ISLAMIC BANKING AND INVESTMENT FINANCING: A CASE OF ISLAMIC BANKING IN KENYA

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DECLARATION

This research project is my original work and has not been presented for examination in any other University.

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This research project has been forwarded for examination with my approval as the University supervisor.

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It is with great pleasure that I submit my thanks to God the almighty for having enabled me go through this program and to reach where I am today. Without Him my wisdom is worthless and before him I shall always observe my prayers.

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DEDICATION

To my late parents Shawanuu Salim Khamis and Abubakar M. Abbas whom I owe a great deal.
ABSTRACT

The purpose of this study is to establish the effect of Islamic banking on investment financing in Islamic banks in Kenya. This study employed descriptive survey design. The population of this research consisted of 8 commercial banks offering shariah compliant products. The study used secondary data. Loans advanced to customers were collected for a period of four years (2009 to 2012). Data was analyzed using Statistical Package for Social Sciences (SPSS) and results were presented in frequency tables and figures. The data was then analyzed in terms of descriptive statistics like frequencies, means and percentages.

The study findings indicated the relationship on how Islamic banks use their investments as loans advanced to customers to finance Islamic banks products. Islamic bank products are the independent variables. The investment is the dependent variable. The products included motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing. The study also indicated that there were various modes of financing used by Islamic banking such as profit and loss sharing, Ijara and murahaba. Regression results revealed that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively correlated.

The study concluded that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from post election violence and people were ready to start ventures all over again and the decrease in following years was may be due to fears of elections in 2013. The study concluded that mortgage financing as a source of investment had an inconsistent pattern as the percentage decreased in the year 2010 and increased rapidly in 2011 to 12.5% and then decreased again in 2012. The inconsistency can be explained by more investors using other Islamic banking products for financing more than mortgage financing. Overall it was possible to conclude that the Islamic banking products have spread in the banking sector as all the financial products have been used to a high percentage across the years.

The study recommends that the more time may be required for the unique characteristics of Islamic financial instruments to be completely accepted and understood by both bank personnel and customers. It is also recommended that the terms and conditions of acquiring a loan be made more appealing and considerate for more investors to approach the banks for assistance as the Shari`ah restricts the type of businesses for which Islamic banks can provide financing. For example, they are not permitted to participate in certain prohibited investments or joint venture projects considered to be detrimental to the individual, society, or the environment.
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<tr>
<td>ANOVA</td>
<td>Analysis of Variance</td>
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<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
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<td>CGAP</td>
<td>Certified Government Auditing Professional</td>
</tr>
<tr>
<td>EAC</td>
<td>East and Central African Region</td>
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<tr>
<td>HSBC</td>
<td>Hong Kong and Shanghai Banking Corporation</td>
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<td>IAF</td>
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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

What triggers curiosity in Islamic finance is the absence of interest, which is the backbone of Western or Conventional banking and financial systems. Islam prohibits interest, known as riba, not as law of the land but as divine orders leaving no space whatsoever to argue or put a case forward otherwise (Al-Qamar & Abdel-Haq, 1996). It is compulsory for Muslims to completely avoid riba in their commercial and non-commercial daily activities. It is even suggested that a shadow of interest will make a transaction haram. Apart from interest, other prohibitions include uncertainty, risk taking, ambiguity and investment in unethical and haram businesses. These prohibitions make up a wide part of activities of conventional banks. Under Islamic faith, all these prohibitions are believed to be signs of immorality and exploitation. In contrast, the Islamic banking operates on the principles of profit loss sharing and financing is done as participatory mode rather than lending mode. The Islamic banking and finance is a system designed to allow Muslims to deal with their financial affairs in accordance with their faith. The theoretical model is appealing and is carefully designed to avoid interest and other prohibition, however, implementation of the Islamic banking and financial system has not always been successful in practice (Shepherd, 1996).

The Islamic Banking has evolved over the decades around the world and it has emerged as the most impermeable shield against all sort of economic downturn. The system is in practice across the world, including some of the most economically strong countries, such as UK (Islamic Bank of Britain (IBB) plc, PO Box 12461, Birmingham, B16 6AQ), USA(Paul Wiseman, Islamic loans turn profit for banks in USA, USA TODAY), Germany(Deutsche Bank Launches Sharia-Compatible Funds), Italy(First Islamic bank in Italy), France(Eleanor Beardsley, France Adjusts Laws To Allow Islamic Banking), Singapore(1st Islamic Bank in Singapore), Japan(Jasim Ali, Islamic finance is gaining importance in non muslim countries (Shepherd, 1996).
The term "Islamic banking" means conduct of banking operations in consonance with Islamic teachings. If there is one distinguishing characteristic of the Islamic economy, it is the prohibition of Riba. This is nothing new. The ban on Riba was already observed in the medieval Muslim world (Udovitch, 1979) and famous scholars such as al-Ghazali took the ban on riba for granted (Ghazanfar and Islabi, 1990). The literal meaning of riba is ‘increase’ or ‘addition’ or ‘surplus’. In the sharia, riba stands for an addition to the principal and, by implication, for a payment for the use of money which has been fixed beforehand (Visser, 2009). It is a form of excess, of unjustified appropriation of income, and it therefore is at variance with the principle of brotherhood and with Islamic ideas about income distribution (Choudhury, 1986). For those who see the ban on riba as the cornerstone of Islamic economics, all forms of interest are forbidden and no discussion is possible on this fundamental tenet (Uzair, 1978). Islamic banks are supposed to offer instruments consistent with the religious beliefs and cultural characteristics of Muslim societies. According to prevailing interpretations of Islamic Law, financial instruments should emphasize profit-and-loss sharing (equity) (Aggarwal and Yousef, 2000).

The huge influx of petrodollars from the late 1970s provided a strong impetus to the development of several Islamic banks in the Middle East (Khan & Bhatti, 2008). Other Muslim countries established their own Islamic financial institutions over time. Islamic banking has made steady progress over recent decades. In recent years it has emerged as the fastest-growing segment of global finance due to consistently rising of oil prices in international markets and other favourable socio-political factors flourishing in Africa, Asia, Europe and North America (Khan & Bhatti, 2008). Though Islamic banking was virtually unknown 30 years ago, by 2006 there were about 300 Islamic financial institutions across 70 countries, holding capital investments worth US$500-800bn, with an average annual growth of 15 per cent (Arekat, 2006). It had been estimated that Islamic banking will have a market value of US$4 trillion by 2010 (Cader, 2007). It is expected to capture about 40-50 per cent of the total savings of 1.3 billion Muslims worldwide by 2015 (Alam, 2006) particulary because it is one of the fastest growing financial services markets in the Islamic world (Venardos, 2005).
According to Ndungu (2010) Islamic Finance is so far the fastest growing segment in the global financial industry. Despite the global financial crisis, Islamic finance has demonstrated strong growth with new areas of business such as mutual funds and Takaful industry attracting a lot of attention. We need to understand this business model that will support our relative comparative advantage in the EAC region. Kenya was the first country in the East and Central African region to introduce Islamic banking. In this regard, two banks were licensed in the last two years to exclusively offer Shariah compliant products with many other conventional banks establishing a window specifically for Shariah compliant products.

The potential for Islamic-banking services has even attracted the attention of conventional banking giants such as City bank and Hong Kong and Shanghai Banking Corporation (HSBC). These industry behemoths have created special subsidiaries or windows to attend to the demand for these services. Indeed Western banks such as Switzerland’s UBS target both Muslim and non-Muslim investors with their Islamic investment products (Iley and Megalli 2002). If, however, Islamic finance is offered alongside conventional finance, the range of products offered to the public is widened; greater choice is in principle a good thing (Visser, 2009).

