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

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

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Abstract

Purpose: The purpose of this study was to establish the effect of Islamic banking on investment financing in Islamic banks in Kenya.

Methodology: This study employed descriptive survey design. The population of this research consisted of 8 commercial banks offering Shariah compliant products. The study used secondary data for the period 2009 to 2012. Data was analyzed using Statistical Package for Social Sciences (SPSS) and results were presented in frequency tables and figures. The data was then analyzed in terms of descriptive statistics like frequencies, means and percentages.

Results: The study findings indicated that there were various Islamic banking products that Islamic banks used to finance their investments. This included motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing. The study also indicated that there were various modes of financing used by Islamic banking such as profit and loss sharing, Ijara and murahaba. Regression results revealed that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively correlated.

Unique contribution to theory, practice and policy: The study recommends that the management of the banks to get well equipped and competent employees on Islamic banking products as most Islamic banks are currently managed by people who have been educated and trained in the conventional banking system. Thus, more time may be required for the unique characteristics of Islamic financial instruments to be completely accepted and understood by both bank personnel and customers. It is also recommended that the terms and conditions of acquiring a loan be made more appealing and considerate for more investors to approach the banks for assistance as the Shari`ah restricts the type of businesses for which Islamic banks can provide financing.

Keywords: *Islamic banking, investment financing, mudarabah, profit and loss sharing*

1.0 BACKGROUND OF THE STUDY

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

The term "Islamic banking" means conduct of banking operations in consonance with Islamic teachings. If there is one distinguishing characteristic of the Islamic economy, it is the prohibition of *Riba*. This is nothing new. The ban on *Riba* was already observed in the medieval Muslim world (Udovitch, 1979) and famous scholars such as al-Ghazali took the ban on *riba* for granted (Ghazanfar & Islabi, 1990). The literal meaning of *riba* is 'increase' or 'addition' or 'surplus'. In the sharia, *riba* stands for an addition to the principal and, by implication, for a payment for the use of money which has been fixed beforehand (Visser, 2009). It is a form of excess, of unjustified appropriation of income, and it therefore is at variance with the principle of brotherhood and with Islamic ideas about income distribution (Choudhury, 1986). For those who see the ban on *riba* as the cornerstone of Islamic economics, all forms of interest are forbidden and no discussion is possible on this fundamental tenet (Uzair, 1978). Islamic banks are supposed to offer instruments consistent with the religious beliefs and cultural characteristics of Muslim societies. According to prevailing interpretations of Islamic Law, financial instruments should emphasize profit-and-loss sharing (equity) (Aggarwal & Yousef, 2000).

According to Ndungu (2010), Islamic Finance is so far the fastest growing segment in the global financial industry. Despite the global financial crisis, Islamic finance has demonstrated strong growth with new areas of business such as mutual funds and Takaful industry attracting a lot of attention. We need to understand this business model that will support our relative comparative advantage in the EAC region. Kenya was the first country in the East and Central African region to introduce Islamic banking. In this regard, two banks were licensed in the last two years to 3 exclusively offer Shariah compliant products with many other conventional banks establishing a window specifically for Shariah compliant products.

The potential for Islamic-banking services has even attracted the attention of conventional banking giants such as City bank and Hong Kong and Shanghai Banking Corporation (HSBC). These industry behemoths have created special subsidiaries or windows to attend to the demand for these services. Indeed Western banks such as Switzerland's UBS target both Muslim and non-Muslim investors with their Islamic investment products (Iley & Megalli, 2002). If,

however, Islamic finance is offered alongside conventional finance, the range of products offered to the public is widened; greater choice is in principle a good thing (Visser, 2009).

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

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

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

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

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

Islamic banks in Kenya account for one per cent of gross assets in the banking sector, the Central Bank of Kenya (CBK). Gulf African Bank and First Community Bank, the two Islamic banks currently operating in Kenya, have a combined loan portfolio of Ksh4.9 billion, customer deposits of Ksh7.5 billion and 27,270 deposit accounts. The banks appeal not just to Kenya's

Muslim population but also to non-Muslims who are looking for an alternative to conventional banking. Islamic banking is based on the principles of the Sharia, which prohibits the collection or payment of interest on money loaned and imposes the sharing of profit and loss (CBK, 2012).

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

1.1 Problem Statement

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

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

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

1.2 Research Objective

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

2.0 LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Islam and the Theory of Interest

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

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

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

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968 (The English version was not published until 1983.) His Islamic banking model was based on *mudaraba* and *shirka* (partnership or *musharaka* as it is now usually called). His model was essentially one based on a two-tier *mudaraba* financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank

into three categories: services based on fees, commissions or other fixed charges; financing on the basis of *mudaraba* and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

2.1.2 Profit and Loss Sharing (PLS) Theory

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

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

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

2.2 Empirical Review

Sudin and Wan (2008) while investigating the impact of selected economic variables on deposits level in the Islamic and conventional banking systems in Malaysia found that recent econometric rates of profit of Islamic bank, rates of interest on deposits of conventional bank, base lending rate, Kuala Lumpur composite index, consumer price index, money supply and gross domestic product have different impact on deposits at both Islamic and conventional banking systems. In most cases, customers of conventional system behave in conformity with the savings behaviour theories. In contrast, most of these theories are not applicable to Islamic banking customers. Therefore, there is a possibility that religious belief plays an important role in the banking decisions of Muslim customers.

