THE RELATIONSHIP BETWEEN ISLAMIC FINANCIAL PRACTICES AND PERFORMANCE OF COOPERATIVES IN MANDERA COUNTY

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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 Candidate's University Supervisor

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All thanks and praise to Almighty Allah for according me health and getting me this far and all those who supported me through my entire studies. Thanks to my parents for enabling me achieve such great things. To my wife and kid, thank you for being the main catalyst of my success. To my supervisor and all colleagues at the university, thanks for the support.

DEDICATION

This project is dedicated to my mom and dad for their enormous contribution in my journey of life.

LIST OF ABBREVIATION AND ACRONYMS

CAMELS: Capital Asset Management Earnings Liquidity Sensitivity

GOK: Government of Kenya

ICA: International Cooperatives Association

ROE: Return on Equity

UFIRS: Uniform Financial Institutions Rating System

SPSS: Statistical Package for Social Sciences

ROA: Return On Asset

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ABSTRACT

Islamic finance, as a financial model based on Islamic Shari'ah has grown enormously across the world and especially so in Kenya. The study sought to establish the relationship between the implementation of Islamic financial practices and the performance of cooperatives in Mandera County in Kenya. The study used descriptive research design. The population of the study comprised all the active cooperatives in Mandera County which were 18. The major reason behind targeting the relationship between the implementation of Islamic financial practices and the performance of cooperatives in Mandera County was because the residents of the area are mostly Muslims and as such will enable better understanding and analysis of the variables involved. Secondary data was used in this study; specifically the study used financial statements that were obtained from the cooperatives and their respective explanatory notes which properly brought out the predicted relationship. The data was coded using SPSS. Descriptive statistics was used to summarize the data; this included the use of weighted means, standard deviation. 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 implementation of Islamic financial practices and the performance of cooperatives in Mandera County. These practices include Musharaka, Mudaraba, Murabaha, and other Islamic financial practices.. The study found strong positive correlation between performance of cooperatives in Mandera county and technology usage. The study concludes that all the Islamic financial practices had a positive impact on the performance of cooperatives in Mandera County and this relationship was exacerbated by the increasing number of Muslims in Mandera County and the failure of the existing conventional banks to adopt their products to the needs of the people in the area. The research recommends that cooperatives in Mandera county need to continue offering Islamic finance products and more so ensure that their members be made aware on the availability of the products and the advantages that they will derive from utilizing the available products. From the Islamic financial practices analyzed in relation to cooperatives, Musharaka was found to be the most desired and preferred by members, followed by Mudaraba and Murabaha. The impact of technology on the performance of cooperatives is also clearly brought out and in the current global village, cooperatives need to up their game in order to survive and remain relevant. The cooperatives that are technologically advanced were found to be performing better than the cooperatives that are not using technology, short messages and social media were among the platforms that cooperatives are utilizing to enable them survive in Mandera County.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The Co-operative Movement in Kenya may be traced to the period immediately after the country's independence. The movement is supposed to play an important role in wealth creation, food security and employment generation and hence participate in poverty alleviation. To date, there are over 11,200 registered cooperative societies country-wide. The membership is over 6.1 million and has mobilized domestic savings estimated at over Ksh. 125 billion. The cooperatives have employed over 300,000 people besides providing opportunities for self-employment. Indeed, a significant number of Kenyans, approximately 63% draw their livelihood either directly or indirectly from cooperative-based enterprises (Republic of Kenya 2007; International Monetary Fund 2007; The Kenya High Commission in the United Kingdom, 2007).

The policy objective of the Kenyan cooperative movement is to spur sustainable economic growth by focusing on achievement of desired outcomes through strengthening of the movement, improving cooperative extension service delivery, corporate governance, access to markets and marketing efficiency (International Monetary Fund 2007). The cooperatives have an immense potential to deliver goods and services in areas where both the public and the private sector have not ventured (Verma, 2004).

Cooperatives play a significant role in the provision of financial services to the poor. They provide savings and credit and investment opportunities to individuals, institutions and group members. Cooperatives perform an active financial intermediation function, particularly mediating from urban and semi-urban to rural areas, and between net savers and net borrowers while ensuring that loan resources remain in the communities from which the savings were mobilized. Equity bank was formed in 1984 as a building society and with time it was transformed to microfinance institution up to its current status of commercial bank (Gathurithu, 2011).

The government through the ministry of cooperative development and marketing is empowering the cooperative movement in Kenya and gets support by cooperative bank of Kenya. There has been established a college to teach matters of cooperative movement (Cooperative College at Nairobi) due to this concern by various stakeholders that cooperative movements started to be more competitive in their field of financial institution since they contribute 30% of economic growth in the country (Gathurithu, 2011).

Islamic finance is a financial system that operates according to Islamic law (which is called sharia) and is, therefore, sharia-compliant. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. However, these entities are governed both by Islamic law and the finance industry rules and regulations that apply to their conventional counterparts (Jamaldeen, 2012).

Islamic economics is based on core concepts of balance, which help ensure that the motives and objectives driving the Islamic finance industry are beneficial to society. Islamic economics is aimed at achieving a Balance between material pursuits and spiritual needs and a Balance between individual and social needs (Jamaldeen, 2012).