There are some core factors contributing to the recent success of Islamic banking and finance, such as spiraling oil prices worldwide, prolonged boom in the Middle eastern economies, product innovation and sophistication, increase receptive attitude of conventional regulators and information advancements that have been acting as a catalyst for the Islamic banking and finance industry to go global (Khan and Bhatti, 2008). According to the PLS (profit and loss sharing) principle, the bank may earn a return on invested funds provided that the bank shares in the risk of the investment and bears a loss if the project fails. Islamic banks utilize two instruments based on this principle:

Mudarabah financing- where the bank provides capital and the entrepreneur contributes effort and exercises complete control over the business venture. In case of a loss, the bank earns no return or a negative return on its investment and the entrepreneur receives
no compensation for his/her effort. In case of a gain, returns are split according to a negotiated equity percentage (Aggarwal and Yousef, 2000). Musharaka financing, where the entrepreneur and the bank jointly supply the capital and manage the project. Losses are borne in proportion to the contribution of capital while profit proportions are negotiated freely (Aggarwal and Yousef, 2000).

Other than the PLS investments there are transactions which are based on the mark-up principles and they are mainly consisting of (i) murabahah- a contract in which a client wishing to purchase equipment or goods requests the bank to purchase the items and sell them to him at cost plus a declared profit (ii) (bai muajjal- a trade deal in which the seller allows the buyer to pay the price of a commodity at a future date in lump sum or installments (iii) (ijara) leasing (iv) (ijara wa iqtina) hire purchase) and, (v) (bai salam) advance cash purchases of products.

Although markup instruments are widely used, their acceptability under Islamic law is disputed because they can imply a fixed return on investment for the bank. Many Islamic scholars have taken the position that markup techniques, while permissible, should still be avoided or restricted (Siddiqi 1983 and Khan 1987). Legally, the fear is that markup financing may open a "back door" to interest.

There is a formal equivalence between markup financing and debt, but the equivalence is not based on the payment of interest. It is argued that the salient feature of debt is that it transfers control of an asset to the debt holder in cases of default. (Aggarwal and Yousef, 2000). The Islamic banking models envisaged three main sources of funds for Islamic banks and at least eight principal uses of these funds. The three sources of funds were identified as (i) the bank's share capital (ii) mudarabah deposits, and (iii) demand deposits. The eight principal uses of these funds were identified as (i) mudarabah financing (ii) financing on the basis of the principles of musharakah (iii) purchase of ordinary shares of commercial or industrial enterprises as well as any investment certificates issued in the private or public sector on profit/loss sharing basis (iv) qard
al-hasanah - are beneficence loans (v) murabahah- (vi) (bai muajjal- (vii) (ijara) leasing (viii) (ijara wa iqtina) and, (ix) bai salam) (Ahmed, 1994).

1.1.1 Islamic Banking in Kenya

Islamic banks in Kenya account for one per cent of gross assets in the banking sector, the Central Bank of Kenya (CBK). Gulf African Bank and First Community Bank, the two Islamic banks currently operating in Kenya, have a combined loan portfolio of Ksh4.9 billion, customer deposits of Ksh7.5 billion and 27,270 deposit accounts. The banks appeal not just to Kenya’s Muslim population but also to non-Muslims who are looking for an alternative to conventional banking. Islamic banking is based on the principles of the Sharia, which prohibits the collection or payment of interest on money loaned and imposes the sharing of profit and loss (CBK, 2012).

Gulf African Bank is the brainchild of a group of Kenyans who in 2005 decided to establish a bank offering only Sharia-compliant products. It was licensed in late 2007 and began offering services early last year. It currently has 12 branches countrywide and plans to increase this number to 16 by the end of the year. First Community Bank also launched services last year. In addition several ordinary banks, including the National Bank of Kenya and Barclays Bank Kenya, now offer Islamic banking products alongside their conventional services. The first modern experiment with Islamic banking took place in Egypt in the 1960s and since then the system has spread throughout the world. It has seen a rise in interest particularly in light of the global financial crisis as a safer and more ethical means of raising money.

1.2 Problem Statement

The financing of investments by the Islamic banks is mainly based on two types one is the profit and loss sharing method which is the cornerstone of Islamic financing and the other is the cost plus or mark-up method which debt like and most of Islamic scholars advocate for its avoidance. According to the research carried out by Aggarwal and Yousef (2000), the analysis revealed that economies characterized by adverse selection
and moral hazard will be biased towards debt financing, and as these problems become more severe, debt will become the dominant instruments in financing. It was also observed that the majority of Islamic banks financing operations are concentrated in short-term investments. The majority of transactions are directed away from agriculture and industry and towards retail and trade. However the study did not address the effects of Islamic banking on investment financing.

A Comparative analysis of credit risk management practices of Islamic and conventional banks in Kenya was done by Ogle (2010), the research revealed that Islamic banks do not have well established credit risk management practices as compared to conventional banks. This was observed by the disparities in monitoring of the credit risk levels. The duration taken by the institution to know that the customer has defaulted and how the institution deal with difficult to pay on time clients. The study did not address the effects of Islamic banking on investment financing.

Several studies have been carried out on the effect of Islamic banking on investment financing in Islamic banks. Some of these studies include Kadubo (2010), Ndungu, (2010), Aggarwal and Yousef (2000), Khan and Bhatti (2008), (Usmani, 2008) and Aioanei (2007) who revealed that Islamic banking was driven by religious compliance and meeting customer needs. The studies also revealed that continuous review and improvement of sharia compliant products together with diversifying market niche will lead to drastic development and marketing of Islamic banking products. However the studies did not address the effect of Islamic banking on investment financing. Therefore, the difference in opinions in global studies and the inadequacies of local studies form the research gap that this study wishes to address. The research question therefore remains; what is the effect of Islamic banking on investment financing in Islamic banks in Kenya.

1.3 Objective of the study

The objective of the study was to establish the effect of Islamic banking on investment financing in Islamic banks in Kenya.
1.4 Significance of the study

This study would establish the relevance of Islamic banks investment financing on both the PLS and the mark-up principles. Scholars and researchers can research further to establish techniques on how Islamic banks investment financing can be improved through new innovations which are shariah compliant products. The investors can have a pool of choices on which products to take either by PLS OR Mark-up which is based on Islamic banking or they may chose to go the conventional banking which will be based on debt contract. The Islamic banks can come up with the ways on how to mitigate or minimize the problems associated with PLS contracts. By asking for collateral, stiff penalty for late payment and reduce the incidences of agency problems.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

The chapter explores literature that focuses on the area of Islamic banking and investment financing. The chapter starts by reviewing the theories that informs the discussion on Islamic banking. It then reviews empirical studies that discuss the link between Islamic banking and investment financing in banks.

2.2 Islamic Banking Theories

The following section reviews theories which have the key tenets on Islamic banking. The theories reviewed are; Islamic banking theory, Islam and the theory of interest, Chapra model of Islamic banking and profit and loss sharing theory.

2.2.1 Islamic Banking Theory

What can be characterized as the ‘theory’ of Islamic banking was, till the end of the nineteen-seventies, largely a plea for replacing interest in bank lending by profit sharing. This would change the nature of financial intermediation, making the fund owners as well as the financial intermediaries share the risks of enterprise with the fund users. Early literature’s main emphasis was on fairness. Making the fund-user-entrepreneur bear all the risks of business and allowing fund owner and bank claim a predetermined return was regarded to be unjust. The environment in which productive enterprise was conducted did not guaranty a positive return, so there was no justification for money capital claiming a positive return irrespective of the results of enterprise, it was argued.(Ghanameh, 1973, Hameedullah, 1970 & Siddiqi,1968). It was also argued that most, though not all, the other problems of capitalism were rooted in the practice of
lending on interest. Among these problems were unemployment, inflation, poverty amidst plenty, increasing inequality and recurrent business cycles (Uzair, 1955; Maududi, 1961, Ahmad, 1972, Hameedullah, 1970 & Hameedullah, 1936). These problems could be solved by abolishing interest and replacing it by profit sharing.

