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Effects of Financial Instruments on Performance of Islamic Banks in Kenya

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Abstract:
This study sought to investigate the effect of Islamic financial instruments on the performance of Islamic banks in Kenya. Correlation analysis was carried out to investigate the strength of the relationship between the dependent variable and independent variables. Multiple regression analysis was carried out to investigate the nature of the relationship between the dependent and independent variables. Analyzing the variables collectively; it was found out that there is a strong positive significant relationship between an Islamic banks performance and different financial instruments. The study found that musharaka, Ijara and murabaha had a positive effect on return on assets. The overall regression was found to be statistically significant. The F ratio for the regression was 21.796 with a p-value of 0.0028. The independent variables reasonably explained variation in return on assets. From this it can be concluded that an increase in either of the variables of interest is associated with an increase in Islamic bank performance. This implied that the diversification and introduction of more financial instruments will enhance Islamic banks performance.The study recommends that Islamic banks in Kenya should increase their funding on musharaka, Ijara and murabaha in order to maximize return on assets for the banks.

Keywords: Islamic Banks, Financial Instruments, Musharaka, Ijara and Mudaraba

1. Introduction

Zamir (1997) defined Islamic financial instruments as instruments that meet the requirements of the Shari'ah or Islamic law. The instruments are founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return which closes the door to the concept of interest and precludes the use of debt-based instruments (Iqbal, 1997). Islamic financial instruments encourage risk-sharing, promote entrepreneurship, discourage speculative behavior and emphasize the sanctity of contract. Islamic markets offer different instruments to satisfy providers and users offunds in a variety of ways: sales, trade financing and investment. These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.

A basic theory of Islamic banking is the sharing of profit and loss since profit is lawful in Islam. Islamic banks share their profits both with their investors and their depositors (Lewis, 2001). This is because the depositors are also seen as owners of the capital used in deriving profits and they are also entitled to "interest income" from the productive utilization of their deposits, the profits generated are then shared with them in profit-sharing basis. Chapra's model of Islamic banking (Chapra 1982), was based on the *mudaraba* principle. His main concern centered on the role of artificial purchasing power through credit creation. Chapra was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. Halim (2008) on the other hand specifies that the bank's main responsibility is towards its shareholders and depositors and hence it should not be burdened with other responsibilities. Halim's view asserts that social objectives can be attained indirectly by the banks being continuously profitable, viable and sustainable. An important element of the Halim model is the complete justification of using debt financing in Islamic banking, which are permissible contracts based on various verses of the Quran. In fact, it is perfectly acceptable for the entire Islamic banking system to be based solely on debt.

In Kenya there are two fully fledged Islamic banks namely Gulf African Bank (GAB) and First Community Bank (FCB) which operate under Islamic principles. They offer Islamic financial instruments that adhere to the Islamic shariah. GAB is the first Islamic bank to be established in Kenya followed by FCB. Gulf African Bank only offers musharaka, murabaha and ijara while First Community Bank offers musharaka, mudaraba, murabaha and ijara.

Majid (2014) noted that Islamic financial instruments are financial instruments which are based and designed in compliance with Shariah (Islamic rules and principles). These financial instruments are mudaraba, musharaka, murabaha and ijara.S.Khan(1989) explained mudaraba as a contract where funds aremade available bythe owner to the entrepreneur to be invested in a productive economic activity in return for a predetermined percentage of the profits earned. In a mudaraba, the project is financed by the investor and the entrepreneur (borrower) contributes skills and experience (Kashif, 2009). Thus, in a mudaraba investors bear all the losses. In mudaraba, the lender does not participate in the management of the enterprise nor are they allowed to request for collateral to reduce credit risk (Shahinpoor, 2009). The capital provider may not interfere in the routine transactions of the manager, but may provide general technical advice, and the manager should provide periodic reports to the capital provider.

Mudaraba is similar to an investment fund where managers handle a pool of funds. The agent-manager has relative limited liability while having sufficient incentives to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customized for each investment. The maturity structure ranges from short to medium term and is more suitable for trade activities. The capital is provided by the Islamic bank while the business is managed by the other party. Losses are only borne by the mudarib (entrepreneur) if he is negligent or violates terms of the contract (Muazzam, 2005). Kashif (2009) described musharaka as a form of partnership where each party involved contributes cash to the venture and profits are distributed according to any previously agreed ratio, but losses can only be shared according to the original investment. Musharaka is a contract of business where all partners share the profit or loss of the joint venture. Profits can be shared on a predetermined mutually agreed ratio or on a pro rata basis. However, in case of losses, each partner bears losses according to his or her proportion of ratio of capital invested (Al-Suweidi, 2009). Both partners or one of them may manage the venture or alternatively both may appoint a third party manager to manage the investment (the Financial Development Report, 2009)

