EFFECT OF ISLAMIC FINANCIAL SERVICES ON THE FINANCIAL PERFORMANCE OF SELECTED BANKS IN KENYA

BY

WILFRED A. ESHIWANI

MASTERS OF SCIENCE IN COMMERCE IN ECONOMICS AND INVESTMENT

KCA UNIVERSITY

2018

EFFECT OF ISLAMIC FINANCIAL SERVICES ON THE FINANCIAL PERFORMANCE OF SELECTED BANKS IN KENYA

BY

WILFRED A. ESHIWANI

A DISSERTATION SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF A MASTERS OF SCIENCE IN COMMERCE DEGREE IN ECONOMICS AND INVESTMENT IN THE SCHOOL OF BUSINESS AND PUBLIC MANAGEMENT AT KCA UNIVERSITY

NOVEMBER, 2018

DECLARATION

This dissertation is my original work and has not been previously published or submitted elsewhere for award of a degree. It contains no material written or published by other people except where due reference is made and author duly acknowledged.

Wilfred Andalya Eshiwani KCA/08/03098

Signed: ……..…….. Date: ……..……..…….

I do hereby confirm that I have examined the master's dissertation of

Wilfred Andalya Eshiwani

And have approved it for examination.

Signed: …….. Date: …….

Dr. Ibrahim Tirimba

Dissertation Supervisor

ABSTRACT

The financial system is the main driver of economic growth and development of a nation. It facilitates the flow and allocation of funds in an economy. For the longest time, the conventional financial system has dominated the market. However, the introduction of Islamic financing is tipping the scales. Islamic finance refers to financial institutions which operate under Islamic *Shari'ah* law. Over time, there has been a continued expansion and uptake of Islamic financial services. This necessitated a study in this field. Islamic financing offer the same services as conventional financing, but, operate on the principles of *Shari'ah* law (Islamic law) which prohibits secured returns, fees, uncertainty caused by speculations and fluctuations in interest rates during the financing repayment period on an investment. Islamic finance offers services to all of its customers regardless of their faiths. Some of the challenges facing Islamic banks are social justice, lack of cooperation, divided social interest and liquidity constraints which have contributed to unfavourable financial performance. These challenges have affected the quality and quantity of financial services provided by Islamic banks hence affecting their performance. The purpose of this study was to find out the effect of Islamic financial services on the financial performance of selected banks in Kenya. The study was anchored on three theories; the shareholder theory, the theory of interest and Islam, and the agency theory. The study adopted a descriptive methodology in which eight banks offering Islamic financial services in Kenya were targeted, namely ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank. Secondary data was obtained from published financial statements from respective bank websites and self-administered data collection forms. Data was analysed using descriptive statistics. Regression analysis was used to measure the relationship between dependent variable and independent variables. The study established that equity sharing and financial training had a positive effect on financial performance of selected banks in Kenya. The study however established that cost-plus financing had a negative effect on financial performance of selected banks in Kenya. The study recommended that increased awareness of Islamic products should be undertaken through development of effective marketing policies, Islamic banks should also invest in operational cost cutting measures like staff training to equip them with knowledge and competence and save on time and material wastages, and also the government should develop policies that encourage Islamic banking and growth in Kenya. The study recommended a further study on challenges facing uptake of Islamic financial services in Kenya with a view of recommending solutions to those challenges and also on the same topic using GARCH model as a way of validating this study.

Key Words: Equity Sharing, Cost-plus Financing, Financial Training, Bank Performance

ACKNOWLEDGEMENT

The success and completion of this dissertation would have not been possible without the help of others. First, I would like to thank my lecturers and acknowledge my supervisor Dr. Ibrahim Tirimba for his scholarly guidance, suggestions and patience that made this study a reality, a special thank you to Hellen and Feirouz. I sincerely appreciate my fellow students, family and friends, for their motivation, encouragement, support and understanding for my continued absence when I was undertaking my studies. The success and completion will not have been possible without your help. Thank you for the support.

TABLE OF CONTENTS

DEDICATION

This dissertation is dedicated to my family; thank you dad and mum, my siblings, Dorice and Fridah. And to God my source of inspiration

LIST OF FIGURES

LIST OF TABLES

ACRONYMS AND ABBREVIATIONS

AAOIFI: The Accounting and Auditing Organization for Islamic Financial Institutions

IAH: Investment Account Holders

IDB: Islamic Development Bank

IFI: Islamic Financial Institutions

IFRS: International Financial Reporting Standards

MLR: Multiple Linear Regressions

PLS: Profit and Loss Sharing

PSIA: Profit-Sharing Investment Accounts

ROA: Return on Asset

ROE: Return on Equity

ROI: Return on Investment

OPERATIONAL DEFINITION OF TERMS

Cost-plus financing: This is a financing method where profit markup is used instead of interest rates, i.e. Sale Price = Cost *x* (1 + Markup %)

Equity sharing: It is an equity-based financing. It is also referred to as profit and loss sharing in Islamic finance. Creditors act as partners in the business and are entitled to profit and loss sharing on the basis of their capital share and effort (Kayed, 2012).

Financial training: Financial training is the action of schooling a person on financial skills in order to impart knowledge and understanding of financial matters, and have the ability to process economic information and make informed decisions about financial planning, wealth accumulation, debt, and pensions (Hendriks, 2010).

Ijarah: An Islamic lease agreement.

Interest (*Riba*): Refers to per cent of premium paid on money at one date in terms of money to be in hand at a future date. It is an increase, growth or accretion of money (Yahia, 2014).

Interest prohibition: Refers to the proscription of charging a premium over and above money lend. Instead of lending money, the financial institution purchases the asset then sells it to the borrower at a fixed agreed upon profit (Yahia, 2014).

Islamic bank: Is a financial institution that provides commercial banking services such as accepting deposits, giving loans, mortgage financing, investment products such as savings accounts and certificates of

deposit to individuals and organizations, in strict compliance with Islamic Shari'ah Laws (Venardos, 2011).

Islamic Financial services: These are facilities offered by Islamic financial institutions to its customers in the course of their operations (Saleh, Quazi, Keating, & Gaur 2017). For purposes of this study, Islamic financial services will be limited to investment products (i.e. prohibition of interest on loans and profit and loss sharing on returns on investment) and financial training.

Mudarabah: An agreement between two or more persons whereby one party provide finance (*rab-ul-amal*), while the other party (*mudarib*) provide entrepreneurship, and management to carry on any business venture with the objective of earning profits. Profits are shared in agreed proportions. Loss is shared by financiers in proportion of capital contribution. Loss to entrepreneur is not getting reward for services offered.

Murabahah: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over installments, the capital user has effectively obtained credit without paying interest.

Musharakah: Profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner.

Performance: Financial performance is the ability of a firm to meet its core objective (Lahrech N., Lahrech A. & Boulaksil 2014). For purposes of this study, financial performance will be measured through profitability.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The financial system has been dominated by the conventional banking system since time immemorial. Entry of other financial intermediaries, such as micro finance institutions and other informal banking methods such as economic groups (*chamas*) has changed the financial landscape significantly. A major shift in the traditional banking sector was however, caused by the entry of the Islamic financial system (Venardos, 2010).

Several authors have defined Islamic banking and Islamic financial services as being based on Islamic principles. According to Venardos (2011), Islamic banking is where all financial transactions are conducted according to Islamic precepts, which emphasizes on development of the society by adding value to the society besides making profits. Islamic finance is based on a comprehensive system of ethics and moral values stemming from the Islamic religion (Bellalah & Omar, 2013). Also El and Amr (2010) opined that Islamic banking is a system of banking that is consistent with the principles of Islamic law and its practical application through the development of Islamic economics. While Ayub (2009) as well as Kettell (2011) define Islamic banking as financial services based on in their objectives, and operations, on Qur'anic principles and its practical application through the development of Islamic economics.

This means that, unlike other conventional banking services, Islamic banking and financial institutions, is based on religious preoccupations, with six key principles, as explained by Kettell; (1) Interest (*riba*) is prohibited. Interest is a predetermined loan repayment amount over and above the principal; (2) Profit and loss sharing is at the heart of the Islamic system; (3)

all financial transactions must be asset backed. This prohibits making money out of money (i.e. trading in capital money markets) and that the bank acquires the asset (investment) first then sells it over to the customer; (4) Speculative behaviour (*Gharar*) is prohibited; (5) Only Sharia approved contracts are acceptable; and (6) Contracts are sacred.

Extant literature lists emerging and unresolved issues in Islamic finance as perception that Islamic financial services are only for the Muslim faith populations (Ringim, 2014; Saleh, Quazi, Keating and Gaur, 2017), a fact supported by existing literature and unfavourable or lack thereof of government policies and guidelines on Islamic finance (Gitongu, 2015; Suandi, 2017). These limitations continue to demand for further researches on Islamic finance with the aim of finding solutions and also a call on governments to formulate accommodating policies that will push the growth of Islamic finance in their respective jurisdictions.

1.1.1 Islamic Bank

The first Islamic bank was called Mit Ghamr Local Savings Bank, established in Egypt in 1963, as explained by (Venardos, 2010; Yahia, 2014), and gradually grew to a finance industry in the Middle East in 1973. Its success led to the formation of several Islamic financial institutions across the globe. Islamic banking success, rapid growth and adoption by people of all faiths was influenced by its ethical alternative of protecting against worst excesses of leverage whilst reinstating values and trust, creeds that have been lost in conventional financing systems (Ismal, 2013; Venardos, 2010).

Islamic Development Bank (IDB) was formed in December 1973 to develop internationally acceptable standards and procedures, and strengthening the sector's architecture in different countries, pursuant of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim countries held in Jeddah (Masood, 2013).

After the success of the first Islamic bank in Egypt, there was a positive uptake of Islamic banking services by other nations across the world. Examples of Dubai Islamic bank which was established in 1979 in the United Arab Emirates headquartered in Dubai, and Islamic insurance company of Sudan established in Sudan in 1979, and also the Amana Income Fund, which is an Islamic mutual fund, created in 1986 in Indiana are just but a few examples. In the 1980's, there was a remarkable growth of Islamic financial service providers across the globe with the practice also taking root in Africa (Venardos, 2010).

Muslim faith dominant countries were the first to embrace Islamic banking in the world and Africa (Ismal, 2013; Venardos, 2010; Yahia, 2014). In Africa, Jaiz bank was the first full-fledged Islamic bank in northern Nigeria licensed in January 2012 while the First National Bank (FNB) was the first bank to offer *Shari'ah* compliant financial services in South Africa in 2004. According to the Central bank of Kenya 2017 report, the first Islamic bank to be established was Gulf African Bank which was licensed to operate in Kenya on 1st November 2007, the second Islamic bank to be licenced in Kenya was the First Community Bank on 29th April 2008, later, Dubai Islamic Bank was the third Islamic bank to be licensed to operate in Kenya in April 2017. In addition to these three Islamic banks, commercial banks also offer Islamic banking services in addition to their conventional banking services. The researcher concentrated on eight financial banking institutions that offer Islamic banking services which are ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank, in Kenya.

From available literature, it can be summed that the major distinguishing features of an Islamic financial institution with the conventional banking system are that Islamic financial institutions focus majorly on investment while conventional banking focus on lending; Islamic

banking emphasize on soundness of the project while conventional banking emphasize on ability to repay lent money; Islamic banking coordinate with partners in resource mobilization while conventional banking depend on borrowing in resource mobilization and finally, Islamic banking apply moral criteria in investment while conventional banking apply only financial criteria.

1.1.2 Bank Performance

Bank performance is determined by the ability of an enterprise to meet the expectations of its owners and other stakeholders. The legal relationship between an investment account holder and Islamic banking rules is of importance in demystifying Islamic banking performance (El & Amr, 2010). An investment account holder expects sustained and increasing interest/yield on his investment while Islamic banking system prohibits this kind of arrangement and goes further to allow sharing on profits and losses on investments. This diminishes the chances of an investor getting a sustained reward on his investment and may also affect bank performance as investors may hold onto their money.

A study on rewards in faith-based vs conventional banking in seven countries; Bahrain, Kuwait, Malaysia, Pakistan, Qatar, United Arab Emirates (UAE) and United Kingdom (UK) done by Ghauri and Qambar (2012) concluded that innovative product structuring is the major determinant for investors' attraction and that Islamic banks have higher operational costs and need to improve on risk management as compared to conventional banks. This often impacts negatively on their financial performance.

In another study on whether Islamic bank profitability is driven by same forces as conventional banks, in the Middle East and North Africa (MENA) region, Zarrouk, Jedidiah, and Moualhi (2016) investigated fifty one Islamic banks operating in this region, and established that profitability is positively affected by bank cost-effectiveness, asset quality and level of capitalization, and that non-financing activities such as gross domestic products (GDP) and

investment allow Islamic banks to earn higher profits. However, inflation rate affects negatively Islamic bank profitability.

Nyathira (2012) sought to find out the effect of financial innovation on financial performance of commercial banks in Kenya. The study concluded that financial innovation in payment systems resulted into improved financial performance of commercial banks and that financial innovation presented a more convenient, efficient and secure platform to commercial bank customers resulting to enhanced uptake of the new innovation services.

