, the customer provides the bank with the descriptions and prices of the goods to be purchased or imported. The Islamic bank studies the application and collects information about the specifications and prices of the goods, focusing especially on the price and conditions for payment. When the bank and its client agree on the terms of the deal, the bank purchases the goods or commodities and resells them to the customer. The profit that accrues to the

bank is mutually agreed upon as a profit margin (mark-up) on the cost of purchase (Othman, Maji, & Rahman, 2017).

The fundamental principles attached to Murabaha are that; goods must be classified, clearly identified according to commonly accepted standards and must exist at the time of sale; goods for sale must be in the ownership of the bank at the time of sale; the cost price must be known at the time of sale and this should be declared to the client. This is especially the case if the bank succeeds in obtaining a discount where the profit margin is calculated on the net purchase price (Al-Jahri & Munawar, 2017). This means discounts also provide benefits to the client; and lastly, the time of delivery of the goods and the time of payment must be specified.

Murabaha contract is considered as a two-party buying and selling contract between bank and customer involving no financial intermediation or financing (Abdirizak, 2016). In other words, the bank offers this service to clients who should pay the cost of the goods plus a profit margin to the bank immediately following receipt. The client can pay for the goods and the bank's profit margin by deferred installments or a deferred lump sum without an increase over the original value (Habiba & Yusoff, 2019).

Hamedian (2017) carried out a study on effect of Murabaha Contracts on Financial Performance of Islamic Banks in Malaysia. The study used secondary data collected for the period 2012-2016. Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables. Multiple regression analysis was carried out to investigate the nature of the relationship between the dependent and independent variables. The study established

a positive significant effect of Murabaha Contracts on Financial Performance of Islamic Banks in Malaysia.

Azkanar (2016) carried out a study on the effectiveness of Murabahah in Islamic law in terms of house financing comparing the UK and Malaysia. A descriptive and diagnostic survey design was used. The targeted study population was two Islamic financial institutions. A five year data for five Islamic products as well as financial performance based on these products was used. Both descriptive and inferential statistics 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 Islamic commercial banks' financial performance. Murabahah, as the study established, has a significant role for sustaining the development of house financing in Islamic finance the UK and Malaysia.

Husaeni (2019) did a study on the effect of Murabaha contracts on financial performance of selected commercial banks in Indonesia. The study targeted management employees in 2 commercial banks. Census approach was employed. Document analysis was used to collect data. Content and face validity was used to validate the research instruments. Test-retest technique through a pilot study was adopted to validate the research instruments. Descriptive statistics were analyzed in form of means and standard deviation. Pearson correlation analysis and multiple regression analysis was employed to test the hypotheses. The study established that Murabaha contracts had a positive significant effect on financial performance of selected commercial banks.

Issack (2015) carried out a survey on how Murabaha financial instruments affected the commercial banks' financial performance in Kenya. To establish how commercial banks' financial performance in Kenya was affected by Islamic banking products the study used descriptive survey approach. Seven banks (commercial) composed the population of this study and were offering Islamic banking products in Kenya. Financial statements formed the secondary data which was used in this study; and which was coded using SPSS (version 21). The summary of the data was done using descriptive statistics. To bring out the linear correlation between variables of this study, Pearson Moment Correlation was carried out. The study by Issack (2015 revealed a positive relationship between Murabaha financial instruments and financial performance of the IFIs.

Abdel-Razzaq (2018) carried out a study on the influence of Murabaha contracts on financial performance of islamic banking and finance industry in Sydney Australia. The study firstly reviewed the existing financial performance literature for both Islamic and conventional models with a reference of the relevant financial theories. The study then set up a methodological framework with a large panel data of 25 years from 10 banks covering the period from 1996 to 2015. The final dataset was tested using various econometric models and robustness checks. The findings of the study revealed a positive significant influence between Murabaha contracts and financial performance of islamic banking and finance industry in Sydney.

Nurhasanah and Melzatia (2019) also carried out a study on the analysis of the influence of Murabaha financing on financial performance of commercial banks in Qatar. A descriptive and diagnostic 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 statistics was used for data analysis. Descriptive statistics generated the amount of Murabaha financing and trends in financial performance while inferential statistics provided a correlation and regression analysis between Murabaha financing and financial performance of Islamic commercial banks. The study findings indicated a notable offer of Murabaha financing within the periods 2009-2013. The study also revealed that a strong positive correlation of 0.858 exists between Murabaha financing and financial performance.

Bintawim (2017) conducted a study on the influence of Murabaha contracts on financial performance of commercial banks in Saudi Arabia. A total of eleven banks were financially analyzed between 2005 and 2009. The methodology used included ratio analysis and panel data regression to test the research hypothesis. Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables. Multiple regression analysis was carried out to investigate the nature of the relationship between the dependent and independent variables. The study established that there was a positive significant relationship between Murabaha contracts and financial performance of commercial banks in Saudi Arabia.

Abdulwahid (2019) conducted a study on the influence of Murabaha contracts on financial performance of commercial banks in Australia. This study used an interpretative and qualitative critical case study method to explore the feasibility of using Murabaha contracts for financing in the Australian commercial banks. A

descriptive research design was used and data was collected from the two main Islamic banks in Sydney. The study target population was the 108 staff of the 2 IB banks in Sydney. The data had a sample population of 85 respondents obtained using Krejcie and Morgan (1970) formal and selected using stratified random sampling, the data was analyzed using descriptive statistics with assistance of Statistical Package for Social Scientists (SPSS) ver. 20. The study established that there was a negative significant relationship between Murabaha contracts and financial performance of commercial banks.

Mohammad and Youssef (2018) also carried out a study on the influence of Murabahah contracts on financial performance of commercial banks in Egypt. The study used a mixed research design where descriptive and quantitative research designs were used. The population for this study was all the forty seven commercial banks in Egypt. Sources of data were both secondary and primary where quantitative techniques were used to undertake data analysis. To determine the relationship that existed between the variables, both multiple regression analysis and chi-square tests were adopted. The study used financial ratio analysis and panel data techniques of random effects, fixed effects estimation and generalized method of moments, GMM to purge time–invariant unobserved firm specific effects and to mitigate potential endogenity problems. The pairwise correlations between the variables were carried out. Wald and F- tests were used to determine the significance of the regression while the coefficient of determination, overall, within and between R^2, were used to determine how much variation in dependent variable is explained by independent variables. Chow and Breusch and Pagan Lagrange multiplier (LM) tests were used to test whether the fixed effects model is better than pooled OLS model and the

appropriateness of the random-effects model relative to the pooled OLS model respectively. T The study found that Murabahah contracts had a strong significant influence on financial performance of commercial banks in Egypt.

