THE IMPACT OF ISLAMIC BANKING ON ECONOMIC GROWTH: A CASE STUDY OF FIRST COMMUNITY BANK IN KENYA.

BY : SAID MOHAMED ALI

UNITED STATES INTERNATIONAL UNIVERSITY AFRICA

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THE IMPACT OF ISLAMIC BANKING ON ECONOMIC GROWTH: A CASE STUDY OF FIRST COMMUNITY BANK IN KENYA.

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STUDENT’S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University Africa in Nairobi for academic credit.

Signed: ________________________  Date: ________________________

Said Mohamed Ali (ID No: 630259)

This project proposal has been presented for examination with my approval as the appointed supervisor.

Signed: ________________________  Date: ________________________

Dr. George.O.Achoki.

Signed: ________________________  Date: ________________________

Dean, Chandaria School of Business
ABSTRACT

The purpose of this study was to investigate the impact of Islamic Banking on economy growth in Kenya. This study was guided by the following research questions. To establish impact of Islamic banking theories on economy growth. To establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth.

The study used a descriptive research design. The target population was 50 employees from the various departments at First Community Bank in Kenya. These include Marketing, Operations, Research and Development, Sales, Customer service and Risk. The research adopted stratified random sampling technique which enabled sufficient representation of the desired data across the population. From the target population a sample size of 25 customers was obtained. The main method of data collection was through the use of questionnaires which were easier and effective to use by the researcher. Data analysis was done through the use of tables, graphs and charts. Descriptive statistics were used to describe features of the data and presentation was done through the use of tables and charts.

On Profit and Loss sharing theory majority of the respondents agreed that the theory contributed to economy growth. Majority of the respondents were of the opinion that they more attracted to interest free products under the Islamic Banking. And lastly on Trust Financing theory, majority of the respondents agreed that they were able to acquire intensive capital assets for their businesses through Trust Financing. Findings on effectiveness of Islamic banking instruments showed that the elements influenced the economy growth in Kenya. Majority of the respondents felt that Islamic banking were highly exposed to mark-up risk.

The study concluded that Islamic banking theories contribute to economy growth. The Islamic banking theories help to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. The study also concludes that the Islamic banking instruments contributed to economic growth. The Islamic banking instruments have enabled banks to grow in terms of customers this is due to the conducive terms of the instruments. Finally, the study concluded that Islamic Banking was
influenced by a number of risks. He Islamic banks are exposed to the risk of losing entire invested capital as their products are not fully secured.

The study recommends that study concludes that the Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. The study also concluded that banks in the country should embrace an Interest Free environment which ensures a level playing field among market participants. This helps to allow the economy to expand and helping to alleviate poverty. Finally, the study concluded that Islamic banking lacks uniform standards of credit analysis as banks have no appropriate standard of credit analysis hence heavily exposing their products. Banks should be more aware of the related banking risks associated within Islamic Banking and address how to counter them.
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DEDICATION

This research project is dedicated to my family and fellow students for their wisdom and inspiration which has been my pillar in search for knowledge and for their continuous support and encouragement throughout my studies.
TABLE OF CONTENTS

CHAPTER ONE ................................................................................. 1
  1.1 Background of the Study .................................................. 1
  1.2 Statement of the Problem ............................................... 6
  1.3 Purpose of the Study ....................................................... 8
  1.4 Research Questions ....................................................... 8
  1.5 Significance of the Study .................................................. 9
  1.6 Scope of the study .......................................................... 9
  1.7 Definition of Terms ......................................................... 9
  1.8 Chapter Summary .......................................................... 11

CHAPTER TWO ................................................................................. 12
  2.0 LITERATURE REVIEW .................................................... 12
  2.1 Introduction .................................................................... 12
  2.2 Islamic Banking and Economic Growth ............................ 12
  2.3 Islamic Banking Theories and Economic Growth ............... 14
  2.4 Islamic Banking Instruments and Economic Growth .......... 18
  2.5 Islamic Banking Risks and Economic Growth ................... 20
  2.6 Chapter Summary .......................................................... 24

CHAPTER THREE ............................................................................. 25
  3.0 RESEARCH METHODOLOGY .......................................... 25
  3.1 Introduction .................................................................... 25
  3.2 Research Design ........................................................... 25
  3.3 Population and Sampling Design ..................................... 26
  3.4 Data Collection Method ................................................. 28
  3.5 Research Procedures ..................................................... 28
  3.6 Pilot Test ....................................................................... 29
  3.7 Data Analysis Methods ................................................... 30
  3.8 Chapter Summary .......................................................... 31

CHAPTER FOUR ............................................................................... 32
  4.0 RESULTS AND FINDINGS ............................................... 32
  4.1 Introduction ................................................................... 32
  4.2 General Information ...................................................... 32
  4.3 Islamic Banking Theories and Economic Growth ............... 35
  4.4 Islamic Banking Instruments and Economic Growth .......... 37
LIST OF TABLES

Table 3.1 Population Distribution........................................................................26

Table 3.2 Sample Size Distribution.....................................................................27

Table 4.1: Interest Theory.......................................................................................36

Table 4.2: Trust Financing......................................................................................37

Table 4.3: Murabaha (Mark up Financing)...............................................................38

Table 4.4: Bai Salam and Bai Istitna......................................................................39

Table 4.5: Diminishing Musharaka........................................................................40

Table 4.6: Credit Risk............................................................................................40

Table 4.7: Mark-Up Risk .......................................................................................41

Table 4.8: Legal Risk.............................................................................................42
LIST OF FIGURES

Figure 4.1: Gender of the Respondents.................................................................32
Figure 4.2: Level of Education...............................................................................33
Figure 4.3: Length of Service ...............................................................................34
Figure 4.4: Work Department ...............................................................................35
Figure 4.5: Profit and Loss Theory .......................................................................36
Figure 4.6: Ijarah (Lease Financing) ....................................................................38
Figure 4.7: Commodity Price Risk .......................................................................42
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The economic growth of a country, among several other factors, is mainly based on the strength of its financial sector’s performance, with the banking sector being the most prominent. Siraj and Pillai (2012) assert that the stability and growth of any economy to a great extent depends on the stability of its banking sector. The development of the banking industry is favorable to the economic growth because the activity of the banks increases the mobilization of the saving, improve the efficiency of the resources allowance, and stimulate the technological innovation (Goaied, 2015). The role and functions of the banking system in a contemporary economy is of great significance to the development process and thus, it is often considered as the heart of every prosperous economy (Usman, 2003). The banking industry plays an important role in economic activities in all countries, especially with regard to those activities related to economic development (Rajaiei-Baghsiyaei, 2011). According to Zeineb and Mensi (2014), banks occur as a crucial and major role in economic growth. Thus, a healthy and sound banking sector is a key ingredient for growth, economic prosperity and general welfare.

Due to the banking sector's significant role in the wellbeing of any economy, it is vital to constantly monitor and evaluate banks' performance; to ensure that the financial sector is strong and efficient. Sayed and Hayes (2012) assert that the continuous assessment of bank performance is fundamental in order to protect the banking operations against its inherent risks or poor management that can threaten the entire financial system of any country. Furthermore, Jamali, Shar and Ali (2012) assert that bank performance is a very important subject to all the banks' stakeholders including customers, investors and the general public. Consequently, numerous studies have been undertaken on financial institutions to determine their impact on the efficiency of economic growth and also discover the determinants of successful bank performance. Rose (2012), claims that although banks are identified by the discernible functions they perform such as; cash management, insurance, brokerage, credit and payment functions; they are above all else considered as financial intermediaries.
managing transactions between different parties. Ahmad (2006) also posits that banking institutions act as financial intermediaries between savers and investors hence they can be of significant help in assisting the process of capital formation and development.

Hudgins and Rose (2013) claim that in the recent years, banks have experienced vibrant and extensive changes which are rapidly reshaping and revolutionizing the banking industry. These key trends include government deregulation, service proliferation, geographic expansion, an increasingly interest-sensitive mix of funds and many others. In the last two decades, the banking sector has witnessed the emergence and the development of a new financial industry: the Islamic banking (Goaied, 2015). The Islamic banking system emerged as a competitive and a viable substitute for the conventional banking system. Today Islamic banks are operating in all areas of the globe, as a practical and feasible alternative system to the conventional banking system. Srairi (2009) asserts that although it was originally developed to satisfy the requirements of Muslims, at present Islamic banking has currently achieved worldwide acceptance and is documented as one of the greatest rising areas in finance and banking as stated in the Global Finance Report (2012). Islamic Banking has grown substantially and has become one of the well and truly established as one of the world’s fastest-growing economic sectors.