1.1.1 Islamic Financial Practices

Islam encourages the earning of profit as profit symbolizes successful business dealing and creation of new wealth. Interest on the other hand is a cost that is in place regardless of the outcome of business operations. If business losses are experienced, there may not be real wealth creation. Social justice requires that lenders and borrowers share both profit and loss in an equitable manner and that the method of accumulating and distributing wealth in the economy is fair and represents true productivity (Iqbal, 2007). To achieve these goals, there are several modes of finance used in Islamic banking, which are as follows:

Murabaha, this is a kind of “cost-plus” transaction in which the bank buys the asset then immediately sells it to the customer at a pre-agreed higher price payable by installments. This facility is often used in the way that mainstream banking customers might seek a mortgage when buying property (Ahmed, 2005). Musharaka, this is a partnership, normally of limited duration, formed to carry out a specific project. Participation in a Musharakah can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution. In this case, the cooperatives enters into a partnership with a client in who both share the equity capital- and maybe even the management -of a project or deal, and both share in the profits or losses according to their equity shareholding (Ahmed, 2005).

Mudaraba, this is a form of investment partnership between an institution and a business that shares the risk and losses/profits between both parties at pre-agreed levels. A mudaraba transaction, bringing some of the benefits of a business loan to sharia-compliant business customers, effectively requires the bank to take a stake in the business, with clients investing their time and expertise in running the enterprise (Ahmed, 2005).

Ijarah, this is a form of sharia law-compliant leasing involving the rights over the use of an asset under which the cooperative buys the asset then leases it to the customer over a fixed period in return for a pre-agreed monthly price. Provisions can be made for the customer to buy the asset at the end of the agreed period. Thought needs to be given to issues such as the provision of insurance, as the asset is effectively owned by the cooperative during the lease period (Ahmed, 2005).

Istisna, another form of forward sales contract, is a longer-term financing mechanism under which a price is agreed before the asset described in the agreement is actually built. Sellers can then either create the asset themselves or subcontract, with buyers also having the option of paying the entire sum due either in advance or as installments during the manufacturing process (Ahmed, 2005).

Salam, this is a kind of forward sales contract which requires the buyer to pay in advance for goods that are to be supplied at a later date. Salam is very useful in reducing agricultural sector poverty easily, by enabling the cooperatives and farmers to contract with each other of the crops and to get finance at an appropriate time, instead of usurious loans, which ultimately deteriorates through the compounding of interest (Ahmed, 2005).

The effect of a cooperative's activity on economic growth will therefore depend on which modes of finance and investment the bank undertakes most, and how much each one of these modes contributes to economic growth. At present, fixed return modes of financing are dominating usage by most Islamic banks modes such as Murabah and leasing. Even though these are clearly distinguishable from interest-based modes, as transactions are always done through real commodities, they do not yield the full benefits in terms of promoting growth with equity which is expected of an Islamic financial system. Specialists in Islamic financial theory had counted on Islamic banks to provide a significant amount of profit-sharing finance, which would have had economic effects similar to direct investment and would have produced a strong economic development impact. However, due to practical difficulties, profit-sharing finance has remained negligible in the operations of Islamic banks (Al Hallaq, 2006).

1.1.2 Performance of Cooperative

The International cooperative alliance defines a cooperative as: "An autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise" (ICA, 2004).

Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility, and caring for others. They adhere to a code of practice enshrined in the Universal Cooperative Principles (Open and Voluntary membership; Democratic Member Control; Member Economic Participation; Autonomy and Independence, Education, Training and Information; Cooperation among Cooperatives and Concern for the Community).

In 1979, the Uniform Financial Institutions Rating System (UFIRS) was implemented in United States of America banking institutions, and later globally, following a recommendation by the United States of America Federal Reserve. The system became internationally known with the abbreviation CAMEL, reflecting five assessment areas: capital, asset quality, management, earnings and liquidity. In 1995 the Federal Reserve replaced CAMEL with CAMELS, adding the "S" which stands for financial System. This covers an assessment of exposure to market risk.

The rating system is designed to take into account and reflect all significant financial and operational factors examiners assess in their evaluation of an institutions performance. Institutions are rated using a combination of specific financial ratios and examiner qualitative judgments. (Brockett et al., 1997) They discussed the key components of the model as follows. Capital adequacy, Capital provides a cushion to fluctuations in earnings so that firms can continue to operate in periods of loss or negligible earnings. It also provides a measure of reassurance to the members that the organization will continue to provide financial services. Likewise, capital serves to support growth as a free source of funds and provides protection against insolvency.

The asset quality measure is a function of present conditions and the likelihood of future deterioration or improvement based on economic conditions, current practices and trends. The quality and trends of all major assets must be considered in the rating. This includes loans, investments, other real estate owned and any other assets that could adversely impact a firms' financial condition.

Management is the most forward-looking indicator of condition and a key determinant of whether a firm possesses the ability to correctly diagnose and respond to financial stress. Reflected in this measure is both the board of directors' and management's ability to identify, measure, monitor, and control the risks of the credit union's activities, ensure its safe and sound operations, and ensure compliance with applicable laws and regulations. Management practices should address some or all of the following risks: credit, interest rate, liquidity, transaction, compliance, reputation, strategic, and other risks.

Earnings, the continued viability of a financial firm depends on its ability to earn an appropriate return on its assets which enables the institution to fund expansion, remain competitive, and replenish and/or increase capital. Liquidity, Asset/liability management is the process of evaluating, monitoring, and controlling balance sheet risk (interest rate risk and liquidity risk). A sound Asset Liability Management process integrates strategic, profitability, and net worth planning with risk management.