Musharaka provides better opportunities for the depositors to share actual profits earned by the business which in normal cases may be much higher than the rate of interest. The profits paid to the depositors cannot be added to the cost of production, since the profits cannot be determined unless the relevant commodities are completely sold, therefore, unlike the interest-based system, the amount paid to the depositors cannot be claimed back through increase in the prices. In Musharaka, loss participation by all partners across the board is justifiable because all partners are also allowed to work. Arsalan (2004) defined murabaha as a sale contract between two parties at a price which includes an agreed profit margin. The payment of acquisition price can be made on the spot, on a deferred lump sum or installment basis. It involves a financier purchasing assets required by the borrower from a seller. The assets are then sold to the borrower with a mark-up or margin. The bank or the financier acts like an intermediary between buyer and seller and does not share in profits or losses (Shahinpoor, 2009).

A murabaha is an outright sale, at a marked-up price, where the selling Islamic financial institution discloses its profit margin to the purchasing client (the borrower in a conventional transaction). It can replace a term loan and can also be used for asset-based financing transactions and mortgages (Jahangiri, 2009). Saeed (2011) defined Ijara as an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. Jahangiri (2009) argued that Ijara replicates operating and finance lease arrangements, and can also be used to replace hire purchase transactions and asset-backed financing transactions. The ijara contract is essentially of the same design as an installment leasing agreement since fixed assets are the subject of the lease, such can return to the leaser at the end of the lease period, in which case the lease takes on the features of an operating lease and thus only a part amortization of the leased asset's value results.

 The Islamic financial institution (IFI) either holds an inventory of assets, in anticipation of customer demand for leases, or buys an asset in response to a specific request. The asset thus acquired by the IFI is leased to the customer for an agreed rent payable for an agreed period of time. At the end of the lease period the asset may be returned to the IFI (as with an operating lease) or transferred to the lessee for an agreed value (as with a finance lease). The terms of Ijara are flexible enough to be applied to the hiring of an employee by an employer in return for a rent that is actually a fixed wage (Waseem, 2014).

Performance is a quantifiable indicator used to assess how well an organization is achieving its desired objectives. Many business managers routinely review various performance measure types to assess such things as results, production, demand and operating efficiency in order to get a more objective sense of how their business is operating and whether improvement is required. Islamic banks have proved to be profitable in all Gulf Cooperation Council banks except for UAE (Hadeel, 2005). That was due to high competition, and more diverse market. In markets where there are customers who are willing to deal with Islamic banks, such as, Kuwait, Bahrain, Saudi Arabia and Qatar. Islamic banks tend to have high liquidity ratios relative to conventional banks and that was due to the fact that Islamic banks cannot rely on borrowing money from central bank or any other sources (Hadeel, 2005).

To evaluate performance, it is necessary to determine the constituents of good performance using performance indicators. Financial ratios such as return on investment, liquidity and profitability are used to assess financial position of a firm (Fabozi and Peterson, 2003). The most commonly used accounting-based measure is the return on assets (ROA). It shows how profitable company's assets are in generating revenue. ROA is given by the ratio between net income and total assets.

The growing size and quality performance of Islamic banking operations is due to the increase and variety of Islamic financial tools and instruments which represent an important part of international banking operations. Offering Islamic products will have a positive effect in increasing the size of a bank's balance sheet. Assets and liabilities will increase hence their income. (Thomi, 2014). There is a strong positive significant relationship between bank performance and bank size, liquidity, murabaha and musharaka. This implies that an increase in provision of Islamic banking services in Kenyan commercial banks will lead to increase in banks performance (Thomi, 2014). Vijay and Ibrahim (2003) revealed that the profitability of Islamic banks is low due to short term investments and low equity base. In case of Islamic banks, shortterm debt financing includes Murabaha, Salam, and Qard fund and long term debt financing includes Sukuk, leasing and Istisna. The contract of mudaraba and musharaka is not popular due to lack of knowledgeable bankers in selecting, evaluating and managing profitable projects (Samad and Hassan, 2000).

1.1. Research Objective

The general research objective of the study was to examine the effect of Islamic financial instruments on financial performance of fully fledged Islamic banks in Kenya. The specific objectives were to evaluate:
    (i)   The effect of Musharaka on financial performance of Islamic banks in Kenya.
    (ii)   The effect of Mudaraba on financial performance of Islamic banks in Kenya
    (iii)   The effect of Murabaha on financial performance of Islamic banks in Kenya

(iv)   The effect of Ijara on financial performance of Islamic banks in Kenya.

