THE EFFECT OF ISLAMIC FINANCIAL INSTRUMENTS ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

BY

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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 submitted for examination with my approval as the University Supervisor

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DEDICATION

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LIST OF ABBREVIATIONS

ANOVA - Analysis of Variance

CBK - Central Bank of Kenya

EAC - East and Central African Region

FCB – First Community Bank

GAB – Gulf African Bank

IFI –Islamic Financial Institution

PLS - Profit and Loss Sharing

ROA- Return on Asset

SPSS-Statistical Package for Social Sciences

ABSTRACT

Financial innovation is the life blood of any financial system and leads to introduction of improved systems, processes and products. Islamic Banking, as a financial innovation based on Islamic Shari'ah has grown phenomenally in the world in the last 40 years and has emerged as a fast growing segment of Kenya's banking industry. The study sought to investigate the effect of Islamic banking product on the financial performance of commercial banks in Kenya. The study was based on Profit and loss sharing theory and Islam Islamic banking theory and theory of interest. The study used descriptive survey method to investigate effect of Islamic banking product on the financial performance of commercial banks in Kenya .The population of this study comprised seven commercial banks offering Islamic banking products in Kenya.

Secondary data was used in this study; specifically the study used financial statements the data was coded using SPSS (version 21). Descriptive statistics was used to summarize the data, this included the use of weighted means, standard deviation, SPSS (version 21) has descriptive statistics features that assisted in variable response comparison and gave clear indications of response frequencies. Pearson moment correlation was conducted to establish the linear relationship between study variables. Regression analysis was conducted to establish the nature of the relationship.

The study found a positive correlation between financial performance of IFIs and Islamic financial instruments which include Musharakah financing, Mudaraba financing, Murabaha financing and Ijara financing. The study established that quality of the assets and the financial performance of banks are strongly and positively correlated and that an increase in the quality of the assets would lead to significant growth in the financial performance of banks, the financial performance of the commercial banks in Kenya is highly dependent on the level of the institutions' liquidity. The study found strong positive correlation between financial performance of Islamic financial institutions and size bank as shown by correlation (coefficient factor 0. 767, P- value 0.003), bigger banks can cope better with changes and has better chances to offset random losses.

The study concludes that all the Islamic financial instruments had a positive impact on the performance of commercial Banks in Kenya, the quality of the assets, larger sized banks had a positive influence on the financial performance of Islamic banks in Kenya and that high levels liquidity had a negative impact on financial performance of commercial banks. The research recommends that Islamic financial institutions need to continue offering Islamic financial instruments as they were all found to positively influence the financial performance of Islamic banks. More investments should therefore be done through establishing more banking networks across the country which is associated positively with their financial performance and to facilitate favorable financial performance in Islamic banks in Kenya, there is need to formulate strategies to facilitate credible levels of liquidity.

CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

The financial services industry plays an important role in the modern economy by mobilizing funds from savers and investors and channeling the same to investments in trade and business. These basic concepts and objectives are common to any banking system whether conventional or Islamic. However, the practices of conventional banking System are unlawful and prohibited from the Islamic perspective. It reflects Islamic principles in its operations, as it abides by the rules of Islamic shariah in the field of finances and other business transactions. It has become an emerging alternative to conventional banking and is expanding rapidly in both Muslim and non-Muslim countries to become an integral part of the global financial system. Islamic banking is a banking system that is consistent with the *Shariah* (Islamic law) and an important part of the system is the prohibition on collecting *riba* (interest) and investing in businesses that are considered *haram* (forbidden) such as selling of alcohol, pork, engaging in gambling etc. Islamic banks provide commercial services that comply with the religious injunctions of Islam.

Since its inception in the mid-1970s, Islamic banking has emerged from being a niche offering to become part of the mainstream financial services landscape. Dubai Islamic Bank established in 1975 is generally acknowledged to be the first full-fledged Islamic bank. Initial attempts to establish Islamic Banking Institutions (IBIs) were made in Egypt (Zaman and Movassaghi, 2001).The growth in Islamic banking has been driven by the needs of retail banking customers seeking to borrow and invest in accordance with their personal beliefs. However, Islamic banking products were initially not as competitive as conventional one, in terms of both pricing and service offerings. In certain countries, governments have fostered the development of the Islamic banking sector. For example, in Malaysia, the government drove the sector's development by funding Islamic financial services institutions and by creating the enabling legal and regulatory frameworks. Over time, economic and demographic growth in predominantly Muslim countries has spurred the demand for shariah compliant solutions. During the decade of 1990s, Islamic banking practices were initiated all

over the world especially in the Muslim dominated parts of the globe. However, the emergence of Islamic banks mushroomed as a large number of banks started to offer shariah compliant product.

Like conventional bank, Islamic bank behaves as an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it (Dar and Presley, 2000). A meaningful development of the practice of Islamic finance will require abandoning emulation of conventional instruments and packaging them as Islamic financial instruments. Hence, conventional banking system can learn from the alternative systems offered by Islamic finance, which is less skewed towards debt instruments, uses equity for greater risk sharing (Rogoff, 2011). The return on savings and investment is closely linked, giving Islamic finance instruments a flexible adjustment mechanism in the case of unanticipated shocks. The adjustment mechanism ensures that the real values of assets and liabilities will be equal at all points in time, and prohibits excessive risk taking. Islamic finance is also more equitable, because investors or partners share in the outcome of the partnership, be it profit or loss (Chapra, 2008). The conventional commercial banks have set up Islamic windows offering Islamic products and services. However, the performance and relative stability of Islamic financial institutions stems from the distinctive features of the instruments they offer.

1.1.1 Islamic Financial Instruments

Islamic banks offer different instruments to satisfy providers and users of funds in a variety of ways i.e. sales, trade financing and investment. These instruments serve as the basic building blocks for developing more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets. A comprehensive range of Islamic Banking products and services is being offered, in order to meet customer's demand of Shariah Compliant Banking. Hassan and Lewis (2007) identify the following basic types of Islamic financial instruments; Murabaha (cost-plus financing), Musharaka (partnership). Mudaraba (profit-sharing), Ijara (leasing), Salam (advance

purchase), Bai bi-thamin ajil (deferred payment financing), Istisnaa (commissioned manufacture).

Murabaha this is a trade contract, stipulating that one party buys a good for its own account and sells it to the other party at the original price plus a mark-up. It is the sale of goods with a pre-agreed profit mark-up on the cost. The mark-up can be seen as a payment for the services provided by the intermediary, but also as a guaranteed profit margin. Among all the modes of Islamic finance, murabaha has played the most important role. Murabaha in traditional *fiqh* (Islamic jurisprudence) is a spot sale contract where the price is based on a cost plus profit margin formula. Since Islamic banks are prohibited from making returns on money lending, these contracts provide for the bank to buy an investment good or commodity on behalf of the client and resell it to the client at a fee which enables the bank to make a profit. For example, an Islamic bank will not offer an interest loan to clients to buy a house; instead it will buy the house and sell it to the client for a profit. Payment may take place immediately or in installments. In summary murabaha is simply a particular type of sale and not mode of financing, unlike other kind of sales the seller under murabaha tells the buyer the cost incurred and the profit on the cost (Brian Kettell 2011).

Mudaraba (finance by way of trust) is a partnership in profit between capital and work. It is a form of partnership in which one partner (rabb al-mal) finances the project, while the other party (mudarib) manages it by bringing personal effort and time to a business transaction. The financial institution provides all of the capital and the customer is responsible for the management of the project. The proportionate share in profit from the business deal is determined by mutual agreement. The profit is shared in pre-agreed ratios, and any loss, unless caused by negligence or violation of terms of the contract by the *Mudarib*, is borne by the Islamic bank. A Mudaraba contract may also be concluded between the Islamic bank, as a provider of capital on behalf of itself or on behalf of investment account holders, and business owners. In the latter case, the bank acts as a mudarib for a fee. The bank also acts as a mudarib in relation to its depositors, as it invests the deposits in various schemes (Hassan and Lewis, 2007).

Musharaka this is a form of partnership between an Islamic bank and its clients where by each party contributes to the partnership capital, in equal or varying degrees, to establish a new project or share in an existing one, hence each of the parties becomes an owner of the capital on a permanent or declining basis and owed its due share of profits. However, Losses are shared in proportion to the contributed capital. There are two forms of musharaka: Constant musharaka this is a musharaka in which the partner's shares in the capital remain constant throughout the period, as specified in the contract and diminishing musharaka is practiced by Islamic banks either on a permanent or on a diminishing basis. In both cases capital is provided by the bank in return for a share in the realized profit or the loss. It is also known as *musharaka mutanaqisa,* it is a Musharaka in which an Islamic bank agrees to transfer gradually to the other partner its share in the Musharaka, with the effect that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture it is mostly used in home finance. Musharaka is also used to describe those joint business enterprises in which the partners share the profit or loss of the venture (Brian Kettell, 2011).