Several centuries after the first conventional bank was established, Islamic banks catching up and or even overriding the benefits obtainable from conventional banking system is a challenge. But Islamic banking services have proved the possibility of providing an alternative financial system that is acceptable to all customers regardless of their faiths. This can be seen through their rapid growth across the globe. A look on the main driving factors of this success necessitates further research on Islamic bank services without comparison with other conventional banking services. Many researchers have concentrated on comparisons between Islamic and conventional banking services not as much as exclusive research on Islamic financial services.

1.1.3 Islamic Financial Services

As explained earlier, *Shari'ah* Law provisions are the defining principles in Islamic financial services. These provisions may differ with other principles and state laws governing financial transactions. Corporate compliance demands that all institutions comply with the laws of the country they operate in. This contrasts with Islamic banking which demands strict compliance with Islamic laws. Conflict in laws and non-supportive Central Bank financial policies is a major concern for Islamic financial institutions.

Saleh, Quazi, Keating and Gaur (2017), in their research on quality and image of banking services: a comparative study of conventional and Islamic banks in Bangladesh concluded that Islamic values, beliefs and religiosity of internal markets and service providers of Islamic banks have been instrumental in building customers' confidence in and positive perceptions of Islamic banking unlike in conventional banking.

Accordingly, Akhtar, Akhter and Shahbaz (2017), in their study of determinants of deposits in conventional and Islamic banking: a case of an emerging economy, a study done in Pakistan, established that depositors of both Islamic and conventional banks are sensitive to returns received on deposits, and that depositors of Islamic banks are inclined to save more money in the form of deposits during high growth period whereas the depositors of conventional banks are inclined to dis-save or withdraw their money from the deposits during high growth period. This differences are explained by the fact that Muslims are persuaded to save rather that to expend lavishly.

On findings on the perception of Nigerian Muslim account holders in conventional banks toward Islamic banking products in Nigeria, Ringim (2014) established that the main reason why people select Islamic banking product was based on their personal perception on religious and economic considerations and that there is need to strengthen public education toward the distinctive characteristics of Islamic banks and how it may profitably suit the interest of customers in their financial dealings.

Despite a lot of research being done on comparison between Islamic and conventional banking, little has been done exclusively on the performance of Islamic financial institutions occasioned by the difference in *Shari'ah* Law provisions that guide them and state laws which

they must also subject to. This study was designed to investigate the effect of financial services on the financial performance of selected banks Kenya.

1.2 Statement of the Problem

One of the distinguishing features of Islamic banks is that they do not charge interest (Bellalah & Masood, 2013; Yahia, 2014). Unlike conventional banks, Islamic banks are regulated by Shari'ah Laws. Some of the financial services they provide entail: *Murabahah, Musharakah, Ijara, Mudarabah* and financial training.

El and Amr (2010) as well as Toutounchian and Kabir (2011) identify some of the challenges facing Islamic banks to be social justice, lack of cooperation, divided social interest and liquidity constraints which have in return contributed to unfavourable financial performance. These challenges have affected the quality and quantity of financial services provided by these banks thereby affecting performance. Researchers have failed to eradicate the dichotomy on the effect of financial services and how they affect the Islamic banking context (El & Amr, 2010; Omar, 2016; Talam, 2014; Thomi, 2012; Toutounchian & Kabir, 2011). While some determine occurrence of a positive effect on bank performance from Islamic products such as *Mudarabah, Murabahah, Musharakah* and *Ijarah* at 91.30% (Thomi, 2012), others find that some of the financial services offered by Islamic banks have a negative implication on performance especially on efficiency by a reduction of mean of 0.13 i.e. from 0.67 in 2009 to 0.54 in 2013 and expenses management by a reduction of mean of 0.07 i.e. from 0.32 in 2009 to 0.25 in 2013 (Talam, 2014). This shows that there exists disagreement in research calling upon further investigations.

It can be ascertained that existing literature focused on Islamic financial products. This study will incorporate the contribution of employees to financial performance of banks through specific objective (iii), financial training. Owing to conflicting research findings on the effect of Islamic financial services and how they affect financial performance of Islamic financial institutions, this area remains new despite the elapse of time due to minimal publications thereby leaving the area on the effect of financial services and how that affect financial performance of banks in Kenya grey. This study therefore pursued to fill this existing gap by determining the effect of Islamic financial services on the performance of selected banks in Kenya.

1.3 Objectives of the Study

1.3.1 General objective

The general objective of this study was to determine the effect of Islamic financial services on the financial performance of selected banks in Kenya.

1.3.2 Specific objectives

The following were the specific objectives of the study;

i) To determine the effect of equity sharing on the financial performance of selected banks in Kenya

ii) To investigate the effect of cost-plus financing on the financial performance of selected banks in Kenya

iii) To assess the effect of financial training on the financial performance of selected banks in Kenya.

1.4 Research Questions

i) What is the effect of equity sharing on the financial performance of selected banks in Kenya?

ii) How does cost-plus financing affect the financial performance of selected banks in Kenya?

iii) In which way does financial training affect the financial performance of selected banks in Kenya?

1.5 Significance of the study

Investors are the main beneficiaries of this study. Exclusive research on Islamic banks gives an opportunity to investors who prefer to solely invest in Islamic bank products due, may be, to their faith beliefs. This offers extra knowledge of services offered by Islamic banks hence offering them with wide information on choices of their financial services.

Management of Islamic banks get to understand the behaviour of their employees and customers towards services offered through one-on-one interactions in financial training sessions and build on this understanding to improve on the quality of their services. This study also gives the management of Islamic banks exclusive knowledge on Islamic bank services without comparison with conventional banks enabling them to improve on their services and enhance customer loyalty.

Scholars and academicians also benefits from this study. The study provides important topical insights on other related areas to be researched on. The study also provides literature review on financial services and Islamic banking that enriches the literatures of potential researchers in this domain.

1.6 Scope of the study

This study focused on the Islamic financial services offered by commercial banks that affect their financial performance. The financial services that were investigated and which formed the independent variables were equity sharing, cost-plus financing and financial training. Bank performance was measured in terms of profitability (i.e. profit before taxation), which was the major indicator of bank performance. The study took six months starting January 2018 and ending June 2018. The study was conducted on eight commercial banks that offer Islamic financial services in Kenya, namely African Banking Corporation Bank, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank,

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter explains the literature for this study. The main sections are the theoretical review, the empirical review, the conceptual framework and the operationalization of variables.

2.2 Theoretical Review

This section presents the main theories under which this study is anchored. The theories that were reviewed are: the shareholder theory, the theory of interest and the agency theory.

The researcher examined the financial performance of Islamic banks based on services offered. This was highly influenced by financial ethics of both the banks and their clients. Boatright (2010) explains Finance ethics as consisting of who owes what to whom, and why, and duties and rights of each player in the financial field. Ethics is a human behaviour which touches on social, emotional and/or cognitive behaviour. Most financial theories are premised on this fact. Modern financial theory and empirical studies concentrate mostly on the risk and return components of the financial system. The financial intermediation theory holds that banks are merely financial intermediaries, i.e. they borrow from depositors with short maturities and lend to borrowers at longer maturities. Efficiency of the financial system is determined by the depth, breath and efficiency of financial institutions. The researcher considered different theories that deal with the performance of Islamic financial institutions such as the shareholder theory, the theory of interest and the agency theory.

2.2.1 The Shareholder Theory

The Shareholder theory states that the primary responsibility of a firm is to maximize the wealth for its shareholders. This theory was first formulated by Friedman in 1962. It proposes that

Managers should invest in those projects which seek to create maximum value for investors using capital advanced to them (Friedman, 1962).

Critics of the shareholder theory such as Freeman (1994), who further came up with the stakeholder theory, argued that the shareholder theory is restricted to generating benefits for shareholders only and neglects the role of other players in a firm such as employees, customers, suppliers, the government and the society as a whole, who contribute incredibly to the success of the organization.

Wealth and or profit maximization is the primary responsibility of any profit making organization and the shareholder theory states as such. This theory explains the behavior of managers toward fulfilling their responsibility of wealth creation which is measured through bank financial performance. The shareholder theory affects the Equity sharing and the profit and loss sharing principle of Islamic Shari'ah laws. This is because any sharing of profits that is considered fair by both parties (i.e. shareholders and deposit account holders) will drastically reduce the profit share of shareholders who are owners of the business. Equity sharing financial services offered by banks is aimed at achieving this goal and benefit to other stakeholders, thus the theory was important to this study.

2.2.2 The Theory of Interest

The Theory of Interest was first proposed by Irving Fisher in 1930. This theory was a revision of his earlier book and theory of *The Rate of Interest*, published in 1907. The theory asserts that the money used for lending purposes is the money not used for consumption, and that earning interest by abstaining from spending makes the funds possible and available for borrowers (Fisher, 1930). In summary, this theory talks of the impatience to spend income and opportunity to invest it. Fisher defines human impatience as the time preference. He identified that the rate of time preference or degree of impatience, for present over future goods of like kind is readily

derived from the marginal desirability of, or wants for, those present and future goods respectively. This simply means that the rate of interest (premium) on the exchange between present and future goods is based on a subjective (psychological) element, a derivative of marginal desirability, i.e. the marginal preference for present over future goods. Interest rate is the link between income and capital.

John Maynard Keynes, in his publication of "*theory of interest rate: a critical approach*," and also in his book, "*the general theory of employment, interest and money (1936)*," criticised fisher's assertions by claiming that he disregarded the impact that income has on the level of interest rate while focusing on capital only. He determined the rate of interest as a reward for parting with liquidity as a result of the supply and demand for money and not as a reward for saving (Keynes, 1936). As elaborated by Appelt (2016), Keynes defines interest rate in three ways; (1) as a measure of reluctance to part with money in liquid form; (2) as the price which brings into balance the desire to hold wealth in the form of cash with the supply of cash; and, (3) as a compensation for parting with liquidity or as a reward for not hoarding.

Kettell, opined that Interest is at the core of Islamic financial services. The aim of this study was to determine how the absence of the rate of interest on investment products and customer deposits affect the performance of Islamic banks. The researcher was to determine how the Islamic alternative to interest, which is profit, contributed to the performance of Islamic banks in Kenya.

Cost-plus financing Islamic financial services will be affected by this theory. Depositors may be reluctant to deposit their money into Islamic banks for lack of ascertained return occasioned by non-charging of interest hence denying the banks enough monetary resources to offer *Murabahah* services.

2.2.3 The Agency Theory

Stephen Ross and Barry Mitnick were the earlier proponents of the agency theory in the early 1970's, but it was Jensen and Meckling who developed it in 1976. 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). In the financial field, commercial banks act as intermediaries (agents) between lenders (depositors) and borrowers (investors). 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 further asserts that the agency theory is premised on five major assumptions, i.e. (1) potential goal conflicts exists between principals and agents; (2) each party acts in its own self-interest; (3) information asymmetry frequently exists between principal and agents; (4) agents are more risk averse than the principal; and (5) 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.

Agency theory affects all the three variables; equity sharing, cost-plus financing and financial training. 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).

Capacity building and financial literacy is crucial in any organization. Banks and other financial institutions provide financial training to its employees and customers through seminars, on-job training, bank visits and advising investors when determining capital allocation to proposed investments. This behaviour promotes awareness of the range of financial services offered. Based on the provisions of Islamic laws, these theories assisted the researcher in determining how expectations of the shareholders, investors, management, employees and customers adjust to services offered by Islamic banks and how this affected bank performance in the long run.

2.3 Empirical Review

This section revised previous studies on financial services and how they affected the performance of Islamic banks. The main sections were: equity sharing, interest prohibition and financial training.

2.3.1 Equity Sharing and Financial Performance

This is referred to as *Musharakah* in Islamic finance. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital contribution or investment portion of each partner.

Solid submissions were emphasized by Abdullah (2016) who sought to find out the legal interpretation of *Ijarah, Murabahah and Musharakah* in the United States of America (USA) in relation to the Islamic law of transactions. Further, he sought to find out if Islamic banks will live to its ideals were they to be subjected to the same standards as conventional banks. By adopting both qualitative and quantitative analysis methodology, the researcher argued that the income generated from these three financial products was without any equivalent counter-value because of the absence of the market risk. Similar to Kayed findings, it can be ascertained that Islamic

finance is concerned with what is owed to the institution and not customers as it should be under *Shari'ah* laws. Islamic finance being asset-backed and not asset-based, should accept market risk with recourse to income and asset appreciation. Islamic finance should be concerned with investment and asset management rather than credit management. Following these findings, it can be concluded that if focus will be on investment and asset management, Islamic bank's financial performance will improve a great deal.

Consequently, Suandi (2017) also sought to find out if Islamic banks maintain uniform practices when subjected to various accounting standards, and also their responsibility on investment account holders under profit-sharing investment accounts (PSIA). Samples of financial statements from sixty three Islamic banks from fifteen countries were compared to information relating to PSIA. The findings were that Islamic banks that apply IFRS do not indicate a uniform accounting practice for PSIA, but application of AAOIFI indicated a more comparable, consistent and transparent result. Majority of Islamic banks apply IFRS and this means fewer disclosures pertaining return to IAH. The study concluded that despite the similarity of investment account holders (IAH) and shareholders, IAH are regarded as less important compared to shareholders. These findings were similarly to Abdullah and Kayed findings, this shows a common trend where Islamic banks prioritize shareholders' to investment account holders' interests, an explanation that can be attributed to management's core responsibility of profit maximization. Of importance to note is the adherence of Islamic banks to IFRS standards in presentation of their financial statements.