1.2. Research Question
The major question for the study was: What is the effect of Islamic financial instruments on the performance of Islamic banks in Kenya?

2. Methods
The study used a descriptive design. The target population of the study was two fully fledged Islamic banks namely Gulf African Bank and First Community Bank. Secondary data on Islamic financial instrument for the period 2011-2015 was obtained from the financial statements of the two fully fledged Islamic banks namely Gulf African Bank and First Community Bank which formed the target population of this study. Descriptive analysis and inferential statistics were used to derive conclusions regarding the population. Inferential statistics such as multiple regressions and Pearson correlation was used. Data analysis involved multi-variate analysis using Statistical Package for Social Sciences (SPSS). The analytical model for this research represents how different Islamic financial instruments affect the performance of Islamic banks.

2.1. Model Specification
A multiple regression model was preferred. The model is expressed implicitly as:
$Y = \alpha + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \varepsilon$
Where:
  ➢ Y= Return on Assets measured by Total Comprehensive Incomes divided by the Total Assets
  ➢ α= Constant Term (The Y -Intercept)
  ➢ Beta (β) = Beta coefficients of the regression model
  ➢ ε= Error term.
  ➢ X_1= Percentage of Musharakah (partnership) financing to total financing
  ➢ X_2= Percentage of Mudaraba (finance by way of trust) financing to total financing
  ➢ X_3= Percentage of Murabaha (cost-plus financing) financing to total financing
  ➢ X_4= Percentage of Ijara (leasing) financing to total financing
  ➢ X_5=Bank's Asset Quality- Ratio of Non-performing loans to Total Financing

The multiple linear regression model was used to determine the relative importance of each independent variable (Islamic financial instrument) in affecting the financial performance of Islamic bank which was measured using Return on Asset of Islamic banks. Where Y is the dependent variable (financial performance) as measured by ROA which is calculated as net income to total assets (in percentage), β_1, β_2, β_3, β_4 and β_5 are the coefficients of independent variables.

3. Results and Discussions

3.1. Data Analysis and Findings

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	10	.0033	.0243	.014952	.0078451
Musharaka	10	.1462	.5930	.376745	.1756927
Murabaha	10	.2121	.5541	.391198	.0907843
Ijara	10	.0163	.0229	.020180	.0021411
Mudaraba	10	.0000	.1414	.061437	.0656386
Asset quality	10	.0223	.0906	.055721	.0188819
Valid N (listwise)	10				

Table 1: Descriptive Statistics

Table 1 provided key descriptive statistics for each variable. From the table the average return on assets (ROA) was found to be 1.495% with a standard deviation of 0.785%. The average ratio of Musharaka to total financing was found to be 37.67% with a standard deviation of 17.57%. The mean ratio of Murabaha to total financing was found to be 39.12% with a standard deviation of 9.08%. The ratio of Ijara to total financing was found to be 2.02% with a standard deviation of 0.214%.   Mudaraba to total financing averaged 6.14% with a standard deviation of 6.66%. Asset quality was reported to have an average of 5.57% and a standard deviation of 1.89%.

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	-.0260	.076		-.343	.539
Musharaka	.031	.006	.705	5.167	.039
Murabaha	.042	.011	.482	3.818	.012
Ijara	2.190	1.894	.598	1.156	.154
Mudaraba	.016	.015	.133	1.074	.209
Asset quality	.007	.322	.017	.022	.984

Table 2: Regression Coefficients

Table 2 indicates the coefficients of the independent variables for the regression. The regression constant was found to be -0.260 with a significance probability of 3.539. Musharaka had a coefficient of 0.031 with a p-value of 0.039. Murabaha was fund to have a coefficient of 0.042 with a p-value of 0.012. Ijara had a coefficient of 2.190 and a p-value of 0.154 while Mudaraba had a coefficient of 0.016 and p-value of 0.209. Asset quality had a coefficient of 0.007 and a p-value of 0.984.
The resulting regression model was:
$ROA = -0.260 + 0.031X_1 + 0.042X_2 + 2.190X_3 + 0.016X_4 + 0.007X_5$

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	126.089	5	25.218	21.796	0.0028
Residual	4.627	4	1.157		
Total	130.716	9			

Table 3: Analysis of Variance

From Table 3 the F statistic for the model is 21.796 with a significance level of 0.0028. The model was found to be statistically significant at 5% level of significance since 0.0028<0.05.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.689	.474	.306	.0210730

Table 4: Model Summary

Table 4 provides a model summary of the regression. The coefficient of determination R^2 for the model was found to be 0.474. This indicated that Musharaka, Murabaha, Ijara, Mudaraba and asset quality jointly explained 47.4% of the variation in return on assets.

