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EFFECTS OF MUSHARAKAH (PARTNERSHIP) CONTRACTS ON THE FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN KENYA

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ABSTRACT

The purpose of the study was to evaluate the effects of Musharakah contracts on the financial performance of Islamic banks in Kenya. A descriptive research design was used in this study focusing on Islamic banks and Islamic windows. The population of the study consisted of bank managers. Sample data was collected by use of the questionnaires administered by the researcher. Data analysis and interpretation was based on descriptive statistics. Regression analysis and analysis of variance (ANOVA) were employed. The study concluded that Musharakah contracts positively influence the performance of Islamic banks in Kenya and recommends that more investments should be done by creating more banking networks across the country.

Key Words: Islamic Banking, Musharakah, Financial performance

1.0 Introduction

Islamic banking refers to a system of banking that is consistent with the principles of the Shariah (Islamic rulings) and its practical application through the development of Islamic economics. The principles which emphasize moral and ethical values in all dealings have wide universal appeal. Shariah prohibits the payment or acceptance of interest charges (*riba*) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to offer an alternative basis to Muslims although Islamic banking is not restricted to Muslims. Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shariah, known as *Fiqh al-Muamalat* (Islamic rules on transactions) (Al-*Ajmi*, 2009)

Although Islamic banking is one of the fastest growing segments in the financial world it is still in its infancy stage, at about 1 percent of the global banking system. When compared to the conventional financial system it certainly faces many challenges. The most important challenge it is facing now is the fact that it operates in economies driven by interest, which is not compliant with Islamic banking principles. (Waheed, 2011) There are encouraging experiences of Islamic banking in Muslim countries and Muslim inhabited countries in Europe and America irrespective of its initial teething hurdles. The development of Islamic banking in the contemporary world has witness remarkable changes particularly in the recent international financial plunge. (Sirelly, (2007)

Important measure of financial performance is profitability which is the ability to make profit from all the business activities of an organization, company, firm, or an enterprise. It measures management efficiency in the use of organizational resources in adding value to the business. Profitability may be regarded as a relative term measurable in terms of profit and its relation with other elements that can directly influence the profit. Profitability is the relationship of income to some balance sheet measure which indicates the relative ability to earn income on assets. Irrespective of the fact that profitability is an important aspect of business, it may be faced with some weakness such window dressing of the financial transactions and the use of different accounting principles. (Karim, 2009)

Islamic banks in Kenya account for one per cent of gross assets in the banking sector, the Central Bank of Kenya (CBK) has said. 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. (Ahmednoor, 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. (Iqbal & Mirakhor, 2011) First Community Bank launched services in 2008. In addition several ordinary banks, including the National Bank of Kenya and Barclays Bank Kenya, now offer Islamic banking products alongside their conventional services. Current market surveys indicate that a large section of the Muslim community remains untapped by the banking industry due to either non availability of riba-free banking on low incomes. The research also indicates that potential productive markets for Islamic banking will be the business community in Nairobi, Mombasa and other towns with sizeable Muslim communities. The challenge will, however, be to convince the Muslim community that these are truly fully fledged Islamic banks with reputable Shari'ah advisory boards of international standards. Both Muslim and non-Muslims look forward to interest-free banking service that is efficient, modern, solid, and transparent and customer friendly. These banks will be requiring investing heavily in the latest state of the art technology to reduce costs and remain competitive with conventional banks. (Al-Tamimi, 2002)

1.1 Research problem

The receipt of interest is not allowed under Islamic Finance Shariah. Therefore, when Islamic banks provide finance they must earn their profits by other means. This can be through a profit share relating to the assets in which the finance is invested, or can be via a fee earned by the bank for services provided. The essential feature of Shariah is that when commercial loans are made, the lender must share in the risk. If this is not so then any amount received over the principal of the loan will be regarded as interest.

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 financial instruments on financial performance of Islamic Banks.

Islamic banks are evolving financial and investment instruments that are not only profitable but are also ethically motivated. The ever-increasing application and innovation of the methodologies associated with derivative instruments that revolutionized the global financial industry have also led to a global financial crisis because of the excess greed for profit and the immense uncertainty and risk associated with these types of transactions. There are doubts associated with the permissibility of derivative instruments under Islamic finance generally (Turk, 2007).This study therefore sought to investigate whether Musharakah as a lending contract has an effect on the financial performance on Islamic banks in Kenya.