Ijara this is a contract under which the financier purchases the required item and leases it to their client. Upon expiration of the lease, the title of the item may be sold to the lessee. Parties may agree to such a sale beforehand in a separate contract. Payments will consist of two components: first, rental for the use of the equipment and second, installments towards the purchase price. The original amount of the rent for the leased assets should be fixed in advance. A necessary condition for ijara to be permissible is that the lessor remains the owner of the leased object for the whole period of the lease and bears any liabilities, such as manufacturing defects emerging from ownership, though not any liabilities pertaining to its use. *Ijarah muntahia bittamleek* (lease ending with ownership) ranks next in importance after *murabahah* as an employment mode. The Islamic bank purchases *real assets* for leasing as requested and specified by its customers. The bank (lessor) and the client (lessee) will mutually agree on the leasing period, rent, and terms of payment. This has opened the door for successful leasing activities by the Islamic banks, particularly in the housing sector. *Ijarah* of houses gives the bank the advantage of keeping the title to a property until the end of leasing period, and gives the lessee the benefit of subleasing rights.

Bai'salam is a sales contract where the buyer pays in advance for goods. It is a purchase with deferred delivery. The goods need not to exist at the time the bai'salam contract is entered into, but they must be ascertainable, that is, they should be described exactly as to both quality and quantity, and the exact date and place of delivery must be specified in the contract.Salam (advance purchase) is the purchase of specified goods for forward payment. This contract is regularly used for financing agricultural production. However, Bai bi-thamin ajil (deferred payment financing) involves a credit sale of goods on a deferred payment basis. At the request of its customer, the bank purchases an existing contract to buy certain goods on a deferred payment schedule, and then sells the goods back to the customer at an agreed price. The bank pays the original supplier upon delivery of the goods, while the bank's customer can repay in a lump sum or make installment payments over an agreed period. Istisnaa (commissioned manufacture) although similar to bai bi-thamin ajil transactions, istisnaa offers greater future structuring possibilities for trading and financing. One party buys the goods and the other party under takes to manufacture them, according to agreed specifications. Islamic banks frequently use istisnaa to finance construction and manufacturing projects (Hassan and Lewis, 2007).

1.1.2 Financial Performance

This term is used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as loans and advances, deposits, total interest income, total interest expense, other costs and other indicators are used in measuring performance of a commercial bank. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt.

One of the relevant issues in Islamic banking is operational performance. In the banking context performance, efficiency and profitability are used interchangeably to denote various measures employed in assessing banking operation**.** Corporate entities are primarily formed to generate profits. Islamic bank is also one of the corporate entities that offer a large number

of products and service for profit. Researchers explored a number of indicators to measure organizational performance (Dess & Robinson, 1984). There are several criteria to evaluate the performance of banks for successful survival. They include profitability, productivity, management performance, liquidity, innovation, quality of products etc.

Wheelen and Hunger (1998) argue that appropriate performance measures depend on the organizations and their objectives i.e. profitability, market share and cost reduction. Moreover, financial indicator such as return on investment (ROI), earning per share (EPS) and return on equity (ROE) etc. are mostly used by number of corporate entities to measure their progress and financial performance. Return on investment is used to reflect the profitability while corporate performance is measured by operating cash flows and return on investment capital (Sorenson, 2002). Rashid, De Zoysa, Lodh and Rudkin, (2003) measured firm's financial performance using the financial indicators such as return on assets, return on investments and current ratios. In today's global, dynamic and competitive environment banks should improve and diversify their products and services to meet changing customers' demands to enhance their performance for successful survival. Islamic banks use the above performance measures to evaluate their progress.

1.1.3 Islamic Financial Instruments and Financial Performance

Profitability is a prerequisite of a competitive banking industry. In order for banks to continue to prosper, there is need for its earnings to be relatively stable for its expansion and growth over time. (Goddard, Molyneux, & Wilson, 2004).The relationship between the Islamic Financial Instruments and the profitability of an investment project is of considerable importance to the entrepreneur. Profit sharing contracts have superior properties for risk management, because the payment the entrepreneur has to make to the creditor is reduced in bad states of nature. lenders regularly receive information on the ups and downs of the client’s business in order to calculate their share of the profits. Ibrahim and Vijay kumar (2003) revealed that the profitability of Islamic banks is low due to short term investments and low equity base. In case of Islamic banks, short term Debt financing includes Murabaha, Salam, and Qard fund and long term debt financing includes Sukuk, leasing and Istisna. Interest towards the development of Sharia-compliant derivative, securitized and structured

based instruments has gained Momentum under asset liability management. Iqbal (1999) pointed out that the Islamic system of contracting allows for designing risk management solutions using the framework of financial derivative products. He analyzes and discusses the case of a specific Islamic contract, istijrar, and highlights its possible use in managing certain forms of risk. He also argued that Islamic finance provides the basic building blocks that can be used to construct more complex financial instruments that will enhance liquidity and offer risk management tools.

Investments in human capital and research and innovation are necessary to facilitate the development of Islamic finance solutions and products to respond to economic needs and financing requirements. Proponents claim that Islamic finance contributes to the stability of the financial system and that Islamic banks escaped the worst effects of the 2008 financial crisis, because they were not exposed to subprime and toxic assets, and had maintained their close connection to the real sector. Hence, some observers have suggested that conventional banking can learn from the alternative systems offered by Islamic finance, which is less skewed toward debt instruments, uses equity for greater risk sharing, and limits the mismatch of short-term demand deposits with long-term loan contracts (Rogoff, 2011).

The performance and relative stability of Islamic financial institutions during the crisis stems from the distinctive features of the instruments they offer. Islamic finance emphasizes asset backing and the principle of risk sharing, ensuring a direct link between financial transactions and real sector activities. The sharing of risk and reward (al ghonm bel ghorm) implies that long-term targets become more important and excessive short-term risk taking is discouraged (El-Ghazali 1986). According to Safiullah (2010) Islamic banks are not suffering from excess liquidity and are more cost effective and profitable than their Conventional counterparts. Hassoune (2002) argues that Islamic banks are certainly more profitable than their conventional peers enjoying the same balance sheet structure. The main reason for such a difference is that Islamic banks benefit from a market imperfection.

Sami (1994) in his paper Progress of Islamic Banking: The Aspirations and The Realities assert that there is excessive resort to the murabahah mode and the neglect of the other

legitimate modes of financing by Islamic Commercial Banks. He further pointed out that the criticism is repeatedly leveled against Islamic banks and although it is valid it is not a violation of the injunctions of Shari'ah as long as the murabahah contract is correct from the Shari'ah point of view and is free from any form of deception. He suggests that It would, however, have been much better, if Islamic banks were able to distribute their investments over various possible forms such as Mudarabah, Musharakah, Salaam, advance-sale and leasing. This would have been optimum from the viewpoint of the soundness of the work and dealings. He further asserts that many critics blame Islamic banks for utilizing the interest rate as a criterion for fixing the profit margin in the murabahah sales. As a matter of fact there is no known way of avoiding the link up with this criterion as long as Islamic banks are operating within an environment where they coexist with traditional banks. But, what is required of Islamic banks is to avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods which some of them employ, which involve calculation of the absolute profit rate while paying no consideration to the installments paid during the year.

Most Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with Islamic banks (Azizul, 1999).The central banks subject Islamic banks to the same controls, conditions, and regulations that they apply to interest based banks. Azizul (1999) notes that there are certain factor that requires Islamic banks be treated differently. A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the inappropriate policies of central banks toward Islamic banks. Although most Islamic banks function under the supervision of a central bank, they cannot benefit from central bank facilities such as lending and interest on deposits held as reserve requirements because funds are usually provided on the basis of interest. Qadeeruddin(2005) notes that Islamic Banks operating within existing legal and regulatory framework will be a great challenge. Ndung'u (2011) highlighted that among the challenges facing Kenya's ambition to be a hub of Sharia compliant investment products to compliment the Islamic banking in the country are lack of; Shari'ah compliant investment vehicles, an enabling legal and regulatory framework and awareness by majority of the populace that hinder the uptake of these investments. For the country to fully embrace

Islamic Finance, there is need to extend beyond the offering of Sharia compliant products by introducing such investment vehicles like unit trusts, corporate bonds (sukuks) and insurance (takaful) products and Sharia compliant treasury bills and bonds (government Sukuk).

1.1.4 Commercial Banks in Kenya

According to Ndungu (2010) Kenya was the first country in the East and Central African region to introduce Islamic banking in the year 2007. It is a fastest growing segment of the financial sector in Kenya. Its principles include banking without giving or receiving interest payments and investing in Muslim-friendly enterprises. The Kenyan Islamic banking market has already attracted the interest of large banks such as Barclays, KCB, Chase bank, NBK etc all of which have set up Islamic windows offering Islamic products and services and there are only two fully-fledged Islamic banks which include; Gulf African bank and First Community bank.

The banking industry in Kenya is governed by the Central Bank of Kenya Act, the Banking Act, and the various guidelines issued by the Central Bank of Kenya (CBK). The CBK is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The Kenya Bankers Association (KBA) , serves as a lobby for the banks' interests and addresses issues affecting its members.

The Kenyan banking sector comprised 43 commercial banks,1 mortgage finance company, 9 microfinance banks, 8 representative offices of foreign banks, 5 money remittance providers, 97 foreign exchange bureaus and 2 credit reference bureaus during the period ended June 30, 2014. The Banking Sector registered improved performance. Assets increased to Ksh 3.0 trillion as at June 30, 2014 from Ksh 2.5 trillion in June 30, 2013, Loans and advances grew to Ksh 1.8 trillion in June 30,2014 compared to Ksh 1.5 trillion as at June 30, 2013, The deposit base expanded to Ksh 2.1 trillion in June 30,2014 an increase from Ksh 1.9 trillion reported in June 30, 2013, Profit before tax for the period ended June 30, 2014 was Ksh 71.0 billion compared to Ksh 61.5 billion reported in the period ended June 30, 2013.(CBK annual Report 2014).