2.4 Research Hypothesis

Null Hypothesis:

H01: Mudaraba loans has no significant effect on commercial banks' financial performance in Kenya

H02: Ijara products has no significant effect on commercial banks' financial performance in Kenya

H03: Murabaha contracts has no significant effect on commercial banks' financial performance in Kenya

2.5 Conceptual Framework

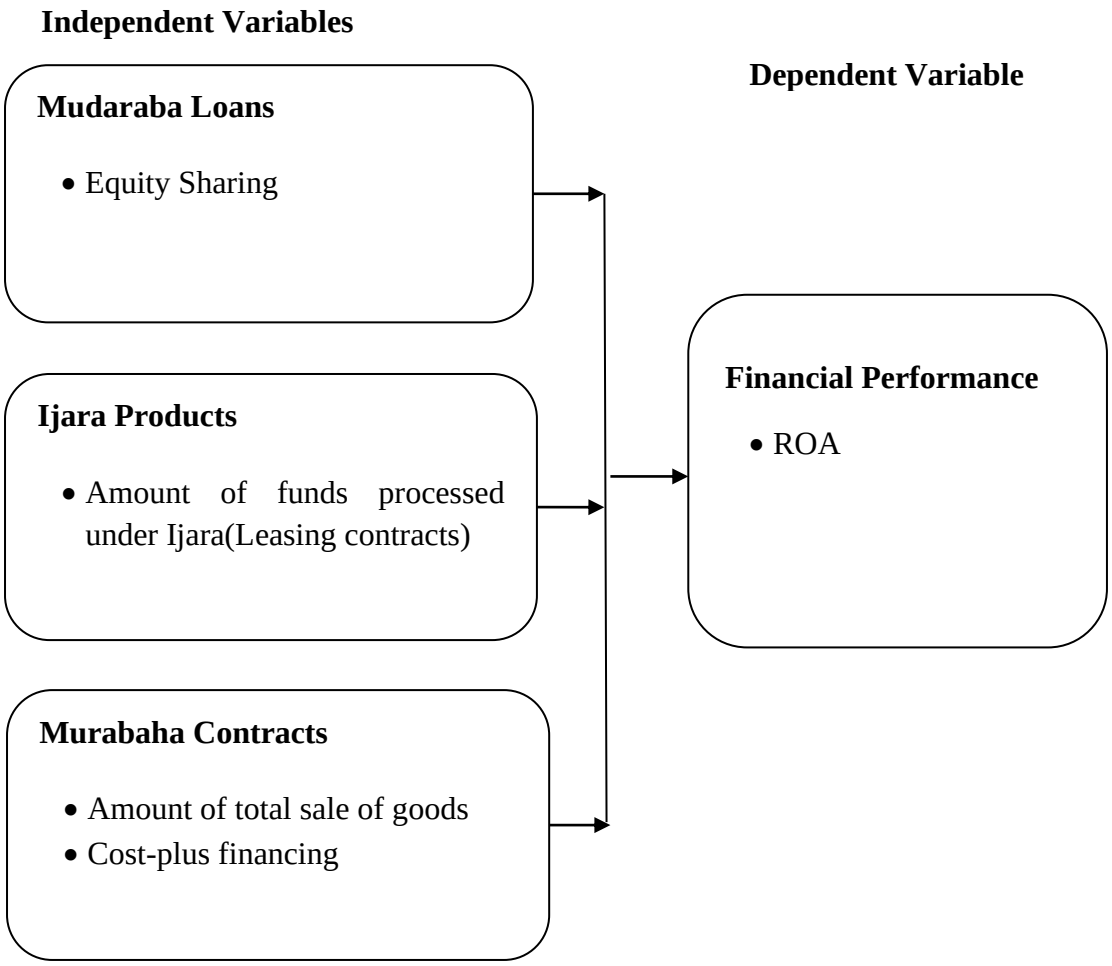

Figure 2.1: Conceptual Framework

2.6 Operationalization of Variables

The Table below shows how each variable will be measured. The dependent variable is financial performance, while the independent variables are; Mudaraba loans, Ijara products and Murabaha products.

VARIABLE	MEASUREMENT
Mudaraba Loans	This was measured in terms of volume of Mudaraba loan product
Ijara Products	This was measured in terms of volume of Ijara loan products
Murabaha Products	This was measured in terms of volume of Murabaha loans products
Financial Performance	Bank performance was measured in terms of ROA

Table 4.0: Operationalization of Variables

2.7 Research Gap

From the reviewed literature, it is clear that very few surveys have been conducted on the influence of Islamic finance on the commercial banks' performance. Alkhazaleh and Al-Dwiry (2018) looked at the magnitude within which the Jordanian Islamic banks' financial performance was impacted by Ijara contracts; Issack (2015) conducted a study on the effect of Murabaha financial instruments on the financial performance of commercial banks. All the other studies have concentrated on other aspects of the Islamic finanicng instruments. For instance, Jasmin, et al., (2018) concentrated on the optimization of Mudarabah Sharia bank finance through the agency theory perspective; Abdul-Khaliq (2015) did a comparison study of Murabaha and Istisnaa in Islamic banking; Mohy-ud-Din, Rais, and Solangi (2017) did a comparative study between Ijarah products and conventional leasing. These studies, among others, illustrate that very few studies have looked directly at the influence of the Islamic financing instruments on the performance of commercial banks.

Additionally, majority of the reviewed studies have been carried out in emerging and developed countries. These include; Jasmin, et al., (2018) in Indonesia, Salman (2017) in Malaysia, Zafar and Nor (2019) in Pakistan, Idries, et al., (2018) in Jordan, Bakhita (2017) in Saudi Arabia, Azkanar (2016) in UK and Malaysia etc. These studies lack generalization to Kenya since they have contextual differences. This study will seek to bridge all these gaps by exploring how Islamic finance affected the commercial banks' performance in Kenya.

2.8 Literature Review Summary

This section has reviewed the literature on the specific aspects of Islamic financing namely, mudaraba loans, Ijarah products and Murabahah contracts. From the reviewed studies it is evident that there is little local literature in the developing countries on how commercial banks' performance is affected by Islamic finance. The theoretical reviews has covered three broader theories relevant for the study's independent variables. The theories outlined have thus been interlinked with the study variables. Literature has also been reviewed within the areas of the conceptual framework to cover both dependent as well as independent variables within this study. Research gap has also been discussed within the chapter to demonstrate the need to undertake this study.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the methodology that was employed by the researcher in carrying out the study. It includes the research design, target population, sample size, data collection and the technique for data analysis.

3.2 Research Design

Research design has been defined by Kothari and Garg (2014) as the scheme, outline or plan that is used to generate answers to research problems. According to Kombo and Tromp (2011), research design can be thought of as the structure of research. This study used a descriptive research design. The advantage of using this design is that it presents an opportunity to fuse both quantitative and qualitative data generated by the study. Additionally, the design is less time consuming compared to other designs. According to Cooper and Schindler (2010), a descriptive study is concerned with finding out the what, where and how of a phenomenon.

3.3 Target Population

Borg and Gall (2012) have postulated that the target population is a complete set of study of the entire membership of actual or assumed set of objects, people or events upon which an investigator wishes to generally view the result. The target population is a representation of the entire group of people and status of the whole population. The study was undertaken in Gulf African bank as well as First Community Bank Limited which are the two completely established Islamic commercial banks in Nairobi as well as the Standard Chartered Bank of Kenya,

National Bank of Kenya, Barclays bank of Kenya, Kenya Commercial Bank and Diamond Trust Bank of Kenya which are the 5 conservative banks offering partial Islamic commercial banking.

3.4 Sample Size and Sampling Technique

Kombo and Tromp (2011), indicated that a sample is a finite part of a statistical population whose properties are studied to gain information about the whole. 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. The study used census since the selected Gulf African bank as well as First Community Bank Limited which are the two completely established Islamic commercial banks in Nairobi as well as the Standard Chartered Bank of Kenya, National Bank of Kenya, Barclays bank of Kenya, Kenya Commercial Bank and Diamond Trust Bank of Kenya have a small population.

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 2015-2019. Data was obtained from financial statements, income statements, balance sheets and bank reports as well as data from internal sources.

3.6 Data analysis and Presentation

Borg and Gall (2012) theorizes that data analysis is the investigation of what has been gathered in a study or experimentation and consequently making inferences and deductions. Descriptive statistics was utilized to organize Data. To scrutinize the

data, descriptive analysis such as standard deviation, frequencies, mean, as well as percentages was utilized. Additionally, Pearson correlation as well as multiple regressions which are inferential statistics were utilized. The statistical technique used for examining how numerous independent variables are related to one dependent variable is known as multiple regression. Thus, the Analysis of Multiple Regression was employed to scrutinize the character of the correlation between independent variables and the dependent one.