1.2 Objective of the Study

The objective of the study was to determine the effect of Musharakah contracts on the financial performance of Islamic Banks in Kenya

2.0 Literature Review

2.1.1 Islamic Banking Theory

The theory of Islamic banking is based essentially on the premise that interest which is strictly forbidden in Islam is neither a necessary nor a desirable basis for the conduct of banking operations, and that Islamic teachings provide a better foundation for organizing the working of banks. Muslim economists have pointed out that it is a historical accident that interest has become the kingpin of modern banking. (Ayub, 2002) The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions.

Muslim scholars recognize the important role banks play in the economy of a country in modern times. Banking institutions act as financial intermediaries between savers and investors. They can be of significant help in assisting the process of capital formation and development (Ayub, 2002). The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental teachings of the Qur'an and the Sunnah. Since banks perform a useful service of financial intermediation, they are wholly acceptable in a Muslim society.

The basic postulate that has guided all theoretical work on Islamic banking is that while interest is forbidden in Islam, trade and profit is permissible. Muslim scholars have developed a radically different model of banking which does not make use of interest. It relies instead on profit/loss sharing for purposes of financial intermediation. The earliest references to the reorganization of banking on the basis of profit/loss sharing are found in the writings of certain Muslim scholars in the late forties, early and mid-fifties of this century. The sixties and seventies saw more elaborate formulations of the concept of Islamic interest free banking. The subsequent period has witnessed further refinements in the theory of Islamic banking (DeYoung & Rice, 2004).
Notably missing were theoretical arguments to assure the fund owners regarding the safety of their monies, beyond the general argument that some kind of "mutual insurance" will take care of the problem. Also, little attention was paid to what later came to be called "trade based modes of finance" (Hassan, 2005). The most significant development during the late nineteen-seventies and early eighties were the advent and proliferation of Murabaha or cost-plus financing.

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. Generally, the Islamic bank allows the client to manage all the affairs of a Musharakah business. (Haron, 2004). 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 Mudarabah that does not provide any control rights to the financier. (Haron, 2004)

2.2 Musharakah contract

Musharakah is an Arabic word which literally means sharing. It is one of the types of lending contracts in Islamic banking. Technically, Musharakah is a contract between the partners to contribute capital to an enterprise or a venture, whether existing or new, or to owner of a real estate or moveable asset, either on a temporary or permanent basis. (Ismael, 2010) Therefore, the partnership can be used in the case of large users of funds to establish investment for short term or long term basis. It can also be used to share profit over the business with the share of loss.
The partners share and control how the investment is managed. And liability in this partnership is unlimited. Therefore, each partner is fully liable for the actions and commitments of the other in financial matters. Profits generated by that venture or real estate or asset are shared in accordance with the terms of the Musharakah agreement, while losses are shared in proportion to each partner's share of capital. (Mufti, 2013)

In banking sector, it is a mode of financing based on the principle of profit and loss sharing in which parties to the contract participate with their money or effort, or skills or a contribution of them as may be provided for in the Musharakah investment agreement contract by the mutual consent of the parties. All parties to the contract shares profit as well as loss. The profit (if any) is divided among the partners according to the agreed ratio, while loss (if any) is distributed exactly according to their ratio of investment in the business. (Ashraf, 2002)

In contrast to the interest-based system, the Islamic bank has to focus on the return on the physical investment, because its own profitability is directly linked to the real rate of return. The direct links between the Islamic Financial Instruments and the profitability of an investment project is of considerable importance to the entrepreneur. Most importantly, profit sharing contracts have superior properties for risk management, because the payment the entrepreneur has to make to the creditor is reduced in bad states of nature. (Iqbal *et.al*, 2005). Also, if the entrepreneur experiences temporary debt-servicing difficulties in the interest-based system, say, on account of a short-run adverse demand shock, there is the risk of a magnification effect; that is, his credit channels might dry up because of lenders overreacting to the bad news. This is due to the fact that the bank's own profitability is not affected by the fluctuating fortunes of the client's investment, except only when there is a regime change from regular interest payments to a default problem. (Iqbal *et. al,* 2005).