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

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

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

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

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

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

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

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

In many cases, the bank invests the four sources of funds in a 'commingled' asset pool. If the aggregate investment portfolio yields a profit, then the shares of profit are allocated between the

parties; saving accounts, investment accounts¹, and stockholders, according to the proportionate shares of their respective investments in the portfolio. The bank's share of profit relates to both its shareholders' own funds and to current accounts funds. However, the shareholders also receive the mudarib share (asset manager) according to predetermined rate (Archer & Karim, 2009).

While this profit allocation mechanism seems fair and straightforward, crucial and controversial decisions should be taken to implement it. These decisions include determination of: methods of profit measurement, recognizable income and expenses that are applicable to IAH funds, reserves and smoothing practices, range of weights and profit-sharing ratios applicable to various tenors of IAH funds and comingled funds of the shareholders (Islamic Financial Services Board, 2010). In his study Oundo (2009) noted that many mainstream banking clients who demand Shariah-compliant products, are the many poor people who insist on these products (CGAP, 2008). The emergence of Islamic banks in Kenya had been an outcome of the demand by mainstream banking clients for Shariah-compliant products. Whereas the mainstream banking sector had options for their Muslim clients, poor micro entrepreneurs had no option of Islamic Microfinance products. The study reveals that due to lack of options most respondents accessed loans from the available institutions as a coping strategy. The study also assessed the knowledge of the respondents on the existence of a Kenyan MFI that provided Shariah-compliant products. All respondents said they had no knowledge of any Islamic MFI in the country and had never heard of one. Asked whether they would switch over to Islamic MFIs if given the option, all respondents responded in the affirmative. This confirmed the existing market niche.

3.0 RESEARCH METHODOLOGY

This study used descriptive survey design. The population of this study was all commercial banks offering Islamic banking products in Kenya. They comprise of to fully fledged Islamic banks (Gulf African Bank and First Community Bank) and six conventional banks that offer partial Islamic banking (Barclays banks, National Bank, Chase Bank, Imperial Bank, Diamond Trust and Standard Chartered Bank). Due to the small number of bans, a census of all these bans was conducted. Secondary data was utilised in this study. SPSS was used to produce frequencies, descriptive and inferential statistics which were used to derive conclusions and generalizations regarding the population.

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

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

Where;

Y= Loans advanced to customers for Islamic bank products

X₁= Motor vehicle financing using Islamic bank finance

X₂= Mortgage services financing using Islamic bank finance

X₃= Asset financing using Islamic bank finance

X_4 = Real estate financing using Islamic bank finance

X_5 = Trade financing using Islamic bank finance

X_6 = SME finance using Islamic bank finance.

α = constant

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$, = beta coefficients

μ = error term

4.0 RESULTS AND DISCUSSIONS

4.1 Descriptive Statistics

4.1.1 Loan Advanced to Customers for Islamic Banking Products

The study sought to determine the loans advanced to customers for Islamic banking products. Figure 1 indicates that loans advanced to customers for Islamic banking products have gradually increased from year 2009 to 2012. The increase may be explained by low interest rates charged and fair terms and conditions on borrowing.

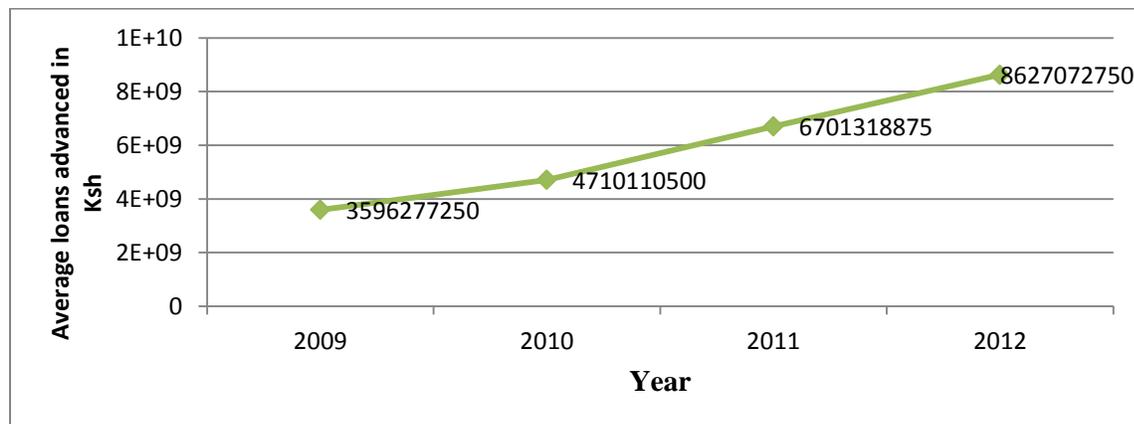


Figure 1: Trend Analysis of Loans Advanced to Customers

4.1.2 Islamic Banking Products

4.1.2.1 Motor vehicle Financing

Results on Figure 2 illustrates that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from post-election violence and people were ready to start ventures all over again and the decrease in following years was may be due to fears of elections in 2013.