Lahrech N., Lahrech A. and Boulaksil (2014) pursued to find out whether Islamic banks are transparent regarding profit and loss sharing to investment account holders and also whether bank's performance affects this, in various countries. The study conducted an empirical study,

and data collected was analyzed using a mathematical model based on the generalized least-squares principle. It was established that disclosure of qualitative and quantitative information enhanced transparency and thereby depositors' confidence in the system. On profit and loss sharing, it was revealed that bank's performance was significantly and positively associated to profit sharing ratio and that capital is a significant factor. It can be concluded that Islamic banks are willing to distribute profit when they have enough capital to cover feasible losses, create value to shareholders and high liquidity levels (Lahrech *et al.*, 2014). These findings are affirmed by Suandi (2017) who established the need of transparency in Islamic banking to interest shareholders.

Kayed (2012) on a study to determine whether the profit-and-loss sharing (PLS) modes of finance are viable alternatives for entrepreneurship and enterprise development, using the methodology of a combination of extensive examination of existing literature and critical analysis of the outcomes of several relevant studies. The study established that *Musharakah* played an insignificant role in financing small and micro enterprises, and on the contrary, just like conventional banking system, Islamic banks extended their facilities to the well-established businesses and individuals. This was tough to young entrepreneurs. According to Kayed, the problem rests with financial institutions and other stakeholders, giving the attitude and behavior of Islamic financial institutions and their reluctance to accommodate entrepreneurship by genuinely implementing the PLS contracts. With these findings, it can be concluded that, just like conventional banking system, Islamic banks aim to create wealth for shareholders and that are more willing to embrace less risky (well-established) clientele over young entrepreneurs.

Hassan (2016) sought to find out the effect of Islamic financing on financial performance of businesses in Eastleigh business community, Nairobi County, Kenya, in three years 2011,

2012 and 2013. By employing a descriptive research design methodology and basing on primary data, the study established that the effect of equity financing on firm performance is insignificant. A finding that was consistent with the pecking order theory that says firms will prefer debt over equity.

Accordingly, Adan (2017) researched on the factors influencing growth of client base of fully fledged Islamic banks in Kenya. The study used descriptive cross-sectional design methodology. The study found out that financing options moderately influenced the growth of Islamic banking in Kenya and that *Musharakah* contracts highly attracted both existing and new customers. It was further concluded that strict compliance with Islamic S*hari'ah* tenets was critical in attracting more clients to fully fledged Islamic banks. These findings are in contrast with Hassan (2016) who established an insignificant role of *Musharakah* contracts on firm's performance.

These findings and other literatures show an inconsistent flow of facts. First, existing literature established that strict compliance with Islamic tenets by Islamic banks attracted more customers (clients) and this contributed positively to financial performance of Islamic banks. On the other hand, existing literature also revealed that Islamic product of joint venture (*Musharakah*) contributed insignificantly to financial performance of Islamic banks because firms preferred debts over equity financing. These divergences in literature called for further studies.

2.3.2 Cost-plus Financing and Financial Performance

This is a financing method where profit markup is used instead of interest rates, i.e. Sale Price = Cost *x* (1 + Markup %). Interest prohibition is the basis of Islamic banking. Shari'ah laws prohibit any activities that contain *Gharar* (uncertainty) such as speculations, short selling or

derivatives. Interest is determined by market forces thus making it difficult to determine with certainty for future contracts. To counter this, IFI charge a fixed return (profit) on their products.

Contrary to what the population is meant to believe, charging of interest (*riba*) is prohibited in all the Abrahamic faiths, (i.e. Judaism, Christianity, and Islam), from the original teachings of Moses in the Torah (Jewish Bible), the teachings of Jesus in the Christian Bible and the teachings of Muhammad as revealed in the Qur'an. The main reason of prohibiting *riba* is to prevent those who have money from taking advantage of and abusing the freedom of the poor and needy (Yahia, 2014).

Islamic writings offer little with regard to rationale of Islamic finance beyond the concept of justice underlying the prohibition of interest (Al-Jarhi, 2017). Interest free Islamic finance started with the origin of Islam, based on investment and finance contracts. Unlike conventional banking system which uses the classical loan contract, Islamic finance uses product based contracts including the possibility of mixing and matching, and securitization. This results in higher contractual and transactions costs which negatively affects bank performance.

Eqbal (2011) sought to find out the relevance of Islamic banking system in the present economic scenario. The study established that based on interest free financing and profit and loss sharing as well as sharing of risk, Islamic finance is not significantly affected by economic slowdown and financial crisis. Interest based financing structure was found to be the main cause of financial market ripples. Islamic banking, based on interest free operations and incorporation of ethics and economics to facilitate financial growth and economic welfare was proven to be the alternative to economic stability. Based on the findings, it can be ascertained that interest free banking is a sure way of maintaining financial performance of Islamic banks, as it will shield them from market risks caused by interest rate ripples.

Murabahah product of Islamic finance was well articulated by Khan (2011). *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. 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.

Accordingly, Iqbal (2010) investigated the prohibition of interest and economic rationality on three grounds; first, interest as a tool of exploitation, second, interest-based external financing leads to unfair distribution of profits and thirdly, exclusive equity financing has the least risk. On exploitation, the study findings were that with time, it contradicts facts because the majority of borrowers are better financially off. However, facts were true on profit sharing and equity financing. This makes economic sense in prohibition of interest. The study further determined that prohibition of interest should not be taken as a restriction on personal liberty but explored by economists irrespective of their religious beliefs. Findings that was similar to Khan (2011) on *Murabahah* products. Risk aversion is practiced in both conventional and Islamic economics especially on choice of financing as interest-based financing are more expensive than interest-free financing modes.

The relationship between financing contracts and financial performance of Islamic banking in Kenya was analyzed by Gitongu in 2015. Using a descriptive design and employing a quantitative approach in the methodology, the study established that all contracts positively correlated to return on income by *Murabahah* being the biggest contributor followed by *Musharakah.* This means a positive impact on the performance of Islamic financial products on Islamic banks. *Murabahah,* being an interest-free contract demonstrated a positive performance effect on the financial performance hence increased profitability. The study further determined that with accommodating Central Bank policies towards Islamic bank financial products, customer satisfaction and profitability of IFI will improve greatly (Gitongu, 2015). Positive contributions of Islamic products of *Murabahah* to economic performance were echoed by Iqbal (2010).

2.3.3 Financial Training and Financial Performance

Several authors are of the opinion that financial literacy enables people to understand their responsibility over social economic risk so that they can act responsibly and be held accountable for their actions, understand and alter economic system that promotes alienation, insecurity and exploitation (Arthur, 2012). Financial literacy is the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being (Hendriks, 2010). The ability to understand and apply the processes and tools associated with personal finances (Lucey, Agnello & Laney, 2015). While Claxton (2007), defines financial literacy as the ability to understand the implications of key financial decisions and to manage money through budgeting, saving, investing, and protecting assets.

Ford, Myrden and Jones (2015) in their research paper on understanding disengagement from knowledge sharing: engagement theory versus adaptive cost theory, sought to find out why employees become disengaged from knowledge sharing. Researchers used a descriptive design

and employed a structured questionnaire as a data collection tool. The study established that job engagement is very motivational and impacts individual and organizational performance. But, there was the irony on the management wanting employees engaged in their jobs and also at the same time, sharing their knowledge. Focusing on employee health and job design (job meaningfulness) encouraged knowledge sharing thus reducing workplace stress and improves workplace conditions (environmental, physical and psychological engagements) which boost their self-confidence and consequently job performance.

These findings were consistent with Kariuki (2014) espousing the importance of employees on financial performance banks. Financial training is a twofold contribution to bank performance, on one hand, it improves employees' morale by boosting self-confidence and on the other hand, it saves company costs through increased efficiency and thereafter improving on profitability..

Mindra and Moya (2017) did a study on financial self-efficacy: a mediator in advancing financial inclusion, seeking to establish the relationships of financial attitude, financial literacy and financial inclusion, in Uganda. By using a quantitative approach and cross-sectional research design methodology, research findings were that one of the major obstacles of financial inclusion is information illiteracy. Further findings were that high levels of financial literacy stimulated positive attitude and greater feelings of empowerment and value judgments in making financial decisions in savings, credit, insurance and remittances. These findings are comparable to Kariuki (2014) and Ford, Myrden and Jones (2015) hence giving more credence to financial training as a prerequisite to financial performance of Islamic financial institutions.

A study about the effect of financial literacy on management of personal finances among employees of commercial banks in Kenya, by Onyango in 2014, using a descriptive survey

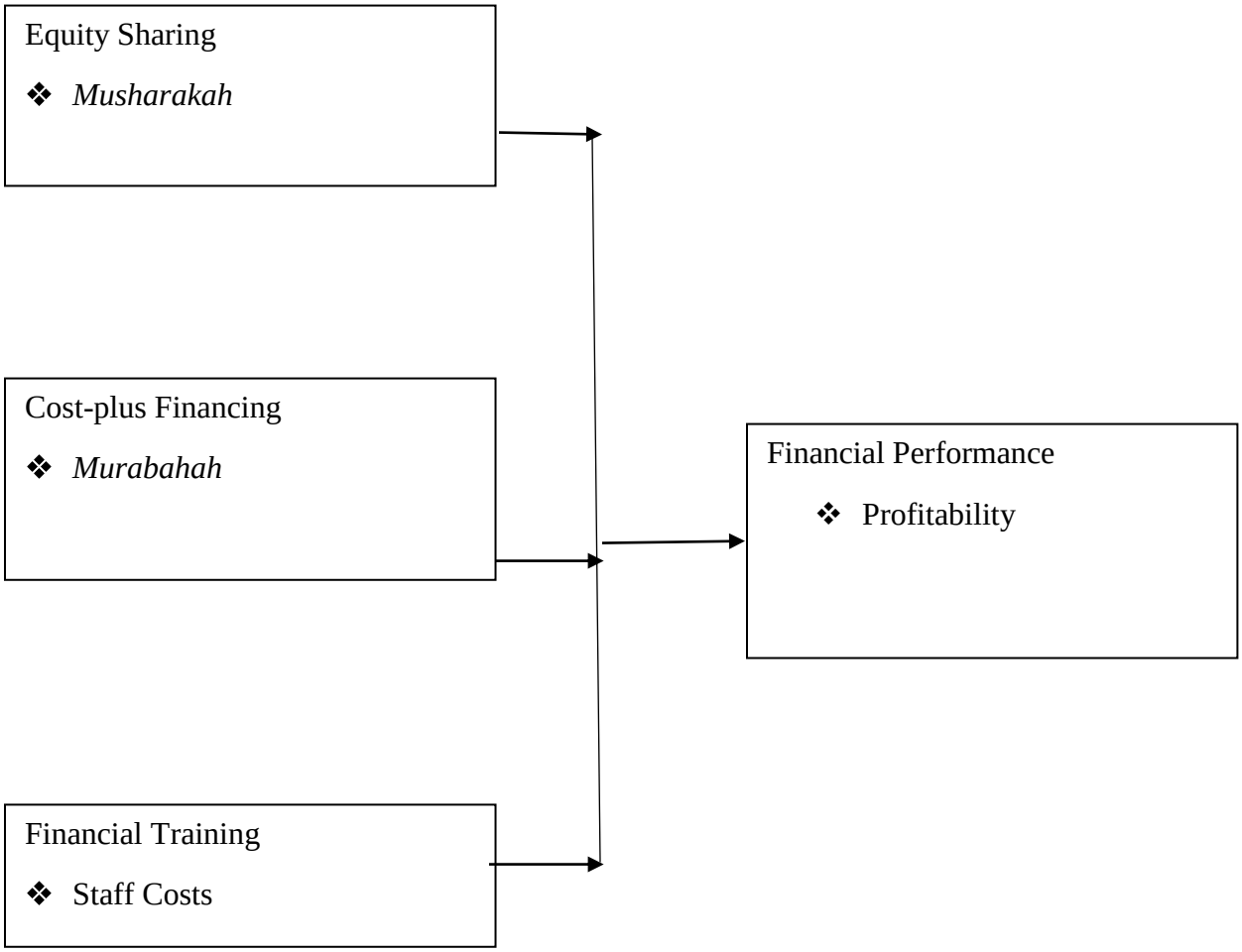
approach and purposive sampling methodology, the researcher argued that financial training have a positive effect on employees' personal financial management, wellbeing, and also, by extension, productivity at their work place. Three quarters of the respondents admitted to having good personal financial management skills which were acquired through institutional training and job experience. This boosted their job satisfaction and in turn, improved the bank's performance (Onyango, 2014). Findings that were consistent with Mindra and Moya (2017) affirming the importance of financial training on the financial performance of banks.

Kariuki (2014) studied the effect of performance appraisal on employees' performance in Barclays bank of Kenya, using descriptive research design and systematic stratified sampling design methodology; the study findings showed that in-house job training programs such as on job training, seminars, and team building events had a positive effect on employee performance. Capacity building through training offered employees the opportunity to receive constructive and developmental feedback on their strength and weaknesses and growth potential in their careers. There was a link between employee career progression and growth and job performance at Barclays bank which further had a positive effect on the overall performance of the bank.