The first Islamic bank launched abiding to Islamic Sharia'a principles was Mit Ghamar in Egypt which commenced in 1963 but closed down in 1967. However, prior to the initiative proposed by the Organization of the Islamic Conference (OIC) and the accrualment of theoretical interest and knowledge in Islamic Finance; the Islamic Development Bank and Dubai Islamic Bank were both scrupulously established in 1975 as cited in Merchant (2013). Despite the fact that the majority of Islamic banks were established within the Middle East Muslim countries, many banks in developed countries have started to value the enormous demand for financial products of Islamic banks. Rashwan (2012) and Al-Mazari (2013) assert that the Islamic Banking industry has been witnessing an accelerating increase with over 614 Islamic banks operating in more 75 countries world-wide. Furthermore, it is worth noting that conventional banks such as HSBC, Citibank and UBS are currently incorporating
Islamic products in their overall banking services due to the evident success of Islamic Banking as asserted by Siddiqi (2008).

Islamic banking is a banking system that is consistent with the Shariah (Islamic law) and an important part of the system is the prohibition on collecting riba (interest) and investing in businesses that are considered haram (forbidden) such as selling of alcohol, pork, engaging in gambling etc. Islamic banks provide commercial services that comply with the religious injunctions of Islam. Islamic banking emanated from Islam which discourages concentration of wealth in a few hands thus the importance of Islamic banking system is to bridge the gap between the rich and the poor by modifying the distribution of wealth and economic resources in favor of the less fortunate (Ismail, 2010). Islamic economics has been developed in the dynamics between aspiration and reality in the theory and practice of Islamic finance. In particular, these dynamics can be observed after the rise of the commercial practice of Islamic finance in the 1970s. While Islamic economics is the theoretical background of the practice of Islamic finance, which is currently achieving rapid growth, its practice shapes the history of Islamic economics by raising arguments on the theoretical feasibility of Islamic economics. In such interactions, some Islamic economists give priority to the aspiration of Islamic economics while others give importance to the economic feasibility of Islamic finance and accept the current situation of commercial Islamic finance (Iqbal & Llewellyn, 2002).

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

The Islamic finance industry in Africa, despite being largely fragmented and nascent in the region, is fast gaining interest of the various stakeholders including central banks, regulatory authorities, international Islamic financial institutions as well as the local demographics. Currently, Africa accounts for 2.4% of global Islamic banking assets (1H2013), 0.6% of sukuk outstanding (1Q14) and 2.8% of Islamic fund management assets (end-2013) (Al-Ajmi, Hussain, & Al-Saleh, 2009). However, the outlook for the Islamic finance industry in Africa looks bright as a number of African governments are making necessary changes to the regulatory and policy framework to support growth of the industry on the back of expectations of a strong demand. During the first quarter of 2014, the Islamic finance mandate in Africa got reaffirmations from the jurisdictions of Mauritania, Morocco, Senegal, South Africa and Libya who have introduced or are in final stages of introducing Islamic finance legislations which would enable the provision of Islamic banking services in the respective countries while also opening doors for sovereign sukuk issuances (Patel & Bhattacharya, 2010).

Islamic finance has tremendous potentials to at least partly support the funding gaps in Africa while enhancing the financial inclusion rates in the region. Islamic finance offers an alternative financing mechanism to support the large infrastructure investment needs in Africa (Torrisi, 2009). In addition, it provides government institutions an alternative financing mechanism to support the country’s capital expenditure needs. On the other hand, infrastructure projects also appeal to Islamic banks and investors due to its links with the real economy. This is because the principles of Shariah, which govern Islamic finance, critically emphasise the role of real asset financing. Therefore, infrastructure development projects and competitive Islamic financing solutions provide a win-win situation for the industry’s stakeholders (Usmani, 2002). The Islamic banking sector in Africa also has abundant opportunities supported by Africa’s large and underserved Muslim population and increasing awareness of Shariah-compliant products. Notably, the Islamic banking sector in countries such as Kenya and South Africa has marketed products to non-Muslims as well, increasing
the sectors outreach. A number of international Islamic banks have begun to set up Islamic banking operations in African countries including Kenya, Egypt and Nigeria (Daniels, 2013).

The history of banking in Kenya traces its roots to early European trade on the East African coast, chiefly Zanzibar, in the later part of the 19th century. Despite political upheavals such as World War II and the subsequent Mau Mau uprising, banking in Kenya experienced considerable growth. The banks expanded but banking access and employment opportunities for Africans in the banking industry took time to materialize. It was only until 1910 that banking services became available to Africans. This was made possible when the Post Office Savings Bank as a department within the colonial postal service opened its doors. By March 1911 Post Office Savings Bank boasted 1,231 accounts, of which 684 belonged to Africans. Even then, the service was only available in places where officials of the colonial postal service were stationed and therefore did not reach the majority of Africans who resided in rural areas. Decades would pass, and with each the industry saw increased Africanization – on both sides (bankers and customers).

According to Ndungu (2010) Kenya was the first country in the East and Central African region to introduce Islamic banking in the year 2007. In Kenya, there are fully-fledged Islamic banks that solely offer Shari’ah-compliant products; and mainstream banks that provide products that are tailored to be in compliance with Islamic law. Examples of such banks targeting lower income and special customers are Jamii Bora Bank, which has carved a niche for itself not only by tailoring its banking services mainly to low-income customers but by also venturing into mortgage financing for low-income housing, and two fully-fledged Islamic banks; First Community Bank and Gulf African Bank, that have succeeded in bringing Sharia-compliant banking services to Kenya. (KBA, 2013). Ndungu (2010), further noted that the concept of Shariah complaint banking has emerged as an alternative vehicle for mobilization and supply of finance. For example, the two banks have already contributed in development agenda of the country by participating in Shari’ah compliant (Sukuk) components of infrastructure bonds issued by the Central Bank of Kenya on behalf of the Government of Kenya and “Structured Sukuk” is expected to cover the bonds and T-Bills market in future. However, although the concept of Islamic Finance has generated a lot of interest and overwhelming support from both Muslim and non-Muslim population in Kenya.
In their short period of existence, Islamic banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. Currently the two Islamic banks operating in Kenya: Gulf African and First Community bank, which had a loan portfolio of 4.9-billion shillings, deposits totaling 7.5billion shillings and 27270 deposit accounts. These indicators point to the tremendous potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population of 36-million (Muriri, 2009).

1.2 Statement of the Problem
In recent years, Islamic banks attempted to fulfill this economic need by providing products that are compliant with Shariah law. Islamic banks offer different instruments to satisfy providers and users of funds in a variety of ways i.e. sales, trade financing and investment. These instruments serve as the basic building blocks for developing more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets. Such products are constructed around the philosophy that no person should profit from another’s loss, thereby prohibiting Riba (interest).

According to Cihak, Martin, Hesse and Heiko (2008), Islamic finance and the Shariah-compliant financial products that form the core of Islamic banking have become one of the fastest growing segments of the financial market industry, operating through more than 300 institutions in 75 countries. Economists view financial and legal systems as two prominent mechanisms through which economic growth either can be supported or suppressed (Levine 1998).

In the short period of existence, Islamic banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets. Kenya has had two authorized Islamic banks since 2008 i.e. Gulf Arab Bank and First Community Bank which were established following the introduction of an Islamic banking law (Global Islamic Finance Report, 2010). Ever since the inauguration of Islamic financing in Kenya in 2008 or thereabouts, Islamic banking has seen a speedy intensification in a comparatively small period. Therefore, the growing recognition of Islamic banking in Kenya
as a viable alternative to the conventional banking necessitates the need to examine its role and impact on the economic development in Kenya.

Islamic banking in Kenya is relatively new. Majority of the Kenyan banks have now adopted and are now offering Islamic banking services. Because they are not fully-fledged Islamic banks, the conventional banks are offering services that are limited to Islamic banking windows. Islamic banks are based on a different set of objectives, beliefs, and assumptions from conventional institutions. The research studies that have been done in this area are few and far between. Most of the Islamic banks are concentrated in the Middle East, North Africa and Southeast Asia and most of the studies on the role of Islamic banking on economic growth have been carried out in those countries. For example, Tabash and Dhankar, (2014) carried several studies on the role of Islamic banking on Economic growth of several countries including Qatar, Bahrain and other Middle East and Northern African countries. However, the studies were carried in countries that have embraced Islamic banking for years making it impossible to generalize the results to the Kenyan Context which adopted Islamic banking six years ago.

In Kenya, most studies have examined different aspects of Islamic banking. For instance, Kinyanjui (2013) investigated the challenges facing the development of Islamic banking in Kenya. Talam (2014) also investigated the effect of Islamic banking on financial performance of commercial banks in Kenya. Abubakar (2014) examined the effect of Islamic banking on investment financing in Islamic banks in Kenya. Mustafa (2013) explored the effects of Islamic banks on financial deepening amongst Kenyan Muslims. However, no significant study has been carried out on the impact of Islamic banking on economic growth.
1.3 **Purpose of the Study**
The purpose of the study was to establish the impact of Islamic Banking towards economy growth in Kenya.