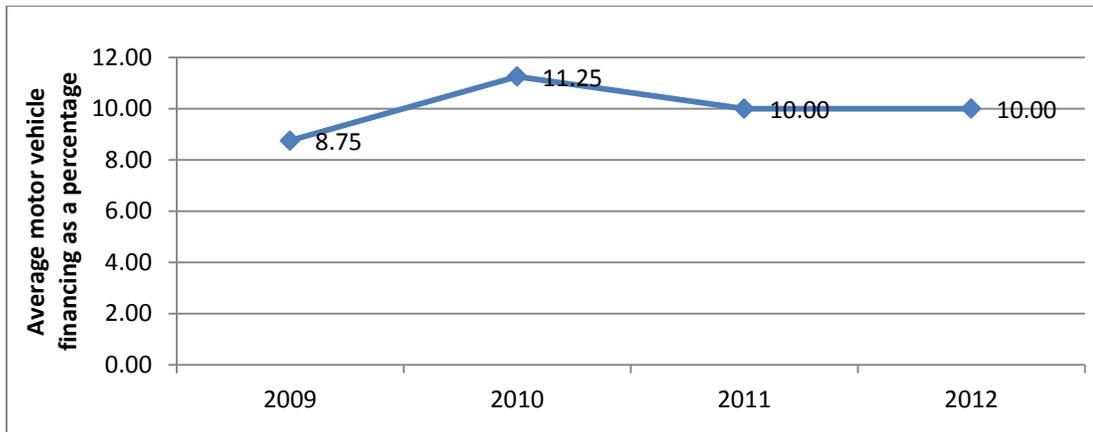


Figure 2: Trend Analysis of Motor Vehicle Financing

4.1.2.2 Mortgage Financing

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

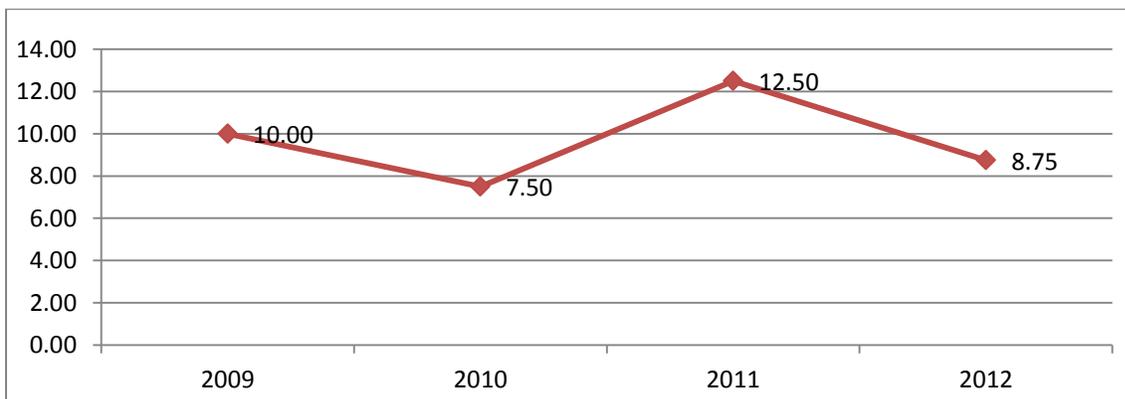


Figure 3: Trend Analysis of Mortgage Financing

4.1.2.3 Asset Financing

Figure 4 shows that there was a gradual increase in the year 2010 and then followed by slight decrease in the following years. This may be as a result of many investors turning into mortgage financing more than asset financing as indicated in the trend analysis for mortgage financing.

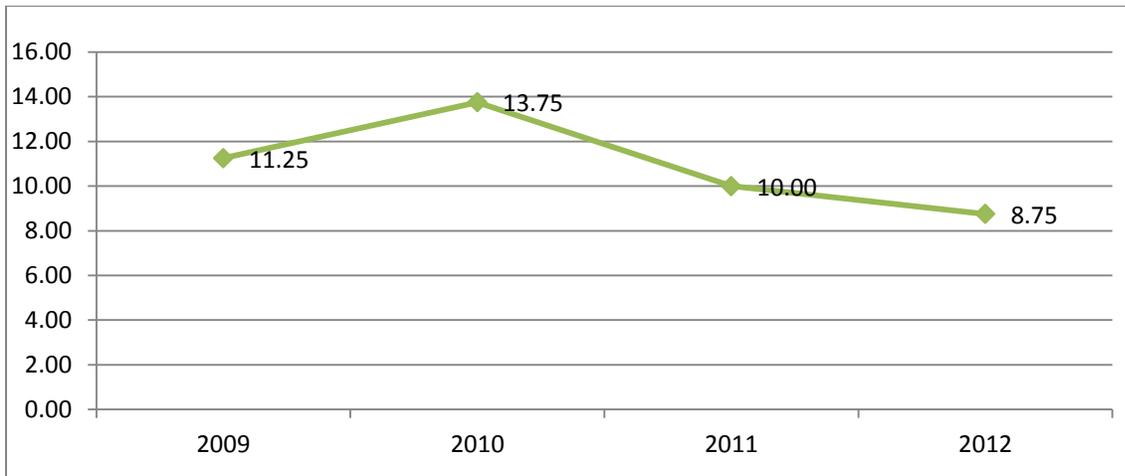


Figure 4: Trend Analysis of Asset Financing

4.1.2.4 Real Estate Financing

The study sought to find out how the Islamic banks distribute their finances on real estate financing.