Sensitivity to market risk, the "S" in CAMELS is a complex and evolving measurement area. It was added in 1995 by Federal Reserve, primarily to address interest rate risk, the sensitivity of all loans and deposits to relatively abrupt and unexpected shifts in interest rates.

1.1.3 Relationship between the Implementation of Islamic Financial Practices the Performance of Cooperatives.

Islamic finance has great potential to provide various schemes and instruments suitable for microfinance practice (Abdul, 2007). Dhumale and Shapcann (1998) explain in great length the impact the three key Islamic practices of Mudaraba, Musharaka and Murabaha can have on the cooperatives and any financial institution if applied in accordance to the principles of Islamic sharia.

In Mudaraba and Musharaka, the cooperatives can develop a partnership with another party whereby they will undertake a project in a profit and loss sharing scheme. This mechanism can be applied either in project financing of saving mobilization. In the case of a success, the profits will be shared based on the predetermined rate and in the case of a loss; it will be borne by the cooperative. Under this setting, the cooperative will have to play a monitoring and evaluation role over the entrepreneurs to ensure that the project does not fail. This scheme will benefit the cooperatives as they will be viewed as a vehicle for promoting and accelerating social development (Dhumale and Shapcann, 1998).

Murabaha is another scheme that can be utilized by the cooperatives. This is similar to the trade contract in the working capital loan and similar to leasing in the context of long term fixed asset investment. This is an asset backed transaction that would prevent the possibility of diverting funds other than the requested funds. In the context of cooperatives, this would ensure that the cooperatives are protected from excessively diverting funds that are not collateralized (Dhumale and Shapcann, 1998). This scheme is easily implemented and as such less costly to the cooperatives and very helpful in reducing the expenses that may face a cooperative (Ahmad, 2005).

Islamic schemes of transaction guarantee and encourage the participation of every segment of the society. In particular, the implementation of the Islamic participatory approach in fund mobilization and financing promotes justice, brotherhood, social equality and financial inclusion of the poor (Dusuki, 2008). In regards to the cooperatives, they will be able to achieve the societal goodwill that will help boost the number of members they have and also have good deposit injections and as such more potent returns (Ahmad, 2005).

1.2 Research Problem

As envisioned in Kenya's development blueprint, Vision 2030, Sacco's are already playing their critical role of savings mobilization for investments. Many rural and urban Kenyans now own homes and other business enterprises courtesy of funds through their Sacco's. Kenya continues to enjoy the fastest growing economy in East Africa, her service industry performing better than any other sector in the economy (GOK,2007).One sector of the service industry is the financial sector whereby many commercial banks and other financial institutions continue to grow day by day. Some banks have even crossed border to offer services in the neighboring East African states. SACCOs are financial institutions which offer similar products like banks and most of them were formed long time ago but their performance is not something to be proud of compared to commercial banks and other financial institutions (Gathurithu, 2011).

Neely et al. (1999) posited that the role of performance measurement as a process of quantifying the efficiency and effectiveness of a company's actions. An organization has to achieve its desired goals with greater efficiency and effectiveness than its competitors to have better performance.

The uniqueness of the cooperative movement is its geographical distribution across Kenya. In all the 47 counties there are numerous cooperatives providing financial access to financially excluded Kenyans. Cooperatives in Kenya are gradually responding to the fast changes in the financial environment and adopting new approaches. These mechanisms, cooperatives argue, have proven their ability to manage risk, enforce lending contracts and reduce the transaction costs of delivering credit. Until recently, cooperatives have been able to retain their membership and attract new members through natural affiliation, stemming from the common bond among members. With increased competition from other financial service providers and other factors such as retrenchment, poor management and loan defaulting have influenced cooperative performance (Karagu and Okibo, 2014).

As envisioned in Kenya's development blueprint, Vision 2030, cooperatives are already playing their critical role of savings mobilization for investments. Kenya continues to enjoy the fastest growing economy in East Africa, her service industry performing better than any other sector in the economy (GOK, 2007). One sector of the service industry is the financial sector whereby many commercial banks and other financial institutions continue to grow day by day. Some banks have even crossed border to offer services in the neighboring East African states. Cooperatives on the other hand are financial institutions which offers similar products like banks and most of them were formed long time ago but their performance is not something to be proud of compared to commercial banks and other financial institutions (Gathurithu, 2011).

In Africa, a study done by Mahmud (2005) clearly brings out the importance of cooperatives on the development of Northern Nigeria but does not go deep into the factors that affect the performance of the cooperatives in the country. In Malawi, a study conducted by Matabi (2012) clearly brings out the impact of Institutional and Governance Factors on Smallholder Agricultural Cooperatives in Malawi.

In Kenya, Barasa (2014) conducted a study on the factors affecting the performance of cooperatives in Bungoma County. He concluded that member's commitment, governance of the cooperative, technology, motivation and cooperative principles all have an impact on the performance of the cooperatives and such, cooperatives should adopt necessary steps to handle and manage the impact brought about by these factors. Similarly, Karagu and Okibo (2014) touched on the impact of member's withdrawal, loan defaulting, funds misappropriation and investment decisions have on the performance of cooperatives and established that all these four aspects impact the performance of the cooperatives and they should be properly and amicably dealt with. No study has been done in Kenya and even globally to bring out the impact that Islamic financial practices has on the performance of the cooperatives, thus clearly emphasizing the need for this study to be conducted.