1.4 **Research Questions**

1.4.1 To establish impact of Islamic banking theories on economy growth?
1.4.2 To establish the effectiveness of Islamic banking tools on economy growth?
1.4.3 To establish the various risks of Islamic banking on economy growth?

1.5 **Significance of the Study**

1.5.1 **Islamic Banks and other Banks**
This study will provide stakeholders within banking sector with information and understanding of how Islamic banking influences the economic growth of the country. The banks will also use the information from this study in making informed decisions necessary to enhance their various products.

1.5.2 **Scholars and Future Researchers in Colleges and Universities**
This research will help academicians gain knowledge generated on the impact of Islamic banking on the country’s economy growth. This is because there is little research done about Islamic banking and economy growth. Therefore, this research provides a basis in which future scholars can expound and base their research on.

1.5.3 **Policy Makers**
The developing countries including Kenya would use the findings of this study to establish a tribunal to strategize on how to formulating more business friendly policies that may enhance operations of Islamic economy into their developing economies. This would help Islamic banks and other conventional banks to easy contribute in the development of the country’s economy.
1.6 Scope of the study
The study assessed the contribution of Islamic banking on economy growth in Kenya. The case study was the First Community Bank, in Nairobi County, Kenya. The target population comprised of 50 employees who work in the various departments, which included; Marketing, Operations, Research and Development, Sales, Customer Service and Risk. The research took a period of six months starting from January 2017. The study used both primary and secondary data. For the primary data, the data collection tool was use of questionnaires and hence the study divided the respondents into different stratum. For secondary data, the study soughted information from financial statements and reports.

However, there were a number of limitations when carrying out the study. First, some of the employees were not willing to provide information through the questionnaires therefore creating a challenge in data collection. Secondly accessing the customers financial information from the Bank was a challenge because of issues of confidentiality, thus information provided was limited.

1.7 Definition of Terms

1.7.1 Islamic Banking
It is defined as a financial and social institution whose objectives and operations as well as principles and practices must conform to the principles of Islamic Shariah (Jurisprudence), and which must avoid the interest in any of its operations (Islamic Development Bank, 2007).

1.7.2 Bai Muajjal
Bai Muajjal (Deferred Payment Contract): A contract involving the sale of goods on a deferred payment basis. The bank or provider of capital buys the goods (assets) on behalf of the business owner. The bank then sells the goods to the client at an agreed price, which will include a markup since the bank needs to make a profit. The business owner can pay the total balance at an agreed future date or make installments over a pre-agreed period. This is similar to a Murabaha contract since it is also a credit sale (Iqbal, 2002).
1.7.3 **Riba**
This is an Arabic word which literally means increasing or adding your money by using money as a commodity. Widely known as Interest (Farouq and Emadul, 2008).

1.7.3 **Sharia**
The Islamic law which is usually governed by the teachings of Islam (Khattak and Rehman, 2010).

1.7.4 **Fiqh**
Islamic jurisprudence. The science of the Shariah. It is an important source of Islamic economics (Usmani, 2007).

1.7.5 **Musharakah**
The relationship between two or more parties. Each of the parties contributes capital to a business or a business activity. They contract to share profits based on a profit-sharing ratio.

1.7.6 **Ijara**
The Arabic word for a wage or a leasing contract. Under Ijara contracts, the owner of an asset allows the use of sharia-compliant assets by the user for sharia-permissible purposes (Salman, 2010).

1.7.7 **Ujrah**
The Islamic bank rent, which is paid by the lessee to the lesser (Usmani, 2007).

1.7.8 **Mudarabah**
A concept similar to Musharakah, except in the case of Mudarabah, one partner contributes capital and agrees to compensate an entrepreneur or investment manager through profit sharing (Iqbal, 2002)
1.8 Chapter Summary

The chapter presented the background information on Islamic banking and economy growth. The first chapter is divided into various main sections which includes a detailed background of the study, the problem statement in the content of other studies. This is followed by the purpose of the study then by the research questions. The next section provides the significance of the study.

The scope of the study is provided as well as the working definitions of the study. This chapter will give a deeper in depth of the research questions.

The next chapter will be looking at the literature review, which will give a deeper insight on the research question. The third chapter will discuss the research methodology that will be used in conducting the research. The fourth chapter will present the results from the research conducted while the fifth chapter will provide the discussions, conclusions and recommendations based on the results presented in chapter four.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction
This chapter presents the literature review of the study. The literature is based on the three research questions, which include: to establish impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth.

2.2 Islamic Banking and Economic Growth.
Studies have established that Islamic finance allows a closer link between real economic activity that creates value and financial activity to be forged (Nedal, 2011). For instance, Hassan, Kayed and Oseni, (2013) pointed out that Islamic banking and finance one of the most significant aspects of the modern global financial system. Kammer et al., (2015) also argued that Islamic finance has the potential to contribute to higher and more inclusive economic growth. In addition, Adeola (2007) noted that Islamic banking enhances economy growth through better integration of the real and financial sectors of the economy, better business ethics since banks will only entertain economically viable financing requests, instead of being lenders and Islamic banks will stay away from financing prohibited activities e.g. producing alcohol among others.

Additionally, Tabash and Dhankar, (2014) explored empirically the relationship between the development of Islamic finance and economic growth in the Middle East and established that Islamic banks’ financing has contributed to the increase of investment and in attracting FDI in the long term and in a positive way. The results obtained from Granger causality test revealed a positive and statistically significant relationship between economic growth and Islamic bank’s financing in the long run. Adedeji and Abdulazeez (2014) explored the importance of Islamic banking system towards economic development in Malaysia. The study established that Islamic banking system is characterized by the ability of attracting huge deposits from both Muslims and Non-Muslims customers through sharia-compliance
retail banking, wholesale banking and investment banking services, which serves as a tool that furnishes enabling business environment that could foster economic development.

Islamic finance is a powerful tool for pro poor and inclusive financial system in Africa regardless the fact that they are Muslim country or not (Nguena, 2014). As such, Kenya has demonstrated considerable promise in the area of Islamic finance; and in its Vision 2030, aims to develop into an international financial center as well as a hub for eastern and central Africa for Islamic finance (Laving, 2013). Kenya was the first country in the East and Central African region to introduce Islamic banking. Currently there are two Islamic banks operating in Kenya: Gulf African and First Community bank, which had a loan portfolio of 4.9-billion shillings, deposits totaling 7.5billion shillings and 27270 deposit accounts. These indicators point to the tremendous potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population of 36-million (Issak & Kwasira, 2012).

Islamic banking is not related to Muslims only it is related to all and it is not related to any particular religion thus it can operate and expand their network in the country along with traditional banks as the focus of it is on social well being and wealth generation activities in the society (Khan, 2014). According to El-Ghazali (1994) as cited in Nedal (2011) the concept of the Islamic economic system as described in all its aspects focuses on the worship of the creator, which includes man’s duty to develop life on earth, thus securing a decent standard of living for the individual. Islamic finance is an increasingly important means for the financing of physical and social infrastructure that supports economic development and job creation in an expanding group of emerging economies (Islamic Financial Services Board, 2014). El-Galfy and Khiyar, (2012) also point out that Islamic banking positively contributes to macroeconomic stability for both developing and developed countries.
2.3 Islamic Banking Theories and Economic Growth.

2.3.1 Profit and Loss Sharing Theory

This notion of equitable sharing is a key element in the concept of Islamic finance as it is supposed to reflect the values of Islam. Under the rules of Shariah, no one can claim any compensation without incurring some of ex ante investment risks (Jedidia & Hamza, 2014). The Profit and loss sharing concept used by the Islamic banks according to the Islamic Shariah laws and according to this rule in Islamic banks, investment depositors are customers with some rights of ownership in the bank. Profit and loss sharing difference introduces a mutuality concept in Islamic banking. The main factor, which contributes to the emergence of the Profit and Loss Sharing -banking system, is the prohibition of Interest (Riba) in the Holy Quran (Ashraf, 2013).

The underlying principles of Shari’ah that govern Islamic banking is to promote a profit and loss sharing framework as an ideal mode of financing to achieve justice and socioeconomic objectives (Zamil, 2014). Profit and Loss sharing is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit and loss. Profit and Loss Sharing is based on two major modes of financing, namely Mudaraba and Musharaka, which are desirable in an Islamic context wherein reward sharing is related to risk-sharing between transacting parties (Farooq, 2006). In these lending arrangements, profits are shared between the investors and the bank on a predetermined basis. In sharing of profit and loss the borrower and the lender share, the profits as well as losses arising from the venture with the finances obtained from the lender. The basic view is that the general community should benefit from such activities (Khan, 2014).