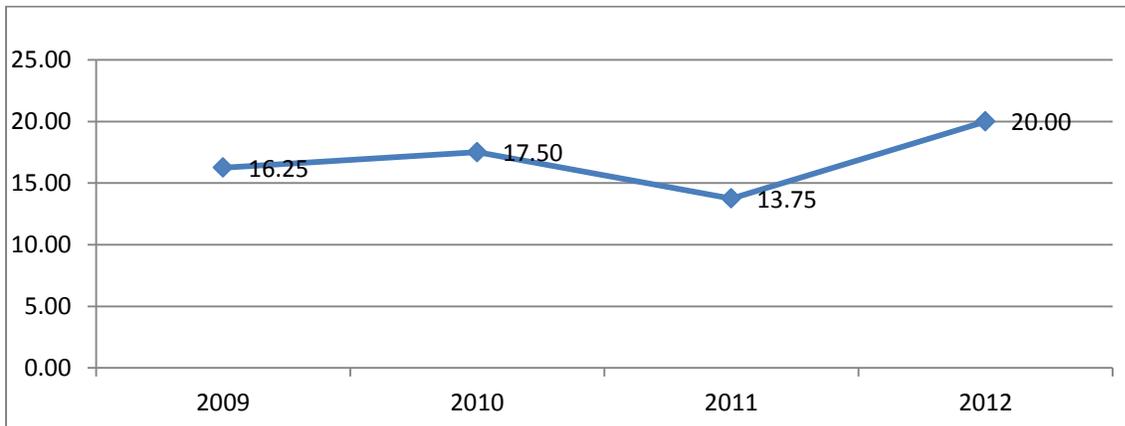


Figure 5: Trend Analysis of Real Estate Financing

Figure 5 illustrates that there was a percentage increase in the year 2010 to 17.5% amount distributed in real estate financing, followed by a slight decline in 2011 to 13.75% and a gradual shoot to hit 20% in the year 2012. The findings imply that more investors are focusing on real estate business as every Kenyan wants to own a home or a business unit. Real estate has also been lately seen as a business opportunity to venture into hence the rise for banks to advance loans to customers via real estate financing.

4.1.2.5 Trade Financing

Figure 6 illustrates that there was a slight increase in percentage for trade financing in the year 2010, followed by a gradual decline in 2011 and a rapid increase in the year 2012.

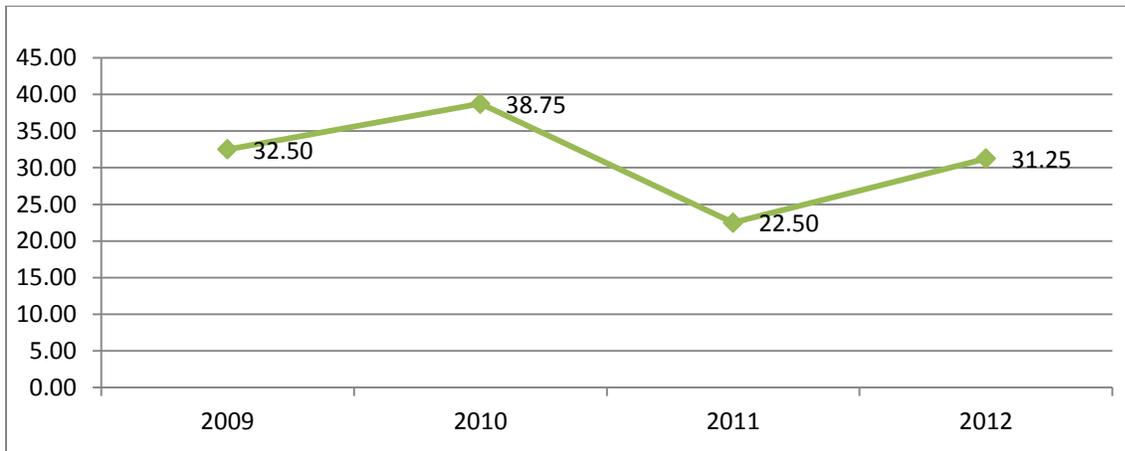


Figure 6: Trend Analysis of Trade Financing

4.1.2.6 SME Financing

Figure 7 shows that there was a rapid decrease in SME financing in the year 2010 to hit a low of 8.75%, followed by a slight increase to 11.25% in 2011 and a slight decline to 10% in 2012. This may be explained by the inflation changes in the country hence the businesses were doing so badly thus many investors withdrawing from small business enterprises.