These and other similar studies provided evidence that financial training is important in boosting financial knowledge among individuals which further influences positively the attitude and feelings of individuals of self-empowerment. This enhances employees' progression through career growth, job performance and employee goals in the organization.

2.4 Conceptual Framework

FIGURE 2.1
Conceptual Framework



Independent Variables **Dependent Variable**

2.5 Operationalization of Variables

Table 2.1 below shows how each variable will be measured. The dependent variable is financial performance, while the independent variables are; equity sharing, prohibition of interest, and financial training.

TABLE 2.1
Operationalization of Variables

VARIABLE	MEASUREMENT
Equity Sharing	Equity sharing contracts was measured against the effect of *Musharakah* contracts on the financial performance of banks that offer Islamic financial services in Kenya.
Cost-plus Financing	***Murabahah*:** This is a cost-plus financing method where profit markup is used instead of interest rates, i.e. Sale Price = Cost *x* (1 + Markup %) Cost-plus financing was measured against the effect of *Murabahah* products on the financial performance of banks that offer Islamic financial services in Kenya.
Financial Training	Financial training was measured against the effect of staff costs on the financial performance of banks that offer Islamic financial services in Kenya.
Bank Performance	Bank performance was measured in terms of how equity sharing, cost-plus financing and financial training affect profitability over the period under study.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This chapter presents the research design, target population, sampling procedure and sample size, research instrument, data collection, data analysis and presentation.

3.2 Research Design

Research design is a scheme and structure of study conceived to obtain answers to research questions (Sachdeva, 2009). It ranges from hypothesis formulation to operational implications to data analysis. Kothari (2004) is of the opinion that research design is the arrangement of conditions for collection and analysis of data to make it relevant to the research purpose. Of consideration are skills of the research team and the researcher, objectives of the study, nature of the problem, means of obtaining information and the availability of time and monetary resources to undertake the study.

The researcher used a descriptive research design. This is a design that defines the existing situation and is best suited to expose any present gaps in the system. Descriptive study is most suited for this study as it defines the features of an existing condition. Descriptive studies explain the, who, why, when, which and what questions regarding a given phenomenon (Lee, 2013).

3.3 Target Population

The target population for this study was eight out of ten commercial banks that offer Islamic financial services namely: ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank,

First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank.

3.4 Sampling Procedure and Sample Size

As defined by Karlsson (2002), sampling is the process of selecting a few numbers of elements from the population to represent properties of the population elements. This method saves time, costs and human resource of the researcher. This study used purposive sampling technique to pick six years (i.e. 2012 to 2017) of a sample of eight commercial banks out of ten that offer Islamic financial services in Kenya namely: ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya and Standard Chartered Bank.

3.5 Research Instrument

Research instruments are tools that help the researcher to obtain data for the study work whose results are reliable and valid (Wilkinson, 2000). The researcher used secondary data. Secondary data was obtained from published financial statements on the banks' websites. The researcher also used data collection forms as a research instrument to obtain additional information that was needed for the study. Data collection forms are alternatives to questionnaires because of their versatility and ability to obtain subjective information about participants and also document objective information and measurable impact results, (Phillips & Stawarski 2008). Their anonymity encourages respondents to provide frank and truthful answers (Fellows & Liu, 2015; Williamson, 2002).

3.6 Data Collection Procedure

This is a process of gathering information from the respondents. Data collection forms were used for this exercise. The data collection forms were self-administered by the researcher and by aid of a research assistant. A brief description of the purpose of the study and where and why it was being conducted accompanied the data collection form in order to win the trust and confidence of respondents.

The researcher used a structured data collection form. The data collection forms also seek to find out the more information regarding the respective banks Islamic financial products being offered. Structured data collection forms are easier to analyse and also facilitate synchronization of information, (Fellows & Liu, 2015; Phillips & Stawarski, 2008; Williamson, 2002).

Apart from data collection forms, banks' previous public financial statements were used as sources of secondary information on bank performance and this was used to assess the progress of performance of these banks over the last six years under study, (i.e. 2012 - 2017). Financial statements were accessed on bank websites, and in instances where they were not published, the researcher requested the information from individual banks in writing.

3.7 Data Processing and Analysis

Once data was collected, it was cleaned, edited and coded. The researcher then used STATA software to aid in data analysis and presentation. Data was analysed by linear regression model. The researcher performed tests to choose the appropriate linear model for analysis between pooled OLS model, fixed effects model and random effects model.

Pooled OLS; this model has no unique attributes of individuals and no effects across time. It is represented by equation (1).

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \varepsilon_{it}$ ..... (1)

Fixed effects model; this model has unique attributes of individuals that do not vary across time (equation 2), or time related fixed effects that do not vary over individuals (equation 3) or both individual and time effects (equation 4) that may be analysed statistically but not accurately predicted. These attributes are represented by μ_i for individuals and λ_t for time in regression equations.

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \mu_i + \varepsilon_{it}$ ..... (2)

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \lambda_t + \varepsilon_{it}$ ..... (3)

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \mu_i + \lambda_t + \varepsilon_{it}$ ..... (4)

Random effects model; this model has unique time constant attributes of individuals that are not associated with the individual regressors that may be analysed statistically but not accurately predicted i.e. the error term is assumed to have a random variation over *i* or t, as shown in equations 5 and 6.

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \varepsilon_i + \varepsilon_{it}$ ..... (5)

Or,

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \omega_{it}$ ..... (6)

Where; Y = Dependent variable (Islamic bank financial performance)

β_0 = Constant (financial services)

$\beta_1, \beta_2, \beta_3$ = coefficients of independent variables (i.e. equity sharing, interest prohibition, financial training respectively)

X = independent (predictor) variable where;

X_1 = equity sharing,

X_2 = prohibition of interest,

X_3 = financial training.

μ_i = observable individual dummy

λ_t = observable time dummy

ε_i = decomposed individual error term

ε = random error term

$\omega_{it} = \varepsilon_i + \varepsilon_{it,}$ unobserved dummy

i = individual index, 1, 2, 3 ……..n

Ł = time index, 1, 2, 3 …….n

3.7.1 Identifying the Appropriate Model

The researcher first identified the appropriate model for the study using the Hausman test. This test was used to choose between the fixed effects model and the random effects model. Taking random effect model as the null hypothesis (H_0) and fixed effect model as the alternative (H_1), If the result showed a p-value < 0.05 (H_1 is true) then the Fixed Effects model was to be appropriate to use while a p-value > 0.05 (H_0 is true), Random Effects model was to be appropriate to use.

	H_0 Is True	H_1 Is True
Random Effect Estimator	✓	
Fixed Effect Estimator		✓

Regardless of the outcome of the Hausman test, the researcher was to perform further tests to choose an appropriate model between pooled OLS and either random or fixed effects models. In the event the random effect model was chosen, a Breusch-Pagan Lagrangian

Multiplier (BPLM) test was to be used to choose between random effects model and pooled OLS model. Taking the null hypothesis (H_0) as random effect (when variance = 0) and alternative (H_1) as pooled OLS (when variance > 0);

	H_0 Is True	H_1 Is True
Random Effect Estimator	✓	
Pooled OLS		✓

In the event the fixed effects model was chosen, the researcher was to use the Wald F-test to compare the appropriate model between fixed effect and pooled OLS models. Taking the null hypothesis (H_0) as fixed effect (when F-value is less than F-critical) and alternative (H_1) as pooled OLS (when F-value is greater than F-critical);

	H_0 Is True	H_1 Is True
Fixed Effect Estimator	✓	
Pooled OLS		✓

The researcher was to further perform regression diagnostic tests to assess the validity of the chosen model. Such tests included multicollinearity, heteroskedasticity and homoskedasticity and autocorrelation.

The study conducted Multicollinearity test to test the relationship/correlations between variables. The presence of multicollinearity makes it difficult for the researcher to assess the effect of independent variables on the dependent variable in regression analysis. The researcher used the VIF tests, to gauge the relationship between variables. The multicollinearity test was gauged as follows;

VIF < 5.0, multicollinearity not a major problem

VIF > 5.0, indicates presence of multicollinearity

VIF > 10.0, indicates severe multicollinearity

The study also conducted heteroskedasticity test. This test measures the dispersion between dependent and independent variables where highly dispersions meant there was a problem of heteroskedasticity. The presence of heteroskedasticity means that errors are biased and the true value of variances are underestimated consequently wrongfully invalidating the test. The researcher used Breusch-Pagan / Cook-Weisberg test, to test for heteroskedasticity. A p-value > 0.05 show no presence of heteroskedasticity while a p-value < 0.05 show presence of heteroskedasticity.

Autocorrelation test was conducted to determine the relationship between variables and itself over time intervals. It measures the relationship over time lags of variables where presence of autocorrelation will indicate errors are not random and can be corrected. The researcher used Wooldridge test to test for autocorrelation. A p-value > 0.05 indicates no presence of first-order autocorrelation in the model (i.e. errors are random) while a p-value < 0.05 indicates presence of autocorrelation (i.e. errors are not random).

The researcher used descriptive statistical techniques and inferential analysis to present analyzed data to derive statistical and logical conclusions. Quantitative and qualitative data was presented by the aid of tables, graphs, charts and textual methods. Inferential analysis aided in qualitative data presentation.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter represents analysis, findings and discussions as set out in research methodology. It demonstrates descriptive statistics, study variables, diagnostic tests and model fitting.

4.2 Descriptive statistics

Descriptive statistics was used to define the general nature of data under study. Table 4.1 shows the descriptive summary statistics obtained from the study represented by mean, standard deviation, minimum and maximum values as performed on bank performance (represented by profit before taxation), equity sharing (represented by *Musharakah* in the model), cost-plus financing (represented by *Murabahah* in the model) and financial training (represented by staff costs in the model).

TABLE 4.1
Summary Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Bank Performance	48	5.909223	6.66032	-1.684397	23.44462
Equity Sharing	48	2.304668	2.541722	0.7472894	12.39986
Cost-plus Financing	48	0.5852816	0.5728399	-0.0718022	1.972524
Financial Training	48	3.687793	3.683006	0.047	12.10736

The findings indicate that bank performance had a mean of 5.909223 and a standard deviation of 6.66032. Equity sharing had a mean of 2.304668 and a standard deviation of 2.541722. Cost-plus financing had a mean of 0.5852816 and a standard deviation of 0.5728399. Financial training had a mean of 3.687793 and a standard deviation of 3.683006. This indicates that bank performance was the most centered and also the most widely spread observation across the entire observations of the data set, while cost-plus financing was the least centered and also the least spread observation.

The researcher further used Skewness to test for asymmetry in normality of the data distribution with a threshold of data distribution falling between -1 and +1 being acceptable. Kurtosis was used to measure the tailed-ness of the probability distribution comparative to a normal distribution with a threshold of data distribution falling below +3 being acceptable. Table 4.2 indicates study results.

TABLE 4.2
Skewness/Kurtosis Tests for Normality

Variable	Obs	Pr (Skewness)	Pr (Kurtosis)	Chi2(2)	Prob > Chi2
Bank Performance	48	0.0175	0.8873	5.44	0.0658
Equity Sharing	48	0.0000	0.0002	28.47	0.0000
Cost-plus Financing	48	0.0034	0.5976	7.77	0.0205
Financial Training	48	0.0130	0.3684	6.42	0.0404

Findings indicate that bank performance had a skewness of 0.0175 and a kurtosis of 0.8873. Equity sharing was normally distributed with a skewness of 0.0000 and a kurtosis of 0.0002. Cost-plus financing had a skewness of 0.0034 and a kurtosis of 0.5976. Financial training had a skewness of 0.0130 and a kurtosis of 0.3684. The Skewness results indicate that the data falls within -1 and +1 hence it is not highly tilted/ skewed. Kurtosis results show that data falls below +3 indicating that data has fewer and less extreme outliers. Skewness and Kurtosis results indicate that the data was fit for the model.