The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. In addition, profit-loss sharing scheme improves capital allocation efficiency as a return on capital depends on productivity and the allocation of funds is based on the success of the project (Nedal, 2011). The profit and loss sharing may lead to a more efficient and optimal allocation of resources than does the interest-based system (Siddiqui 2001).
Khan and Ahmad (2001) state that, theoretically, it has been an aspiration of Islamic economists that on the liability side, Islamic banks shall have only investment deposits. On the asset side, these funds would be channeled through Profit and Loss sharing contracts. Under such a system, any shock on the asset side shall be absorbed by the risk sharing nature of investment deposits. Profit and loss sharing dominates the theoretical literature of Islamic finance. However, the practice of IFIs has become different from the theoretical aspirations with the predominance of trade based operations. However, the contractual arrangement in Islamic banks differs from the conventional banks. The adoption of the Profit-Loss Sharing arrangement can be applied on the asset and liability sides of Islamic banking operations.

However, some studies such as Khan (1995) and Aggarwal and Yousef (2000) pointed out several factors that hamper the use of Profit Sharing modes of financing. The former emphasize the lack of application Profit sharing modes of financing due to firms believe they can reinvest their surpluses to enhance growth. The latter highlights the issue of agency problem cause the reluctant of the banks to use the Profit Sharing modes of financing. Ahmed (2002) believes that since the PS contract on the asset and liability side of an Islamic bank are different, as fund user and fund owner, respectively, lack adoption of Profit-Loss Sharing on the asset side due to higher risk exposure as a fund owner. However, Ruhaini and Abdul Ghafar (2010) shows that Profit-Loss sharing arrangement is able to minimize asymmetrical information and transaction costs. Thus, Islamic banks can maximize their net profit and hence they could create value to their shareholders. Kettel (2011) also declares that Islamic banks promote risk sharing between providers of funds (investors) and users of funds (entrepreneurs), while their counterpart conventional banks assure the investor a predetermined rate of interest and pass all the risk to the entrepreneur.

Accordingly, past studies have emphasized that the profit-and-loss sharing contracts promote greater stability in financial markets. In addition, the Profit and Loss sharing framework is expected to reduce significantly the inequitable distribution of income and wealth and is likely to control inflation to some extent (Zamil, 2014). Funds generated by the Islamic bank under the risk sharing agreement (Dejonse, 2011) are distributed in either direct profitable investments or given to entrepreneurs under the same risk sharing agreement as it were.
obtained. The Islamic banks are able to sustain their operations through murabaha profits. This is the best option considering it does not contravene the Islamic sharia’h laws.

2.3.2 Interest Theory
The earliest writings on the subject of Islamic banking and finance date back to the forties of the twentieth century by Siddiqi. The theory of Islamic banking is based on the idea that interest is strictly forbidden in Islam, and that Islamic teachings provide the required guidance on which to base the working of banks (Hassan and Lewis, 2007). According to Ahmad (2006), 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. 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. The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible (Hassan and Lewis, 2007).

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. Theoretical work on Islamic banking encompasses several aspects related to both the operating procedures of Islamic banks and the possible socioeconomic consequences of the adoption of the new system (Ahmad, 2006).

Islam seeks to establish a society based upon fairness and justice (Holy Qur’an 2:239). Thus, the concept of Islamic banking has proceeded on the basis that guidance for all institutionalized developments in an Islamic society should be derived from the principles of Sharia. The form and content of Islamic banking practices have, therefore, to be derived from the teachings of Islam (Ahmad, 2006). For instance, if a loan provides the lender with a fixed return irrespective of the outcome of the borrower’s venture. It is much fairer to have a
sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and thus be governed by the return on the individual project for which funds are supplied (Hassan and Lewis, 2007). An interest-free financial system calls for a modified monetary policy framework. With the prohibition of interest in the economy, the design of Sharia-compliant monetary policy is the center of attention among Islamic bankers and economists. Islamic principles call for ensuring a level playing field among market participants, thereby allowing the economy to expand and helping to alleviate poverty. In a conventional economy, monetary policy traditionally seeks to curb inflation and mitigate output fluctuation.

As noted by Khan and Mirakhhor (1994) and echoed by others, monetary policy in an Islamic system is expected to facilitate the mobilization of savings and allocation of resources consistent with the economic development objectives of the system. Whereas the monetary policy objectives of the Islamic economy seem to be in line with those of the conventional economy, the monetary authorities in a Shari’ah-compliant system are prohibited from using any tool that involves a discount rate or other forms of interest rates. Nonetheless, open market operations, credit policies, reserve requirements, statutory reserves, equity-based instruments, refinancing ratios, and profit-sharing ratios have been suggested for the design of Shari’ah-compliant monetary policy tools (Dewatripont & Legros, 2005).

### 2.3.3 Trust Financing Theory

The trust financing theory is referred to Mudaraba in Islam (finance by way of trust). According to Mirakhor and Zaidi (2007) Mudaraba is a form of partnership in which one partner (rabb al-mal) finances the project, while the other party (mudarib) manages it. This mode of financing does not require that a company be created; the financial institution provides all of the capital and the customer is responsible for the management of the project. Thus, profits from the investment are distributed according to a fixed, predetermined ratio. The partner has possession of the assets, but the other party has the option to buy out the partner’s investment. Mudaraba may be concluded between an Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee of their funds, and its business - owner clients (Mirakhor and Zaidi, 2007).
The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra (1985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of *riba*, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social- welfare-oriented rather than a profit maximizing role. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers.

2.4 Islamic Banking Instruments and Economic Growth

2.4.1 Murabaha (Mark Up Financing)

Under the Murabaha arrangement, the client makes a promise to buy specified goods from the Islamic bank on a deferred payment basis. The Islamic bank purchases goods from the original supplier and sells them on to the client after adding its own profit margin. The legality of murabaha could not be established from the primary sources of Islamic Shari’ah, i.e. the holy Quran and Sunnah. The early Islamic jurists, such as Imam Malik (796) and Imam Shafi (820), approved murabaha sales but they did not refer to the increase in price in the case of deferred payment. Subsequently, certain other Islamic jurists, such as Sarakhsi (1091), Marghinani (1197) and Nawawi (1277), allowed the seller to charge a higher price in the deferred payment sale by characterizing it as a normal trade practice (Saadullah, 1994; Vogel and Hayes, 1998). Contemporary Islamic scholars have mixed opinions about the murabaha banking system. The majority of them have strong reservations about it because of its close resemblance to conventional banking practice.
2.4.2 Ijarah (lease financing)

The features of Ijarah financing are very similar to those of conventional lease financing. However, unlike in the conventional lease contract, Shari’ah holds the leaser responsible for all damage, repairs, insurance and depreciation of the leased asset. The leaser should also bear the risk of uncertainty attached to the useful life of the leased asset. Islamic financial institutions mostly rely on leasing, known as Ijarah wa iqtina, for meeting financing needs in the real estate, retail, industry and manufacturing sectors. Leasing enjoys strong support from Shari’ah scholars and bears a close resemblance to conventional leasing (Iqbal, 2000).

Ijarah is commonly used for long and medium term fixed asset financing, project financing and for retail products such as homes and automobiles. This mode of financing is based on the bank allowing the customer to use tangible assets, such as property, machinery, etc., on rental for an agreed period of time. The concept is similar to "leasing". However there are some specific prohibitions which render conventional leasing to be forbidden under Shariah.

According to Iqbal (2000) banks are able to expand their business through the assets that are leased to the customers hence gaining monetary value from the asset. This also attracts many customers who are interested in leasing of property rather than buying. The bank is able to remain the sole owner of the property.

2.4.3 Bai Salam (advance payment) and Bai Iistisna (procurement engagement)

Bai salam and bai istisna are forward sale contracts in which the seller pays in advance the price of goods that are to be delivered to him at a specified future date. Bai salam was widely practiced in the Arabian agricultural sector long before the dawn of Islam. These instruments are best suited to meet the financing needs of the farming and manufacturing industries in the Islamic economy. Shari’ah stipulates that the terms and conditions of bai salam and bai istisna contracts, such as price, quantity and quality of goods, should be clearly determined without involving any features of interest, gharar (speculation) or dubious sale (Iqbal, 2000).
2.4.4 Diminishing Musharaka

Diminishing Musharaka is most commonly used for the financing of fixed assets, plants and machinery, homes and automobiles. Under this structure, the Islamic Bank and the customer participate in the joint ownership of an asset. The asset is divided into a number of units and the customer periodically purchases these units from the bank over a specified period. The customer also pays rent for using the bank's portion of the asset. Over time, the customer purchases all units owned by the bank, making him or her sole owner of the asset or the commercial enterprise.

The Islamic Banks with this product have been able to increase its asset base through musharaka. This has enabled the banks to compete with other well-established bank not necessarily Islamic banks but also conventional banks.

Musharakah has enabled banks to grow in terms of customers this is due to the conducive terms of the instruments. Most of the customers have invested heavily on this method since it has a long term benefit to the customer where he or she becomes the sole owner of the asset after successfully buying all the units owned by the bank.