1.3 Research Objective

To determine the relationship between the Islamic financial practices and the performance of cooperatives in Mandera County.

1.4 Value of the Study

This study will be of benefit to the people of the area who will be able benefit from the application of Islamic financial practices by the cooperatives that are located in northern Kenya. Most of the residents of the region are Muslims and will be very much happy with services that match their religion.

The county governments of the northern part of the country will be able to generate viable policies to encourage the development of cooperatives and more deeply understand the priceless contribution that the cooperatives bring to the development there counties. The national government will be able to understand the needs of the people of the northern part of the country and be able to act accordingly thus ensuring that they prosper and throw away the tag of being marginalized. Prospective investors in the region, most viably the cooperatives will be able to understand the need of their services in the area and therefore pitch camp in the area to the benefit of themselves and the people of the region.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. The specific areas covered here are theoretical review and empirical review.

2.2 Theoretical Review

The following theories are helpful in trying to understand the impact of implementation of Islamic financial practices on the performance of cooperatives in northern Kenya.

2.2.1 Performance Theory

This theory was developed by Richard Schechner (1988). He presupposed that an Organization is a structured entity that is established to achieve specific goals. It consists of physical, human, informational and financial resources that are combined to realize certain objectives. Business organization is primarily formed for the sake of profit by performing legal activities. A cooperative is also one of the business organizations that offer a large number of products and service for profit. Organization as it is goal oriented, boundary-maintained and socially constructed systems of human activity (Aldrich, 2009).

Every organization is trying to enhance the performance of individuals for overall improvement of the whole organization. Performance evaluation enables the organization to assess its efficiency and effectiveness over a period of time by comparing with its objectives or with market leader to overcome its weaknesses. Researchers explored a number of indicators to measure organizational performance (Dess & Robinson, 2004). There are several criteria to evaluate the performance of cooperatives for successful survival in the era of globalization and competition. Multiple aspects like profitability, liquidity, management performance, leverage, market share, productivity, innovation, quality of products, human resources and sales volume etc. can evaluate any organization.

Inception of Islamic cooperatives necessitated the importance of performance evaluation to compete with conventional banks in Africa. Tvorik and McGivern (2007) investigated performance by comparing economic and organizational factors. They concluded that organizational factors influenced the profitability more than that of the economic factors. Successful organizations realized the importance of ongoing performance measurement practices (Weiss and Hartle, 2008).

Organization's performance could be assessed by resource-based view as explored by a number of researchers (Wernerfelt, 2004; Barney, 2006 a,b; Prahalad and Hamel, 2000). It may be shown by varied combination in the literature. Organizational performance could be linked with market orientation, organization learning, human resource productivity, quality improvement or any other component (Day, 2004; Banker and Sinkula, 2009; Santos-Vijande et al., 2005).

Islamic cooperatives are targeting new members every day to be able to sustain themselves. There are several measures that were adopted by the researchers to assess the performance of cooperatives like profitability, liquidity, management performance, innovation, productivity, and human resources. There are different qualitative and quantitative tools that are used to measure the cooperatives performance. The measure of performance evaluation should be meaningful. It reflects management's clarity about organization's current situation and its viability to achieve its goals. It should be manageable as it can be handled easily based on simple calculations and manipulation of data.

2.2.2 Service Quality Theory

According to Mishkin (2001) reported that banking and financial services are the integral part of services industry and its contribution is increasing with the passage of time. However, expansion of global and integrated banking sector has to face many challenges of legislation, technological and structural changes (Angur et al. 2009). The relationship between service quality and customer (member) satisfaction is investigated by a number of researchers across the globe. It is concluded that there is strong association between dimensions of service quality and overall customer (member) satisfaction (Anderson and Sullivan, 1993). It is found that the banking and financial services industry has a link between service quality and customer satisfaction (Avkiran, 2004).

From this theory, it is clear that any financial institution has to improve its services in order to ensure that it attracts customers (members) and at the same time maintain the ones they have. The ability of a cooperative to attract and retain members will greatly influence its performance and offering islamically clean products is a key factor for the cooperatives in Mandera County.

2.2.3 Theory of Financial Intermediation

Theories of the economic role of financial intermediaries build on the economics of imperfect information that began to emerge during the 1970s with the seminal contributions of Akerlof (1970), Spence (1973) and Rothschild and Stiglitz (1976). Financial intermediaries exist because they can reduce information and transaction costs that arise from an information asymmetry between borrowers and lenders. Financial intermediaries thus assist the efficient functioning of markets, and any factors that affect the amount of credit channeled through financial intermediaries can have significant macroeconomic effects.

There are two strands in the literature that formally explain the existence of financial intermediaries. The first strand emphasizes financial intermediaries' provision of liquidity. The second strand focuses on financial intermediaries' ability to transform the risk characteristics of assets. In both cases, financial intermediation can reduce the cost of channeling funds between borrowers and lenders, leading to a more efficient allocation of resources.

Diamond and Dybvig (1983) analyse the provision of liquidity (the transformation of illiquid assets into liquid liabilities) by banks. In Diamond and Dybvig's model, depositors are risk averse and uncertain about the timing of their future consumption needs. Without an intermediary, all investors are locked into illiquid long-term investments that yield high payoffs only to those who consume late. Those who must consume early receive low payoffs because early consumption requires premature liquidation of long-term investments. Banks can improve on a competitive market by providing better risk sharing among agents who need to consume at random times. An intermediary promising investors a higher payoff for early consumption and a lower payoff for late consumption relative to the non-intermediated case enhances risk sharing and welfare.