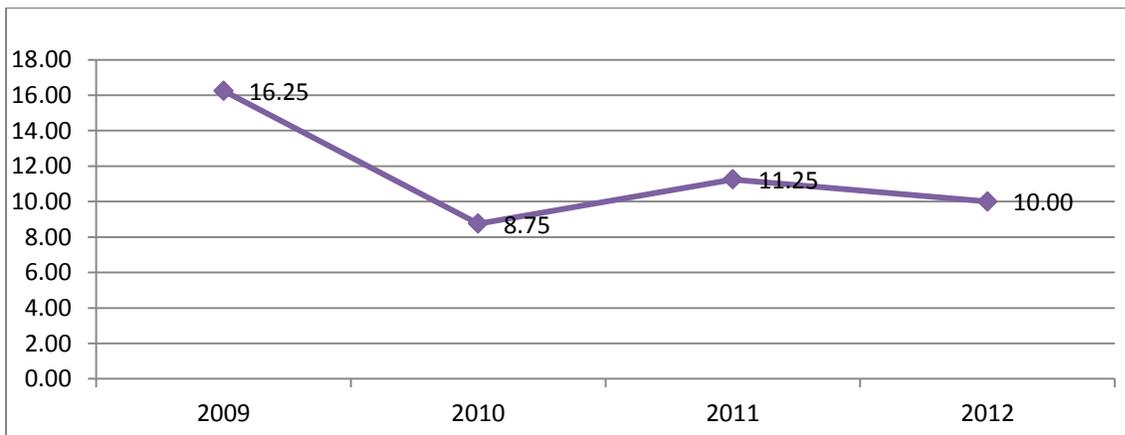


Figure 7: Trend Analysis of SME Financing

4.1.3 Mode of Financing Islamic Banking Products

4.1.3.1 Profit and Loss Sharing

Figure 8 indicates that there was steadily increase in percentage in the profit and loss sharing mode of financing in the years 2009, 2010 and 2011 and a slight decrease in the year 2012. This could be explained by the election campaigns taking place in the country thus low business ventures in the year 2012.

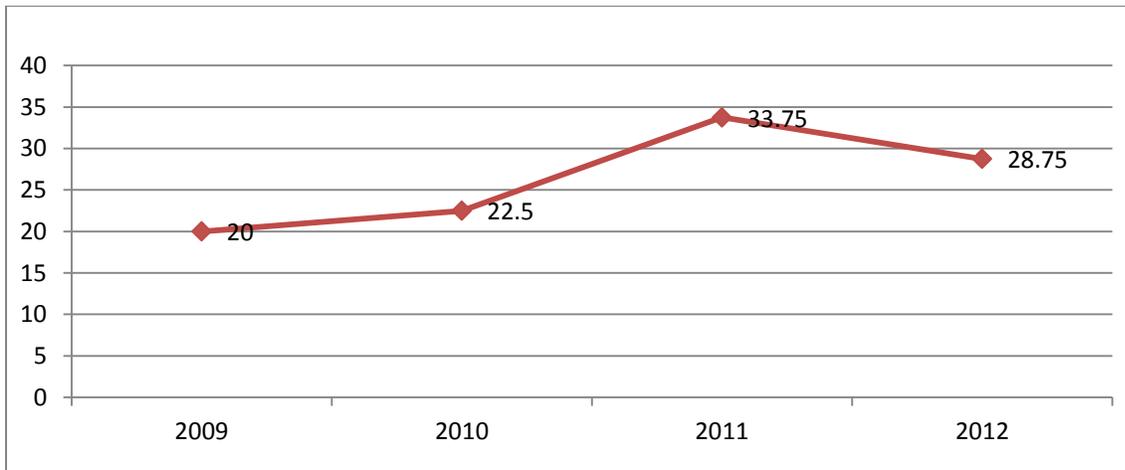


Figure 8: Trend Analysis for Profit and Loss Sharing

4.1.3.2 Ijara & Ijara wa Iqtina

Figure 9 reveals that there was inconsistency in the years of study for Ijara & Ijara wa Iqtina as a mode of financing. There was no consistency as there was a slight increase in the year 2010, then gradual decline in 2011 and a steady increase in 2012.