The clients' deposits fall under the category of qard (Loan) to the bank and the bank is obliged to pay back. These loans fall under the category of Musharakah. The bank is obliged to share in the profits of the bank with its depositors. Bank must protect these assets on behalf of its clients as well as get them the highest halal returns. Since banks do not pay interest, clients must therefore become a partners or Mushariks to share in the profits. The only way to become a partner is to open an investment account (Time or Saving Deposit) which allows the bank to invest one's money. Profit sharing is then calculated and distributed. Profits will be very close to prevailing deposit rates. (Rahma, 2014)

Musharakah contracts can be established in one of two ways. The first way of these is a permanent contract which ensures for its parties, the investor, bank and entrepreneur, an equitable share in the annual profit/loss on pre-agreed terms. This kind of permanent contract holds constant for a limited or unlimited period according to the original agreement (Lewis & Algaoud, 2001). The second type of Musharakah is a diminishing contract preferred by bankers because it allows the bank to reduce its share of equity each year and receive periodic profits based on the reducing equity balance. In this form, the equity share of the customer in the capital of enterprise increases over time until he or she becomes the sole owner of the enterprise. Musharakah is very beneficial to all parties to the business transaction and Islamic scholars agree on its authenticity under Islamic Shari'ah. However it has been observed that most of the parties in Musharakah contracts usually require the help of legal experts to ensure that any potential Riba or Gharar is carefully avoided (El Gamal, 2000).

2.3 Conceptual Framework

Arrays of theoretical and empirical reviews result into various variable dimensions. The independent variable of this study will therefore comprise of loan repayment, contract period and deposits contributions. These are the perceived independent variables expected to determine the performance of Islamic banks in Kenya. Financial performance will thus be the dependent variable of this study.

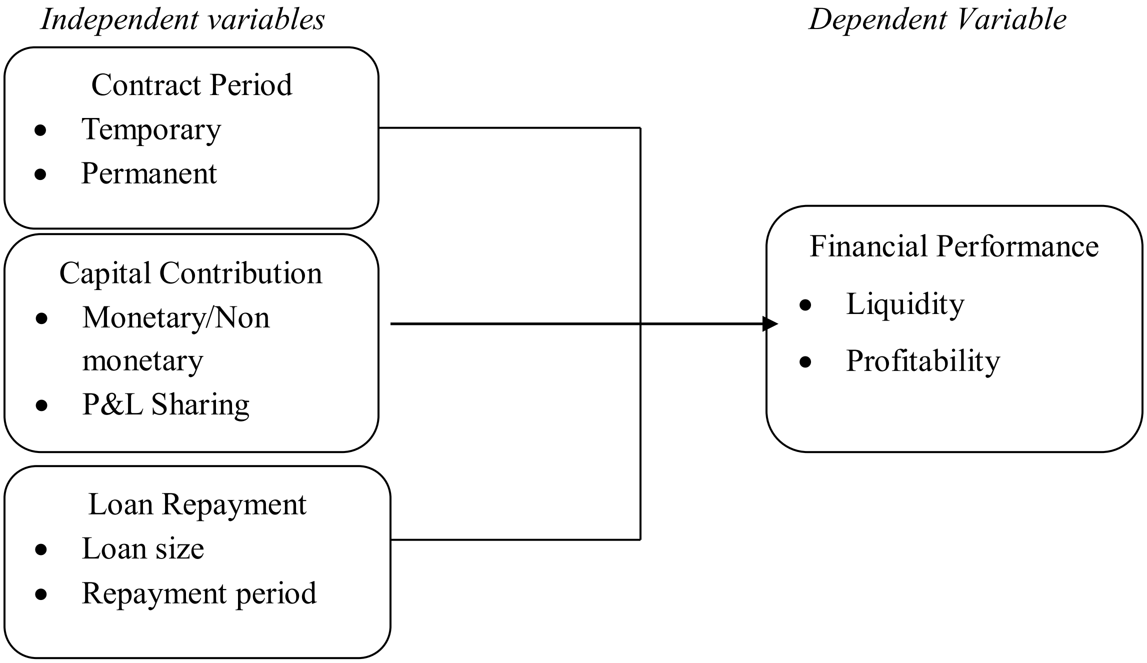

Figure 1: Conceptual Framework

3.0 Research Methodology

3.1 Research Design

Descriptive research design was used on this study. According to (Sekaran & Bougie 2011) descriptive study is undertaken in order to ascertain and be able to describe the characteristics of the variable of interest in a situation. Descriptive studies are essential in many situations especially when using qualitative data in understanding the phenomena.