The Banking sector recorded improved performance during the year under review with total assets 18 percent higher in June 2014 compared to June 2013. The major components of the balance sheet were loans and advances, government securities and placements which accounted for 58 percent, 21.3 percent and 5.1 percent of total assets, respectively. The sector also registered improved capital levels in the period ended June 2014 with total capital, which comprises core and supplementary capital, growing by 19.9 percent from Ksh 364.0 billion in June 2013 to Ksh 436.6 billion. The shareholders' funds increased by 16.5 percent from Ksh 394.4 billion in June 2013 to Ksh 459.4 billion in June 2014. However, the ratios of total and core capital to total risk-weighted assets decreased from 23.3 percent and 20.2 percent in June 2013 to 17.5 percent and 15.0 percent in June 2014 respectively .Customer deposits were the main source of funding for the banking sector assets, accounting for 72.3 percent of total liabilities. The deposit base increased by 16.5 percent from Ksh 1.9 trillion in June 2013 to Ksh. 2.1 trillion in June 2014 mainly attributed to branch expansion, remittances, receipts from exports and agency banking. The deposit accounts increased by 33.9 per cent from 18.9 million accounts in June 2013 to 25.3 million in June 2014 (CBK annual Report, 2014).

According to CBK annual report 2014, the banking sector registered Ksh 71.0 billion pre-tax profits during the period ending June 30, 2014, which was an increase of 15.4 percent from Ksh 61.5 billion for the period ending June 2013. Total income for the period stood at Ksh 199.0 billion, a growth of 12.2 percent compared with Ksh 177.3 billion registered at the end of June 2013. However, total expenses increased by 10.4 percent from Ksh 115.9 billion in June 2013 to Ksh. 128.0 billion in June 2014. Interest on loans and advances of Ksh 116.4 billion constituted 59 percent of total income in the period ended June 2014. On the other hand, interest on deposits, staff costs and other expenses were the key components of expenses, accounting for 33 percent, 28 percent and 24 percent of total expenses, respectively. Owing to the increasing interest of Islamic investors to diversify their portfolios, conventional banks are increasingly becoming interested in entering the market of Islamic financial products and to remain competitive there is need to develop and adopt new products and technology. Such products include adoption of Islamic products, use of

technology i.e. internet banking and mobile banking. This study therefore looks at the effect of Islamic financial instruments on the financial performance of commercial banks in Kenya.

1.2 Research Problem

Financial innovation is the lifeblood of any financial system and leads to introduction of improved systems, processes and products. Islamic Banking, as a financial innovation based on Islamic Shari'ah has grown phenomenally in the world and has emerged as a fast growing segment of Kenya's banking industry. The global proliferation of Islamic financial institutions has been accompanied by parallel developments in Islamic financial products which now cover a broad range of financial services including funds management, asset allocation, payment and exchange settlement services, insurance and reinsurance, and risk management (El-Qorchi 2005). The aim of introducing the financial instruments was to offer the traditional banking operation such as deposits and financing. These simple financial transactions were later moved to more sophisticated Islamic financial instruments.

An Islamic finance system plays vital role in the economic development of Islamic and non-Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest based financial channels and facilitating the development of capital markets (Zaher and Hassan, 2001). They have a responsibility just like conventional bank to support country's economy through mobilization of saving and provision of credit for business expansion. Turk (2007) observed that Islamic financial institutions operate under the constraints of complying with the Islamic legal code. Notwithstanding, they have to find alternative but acceptable means to improve financial performance and compete in a banking environments structured along western guidelines. profitability remains a critical factor for Islamic banking growth and sustainability. A study by Musa (2007) showed that several conventional banks have introduced Shariah compliant deposit products while two fully fledged Islamic banks have been licensed by the Central Bank of Kenya in 2007. It is necessary that Muslims are able to access financial services that do not violate their principles and beliefs. The Central Bank of Kenya (C.B.K) and other financial regulatory bodies like financial regulators worldwide are now faced with the need to harmonize and

standardize regulations of a financial system that includes Islamic financial institutions and products (Choudhry and Mirakor 1997; Kahf 1997; El-Hawary et al. 2004).

Islamic banks escaped the 2008 financial crisis and economic downturn than the conventional banks because Islamic banks tended to avoid speculative investments such as derivatives that many analysts believe led to the financial crisis. Islamic banks also avoided sub-prime crisis and so did not lend to sub-prime borrowers. Dridi (2010) analyzed the performances of 120 conventional and Islamic banks after the global financial crisis. The study found out that global financial crisis of 2008 did not adversely affect the economies of countries practicing Islamic banking and financial system as much as it affected the Western economies. 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. Financial liberalization of early 1990s in Kenya opened the banking industry to a number of players leading to stiff competition and weakening of financial performance of a number of commercial banks. In response, commercial banks diversify their source of income to accommodate other options of improving their performance. This has led many commercial banks to offer Islamic products hence becoming one of the most critical developments in the banking sector in the recent past. As it is evident that a significant proportion of Muslims refrain from using interest based financial services for fear of breaching their religious beliefs (ibid).

While the emergence of Islamic banking in Kenya is viewed as a positive gesture that will support entrepreneurship and economic growth religious, language and social complexity may however act against full understanding by regulators, policymakers, researchers and practitioners Most of Islamic financial instruments were developed in the daily practices of Islamic finance and banking. These instruments have been developed according to nature of business of particular Islamic financial institution and needs of particular markets. Since Islamic finance industry is growing broader and more sophisticated, Islamic financial

instruments are also growing in variety. The academic discourse in the literature regarding the impact of Islamic financial instruments does not fill all the theoretical, methodological and practical gaps. Fewer financial performance studies have been conducted on Islamic banks compared with conventional banks in Kenya. Ahmednoor (2012) did an evaluation of Islamic banking products while Joseph at (2012) investigated on sharia compliant products. Oundo (2009) suggested that there was poor supply of Shari'ah compliant products in Kenya's financial institution. Therefore, our understanding remains incomplete, particularly in respect of Islamic financial instruments. Thus, the present study is justified by the lack of extensive academic investigation regarding the effect Islamic financial instruments on the performance of banks. By studying the financial performance due to adoption of Islamic financial instruments by commercial banks, we will seek to enrich the literature in Islamic financial instruments. This leads to the question: what is the effect of Islamic financial instrument on the performance of commercial banks in Kenya?

1.3 Research Objective

The objective of this study is to establish the effect of Islamic financial instruments on the performance of commercial Banks in Kenya.

1.4 Value of the Study

This work will be useful to policy formulators such as bank managers since they are the agents of the shareholders and are entrusted to make policy decisions. Information on Islamic financial instruments will enable them evaluate the key drivers of profitability and hence be able to come up with strategies on optimal combination of financial instruments. Scholars and researchers can research further to establish techniques on how Islamic financial Instruments can be improved through new innovations which are sharia'h compliant products. It will be beneficial to students and researchers as it will add to the body of existing knowledge which will open way for further research on related subject matters. Research gaps identified help discuss this topic to the finer details hence improve information out in public on the Islamic Financial Instruments.

Therefore, it is hoped that the adoption of this study's findings and recommendations are to contribute to the efforts towards the financial inclusion of the Kenyan Muslims, who because of their socio-religious values, have shunned conventional financial products.

This research finding would help potential investors and shareholders to identify investment opportunity available to them, so that they can make best investment decision. The finding would enable the bank management to focus on a competitive strategy aim to improve shareholders value; while at the same time strive to meet public expectations by embracing best market practice in terms of offering quality services and improved efficiency. The study should make significant contribution to a growing body of scholars and academicians existing literatures on Islamic financial instruments. The study provides important information for marketing personnel of banks who need to understand factors that lead to the emergence of banking innovations. This helps in trying to predict the next wave of financial services product to come to the market and the demands of marketing them.

CHAPTER TWO
LITERATURE REVIEW

2.1. Introduction

The chapter explores literature that focuses on the area of Islamic banking and Islamic Financial Instruments. The chapter starts by theoretical reviews done on the study area, empirical reviews and determinants of bank performance. The chapter ends with a summary of literature review**.**

2.2. Theoretical Review

The theory of Islamic finance was until the end of the nineteen-seventies, largely a plea for replacing interest in banks 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. This section covers three theories; Islam and the Theory of interest, Profit and loss sharing theory and Islamic banking theory, which serve to extend existing knowledge on the origin and basis of Islamic banking.

2.2.1. Islam and Theory of Interest

It was argued that most of the problems of capitalism was rooted in the practice of lending on interest. Among these problems was 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).

The concept of Islamic finance has existed long time ago. However, it was not as developed and systematic as today. The main idea of Islamic finance is perhaps best described by Iqbal and Molyneux (2005). They state that under Islamic jurisprudence there are two kinds of rulings, the worship ruling which governs the relationship between man and Allah, and the second being mutual dealing rulings which governs the relationship among mankind. The general principle of mutual dealing rulings is that, everything is permitted unless clearly prohibited, which includes the principle of Halal and Haram. They call it the "Doctrine of Universal permissibility". Iqbal and Molyneux (2005) they further state that; "In addition to the Doctrine of Universal Permissibility, Islam permits the contracting parties to agree on any conditions as long as they do not violate any Shariah ruling. they call this the 'Golden Principle of Free Choice'. As may be seen, this principle gives a very wide scope for designing contracts". They argue that; "the purposes of such prohibitions are to provide a level playing field to protect the interests of weaker parties, to ensure justice and fairness and in general to ensure mutual benefit for the parties as well as society at large, and to promote social harmony".