It was not until the next decade that Islamic economists were able to fortify these claims by sophisticated economic analysis, especially at the macroeconomic level. The focus at this stage was largely on pointing out the deficiencies of capitalism and linking them to the institution of interest, among other things. With this went the arguments showing that it was possible to have banking without interest and that it would not adversely affect savings and investment (Maududi, 1961, Maududi, 1969, Qureshi, 1946, Siddiqi, 1969). Some argued that abolishing interest would boost investments leading to increased production (Mannan, 1970). Notably missing were theoretical arguments to assure the fund owners regarding the safety of their monies, beyond the general argument that some kind of ‘mutual insurance’ will take care of the problem. Also, little attention was paid to what later came to be called ‘trade based modes of finance’ (Ismail: 2002, Hasan: 2005).

The most significant development during the late nineteen-seventies and early eighties was the advent and proliferation of murabahah or cost-plus financing. What the businessman got from the Islamic bank under this arrangement is the commodity he needed purchased by the bank at his request, with the promise to purchase it from the bank at a price higher than its purchase price, to be paid after a period of time. Each murabahah transaction created a debt. Compared to funds supplied on a profit-sharing basis, funds invested in murabahah transactions were safe. Within a couple of years of the introduction of murabahah in late nineteen seventies, it conquered the landscape of Islamic finance, assigning mudarabah or profit-sharing to a corner accounting for less than ten percent of the operations.

Security of capital invested rather than magnitude of returns to capital ruled the roost, insofar as the fund owners were concerned. However, the proliferation of murabahah did give a big boost to Islamic finance during the coming decades. Their total number by
year 2004 may have exceeded 200, spread over more than fifty countries. The seventies also saw Pakistan officially committing to interest-free Islamic banking, followed by Iran and Sudan in the eighties. Meanwhile Malaysia developed a new approach of introducing Islamic banking and finance under official patronage, while the main system continued along conventional lines (Archer and Karim, 2002). Indonesia followed in early nineties. This pattern later became the model for certain countries in the Gulf, like Bahrain, Qatar and the UAE. With the spread of Islamic financial institutions across the globe and enlargement of the size of funds managed by them, came the involvement of big players in the international financial arena like Citibank, HSBC and ABN AMRO.

2.2.2 Islam and the Theory of Interest

The early contributions on the subject of Islamic banking were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on *Islam and the Theory of Interest* (Qureshi, 1946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing.

Ahmad (1952) in his book *Economics of Islam* envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that
banks should cash bills of trade without charging interest, using the current account funds.

The principle of mudaraba based on Shariah was invoked systematically by Uzair (1955). His principal contribution lay in suggesting mudaraba as the main premise for 'interestless banking'. However, his argument that the bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical. Al-Arabi (1966) envisaged a banking system with mudaraba as the main pivot. He was actually advancing the idea of a two-tier mudaraba which would enable the bank to mobilize savings on amudaraba basis, allocating the funds so mobilized also on amudaraba basis. In other words the bank would act as a mudarib in so far as the depositors were concerned, while the 'borrowers' would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968. (The English version was not published until 1983.) His Islamic banking model was based on mudaraba and shirka (partnership or musharaka as it is now usually called). His model was essentially one based on a two-tier mudaraba financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of mudaraba and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.
2.2.3 Chapra Model of Islamic Banking

Chapra's model of Islamic banking (Chapra, 1982), was based on the *mudaraba* principle. His main concern, however, centred on the role of artificial purchasing power through credit creation. He even suggested that 'seigniorage' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. Al-Jarhi (1983) went so far as to favour the imposition of a 100 per cent reserve requirement on commercial banks. Chapra was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. He therefore preferred medium sized banks which are neither so large as to wield excessive power nor so small as to be uneconomical. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Mohsin (1982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that *riba*-free banks could coexist with interest-based banks.

The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra (1985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of *riba*, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-
maximizing role. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers. Unlike conventional banks which depend heavily on the crutches of collateral and of non-participation in risk, Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges.

2.2.4 Profit and Loss Sharing (PLS) Theory

Islamic scholars treat PLS instruments, mudarabah and musharakah as a central pillar of the Islamic banking model. In mudarabah banking, the Islamic bank accepts funds from depositors under risk-sharing arrangements. The Islamic bank either directly invests these funds in profitable investments or extends them to entrepreneurs on a risk-sharing basis. The Islamic bank shares the profit or loss made on mudarabah ventures with its depositors. In musharakah banking, the Islamic bank contributes the depositors' funds to a joint enterprise with the client (an entrepreneur). Generally, the Islamic bank allows the client to manage all the affairs of a Musharakah business. The Islamic bank and the client mutually share the profit or loss made on the Musharakah investment.

In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS, especially in case of Mudaraba that does not provide any control rights
to the financier (the Islamic bank in this case). Fiqh literature on this issue is quite out-of-date and needs serious reconsideration. For example, Saleh (1986) lists three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower.

The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract. The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. There is a need for construction of standardized PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organizational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

2.3 Empirical Literature Review

Amin (2008) carried out study to investigate the choice criteria for Islamic home financing in Malaysian Islamic banks. Most importantly, this study considers establishing a specific rank of choice criteria for Islamic home financing. Moreover, these choice criteria will also be ranked according to the selected demographic elements such as gender, marital status and age range. He used a quantitative study similar to what was employed by previous researchers. The study presents primary data collected by self administered questionnaires involving a sample of 150 Malaysian bank customers in Labuan, Malaysia. Of these, 141 questionnaires were returned with a response rate equivalent to 94 per cent. The Islamic home financing choice criteria as perceived by the Malaysian bank customers are analyzed using frequencies, independent samples t-test and ANOVA.
Siddiqi (2006) noted that Muslims have the same orientation and motivation in finance as everybody else, they will end up having the system that has resulted from other people’s choices, the one we call conventional financial system. A genuinely distinctive system can emerge only out of a genuinely distinct orientation and motivation, a different set of norms. If Muslims do not have one, they do not need a different financial system. If they have one, we need research on what it is and how can it can be translated into behavioral patterns and institutions. This is quite appropriate as Muslims themselves feel that their current motivations may not be what they ought to be. Whereas Sudin and Wan (2008) study investigating the impact of selected economic variables on deposits level in the Islamic and conventional banking systems in Malaysia found recent econometric rates of profit of Islamic bank, rates of interest on deposits of conventional bank, base lending rate, Kuala Lumpur composite index, consumer price index, money supply and gross domestic product have different impact on deposits at both Islamic and conventional banking systems. In most cases, customers of conventional system behave in conformity with the savings behaviour theories. In contrast, most of these theories are not applicable to Islamic banking customers. Therefore, there is a possibility that religious belief plays an important role in the banking decisions of Muslim customers.

A study carried out on the factors influencing development of Islamic banking in Kenya by Kadubo (2010), revealed Islamic banking was driven by religious compliance and customers need being met. It also revealed that continuous review and improvement of sharia compliant products together with diversifying market niche will lead to drastic development and marketing of Islamic banking products. From the study the following conclusions were drawn: firstly, the factors that influence development of Islamic banking products in Kenya are purely religious compliance and customers need being met.

A Comparative analysis of credit risk management practices of Islamic and conventional banks in Kenya was done by Ogle (2010), the research revealed that Islamic banks do not have well established credit risk management practices as compared to conventional
banks. This was observed by the disparities in monitoring of the credit risk levels. The duration taken by the institution to know that the customer has defaulted and how the institution deal with difficult to pay on time clients. It was concluded that both the conventional and Islamic banks take risks equally with an exception of interest rates risk in Islamic banks as their loans do not have a risk with the interest rates. Loan recovery mechanisms are different between conventional banks and Islamic banks with Islamic banks being more flexible thus preferring to restructure the loan contrary to the conventional banks who prefer to taking legal action on defaulters. Some of the setbacks or impediments on Islamic banks credit policies were the restrictions placed by the rules of sharia pertaining to financial contracts, some instruments used by conventional banks for credit risk are not permitted to Islamic banks and the ability of Islamic banks in dealing with credit risk as well as the means available to these banks for balancing claims on assets is limited.