4. Discussion of Findings

4.1. Effect of Musharaka on Financial Performance
The study sought to examine the effect of Musharaka on the financial performance of Islamic banks. The study found that Musharaka had a positive effect on return on assets. As reported in Table 2 the coefficient of Musharaka was found to be 0.031. The coefficient had a significant probability of 0.039. The effect of Musharaka on return on assets was found to be statistically significant at 5% level of significance since 0.039<0.05.

4.2. Effect of Murabaha on Financial Performance
The study examined the effect of Murahaba on financial performance of Islamic banks. The study found that Murabaha had a positive effect on return on assets. As reported in table 4.2, the coefficient of Murabaha was 0.042. The coefficient had a p-value of 0.012. The effect of Murabaha on return on assets was statistically significant at 5% level of significance since the p-value of 0.012 is less than 0.05.

4.3. Effect of Ijara on Financial Performance
Also the study evaluated the effect Ijara on financial performance of Islamic banks. The study found that Ijarahad a positive effect on return on assets. Table 4.2 reports a coefficient of Ijara of 2.19. The coefficient had a p-value of 0.154. Since 0.154>0.05, the effect of Ijara on return on assets was not statistically significant at 5% level of significance.

4.4. Effect of Mudarabah on Financial Performance
Further the study evaluated the effect of Mudarabahon financial performance of Islamic banks. It was found that Mudarabahhad a positive effect on return on assets. Table 2 reports a coefficient of Mudarabah of 0.016. The p-value for this coefficient is 0.209. Thus the effect of Mudarabah on return on assets was not statistically significant at 5% level of significance.
Asset quality was used a control variable in the regression. Asset quality was found to have a positive effect on return on assets. Table 2 shows that asset quality had a coefficient of 0.007. The associated p-value was 0.984. This indicated that the effect of asset quality was not significant at 5% significance level. The overall regression was found to be statistically significant. As reported in table 4.3,

the F ratio for the regression was 21.796 with a p-value of 0.0028. Because 0.0028<0.05, the regression was significant at 5% level. The coefficient of determination $R^2$was 0.474 as reported in Table 4. The independent variables reasonably explained variation in return on assets.

4.5. Conclusions

This study sought to evaluate the effect of Islamic financial instruments on financial performance of fully fledged Islamic banks in Kenya. The study sought to evaluate the effect of Musharaka on return on assets. The result of regression indicated that Musharaka had a positive effect on return on assets. The t-test for the significance of Musharaka showed that the effect was statistically significant at 5% significance level. The study also sought to evaluate the effect of Murabaha on financial performance return on assets. It was found that Murabaha had a positive effect on return on assets. The result of t-test indicated that the effect was statistically significant at 5% level of significance. Also the study sought to evaluate the effect of Ijara on financial performance. The result of regression indicated that Ijara had a positive effect on return on assets. However, the result of t-test indicated that the effect of Ijara was not statistically significant at 5% significance level. Further the study sought to examine the effect of Mudaraba on financial performance. Mudaraba was found to have a positive effect on return on assets. However, the result of t-test showed that effect was not statistically significant at a 5% level of significance. When considered together, Musharaka, Murabaha, Ijara, and Mudaraba had a positive effect on return on assets. The result of F test showed that these variables jointly had a significant effect on return on assets.

4.6. Recommendations

The study shows that for Islamic banks in Kenya, Musharaka and Murabaha have a positive and statistically significant effect on returns on assets. Ijara, Mudaraba and asset quality have a positive effect on return on assets but the effect is not statistically significant. The study recommends that Islamic banks in Kenya should increase their funding on Musharaka and Murabaha in order to maximize return on assets for the banks.

4.7. Limitations of the Study

There are only two fully fledged Islamic banks in Kenya. This is too small a population of study to allow proper conclusions to be made. Further the period considered is relatively short occasioned by the fact that the fully fledged Islamic banks in Kenya have not been in operation for a long period to allow data to be extracted for many years.

4.8. Suggestion for Further Study

Further studies may seek to evaluate the effect of adoption of Islamic finance products by other commercial banks in Kenya. Further it may focus on evaluating the how the evolution of Islamic banking in Kenya has enhanced financial inclusivity and helped in alleviating poverty among the citizens.

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