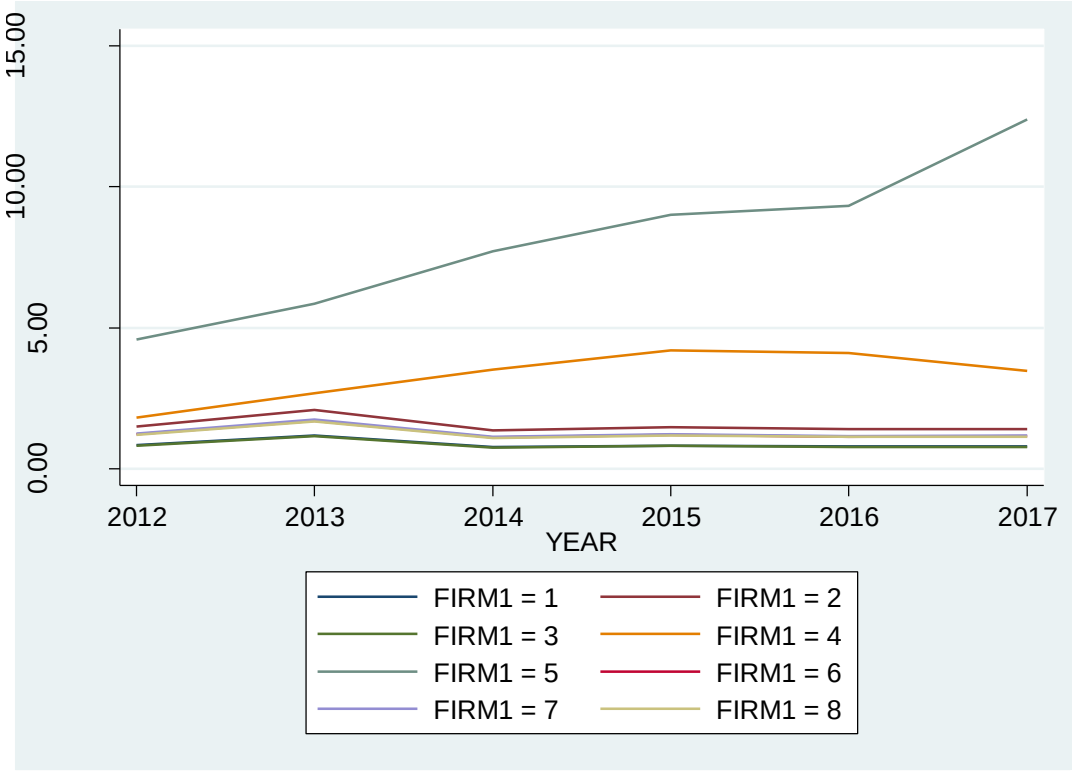
4.3 Study variables

The researcher sought to establish the relationship and trends on each study variable on each bank, i.e. ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), Kenya Commercial Bank (FIRM6), National Bank of Kenya (FIRM7), Standard Chartered Bank (FIRM8). The independent variables of the study were equity sharing (represented by *Musharakah* in the model), cost-plus financing (represented by *Murabahah* in the model) and financial training (represented by staff costs in the model), while the dependent variable was bank performance (represented by profit before taxation in the model).

4.3.1 Equity Sharing

This was measured by *Musharakah* mode of Islamic financing. FIRM 1 to FIRM 8 represents the eight banks under study as illustrated in Figure 4.1.

FIGURE 4.1
Equity Sharing



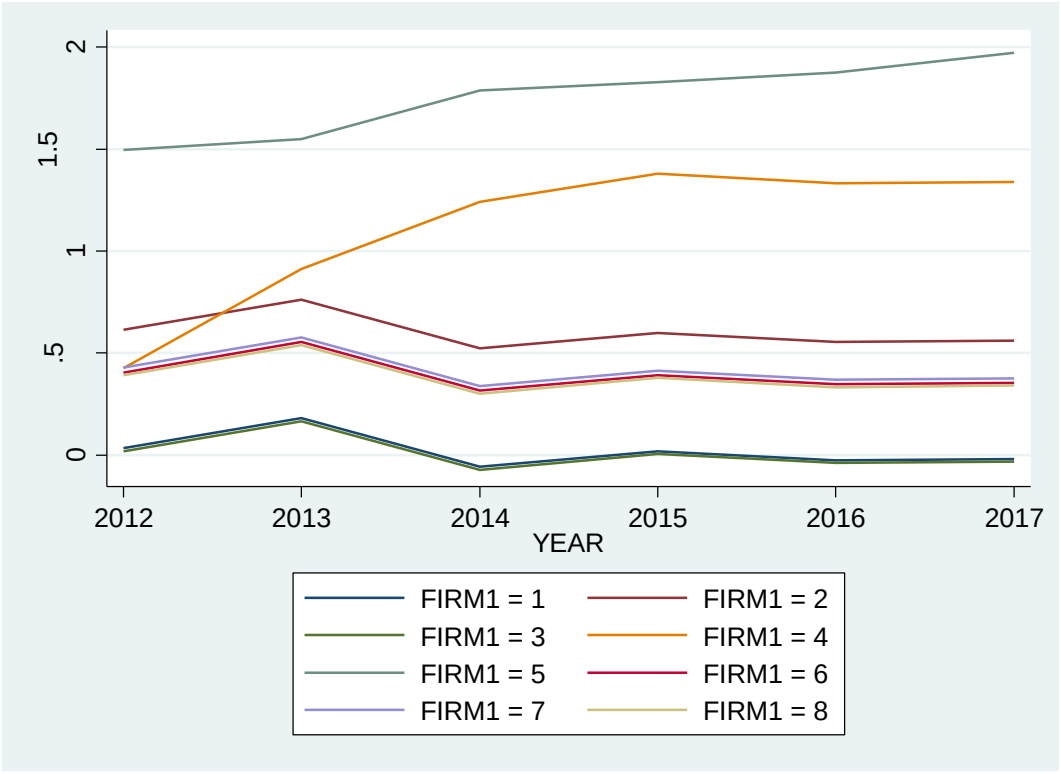
There was a consistent increase in uptake of *Musharakah* contracts in First Community Bank (FIRM4) and Gulf African Bank (FIRM5) for the periods 2012 to 2015. A constant was experienced between year 2015 and 2016. However, Gulf African Bank experienced a sharp increase in uptake of *Musharakah* contract in the year 2016 to 2017 while First Community Bank experienced a slight decrease. While ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), Kenya Commercial Bank (FIRM6), National Bank of Kenya (FIRM7), and Standard Chartered Bank (FIRM8) had a flat curve throughout the period under study. This may be due to

First Community Bank adopting a cautious business approach due to an increase in political activities in Kenya leading to 2017 elections while Gulf African Bank taking chances with the political atmosphere. Another factor that explains the trend may be due to Gulf African Bank leveraging on its dominance in the Islamic financial market over other banks.

4.3.2 Cost-plus Financing

This was measured by *Murabahah* mode of Islamic financing. FIRM 1 to FIRM 8 represents the eight banks under study as illustrated in Figure 4.2. From the findings, there is a similar trend for both Gulf African Bank and First Community Bank. There was a sharp increase in year 2012 to 2014 thereafter a slow growth between years 2014 to 2016 before an increase between 2016 and 2017. ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), Kenya Commercial Bank (FIRM6), National Bank of Kenya (FIRM7), and Standard Chartered Bank (FIRM8) had a flat curve throughout the period under study. This trend may be explained by Kenya's economic recovery from an election in 2013 hence a sharp growth. Structural adjustments in laws by the new government may have caused the slow growth between 2014 and 2016. While an increase to year 2017 may have been influenced by market factors other than political factors.

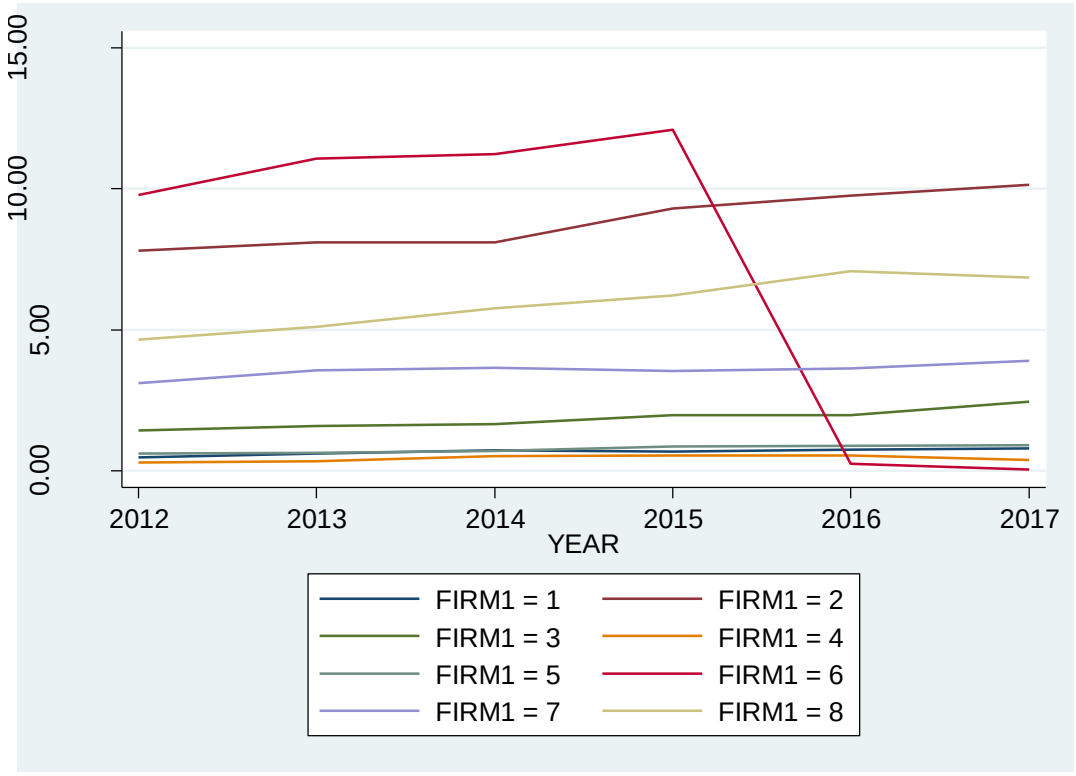
FIGURE 4.2
Cost-plus Financing



4.3.3 Financial Training

This was measured by staff costs of banks under study. FIRM 1 to FIRM 8 represents the eight banks under study as illustrated in Figure 4.3.

FIGURE 4.3
Financial Training

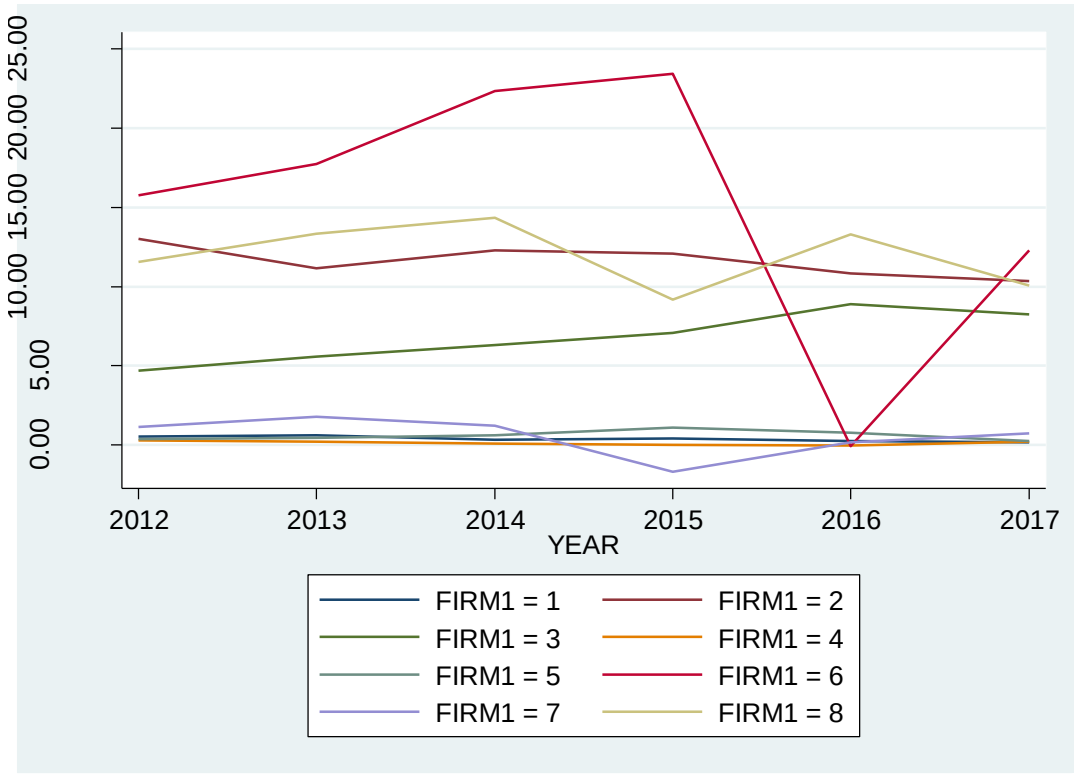


ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), National Bank of Kenya (FIRM7), Standard Chartered Bank (FIRM8) appears to have a fairly consistent trend. This shows that it had a steady management of its operations. While Kenya Commercial Bank (FIRM6) had a constant trend from year 2012 to 2015, thereafter a sharp decrease to year 2016 then a flat curve to year 2017. This may be explained by factors both within and without the financial markets affecting its operations such as political heat due to elections and changes in legislation on the banking sector in the country, but for Kenya Commercial Bank (FIRM6), this trend may be explained by its radical cost cutting restructuring plan that involved staff layoff.

4.3.4 Bank Performance

This was measured by profit before taxation of the banks over the study period. FIRM 1 to FIRM 8 represents the eight banks under study as illustrated in Figure 4.4.

FIGURE 4.4
Bank Performance



From the findings, the profitability of ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), National Bank of Kenya (FIRM7), Standard Chartered Bank (FIRM8) had a

similar trend. There was a steady growth in profitability from 2012 to 2016 thereafter a slump to 2017 as demonstrated by the graph. However, Kenya Commercial Bank (FIRM6) experienced a loss of Kshs. 90 million in 2016 then recovering with a profit of Kshs. 12.29 billion in 2017. The slump may be explained by Kenya's political situation as it approached elections which may have caused a tumble in economic growth, while Kenya Commercial Bank (FIRM6) profit may be due to its radical cost cutting measures adopted.