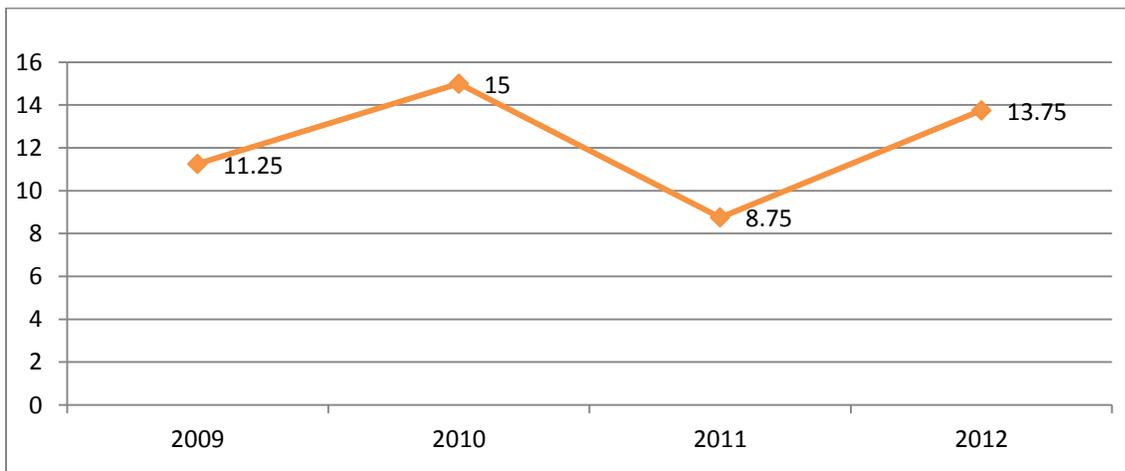


Figure 9: Trend Analysis for Ijara & Ijara wa Iqtina

4.1.3.3 Muharaba

Results on Figure 10 indicate that there was a slight increase in 2010 to hit a high of 41% and then followed by consistent decrease in the following years to hit a low of 20% in the year 2012.

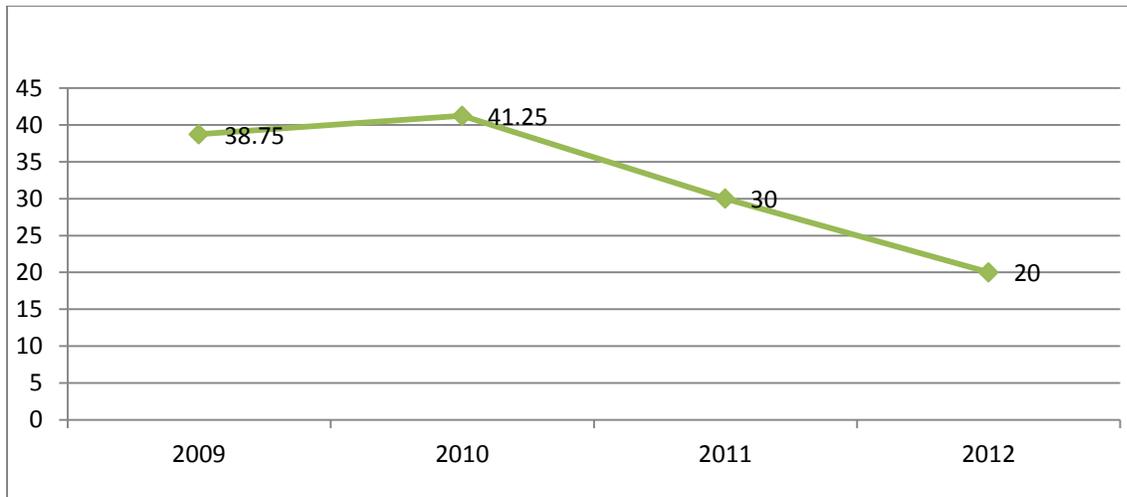


Figure 10: Trend Analysis for Muharaba

4.1.3.4 Other Modes of Financing

Figure 11 illustrates that there were other modes of financing that Islamic banks used to finance its customers with. However they were not consistent as there were highs and lows across the years of study. This other modes of financing could include mudarabah (trust financing), musharakah (equity financing), qard al-hassan (welfare loan), bay` bi al-thaman al-ajil (deferred payment financing), and and istisna` (progressive payments).

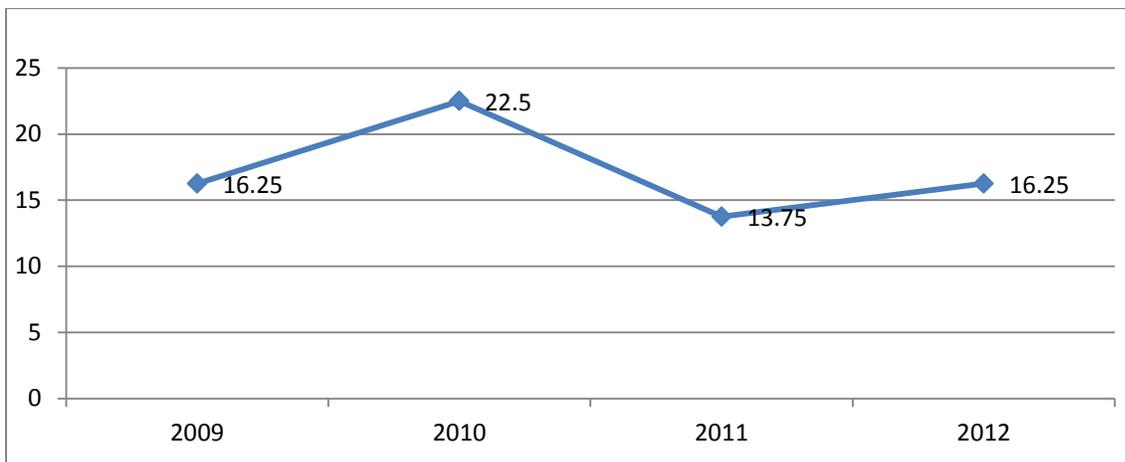


Figure 11: Trend Analysis for Other Modes of Financing

4.1.4 Nature of the period taken to finance Islamic banking products

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

4.1.4.1 Short Term

Figure 12 shows there were an increase in percentage the duration taken by banks to finance their investments via short term. The trend shows there was consistent increase from 31% in 2009 to 43% in the year 2012. The findings imply that most of the investors were taking loans for short term.