The analytical model thus was:

$$\mathbf{Yit = \beta_0 + \beta_1 X_{it} + \beta_2 X_{it} + \beta_3 X_{it} + \varepsilon it}$$

Where:

Yit = Financial performance as measured by ROA, ROE and profitability

$\mathbf{X_{it}}$ = Mudaraba financing (finance by way of trust) as measured by the natural logarithm of amount invested

$\mathbf{X_{it}}$ = Ijara (leasing) financing as measured by the natural logarithm of amount invested.

$\mathbf{X_{it}}$ = Murabaha (cost-plus financing) financing as measured by the natural logarithm of amount invested.

$\boldsymbol{\beta_0}$ = Constant

$\boldsymbol{\beta_1}$ $\boldsymbol{\beta_2}$ **and** $\boldsymbol{\beta_3}$ = coefficients of variables

$\boldsymbol{\varepsilon}$ = error term

3.7 Diagnostic Tests

To come up with a reliable model for this survey the researcher carried out appropriate diagnostic tests. Tests on diagnostics for normality, linearity, homoscedasticity, multicollinearity, and test for outliers.

3.7.1 Normality

Normality tests the difference between forecasted and obtained responses variable which need to be generally distributed about the distributed dependent variable scores (Cooper & Schindler, 2011). For normality test in this research, Shapiro Wilk test was utilized by the researcher. The data was considered normally distributed if the significant value (p-value) > 0.05, on the contrary the null hypothesis was rejected if the value is < 0.05, which implied that there is normal distribution of data.

3.7.2 Linearity

Linearity is the examination of whether the relationship of the independent variable and dependent is linear. It tests whether the residuals have a straight-line relationship with the predicted dependent variables (Borg & Gall, 2012). It is measured using correlation analysis. Linearity was tested using analysis of variance (ANOVA) to determine the relationship between independent and dependent variables. Deviation from linearity was > 0.05, then the relationship between the dependent and independent variables were linearly dependent while if < 0.05 there was no linear relationship.

3.7.3 Homoscedasticity

Homoscedasticity refers to the supposition that the dependent variable exhibits similar amounts of variance across the array of values for an independent variable (Babbie, 2011). The error term (ϵ) is normally and identically independently distributed with mean zero and constant variance (homoscedasticity). One can use graphical method to check for homoscedasticity. If the error term is not constant, the data suffers from heteroscedasticity. The Breusch-Pagan test was undertaken where the BP Lagrange Multiplier (LM) statistic was computed for the residuals. The BP and Koenker test the hypothesis that H0: residuals do not exhibit heteroscedasticity (residuals are homoscedastic). If the P-value of the BP-LM test are greater than 0.05 it implied that the residuals did not exhibit heteroscedasticity thus meeting the homoscedasticity assumption.

3.7.4 Multicollinearity

To ascertain whether independent variables had resemblance with each other, Multicollinearity was carried out. There was a very strong relationship if the independent variables were similar in any way (Kothari & Garg, 2014). Testing for Multicollinearity involved the use of variation inflation factors (VIF). Absence of Multicollinearity indicators was shown by a VIF value of 1-10.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

This chapter has presented the study findings on the effect of Islamic finance on performance of commercial banks in Kenya. Specifically, findings are presented on Mudarabah financing, Injara products as well as Murabaha Contracts and their effect on the performance of commercial banks. The researcher has used tables to present the findings of the study.

4.2 Rate of Response

The study had sampled 7 banks that would provide information necessary for the study. Out of the 7 the researcher managed to get data from 6 banks which represents 86% response rate. The response rate was appropriate for the study as Kothari (2014) suggests that a response rate above 60% is appropriate to conduct a study.

Table 4.1: Rate of Response

Category	Frequency	Percent
Data gathered	6	86
No response	1	14
Total	**7**	**100**

4.3 Descriptive Statistics

Table 4.2 illustrates the descriptive statistics for the study variables. The mean average return on assets was 1.61% and standard deviation of 0.015% indicate that banks offering Islamic banking have almost the same performance. As illustrated in

the table, Murabaha financing was the most practiced Islamic financing in the banks with an average amount of Ksh3,392,335,000, followed by Ijara financing with Ksh1,000,260,000 and Mudaraba financing with 903,273,000. The average net assets was Ksh31, 645,156,000 with a net income of Ksh5, 541,482,000.

Table 4. 2: Overall Descriptive Statistics

Category	Mean	Std. Dev
Net assets	31,645,156,000	30892794100
Net income	5,541,482,000	7111912851
ROA	1.61%	0.015066659
Amount of Mudaraba financing	903,273,000	1878478093
Amount of Ijara financing	1,000,260,000	2170884.885
Amount of Murabaha financing	3,392,335,000	2488201603

The study covered the period 2015 to 2019. Therefore, descriptive statistics was carried out for the specific years as demonstrated in the following tables.

Table 4.3: Year 2015 Descriptive Statistics

Category	Mean	Std. Dev
Net assets	28,033,210,000	27501147480
Net income	4,167,828,000	5384743477
ROA	1.7%	0.016202237
Amount of Mudaraba financing	602,145,000	1248859966
Amount of Ijara financing	1,179,802,000	2460647278
Amount of Murabaha financing	3,186,954,000	2347917738

As illustrated in table 4.3, despite the existence of Islamic finance in the commercial banks, their average performance was poor with a Return on Assets of 1.7% despite having net assets at Ksh28,033,210,000. Murabaha was the highest form of Islamic financing with an average amount of Ksh3, 186,954,000.

Table 4.4: Year 2016 Descriptive Statistics

Category	Mean	Std. Dev
Net assets	29,709,279,000	27871451960
Net income	5,875,501,000	7661689560
ROA	2.0%	0.017660436
Amount of Mudaraba financing	812,739,000	1830299595
Amount of Ijara financing	1,289,439,000	2966464901
Amount of Murabaha financing	3,135,639,000	2416448571

As demonstrated in table 4.4, there was a slight improvement in the performance of the commercial banks in the year 2016 with a return on assets of 2.0% and net assets and net income of Ksh29, 709,279,000 and Ksh5, 875,501,000 respectively. The most common Islamic financial products were Mudaraba financing as well as Ijara financing amounting to Ksh3, 135,639,000 and Ksh 1,289,439,000 respectively.

Table 4.5 below depicts high averages of the Islamic financial products and a return on assets of 1.64%. There is also an increase in net assets and net income at Ksh31, 625,824,000 and Ksh5, 616,417,000 respectively. The Mudaraba financing

and Murabaha financing increased slightly to Ksh1, 004,990,000 and Ksh3, 194,110,000 respectively.

Table 4.5: Year 2017 Descriptive Statistics

Category	Mean	Std. Dev
Net assets	31,625,824,000	34139152.8
Net income	5,616,417,000	7868829311
ROA	1.64%	0.013310059
Amount of Mudaraba financing	1,004,990,000	2254997821
Amount of Ijara financing	1,100,775,000	2511435687
Amount of Murabaha financing	3,194,110,000	2357367753

Table 4.6 illustrates the descriptive statistics for the year 2018. The average return on assets continued to decrease at 1.43% while Murabaha financing increased at Ksh3, 302,225,000 and Mudaraba financing slightly increased to Ksh1, 035,821,000. This was so even with the increase of net assets and net income to Ksh33, 918,808,000 and Ksh6, 488,288,000 respectively.

Table 4.6: Year 2018 Descriptive Statistics

Category	Mean	Std. Dev
Net assets	33,918,808,000	37580155500
Net income	6,488,288,000	9330870614
ROA	1.43%	0.018445207
Amount of Mudaraba financing	1,035,821,000	2315145970
Amount of Ijara financing	860,962,000	1928689939
Amount of Murabaha financing	3,302,225,000	2598064711

Table 4.7 demonstrates a further decline in the return on assets at 1.33% even as net assets increased to Ksh34, 938,661,000 while net income decreased to Ksh5, 559,377,000. Murabaha financing and Mudaraba financing continued with the increase to Ksh4, 142,749,000 and Ksh1, 060,669,000 respectively. Ijara financing on the other hand decreased to Ksh570, 324,000.