The empirical evidence confirms this conjecture; the available figures show that profit-sharing and profit-and-loss-sharing arrangements are far from dominant. Iqbal (1997) estimated that in the mid-1990s murabaha contracts made up some three-quarters of Islamic bank financing and ijara contracts some 10 per cent. These two categories averaged 95.3 per cent of new financing by Bank Islam Malaysia over the 1983–94 period (Aggarwal and Yousef, 2000). In Iran instalment sales, the Iranian version of murabaha, rose from 34 per cent of the outstanding facilities of Islamic banks extended to the non-public sector in 1984–85 to 49 per cent in 1990–91, falling to 43.4 per cent in 1996–97. Mudaraba financing steadily declined from 18.5 per cent in 1984–85 to 6.7 per cent in 1996–97 but musharaka participations started at 18.6 per cent and ended up at 23.4 per cent (Sadr and Iqbal 2002; Yasseri 2002). Even the IDB, set up by governments to promote the use of Islamic financial instruments, saw the share of musharaka and mudaraba financing in its asset portfolio fall from 55 per cent in 1975 to a very meagre 1 per cent in 1986, whereas murabaha rose from nil to over 80 per cent, the rest largely taken up by ijara (Kuran, 2006). The Indonesian Bank Muamalat reported that 39 per cent of finance was provided in PLS forms and 56 per cent as murabaha loans in 2003 (Wolters, 2005). In Sudan musharaka took up between 23 and 32 per cent of banks’
financing in 2002–04 and mudaraba between 4.6 and 5.7 per cent (El-Hawary et al., 2007).

According to Ndungu (2010) the developments of Islamic banking have enabled the formerly unbanked Kenyans and specifically the Muslim community in the marginal areas have access to financial services adding to the wealth creation in the economy. This is a solid testimony of the vast potential of Islamic finance in Kenya, which should be tapped, and opportunities explored in the insurance (takaful) and capital market segments using sharia compliant vehicles. There are many people who could never bring themselves to enter a conventional bank’s office and make use of the bank’s services. If an Islamic bank sets up shop in their neighbourhood, the fact that it is Islamic might be just the incentive they need to enter the world of formal finance (Scheepens 1996; Demir et al. 2004). That was one of the reasons for Turkey’s government under Turgut Ozal to set up Islamic finance houses in 1983 (Jang, 2005). In this way Islamic bank have contributed to a higher degree of financial intermediation, which both economic theory and econometric research say generally fosters economic development (Christopoulos and Tsionas 2004; Levine 2004; Ang 2008).

Khan and Bhatti (2008) commented that due to the relative infancy of Islamic Banks the importance of their products must compare well to those of the conventional banks as many of the high street banks now have Islamic windows within their branches. HSBC AMANAH was one of the first conventional banks to start offering ethical banking products, Islamic financial instruments, to their customers. Many firms, like Lloyds TSB, started to see the potential of the market when double stamp duty was abolished after the 2003 Budget. Through acquisitions many banks purchased the infrastructure of other commercial banks to sell Islamic products. It took a few years but eventually many Islamic Banks from the Gulf then recognised the potential in the UK and negotiated with conventional banks to distribute their financial instruments through their branches.

The products which were initially available to customers were two types of house finance options: Murabaha, where the customer would have to pay monthly repayments which would include a cost plus mark up for the banks profit and Ijara, this was the
option where the bank would purchase the property, and the client would pay a monthly repayment as well as a monthly rent, the rent would be calculated according to LIBOR index which would avoid expensive re-valuations. Even thought the use of LIBOR is Riba based, it was accepted by the Shari’ah council, due to wide acceptance by the banking community, it can be debated that at the start of Islamic banking scholars would have never accepted this policy as the rules when Islamic banking was still infant were adhered to much more due to the reason why Islamic banking was needed, to lose western influences in the Gulf (Usmani, 2008).

At present the main deterring factor for Muslims, for not choosing an Islamic Mortgage is the higher costs due to high fees charged by the Shari’ah councils, however in the future as the number of suppliers of Islamic finance increase the cost of the products will decrease. Currently no Islamic financial institution of conventional bank with’ Islamic windows’ offer savings or investment accounts on a Mudaraba basis. This is due to the fact that there are no facilities available to match the liabilities against an Islamic mortgage asset, which are generally done by investing in Shari’ah compliant investments in the Gulf. The reason is the Gulf has heavily invested in assets within the Gulf but they are running out and other nations are being looked at to be the suppliers of the bonds to allow Islamic financial instruments, like the potential issue of a sovereign Sukuk by the UK government(Amin, 2007).

Aioanei (2007) is of the view that currently the direction of the retail banking industry is moving towards catering to high net worth individuals. The development of premier banking by numerous banks Islamic and conventional, such as IBB and HSBC AMANAH looked to gain customers who can invest larger amounts of money to improve the liquidity of the Islamic banks or conventional banks and their Islamic funds. For instance the IBB approach is very well orientated as they placed their premier banking office in Mayfair, which is London’s most expensive area, where the majority of home owners are extremely high earners with numerous Arab millionaires and billionaires residing during the summer. They are attempting to attract the petrodollars of Arab sheikhs so they can appeal to them to invest their money into Shari’ah
compliant investments. It is evident that the banks in the UK are proving to be more innovative than the Islamic banks abroad as the IBB won first place in a global vote for their services, even beating the Abu Dhabi Islamic Bank.

Abdul-Gafoor (2006) investigated the mudarib role of the Islamic banks from another angle. His argument was as follows: the Islamic bank raises the funds from the depositors then finances projects put forward by entrepreneurs. In this mechanism, the Islamic bank plays the role of the intermediary between investors and entrepreneurs, i.e. the role of the financer. However, and in order to meet the Mudarabah concept, the Islamic bank (as mudarib) should assume the role of trader. Abdul-Gafoor (2006) claims that Islamic banks are financers in substance and traders in form, and this alteration from financer to trader are achieved by ‘legal’ documentation and some self-persuasion. He proposed an approach to overcome this “split personality” problem and suggested “let the financiers be financiers, and the traders and entrepreneurs be traders and entrepreneurs”. He proposed that the Islamic bank, as an intermediary, should be independent of both the investors and the entrepreneurs. The bank is responsible for identifying good projects for financing as well as for monitoring their progress. The system proposed emphasized the features that the intermediaries and entrepreneurs should carry.

Archer et al. (2010) argued that the management of the Islamic bank may engage in a range of practices that smooth or cushion the cash returns paid to IAH, thus keeping a stable trend of income from assets financed by those funds. This is done either to pay market-related returns to IAH or to reduce the risk of investment accounts drawing. Asian-Oceanian Standard-Setters Group (2010) also addressed this issue and mentioned that Islamic banks may practice earnings management by utilizing four main methods; a) profit equalization reserves, b) investment reserve risk, c) an Islamic bank forgoing some portion of its share of profits, and d) an Islamic bank transfers amounts from shareholders' current or retained profits.

Bulut (2005) indicated that IAH could be operated as an open-end or closed-end mutual funds depending upon whether account holders have a right to withdraw. He stated that
with minor adjustments to the investment management agreement, a mutual fund structure can easily replace the Mudarabah contract. In this model, a separate entity for mutual fund is initiated and transacted in the primary and the secondary markets as is the case for any publicly held corporation. Different investment strategies and purposes can be adopted by this entity in order to meet the different risk preferences and maturities of the investors. Some of these funds may follow a specialization approach based on certain stages of ventures and certain sectors/industries, while others will follow a portfolio approach in their investment strategies.

In many cases, the bank invests the four sources of funds in a ‘commingled’ asset pool. If the aggregate investment portfolio yields a profit, then the shares of profit are allocated between the parties; saving accounts, investment accounts\(^1\), and stockholders, according to the proportionate shares of their respective investments in the portfolio. The bank’s share of profit relates to both its shareholders’ own funds and to current accounts funds. However, the shareholders also receive the mudarib share (asset manager) according to predetermined rate (Archer and Karim, 2009).

While this profit allocation mechanism seems fair and straightforward, crucial and controversial decisions should be taken to implement it. These decisions include determination of: methods of profit measurement, recognizable income and expenses that are applicable to IAH funds, reserves and smoothing practices, range of weights and profit-sharing ratios applicable to various tenors of IAH funds and comingled funds of the shareholders (Islamic Financial Services Board, 2010).