2.3 Determinants of Financial Performance

The performance of a cooperative is influenced by the following financial factors as clearly illustrated by Karagu and Okibo (2014) funds misappropriation, investment decisions, loan defaulting and membership withdrawal. Similarly, the impact of technology is clearly illustrated by Barasa (2014).

2.3.1 Funds misappropriation

To find out whether funds misappropriations affect performance of cooperatives, the study established that funds misappropriation influences performance of cooperatives. The study concluded that cooperatives need to improve on their internal audit department and other internal control measures (Karagu and Okibo, 2014).

2.3.2 Investment decisions

To determine whether investment decisions affect performance of cooperatives, the study established that investment decisions made by cooperatives influence their performance. The study therefore concluded that cooperatives need to invest in prudent projects in order to achieve better returns (Karagu and Okibo, 2014).

2.3.3 Loan defaulting

To establish whether loan defaulting influences cooperatives performance, the study established that loan defaulting influences cooperatives performance. The study concluded that cooperatives should put in place loan recovery strategies and introduce collateral securities as a way of eliminating or reducing loan defaulting (Karagu and Okibo, 2014).

2.3.4 Membership withdrawal

To investigate whether member withdrawal affects cooperatives performance, the study established that member withdrawal affects cooperatives performance. The study concluded that cooperatives should introduce more products in order compete with other organizations such as banks and ensure they retain their members (Karagu and Okibo, 2014).

2.3.5 Technology

As per Barasa (2014), technology greatly influences the functioning of cooperatives. He stated that cooperatives are a bit behind on their use of the internet as compared to the other technological devices available to them.

2.4 Empirical Review

The topic has not been done widely but there are related empirical studies from other countries and related sectors such as micro finance and commercial banks. According to a study done in in Tanzania in 2011involving Kibaigwa Financial Services and Credit Co-operative, it was observed that among the factors affecting the performance of the cooperative was Management leniency on loan follow ups. In 2006 the Board extended the repayment time for a year to all agricultural loan debtors One of the key factors that is likely to influence performance in Cooperatives, Microfinance Institutions and Commercial Banks is loan defaulting. The lending modality is one reason influencing loan repayment. There are more factors that have an effect on settling loans which include; inadequate loan follow ups by the management, inadequate collateral verification, bad repayment system and members' failure to honor their obligations (Karumuna and Akyoo, 2011).

Mahmoud, (2005) clearly brings out the importance of the cooperatives in the development of the economy as a whole and more importantly in helping to solve the problem of poverty. This study can therefore help in bringing out the significance of cooperatives in any society.

Samad (2004) examined comparative financial performance of Islamic banks and the conventional banks during 1991-2001. The result showed that there was no significant difference between Islamic banks and conventional banks in respect of profitability and liquidity. Kader, et al. (2007) also examined comparative financial performance of

Islamic banks and conventional banks in the UAE. The finding showed that there was no major difference between Islamic banks and conventional banks with respect to profitability and liquidity.

Anouar (2004) has also studied on profitability of Islamic banks and he concluded that, If returns on assets are high and non-interest charges are low (which is the case when the cycle is in its upward phase), the possibility of the Islamic bank being more profitable than conventional banks is low. In short, if we assume that Islamic banks completely control the rate at which they share profits, then they are surely always more profitable. If, on the opposing, it is assumed that this rate is fixed, then Islamic banks are characterized by another interesting feature: their profitability, over the cycle, is in fact less volatile than that of conventional banks, thanks to the cushioning role that played by profit and loss sharing. The Islamic bank's ROE is less unstable than that of the conventional one. Such a smoothing effect comes from the ability of the Islamic bank to absorb shock on assets' returns throughout profit and loss sharing. This particular technique plays the role of a cushion, or an insurance against cyclicality in returns, which the conventional bank can't rely, because it has to pay the interest charges, which are the less flexible.

Nasra (2013) conducted a study that focused on the influence of Islamic microfinance products on the welfare of Muslim community in Kisumu Municipality. It sought to assess the Islamic microfinance products available and their perceived influence on certain aspects of welfare of Muslim community in Kisumu Municipality. She concluded that musharaka and murabaha have a bigger impact on the welfare of members of Kisumu municipality in comparison to the other financial products.

Mwatuwano (2012) carried out an evaluation of the performance of islamically screened portfolios at the Nairobi Stock Exchange. Her results showed that there was no significant difference between the risk and raw returns of the conventional portfolio and Islamic portfolio. All the studies conducted in relation to Islamic banks, can be redirected to Islamic cooperatives and the impact of the implementation of Islamic financial practices on the performance of cooperatives in Northern Kenya brought out.

2.5 Summary of Literature Review

From the above studies, it is clear that the implementation of Islamic financial practices has some impact on the performance of a cooperative. Although no direct studies have been done to suggest the relation between the performance of cooperatives and implementation of Islamic financial practices in Mandera County, this paper will be majorly geared towards providing clear answer on the topic. The analysis is important as this part of the country is majorly populated by Muslims who prefer and are usually adamant that all the services that are offered to them be islamically correct and acceptable.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the general methodology that was used to conduct the study. It specifies the research design, target population, sampling design, data collection method and instruments, and data analysis and interpretation.