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. He also spoke of partnerships between banks and entrepreneur as a possible alternative, sharing losses if any.Like Qureshi, 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. Friedman (1969) suggested that a nominal zero interest rate is necessary condition for optimal allocation of resource. It was found that zero interest rate is required and sufficient for allocative efficiency by investigation within general equilibrium models (Wilson and Charles, 1979; Cole and Kocherlakota, 1998). Literature also supported that interest-free (profit and loss sharing) system is viable and superior to an interest-based system (Chapra, 1985; Mirakhor, 1997).

2.2.2. Profit and Loss Sharing Theory

Irshad (1964) spoke of *mudaraba* as the basis of Islamic banking, but his concept of *mudaraba* was quite different from the traditional one in that he thought of capital and labour (including entrepreneurship) as having equal shares in output, thus sharing the losses and profits equally. This actually means that the owner of capital and the entrepreneur have equal share in the profit or loss, which runs counter to the *Shariah* position. Irshad envisaged two kinds of deposit accounts. The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund which would absorb all losses so that no depositor would have to bear any loss. According to Irshad, all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

Khan and Ahmad (2001) state that, theoretically, it has been an aspiration of Islamic economists that on the liability side, Islamic banks shall have only investment deposits. On the asset side, these funds would be channeled through PLS contracts. Under such a system, any shock on the asset side shall be absorbed by the risk sharing nature of investment deposits. PLS dominates the theoretical literature of Islamic finance. However, the practice of IFIs has become different from the theoretical aspirations with the predominance of trade based operations. However, the contractual arrangement in Islamic banks differs from the conventional banks. The adoption of the Profit-Loss Sharing arrangement can be applied on the asset and liability sides of Islamic banking operations. On the liability side, Islamic banks use *mudharaba* contract more dominantly. While on the asset side, Islamic banks use *mudharaba* and *musharaka* contracts as Profit-Loss Sharing arrangement in providing financing. But, some studies such as Khan (1995) and Aggarwal and Yousef (2000) pointed out several factors that hamper the use of Profit Sharing (PS) modes of financing. The former emphasize the lack of application PS modes of financing due to firms believe they can reinvest their surpluses to enhance growth. The latter highlights the issue of agency problem cause the reluctant of the banks to use the PS modes of financing.

Ahmed (2002) believes that since the PS contract on the asset and liability side of an Islamic bank are different, as fund user and fund owner, respectively, lack adoption of Profit-Loss Sharing on the asset side due to higher risk exposure as a fund owner. However Ruhaini and Abdul Ghafar (2010) shows that Profit-Loss sharing arrangement is able to minimize asymmetrical information and transaction costs. Thus, Islamic banks can maximize their net profit and hence they could create value to their shareholders.

2.2.3. Islamic Banking Theory

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 l00 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.

2.3. Determinants of the Bank Performance

Important measure of financial performance is profitability; it is the relationship of income to some balance sheet measure which indicates the relative ability to earn income on assets. Performance to banks refers to the capacity in generating sustainable profitability (Wild,Shaw & Chiappetta, 2009). Muthini (2005) conducted a study on the determinants of banks profitability in Kenya by empirically evaluating the link between internal and external determinants over profitability over a period of ten years (2002 to 2012) using descriptive analysis and inferential analysis. The study indicates that banks profitability performance is affected by Capital Adequacy, Bank Size, Liquidity, Asset Quality, Expenses Management, Operational Inefficiency, Credit Deposit Ratio, Credit Risks, Liquidity Risks, Efficiency and Productivity, Age, Cost Per Borrower, Cost Income Ratio and Operating Expenses to Loan Portfolio, Ownership, Concentration, Interbank rate, Market share and Banking system

reform, Real GDP Growth Rate, Treasury bills rate, Spread, Inflation rate and Market Capitalization on profitability measures.

Cornett and Tehania (1992), Mercia, et al. (2002), Toddard, et al. (2004), Guru et al.(2001)and Panayiotis et al.(2006), (Al-Tamimi, 2010; Aburime, 2005) show that bank profitability is a function of internal and external factors. Internal factors are individual bank characteristics which affect the banks performance. These factors are basically influenced by internal decisions of management and the board they include; capital ratio, bank size, liquidity, expenses management and asset quality. These factors can be managed by the management of a bank. The external factors are country wide factors which are beyond the control of the bank management and affect the profitability of banks they include gross domestic product (GDP), inflation, money supply and competition. It is mostly the macroeconomic factors. The framework used to evaluate bank's performance is 5 factors noted as CAMEL. They include; Capital Adequacy, Asset Quality, Management Quality, Earnings and Liquidity. Fitch (1990) states that CAMEL bank rating is used by bank's management to evaluate financial health and performance. They is an increased likelihood of bank failure when any of these factors prove inadequate. CAMEL framework often used to proxy the bank specific factors (Dang, 2011) include;

2.3.1. Capital Adequacy

Capital is the amount of own fund available to support the bank's business and act as a buffer in case of adverse situation (Athanasoglou et al. 2005).Banks capital creates liquidity for the bank due to the fact that deposits are most fragile and prone to bank runs. Moreover, greater bank capital reduces the chance of distress (Diamond, 2000). According to Dang (2011), the adequacy of capital is judged on the basis of capital adequacy ratio (CAR). Capital adequacy ratio shows the internal strength of the bank to withstand losses during crisis. Capital adequacy ratio is directly proportional to the resilience of the bank to crisis situations. It has also a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas (Sangmi and Nazir, 2010).

2.3.2. Asset Quality

Another bank specific variable that affects the profitability of a bank is bank asset. The bank asset includes among others current asset, credit portfolio, fixed asset, and other investments. Often a growing asset (size) related to the age of the bank (Athanasoglou et al.2005). The loan of a bank is the major asset that generates the major share of the banks income. Loan is the major asset of commercial banks from which they generate income. The quality of loan portfolio determines the profitability of banks. The loan portfolio quality has a direct bearing on bank profitability. The highest risk facing a bank is the losses derived from delinquent loans (Dang, 2011). Thus, nonperforming loan ratios are the best proxies for asset quality. It is the major concern of all commercial banks to keep the amount of nonperforming loans to low level. This is so because high nonperforming loan affects the profitability of the bank. Thus, low nonperforming loans to total loans shows that the good health of the portfolio. The lower the ratio the better the bank performing (Sangmi and Nazir, 2010).

2.3.3. Management Efficiency

Management Efficiency is one of the key internal factors that determine the bank profitability. It is represented by different financial ratios like total asset growth, loan growth rate and earnings growth rate. Operational efficiency in managing the operating expenses is another dimension for management quality. The performance of management is often expressed qualitatively through subjective evaluation of management systems, organizational discipline, control systems, quality of staff, and others. Yet, some financial ratios of the financial statements act as a proxy for management efficiency. The capability of the management to deploy its resources efficiently, income maximization, reducing operating costs can be measured by financial ratios. One of this ratios used to measure management quality is operating profit to income ratio (Rahman et al. in Ilhomovich, 2009; Sangmi and Nazir, 2010). The higher the operating profits to total income (revenue) the more the efficient management is in terms of operational efficiency and income generation. The other important ratio is that proxy management quality is expense to asset ratio. The ratio of operating expenses to total asset is expected to be negatively associated with profitability. Management quality in this regard, determines the level of operating expenses and in turn affects profitability (Athanasoglou et al.2005).

2.3.4. Liquidity Management

Liquidity is another factor that determines the level of bank performance. Liquidity refers to the ability of the bank to fulfill its obligations, mainly of depositors. According to Dang (2011) adequate level of liquidity is positively related with bank profitability. The most common financial ratios that reflect the liquidity position of a bank according to Dang are customer deposit to total asset and total loan to customer deposits. Other scholars use different financial ratio to measure liquidity. For instance Ilhomovich (2009) used cash to deposit ratio to measure the liquidity level of banks in Malaysia. However, the study conducted in China and Malaysia found that liquidity level of banks has no relationship with the performances of banks (Said and Tumin, 2011).

2.3.5. External Factors/ Macroeconomic Factors

The macroeconomic policy stability, Gross Domestic Product, Inflation, Interest Rate and Political instability are some of the macroeconomic variables that affect the performances of banks. For instance, the trend of GDP affects the demand for banks asset. During the declining GDP growth the demand for credit falls which in turn negatively affect the profitability of banks. On the contrary, in a growing economy as expressed by positive GDP growth, the demand for credit is high due to the nature of business cycle. During boom the demand for credit is high compared to recession (Athanasoglou et al.,2005). The same authors state in relation to the Greek situation that the relationship between inflation level and banks profitability is remained to be debatable. The direction of the relationship is not clear (Vong and Chan, 2009).

2.4. Review on Empirical Studies

Pickett (2006) defines empirical evidence as a source of knowledge acquired by means of observation or experimentation. This section highlights research done on banking performance. Uzair (1976) has presented the working structure of Islamic bank and developed a mechanism to cope with the challenges of risk and interest. Risk of loss is a potential threat that creates obstacles for productive activities in the economy. The study suggested that Islamic banks could help to reduce risk to enhance productive activities in the economy. It is reported that different stakeholders dealing with Islamic bank are risk neutral

and actively engaged in productive activities according to profit and loss based contracts (Siddiqui, 1973).