In his study Oundo (2009) noted that many mainstream banking clients who demand Shariah-compliant products, are the many poor people who insist on these products (CGAP, 2008). The emergence of Islamic banks in Kenya had been an outcome of the demand by mainstream banking clients for Shariah-compliant products. Whereas the mainstream banking sector had options for their Muslim clients, poor micro entrepreneurs had no option of Islamic Microfinance products. The study reveals that
due to lack of options most respondents accessed loans from the available institutions as a coping strategy. The study also assessed the knowledge of the respondents on the existence of a Kenyan MFI that provided Shariah-compliant products. All respondents said they had no knowledge of any Islamic MFI in the country and had never heard of one. Asked whether they would switch over to Islamic MFIs if given the option, all respondents responded in the affirmative. This confirmed the existing market niche.

2.4 Conclusion

Islamic banking has been growing at an impressive rate. Its presence in Kenya as a financial intermediary can be viewed positively as a compliment to conventional banking. It has created an environment of competition and we expect that there will be an improvement of the overall services provided by the banks. The government has to come up with improved policies for an enabling environment to foster for a friendly investment conditions. There are lot of opportunities to be tapped with rich oil producing Middle-East countries were the hub of Islamic banking is concentrated. The government can immensely benefit through the issue of Islamic bonds (sukuk) which they can be used to finance various infrastructures projects. Islamic banking also provides for an opportunity for those pious individuals who will find their conscience at peace when banking with Islamic banks.

Despite these achievements it is important to critically look at the products offered by the Islamic banking and evaluate them in order to analyse their competitiveness, risks and cost to benefits. Islamic banks deal with real assets when dealing with mark up transactions which can be cumbersome and costly during the transition period. PLS transactions carry with it a lot tasks like screening, monitoring and evaluations which involves extra costs both in terms of money and time. Ijara and ijara wa iqtina contracts carry with them the price risk. Since ijara contracts cannot be terminated before the contract period, the residual value of the asset or resale price if fixed in advance. The quality of the asset at the end of the period is unknown when the lease conditions are made up, and the market related price is also unknown. More creativity and innovation is required to come up with products which are shariah compliant and at the same time
friendlier and cost effective. This will create a level ground for competitiveness with conventional banks.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section outlines the methods and techniques used in this study. Methodology is a related set of assumptions that reflect how a researcher views reality and how this reality is articulated through research. Choice of method is reflective of what the researcher wants to uncover. To concretize research methodology this chapter shall cover research design, population, sample size, instruments and data analysis.

3.2 Research Design

A research design is the structure of research. It is the glue that holds all the elements in a research process project together. A design is used to structure the research, to show how all of the major parts of the research project work together to try to address the central research questions. Orodho (2003) defines it as the scheme outline or plan that is used to generate answers to research problems. It is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance with research purpose. It constitutes the blueprint for the collection, measurement and analysis of data (Kothari, 2004).

This study used descriptive survey design. According to Sekaran and Bougie (2011) descriptive study is undertaken in order to ascertain and be able to describe the characteristics of the variable of interest in a situation. Descriptive studies are essential in many situations especially when using qualitative data in understanding the phenomena. Descriptive research design has been used in other studies like Clarence (2010) in analysis of sociological analysis of youth inactivity in the Philippine while Saeed (2010) used it to study supply chain as well as risk management concepts on the oil industry and Moodley (2007) used it to investigate the impact of employee
satisfaction levels on customer service in the service utility at Telkom South Africa. In view of the above descriptions and strengths, descriptive survey is the most appropriate design for this study.

3.3 Target Population

Newing (2011) describes a population as the set of sampling units or cases that the researcher is interested in while Burns and Grove (2003) describe population as all the elements that meet the criteria for inclusion in a study. The population of this study was all commercial banks offering Islamic banking products in Kenya. They comprise of two fully fledged Islamic banks (Gulf African Bank and First Community Bank) and six conventional banks that offer partial Islamic banking (Barclays banks, National Bank, Chase Bank, Imperial Bank, Diamond Trust and Standard Chartered Bank).

3.4 Sampling Technique and Sample Size

The study sample comprised of eight commercial banks which offer Islamic banking products. This means that a census was employed in order to include all commercial banks in Kenya which offer Islamic products.

3.5 Data Collection Instrument and Procedure

Secondary data was utilised in this study. This means that all the study variables utilised quantitative data. The data obtained from the annual reports of the banks and also from banks’ internal sources. To compile the data, a secondary data collection template was used.

3.6 Data Analysis

Data Analysis is the processing of data to make meaningful information (Sounders, Lewis & Thornbill, 2009). Burns and Grove (2003) define data analysis as a mechanism for reducing and organizing data to produce findings that require interpretation by the researcher. According to Hyndman (2008) data processing involves translating the
answers on a questionnaire into a form that can be manipulated to produce statistics. This involves coding, editing, data entry, and monitoring the whole data processing procedure.

After data was collected, it was prepared in readiness for analysis by editing, handling blank responses, categorizing and keying into Statistical Package for Social Sciences (SPSS) computer software for analysis. SPSS was used to produce frequencies, descriptive and inferential statistics which were used to derive conclusions and generalizations regarding the population.

Inferential statistics included regression analysis. Regression analysis was done by use of an econometric model which is laid below.

\[ Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \mu \]

Where;

- \( Y \): Loans advanced to customers for Islamic bank products
- \( X_1 \): Motor vehicle financing using Islamic bank finance
- \( X_2 \): Mortgage services financing using Islamic bank finance
- \( X_3 \): Asset financing using Islamic bank finance
- \( X_4 \): Real estate financing using Islamic bank finance
- \( X_5 \): Trade financing using Islamic bank finance
- \( X_6 \): SME finance using Islamic bank finance.

\( \alpha \): constant
\( \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6 \): beta coefficients
\( \mu \): error term

The regression results were evaluated and interpreted as follows; the coefficient of determination (r squared) was evaluated to determine the explanatory power of the model. The F statistic was evaluated to determine the overall significance of the models. A reported p value less than the critical value of 0.05 was construed to mean that the overall model was significant. The sign of the beta coefficient was used to determine
whether the relationship between the dependent and independent variables is positive or negative. The significance of the independent variable was determined by the t statistics and the associated p values. A reported p value less than the critical value of 0.05 was construed to mean that the independent variable has a significance relationship with the dependent variable.
CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION OF THE FINDINGS

4.1 Introduction

This chapter presents the results of the study. The descriptive statistics were presented first followed by the model results. The interpretation and discussion of the results are presented in a separate section. The chapter summary is also given.

4.2 Demographic Information

This section presented the demographic characteristics for the bank managers.

4.2.1 Gender of the Respondents

The study sought to find out the gender spread of respondents. Figure 4.1 shows that 75% of the respondents were male and 25% were female. The findings imply that the bank is a male dominated field. According to Ellis, Cutura, Dione, Gillson, Manuel and Thongori (2007), in spite of women being major actors in Kenya’s economy, and notably in agriculture and the informal business sector, men dominate in the formal sector citing the ratio of men to women in formal sector as 74%:26%.
4.2.2 Level of Education

The study sought to determine the level of education for the bank managers. Figure 4.2 shows that 62% of the respondents had attained university level and 38% had post graduate level. The findings imply that the respondents had high level of education in this sector and perhaps this observed level of education may have had a bearing on the quality of our responses.

Figure 4.2: Level of Education

4.2.3 Years in Employment

The study sought to establish the number of years the respondents had been in the employment. Figure 4.3 illustrates that 63% of the respondents indicated more than 5 years and 37% indicated between 3 to 5 years. The findings imply that that the respondents were appropriate and may impact positively on the coherence of the data obtained as they had worked for the Banks long enough for them to be well aware of the Islamic products offered by the banks under study.
4.2.4 Bank Commenced Operation

The study sought to find out the number of years since the banks commenced operations. Figure 4.4 reveals that 38% indicated more than 5 years, 37% indicated between 3 to 5 years and 25% indicated between 1 to 2 years. The findings imply that Islamic banking is picking up since its introduction in the Kenyan market.