3.2 Research Design

Research design is the method of carrying out the research (Babbies 1973). In this study, a descriptive survey research design utilizing both qualitative and quantitative approaches will be employed. According to Babbies (1973), descriptive survey research design utilizes both qualitative and quantitative approaches. The design is preferred because it is concerned with answering questions such as who, what, which, why and when (Cooper, 2001). A descriptive study ensures complete description of the situation making sure that there is minimum bias in the collection of data, (Boyd, 2006). Description is sometimes the only way to study behavior or situation which cannot be done through experiment (Heinman, 2001).

Descriptive research design was used for collecting data to answer the current status of the subject of study. Descriptive research involves either identifying the characteristics of an observed phenomenon or exploring possible correlations among two or more phenomena. Therefore descriptive research was justified for this study since the objective was to provide a systematic description that is factual and accurate as possible.

3.3 Target Population and Sampling

The major focus of the study was the county of Mandera in northern Kenya. The county has 32 cooperative societies, out of which 18 are active and the rest are dormant (Mandera County Government Plan, 2013). Our study targeted the 18 active cooperatives and more so, tried to bring out clearly the contributions that implementing the Islamic financial practices have to the cooperatives that implement them and the performance of those that do implement the Islamic financial practices. Sampling design is the process of selecting a sample size from the population to be used in the study. Sample size is a fraction representing the target population in a research (Westlund, 2000). Due to the small number of cooperatives in Mandera County, no sampling was done and the entire population was used.

3.4 Data Collection Methods

The study used secondary data. The use of information from the cooperatives as a major source of secondary data was justified by the fact that most of the cooperatives are legally required to maintain accurate and up to date information about their operations and as such the data that they will be having will be reliable. The financial statements of the cooperatives were utilized. In analyzing the financial statements, the revenues generated by the various Islamic financial practices were analyzed. This was done with the financial statements of the cooperatives for the past 5 years. In the collection of data, the importance of validity and reliability was greatly emphasized.

3.5 Data Analysis

To achieve the objective of the study, multiple regression analysis was used. The equation was specified as follows;

3.5.1. Analytical Model

$Y = A + RX_1 + PX_2 + QX_3 + WX_4 + VX_5 + e$

Where

Y represents the performance of cooperatives in Mandera County, this is the dependent variable.

X_1 to X_4 represents the independent variables where

X_1 is Musharaka

X_2 is Murabaha

X_3 is Mudaraba

X_4 represents the other Islamic financial practices

X_5 is technology usage which is a control variable

R, P, Q, V and W are the coefficients that capture and quantify the impact of the various independent variables on the performance of the cooperative.

To measure variables X_1 to X_5, income generated from the respective engagements as a percentage of the total net income of the cooperative.

3.5.2. Test of Significance

T-test was used to test the hypothesis that there is a relationship between the variables. Coefficient of Determination (R^2) was used to provide a measure of how well the observed outcomes are replicated by the model, as the proportion of total variation of outcomes explained by the model.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter presents analysis and findings of the research. The objective of this study was to establish the effect of Islamic financial practices on the financial performance of cooperatives in Mandera County between 2010 -2014.

4.2 Descriptive Statistics

4.2.1 Musharaka Financing

Table 4.1: Amount of Musharakah used in financing

Years	Mean	Std deviation
2010	1,893,009	.019
2011	1,986,941	.024
2012	2,487,345	.018
2013	2,578,244	.041
2014	2,736,052	.069

Source: Research findings (2015)

From the findings the year 2010 recorded the lowest amount of Musharaka used in financing as shown while 2014 recorded the highest amount of Musharaka used in financing as shown, in addition, values for standard deviation depicts variability in amount of Musharaka used in financing during the five year period .

4.2.2 Murabaha Financing

Table 4.2: Murabaha financing

Years	Mean	Std deviation
2010	547,672	.251
2011	567,454	.041
2012	604,251	.016
2013	641,000	.041
2014	671,423	.234

Source: Research findings (2015)

From the findings the year 2010 recorded the lowest amount of Murabaha used in financing as shown by 547,672 while 2014 recorded the highest amount of Murabaha used in financing as shown by 671,423, in addition, values for stardard deviation depicts variability in amount of Murabaha used in financing during the five year period.

4.2.3 Mudaraba Financing

Table 4.3: Mudaraba financing

Years	Mean	Std deviation
2010	457,364	1.25
2011	463,152	.037
2012	450,977	.056
2013	480,791	.021
2014	501,841	.007

Source: Research findings (2015)

From the findings the year 2012 recorded the lowest amount of Mudaraba used in financing as shown by 450,977 while 2014 recorded the highest amount of Mudaraba used in financing as shown by 501,841, in addition, values for stardard deviation depicts variability in amount of Mudaraba used in financing during the five 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 five year period.

4.2.4 Other Islamic Financial practices

Table 4.4: other Islamic Financial practices

Years	Mean	Std deviation
2010	69,479	.139
2011	77,823	.029
2012	78,324	.011
2013	85,749	.159
2014	94,987	.058

Source: Research findings (2015)

From the findings, it was revealed the years 2010 recorded the lowest amount of other Islamic financial practices used in financing as shown by 69,479 while 2014 recorded the highest amount of other Islamic financial practices used in financing as shown by 94,987, in addition, values for stardard deviation depicts variability in amount of other Islamic financial practices used in financing during the five 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 other Islamic financial practices used in financing during the five year period.