Table 4.7: Year 2019 Descriptive Statistics

Category	Mean	Std. Dev
Net assets	34,938,661,000	35627354730
Net income	5,559,377,000	7583872187
ROA	1.33%	0.013755871
Amount of Mudaraba financing	1,060,669,000	2307316522
Amount of Ijara financing	570,324,000	1336930320
Amount of Murabaha financing	4,142,749,000	3394546412

4.4. Diagnostics Tests

To come up with a reliable model for this survey the researcher carried out appropriate diagnostic tests. Tests on diagnostics for normality, linearity, homoscedasticity and multicollinearity.

4.4.1 Test for Normality

Normality tests are done to determine whether the sample data has been drawn from a normally distributed population. Normality assessment can be done using a graphical or numerical procedure. In terms of numerical approach, the common normality test is he Shapiro-Wilk test. However, this has been found to be less

effective for panel data, and hence the command xtsktest was used to test panel data normality (Razali & Wah, 2011). xtsktest assesses whether data is normally distributed against hypothesis that:

H_0: Sample follows a non-normal distribution.

H_a: Sample does follow a Normal distribution.

When the p-value is greater than the alpha value, then one fails to reject the null hypothesis.

Table 4. 8: Normality Tests

```
. xtsktest ROA AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing , reps(50
> 0) seed(123)
(running _xtsktest_calculations on estimation sample)

Bootstrap replications (500)
----+--- 1 ---+--- 2 ---+--- 3 ---+--- 4 ---+--- 5
..................................................    50
.........................x........................   100
..................................................   150
..................................................   200
..................................................   250
..................................................   300
..................................................   350
..................................................   400
.............................................x....   450
..................................................   500

Tests for skewness and kurtosis                Number of obs     =         30
                                               Replications      =        498

                          (Replications based on 6 clusters in Institution_id)
------------------------------------------------------------------------------
             |   Observed   Bootstrap                         Normal-based
             |      Coef.   Std. Err.      z    P>|z|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
  Skewness_e |   3.54e-08   2.09e-07     0.17   0.865    -3.74e-07    4.45e-07
  Kurtosis_e |  -2.10e-10   1.68e-09    -0.12   0.901    -3.51e-09    3.09e-09
  Skewness_u |  -5.73e-07   4.05e-07    -1.42   0.157    -1.37e-06    2.20e-07
  Kurtosis_u |  -8.23e-09   6.87e-09    -1.20   0.231    -2.17e-08    5.24e-09
------------------------------------------------------------------------------
Note: One or more parameters could not be estimated in 2 bootstrap replicates;
      standard-error estimates include only complete replications.
Joint test for Normality on e:        chi2(2) =   0.04    Prob > chi2 = 0.9781
Joint test for Normality on u:        chi2(2) =   3.44    Prob > chi2 = 0.1793
------------------------------------------------------------------------------
```

Findings in table 4.2 show that the panel data model including all the variables of Return of assets, Ijara financing, Mudaraba financing, Mubaraha financing were all following normal distribution. This is because the two joint normality are not significant hence the assumption of normality is not violated.

4.4.2 Test for Linearity

Linearity assumption of linear estimation is that the dependent variable has a linear relationship with the independent variables. Computation of ANOVA statistics was used to test for the linearity assumption. ANOVA results were computed with F-statistics for both the linear and the non-linear components for each independent variable. Linearity is attributed to an insignificant deviation from linearity. The F-statistics for each independent variable deviation from linearity with the p-values are shown in Table 4.9. All the p-values are above 0.05 hence confirming insignificant deviations from linearity and thus linear relationships (constant slope) between the independent variables and the dependent variable.

Table 4. 9: Test for Linearity between ROA and Ijara Financing

```
. reg ROA AmtofIjaraFinancing
```

Source	SS	df	MS	Number of obs	=	30
				F(1, 28)	=	1.43
Model	.00033106	1	.00033106	Prob > F	=	0.2417
Residual	.006479067	28	.000231395	R-squared	=	0.0486
				Adj R-squared	=	0.0146
Total	.006810127	29	.000234832	Root MSE	=	.01521

ROA	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AmtofIjaraFinancing	1.53e-09	1.28e-09	1.20	0.242	-1.09e-09	4.15e-09
_cons	.0146027	.0030579	4.78	0.000	.0083389	.0208665

```
. acprplot AmtofIjaraFinancing , lowess lsopts (bwidth(1))
```

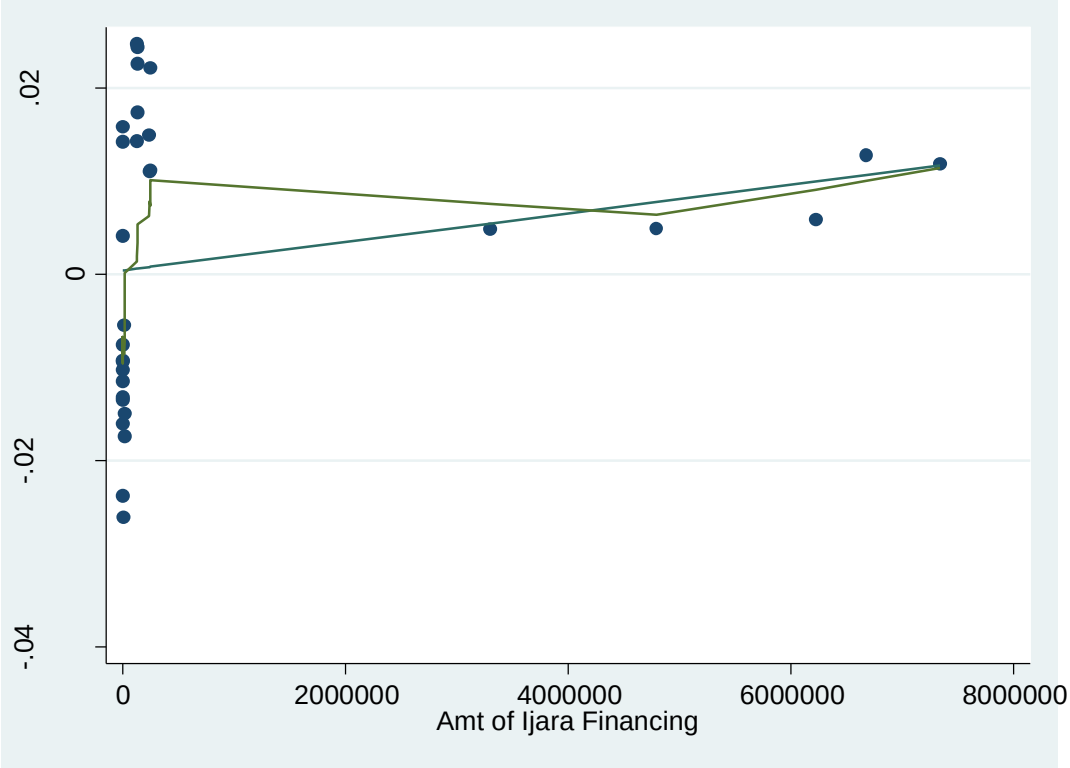

Figure 4. 1: Residual Plot of relationship between ROA and Ijara Financing

Table 4.10: Test for Linearity between ROA and Murabaha Financing

```
.          reg ROA AmtofMurabahaFinancing
```

Source	SS	df	MS	Number of obs	=	30
				F(1, 28)	=	11.95
Model	.002036962	1	.002036962	Prob > F	=	0.0018
Residual	.004773165	28	.00017047	R-squared	=	0.2991
				Adj R-squared	=	0.2741
Total	.006810127	29	.000234832	Root MSE	=	.01306