4.4 Diagnostic tests

The researcher employed several tests to choose the appropriate model for the study and also to test whether the model is a good fit.

4.4.1 Choosing the Appropriate Model

The researcher first identified the appropriate model for the study by using the Hausman test to choose between the fixed effects model and the random effects model. Taking random effect model as the null hypothesis (H_0) and fixed effect model as the alternative (H_1), the result showed a p-value > 0.05 (H_0 is true) of 0.7988 as presented in table 4.3, Random Effects model was chosen. The researcher further performed a Breusch-Pagan Lagrangian Multiplier (BPLM) test to choose between pooled OLS and random effects model. Taking the null hypothesis (H_0) as random effects model (when variance = 0) and alternative (H_1) as pooled OLS model (when variance > 0); Findings as demonstrated in table 4.3 showed a p-value of 0.0000 which was less than 0.05 and random effects model was chosen to be appropriate to use.

TABLE 4.3
Model Selection

	GLS Model	Fixed Effect Model	Random Effect Model	Hausman Test	BPLM Test
Prob. – values	0.0000	0.0000	0.0000	0.7988	0.0000
F – test	40.28	17.34			
Wald chi2(3)			69.06	1.01	
chibar2(01)					39.24

4.4.2 Test for Multicollinearity

The researcher conducted a multicollinearity test to examine the relationship between variables. The researcher used the VIF test, to gauge the relationship between variables. A VIF mean of below 5 is considered suitable.

The VIF mean of 4.47 was obtained as indicated in table 4.4. This showed no presence of multicollinearity as it was below a mean of 5 hence multicollinearity could not affect regression results.

TABLE 4.4
Variance Inflation Factor (VIF) Test

Variable	VIF	1/VIF
Equity Sharing	6.32	0.158188
Cost-plus Financing	5.94	0.168475
Financial Training	1.16	0.860415
Mean VIF	4.47	

4.4.3 Test for Heteroskedasticity

The researcher also conducted a heteroskedasticity test to evaluate model appropriateness. A p-value above 0.05 indicates no presence of heteroskedasticity. The researcher used Breusch-Pagan / Cook-Weisberg test, to test for heteroskedasticity. Results of a p-value of 0.7332 which was greater than p-value of 0.05 indicated no presence of heteroskedasticity hence the model was okay as shown in table 4.5.

TABLE 4.5
Breusch-Pagan / Cook-Weisberg Test

Ho: Constant variance
Variables: fitted values of Bank Performance

chi2(1) = 0.12
Prob > chi2 = 0.7332

4.4.4 Test for Autocorrelation

Autocorrelation test was performed to determine the relationship between variables over time intervals. The researcher used Wooldridge test to test for autocorrelation. A p-value above 0.05 is considered appropriate and indicates no presence of autocorrelation. A p-value of 0.1395 was obtained which was greater than a p-value of 0.05 indicated no presence of first-order autocorrelation in the model (i.e. errors are random) as shown in table 4.6. Results indicated that the data was fit for the model.

TABLE 4.6
Wooldridge Test for Autocorrelation

H0: no first-order autocorrelation	
F(1, 7) =	2.779
Prob > F =	0.1395

4.4.5 Correlation Analysis

The researcher used Karl Pearson correlation to establish the degree of relationship between variables. Table 4.7 shows the results. The relationship ranges from -1 (perfect negative) to +1 (perfect positive), while a 0 (zero) means there is no relationship between variables. Findings indicate that equity sharing and cost-plus financing had a weak negative relationship at -0.3401 and -0.2862 respectively, with bank performance while financial training had a strong positive relationship with bank performance at 0.8446.

TABLE 4.7
Correlation Matrix

	Bank Performance	Cost-plus Financing	Equity Sharing	Financial Training
Bank Performance	1.0000			
	48			
Cost-plus Financing	-0.2862	1.0000		
	0.0486			
	48	48		
Equity Sharing	-0.3401	0.9074	1.0000	
	0.0180	0.0000		
	48	48	48	
Financial Training	0.8446	-0.1986	-0.3132	1.0000
	0.0000	0.1760	0.0302	
	48	48	48	48

4.5 Model fitting

When fitting the model, the researcher carried out a multiple regression analysis based on the identified random effects model of equation (6) as shown;

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \omega_{it} \quad \ldots\ldots (6)$$

4.5.1 Model Summary

The model summary of the study is explained in table 4.8. It shows that the coefficient of determination, R-squared is 0.7331. This indicates that 73.31% of the variation in the dependent variable (bank performance) is explained by independent variables (equity sharing, cost-plus financing, financial training) while 26.69% of the variation is explained by other factors and the error term. This was also explained by a strong correlation between variables with findings indicating that financial training had a strong positive relationship with bank performance at 0.8446.

TABLE 4.8
Model Summary for Performance of Selected Banks in Kenya

R-squared	=	0.7331
Adj R-squared	=	0.7149
Root MSE	=	3.5565

4.5.2 Analysis Of Variance (ANOVA)

Analysis of variance (ANOVA) was used to estimate the model fitness as shown in table 4.9. The results show that independent variables (equity sharing, cost-plus financing, financial training) have a statistically significant effect in explaining the performance of Islamic banks as demonstrated by a p-value of 0.0000 which is less than the critical p-value of 0.05. This indicates that the model is a good predictor of the effects of Islamic financial services on the financial performance of selected banks in Kenya.

TABLE 4.9
ANOVA for Performance of selected Banks in Kenya

Source	SS	df	MS
Model	1528.36678	3	509.455592
Residual	556.546808	44	12.6487911
Total	2084.91358	47	44.3598635

Number of obs = 48
F(3, 44) = 40.28
Prob. > F = 0.0000

4.5.3 Regression Analysis

Table 4.10 shows regression coefficients as calculated by the statistical software, STATA while table 4.11 shows regression results summary that explain the independent variables (equity

sharing, cost-plus financing, financial training). The results show that equity sharing and financial training have a positive relationship with bank performance measured by profit before taxation while cost-plus financing has a negative relationship with bank performance. However, equity sharing and cost-plus financing were statistically insignificant in explaining bank performance, while financial training was statistically significant in explaining bank performance.

TABLE 4.10
Regression Coefficients

Bank Performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Cost-plus Financing	-1.059046	2.326634	-0.46	0.649	-5.619165	3.501073
Equity Sharing	.0125308	.4195062	0.03	0.976	-.8096863	.8347478
Financial Training	1.246497	.1508624	8.26	0.000	.9508117	1.542181
_cons	1.903363	1.679444	1.13	0.257	-1.388287	5.195013

Table 4.11 explains the regression results. Equity sharing had a positive coefficient of 0.0125308 and a standard deviation of 0.4195062. Cost-plus financing had a negative coefficient of -1.059046 and a standard deviation of 2.326634 and financial training had a positive coefficient of 1.246497 and a standard deviation of 0.1508624. Bank performance had an intercept (constant) of 1.903363 with a standard deviation of 1.679444.

TABLE 4.11

Regression Results of Bank Performance against Predictor Variables

Dependent Variable: Bank Performance (Profitability)	
Independent Variables	Results
Equity Sharing (*Musharakah*)	0.0125308 (0.4195062)
Cost-plus financing (*Murabahah*)	-1.059046 (2.326634)
Financial Training (*Staff Costs*)	1.246497 (0.1508624)
Constant	1.903363 (1.679444)
Observations	48
R-Squared	0.7331

The model summary as represented by the equation;

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \omega_{it}$

Thus; Bankperfor~e_{it} = 1.9033 + 0.0125Equityshar~g_{it} - 1.0590Costplusfi~g_{it} + 1.2464Financialt~g_{it} + ω_{it}

Where; Y = Dependent variable (Selected bank financial performance)

β_0 = Constant (financial services)

$\beta_1, \beta_2, \beta_3$ = coefficients of independent variables (i.e. equity sharing, cost-plus financing, financial training respectively)

X = independent (predictor) variable where;

X_1 = equity sharing,

X_2 = cost-plus financing,

X_3 = financial training.

ω_{it} = unobserved dummy

4.6 Summary and Interpretation of Findings

This study sought to determine the effect of Islamic financial services on the financial performance of selected banks in Kenya. With specific objectives being; to determine the effect of equity sharing on the financial performance of selected banks in Kenya; to investigate the effect of cost-plus financing on the financial performance of selected banks in Kenya; and to assess the effect of financial training on the financial performance of selected banks in Kenya.

Descriptive research design was adopted and a purposive sampling technique was used to select eight commercial banks that offer Islamic financial services in Kenya, i.e. ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank. Data for the study was obtained all the eight Banks. Data was obtained from banks' annual reports and financial statements and a data collection form was also used to collect additional secondary data. Analysis was done using linear regression analysis framework and descriptive statistics were employed and presentation of results was done using figures, tables and graphs.

4.6.1 Equity Sharing on Performance of Selected Banks in Kenya

Equity sharing was measured by *Musharakah* mode of Islamic financing. The study established a consistent increase in uptake of *Musharakah* contracts in First Community Bank (FIRM4) and Gulf African Bank (FIRM5) for the periods 2012 to 2015. A constant was experienced between year 2015 and 2016. While Gulf African Bank experienced a sharp increase in uptake of *Musharakah* contract in the year 2016 to 2017, First Community Bank experienced a slight decrease. ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), Kenya Commercial Bank (FIRM6), National Bank of Kenya (FIRM7), and Standard Chartered Bank (FIRM8) had a flat curve throughout the period under study.

Similar to Lahrech *et al.*, (2014) who pursued to find out whether Islamic banks are transparent regarding profit and loss sharing to investment account holders and also whether bank's performance is affected by this. Findings were that bank's performance was significantly and positively associated to profit sharing ratio and that capital is a significant factor. Thomi, (2012) also concurred with these findings.

Also, these findings concur with Adan (2017) who researched on the factors influencing growth of client base of fully fledged Islamic banks in Kenya and established that *Musharakah* contracts highly attracted both existing and new customers. The study further established that strict compliance with Islamic S*hari'ah* tenets was critical in attracting more clients to fully fledged Islamic banks.

4.6.2 Cost-plus Financing on Performance of Selected Banks in Kenya

Cost-plus financing was measured through *Murabahah* products. There was a similar trend for both Gulf African Bank and First Community Bank. A sharp increase in year 2012 to 2014 was witnessed thereafter a slow growth between years 2014 to 2016 and a slight increase between

2016 and 2017. ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), Kenya Commercial Bank (FIRM6), National Bank of Kenya (FIRM7), and Standard Chartered Bank (FIRM8) had a flat curve throughout the period under study. Findings that Islamic financial services has a negative impact on profitability were echoed by El and Amr (2010) and Toutounchian and Kabir (2011) who cited liquidity constraints occasioned by failure to charge interest on *Murabahah* products, which have contributed to unfavourable financial performance of Islamic financial institutions. Similar concurrences were established by (Talam, 2014).

To the contrary, Eqbal (2011) ascertained that interest free banking is a sure way of maintaining financial performance of Islamic banks, as it will shield them from market risks caused by interest rate ripples, as it is not significantly affected by economic slowdown and financial crisis.

4.6.3 Financial Training on Performance of Selected Banks in Kenya

Financial training was measured by staff costs of banks. Financial training had a positive relationship with profitability i.e. an increase resulted in a decrease in profitability. ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), National Bank of Kenya (FIRM7), and Standard Chartered Bank (FIRM8) appear to have a fairly consistent trend. Kenya Commercial Bank (FIRM6) has a constant trend from year 2012 to 2015, thereafter a sharp decrease to year 2016 then a flat curve to year 2017.

A positive relationship to bank performance was also demonstrated by Ford, *et al*., (2015) who established that employee training encouraged knowledge sharing, reduced workplace stress and improves workplace conditions which boost their self-confidence and consequently job

performance through reduced operational costs. Also, Onyango (2014) found that financial training had a positive effect on employees' productivity at their work place through job satisfaction and in turn, improved the bank's performance. Consequently, Kariuki (2014) established that employee performance had a positive effect on the overall performance of the bank.

4.6.4 Performance of Selected Banks in Kenya as effected By Equity Sharing, Cost-Plus Financing and Financial Training

Bank performance was measured by profit before taxation of banks in the study. From the findings, the profitability of ABC Bank Kenya (FIRM1), Barclays Bank of Kenya (FIRM2), Diamond Trust Bank (FIRM3), First Community Bank (FIRM4), Gulf African Bank (FIRM5), National Bank of Kenya (FIRM7), Standard Chartered Bank (FIRM8) had a steady trend. Kenya Commercial Bank (FIRM6) experienced a loss in 2016 then recovering with a profit in 2017.

Thomi (2012) determined occurrence of a positive effect on bank performance from Islamic products such as *Mudarabah, Murabahah, Musharakah* and *Ijarah* at 91.30%. Similar findings were supported by Ghauri and Qambar (2012) who concluded that innovative product structuring is the major determinant for investors' attraction and that Islamic bank has higher operational costs and need to improve on risk management as these impacts negatively on their financial performance.