4.3 Descriptive Statistics

This section presents the descriptive results. The results are presented by the trend analysis.
4.3.1 Loan Advanced to Customers for Islamic Banking Products

The study sought to determine the loans advanced to customers for Islamic banking products. Figure 4.4 indicates that loans advanced to customers for Islamic banking products have gradually increased from year 2009 to 2012. The increase may be explained by low interest rates charged and fair terms and conditions on borrowing.

![Figure 4.5: Trend Analysis of Loans Advanced to Customers](image)

4.3.2 Islamic Banking Products

This section presented the Islamic banking products offered in banks.

4.3.2.1 Motor vehicle Financing

Results on Figure 4.6 illustrates that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from post election violence and people were ready to start ventures all over again and the decrease in following years was may be due to fears of elections in 2013.
4.3.2.2 Mortgage Financing

The trend analysis for mortgage financing as a source of investment indicates that there was a inconsistent pattern as the percentage decreased in the year 2010 and increased rapidly in 2011 to 12.5% and then decreased again in 2012. The inconsistency can be explained by more investors using other Islamic banking products for financing more than mortgage financing.

Figure 4.6: Trend Analysis of Motor Vehicle Financing

Figure 4.7: Trend Analysis of Mortgage Financing
4.3.2.3 Asset Financing

Figure 4.8 show that there was a gradual increase in the year 2010 and then followed by slight decrease in the following years. This may be as a result of many investors turning into mortgage financing more than asset financing as indicated in the trend analysis for mortgage financing.

![Figure 4.8: Trend Analysis of Asset Financing](image)

4.3.2.4 Real Estate Financing

The study sought to find out how the Islamic banks distribute their finances on real estate financing. Figure 4.9 illustrates that there was a percentage increase in the year 2010 to 17.5% amount distributed in real estate financing, followed by a slight decline in 2011 to 13.75% and a gradual shoot to hit 20% in the year 2012. The findings imply that more investors are focusing on real estate business as every Kenyan wants to own a home or a business unit. Real estate has also been lately seen as a business opportunity to venture into hence the rise for banks to advance loans to customers via real estate financing.
4.3.2.5 Trade Financing

Figure 4.10 illustrates that there was a slight increase in percentage for trade financing in the year 2010, followed by a gradual decline in 2011 and a rapid increase in the year 2012.
4.3.2.6 SME Financing

Figure 4.11 shows that there was a rapid decrease in SME financing in the year 2010 to hit a low of 8.75%, followed by a slight increase to 11.25% in 2011 and a slight decline to 10% in 2012. This may be explained by the inflation changes in the country hence the businesses were doing so badly thus many investors withdrawing from small business enterprises.

Figure 4.11: Trend Analysis of SME Financing

4.3.3 Mode of Financing Islamic Banking Products

The study sought to determine the mode of financing for Islamic banking products.

4.3.3.1 Profit and Loss Sharing

Figure 4.12 indicates that there was a steadily increase in percentage in the profit and loss sharing mode of financing in the years 2009, 2010 and 2011 and a slight decrease in the year 2012. This could be explained by the election campaigns taking place in the country thus low business ventures in the year 2012.
Figure 4.12: Trend Analysis for Profit and Loss Sharing

4.3.3.2 Ijara & Ijara wa Iqtina

Figure 4.13 reveals that there was inconsistency in the years of study for Ijara & Ijara wa Iqtina as a mode of financing. There was no consistency as there was a slight increase in the year 2010, then gradual decline in 2011 and a steady increase in 2012.

Figure 4.13: Trend Analysis for Ijara & Ijara wa Iqtina
4.3.3.3 Muharaba

Results on Figure 4.14 indicate that there was a slight increase in 2010 to hit a high of 41% and then followed by consistent decrease in the following years to hit a low of 20% in the year 2012.

![Figure 4.14: Trend Analysis for Muharaba](image)

4.3.3.4 Other Modes of Financing

Figure 4.15 illustrates that there were other modes of financing that Islamic banks used to finance its customers with. However they were not consistent as there were highs and lows across the years of study. This other modes of financing could include mudarabah (trust financing), musharakah (equity financing), qard al-hassan (welfare loan), bay’ bi al-thaman al-ajil (deferred payment financing), and and istisna’ (progressive payments).
4.3.4 Nature of the period taken to finance Islamic banking products

The study sought to establish the duration taken by Islamic banks to finance their investments. The trend analysis for short term, medium term and long term durations are presented below.

4.3.4.1 Short Term

Figure 4.16 shows there were an increase in percentage the duration taken by banks to finance their investments via short term. The trend shows there was consistent increase from 31% in 2009 to 43% in the year 2012. The findings imply that most of the investors were taking loans for short term.
Figure 4.16: Trend Analysis for Short Term

4.3.4.2 Medium Term

Figure 4.17 illustrates that there was a slight increase in the year 2010 to hit a high of 21% followed by a slight decline in 2011 to hit a low of 16% and then gradually increased to 25% in the year 2012.

Figure 4.17: Trend Analysis for Medium Term
4.3.4.3 Long term

Figure 4.18 illustrates that there was a gradual decline to hit a low of 23% in 2011 followed by a rapid shoot to 33% in the year 2012. This could mean that most of the mortgages given fall under this category hence variations across the years.

![Figure 4.18: Trend Analysis for Long Term](image)

4.4 Model Results

This section presented the model results. Result in table 4.1 indicates that the goodness of fit of the model was adequate. This is reported by an $r^2$ squared of 0.865 which means that 86.5% of the variation in loans advanced to customers is explained by motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks. The correlation coefficient of 93% indicates that the combined effect of the predictor variables have a strong and positive correlation with loans advances. This also meant that a change in the drivers of loans advances to customers has a strong and a positive effect on loans distributed to customers.
Table 4.1: Model Fitness

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>R</td>
<td>0.930</td>
</tr>
<tr>
<td>R Square</td>
<td>0.865</td>
</tr>
<tr>
<td>Std. Error of the Estimate</td>
<td>2,578,056,699</td>
</tr>
</tbody>
</table>

Analysis of variance (ANOVA) on Table 4.2, shows that the combined effect of motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing was statistically significant in explaining changes in loans advances to customers in Islamic banks. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05.

Table 4.2: Analysis of Variance (ANOVA)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>1.1E+21</td>
<td>6</td>
<td>1.8E+20</td>
<td>27.775</td>
<td>0.000</td>
</tr>
<tr>
<td>Residual</td>
<td>1.7E+20</td>
<td>26</td>
<td>6.6E+18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1.28E+21</td>
<td>32</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4.3 displays the regression coefficients of the independent variables. The results reveal that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively.
Table 4.3: Regression Coefficients

<table>
<thead>
<tr>
<th>Variable</th>
<th>Beta</th>
<th>Std. Error</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motor vehicle financing</td>
<td>118,583,069</td>
<td>65,911,985</td>
<td>2.755</td>
<td>0.011</td>
</tr>
<tr>
<td>Mortgage</td>
<td>95,001,881</td>
<td>85,255,094</td>
<td>1.114</td>
<td>0.275</td>
</tr>
<tr>
<td>Asset financing</td>
<td>17,593,358</td>
<td>66,246,370</td>
<td>0.266</td>
<td>0.793</td>
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</table>

4.5 Summary and Interpretation of Findings

This section summarizes the results of the study. The study findings indicate that loans advanced to customers for Islamic banking products have gradually increased from year 2009 to 2012. The increase may be explained by low interest rates charged and fair terms and conditions on borrowing.

Results illustrated that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from post election violence and people were ready to start ventures all over again and the decrease in following years was may be due to fears of elections in 2013. Regression results indicated that there was a positive and significant relationship between motor vehicle financing and loans advanced to customers in Islamic banks. This was evidence by a regression coefficient of 181,583,069 (p value = 0.011). The relationship was significant at 0.05 critical value since the reported p value 0.011 was less than that the critical value of 0.05.