3.2. Target Population

(Burns & Grove 2003) describe population as all the elements that meet the criteria for inclusion in a study. The population of this study included all Islamic banks and divisions. There are 3 fully fledged Islamic banks (Dubai Islamic Bank, Gulf Bank and First Community Bank) and 5 conventional banks offering Islamic products under Islamic divisions (Barclays Bank, Kenya Commercial Bank, National Bank, Chase Bank, & Standard Chartered Bank)

3.3 Sampling

The sampling frame which determines the population in the study included the three fully fledged Islamic Banks, the Islamic Divisions and the managers from the same institutions. The managers were expected to give out their views on Musharakah as an Islamic product and its benefits to the beneficiaries. A total sample of 24 managers and 8 institutions was used to form part of the study. From 8 banks, the researcher selected 3 respondents from each bank ie 24 respondents. The researcher employed census for this study since there are few Islamic banks and Islamic divisions to capture all relevant information required for this study. When the census is small, there is no point of sampling if time and resources allow and this increases reliability (Mugenda, 2003)

3.4 Data Collection

The researcher used the information he collected from the questionnaires that he administered. The use of questionnaire was an effective way of collecting information from a literate sample in a short period of time and at a reduced cost compared to other methods.

3.5 Data Processing and Analysis

According to Hyndman (2008) data processing involves translating the answers on a questionnaire into a form that can be manipulated to produce statistics. SPSS was used to produce frequencies, descriptive and inferential statistics which were used to derive conclusions and generalizations regarding the population. The data was analyzed using frequencies and percentages so as to enable the researcher to arrive at conclusions and presented using tables and figures for easy reading and interpretation. Regression analysis was done by use of an econometric model which is laid below.

$Y = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \varepsilon$

Where; Y= Financial Performance of Islamic banks

X1= Contract period

X2= Capital contribution

X3= Loan repayment

α = constant

β_1, β_2, β_3, = beta coefficients

ε = Error Term

4.0 Research Analysis

4.1Regression Analysis

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

Table 1: Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.736(a)	.542	.541	1.63517.

In the model summary table, the capital "R" shows coefficient of correlation. The coefficient of correlation from the sample data measures the strength direction of linear relationship between two or more variables. The range of the correlation coefficient is from -1 to +1. If there is a strong positive linear relationship between the variables, the value of "R" will be close to +1. If there is a strong negative linear relationship between the variables, the value of "R" will be close to -1. When there is no linear relationship between the variables or only a weak relationship, the value of "R" will be close to 0. From data in the above the R^2 was 0.542 which means that there was 54.2% variation in the financial performance due to changes in capital contribution, contract period and loan repayment. The correlation coefficient indicates the strength of relationship between the variable. The study found that the correlation coefficient was 0.736 thus there was positive relationship between financial performance and the independent variables.

4.2 Analysis of Variance (ANOVA)

The study further tested the significance of the model by use of ANOVA technique. From the ANOVA statistics, the study established the regression model had a significance of 0.002 which is an indication that the data was ideal for making a conclusion on the financial performance as the value of significance i.e. P-Value was less than 5% this shows that the contract period, capital contribution and loan repayment all have a significant effect on the financial performance of Islamic banks. The findings are tabulated in the table below

Table 2: Analysis of Variance ANOVA[a]					
Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	.578	4	.145	3.485	.002[b]
Residual	5.96	20	.298		
Total	6.538	24			

4.3 Multiple Regression Analysis

The results in the table below show the coefficients of the model. The results show a positive and significant relation between the dependent variable and the independent variables.

Analysis of coefficient of contract period tells us that there is positive relationship towards financial performance of Islamic Banks in Kenya. It further reveals that 1% change in the contract period will bring 39% change in the financial performance of Islamic Banks in Kenya. Furthermore, for every 1% change in loan repayment brings 49.2% change of financial performance of Islamic Banks in Kenya by holding other variables constant. From the above model it is also clear that an increase in 1% of capital contribution there will be increase in 52.4% of the financial performance of Islamic Banks in Kenya. The equation, **Y=3.574+ -0.213X1 + 0.383X2+ 0.025X3** was therefore obtained. The finding above conform to the findings by Isaac (2015) who found out that a bank's financial performance is positively related with the amount of various financial Islamic instruments it offers. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the obtained probability value and α=0.05. if the probability value was less than the alpha value, then the predictor variable was significant otherwise it wasn't. all the predictor variables were significant in the model as their probability values were less than α=0.05