Zarrouk, *et al*., (2016) also established that profitability is positively affected by bank cost-effectiveness, asset quality and level of capitalization, and that non-financing activities such as gross domestic products (GDP) and investment allow Islamic banks to earn higher profits. These findings are similar to this study finding.

4.6.5 Diagnostic Tests

Descriptive statistics showed that bank performance was the most centered observation with a mean of 5.909223 and also the most widely spread observation with a standard deviation of 6.66032, while cost-plus financing was the least centered observation with a mean of 0.5852816 and also the least spread observation with a standard deviation of 0.5728399. Also, findings indicate that Skewness results falls within -1 and +1 hence it is not exceedingly tilted/ skewed. Kurtosis results show that data falls below +3 indicating that data has fewer and less extreme outliers. Skewness and Kurtosis results indicate that the data was fit for the model.

The researcher identified the appropriate model for the study by using the Hausman test to choose between the fixed effects model and the random effects model. The result showed a p-value > 0.05 (H0 is true) of 0.7988 thus Random Effects model was chosen to be appropriate to use. Breusch-Pagan Lagrangian Multiplier (BPLM) test used to choose between pooled OLS and random effects model demonstrated a p-value of 0.0000 which was less than 0.05 and random effects model was chosen to be appropriate to use.

A multicollinearity test used to examine the relationship between variables. The VIF mean of 4.47 obtained indicated no presence of multicollinearity as it fell below acceptable value of 5.0. The researcher used Breusch-Pagan / Cook-Weisberg test, to test for heteroskedasticity. Results of a p-value of 0.7332 which was greater than p-value of 0.05 indicated no presence of heteroskedasticity. Also the researcher used Wooldridge test to test for autocorrelation. A p-value of 0.1395 was obtained which was greater than a p-value of 0.05 indicated no presence of first-order autocorrelation in the model (i.e. errors are random). Results indicated that the data was fit for the model.

The researcher used Karl Pearson correlation to establish the degree of relationship between variables. The relationship ranges from -1 (perfect negative) to +1 (perfect positive), while a 0 (zero) means there is no relationship between variables. Findings indicate that equity sharing and cost-plus financing had a negative relationship at -0.3401 and -0.2862 respectively, with bank performance while financial training had a strong positive relationship with bank performance at 0.8446.

The model summary of the study revealed the coefficient of determination, R-squared to be 0.7331. This indicated that 73.31% of the variation in the dependent variable (bank performance) is explained by independent variables (equity sharing, cost-plus financing, financial training) while 26.69% of the variation is explained by other factors and the error term. This was further described by a strong correlation between variables with findings indicating that financial training had a strong positive relationship with bank performance at 0.8446.

Analysis of variance (ANOVA) was used to estimate the model fitness. Results show independent variables (equity sharing, cost-plus financing, financial training) had a statistically significant effect in explaining the performance of selected banks as demonstrated by a p-value of 0.0000 which is less than the critical p-value of 0.05. This indicated that the model was a good predictor of the effects of Islamic financial services on the financial performance of the selected banks in Kenya.

Regression coefficients as calculated by the statistical software, STATA showed that Equity sharing had a positive coefficient of 0.0125308 and a standard deviation of 0.4195062. Cost-plus financing had a negative coefficient of -1.059046 and a standard deviation of 2.326634. Also, financial training had a positive coefficient of 1.246497 and a standard deviation of 0.1508624. Bank performance had an intercept (constant) of 1.903363 with a standard

deviation of 1.679444. The results show that equity sharing and financial training have a positive relationship with bank performance measured by profit before taxation while cost-plus financing had a negative relationship with bank performance. Equity sharing and cost-plus financing were statistically insignificant in explaining bank performance, while financial training was statistically significant in explaining bank performance.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter represents summary of findings of the study. It represents research objectives, conclusions and recommendations for future research.

5.2 Summary

This study sought to determine how selected banks' financial performance was affected by Islamic financial services such as equity sharing, cost-plus financing and financial training. Eight banks that offer Islamic financial services were studied i.e. ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank. Data was obtained from banks' annual reports and financial statements. Data analysis was done using linear regression analysis framework.

5.2.1 Equity Sharing on Performance of Selected Banks in Kenya

Equity sharing was measured by *Musharakah* mode of Islamic financing. The study established a consistent increase in uptake of *Musharakah* contracts in both banks for the periods 2012 to 2015. A constant was experienced between year 2015 and 2016. While Gulf African Bank experienced a sharp increase in uptake of *Musharakah* contract in the year 2016 to 2017, First Community Bank experienced a slight decrease. ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank had a flat curve throughout the period under study.

Similar findings were consistent with the banks' performance which showed a steady trend with ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, First Community Bank, Gulf African Bank, National Bank of Kenya, and Standard Chartered Bank had a steady trend. These findings show that *Musharakah* contracts have a positive effect on bank performance of 0.0125308.

Similar to Lahrech *et al.*, (2014) who pursued to find out whether Islamic banks are transparent regarding profit and loss sharing to investment account holders and also whether bank's performance is affected by this. Findings were that bank's performance was significantly and positively associated to profit sharing ratio and that capital is a significant factor. Also, these findings concur with Adan (2017) who researched on the factors influencing growth of client base of fully fledged Islamic banks in Kenya and established that *Musharakah* contracts highly attracted both existing and new customers. The study further established that strict compliance with Islamic S*hari'ah* tenets was critical in attracting more clients to fully fledged Islamic banks. However, Hassan (2016) was of the contrary opinion and stated that *Musharakah* contracts had an insignificant effect on bank financial performance.

5.2.2 Cost-plus financing on Performance of Selected Banks in Kenya

Cost-plus financing was measured through *Murabahah* products. There was a similar trend for both Gulf African Bank and First Community Bank. A sharp increase in year 2012 to 2014 was witnessed thereafter a slow growth between years 2014 to 2016 and a slight increase between 2016 and 2017. ABC Bank Kenya, Barclays Bank of Kenya, Diamond Trust Bank, Kenya Commercial Bank, National Bank of Kenya, and Standard Chartered Bank had a flat curve throughout the period under study.

The financial performance of all banks had a steady trend from 2012 to 2017, except Kenya Commercial Bank which experienced a loss in 2016. These findings show that *Murabahah* products have a negative effect on bank performance of -1.059046.

A negative relationship of *Murabahah* products to bank performance due to failure to charge interest resonated with findings of El and Amr (2010), Talam (2014), Toutounchian and Kabir (2011). However, Eqbal (2011) was of the contrary opinion with a positive effect and cited safeguard from market risks caused by interest rate ripples, as not significantly affected by economic slowdown and financial crisis.

5.2.3 Financial Training on Performance of Selected Banks in Kenya

Financial training was measured by staff costs of banks. Financial training had a positive relationship with bank performance. All banks except Kenya Commercial Bank had a fairly consistent trend throughout the period under study. Kenya Commercial Bank had a constant trend from year 2012 to 2015, thereafter a sharp decrease in year 2016 then a flat curve in year 2017.

These findings explain why bank performance of all banks had a steady growth trend from 2012 to 2017 except Kenya Commercial Bank experienced a loss in 2016 despite a significant reduction in staff costs in the same year. It can be concluded that financial training had a positive relationship with bank performance of 1.246497.

Similar findings were demonstrated by Ford, *et al*., (2015) who established that employee training encouraged knowledge sharing, reduced workplace stress and improves workplace conditions which boost their self-confidence and consequently job performance through reduced operational costs. Also, Onyango (2014) and Kariuki (2014) concurred with these findings and

stressed the positive effect of financial training of employees and its contribution to banks' financial performance.

5.3 Conclusions

This represents a summary of findings as per the objectives i.e. equity sharing, cost-plus financing and financial training.

5.3.1 Equity Sharing

Following the findings, the study concludes that equity sharing, represented by *Musharakah* contracts have a positive relationship with profitability and thus an increase in uptake will result in an increase in financial performance of banks that offer Islamic financial services in Kenya.

5.3.2 Cost-plus Financing

The study concludes that the principle of cost-plus financing in Islamic financial services is negatively correlated with firms' financial performance. An increase in volumes of *Murabahah* products will lead to a reduction in profitability of the banks due to increased interest costs not charged by Islamic financial institutions.

5.3.3 Financial Training

Further, the study concludes that financial training reduces operational costs through reduced staff costs. This is exhibited through a positive relationship between bank financial performance and staff costs. Financial training lowers operational costs will result in an improved financial performance of banks.

5.4 Recommendations

This part represents suggestions for policy actions by industry players.

5.4.1 Recommendations to Bank Managers

The study recommends that increased awareness on Islamic financial products of *Musharakah,* and *Murabahah* should be undertaken through mobilization and development of effective marketing policies.

The study further recommends investment in operational cost-cutting measures by the management of Islamic banks through a robust system of staff training on Islamic financial services that will not only equip employees with knowledge and competence on Islamic bank products but also reduce operational costs through a seamless service process that saves on time and material wastage.

5.4.2 Recommendations to the Government

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

This study was limited to commercial banks and a period under study of six years, i.e. 2012 to 2017. 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.

This study only considered equity sharing, cost-plus financing and financial training as its variables. These may not be a total representative of factors affecting profitability of the bank. 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.

5.6 Suggested Areas for Future Research

This study suggests a study on challenges facing uptake of Islamic financial service systems in Kenya with a view on recommending solutions to those challenges. The study also suggests further studies be conducted on the effect of Islamic financial services on the performance of selected banks in Kenya using GARCH model as a way of validating this study findings.

REFERENCES

Abdullah, A. (2016). Examining us approvals of Islamic financing products and the Islamic theory of lawful profit, *International Journal of Islamic and Middle Eastern Finance and Management*, 9(4):532-550.

Adan I. A. (2017). *Factors influencing growth of client base of fully fledged Islamic banks in Kenya.* Unpublished Masters Thesis KCA University Repository, Nairobi.

Ahmed, G. A. (2008). The implication of using profit and loss sharing modes of finance in the banking system, with a particular reference to equity participation (partnership) method in Sudan, *Humanomics*, 24(3):182-206.

Akhtar, B. Akhter, W. & Shahbaz, M. (2017). Determinants of deposits in conventional and Islamic banking: a case of an emerging economy, *International Journal of Emerging Markets*, 12(2):296-309.

Al-Jarhi, M. A. (2017). An economic theory of Islamic finance, *ISRA International Journal of Islamic Finance*, 9(2):117-132.

Appelt, K. (2016). Keynes' theory of the interest rate: a critical approach. *Club of Economics in Miskolc'* TMP 12(1): 3-8. 2016.

Arthur, C. (2012). *Financial literacy education: neoliberalism, the consumer and the citizen*, Sense Publishers, Rotterdam, Netherlands.

Ayub, M. (2009). *Understanding Islamic finance*, John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Bellalah, M. & Masood, O. (2013). *Islamic banking and finance*, Cambridge Scholars Publishing, England, United Kingdom.

Boatright, J. R. (2010). *Finance ethics: critical issues in theory and practice*. Wiley, Hoboken, New Jersey, USA.

Claxton, N. (2007). *Using deliberate techniques to teach financial literacy*, International Debate Education Association Brussels, Belgium.

El, T. A. & Amr, M. (2010). *Islamic Banking*: 5–6. El, John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Eqbal, Z. (2011). Relevance of Islamic banking system in the present economic scenario. *Journal of the Indian Law Institute, 53*(2):356-361. Indian Law Institute, India.

Fellows, R. F. & Liu, A. M. M. (2015). *Research methods for construction*, John Willey & Sons, Incorporated, Hoboken, New Jersey, USA.

Fisher, I. (1930). *The theory of interest, as determined by impatience to spend income and opportunity to invest it*. Macmillan, 1930, New York.

Ford, D., Myrden S. E. & Jones, T. D, (2015). Understanding disengagement from knowledge sharing: engagement theory versus adaptive cost theory, *Journal of Knowledge Management*, 19(3):476-496.

Ghauri, S. M. K. & Qambar, A. S. O. (2012). Rewards in faith-based vs conventional banking, *Qualitative Research in Financial Markets*, 4(2/3):176-196.

Gitongu, S. W. (2015). *The relationship between financing contracts and financial performance of Islamic banking in Kenya*. Unpublished Masters Thesis University Of Nairobi Repository, Nairobi.

Hassan, B. I. (2016). *Effect of Islamic financing on financial performance of businesses in Eastleigh business community, Nairobi County*. Unpublished Masters Thesis KCA University Repository, Nairobi.

Hendriks, T. P. (2010). *National financial literacy strategy*, Nova Science Publishers Inc. Hauppauge New York USA.

Iqbal, M. (2010). Prohibition of interest and economic rationality. *Arab Law Quarterly, 24*(3): 293-308. Brill Leiden Netherlands.

Ismal, R. (2013). *Islamic Banking in Indonesia*, John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Jensen, M. C. & Meckling W. H. (1976). Theory of the firm: managerial behaviour, agency costs and ownership structure, *Journal of Financial Economics* 3 (1976): 305-360.

Kariuki, R. W. (2014). *Effect of performance appraisal on employees' performance in Barclays bank of Kenya*. Unpublished Masters Thesis KCA University Repository, Nairobi.