4.2.5 Technology usage

Table 4.5: Technology usage

Years	**Median**	**Minimum**	**Maximum**	**Mean**	**Std deviation**
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 (2015)

From the summary 2010 recorded the lowest value for technology usage at 0.0543 while 2014 recorded the highest value for technology usage at 0.0857, In addition, values for stardard deviation depicts variability in value for Firm size during the five year period with the highest deviation of 0. 326 in the year 2011 and the lowest at 0.118 in the year 2014, the findings revealed a significant increase in technology usage during the seven year period.

4.3 Diagnostic statistics

4.3.1 Test for Multicollinearity

Collinearity is defined as the linear association between two independent variables. Multicollinearity refers to the correlation of three or more independent variables. The presence of this relationship among the independent variables distorts the standard error and hence leads to problems when conducting tests for statistical significance of parameters. To determine the presence of the problem among the independent variables in this study, variance inflation factor (VIF) values were used. The measure indicates the degree to which an independent variable is explained by another independent variable (Hair et al, 2006). Table 4.1 showed the range of the VIF values

Table 4.6: Variance Inflation Factor Values

Statistic	Musharaka	Murabaha	Mudaraba	Other Islamic financial practices	Technology usage
VIF	1.634	1.781	1.423	1.563	2.112

From the table, the tolerance values range between 2.112 to 1.423 which are within the acceptable margin as per Gujarati (2013) who stated that the rule of thumb regarding the benchmark for VIF is that if the value does not exceed 10, there is no need for concern.

4.3.2 Goodness of fit statistic

The study used amongst other statistics, the Durbin Watson test to check that the residuals of the model were not autocorrelated since independence of the residuals is one of the basic hypotheses of regression analysis. The figure obtained for Durbin Watson statistic is 1.875 which is close to the mark that is prescribed by researchers, which is 2.0

4.4 Correlations

Table 4.7: Correlations

		Return On Assets	Musharakah Financing	Murabaha Financing.	Mudaraba Financing	Other Islamic practices	Technology usage
Return on assets	Pearson Correlation	1	.367	.418**	.298*	.418**	.767**
Musharakah financing	Pearson Correlation	.367	1	.016	.005	.103	.293*
Mudaraba financing	Pearson Correlation	.418**	.016	1	.746**	.021	.168
Murabaha financing	Pearson Correlation	.298*	.005	.746**	1	.052	.058
Other Islamic financial pratices	Pearson Correlation	.418**	.103	.021	.052	1	.580**

Source: Research findings (2015)

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 other Islamic financial practices , 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 technology usage as shown by correlation coefficient of 0.767, the significant value was 0.003 which is less than 0.05. The findings further agree with Ayodele (2011) who found out that strong positive correlation between Musharaka financing and return on assets.

4.5 Islamic financial practices and financial performance

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 is presented in the table below.

Table 4.8: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.819[a]	.670	.653	.37270

Source: Research findings (2015)

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 0.653 and which implied that 65.3% 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 other Islamic financial practices used in financing and Technology usage used in financing).

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

Table 4.9: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.244	.094	.239	2.585	.000
Musharakah financing	.412	.134	.401	3.125	.011
Murabaha financing.	.369	.128	.346	2.913	.016
Mudaraba financing.	.248	.075	.210	3.208	.004
Other Islamic financial practices	.359	.104	.323	3.471	.018
Technology usage	.699	.126	.579	5.576	.008

Source: Research findings (2015)

As per the SPSS generated output as presented in table above, the equation

($\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon}$) becomes:

$\mathbf{Y = 0\ .244 + 0.412\ X_1 + 0.\ 369 X_2 + 0.248 X_3 + 0.359 X_4 + 0.699 X_5}$

From the regression model obtained above, a unit change in musharaka financing holding the other factors constant would lead to increase in return on assets by a factor of 0.412, a unit change in Murabaha financing while holding the other factors constant would an increase in return on assets by a factor of 0.369, 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 0.248, a unit change in other Islamic financial practices, while holding the other factors constant would lead to an increase in return on assets by a factor of 0.359, a unit change in technology usage while holding the other factors constant would lead to an increase in return on assets by a factor of 0. 699.

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 $\alpha=0.05$. 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 $\alpha=0.05$.

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

The research investigated the relationship between amount used in Musharakah by cooperatives in Mandera county and ROA. The research findings showed an evidence of positive correlation between Musharakah means of financing and the performance of cooperatives. The study also established that members 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 (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 revealed positive correlation between return on assets and Murabaha financing. 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 0.369. 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 also 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 cooperatives, would lead to an increase in Return on Assets by a factor of 0.248. 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 found that there was positive correlation coefficient between return on assets and other Islamic financial practices, the research also established that a unit change in other Islamic financial practices, while holding the other factors constant would lead to an increase in Return on Assets by a factor of 0.359. The study found a strong positive correlation between technology usage and Return on assets, the value for coefficient of variation was 0.699, implying that unit change in technology usage while holding the other factors constant would lead to an increase in return on assets.

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 relationship between Islamic financial practices and performance of cooperatives in Mandera County.