Iran and Sudan, where only Islamic banking operates in the financial system, have developed musharakah-type contracts for their monetary policy. The central bank of Sudan Musharakah Certificates, issued against the participation of the central bank in the equity of private banks, as well as Ijarah certificates, are used to manage the liquidity of the domestic banking sector through open market operations, though it has been an expensive instrument in practice (Maziad, S., and AlSaeed, 2015). Authorities in Sudan also issued government musharakah certificates (Shahama) and government investment certificates (Sarah) to help conduct monetary policy.

2.5 Islamic Banking Risks and Economic Growth

2.5.1 Credit Risk

Credit risk is known as the potential risk attributed to delayed, deferred and default in payments by counterparties. It covers profit-sharing contracts (Mudarabah and Musharakah), receivables and lease (Murabahah, Diminishing Musharakah and Ijarah) and working capital
financing (Salam, Istisna’ and Mudarabah). The techniques used by Islamic banks to mitigate risk are similar to conventional banks. The importance of credit risk management becomes critical in the case of Islamic financial institutions where lending is replaced with investments and partnership (Della Croce, 2011).

In the case of Mudarabah investments, Islamic bank as a Rabbul-mal (principal) is exposed to an enhanced credit risk on the amounts advanced to the mudarib (agent), in addition to the typical principal-agent problems. The bank is not in the position to know and decide how the activities of mudarib can be monitored accurately, especially if claims of losses are made, since the nature of the Mudarabah contract does not give the bank appropriate rights to monitor the mudarib or to participate in the management of the project. Thus, it makes the assessment and management of credit risk difficult and the risk especially present in markets where information asymmetry is high and there is lack of transparency in financial disclosure by the mudarib (Della Croce, 2011).

In Murabahah transactions, Islamic banks are exposed to credit risks when the bank has already delivered the asset to the client but it does not receive payment from the client in time. Furthermore, in Salam and Istisna’ contracts, the bank is exposed to the risk of failure to supply goods on time or to supply at all, or failure to adhere to the quality of goods as contractually specified. Such failure can expose Islamic banks to financial losses of income as well as capital. The Islamic banks are exposed to the risk of losing entire invested capital in Musharakah, since such capital may not be recovered as it ranks lower than debt instruments upon liquidation (Akkizidis and Khandelwal, 2008).

### 2.5.2 Mark-up risk

Islamic financial institutions use a benchmark rate to price different financial instruments. For example, in a murabaha contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the London Interbank Offer Rate (LIBOR)).

The nature of a murabaha is such that the mark-up is fixed for the duration of the contract. Consequently, if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result Islamic banks face risks arising from movements in market interest rate. Markup risk can also appear in profit-sharing modes of financing like
mudaraba and musharaka as the profit-sharing ratio depends on, among other things, a benchmark rate like LIBOR (Tahir and Haron, 2010).

2.5.3 Commodity/asset price risk
The murabaha price risk and commodity/asset price risk must be clearly distinguished. As pointed out, the basis of the mark-up price risk is changes in LIBOR. Furthermore, it arises as a result of the financing, not the trading process. In contrast to mark-up risk, commodity price risk arises as a result of the bank holding commodities or durable assets as in salam, ijara and mudarabah/musharaka. Note that both the mark-up risk and commodity/asset price risk can exist in a single contract. For example, under leasing, the equipment itself is exposed to commodity price risk and the fixed or overdue rentals are exposed to mark-up risks.

2.5.4 Shari’ah Risk
Shari’ah risk is related to the structure and functioning of the Shari’ah boards at the institutional and systemic level. This risk consists of two types; the first is due to nonstandard practices in respect of different contracts in different jurisdictions and second is due to failure to comply with Shari’ah rules. Different adoption of Shari’ah rules results in differences in financial reporting, auditing and accounting treatment by Islamic banks. For example, some Shari’ah scholars consider the terms of a Murabahah contract to be binding on the buyer, others argue that the buyer has the option to decline even after placing an order and paying the commitment fee. While each practice is acceptable by different schools of thought, the bank’s risk is higher in non-binding cases and it may lead to potential litigation problems in case of unsettled transactions. Banks are exposed to the risk of non-compliance with the Shari’ah rules and principles determined by the Shari’ah board or the relevant body in the jurisdiction. The nature of relationship between the bank and investors/depositors is not only of an agent and principal, but it is also based on implicit trust to fully comply with the Shari’ah where this relationship distinguishes Islamic banking from conventional (Tahir and Haron, 2010).

In case where the bank is unable to maintain this trust and the bank’s actions lead to non-compliance with the Shari’ah, the bank is exposed to the risk of breaking the confidence of the investors/depositors. Breaching the trust and confidence of the depositors/investors will
lead to serious consequences, including the withdrawal and insolvency risk. To some extent, a few Shari’ah scholars have suggested that if a bank fails to act in accordance with Shari’ah rules, the transaction should be considered null and void and any income derived from it should not be included in the profits to be distributed to the investors/depositors (Iqbal and Mirakhor, 2007).

2.5.5  Legal Risk
Legal risks for Islamic banks are also significant and arise for various reasons. First, as most countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks’ main activity is in trading (murabaha) and investing in equities (musharaka and mudaraba), current banking law and regulations in most jurisdictions forbid commercial banks undertaking such activities. Second, non-standardization of contracts makes the whole process of negotiating different aspects of a transaction more difficult and costly. Financial institutions are not protected against risks that they cannot anticipate or that may not be enforceable. Use of standardized contracts can also make transactions easier to administer and monitor after the contract is signed. Finally, lack of Islamic courts that can enforce Islamic contracts increases the legal risks of using these contracts (Rashwan, 2012)
2.6 Chapter Summary

This chapter has explored and reviewed literature review on the impact of Islamic Banking on the Kenyan economy. The literature is based on the three research questions, which include; to establish impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth.

The following chapter describes the methods and procedures used to carry out the study by paying emphasis to research design, population and sample design, data collection methods, research procedures and data analysis methods.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction
This chapter presents the research methodology of the study. It reviews the research design, population and sampling method that was used in gathering, analyzing the data and reporting the results. It gives details on population and sampling techniques, data collection methods, research procedure and data analysis procedure. Research methods involve form of data collection, analysis and interpretation that researchers propose for their studies (Cresswell 2009).

3.2 Research Design
This study used the case design of First Community Bank in Kenya. A case study places more emphasis on the full analysis of a limited number of events or conditions and their interrelations Kothari (2004). There was a need for an in-depth analysis of the products offered by First Community Bank and their impact on the growth of the economy.

This research adopted a descriptive research design. A descriptive research design is a scientific method, which involves observing and describing the behavior of a subject without influencing it in any way (Malhotra, 2007). Additionally, a descriptive study attempts to describe a subject, often by creating a profile of a group of problem, people or events, through collections of data and the tabulation of frequencies on research variables and the research reveals who, what, when, where or how much (Cooper and Schindler, 2003). Descriptive research is considered appropriate because subjects are normally observed in their natural set up and can result in accurate and reliable information (Britt, 2006). This design lends itself to various approaches. This study adopted the survey approach. A survey in form of standardized questions in a questionnaire was used to collect data. A survey is defined by Malhotra (2007) as a method of collecting data from people about who they are, how they think and what they do (behavior).
The independent variable of the study are Islamic banking theories and economic growth, Islamic banking instruments and economic growth and lastly Islamic banking risks and economic growth. The dependent variable of the study is economic growth.

3.3 Population and Sampling Design

3.3.1 Population

Cooper and Schindler (2003) describe a population as the total collection of elements whereby references have to be made. A target population includes all cases about which the researcher would like to make generalizations while the accessible population comprises all the cases that conform to the designated criteria and are accessible to the researcher as a pool of subjects for a study.

In this study, the population comprised of 50 employees from the various departments at the bank. These departments included Marketing, Operations, Research and Development, Sales, Customer service and Risk.

Table 3.1: Total Population Distribution

<table>
<thead>
<tr>
<th>Department</th>
<th>Total Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing</td>
<td>12</td>
</tr>
<tr>
<td>Operations</td>
<td>10</td>
</tr>
<tr>
<td>Research and Development</td>
<td>8</td>
</tr>
<tr>
<td>Sales</td>
<td>6</td>
</tr>
<tr>
<td>Customer Service</td>
<td>9</td>
</tr>
<tr>
<td>Risk</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
</tr>
</tbody>
</table>

3.3.2 Sampling Design and Sample Size

3.3.2 Sampling Frame

A research sampling frame is that part of the research plan that indicates how cases are to be selected for observation. The design therefore maps out the procedure to be followed to draw the study’s sample. A sampling frame is a list of elements from which the sample is actually drawn and is closely related to the population under study (Cooper & Schindler, 2003). A list of elements from which a sample may be drawn is also called a working population.
In this study, the sampling frame constituted of the 6 departments that are in close touch with products been offered by First Community Bank.

3.3 Sampling Techniques

The study adopted a stratified random sampling technique that enabled the researcher to capture the desired data across the population. According to William Zikmund and Barry Babin (2012), this type of sampling which selects members of the sample proportionally from each subpopulation or stratum. Considering the accessible population and the scope of the study, the method technique was sufficient enough to capture the required information across the various strata.