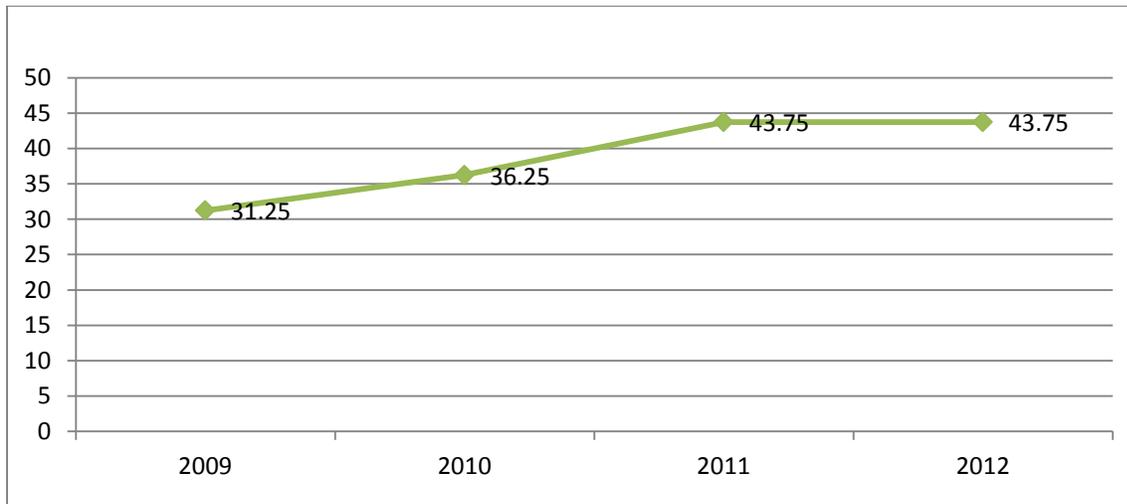


Figure 12: Trend Analysis for Short Term

4.1.4.2 Medium Term

Figure 13 illustrates that there was a slight increase in the year 2010 to hit a high of 21% followed by a slight decline in 2011 to hit a low of 16% and then gradually increased to 25% in the year 2012.

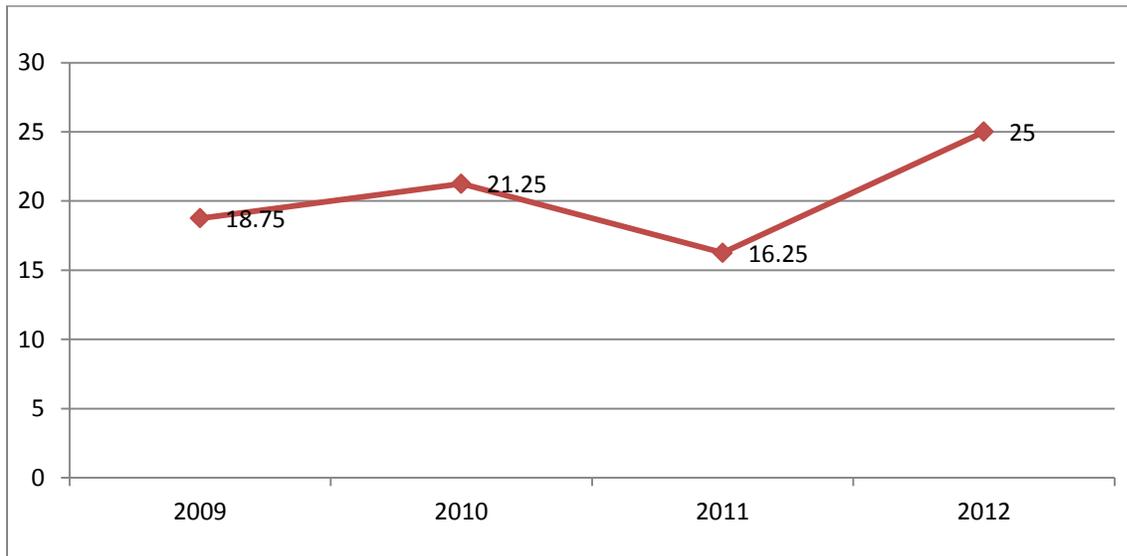


Figure 13: Trend Analysis for Medium Term

4.1.4.3 Long term

Figure 14 illustrates that there was a gradual decline to hit a low of 23% in 2011 followed by a rapid shoot to 33% in the year 2012. This could mean that most of the mortgages given fall under this category hence variations across the years.