Empirical studies on the attitudes of financial institutions towards Islamic methods of finance have been reported in two main studies. Jalaluddin (1999) interviewed eighty Australian financial institutions based in Sydney on their attitudes towards Islamic finance and whether they would be agreed to lend funds in accordance with profit and loss sharing methods. It was observed that more than forty percent of respondents were prepared to lend funds on a profit and loss sharing basis, motivated in part by the need to provide business support, strong growth in the demand for funds, the high risks of default under the conventional banking system, and the potential for higher returns to lenders.

Chong and Liu (2009) researched on whether Islamic banks are indeed interest-free, using Malaysian experiences as a case study. Their findings suggest that profit- and loss sharing schemes are indeed the distinguishing feature of Islamic banking although they tend not to be as important as a mode of financing on the assets side of the balance sheet. While the financing structure on the deposit-side is theoretically a profit- and loss-sharing contract, pay-outs tend to be closely pegged to rates on conventional deposits. They also found that there is little difference in substance between Islamic and conventional banks. Unlike conventional banks, Islamic banks do earn fees and commissions relating to services beyond traditional deposit and loan financing activities.

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.

Ongore and Gemechu (2013) conducted by a study on determinants of financial performance of commercial banks in Kenya covering 37commercial banks using multiple linear regression model and t-statistic to determine the relative importance (sensitivity) of each explanatory

variable in affecting the performance of banks. The study concluded that capital adequacy, asset quality and management efficiency significantly affect the performance of commercial banks in Kenya. However, the effect of liquidity on the performance of commercial banks is not strong. The relationship between bank performance and capital adequacy and management efficiency was found to be positive and for asset quality the relationship was negative. Findings of the study on the direction and effect of macroeconomic variables on the performance of commercial banks in Kenya was inconclusive.

Wako et al. (2014) conducted a study that sought to determine the challenges affecting the performance of Islamic banks in Kenya. The research was carried out through descriptive survey design and it involved gathering of facts opinions and views of staffs on the challenge that affect the performance of Islamic banks. The target population for the research study included 250 Islamic banking staff in Nairobi County. This study adopted random sampling method. It found out that global economy changes, advancement in information technology, the difficulties of legal and institutional framework, weak risk assessment and management, weak corporate governance standards and poor human resource practices were major factors affecting Islamic commercial banks performance in Kenya. There has been a good size of literature developed around various aspects of Islamic banking in general and in particular on GCC. For general framework of analysis about Islamic banking, see for example, Chopra (1985), Aljarhi (1983), Al-Salous (1987), Khan (1984), Ahmad (1989), Al-Jarhi (1983) Khan and Mirakhor (1990), Kazarian (1993), Metwally (1993), Kleem (2000).

2.5. Summary of the Literature Review

Based on the literature review Islamic banking has emerged from being a niche offering to become part of the mainstream financial services landscape. It has become an emerging alternative to conventional banking and is expanding rapidly in both Muslim and non-Muslim countries and evolved to become an integral part of the global financial system as it witnessed considerable progress worldwide. Its presence in Kenya as a financial intermediary can be viewed positively as a compliment to conventional banking, 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. The

banks performance is affected by Capital Adequacy, Liquidity, Asset Quality, Bank Size, Expenses Management, Operational Inefficiency, Credit Deposit Ratio, Credit Risks, Liquidity Risks, Efficiency and Productivity, Operating Expenses to Loan Portfolio, Real GDP Growth Rate, Treasury bills rate, Spread, Inflation rate and Market Capitalization on profitability measures.

The literature review also shows that riba-free banks could coexist with interest-based banks. The point that there is more to Islamic finance 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.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1. Introduction

This chapter discusses an overview of different methods and tools used to gather data to meet the objective of the study. It describes the research design, it state the target population, sample design, highlight data collection procedure and data analysis.

3.2. Research Design

Ogula (2005) describes a research design as a plan, structure and strategy of investigation to obtain answers to research questions and control variance. Additionally, Orodho (2003) has defined a research design as the scheme, outlie or plan that is used to generate answer to research problems. A descriptive survey was used to conduct the research. A survey is a method of collecting information by interviewing or administering a questionnaire to a sample of individuals (Orodho, 2003). Descriptive research involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data collection (Glass & Hopkins, 1984). They are aimed at finding out "what is," so observational and survey methods are frequently used to collect descriptive data (Borg & Gall, 1989).

3.3. Target Population of the Study

Target population refers to the total number of subjects or the total environment of interest to the researcher (Oso and Onen, 2009). Secondary data is used to analyze the effect of Islamic financial instrument on the performance of commercial banks in Kenya. 7 commercial banks were used for purposes of the study. Burns and Grove (2003) describe population as all the elements that meet the criteria for inclusion in a study. The population of this study is 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 five conventional banks that has Islamic windows; Barclay’s banks, National Bank, Chase Bank, Kenya Commercial Bank and Standard Chartered Bank.

3.4. Data Collection

The study made use of both primary and secondary sources of data. Primary data was collected using a structured questionnaire which were administered to the management of the banking industry using self administered a drop and pick method. The questionnaire sought to obtain information pertaining to general information of the respondent, financial instruments used, effect on financial performance, investment opportunities. Secondary data from published financial statements will also be used. Secondary data on Islamic banking products for financial years 2008-2014 was obtained from the published financial statements of commercial banks that offer Islamic banking products. The study variables utilized quantitative data. The data is obtained from the annual reports of the banks and also from banks internal sources. The information to be used in the study will be the amount of financing made for various instruments, grading of each financial instruments and after tax profits generated by each instruments.

3.5. Data Analysis

Burns and Grove (2003) define data analysis as a mechanism for reducing and organizing data to produce findings that require interpretation by the researcher. This involves coding, editing, data entry, and monitoring the whole data processing procedure. The data collected will be analyzed using descriptive statistics and the results will be presented using descriptive analysis such as frequency distribution, mean, percentages and standard deviations. Data analysis will be done using the Statistical Package for Social Sciences (SPSS). Inferential statistics such as multiple regressions and Pearson correlation would be used. Multiple regressions are used to determine the nature of relationship between independent variables and the dependent variable. According Hair, Black, Babin, Anderson, and Tathan (2006) multiple regression analysis is described as a statistical technique that is used to analyze the relationship between dependent variable and several independent variables .The objective is to predict the dependent variable from known independent variables. The coefficient of multiple correlations is symbolized by the correlation R which indicates the strength of the correlation between the combination of the predictor variables and criteria variables. The required assumptions of this multiple regression model are; the error variable (ε) is normally distributed, the mean value of the error variable is zero, the variance of the error variable is a

fixed but unknown value, the values of the error variable are independent of one another, and relationship between profits of commercial banks and variables of financing modes is linear.

3.5.1 Analytical Model

Regression analysis is done by use of an econometric model below.

$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \beta 5X5 + \beta 6X6 + \beta 7X7 + \beta 8X8 + \beta 9X9 + \beta 10X10 + \varepsilon$

Where:

Y= Return on Assets (ROA-Dependent variable)

α= Constant Term Y-intercept

β1,β2,β3,β4,β5,β6,β7,β8,β9,β10 = Beta coefficients

ε= Error term.

X1= Amount of Musharakah used in financing.

X2= Amount of Mudaraba used in financing.

X3= Amount of Murabaha used in financing

X4=Amount of Ijara used in financing

X5= Amount of Salam used in financing.

X6=Amount of Bai bi-thamin ajil used in financing.

X7= Amount of Istisnaa used in financing

X8= Size of the Bank-Natural Logarithm of book value of assets

X9=Bank's Asset Quality shown by Ratio of Non-performing Loan to Total loan

X10 = Liquidity indicated by short term investments of the bank in relation to Total assets

The above variables are measured by the natural logarithm of the amount used in financing and the ratios. Return on asset is measured by total comprehensive income divide by total asset.

3.5.2 Test of Significance

The coefficient of determination R^2 is evaluated to determine the explanatory power of the model and how well data fit into the statistical model. The F statistic is evaluated to determine the overall significance of the models. Analysis of variance (ANOVA) tests is used in the analysis of experimental data to test the variables for statistical significance.

CHAPTER FOUR
DATA ANALYSIS, RESULTS AND INTERPRETATION

4.1 Introduction

This chapter presents analysis and findings of the research. The objective of this study is to establish the effect of Islamic financial instruments on the financial performance of commercial Banks in Kenya period between 2008 -2014.

4.2 Descriptive Statistics

4.2.1 Musharaka Financing

Table 4.1: Amount of Musharakah used in financing

Years	Mean	Std deviation
2008	452,369	.031
2009	1,103,652	.423
2010	2,117,325	.178
2011	4,586,941	.024
2012	6,487,345	.018
2013	6,578,244	.041
2014	7,136,052	.069

Source: Research findings

From the findings the year 2008 recorded the lowest amount of Musharaka used in financing as shown by 452,369 while 2014 recorded the highest amount of Musharaka used in financing as shown by 7,136,052, in addition, values for standard deviation depicts variability in amount of Musharak used in financing during the seven year period with the highest deviation of 0.423 in the year 2009 and the lowest at 0.018 in the year 2012, the findings revealed that there has been a significant increase in the amount of Musharaka used in financing during the seven -year period.