ROA	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AmtofMurabahaFinancing	3.31e-09	9.58e-10	3.46	0.002	1.35e-09	5.27e-09
_cons	.0048991	.0040304	1.22	0.234	-.0033569	.0131551

```
. acprplot AmtofMurabahaFinancing , lowess lsopts (bwidth(1))
```

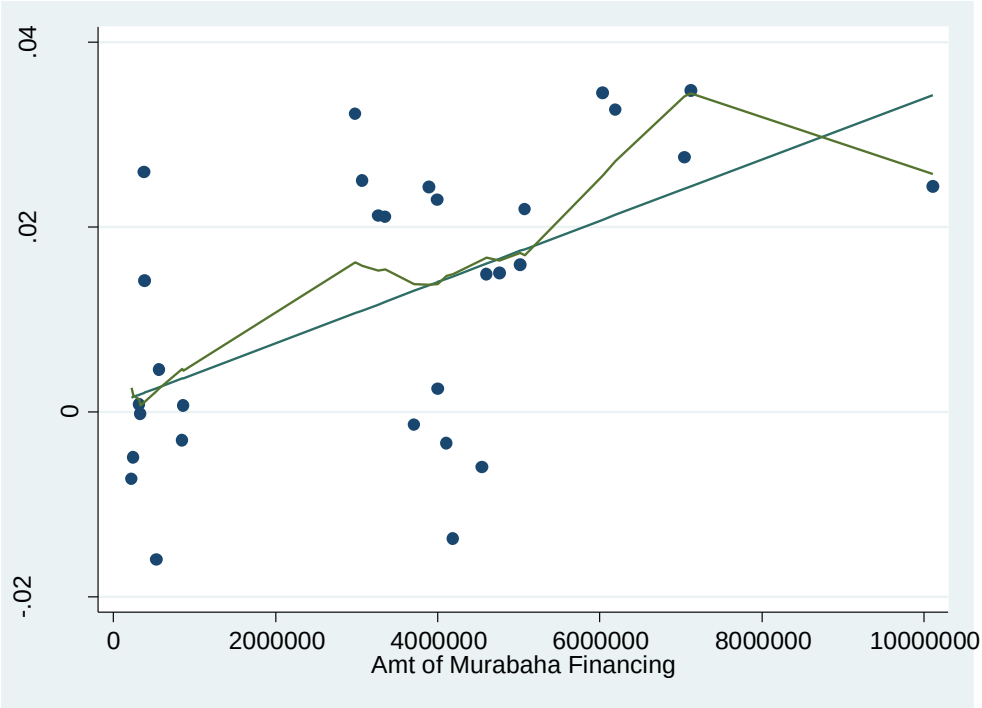

Figure 4.2:Residual Plot of relationship between ROA and Mubaraha Financing

Table 4.11: Test for Linearity between ROA and Mudaraba Financing

```
.          reg NetAssets AmtofMudarabaFinancing

      Source |       SS           df       MS      Number of obs   =        30
-------------+----------------------------------   F(1, 28)        =      0.58
       Model |  5.8401e+14         1  5.8401e+14   Prob > F        =    0.4515
    Residual |  2.8047e+16        28  1.0017e+15   R-squared       =    0.0204
-------------+----------------------------------   Adj R-squared   =   -0.0146
       Total |  2.8631e+16        29  9.8727e+14   Root MSE        =    3.2e+07

------------------------------------------------------------------------------
   NetAssets |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
AmtofMudarab~g |   2.348779   3.076075     0.76   0.452    -3.952275    8.649833
       _cons |   2.95e+07    6411666     4.60   0.000     1.64e+07    4.27e+07
------------------------------------------------------------------------------

.          acprplot AmtofMudarabaFinancing, lowess lsopts (bwidth(1))
```

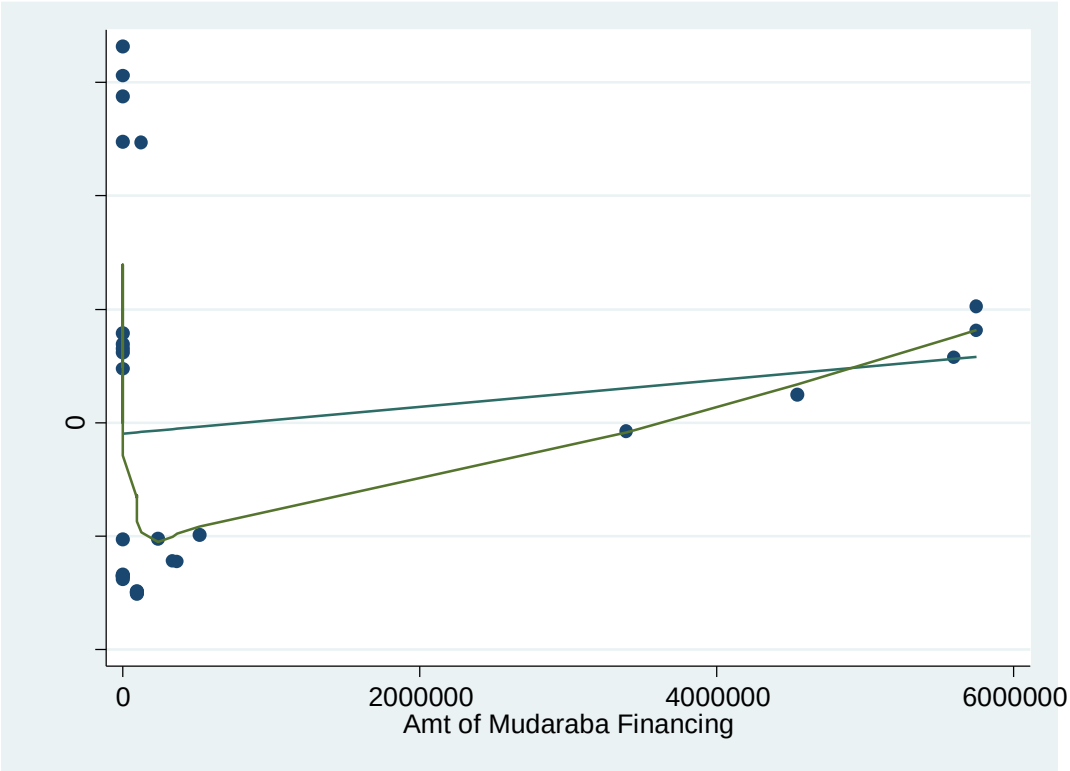

Figure 4.3: Residual Plot of relationship between ROA and Mudaraba Financing

Results in table 4.3-4.5 shows that there was no statisticall signficance on relationship between ROA and different Islamic products finance. However, findings in figure 4.1-4.3 shows that there was a general pattern of linearity on residual relationship thus proving the existence of linearity for Islamic finance products and ROA.

4.4.3 Test for Multicollinearity

In statistics, multicollinearity refers to the predictors that are correlated with other predictors in the model. Severe multicollinearity can cause problems because it increases the variance of coefficient estimates, which make the estimates very sensitive to minor changes in the model. This then makes the coefficient estimates

unstable and difficult to interpret. In this study, multicollinearity was tested by computing the correlation analysis. To detect for multicollinearity, the study used Variance Inflation Factor (VIF) as shown in Table 4.10.