5.2 Summary of findings

The research investigated the relationship between amount used in Musharaka by Islamic cooperatives and ROA. The research findings showed an evidence of positive correlation between Musharaka financing and the performance of cooperatives. The study also established that members preferred Musharaka.

The study established a strong relationship between Mudaraba means of financing and financial performance of cooperatives in Mandera County. The coefficient of variation showed that a unit increase in Mudaraba financing by cooperatives, would lead to an increase in Return on Assets by a factor of 0.248, the findings are in line with the call by Usmani (1998) that this instrument should be used as a transitory step taken in the process of making economies more Shari'ah compliant. And its use should be restricted only to those cases where Murabaha and Musharaka are not practicable.

The study found a positive correlation between return on assets and Murabaha financing as shown by correlation coefficient of 0.369, 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 a positive correlation between the return on assets and the implementation of Islamic financial practices in Mandera County. These practices include Istisna and Qardh Hassan. The other Islamic practices are used in one way or the other by the different cooperatives and they were found to positively impact the performance of the cooperatives positively.

The study found that there was positive correlation coefficient between return on assets and other Islamic financial practices, the research also established that a unit change in other Islamic financial practices, while holding the other factors constant would lead to an increase in Return on Assets by a factor of 0.359. The study found strong positive correlation between performance of cooperatives and technology usage. The technologies that the cooperatives implemented enable them to attract new members and retain their existing members while ensuring that their members are well informed of all the happenings in the cooperatives.

The study also found that the existence and the performance of the cooperatives in Mandera County were greatly influenced by whether they implement islamically acceptable practices or not. Members mostly prefer to engage with cooperatives that are islamically compliant.

5.3 Conclusions

The study found a positive correlation between performance of cooperatives and Islamic financial practices which include Musharaka financing, Mudaraba financing, Murabaha financing and other Islamic financial practices., Thus the study concludes that all the Islamic financial practices had a positive impact on the performance of cooperatives in Mandera county.

The study found that the most popular Islamic practice among the cooperatives was Musharaka and Mudaraba as they can be applied either in project financing of saving mobilization. In the case of a success, the profits will be shared based on the predetermined rate and in the case of a loss; it will be borne by the cooperative. Under this setting, the cooperative will have to play a monitoring and evaluation role over the entrepreneurs to ensure that the project does not fail.

Murabaha is preferred as it is an asset backed transaction that would prevent the possibility of diverting funds other than the requested funds. In the context of cooperatives, this would ensure that the cooperatives are protected from excessively diverting funds that are not collateralized. This scheme is easily implemented and as such less costly to the cooperatives.

Islamic schemes of transaction guarantee and encourage the participation of every segment of the society. In particular, the implementation of the Islamic participatory approach in fund mobilization and financing promotes justice, brotherhood, social equality and financial inclusion of the poor. In regards to the cooperatives, they will be able to achieve the societal goodwill that will help boost the number of members they have and also have good deposit injections and as such more potent returns.

The study found strong positive correlation between technology usage and the performance of cooperatives in Mandera County, thus indicating that cooperatives need to invest more in the new technologies and utilize them well in order to ensure their survival and sustenance.

5.4 Policy Recommendations

Based on the study findings the research recommends that cooperatives in Mandera county need to continue implementing Islamic financial instruments as they were all found to positively influence their performance. The findings revealed that technology usage is also positively related to the performance of the cooperatives in Mandera County. More measures should be implemented at both the county and national level to ensure that the cooperatives in Mandera County are able to offer these services and enable their members to benefit from them.

The study recommends that the national and county governments ensures that the boards and management of the cooperatives are compliant in relation to maintaining up to date and accurate financial statements as this is the only way through which the members and the management of a particular cooperative will be able to survive and thrive. If the cooperatives do not comply to this, room for theft and misappropriation will be created. The cooperatives in collaboration with both the national and county governments should conduct trainings for their members to enable them to acquaint themselves well with the provisions of the various Islamic practices and as such benefit from them.

Both the national and county governments should embark on a campaign that is meant to enlighten the county residents of the advantages of forming cooperatives and the benefits that they will derive from coming together including being able to come together and conducting transactions that are sharia compliant.

5.5 Limitations of the Study

The study covered a period of only five years. However, some cooperatives within the population introduced Islamic financial practices recently. This make it difficult to capture the years which the cooperatives had not introduced the Islamic financial practices.

The analysis done relied on secondary data which had already been compiled by cooperatives. 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. Most of the cooperatives in Mandera County are not strictly supervised and as such not compliant, obtaining information and statements that are organized in an orderly and formal manner was very difficult.

5.6 Recommendations for Further Research

The study sought to determine the relationship between Islamic financial practices and performance of cooperatives in Mandera County. The research recommends that similar studies need to be done to determine the relationship between Islamic financial practices and performance of cooperatives in other counties in Kenya.

The study also recommends that further studies be undertaken to determine why there are very few formal cooperatives operating while in reality the practice on which cooperatives are based is being implemented and utilized especially in the northern part of Kenya.

The study also recommends that further studies be undertaken to understand why Muslims are so resistant to anything that bears interest and what can be done to ignite their potential in terms of finance.

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APPENDIX I

DATA COLLECTION TEMPLATE

Name of Cooperative ____

Year	**2010**	**2011**	**2012**	**2013**	**2014**
Total assets					
Returns on assets					
Musharaka engagements					
Mudaraba engagements					
Murabaha engagements					
Other Islamic financial practices engagements					
Technology usage					