Table 3: Model Coefficient

Model	Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	T	Sig.
(Constant)	3.574	1.342		2.663	.013
Contract period	.213	.091	.390	2.354	.026
Capitalcontribution	.383	.120	.524	3.184	.004
Loan repayment	.025	.007	.492	3.184	.004

4.4 Research Findings

The research findings showed positive correlation between Musharakah contracts and the financial performance of Islamic banks. The coefficient of variation revealed that any further investments by Islamic banks on Musharakah financing would lead to increase in the performance in general. The coefficient of variation revealed any further investments by Islamic banks on Musharakah financing would lead to an increase in the financial performance in general. The results showed positive relation between the dependent and independent variables. The study also showed the value of R^2 to be 0.542 which implied that 54.2% variation in the financial performance of Islamic banks is due to changes in the contract period, capital contribution and loan repayment

4.4.1 Effects of the contract period on the financial performance

The study established that the contract period is statistically significant in influencing the profitability of Islamic banks in Kenya therefore a positive effect on their financial performance. as reported in table 3, the coefficient of contract period was found to be 0.213 and the coefficient had a significant probability of 0.026 which implies that the effect of contract period of Musharakah contracts was found to be statistically significant at 5% level of significance since 0.026< 0.05.

4.4.2 Effects of capital contribution on the financial performance

The study established that capital contribution also showed a positive effect on the profitability of Islamic banks in Kenya therefore statistically significant in influencing the performance. As presented in table 3, the coefficient of capital contribution was found to be 0.383 and the coefficient had a significant probability of 0.004 which implies that the effect of capital contribution of Musharakah contracts was found to be statistically significant at 5% level of significance since $0.004<0.05$

4.4.3 Effects of loan repayment on the financial performance

The study also showed that loan repayment has a positive effect on the profitability of Islamic banks in Kenya. As presented in table 3, the coefficient of loan repayment was found to be 0.025 and the coefficient had a significant probability of 0.004 which implies that the effect of loan repayment of Musharakah contracts was found to be statistically significant at 5% level of significance since $0.004<0.05$. The F-ratio for the regression was 3.485 with a P-value of 0.02. Because $0.02<0.05$, the regression was significant at 5% level. The coefficient of determination R^2 was 0.542 as reported in table 1 The independent variables therefore reasonably explained the variation in the financial performance of Islamic banks.

5.0 Conclusion

The study sought to evaluate the effects of Musharakah contracts on the financial performance of Islamic banks in Kenya. The result of the regression model indicated that the contract period capital contribution and loan repayment had a positive impact on the financial performance. The T-Test for the significance of contract period showed the effect was statistically significant at 5% significance level. The study also sought to evaluate the effect of capital contribution on the financial performance of Islamic banks. It was found that capital contribution made a positive effect on the financial performance; the results of the T-Test indicated the effect was statically significant at 5% level of significance. Also, the study sought to evaluate the effect of loan repayment on financial performance. The results of regression indicated that loan repayment had a positive effect on financial performance; moreover, the results of the T-Test also indicated that the effect was statistically significant at 5% level of significance, when considered together; Musharakah contracts had a positive effect on the financial performance. The results of F-test showed that all independent variables jointly had a significant effect on financial performance of Islamic banks.

6.0 Recommendations

From the findings, the study established that the contract period of Musharakah contracts positively affected the financial performance of Islamic banks and windows in Kenya. Therefore the study recommends that the management of the banks should aggressively market their Islamic products in order to increase their clientele so as to enhance their firms' financial performance. From the findings, the study established that the capital contribution of Musharakah contracts positively affected the financial performance Islamic banks and windows in Kenya. Therefore the study recommends that the management of the banks should formulate strategies to facilitate credible levels of liquidity so as to ensure efficient in financial operations hence leading to an increase in their firms' financial performance. From the findings, the study established that the loan repayment of Musharakah contracts positively affected the financial performance of Islamic banks and windows in Kenya. Therefore the study recommends that the management of the banks should have a proper and effective credit and risk management system as well as a flexible repayment system to follow up on the repayments. The research therefore recommends that Islamic banks and windows need to continue offering Musharakah contracts as they were found to positively influence the financial performance of Islamic banks.

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