Kayed, R. N. (2012). The entrepreneurial role of profit-and-loss sharing modes of finance: theory and practice, *International Journal of Islamic and Middle Eastern Finance and Management*, 5(3):203-228.

Kettell, B. (2011). *Introduction to Islamic banking and finance*, Wiley, Hoboken, New Jersey, USA.

Kettell B. (2011). *The Islamic banking and finance workbook*, John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Khan, M. (2011). Islamic banking practices: Islamic law and prohibition of ribā. *Islamic Studies, 50*(3/4): 413-422. Islamic Research Institute, International Islamic University, Islamabad, Pakistan.

Kothari, C. R. (2004). *Research methodology: methods and techniques*. New Age International Pvt Ltd. Daryaganj, Delhi, India.

Lahrech, N., Lahrech A., & Boulaksil, Y. (2014). Transparency and performance in Islamic banking: implications on profit distribution, *International Journal of Islamic and Middle Eastern Finance and Management*, 7(1):61-88.

Lee, A. M. (2013). *Understanding and applying research design*. Somerset, John Wiley & Sons. NJ, USA.

Lucey, T. A., Agnello, M. F. & Laney, J. D. (2015). *A critical compassionate approach to financial literacy,* Sense Publishers, Rotterdam Netherlands.

Martin, W. E., & Bridgmon, K. D. (2012). *Quantitative and statistical research methods: from hypothesis to results*. John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Mindra, R., & Moya M., (2017). Financial self-efficacy: a mediator in advancing financial inclusion, equality, diversity and inclusion: *An International Journal*, 36(2):128-149.

Mindra, R., Moya, M., Zuze, L. T. & Kodongo, O. (2017). Financial self-efficacy: a determinant of financial inclusion, *International Journal of Bank Marketing*, 35(3):338-353.

Muth, J. F. (1961). Rational expectations and the theory of price movements. *Econometrica*, 29(3):315–35. The Econometric Society.

Nyathira, N. C. (2012). *Financial innovation and its effect on financial performance of commercial banks in Kenya.* Unpublished Masters Thesis University of Nairobi Repository, Nairobi.

Omar, J. H. (2016). *Impact of Islamic banking on the financial performance of conventional banks offering Islamic banking products in Kenya.* Unpublished Masters Thesis University of Nairobi Repository, Nairobi.

Onyango, S. O. (2014). *Effect of financial literacy on management of personal finances among employees of commercial banks in Kenya.* Unpublished Masters Thesis University of Nairobi Repository, Nairobi.

Phillips, P. P. & Stawarski, C. A. (2008). *Data collection: planning for and collecting all types of data*. Centre for Creative Leadership, Hoboken, Wiley. NJ, USA.

Ringim, K. J. (2014). Perception of Nigerian Muslim account holders in conventional banks toward Islamic banking products, *International Journal of Islamic and Middle Eastern Finance and Management*, 7(3):288-305.

Rowe, W. L. (1982). Two criticisms of the agency theory. *Philosophical Studies: An International Journal for Philosophy in the Analytic Tradition* 42(3):363-378, Springer.

Rugg, G. & Petre, M. (2006). *Gentle guide to research methods*. McGraw-Hill Education, Pennsylvania Plaza New York City USA.

Sachdeva, J.K. (2009). *Business research methodology*. Himalaya Publishing House. Mumbai, IND.

Saleh, M. A., Quazi, A., Keating, B., & Gaur, S. S. (2017). Quality and image of banking services: a comparative study of conventional and Islamic banks, *International Journal of Bank Marketing*, 35(6):878-902.

Suandi, A. B. (2017). Classification of profit-sharing investment accounts: a survey of financial statements of Islamic banks in Asia, *International Journal of Islamic and Middle Eastern Finance and Management*, 10(3):351-370. Emerald Publishing Limited.

Talam. K. N. (2014). *Effect of Islamic banking on financial performance of commercial banks in Kenya.* Unpublished Masters Thesis University of Nairobi Repository, Nairobi.

Thomi. D. K. (2014). *The effect of Islamic banking products on financial performance of commercial banks in Kenya.* Unpublished Masters Thesis University of Nairobi Repository, Nairobi.

Toutounchian, I. & Kabir, H. M. (2011). *Islamic money and banking*: 39 – 40. John Wiley & Sons, Incorporated, Hoboken, New Jersey, USA.

Tse, T. (2011). Shareholder and stakeholder theory: after the financial crisis, *Qualitative Research in Financial Markets.* 3(1):51-63.

Venardos, A. M. (2006). *Islamic banking and finance in South-East Asia*, World Scientific Publishing Company, Singapore.

Venardos, A. M. (2010). *Current issues in Islamic banking and finance*, World Scientific Publishing Company, Singapore.

Venardos, A. M. (2011). *Islamic banking and finance in South-East Asia*, World Scientific Publishing Company, Singapore.

Wilkinson, D. (2000). *Researcher's toolkit: the complete guide to practitioner research*. Routledge. Florence, KY, USA.

Williamson, K. (2002). *Research methods for students, academics and professionals: information management and systems*, (2nd Ed.). Elsevier Science & Technology, Amsterdam, Netherlands.

Yahia, A. R. (2014). *Art of RF (Riba Free) Islamic banking and finance: tools and techniques for community-based banking*, Willey. Hoboken, New Jersey, USA.

Zarrouk, H., Jedidiah, K. B. & Moualhi, M. (2016). Is Islamic bank profitability driven by same forces as conventional banks? *International Journal of Islamic and Middle Eastern Finance and Management*, 9(1):46-66.

Zu, X. & Kaynak, H. (2012). An agency theory perspective on supply chain quality management, *International Journal of Operations & Production Management*, 32(4):423-446.

APPENDICES

APPENDIX I: INTRODUCTORY LETTER

Mr. Wilfred A. Eshiwani
School of Graduate Studies
KCA University.
Nairobi.

The Management,
Bank Ltd,
Mombasa, Kenya.

RE: REQUEST FOR RESEARCH DATA

Dear Respondent

I am a KCA University student currently pursuing a Masters of Science Degree in Economics and Investment. As part of the partial requirements of my course, I am supposed to conduct a research project.

I am inviting you to be part of a survey I am conducting in order to gather information regarding the **"effect of Islamic financial services on the performance of Islamic banks in Mombasa County, Kenya".**

Kindly feel free to provide the required information as it will be used only for academic purposes. Confidentiality of the research is utmost assured.

Mr. Wilfred A. Eshiwani,
Reg. No. KCA/08/03098.
School of Business and Public Management.
KCA University.
Nairobi.

APPENDIX II: DATA COLLECTION FORM

FIRM	FIRM1	YEAR	COST-PLUS FINANCING (MURABAHAH)	EQUITY SHARING (MUSHARAKAH)	FINANCIAL TRAINING (STAFF COSTS)	PROFIT BEFORE TAXATION
ABC BANK	1	2012	1.03	0.83	0.47	0.53
ABC BANK	1	2013	1.20	1.17	0.61	0.59
ABC BANK	1	2014	0.94	0.76	0.72	0.34
ABC BANK	1	2015	1.02	0.82	0.69	0.39
ABC BANK	1	2016	0.97	0.78	0.75	0.24
ABC BANK	1	2017	0.98	0.79	0.79	0.18
BARCLAYS BANK OF KENYA	2	2012	1.85	1.49	7.81	13.02
BARCLAYS BANK OF KENYA	2	2013	2.14	2.09	8.11	11.13
BARCLAYS BANK OF KENYA	2	2014	1.69	1.35	8.10	12.29
BARCLAYS BANK OF KENYA	2	2015	1.82	1.46	9.31	12.07
BARCLAYS BANK OF KENYA	2	2016	1.74	1.40	9.77	10.85
BARCLAYS BANK OF KENYA	2	2017	1.75	1.41	10.15	10.36
DIAMOND TRUST BANK	3	2012	1.02	0.82	1.41	4.67
DIAMOND TRUST BANK	3	2013	1.18	1.15	1.58	5.57
DIAMOND TRUST BANK	3	2014	0.93	0.75	1.66	6.31
DIAMOND TRUST BANK	3	2015	1.01	0.81	1.97	7.05
DIAMOND TRUST BANK	3	2016	0.96	0.77	1.97	8.88
DIAMOND TRUST BANK	3	2017	0.97	0.78	2.45	8.23
FIRST COMMUNITY BANK	4	2012	1.53	1.81	0.28	0.29
FIRST COMMUNITY BANK	4	2013	2.49	2.67	0.34	0.20
FIRST COMMUNITY BANK	4	2014	3.46	3.53	0.53	0.10
FIRST COMMUNITY BANK	4	2015	3.98	4.20	0.54	0.01
FIRST COMMUNITY BANK	4	2016	3.79	4.11	0.53	(0.04)

FIRST COMMUNITY BANK	4	2017	3.82	3.47	0.39	0.22
GULF AFRICAN BANK	5	2012	4.46	4.59	0.60	0.37
GULF AFRICAN BANK	5	2013	4.71	5.86	0.63	0.43
GULF AFRICAN BANK	5	2014	5.99	7.71	0.70	0.62
GULF AFRICAN BANK	5	2015	6.22	9.02	0.87	1.09
GULF AFRICAN BANK	5	2016	6.52	9.32	0.88	0.75
GULF AFRICAN BANK	5	2017	7.19	12.40	0.91	0.25
KENYA COMMERCIAL BANK	6	2012	1.50	1.21	9.78	15.76
KENYA COMMERCIAL BANK	6	2013	1.74	1.70	11.08	17.75
KENYA COMMERCIAL BANK	6	2014	1.37	1.10	11.23	22.36
KENYA COMMERCIAL BANK	6	2015	1.48	1.19	12.11	23.44
KENYA COMMERCIAL BANK	6	2016	1.42	1.14	0.25	(0.09)
KENYA COMMERCIAL BANK	6	2017	1.43	1.14	0.05	12.29
NATIONAL BANK OF KENYA	7	2012	1.53	1.24	3.11	1.15
NATIONAL BANK OF KENYA	7	2013	1.78	1.74	3.56	1.78
NATIONAL BANK OF KENYA	7	2014	1.40	1.13	3.64	1.20
NATIONAL BANK OF KENYA	7	2015	1.51	1.22	3.53	(1.68)
NATIONAL BANK OF KENYA	7	2016	1.45	1.16	3.62	0.16
NATIONAL BANK OF KENYA	7	2017	1.46	1.17	3.91	0.74
STANDARD CHARTERED BANK	8	2012	1.48	1.19	4.65	11.57
STANDARD CHARTERED BANK	8	2013	1.72	1.68	5.09	13.35
STANDARD CHARTERED BANK	8	2014	1.35	1.08	5.77	14.35
STANDARD CHARTERED BANK	8	2015	1.46	1.17	6.22	9.16
STANDARD CHARTERED BANK	8	2016	1.40	1.12	7.08	13.29
STANDARD CHARTERED BANK	8	2017	1.41	1.13	6.84	10.07

APPENDIX III: OPERATIONAL DEFINITION OF ARABIC TERMS

Amanah: Trust, or trustworthiness, faithfulness and honesty. Is a transaction where one party keeps another's funds or property in trust, e.g. deposit taking or custody or goods on consignment.

Arbun: Earnest money/Down payment; a nonrefundable deposit paid by the client (buyer) to the seller upon concluding a contract of sale, with the provision that the contract will be completed during the prescribed period.

Bai bi-thamin ajil: Is an installment or deferred payment sale with pre-agreed payment dates. The sale price is inclusive of profit. The contract is asset backed.

Gharar: Uncertainty. A sophisticated concept that covers certain types of uncertainty or contingency in a contract, e.g. short selling, speculation and derivatives.

Haram: Forbidden or prohibited by Islamic law.

Ijarah-wa-iqtinah: extends the concept of Ijarah to a hire and purchase agreement.

Istisna: A contractual agreement for manufacturing goods (commodities), allowing cash payment in advance and future delivery or future payment and future delivery (based on agreed terms).

Maysir: Gambling.

Mudarib: The entrepreneurial partner who provides the expertise and management in a *mudarabah* partnership.

Rab-ul-amal: The partner (investor) who provides finance in a *mudarabah* partnership.

Riba: Interest. Riba covers any return of money on money - whether the interest is fixed or floating, simple or compounded, and at whatever the rate.

Shari'ah compliant: An act or activity that complies with the requirements of the Shari'ah, or Islamic law.

Shari'ah: Shari'ah or Islamic refers to divine guidance as given by the Holy Quran and the Sunnah (practice) of the Prophet Muhammad (Peace Be upon Him) and embodies all aspects of the Islamic Faith, including beliefs and practice.

Sukuk: Similar characteristics to that of a conventional bond with the difference being that they are asset backed.

Takaful: Islamic insurance. Structured as a charitable collective pool of funds that is based on the idea of mutual assistance, i.e. designed to avoid the elements of conventional insurance (interest and gambling).

APPENDIX IV: LIST OF BANKS OFFERING ISLAMIC SERVICES IN KENYA

1. ABC Bank Kenya
2. Barclays Bank of Kenya
3. Diamond Trust Bank
4. Dubai Islamic bank
5. First Community Bank
6. Gulf African Bank
7. Kenya Commercial Bank
8. Middle East Bank Kenya
9. National Bank of Kenya
10. Standard Chartered Bank