3.3.3 Sampling Size

Determining sample size is a very important issue for collecting an accurate result within a quantitative survey design. The sample size is a smaller set of the larger population (Cooper & Schindler, 2003). Cooper and Schindler argued that the sample must be carefully selected to be representative of the population and the need for the researcher to ensure that the subdivisions entailed in the analysis are accurately catered for. The researcher obtained a 50% sample of all strata this was viewed as adequate more representative.

Table 3.2 Sample Size Distribution

<table>
<thead>
<tr>
<th>Department</th>
<th>Population (N)</th>
<th>Percentage</th>
<th>Sample Size(n)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing</td>
<td>12</td>
<td>50</td>
<td>6</td>
</tr>
<tr>
<td>Operations</td>
<td>1</td>
<td>50</td>
<td>5</td>
</tr>
<tr>
<td>Research and Development</td>
<td>8</td>
<td>50</td>
<td>4</td>
</tr>
<tr>
<td>Sales</td>
<td>6</td>
<td>50</td>
<td>3</td>
</tr>
<tr>
<td>Customer Service</td>
<td>9</td>
<td>50</td>
<td>5</td>
</tr>
<tr>
<td>Risk</td>
<td>5</td>
<td>50</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
<td></td>
<td><strong>25</strong></td>
</tr>
</tbody>
</table>
3.4 Data Collection Method

The study used primary data collection. The data collection method was through questionnaires. Maholtra (2007) explains that questionnaires are an important data collection tool. In addition, the use of mixed questionnaires with both close and open end questions were justified because they provided an effective and efficient way of gathering information within a very short time. Further, the questionnaires facilitated easier coding and analysis of data collected. The questionnaires have closed ended questions divided into four sections: first section contained the respondent’s demographics with ten questions. The second section addressed Islamic banking theories and economy growth. The third section addressed Islamic banking instruments and economy growth. The fourth investigated Islamic banking risks and economy growth.

3.5 Research Procedures

The structured questionnaire were formulated and submitted to general manager for clarity and content validity. This was preceded by seeking the approval of the relevant authority. After the approval and before the actual data collection the questionnaires were pretested for efficiency among 5 respondents who were not part of the study. This enabled the researcher to fine tune the questionnaire for objectivity and efficiency of the process.

According to Mugenda and Mugenda (2009), this ensures the reliability of the data collected for the purposes of the research. A letter of introduction was attached to the questionnaire explaining the purpose of the study. The questionnaire were administered with the aid of a research assistant using drop and pick method from the respondents during week days. Follow up reminders, which included emails, text messages and phone calls were used to achieve high response rate. Each questionnaire was estimated to take fifteen minutes to complete and the respondents’ confidentiality was assured to be maintained.
3.6 Pilot Test

A pilot test was administered to at least 10% of the study sample. This is in line with Connelly (2008) who suggested that the pilot study sample should be at least 10% of the study sample. Pilot test was necessary in identifying and coming to face with realities and anticipated problems during the actual research. The pilot test was aimed at assisting in pre-testing the questionnaire as a data collection tool.

Focus of the pilot test was on the effectiveness of the questionnaire, its reliability and validity of data collected, correctness of data and identification of necessary modification required. In addition the pilot test was to gauge the level of cooperation or resistance expected during the actual study as well as the level to which the questionnaire meets the objective of the study.

3.6.1 Reliability Test

The pilot test seeked to measure the reliability of the data collection instrument (questionnaire). Reliability estimate shows the amount of measurement error in a test. Further it is concerned with internal constituency of a test or a scale. Reliability is often measured using percentage. It refers to the number of times an actual value falls within a prescribed precision limit.

The study used the Cronbach alpha formulae to test the reliability of the data collection tool. The alpha was developed in 1951 by Lee Cronbach and lie between negative infinity and 1. However it is only the positive value that makes sense and hence the range used for the Cronbach alpha is between 0 and 1. A Cronbach alpha score of greater than 0.6 is considered to be good enough to assure reliability of the data collection tool. However Nunnaly (1978) has indicated 0.7 to be an acceptable reliability coefficient but lower thresholds are sometimes used.

3.6.2 Validity Test

Validity is the extent to which a test measures what it is supposed to measure or the subject matter of the study. The question of validity is raised in the content the form of the test, the purpose of the test and the population for whom it is intended. The pilot test seeked to answer
the question “how valid is this test for the decision the study needs to make?” and “how valid is the interpretation?”

For the purpose of this study content validity was tested. Content validity refers to the extent to which a measuring instrument (questionnaire) provides adequate coverage of the topic under study. Thus emphasis on the validity test was on the content of the questionnaire and whether it address all the study variable.

### 3.7 Data Analysis Methods

To ensure easy analysis, the questionnaires were coded according to each variable of the study. This study used descriptive statistics. According to Mugenda and Mugenda (2009), descriptive analysis involves a process of transforming a mass of raw data into tables, charts, with frequency distribution and percentages, which are a vital part of making sense of the data. In this study, the descriptive statistics were used to give meaning to the data.
3.8 Chapter Summary
This chapter presented the various methods and procedures the researcher adopted in conducting the study in order to answer the research questions raised in the first chapter. The chapter was organized in the following ways: the research design, population and sample, data collection methods, sampling design and sample size, research procedures and data analysis. The next chapter presents the results and findings of the study.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

This chapter presents the results and findings of the study. The data was analyzed on the three research questions, which included; to establish the impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth.

4.2 General Information

This section provides the demographic characteristics of the respondents. These include the customer segment, gender, level of education, length of service and department. Information of the respondents was necessary because it allowed the researcher to determine whether the target audience had reached and if the information sought was gathered.

4.2.1 Gender of the Respondents

Gender was chosen as one of the respondents’ characteristics so as to ensure that there was no biasness. Majority of the respondents were male (56%) were males whereas only 44% of the respondents were female as shown in Figure 4.1.

![Figure 4.1: Gender of the Respondents](image)

Figure 4.1: Gender of the Respondents
4.2.2 Level of Education

The respondents were asked to give brief background of their education level in the study and the following findings were noted. Respondents with education qualification of degree made up 58% of the total respondents, those with master’s level qualification made up 25%, secondary level made up 10% while those with college level made up 6.6%. Majorities of the respondents were of degree holder’s, this is because this was the minimum qualification for entry jobs in the banking industry. Few number of secondary level education at 10% is attributed to low openings of opportunities requiring such qualification, this is indicated in Figure 4.2.

![Figure 4.2: Level of Education](image)

4.2.3 Length of Service

From the data obtained, 42.6% of the respondents had served the company for over 10 years, 35.2% of the respondents indicated that they had served the company for 6 to 10 years, 16.7% of the respondents indicated that they had served the company for a period of 1 to 5 years whereas 5.6% of the respondents indicated that they had served the company for less than a year. This depicts that most of the respondents have been working with the company
long enough hence giving them a better understanding of the bank’s operations and products. This is shown in Figure 4.3.

![Figure 4.3: Length of Service](image)

4.2.4 Work Department

From the data obtained, 26% of the respondents indicated they worked in the Customer Service department, 22% indicated that they worked in Sales department, 18% of the respondents indicated that they worked in Research & Development department, 14% of the respondents indicated that they worked in Marketing department, 12% of the respondents indicated that they worked in Operations department whereas 8% of the respondents indicated that they worked in the Risk department. This is an indication the all the departments are involved in the investigation process. The results are shown in Figure 4.4.
4.3 Islamic Banking Theories and Economic Growth.
A number of factors evaluated the impact of Islamic banking on economic growth at First Community Bank. Among them was Islamic banking theories which had sub-factors such as Profit and Loss sharing theory, Interest theory and Trust financing theory. The researcher sought to find out how these theories affected economic growth.

4.3.1 Profit and Loss Sharing Theory
The respondents asked if they felt that Profit and Loss sharing concept contributed to economy growth in the country. 47% of the respondents agreed, 22.7% strongly agreed, 19.4 were not sure, 10% disagreed, while 1% of the population strongly disagreed with the statement. From the above data a majority of the respondents agreed that Profit and Loss sharing theory contributed to economy growth. This is illustrated in Figure 4.5.
4.3.2 Interest Theory

When the respondents were asked if they were more attracted to interest free products under the Islamic banking, 40.00% of the respondents agreed with the statement, 24.00% strongly agreed, 16.00% were not sure, 12.00% disagreed, while another 8.00% of the respondents strongly disagreed with the statement. Majority of the respondents were of the opinion that they more attracted to interest free products under the Islamic Banking. The results are shown in Table 4.3.