4.2.2 Murabaha Financing

Table 4.2: Murabaha financing

Years	Mean	Std deviation
2008	943,361	.037
2009	2,325,214	.025
2010	1,547,672	.251
2011	10,327,454	.041
2012	17,364,251	.016
2013	18,141,000	.041
2014	438,371,423	.234

Source: Research findings

From the findings the year 2008 recorded the lowest amount of Murabaha used in financing as shown by 943,361 while 2014 recorded the highest amount of Murabaha used in financing as shown by 438,371,423, in addition, values for stardard deviation depicts variability in amount of Murabaha used in financing during the seven year period with the highest deviation of 0.251 in the year 2010 and the lowest at 0.016 in the year 2012, the findings revealed that there has been a significant increase in the amount of Murabaha used in financing during the seven -year period.

4.2.3 Mudaraba Financing

Table 4.3: Mudaraba financing

Years	Mean	Std deviation
2008	1,463,969	.045
2009	2,567,478	.065
2010	3,957,364	1.25
2011	4,789,152	.037
2012	3,658,977	.056
2013	5,781,791	.021
2014	6,987,841	.007

Source: Research findings

From the findings the year 2008 recorded the lowest amount of Mudaraba used in financing as shown by 1,463,969 while 2014 recorded the highest amount of Mudaraba used in financing as shown by 6,987,841, in addition, values for stardard deviation depicts variability in amount of Mudaraba used in financing during the seven year period with the highest deviation of 1.25 in the year 2010 and the lowest at 0.007 in the year 2014, the findings revealed that there has been a significant increase in the amount of Mudaraba used in financing during the seven -year period.

4.2.4 Ijara Financing

Table 4.4: Ijara financing

Years	Mean	Std deviation
2008	54,874	.018
2009	69,894	.142
2010	89,479	.139
2011	97,823	.029
2012	78,324	.011
2013	95,749	.159
2014	244,987	.058

Source: Research findings

From the findings, it was revealed the years 2008 recorded the lowest amount of Ijara used in financing as shown by 54,874 while 2014 recorded the highest amount of Ijara used in financing as shown by 244,987, in addition, values for stardard deviation depicts variability in amount of Ijara used in financing during the seven year period with the highest deviation of 0.159 in the year 2013 and the lowest at 0.011 in the year 2012, the findings revealed that there has been a significant increase in the amount of Ijara used in financing during the seven -year period.

4.2.8 Size of the Bank

Table 4.5: Size of the Bank

Years	**Median**	**Minimum**	**Maximum**	**Mean**	**Std deviation**
2008	.0213	.0198	.0265	.0122	.074
2009	.0351	.0251	0382	.0355	.135
2010	.0447	.0563	.0581	.0543	.187
2011	.0631	.0593	.0712	.0631	.326
2012	.0726	.0737	.0846	.0769	.267
2013	.0811	.08014	.08596	.0848	.141
2014	.0853	.0863	.0868	.0857	.118

Source: Research findings

From the summary 2008 recorded the lowest value for Firm size at 0.122 while 2014 recorded the highest value for Firm size at 0.0857, In addition, values for stardard deviation depicts variability in value for Firm size during the seven year period with the highest deviation of 0. 326 in the year 2011 and the lowest at 0.074 in the year 2008, the findings revealed a significant increase in Firm size during the seven year period.

4.2.9 Bank's Asset Quality

Table 4.6: Bank's Asset Quality

Years	**Total Loans and Advances (000)**	**Gross Non performing loans (000)**	**Net Asset Qualities**
2008	3,190,985	52,476	0.0039
2009	4,425,936	47,524	0.0107
2010	5,569,879	36,567	0.0066
2011	7,190,985	32,468	0.0045
2012	8,330,465	57,632	0.0309
2013	10,578,567	50,859	0.0143
2014	10,970,882	58,312	0.0053

Source: Research findings

From the results, the lowest net value for asset qualities was 0.0039 in 2008 while the highest was 0.0309 in 2012 the findings revealed that there have been a significant increase in asset quality during the seven -year period.

4.2.10 Liquidity

Table 4.7: Liquidity

Years	Mean	Std deviation
2008	18.36	0.22
2009	20.16	0.13
2010	24.67	0.08
2011	34.18	0.14
2012	38.14	0.78
2013	35.12	0.23
2014	30.89	0.14

Source: Research findings

The research sought to assess the levels in liquidity, from the research findings it noted that in the year 2012 recorded the highest value in liquidity, as shown by a 38.14 percent while the years 2008 recorded the lowest value in liquidity as shown by a value of 18.36 percent Further the values for stardard deviation depict variability in liquidity during the four year period with the highest deviation of 0.78 n the year 2012 and the lowest at 0.08 in the year 2010.

4.3. Inferential Statistics

The study used inferential statistics to make inferences based on probability.

4.3.1 Correlations Analysis

After the descriptive analysis, the study conducted Pearson correlation analysis to indicate a linear association between the predicted and explanatory variables or among the latter. It, thus, help in determining the strengths of association in the model, that is, which variable best explained the relationship between Islamic financial instruments and the financial performance of commercial Banks in Kenya.

Table 4.8: Correlations

		Return On Assets	Musharakah Financing	Murabaha Financing.	Mudaraba Financing	Ijara Financing.	Size of the Bank	Bank's asset	Liquidity
Return on assets	Pearson Correlation	1	.367	.418**	.298*	.418**	.767**	.740	-.180**
	Sig. (2-tailed)		.001	.000	.014	.000	.003	.049	.002
	N	7	7	7	7	7	7	7	7
Musharakah financing	Pearson Correlation	.367	1	.016	.005	.103	.293*	.016	.158
	Sig. (2-tailed)	.001		.898	.965	.406	.016	.897	.202
	N	7	7	7	7	7	7	7	7
Mudaraba financing	Pearson Correlation	.418**	.016	1	.746**	.021	.168	.731**	.077
	Sig. (2-tailed)	.000	.898		.000	.863	.173	.000	.535
	N	7	7	7	7	7	7	7	7
Murabaha financing	Pearson Correlation	.298*	.005	.746**	1	.052	.058	.591**	-.027
	Sig. (2-tailed)	.014	.965	.000		.676	.641	.000	.831
	N	7	7	7	7	7	7	7	7
Ijara financing	Pearson Correlation	.418**	.103	.021	.052	1	-.580**	-.022	.820**
	Sig. (2-tailed)	.000	.406	.863	.676		.000	.862	.000
	N	7	7	7	7	7	7	7	7
Size of the Bank	Pearson Correlation	.767**	.293*	.168	.058	-.580**	1	.170	-.583**
	Sig. (2-tailed)	.003	.016	.173	.641	.000		.168	.000
	N	7	7	7	7	7	7	7	7
Bank's asset	Pearson Correlation	.740	.016	.731**	.591**	.022	.170	1	.078
	Sig. (2-tailed)	.049	.897	.000	.000	.862	.168		.531
	N	7	7	7	7	7	7	7	7
Liquidity	Pearson Correlation	-.180**	.158	.077	.027	.820**	.583**	.078	1
	Sig. (2-tailed)	.002	.202	.535	.831	.000	.000	.531	
	N	7	7	7	7	7	7	7	7

Source: Research findings

On the correlation of the study variable, the researcher conducted a Pearson moment correlation. from the finding in the table above, the study found that there was positive correlation coefficient between return on assets and Musharakah financing, as shown by correlation factor of 0.367, this relationship was found to be statistically significant as the significant value was 0.001 which is less than 0.05, the study found strong positive correlation between return on assets and Murabaha financing. as shown by correlation coefficient of 0.418, the significant value was 0.000 which is less than 0.05, the study found positive correlation between return on assets and Mudaraba financing as shown by correlation coefficient of 0.298, the study found that there was positive correlation coefficient between return on assets and Ijara financing , as shown by correlation factor of 0.418, this relationship was found to be statistically significant as the significant value was 0.000 which is less than 0.05 , the study found positive correlation between return on assets and Size of the Bank as shown by correlation coefficient of 0.767, the significant value was 0.003 which is less than 0.05, the study found positive correlation between return on assets and quality Bank's Asset as shown by correlation coefficient of 0.740 this too was also found to be significant at 0.049, and finally the study found negative correlation between return on assets and Liquidity as shown by correlation coefficient of -0.180 at 0.002 levels of confidence.

The findings concur with Franks and Curswoth, (2003) who found out that strong positive correlation between Ijarah financing and return on assets. The findings further agree with Ayodele (2011) who found out that strong positive correlation between Musharaka financing and return on assets.

4.3.2 Regression Analysis

In this study, a multiple regression analysis was conducted to test the influence among predictor variables. The research used statistical package for social sciences (SPSS V 21.0) to code, enter and compute the measurements of the multiple regressions. The model summary are presented in the table below.

4.3.2.1 Model Summary

In this study, a multiple regression analysis was conducted to test the influence among predictor variables. The research used statistical package for social sciences (SPSS V 21.0) to code, enter and compute the measurements of the multiple regressions. The model summary are presented in the table below.

Table 4.9: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.818[a]	.669	.652	.37290

Source: Research findings

The study used coefficient of determination to evaluate the model fit. The adjusted $R^{2,}$ also called the coefficient of multiple determinations, is the percent of the variance in the dependent variable explained uniquely or jointly by the independent variables. The model had an average adjusted coefficient of determination (R^2) of 0.652 and which implied that 65.2% of the variations in Return on Assets are explained by the independent variables understudy (Amount of Musharakah financing, Amount of Murabaha used in financing, Amount of Mudaraba used in financing, Amount of Ijara used in financing, Size of the Bank-Natural Logarithm of book value of assets, Bank's Asset Quality).