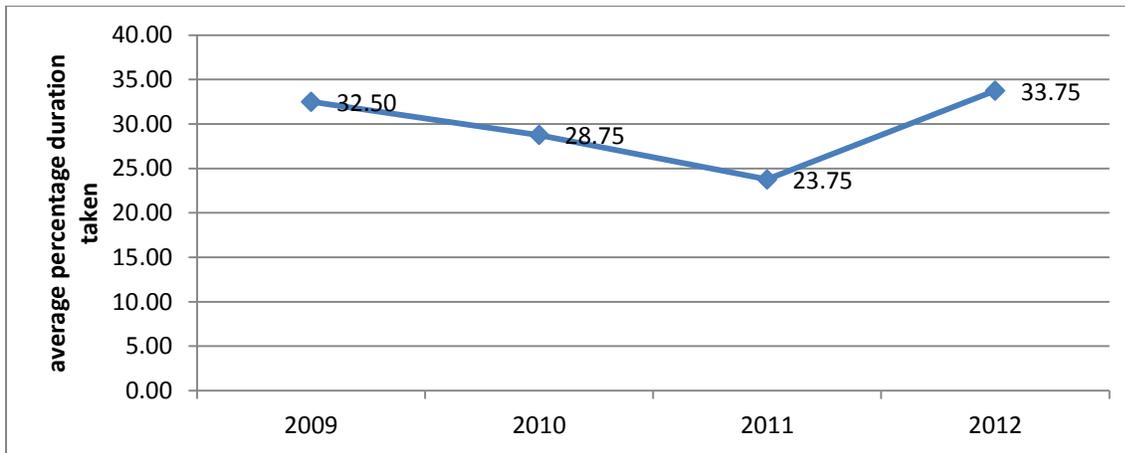


Figure 14: Trend Analysis for Long Term

4.2 Model Results

This section presented the model results. Result in table 1 indicates that the goodness of fit of the model was adequate. This is reported by an r squared of 0.865 which means that 86.5% of the variation in loans advanced to customers is explained by motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing in Islamic banks. The correlation coefficient of 93% indicates that the combined effect of the predictor variables have a strong and positive correlation with loans advances. This also meant that a change in the drivers of loans advances to customers has a strong and a positive effect on loans distributed to customers.

Table 1: Model Fitness

Indicator	Coefficient
R	0.930
R Square	0.865
Std. Error of the Estimate	2.6E+09

Analysis of variance (ANOVA) on Table 2, shows that the combined effect of motor vehicle financing, mortgage financing, asset financing, real estate financing, trade financing and SME financing was statistically significant in explaining changes in loans advances to customers in Islamic banks. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05.

Table 2: Analysis of Variance (ANOVA)

Indicator	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.1E+21	6	1.8E+20	27.775	0.000
Residual	1.7E+20	26	6.6E+18		
Total	1.28E+21	32			

Table 3 displays the regression coefficients of the independent variables. The results reveal that motor vehicle financing was statistically significant in explaining loans advanced to customers in Islamic banks. However mortgage financing, asset financing, real estate financing, trade financing and SME financing were not statistically significant in explaining loans advanced to customers in Islamic banks but they were positively.

Table 3: Regression Coefficients

Variable	Beta	Std. Error	t	Sig.
Motor vehicle financing	1.8E+08	6.6E+07	2.755	0.011
Mortgage	9.5E+07	8.5E+07	1.114	0.275
Asset financing	1.8E+07	6.6E+07	0.266	0.793
Real estate	8E+07	6E+07	1.335	0.194
Trade financing	5E+07	2.5E+07	1.989	0.057
SME financing	-1E+07	6.7E+07	-0.179	0.859

5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

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

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

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

5.2 Conclusions

The study concluded that there was a gradual increase of motor vehicle financing in the year 2010 followed by slight decrease in the following year and then stabilized as it remained constant at 10%. The gradual increase in 2010 could be because the country was healing from

post-election violence and people were ready to start ventures all over again and the decrease in following years may be due to fears of elections in 2013.

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

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

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

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

5.3 Recommendations

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

It is also recommended that the terms and conditions of acquiring a loan be made reliant for more investors to approach the banks for assistance as the Shari`ah restricts the type of businesses for which Islamic banks can provide financing. For example, they are not permitted to participate in certain prohibited investments or joint venture projects considered to be detrimental to the individual, society, or the environment. As a result, the scope of mudarabah and Musharakah for Islamic banks is somewhat more limited than it is for conventional banks.

The study further recommends the banks management to ensure that during the initial development of the Islamic banking system, Musharakah and mudarabah financing should be deemphasized due to the increased risk associated with them. Nevertheless, we can expect that these Islamic financial instruments will increase in importance as the Islamic banking system continues to mature.

5.4 Suggested Areas of Further Research

Suggested areas of study should be on internal and external factors that affect the decision on sources of financing for investments in Islamic banking. This will analyze critical factors that managers ought to consider in order to make their decision on modes of financing that yield successful results. Further studies should also include the effects of sources of financing in unsuitable economic conditions, political instability and a global economic crisis. This study will

be able to come up with decisions on the best methods to source for finances during such times. A further study can also be done on the other modes Islamic financing on investments to find if the findings of this study hold true and find out whether they are also being offered in the banks. Other modes of financing would be musharakah (equity financing), qard al-hassan (welfare loan), bay` bi al-thaman al-ajil (deferred payment financing), and istisna` (progressive payments).

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