Table 4.1: Interest Theory

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Disagreed</td>
<td>4</td>
<td>8.00%</td>
</tr>
<tr>
<td>Disagree</td>
<td>6</td>
<td>12.00%</td>
</tr>
<tr>
<td>Not Sure</td>
<td>8</td>
<td>16.00%</td>
</tr>
<tr>
<td>Agreed</td>
<td>20</td>
<td>40.00%</td>
</tr>
<tr>
<td>Strongly Agreed</td>
<td>12</td>
<td>24.00%</td>
</tr>
<tr>
<td>Total</td>
<td>50</td>
<td>100%</td>
</tr>
</tbody>
</table>
4.3.3 Trust Financing

When the respondents were asked if through Trust Financing they were able to acquire intensive capital assets for their businesses, 40.00% disagreed, 30.00% strongly disagreed, 26.67% were not sure, 3.33% agreed with statement and 0% of the respondent strongly agreed with the statement. Going by the response above, majority of the respondents agreed that they were able to acquire intensive capital assets for their businesses through Trust Financing as shown in Table 4.4.

Table 4.2: Trust Financing

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
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4.4 Islamic Banking Instruments and Economic Growth.

A number of factors evaluated the impact of Islamic banking on economic growth at First Community Bank. Among them was Islamic banking instruments, which had sub-factors such as Murabaha, Ijarah, Bai Salam & Bai Istisna and Diminishing, Musharaka. The researcher sought to find out how these instruments affected economic growth.

4.4.1 Murabaha (Mark Up Financing)

When the respondents were asked if Murabaha product enabled traders to acquire goods more easily and conveniently, 44.00% of the respondents agreed, 32.00% strongly agreed, 12.00% of the respondents were not sure, 8.00% said they strongly disagreed with the statement while 2.00% disagreed. It is evident from the response that a majority of the
respondents agreed that indeed that Murabaha product enabled traders to acquire goods more easily and conveniently as shown in Table 4.6.

**Table 4.3: Murabaha (Mark Up Financing)**

<table>
<thead>
<tr>
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<tr>
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<td><strong>Total</strong></td>
<td><strong>50</strong></td>
<td><strong>100.00%</strong></td>
</tr>
</tbody>
</table>

**4.4.2 Ijarah (lease financing)**

The respondent were asked if Ijarah enabled them to acquire high capital assets for their businesses easily and 53.33% agreed, 33.34% strongly agreed, 0.00% were not sure, 10.00% disagreed while 3.33% strongly disagreed with the statement. The response clearly show that the majority of the respondents agreed that Ijarah enabled them to acquire high capital assets for their businesses. This is illustrated in Figure 4.7.

![Figure 4.6: Ijarah (lease financing)](image-url)
4.4.3 Bai Salam (advance payment) and Bai Istisna (procurement engagement)

The respondents were also asked if Bai salam and Bai istisna products were bested suited to meet their financing needs of the farming and manufacturing industries. 32.00% agreed that indeed it met their needs, 30.00 % strongly agreed with the statement, 24.00% were not sure, 10.00% disagreed, while 4.00% strongly disagreed with the statement. From the results majority of the respondents felt that indeed Bai Salam and Bai Istisna products were bested suited to meet their financing needs of the farming and manufacturing industries as shown in Table 4.7.

<table>
<thead>
<tr>
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<tr>
<td>Total</td>
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</tbody>
</table>

4.4.4 Diminishing Musharaka

The respondents were asked whether Diminishing Musharaka was commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles. 32.00% strongly agreed, 26.00% were not sure, 20.00% agreed, 14% disagreed while 8.00% strongly disagreed with the statement. The results clearly showed that majority of respondents were of the opinion that Diminishing Musharaka was commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles as shown in Table 4.8.
Table 4.5: Diminishing Musharaka

<table>
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<tbody>
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<tr>
<td>Total</td>
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</table>

4.5 Islamic Banking Risks and Economic Growth

A number of factors evaluated the impact of Islamic banking on economic growth at First Community Bank. Among them was Islamic banking associated risks, which had sub-factors such as Credit risk, Mark-Up risk, Commodity/Asset price risk and Legal risk. The researcher sought to find out how these risks affected economic growth.

4.5.1 Credit Risk

The respondents were asked if Islamic banking instruments had high potential of credit risks due to delayed, deferred and default payments. 44.00% strongly agreed, 34.00% agreed, 16.00% were not sure, 2.00% disagreed while 4.00% strongly disagreed with the statement. From the data obtained the results showed that indeed majority of the respondents felt that Islamic banking instruments had high potential of credit risks due to delayed, deferred and default payments. This is illustrated in Table 4.10.

Table 4.6: Credit Risk

<table>
<thead>
<tr>
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<tbody>
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<tr>
<td>Disagree</td>
<td>1</td>
<td>2.00%</td>
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</table>

40
4.5.2 Mark-Up risk
The respondents were asked if they felt that contracts like Mudaraba, Isalamic banking were highly exposed to mark-up risk arising from movements in market interest rate and 56.00% strongly agreed, 20.00% agreed, 16.00% were not sure, 8.00% disagreed while 0.003% strongly disagreed with the statement. Going by the above data, majority of the respondents felt that Isalamic banking were highly exposed to mark-up risk as shown in Table 4.11.

Table 4.7: Mark-Up risk

<table>
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<td>Strongly Agree</td>
<td>28</td>
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<td>Total</td>
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</tbody>
</table>

4.5.3 Commodity/Asset Price Risk
The respondents were also asked if they felt that Commodity price/Asset risk resulted from the bank holding commodities or durable assets for too long. 40.00% of the respondents agreed with the statement, 30.00% strongly agreed, 26.67% were not sure, 3.33% disagreed with the statement while 0.00% strongly disagreed. According to the results above it is evident that a majority of the respondents felt Commodity price/Asset risk resulted from the bank holding commodities or durable assets for too long as shown in Figure 4.7.
4.5.3 Legal Risk

When the respondents were asked if the legal framework in the country had specific laws/statutes that support the unique features of Islamic financial products. 60.00% agreed with the statement, 20.00% strongly agreed, 6.67% disagreed, 3.33% strongly disagreed while 0.00% were not sure with the statement. From results the researcher majority of the respondents felt that technological failures affected their online interaction as shown in Table 4.13.

Table 4.8: Legal Risk

<table>
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<td>8.00%</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
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4.6 Chapter Summary

This chapter discussed the results and findings of the study. It reported the findings of the research questions, which included; to establish the impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth. The data was presented by use of graphs and tables. The next chapter will cover on discussions, conclusions and recommendation of the study.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS.

5.1 Introduction

This chapter presents the discussions, conclusions and recommendations of the study. The chapter analyzes the research questions of the study which included; which include; to establish impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth. It also discusses and analyses the data based on the findings. Finally, it provides recommendations and further research options.

5.2 Summary of Findings

The main purpose of the study was to determine the impact of Islamic Banking on economy growth in Kenya. The study was guided by the following research questions which included; to establish impact of Islamic banking theories on economy growth, to establish the effectiveness of Islamic banking tools on economy growth and lastly to establish the various risks of Islamic banking on economy growth.

The study used a descriptive research design. The target population was 50 employees from the various departments at First Community Bank in Kenya. These include Marketing, Operations, Research and Development, Sales, Customer service and Risk. The research adopted stratified random sampling technique which enabled sufficient representation of the desired data across the population. From the target population a sample size of 25 customers was obtained. The main method of data collection was through the use of questionnaires which were easier and effective to use by the researcher. Data analysis was done through the use of tables, graphs and charts. Descriptive statistics were used to describe features of the data and presentation was done through the use of tables and charts.

On Islamic banking theories a number of factors were identified which included Profit and Loss sharing theory, Interest theory and Trust financing theory. On Profit and Loss sharing theory majority of the respondents agreed that the theory contributed to economy growth. Majority of the respondents were of the opinion that they more attracted to interest free
products under the Islamic Banking. And lastly on Trust Financing theory, majority of the respondents agreed that they were able to acquire intensive capital assets for their businesses through Trust Financing.

Findings on effectiveness of Islamic banking instruments showed that the elements influenced the economy growth in Kenya. A number of factors were investigated such as Murabaha, Ijarah, Bai Salam & Bai Istisna and Diminishing Musharaka On Murahaba, majority of the respondents agreed that indeed that the instrument enabled them to acquire goods more easily and conveniently. Also a majority of the respondents agreed that through Ijarah customers have been able to acquire assets for their businesses easily. On Bai Salam and Bai Istisna products, majority of the respondents strongly agreed that the products met their financing needs of the farming and manufacturing industries. And lastly majority of the respondents were of the opinion that Diminishing Musharaka was commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles.

On Islamic banking associated risks, which had sub-factors such as Credit risk, Mark-Up risk, and Legal risk. On Credit risk majority of the respondents felt that Islamic banking instruments had high potential of credit risks due to delayed, deferred and default payments. Majority of the respondents felt that Islamic banking were highly exposed to mark-up risk. And lastly, majority of the respondents agreed that majority of the respondents felt that Islamic banking was highly affected by legal risk associated with the Shari’ah law.