Table 4.12: Multicollinearity

```
. correlate ( AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing )
(obs=30)

             | A~dara~g AmtofI~g AmtofM..
-------------+---------------------------
AmtofMudar~g |   1.0000
AmtofIjara~g |   0.9018   1.0000
AmtofMurab~g |   0.2410   0.2417   1.0000
```

Results in Table 4.6 shows that there is high degree of correlation between variable Mudaraba Financing and Ijara Financing as shown with correlation value of 0.9018 that is very close to 1. To further confirm the existence of multi-collinearity, VIF tests was conducted, with VIF less than 10 showing absence of multicollinearity. From the analysis the following VIF were achieved: Mudaraba financing (1.118), Ijara financing (1.0098) and Murabaha financing (1.0087). This implies that there was no severe collinearity with the variables thus all the variables were maintained in the regression model.

4.4.4 Heteroscedasticity

The modified wald test for group hetescedasticity was undertaken for the residuals. The modified wald test the hypothesis that H0: residuals do not exhibit heteroscedasticity (residuals are homoscedastic). If the P-value of the test are greater than less than 0.05 it implied that the residuals did exhibit heteroscedasticity. As

illustrated in table 4.11, with p-value of 0.000, the results indicated that the residuals did exhibit heteroscedasticity and therefore met the homoscedasticity assumption.

Table 4.13: Heteroscedasticity

```
. xttest3

Modified Wald test for groupwise heteroskedasticity
in fixed effect regression model

H0: sigma(i)^2 = sigma^2 for all i

chi2 (6)  =     1994.43
Prob>chi2 =      0.0000


.
```

4.4.5 Test for Autocorrelation

A number of tests exist for autocorrelation analysis. However, to address the problem of serial correlation in linear panel-data models biases, Wooldridge test of autocorrelation was applied. The findings show the absence of autocorrelation as shown with p>0.05 = 0.884 in table 4.6 below

Table 4.14: Autocorrelation Test for Model.

```
. xtserial ROA AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing

Wooldridge test for autocorrelation in panel data
H0: no first-order autocorrelation
    F(  1,       5) =      0.022
           Prob > F =      0.8884
```

4.5 Inferential Statistics

After the descriptive statistics, the study further utilized inferential statistics in order to establish and make conclusions on the relationship between the Islamic

financing products and commercial banks' performance. Panel data regression was employed to evaluate the strength of the relationship between the study variables. One way ANOVA was also used to determine of the performance of Islamic products differs for conventional banks and Islamic banks.

4.5.1. Regression Analysis

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (bank performance) that is explained by all the three independent variables (mudaraba financing, Ijara financing and Murabaha financing). Panel data regression through fixed effect was used to test the effect of Islamic products on the performance of commercial banks as measures through ROA, net income and net assets. However, the researcher included all the three performance measures to gain a complete understanding on how they are affected by banking products. Nonetheless, the study also uses ROA to determine the research hypothesis.

Effect of Islamic Product Finance on Performance of Commercial Banks in Kenya

Table 4.15: Effect of Islamic Product Finance on Performance of Commercial Banks Measured by Net Income

```
. xtreg NetIncome AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing , fe

Fixed-effects (within) regression               Number of obs      =         30
Group variable: Institutio~d                    Number of groups   =          6

R-sq:                                           Obs per group:
     within  = 0.0073                                         min =          5
     between = 0.0484                                         avg =        5.0
     overall = 0.0452                                         max =          5

                                                F(3,21)            =       0.05
corr(u_i, Xb)  = -0.3475                        Prob > F           =     0.9841
```

NetIncome	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AmtofMudarabaFinancing	.3678711	1.037789	0.35	0.727	-1.790329	2.526071
AmtofIjaraFinancing	.1745212	.665411	0.26	0.796	-1.209277	1.558319
AmtofMurabahaFinancing	-.1088315	.4599651	-0.24	0.815	-1.065381	.8477183
_cons	5403821	1940115	2.79	0.011	1369130	9438511
sigma_u	7963443.2					
sigma_e	1614553.5					
rho	.96051717	(fraction of variance due to u_i)				

```
F test that all u_i=0: F(5, 21) = 37.13                     Prob > F = 0.0000

. do "C:\Users\user\AppData\Local\Temp\STD11000000.tmp"
```

Results in table 4.8 indicates that the different Islamic bank products have a non-significant effect on the net income as a performance of bank measures. This was supported by R squared 0.04529 (4.529%) which shows that the contribution of Islamic products on commercial banks performance is negligible in Kenya.

Table 4.16: Effect of Islamic Product Finance on Performance of Commercial Banks Measured by Return on Assets

```
. xtreg ROA AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing , fe

Fixed-effects (within) regression               Number of obs      =        30
Group variable: Institutio~d                    Number of groups   =         6

R-sq:                                           Obs per group:
     within  = 0.1181                                         min =         5
     between = 0.3075                                         avg =       5.0
     overall = 0.1895                                         max =         5

                                                F(3,21)            =      0.94
corr(u_i, Xb)  = -0.7309                        Prob > F           =    0.4401
```

ROA	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AmtofMudarabaFinancing	-4.52e-10	4.42e-09	-0.10	0.920	-9.65e-09	8.75e-09
AmtofIjaraFinancing	1.77e-09	2.84e-09	0.62	0.540	-4.13e-09	7.66e-09
AmtofMurabahaFinancing	-2.65e-09	1.96e-09	-1.35	0.191	-6.73e-09	1.43e-09
_cons	.0237662	.0082703	2.87	0.009	.0065673	.0409652
sigma_u	.01971413					
sigma_e	.00688246					
rho	.891361	(fraction of variance due to u_i)				

```
F test that all u_i=0: F(5, 21) = 14.68                     Prob > F = 0.0000
```

Results in table 4.9 indicates that the different Islamic bank products have a non-significant effect on the net income as a performance of bank measures. The effect of Mudaraba financing and Murabaha financing is negative while the effect of Ijara financing is positive amongst commercial banks in Kenya. This overall effect of Islamic products financing on performance of banks in Kenya is low as shown by R squared 0.1895 (18.85%).

Table 4.17: Effect of Islamic Product Finance on Performance of Commercial Banks Measured by Net Assets

```
. xtreg NetAssets AmtofMudarabaFinancing AmtofIjaraFinancing AmtofMurabahaFinancing , fe

Fixed-effects (within) regression               Number of obs      =         30
Group variable: Institutio~d                    Number of groups   =          6

R-sq:                                           Obs per group:
     within  = 0.6121                                         min =          5
     between = 0.6783                                         avg =        5.0
     overall = 0.5393                                         max =          5

                                                F(3,21)            =      11.05
corr(u_i, Xb)  = 0.6255                         Prob > F           =     0.0001
```

NetAssets	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
AmtofMudarabaFinancing	3.595503	2.084604	1.72	0.099	-.7396686	7.930675
AmtofIjaraFinancing	-3.261961	1.33661	-2.44	0.024	-6.041593	-.4823289
AmtofMurabahaFinancing	2.110371	.9239311	2.28	0.033	.1889515	4.031791
_cons	2.45e+07	3897106	6.29	0.000	1.64e+07	3.26e+07
sigma_u	29194069					
sigma_e	3243150.7					
rho	.98780959	(fraction of variance due to u_i)				

```
F test that all u_i=0: F(5, 21) = 145.49                     Prob > F = 0.0000
```

Findings in table 4.10 above show that Mudaraba financing has a non-significant effect on net assets. Ijara financing has a negative and statistically significant effect on net assets of commercial banks in Kenya while Murabaha financing has a positively statistically significant effect on net assets of banks in Kenya. The overall effect of Islamic banking on net assets of banks in Kenya is R squared = 0.5393 (53.93%).