The study further tested the significance of the model by use of ANOVA technique. The findings are tabulated in table below.

Table 4.10: Summary of One-Way ANOVA results

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	25.904	4	6.476	5.291	.000[b]
	Residual	4.896	3	1.224		
	Total	30.8	7			

Source: Research findings

Critical value =3.84

From the ANOVA statics, the study established the regression model had a significance level of 0.1% which is an indication that the data was ideal for making a conclusion on the population parameters as the value of significance (p-value) was less than 5%. The calculated value was greater than the critical value (5.291>3.84) an indication that Amount of Musharakah financing, Amount of Murabaha used in financing, Amount of Mudaraba used in financing, Amount of Ijara used in financing, Size of the Bank-Natural Logarithm of book value of assets, Bank's Asset Quality all have a significant effects on Return on Assets. The significance value was less than 0.05 indicating that the model was significant.

4.3.2.3 Regression Coefficients

In addition, the study used the regression coefficient table to determine the study model. The findings are presented in the table below.

Table 4.11: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.243	.094	.239	2.585	.000
	Musharakah financing	.425	.136	.401	3.125	.011
	Murabaha financing.	.367	.126	.346	2.913	.016
	Mudaraba financing.	.247	.077	.210	3.208	.004
	Ijara financing.	.361	.104	.323	3.471	.018
	Size of the Bank	.697	.125	.579	5.576	.008
	Bank's Asset	.314	.121	.302	2.595	.005
	Liquidity	.339	.111	.321	3.054	.003

Source: Research findings

As per the SPSS generated output as presented in table above, the equation ($\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \varepsilon}$) becomes:

$\mathbf{Y = 0\ .243 + 0.425\ X_1 + 0.\ 367 X_2 + 0.247 X_3 + 0.361 X_4 + 0.697 X_5 + 0.314 X_6 + 0.339 X_7}$

From the regression model obtained above, a unit change in musharakah financing holding the other factors constant would lead to increase in return on assets by a factor of 0.425, a unit change in Murabaha financing while holding the other factors constant would an increase in return on assets by a factor of 0.367, a unit change in Mudaraba financing, while holding the other factors constant would lead to an increase in return on assets by a factor of 0.247, a unit change in Ijara financing, while holding the other factors constant would lead to an increase in return on assets by a factor of 0.361, a unit change in size of the bank while holding the other factors constant would lead to an increase in return on assets by a factor of 0. 697. a unit change in bank's asset while holding the other factors constant would an increase in return on assets by a factor of 0.314,a unit change in bank's asset quality while holding the other factors constant would led to an increase in return on assets by a factor of 0.339.

The findings above conform to the findings by franks and Curswoth, (2003) who found out that bank's asset quality is positively related with return on assets. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the obtained probability value and α=0.05. If the probability value was less than α, then the predictor variable was significant otherwise it wasn't. All the predictor variables were significant in the model as their probability values were less than α=0.05.

4.4 Interpretation of the Findings

The analysis indicates that Musharaka and Murabaha are the biggest contributors to an Islamic banking portfolio. Other financing instruments are still lagging behind and despite their growth overtime, their contribution in the portfolio is minimal. There is a significant relationship between ROA and different Islamic financial instruments. The results of the study also revealed that all the determinant variables have an influence on performance of commercial banks as indicated by their positive mean values and their standard deviation. Therefore, the different financing instruments play a critical role in the performance of commercial banks offering Islamic financial services.

The research investigated the relationship between amount used in Musharakah by Islamic financial institutions and ROA. The research findings showed an evidence of positive correlation between Musharakah means of financing and the performance of Islamic financial institutions. (Pearson correlation value = 0.367, significance value = 0.001), The coefficient of variation revealed that any further investments by Islamic financial institutions on Musharakah financing would lead to increase in return on assets by a factor of 0.425. The study also established that clients preferred Musharaka, because every partner has a right to take part in the management, and to work for it, the partners may agree upon a condition where the management is carried out by one of them, and no other partner works for the Musharaka. In such a case the "sleeping" (silent) partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the relative size of his investment in the business (Gafoor 1996). The financier in an interest-bearing loan cannot suffer loss, while the financier in Musharaka can suffer loss if the joint venture fails to produce fruits (Usmani, 1998).

The study also established a strong relationship between Mudaraba means of financing and financial performance of Islamic banking institutions. (Persons correlation coefficient = 0.298, P value = 0.014) The coefficient of variation showed that a unit increase in Mudaraba financing by IFI, would lead to an increase in Return on Assets by a factor of 0.247. Further the research revealed that Mudaraba transaction helped entrepreneurs who have projects, to start a business and has enough level of knowhow but can't find money to do that. Though mudaraba is some similar to conventional interest based loans that are issued by conventional banks, the findings are in line with the call by Usmani (1998) instrument should be used as a transitory step taken in the process of Islamization of the economy.

The study revealed positive correlation between return on assets and Murabaha financing (Persons correlation coefficient = 0.418, P value = 0.000), the study coefficient of variation revealed that a unit change in Murabaha financing would lead to an increase in return on assets by a factor of 0.367. The study also established that Murabaha could be named as the locomotive of Islamic finance because it was after the introduction of Murabaha that Islamic

banking assets grew. Murabaha is like device to escape from 'interest' and not an ideal instrument for carrying out the real economic objectives of Islam.

The study found that there was positive correlation coefficient between return on assets and Ijara financing, (Persons correlation coefficient = 0.418, P value = 0.000), the research also established that a unit change in Ijara financing, while holding the other factors constant would lead to an increase in Return on Assets by a factor of 0.361. Further it was revealed that Ijarah does not involve interest bearing contracts and they should be Shariah-compliant. Islamic leasing creates a great potential for securitization. Sukuk based on ijara can be traded in the market, affording a convenient instrument for investing for the people of small incomes who constitute the overwhelming majority in the developing countries in general and in the Muslim countries in particular. Islamic leasing is especially suitable for some sectors of the economy for which sharing-based modes proved to be rather difficult to practice, e.g. the consumers sector and the public sector. It can take care of the public sector projects related to infrastructure building, e.g., roads and bridges, airports, irrigation systems, hospitals, schools, etc.

The study found a strong positive correlation between Size of the Bank and Return on assets, (Persons correlation coefficient = 0.767, P value = 0.003), the value for coefficient of variation was 0.697, implying that unit change in size of the bank while holding the other factors constant would lead to an increase in return on assets.Further the research revealed that bigger banks are expected to cope better with changes and has better chances to offset random losses, i.e. due to market uncertainties bigger banks have lower riskiness. The findings confirms with the findings by Lee (2009) examined the role that firm size plays in profitability, and found that absolute firm size plays an important role in explaining profitability.

The research investigated the relationship between asset quality and financial performance of commercial banks; the findings as well indicated that quality of the assets and the financial performance of banks are strongly and positively correlated. (Persons correlation coefficient = 0.740, P value = 0.049). The value for coefficient of determination established was 0.314

implying that unit change in bank's asset quality while holding the other factors constant would lead to an increase in return on assets. The research also established that banking sector has to take greatest care on the variables which relate to asset liability management and that all the banking groups have to take necessary steps to improve the overall performance of the banking sector.

The study also found negative correlation between high levels of liquidity and return on assets by Islamic financial institutions (Correlation Coefficient value - 0.180, P- value 0.002) The research also established that bank's liquidity needs and the sources of liquidity available to meet those needs depend significantly on the bank's business and product mix, balance sheet structure and cash flow profiles of its on- and off-balance sheet obligations. Further the study found that profitability of the Islamic bank in Kenya is negatively affected due to increase in the liquidity gap and leverage. With a significant liquidity gap, the banks may have to borrow from the repo market even at a higher rate thereby pushing up the cost of banks. Kimari (2013) concluded that there was a positive relationship between credit risk management and financial performance of banks in Kenya.

CHAPTER FIVE
SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents summary, conclusion and recommendations. The objective of this study is to establish the effect of Islamic financial instruments on the financial performance of commercial Banks in Kenya.

5.2 Summary

The research investigated the relationship between amount used in Musharakah by Islamic financial institutions and ROA. The research findings showed an evidence of positive correlation between Musharaka financing and the performance of Islamic financial institutions. The coefficient of variation revealed that any further investments by Islamic financial institutions on Musharakah financing would lead to increase in return on assets by a factor of 0.425. The study also established that clients preferred Musharaka, because every partner has a right to take part in the management, and to work for it, the partners may agree upon a condition where the management is carried out by one of them, and no other partner works for the Musharaka.

Further the research revealed that Diminishing Musharakah is increasingly used in sectors like housing and real estate, project finance, and construction. Musharaka can take the form of an unlimited, unrestricted, and equal partnership in which the partners enjoy complete equality in the areas of capital, management, and right of disposition. Each partner is both the agent and guarantor of the other. The financier in an interest-bearing loan cannot suffer loss, while the financier in Musharaka can suffer loss if the joint venture fails to produce fruits (Usmani, 1998).