The trend analysis for mortgage financing as a source of investment indicates that there was a inconsistent pattern as the percentage decreased in the year 2010 and increased rapidly in 2011 to 12.5% and then decreased again in 2012. The inconsistency can be explained by more investors using other Islamic banking products for financing more than mortgage financing. Regression results indicated that there was a positive and
insignificant relationship between mortgage financing and loans advanced to customers in Islamic banks. This was evidence by a regression coefficient of 95,001,881 (p value = 0.275). The relationship was insignificant at 0.05 critical value since the reported p value 0.275 was more than that the critical value of 0.05.

The study findings showed that there was a gradual increase in the year 2010 and then followed by slight decrease in the following years. This may be as a result of many investors turning into mortgage financing more than asset financing as indicated in the trend analysis for mortgage financing. Regression results indicated that there was a positive and insignificant relationship between asset financing and loans advanced to customers in Islamic banks. This was evidence by a regression coefficient of 17,593,358 (p value = 0.793). The relationship was insignificant at 0.05 critical value since the reported p value 0.793 was more than that the critical value of 0.05.

The findings agree with those in Iqbal (1997) who confirms the conjecture that the available figures show that profit-sharing and profit-and-loss-sharing arrangements are far from dominant. Iqbal (1997) estimated that in the mid-1990s murabaha contracts made up some three-quarters of Islamic bank financing and ijara contracts some 10 per cent. These two categories averaged 95.3 per cent of new financing by Bank Islam Malaysia over the 1983–94 period (Aggarwal and Yousef, 2000). In Iran instalment sales, the Iranian version of murabaha, rose from 34 per cent of the outstanding facilities of Islamic banks extended to the non-public sector in 1984–85 to 49 per cent in 1990–91, falling to 43.4 per cent in 1996–97. Mudaraba financing steadily declined from 18.5 per cent in 1984–85 to 6.7 per cent in 1996–97 but musharaka participations started at 18.6 per cent and ended up at 23.4 per cent (Sadr and Iqbal 2002; Yasseri 2002).

The study sought to find out how the Islamic banks distribute their finances on real estate financing. Results revealed that there was a percentage increase in the year 2010 to 17.5% amount distributed in real estate financing, followed by a slight decline in 2011 to 13.75% and a gradual shoot to hit 20% in the year 2012. The findings imply that more investors are focusing on real estate business as every Kenyan wants to own a home or a business unit. Real estate has also been lately seen as a business opportunity.
to venture into hence the rise for banks to advance loans to customers via real estate financing. Furthermore, results indicated that there was a slight increase in percentage for trade financing in the year 2010, followed by a gradual decline in 2011 and a rapid increase in the year 2012. Regression results indicated that there was a positive and insignificant relationship between real estate and trade financing and loans advanced to customers in Islamic banks. This was evidence by a regression coefficient of 80,463,376 (p value = 0.194) and 50,393,063 (p value =0.057). The relationship was insignificant at 0.05 critical value since the reported p value 0.194 and 0.057 was more than that the critical value of 0.05.

The findings agree with those in Kuran, (2006) who asserted that even the IDB, set up by governments to promote the use of Islamic financial instruments, saw the share of musharaka and mudaraba financing in its asset portfolio fall from 55 per cent in 1975 to a very meagre 1 per cent in 1986, whereas murabaha rose from nil to over 80 per cent, the rest largely taken up by ijara. The findings also agree with those in Wolters (2005) who asserted that the Indonesian Bank Muamalat reported that 39 per cent of finance was provided in PLS forms and 56 per cent as murabaha loans in 2003. In Sudan musharaka took up between 23 and 32 per cent of banks’ financing in 2002–04 and mudaraba between 4.6 and 5.7 per cent (El-Hawary et al., 2007).

In addition results showed that there was a rapid decrease in SME financing in the year 2010 to hit a low of 8.75%, followed by a slight increase to 11.25% in 2011 and a slight decline to 10% in 2012. This may be explained by the inflation changes in the country hence the businesses were doing so badly thus many investors withdrawing from small business enterprises. Regression results indicated that there was a negative and insignificant relationship between SME financing and loans advanced to customers in Islamic banks. This was evidence by a regression coefficient of -12,097,761 (p value = 0.859). The relationship was insignificant at 0.05 critical value since the reported p value 0.859 was more than that the critical value of 0.05. The findings agree with those in Archer and Karim (2009) who asserted that bank invests the four sources of funds in a ‘commingled’ asset pool. If the aggregate investment portfolio yields a profit, then the
shares of profit are allocated between the parties; saving accounts, investment accounts, and stockholders, according to the proportionate shares of their respective investments in the portfolio. The bank’s share of profit relates to both its shareholders’ own funds and to current accounts funds. However, the shareholders also receive the mudarib share (asset manager) according to predetermined rate.

The study sought to find out the mode of financing used by Islamic banks to finance its investments. The study findings indicated that there was steadily increase in percentage in the profit and loss sharing mode of financing in the years 2009, 2010 and 2011 and a slight decrease in the year 2012. This could be explained by the election campaigns taking place in the country thus low business ventures in the year 2012.

The findings agree with those in Abdul-Gafoor (2006) who investigated the mudarib role of the Islamic banks from another angle. His argument was as follows: the Islamic bank raises the funds from the depositors then finances projects put forward by entrepreneurs. In this mechanism, the Islamic bank plays the role of the intermediary between investors and entrepreneurs, i.e. the role of the financer. However, and in order to meet the Mudarabah concept, the Islamic bank (as mudarib) should assume the role of trader. Abdul-Gafoor (2006) claims that Islamic banks are financers in substance and traders in form, and this alteration from financer to trader are achieved by ‘legal’ documentation and some self-persuasion. He proposed an approach to overcome this “split personality” problem and suggested “let the financiers be financiers, and the traders and entrepreneurs be traders and entrepreneurs”. He proposed that the Islamic bank, as an intermediary, should be independent of both the investors and the entrepreneurs. The bank is responsible for identifying good projects for financing as well as for monitoring their progress. The system proposed emphasized the features that the intermediaries and entrepreneurs should carry.

The study findings revealed that there was inconsistency in the years of study for Ijara & Ijara wa Iqtina as a mode of financing. There was no consistency as there was a slight increase in the year 2010, then gradual decline in 2011 and a steady increase in 2012. Results further indicated that there was a slight increase in 2010 to hit a high of 41% and
then followed by consistent decrease in the following years to hit a low of 20% in the year 2012. The study findings also indicated that there were other modes of financing that Islamic banks used to finance its customers with. However they were not consistent as there were highs and lows across the years of study. This other modes of financing could include mudarabah (trust financing), musharakah (equity financing), qard al-hassan (welfare loan), bay` bi al-thaman al-ajil (deferred payment financing), and istisna` (progressive payments).

The findings agree with those in Usmani (2008) who argued that the products which were initially available to customers were two types of house finance options: Murabaha, where the customer would have to pay monthly repayments which would include a cost plus mark up for the banks profit and Ijara, this was the option where the bank would purchase the property, and the client would pay a monthly repayment as well as a monthly rent, the rent would be calculated according to LIBOR index which would avoid expensive re-valuations. Even thought the use of LIBOR is Riba based, it was accepted by the Shari`ah council, due to wide acceptance by the banking community, it can be debated that at the start of Islamic banking scholars would have never accepted this policy as the rules when Islamic banking was still infant were adhered to much more due to the reason why Islamic banking was needed, to lose western influences in the Gulf.

The study further revealed that the Islamic banks had different duration allocated in financing different Islamic banking products. The study findings showed there was an increase in percentage the duration taken by banks to finance their investments via short term. The trend shows there was consistent increase from 31% in 2009 to 43% in the year 2012. The findings imply that most of the investors were taking loans for short term. In addition results indicated that there was a slight increase in the year 2010 to hit a high of 21% followed by a slight decline in 2011 to hit a low of 16% and then gradually increased to 25% in the year 2012. Finally results revealed that there was a gradual decline to hit a low of 23% in 2011 followed by a rapid shoot to 33% in the year
2012. This could mean that most of the mortgages given fall under this category hence variations across the years.