4.5.2 ONE-WAY ANOVA Results

The study sought to analyze whether there is no difference in the performance of Islamic products in Islamic banks and conventional banks. Hence one-way ANOVA was conducted to test the existence of this difference. Given that the study settled on ROA as a measure for testing the research hypothesis, only one-way ANOVA test of ROA was performed

Table 4.18: Difference in Performance between Islamic Banks and Conventional Performance

```
. oneway ROA TypeofBanks, bonferroni tabulate
```

Type of Banks	Summary of ROA Mean	Std. Dev.	Freq.
Conventio	0.0214	0.0144	20
Islamic b	0.0056	0.0116	10
Total	0.0161	0.0153	30

Analysis of Variance

Source	SS	df	MS	F	Prob > F
Between groups	.00167376	1	.00167376	9.12	0.0053
Within groups	.005136366	28	.000183442		
Total	.006810127	29	.000234832		

```
Bartlett's test for equal variances:  chi2(1) =   0.4963  Prob>chi2 = 0.481
```

Comparison of ROA by Type of Banks
(Bonferroni)

Row Mean-Col Mean	Conventi
Islamic	-0.0158
	0.005

```
.
```

With F=9.12, p<0.05, this data provides evidence that there is a difference in ROA between conventional and Islamic

banks. After conducting post-hoc testing using a Bonferroni correction, we determined that the ROA of conventional and Islamic banks significantly differ (p<0.01). Given that conventional bank have a negative Bonferroni correction value it can be concluded that Islamic banks have better performance than conventional banks in Kenya.

4.6 Test of Hypotheses

The main aim of the study was to establish the relationship between Islamic finance and the performance of commercial banks. Three hypotheses were developed to empirically test the relationship between Mudaraba loans, Ijara products and Murabaha contracts and performance of commercial banks in Kenya.

Hypothesis H1 predicted that Mudaraba loans have no significant effect on commercial banks' financial performance in Kenya. Hypothesis H2 predicted that Ijara products have no significant effect on commercial banks' financial performance in Kenya. Hypothesis H3 predicted that Murabaha contracts have no significant effect on commercial banks' financial performance in Kenya. Table 4.15 illustrates the summary results of the hypotheses.

Table 4.19: Summary of Hypothesis

Objective	Hypothesis	Rule	P-value	Comment
To establish the effect of Mudaraba loans on commercial banks' financial performance in Kenya	$H0_1$:Mudaraba loans have no significant effect on commercial banks' financial performance in Kenya	Reject Ho if p value <0.05	p>0.05 at 4.52	The null hypothesis was not rejected; therefore Mudaraba loans have no significant effect on commercial banks' financial performance in Kenya
To assess the effect of Ijara products on commercial banks' financial performance in Kenya	$H0_2$: Ijara products have no significant effect on commercial banks' financial performance in Kenya	Reject Ho if p value <0.05	p>0.05 at 0.54	The null hypothesis was not rejected; therefore Ijara products have no significant effect on commercial banks' financial performance in Kenya
To evaluate the effect of Murabaha contracts on commercial banks' financial performance in Kenya	$H0_3$:Murabaha contracts have no significant effect on commercial banks' financial performance in Kenya	Reject Ho if p value <0.05	p>0.05 at 2.65	The null hypothesis was not rejected; therefore there is a non-significant positive significant relationship between Murabaha contracts and commercial banks' financial performance

4.7 Findings and Discussion

4.7.1 Mudaraba Loans

The study sought to establish the effect of Mudaraba loans on commercial banks' financial performance in Kenya. From the findings, on average for the period 2015 to 2019, Mudaraba product had the least uptake at Ksh903, 273,000. Mudaraba financing however gradually increased throughout the period moving from Ksh602, 145,000 in the year 2015 to Ksh1,060,669,000 in the year 2019.

From the regression results, the study established that there was an insignificant negative relationship between Mudaraba financing and bank performance as shown by a negative coefficient (-5.52e-09) and a non-significant value of 0.244. These findings were contrary to the findings of Habiba and Yusoff (2019), Abdirizak (2016) and Zafar and Nor (2019) who established that mudarabah loans had a positive significant effect on financial performance of commercial banks. The findings were however in line with Idries, et al., (2018) who indicated that there exists a grave problem with offering Mudarabah loans for Islamic banks with operations in countries that have a banking structure that is hybrid, that is, countries with conventional and Islamic banks. The findings were also in agreement with Odongo and Muchelule (2019) who established that Mudarabah loans had a negative and insignificant effect on financial performance of commercial banks. The findings were also in agreement with Entissar (2016) who established that Mudarabah loans had a negative insignificant influence on the financial performance of Sudanese Commercial Banks.

4.7.2 Ijarah Products

The study also assessed the effect of Ijara products on commercial banks' financial performance in Kenya. On average for the period 2015 to 2019, Ijara financing was Ksh1, 000,260,000. The amount of Ijara financing reduced over the five years, having increased from Ksh1,179,802,000 in the year 2015 to Ksh1,289,439,000 in the year 2016, reducing gradually to Ksh570,324,000 in the year 2019.

From the regression results, Ijara had positive effect on bank performance where a unit increase in Ijara would lead to 1.77e-09 increase in bank performance. The significance level was however low as shown by a significance level of 0.198 which is above the 0.05 significance level. These findings were not in agreement with Omar (2018), Alkhazaleh and Al-Dwiry (2018), Szczepanowicz (2016) and Muatuz, (2017) who indicated that Ijarah contract had a positive significant effect on financial performance of the commercial banks. The findings were however in agreement with Chepchirchir, Bogonko and Osodo (2019) who showed that there was no significant relationship between Ijarah products and financial performance of the commercial banks and Ibrahim (2015) who noted that there was a negative relationship between the Ijarah products and performance of Islamic banking in United Arab Emirates.

4.7.3 Murabaha Contracts

The study also evaluated the effect of Murabaha contracts on commercial banks' financial performance in Kenya. The study established that Murabaha financing was the most practiced Islamic financing in the banks with an average amount of Ksh3, 392,335,000. The financing product increased from Ksh3, 186,954,000 in the year 2015 to Ksh4, 142,749,000 in the year 2019. From the

Pearson Moment correlation results, the study established that among the Islamic products, Murabaha had the strongest positive correlation with return on assets with a Pearson correlation of 0.547.

From the regression results, there was a negative non-significant relationship between Murabaha and bank performance as shown by a positive coefficient 2.65e-09 with a non-significance level of 0.191. This implies that a unit increase in Murabaha would lead to a 2.65e-09 decrease in bank performance as measured by ROA. These findings are contrary to the findings by Issack (2015), Azkanar (2016), Hamedian (2017) and Husaeni (2019) who all established that Murabaha contracts had a positive significant effect on financial performance of commercial banks. The findings were also in agreement with Abdel-Razzaq (2018) Nurhasanah and Melzatia (2019) and Bintawim (2017) who established that Murabaha has a statistically non-significant effect on the performance of banks in Australia. Similarly the findings support the conclusion of Abdulwahid (2019) that there is a negative significant relationship between Murabaha contracts and financial performance of commercial banks.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter gives a summary of the study findings as per the specific objectives of the study. The chapter also highlights the conclusions of the study as well as the study recommendations based on the findings. The chapter also presents the recommendations for further research.

5.2. Summary of Findings

The main aim of this study was to establish the effect of Islamic finance on the performance of commercial banks in Kenya. Specifically, the study investigated on Mudaraba loans, Ijara products and Murabaha contracts and how they affect commercial banks' performance. To achieve this objective data was collected from commercial banks operating in Kenya which were offering Islamic finance. Data collected was then analyzed using both descriptive and inferential statistics. Correlation design was adopted to explain the causal relationship between Islamic finance products and banks financial performance.

5.2.1 Mudaraba Loans

On the effect of Mudaraba loans on commercial banks' financial performance in Kenya, the study established that Mudaraba financing had an insignificant correlation with return on assets. From the regression results, the study established that there was an insignificant negative relationship between Mudaraba financing and bank performance. The study therefore failed to reject the null hypothesis, "Mudaraba loans have no significant effect on commercial banks' financial performance in Kenya".