The study established a strong relationship between Mudaraba means of financing and financial performance of Islamic banking institutions. The coefficient of variation showed that a unit increase in Mudaraba financing by IFI, would lead to an increase in Return on Assets by a factor of 0.247. Though mudaraba is some similar to conventional interest based

loans that are issued by conventional banks. In a mudaraba transaction, the capital owner (Rabb-ul Mal) provided all the necessary money while the Entrepreneur only offer his labor. At the end of transaction; if there is profit, parties share the profit according to decided ratio. If there is a loss; only the capital owner bears the loss, entrepreneur pays nothing. the findings are in line with the call by Usmani (1998) instrument should be used as a transitory step taken in the process of Islamization of the economy. And its use should be restricted only to those cases where Mudarabah and Musharakah are not practicable.

The study found a positive correlation between return on assets and Murabaha financing as shown by correlation coefficient of 0.367, the study revealed that further investments in unit change in Murabaha financing by IFI would lead to an increase in return on assets by a factor of 0.367. Murabaha is like device to escape from 'interest' and not an ideal instrument for carrying out the real economic objectives of Islam.

The study found that there was positive correlation coefficient between return on assets and Ijara financing, as shown by correlation factor of 0.418, the research also established that a unit change in Ijara financing, while holding the other factors constant would lead to an increase in Return on Assets by a factor of 0.361. Further it was revealed that Ijarah does not involve interest bearing contracts and they should be Shariah-compliant. Islamic leasing creates a great potential for securitization. Islamic leasing is especially suitable for some sectors of the economy e.g. the consumers sector and the public sector. It can take care of the public sector projects related to infrastructure building, e.g., roads and bridges, airports, irrigation systems, hospitals, schools, etc. Further the study established that Lease finance has some of the good features of debt finance. There is less possibility of moral hazard or adverse selection than the sharing modes. There is no agency relationship between the lessor and the lessee, as is in the case of mudarabah (profit sharing), for example. The payment obligation of the lessee, the rent, is fixed, as in case of debt. It is not a case for adverse selection as no part of unforeseen losses/costs can be passed over to the lessor.

The study found strong positive correlation between financial performance of Islamic financial institutions and size bank as shown by correlation (coefficient factor 0. 767, P-

value 0.003) the research also established that The size of the bank can have a positive effect on financial performance because larger banks can use this advantage to get some financial benefits in business relations, large banks can get a better interest rate and also a better discount rate due to a large quantity that it buys, absolute banks size plays an important role in explaining profitability, The findings confirms with the findings Majumdar (1997) who investigated the impact that banks size on profitability and found evidence that larger banks are less productive but more profitable. Further the research revealed that bigger banks are expected to cope better with changes and has better chances to offset random losses, i.e. due to market uncertainties bigger banks have lower riskiness. The findings confirms with the findings by Lee (2009) examined the role that firm size plays in profitability, and found that absolute firm size plays an important role in explaining profitability.

The research investigated the relationship between asset quality and financial performance of commercial banks; the findings as well indicated that quality of the assets and the financial performance of banks are strongly and positively correlated. This had a correlation coefficient of 0.740 indicating that the two variables are strongly associated. The regression coefficient indicated that, an increase in the quality of the assets would lead to significant growth in the financial performance of banks. Therefore, increasing quality of assets brings in improved performances in finance. The research also established that banking sector has to take greatest care on the variables which relate to asset liability management.

The study also found negative correlation between high levels of liquidity and return on assets by Islamic financial institutions (Correlation Coefficient value - 0.180, P- value 0.02). Further the study found that profitability of the commercial bank in Kenya is negatively affected due to increase in the liquidity gap and leverage. With a significant liquidity gap, the banks may have to borrow from the repo market even at a higher rate thereby pushing up the cost of banks. The level of customer deposit was also found to positively affect the bank's profitability and it will therefore be encouraged for banks to open more branches in the country. Kimari (2013) concluded that there was a positive relationship between credit risk management and financial performance of banks in Kenya.

The above findings confirm with the research findings by Tianwei & Paul (2006) who found that liquidity risk management significantly led to financial performance of agricultural firms. The study also revealed that banks should ensure that assets are prudently valued according to relevant financial reporting and supervisory standards. Bank should fully factor into its risk management the consideration that valuations may deteriorate under market stress, and take this into account in assessing the feasibility and impact of asset sales during stress on its liquidity position.

5.3 Conclusions

The study found a positive correlation between financial performance of IFIs and Islamic financial instruments which include Musharakah financing, Mudaraba financing, Murabaha financing and Ijara financing, Thus the study concludes that all the Islamic financial instruments had a positive impact on the performance of commercial Banks in Kenya.

The study established that that quality of the assets and the financial performance of banks are strongly and positively correlated and that an increase in the quality of the assets would lead to significant growth in the financial performance of banks, Thus study concludes that increase in the quality of the assets had a positive influence on the financial performance of commercial banks in Kenya.

The financial performance of the commercial banks in Kenya is highly dependent on the level of the institutions' liquidity. There is also a negative association between high levels liquidity and financial performance of commercial banks. This explains the need to keep liquidity level at considerable rate in order to increased efficiency in the sector's operations.

The study found strong positive correlation between financial performance of Islamic financial institutions and size bank as shown by correlation (coefficient factor 0. 767, P-value 0.003), bigger banks can cope better with changes and has better chances to offset random losses, Thus the study concludes that larger sized banks had a positive influence on the financial performance of Islamic banks in Kenya.

5.4 Policy Recommendations

Based on the study findings the research recommends that Islamic financial institutions need to continue offering Islamic financial instruments as they were all found to positively influence the financial performance of Islamic banks. The findings revealed that quality of the assets is directly related to the Islamic banks financial performance. More investments should therefore be done through establishing more banking networks across the country which is associated positively with their financial performance, The findings illustrated that financial performance of Islamic banks in Kenya is highly dependent on the level of the institutions' liquidity, to facilitate favorable financial performance in Islamic banks in Kenya, there is need to formulate strategies to facilitate credible levels of liquidity so as to ensure efficiency in financial operations.

5.5 Limitations of the Study

The study covered a period of only seven years. However, some commercial banks within the sample introduced Islamic banking recently and thereafter making data availability limited for the period under consideration (2008-2014).The descriptive and correlation analysis relied on secondary data which had already been compiled by banks. Secondary data used in this research was obtained from the sources and the researcher had no means of verifying for the validity of the data which were assumed to be accurate for the purpose of this study.

The study results are therefore subject to the validity of the data used, the study used the ordinary least square regression method of analysis which may have its own weaknesses compared to other methods which may limit the general applicability of the study results. One of the commercial banks in the population completely refused to share its data per financing mode and performance of its Islamic banking window. This distorts the analysis done due to inadequate data available for Islamic banking.

5.6 Recommendations for Further Research

The study sought to determine the effect of Islamic financial instruments on the financial performance of commercial Banks in Kenya. The research recommends that similar studies need to be done exploring effect of CBK regulations on financial performance of Islamic

banks. Other areas of study would include the concept of Profit and Loss Sharing (PLS) in Islamic banking, other Islamic financing instruments not used in Kenya such as Salam Bai bi-thamin ajil and Istisnaa and how to come up with innovative Islamic financing instruments. Of interest may also be how to regulate Islamic banks in a conventional environment in compliance with Shariah. It's also important to investigate the extent of awareness of Islamic financial instruments on entire public and the extent of embracement. There of need to investigate the effect on effectiveness of strategies being employed by Islamic banks in marketing Islamic financial products.

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APPENDICES

APPENDIX I: LIST OF BANKS PROVIDING ISLAMIC BANKING SERVICES IN KENYA AS AT 2013

Bank	Address
Gulf African Bank Limited	Geminia Insurance Plaza P.O. Box 43683 -00100 Nairobi.
First Community Bank Limited	Prudential Building,Wabera Street, P.O. Box 26219-00100, Nairobi Kenya.
Barclays Bank of Kenya Limited (La riba)	Barclays Bank of Kenya Ltd, Barclays West End Building, Off Waiyaki Way, PO Box 30120 – 00100Nairobi, Kenya.
National Bank Limited (National Amanah)	National Bank Building, Harambee Avenue, Nairobi.Mail:corporateaffairs@nationalbank.co.ke
Chase Bank Limited (Chase Iman)	Riverside Mews, along Riverside Drive, P.O. Box 66015 -00800, Nairobi
Standard Chartered Bank Limited (Saadiq)	Westlands Road, Nairobi, Kenya, P.O. Box 30003 –00100 GPO, Nairobi
Kenya Commercial Bank Limited	Kenya Commercial Bank Limited, Kencom Building, P.O Box 48400-00100 Nairobi, Kenya.

Source: Central Bank of Kenya (CBK)

APPENDIX II: DATA COLLECTION FORM

PART A

BANK PROFILE

Name of the Bank……

Year of Establishment……

Mode of Islamic financial services operation at the bank (tick where appropriate)

A fully fledged Islamic Bank ☐ An Islamic Window within conventional bank ☐

PART B

The following statements relate to the financial performance and modes of financing distribution of the Islamic banking portfolio over the last 5 years.

Year/ Performance Measure	2008	2009	2010	2011	2012
Net Assets					
Total loan					
Total Islamic Non Performing Loans					
Amount of Musharaka financing					
Amount of Murabaha financing					
Amount of Mudaraba Financing					
Amount of Ijara Financing					
Amount of Salam Financing					
Amount of Bai bi-thamin ajil financing					
Amount of Istisnaa financing					
Book value of Asset					
Amount of Short term investment					