The findings agree with those in Bulut (2005) who indicated that IAH could be operated as an open-end or closed-end mutual funds depending upon whether account holders have a right to withdraw. The author stated that with minor adjustments to the investment management agreement, a mutual fund structure can easily replace the Mudarabah contract. In this model, a separate entity for mutual fund is initiated and transacted in the primary and the secondary markets as is the case for any publicly held corporation. Different investment strategies and purposes can be adopted by this entity in order to meet the different risk preferences and maturities of the investors. Some of these funds may follow a specialization approach based on certain stages of ventures and certain sectors/industries, while others will follow a portfolio approach in their investment strategies.
CHAPTER FIVE
SUMMARY AND CONCLUSIONS

5.1 Summary

The purpose of this study was to establish the effect of Islamic banking on investment financing in Islamic banks in Kenya. The research design adopted was a descriptive survey design in form of census. The population of this study was all commercial banks offering Islamic banking products in Kenya. The study sample comprised of eight commercial banks which offer Islamic banking products. This means that a census was employed in order to include all commercial banks in Kenya which offer Islamic products. The comprise of two fledged Islamic banks (Gulf African Bank and First Community Bank) and six conventional banks that offer partial Islamic bank (Barclays bank, National Bank, Chase Bank, Imperial Bank, Diamond Trust and Standard Chartered Bank).

Secondary data was utilised in this study. This means that all the study variables utilised quantitative data. The data obtained from the annual reports of the banks and also from banks’ internal sources. To compile the data, a secondary data collection template was used. Descriptive statics’ based on mean, mode, median and factor analysis was used to analyse the data and make comparison among desired variables. The findings were presented using tables and graphs.

Regression analysis was conducted to establish the relationship between loans advanced to customers and the independent variables (motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks).

The study findings indicate that the goodness of fit of the model was adequate. This is reported by an r squared of 0.865 which means that 86.5% of the variation in loans advanced to customers is explained by changes in motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks.
Islamic banks. The correlation coefficient of 93% indicates that the combined effect of the predictor variables have a strong and positive correlation with loans advances. This also meant that a change in the drivers of loans advances to customers has a strong and a positive effect on loans distributed to customers.

Analysis of variance (ANOVA) results showed that the combined effect of motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing was statistically significant in explaining changes in loans advances to customers in Islamic banks. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05. Regression results revealed that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively.

5.2 Conclusions

The study concluded that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from post election violence and people were ready to start ventures all over again and the decrease in following years was may be due to fears of elections in 2013.

The study concluded that mortgage financing as a source of investment had an inconsistent pattern as the percentage decreased in the year 2010 and increased rapidly in 2011 to 12.5% and then decreased again in 2012. The inconsistency can be explained by more investors using other Islamic banking products for financing more than mortgage financing.

It was also possible to conclude that there was a gradual increase in asset financing in the year 2010 and then followed by slight decrease in the following years. This may be as a result of many investors turning into mortgage financing more than asset financing.
as indicated in the trend analysis for mortgage financing. It was also to conclude that real estate financing has been embraced so much by all banks as many investors can see many opportunities in real estate investments.

Finally the study concluded that there was a rapid decrease in SME financing in the year 2010 to hit a low of 8.75%, followed by a slight increase to 11.25% in 2011 and a slight decline to 10% in 2012. This may be explained by the inflation changes in the country hence the businesses were doing so badly thus many investors withdrawing from small business enterprises.

Overall it was possible to conclude that the Islamic banking products have spread like a bush fire in the banking sector as all the financial products have been used to a high percentage across the years.

5.3 Policy Recommendations

The study recommends that the management of the banks to get well equipped and employees competent on Islamic banking products as most Islamic banks are currently managed by people who have been educated and trained in the conventional banking system. Thus, more time may be required for the unique characteristics of Islamic financial instruments to be completely accepted and understood by both bank personnel and customers.

It is also recommended that the terms and conditions of acquiring a loan be made reliant for more investors to approach the banks for assistance as the Shari`ah restricts the type of businesses for which Islamic banks can provide financing. For example, they are not permitted to participate in certain prohibited investments or joint venture projects considered to be detrimental to the individual, society, or the environment. As a result, the scope of mudarabah and musharakah for Islamic banks is somewhat more limited than it is for conventional banks.
The study further recommends the banks management to ensure that during the initial development of the Islamic banking system, musharakah and mudarabah financing should be deemphasized due to the increased risk associated with them. Nevertheless, we can expect that these Islamic financial instruments will increase in importance as the Islamic banking system continues to mature.

5.4 Limitations of the Study

One of the limitations of the study was that the study did not consider the effects of political crises especially in year 2008/2009 post election violence which affected the returns of most investments especially when people were forced to move out of areas deemed to be unsafe as a result of the violence.

The study did not analyze internal and external factors that affect investors when deciding on the various sources of financing. Perhaps, competition, performance of the company or individual, operating efficiency could have influenced the decision on financing.

5.5 Suggested Areas of Further Research

Suggested areas of study should be on internal and external factors that affect the decision on sources of financing for investments in Islamic banking. This will analyze critical factors that managers ought to consider in order to make their decision on modes of financing that yield successful results.

Further studies should also include the effects of sources of financing in unsuitable economic conditions, political instability and a global economic crisis. This study will be able to come up with decisions on the best methods to source for finances during such times.

A further study can also be done on the other modes Islamic financing on investments to find if the findings of this study hold true and find out whether they are also being offered in the banks. Other modes of financing would be musharakah (equity financing),
qard al-hassan (welfare loan), bay` bi al-thaman al-ajil (deferred payment financing), and istisna` (progressive payments).
REFERENCES


Yasseri, A. (2002). *Islamic banking contracts as enforced in Iran,* in Munawar Iqbal and David T. Llewellyn (eds), *Islamic Banking and Finance: New Perspectives on*
APPENDICES

Appendix I: Questionnaire

Introduction
I am a student at University of Nairobi pursuing Masters of Science in Finance (Finance and Investment Option). My Research Project is on the Islamic Banking and Investment Financing: a case of Islamic Banking in Kenya. This Questionnaire is aimed at collecting information on the given topic. The information provided will be held confidential and used for the purpose of enabling the researcher accomplish an academic requirement.

PART A
GENERAL DATA

Please respond each question by putting a tick (√)

1. Gender
   a) Male
   b) Female

2. Highest level of education
   a) Secondary level
   b) College level
   c) University level
   d) Post graduate level

3. Number of years in current employment
   a) Less than one year
   b) 1 to 2 year
   c) 3 to 5 years
d) More than 5 years

4. When did your bank commence its operation?
   a) less than one year
   b) 1 to 2 year
   c) 3 to 5 years
   d) More than 5 years

PART B

Loans advanced to customers for Islamic banking products

Indicate the monitory value of the asset that would be reflected on your balance sheet as loans advanced to customers for Islamic banking products. This would cover the balance sheets for the four years:

2009__________
2010__________
2011__________
2012__________

PART C

Islamic Banking Products

The following statement relates to how Islamic banks/Islamic bank window distribute their investment finances on different products. Indicate the agreeable percentage on how Islamic banks/Islamic bank window finance their investment by placing a tick (√) against the correct option. This would cover a period of four years.
### YEAR 2009

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PART D

Mode of Financing Islamic Banking products

The following statement relates to how Islamic banks/Islamic bank window finance their investments. Indicate the agreeable percentage on how Islamic banks/Islamic bank window finance their investment by placing a tick (√) against the correct option. This would cover a period of four years.

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### PART E

**The nature of the period taken to finance Islamic banking products**

The following statement relates on the duration taken by Islamic bank/Islamic window to finance their investments. Indicate the agreeable percentage of the duration on how Islamic banks/Islamic window take to finance their investments by placing a tick (√) against the correct option. This should cover for the period of four years.
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