This implies that Mudaraba does significantly affect the performance of banks negatively but not in Kenya.

5.2.2 Ijarah Products

On the effect of Ijara products on commercial banks' financial performance in Kenya, the study established that Ijara had positive effect on bank performance. The effect of Ijara financing on banks performance was also non-significance level as shown. The study therefore failed to reject the hypothesis, "Ijara products have no significant effect on commercial banks' financial performance in Kenya." This implies that Ijara products impact positively on the performance of banks but not in Kenya.

5.2.3 Murabaha Contracts

On the effect of Murabaha contracts on commercial banks' financial performance in Kenya, the study established that Murabaha financing was the most practiced Islamic financing amongst the banks. There was a negative non-significant relationship between Murabaha and bank performance. The study therefore failed to rejected the hypothesis, "Murabaha contracts have no significant effect on commercial banks' financial performance in Kenya."

5.3 Conclusion

5.3.1 Mudaraba Loans

The study further concluded that there was an insignificant negative relationship between Mudaraba financing and bank performance. The study therefore accepted the null hypothesis and concluded that indeed Mudaraba loans have no significant effect on

commercial banks' financial performance in Kenya. This suggests that commercial banks in Kenya that have Mudaraba loans are more likely to have negative performance effects occasioned by the loans but not significant enough.

5.3.2 Ijarah Products

The study concluded that a unit increase in Ijara would lead to anincrease in bank performance. However, the results were not significant. The study failed to reject the null hypothesis and concluded that Ijara products has non-significant effect on commercial banks' financial performance in Kenya. This points out that local banks that have Ijara Islamic products can experience slight increases in their performance but not significant enough to be seen in their bottom line.

5.3.3 Murabaha Contracts

The study concluded that there was a negative non-significant relationship between Murabaha and bank performance. The study concluded that a unit increase in lead to a decrease in bank performance as measured by ROA. The study therefore failed to reject the null hypothesis, "Murabaha contracts have no significant effect on commercial banks' financial performance in Kenya" and concluded that Murabaha contracts do not have significant effect on bank performance in Kenya.

5.4. Recommendation

The following recommendations were on the basis of the study findings.

The study revealed that was Mubaraha loan products have a non-significant effect on bank performance. Therefore, commercial banks in Kenya should not strongly

prioritize Mubaraha products in their loan portfolio. This is because they still don't have a significant effect on banks performance in Kenya.

The study findings also revealed that only Ijara financial products have a positive but non-signficant effect on the financial performance. The study thus recommends that banks that are looking into Islamic financial products should strongly prioritize Ijara products for they are more likely to impact bank performance positively.

The findings also revealed that Murabaha loans have negative non-significant effect on performance of banks. Therefore, banks should strongly work on the loan costs associated with these loans in order to minimize their negative effect on bank performance.

The study recommends that the operating environment of Islamic bank be enhanced. This can be achieved through the government developing effective policies that will encourage Islamic banking in the financial market and also help the growth of Islamic banks in Kenya.

5.5 Limitations of the Study

The study was limited to only the commercial banks offering Islamic finance in Kenya. Islamic banking is yet to be fully entrenched in the Kenyan banking sector with just about fourteen years since inception in Kenya. Hence, the results are representative of a banking sector that is still in the growth stage. Therefore, the study findings should be treated with caution.

This study was limited to commercial banks and a period under study of six years, i.e. 2015 to 2019. This is a small sample and further studies should be done on other

financial institutions such as microfinance institutions which offer Islamic financial services with longer study periods of over ten years.

Additionally, there are a few Islamic products available in the commercial banks in Kenya. This is in comparison with the vast number of Islamic financing products that currently exist in the Gulf countries. There is also no regulatory body in Kenya tasked with ensuring that in as much as the Islamic banks are performing well, they are also Sharia compliant in all their business transactions.

5.6 Suggestions for Further Research

Having established that the three independent variables that were studied, explain 18.95% percent of the bank performance, the study recommends that further research should be conducted to investigate the other effects (81.15 percent) of Islamic banking. The study also recommends that further research be conducted on the same topic having increased the scope to other areas not covered by Islamic finance so as to make comparisons and derive the true picture in as far as the effect of Islamic finance on bank performance. Future studies should incorporate other factors that influence profitability such as political instability, taxation, bank size, financial structure and competition from other financial institutions. It cannot be ascertained if the results won't change if more variables and longer periods would have been considered in the study.

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APPENDICES

Appendix I: Data Collection Form

	Amount '000'				
Year/ Performance measure	**2015**	**2016**	**2017**	**2018**	**2019**
Net assets					
Net income					
Profitability					
Amount of Mudaraba financing					
Amount of Ijara financing					
Amount of Murabaha financing					

Appendix II: Data Sheet

		Diamond Trust Bank (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	29,996,201	36,431,809	43,003,972	47,712,838	52,001,378
Net income	4,792,851	6,151,903	5,499,671	5,786,916	5,380,422
ROA	2.70%	2.60%	2.00%	1.91%	1.90%
Amount of Mudaraba financing	3,392,468	4,544,025	5,600,406	5,752,702	5,752,702
Amount of Ijara financing	6,678,390	7,341,537	6,223,505	4,793,130	3,297,427
Amount of Murabaha financing	3,996,431	5,072,986	5,020,237	4,759,643	4,602,783
		First Community Bank (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	1,611,608	1,557,408	1,709,205	1,271,103	1,462,059
Net income	-12,114	-55,734	151,797	-212,062	190,927
ROA	-0.08%	-0.32%	0.87%	-1.19%	0.10%
Amount of Mudaraba financing	94,400	94,400	94,400	94,400	94,400
Amount of Ijara financing	19,012	19,109	11,078	8,000	0
Amount of Murabaha financing	248,252	222,413	568,881	532,736	846,829
		Gulf African (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	3,877,386	4,375,707	4,419,463	4,467,964	4,634,964
Net income	730,703	498,321	153,653	131,589	167,000
ROA	3.00%	1.83%	0.49%	0.39%	0.48%
Amount of Mudaraba financing	1,000	1,000	1,000	1,000	1,000
Amount of Ijara financing	0	0	0	0	0
Amount of Murabaha financing	378,649	385,056	319,279	330,120	860,775

		National Bank of Kenya (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	10,913,622	10,996,083	7,047,537	6,935,718	11,704,420
Net income	-1,200,290	82,461	292,668	754,664	-206,806
ROA	-0.96%	0.07%	0.27%	0.66%	-0.19%
Amount of Mudaraba financing	0	237,007	334,134	366,822	515,910
Amount of Ijara financing	0	0	0	0	0
Amount of Murabaha financing	4,187,457	4,110,825	3,710,328	3,998,390	4,547,632
		Kenya Commercial Bank (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	80,885,958	80,989,889	88,990,915	97,788,946	92,607,634
Net income	14,769,045	19,495,565	20,417,714	24,193,178	19,243,967
ROA	3.16%	3.86%	3.68%	3.89%	2.85%
Amount of Mudaraba financing	125,000	0	0	0	0
Amount of Ijara financing	134,503	132,006	129,509	127,013	124,516
Amount of Murabaha financing	7,045,892	6,036,804	6,194,697	7,121,150	10,104,529
		Standard chartered Bank (sh'000)			
Year/ Performance measure	2015	2016	2017	2018	2019
Net assets	40,914,483	43,904,779	44,583,852	45,336,279	47,221,510
Net income	5,926,772	9,080,492	7,183,001	8,275,443	8,580,752
ROA	2.53%	3.63%	2.52%	2.91%	2.84%
Amount of Mudaraba financing	0	0	0	0	0
Amount of Ijara financing	246,908	243,980	240,557	237,630	0
Amount of Murabaha financing	3,265,044	2,985,751	3,351,240	3,071,308	3,893,947