The study concluded that Islamic banking theories contribute to economy growth. The Islamic banking theories help to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. Islamic banking enhances economy growth through better integration of the real and financial sectors of the economy, better business ethics since banks will only entertain economically viable financing requests, instead of being lenders. The study also concludes that the Islamic banking instruments contributed to economic growth. The Islamic banking instruments have enabled banks to grow in terms of customers this is due to the conducive terms of the instruments. Most of the customers have invested heavily on these instruments since they have long term benefits to the customers and more convenient. Finally, the study concluded that Islamic Banking was influenced by a number of risks. The Islamic banks are
exposed to the risk of losing entire invested capital as their products are not fully secured. As most countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products.

The study recommends that study concludes that the Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. The study also concluded that banks in the country should embrace an Interest Free environment which ensures a level playing field among market participants. This helps to allow the economy to expand and helping to alleviate poverty. The study concludes that lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. Finally, the study concluded that Islamic banking lacks uniform standards of credit analysis as banks have no appropriate standard of credit analysis hence heavily exposing their products. Banks should be more aware of the related banking risks associated with the Islamic Banking.

5.3 Discussion

5.3.1 Islamic Banking Theories and Economic Growth

According to Kammer et al., (2015), Islamic banking has the potential to contribute to higher and more inclusive economic growth. In addition, Adeola (2007) noted that Islamic banking enhances economy growth through better integration of the real and financial sectors of the economy, better business ethics since banks will only entertain economically viable financing requests. El-Galfy and Khiyar, (2012) also point out that Islamic banking positively contributes to macroeconomic stability for both developing and developed countries. According to the Islamic Financial Services Board (2014), Islamic finance is an increasingly important means for the financing of physical and social infrastructure that supports economic development and job creation in an expanding group of emerging economies. Islamic finance is important to the world economy because it goes together with the traditional system and tackles the conventional system’s incapability of assimilating the Islamic markets and into the global economy. The Islamic banking theories investigated by the study included were Profit and Loss sharing theory, Interest theory and Trust financing theory.
On Profit and Loss Theory, the study found that the theory contributed to economic growth in the country. This was in line with what Zamil (2014) stated that, the underlying principles of Shari’ah that govern Islamic banking is to promote a profit and loss sharing framework as an ideal mode of financing to achieve justice and socioeconomic objectives. The Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. The country should strive to encourage Islamic Banking theories, so as to influence more people in investing through the attractive and friendly packages under Islamic Banking. This study found that majority of the respondents agreed that Profit and Loss sharing contributes to economy growth.

With regard to Interest Free theory, the study found that the theory helped to contribute to economy growth in the country. This was echoed by what Hassan and Lewis (2007) stated, that 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. The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible. Banks in the country should embrace an Interest Free environment which ensures a level playing field among market participants, thereby allowing the economy to expand and helping to alleviate poverty. In contrast to a conventional economy, monetary policy which traditionally seeks to curb inflation and mitigate output fluctuation. As noted by Khan and Mirakhor (1994), monetary policy in an Islamic system is expected to facilitate the mobilization of savings and allocation of resources consistent with the economic development objectives of the system. This study found that majority of the respondents agreed that they were more attracted to interest free products under the Islamic Banking.

On Trust Financing theory, majority of the respondents agreed that they were able to acquire intensive capital assets for their businesses through the same. This was confirmed by what Mirakhor and Zaidi (2007) said that Trust Financing is a form of partnership in which one partner (bank) finances the project, while the other party (client) manages it, thus fostering trust and team work. As a result this contributes highly to the success of the project which in turn contributes to economy growth. Banks should embrace the theory since there is close monitoring of the project hence reducing any associated risks. This study found that majority
of the respondents agreed that they were able to acquire intensive capital assets for their businesses through Trust Financing.

5.3.2 Islamic Banking Instruments and Economic Growth

According to Burger, Tyson, Karpowicz, Delgago and Coelho (2009, infrastructure development under Islamic banking is financed through various sources using different instruments which generally contributed to economic empowerment. These findings are in line with those of Abdul-Gafoor, Al-Jarhi and Mabid Ali (2003) who found out those products offered by convectional banks are slightly expensive as compared to those offered by Shariah compliant banks. Kammer et al., (2015) also argued that Islamic finance has the potential to contribute to higher and more inclusive economic growth. In addition, Adeola (2007) noted that Islamic banking enhances economy growth through better integration of the real and financial sectors of the economy, better business ethics since banks will only entertain economically viable financing requests, instead of being lenders and Islamic banks will stay away from financing prohibited activities e.g. producing alcohol among others. Islamic Banking instruments elements investigated by the study included Murabaha, Ijarah, Bai Salam & Bai Istisna and Diminishing Musharaka.

Imam Malik (796) and Imam Shafi (820) asserted that Murabaha enables customers to own goods at a preferred time even in instances when the customer has no capital. Since the bank purchases goods from the original supplier and sells them on to the client after adding its own profit margin. This enables customers not to miss business opportunities in the event that they don’t have adequate capital. Banks should closely work in hand with their customers so as to maximize on business opportunities and provide necessary assistance where necessary so that customers don’t loose on business opportunities. The study found out that majority of the respondents agreed that indeed Murabaha enabled them to acquire goods more easily and conveniently.

From the data obtained, the results showed that majority of the respondents agreed that through Ijarah customers have been able to acquire assets for their businesses easily. Islamic financial institutions mostly rely on leasing, known as Ijarah wa iqtina, for meeting financing needs in the real estate, retail, industry and manufacturing sectors which highly contribute to
economy growth. According to Iqbal (2000), banks are able to expand their business through the assets that are leased to the customers hence gaining monetary value from the asset. This also attracts many customers who are interested in leasing of property rather than buying. The bank is able to remain the sole owner of the property. Through Ijarah banks should enable customers to acquire high capital intense assets more easily and affordable which contributes to economy growth.

According to Iqbal (2000), Bai Salam and Bai Istisna instruments are best suited to meet the financing needs of the farming and manufacturing industries in the Islamic banking. Shari’ah stipulates that the terms and conditions of Bai Salam and Bai Istisna contracts, such as price, quantity and quality of goods, should be clearly determined without involving any features of interest. This enables customers to maximize on their profits and even reinvesting the same towards the growth of the economy. This study found that majority of the respondents were of the opinion that the products met their financing needs of the farming and manufacturing industries.

The Diminishing Musharaka instrument is most commonly used for the financing of fixed assets, plants and machinery, homes and automobiles. Most of the customers have invested heavily on this method since it has a long term benefit to the customer where he or she becomes the sole owner of the asset after successfully buying all the units owned by the bank. This was echoed by Maziad, S., and AlSaeed, (2015) who stated that, Musharakah has enabled banks to grow in terms of customers this is due to the conducive terms of the instruments. The Islamic Banks with this product have been able to increase its asset base through musharaka. This has enabled the banks to compete with other well-established bank not necessarily Islamic banks but also conventional banks. From the study, majority of respondents were of the opinion that Diminishing Musharaka was commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles.
5.3.2 Islamic Banking Risks and Economic Growth

According to Khan and Bhatti (2008) Islamic Banks are haunted by the chronic problem of excess liquidity, because they carry about 40% surplus cash and other liquid assets in comparison to conventional banks due to the serious risk of long-term Sharia'a-compliant investment tools and avenues. As a result, Hassan (2009) confirms that Islamic banks face not only the regular risks encountered by conventional banks but they also face other risks as a result of their unique asset classes and liability structures. Islamic banks cannot use conventional risk management techniques and tools because they are based on interest, gambling and speculation, which are prohibited by Sharia and hence extremely exposed to all sorts of risks, such as those relating to interest rates, liquidity and non-payment. The Islamic banking risks investigated by the study included Credit risk, Mark-Up risk, and Legal risk.

According to Della Croce (2011), the importance of credit risk management becomes critical in the case of Islamic financial institutions where lending is replaced with investments and partnership. The study found that credit risk highly affects Islamic banking. This was confirmed by Akkizidis and Khandelwal (2008) who stated that, Islamic banks are exposed to the risk of losing entire invested capital in Musharakah, since such capital may not be recovered as it ranks lower than debt instruments upon liquidation. From the study, majority of the respondents felt that Islamic banking instruments had high potential of credit risks due to delayed, deferred and default payments. Della Croce (2011) further stated that the bank is not in the position to know and decide how the business activities can be monitored accurately, especially if claims of losses are made, since the nature of the Mudarabah contract does not give the bank appropriate rights to monitor or participate in the management of the project. Thus, it makes the assessment and management of credit risk difficult and the risk especially present in markets where information asymmetry is high and there is lack of transparency in financial disclosure. This possesses as high risk to banks which results to them shying away from Islamic banking products.

On Mark-Up risk, majority of the respondents felt that Islamic banking was highly exposed to mark-up risk. According to Tahir and Haron, (2010), Islamic banks face risks arising from movements in market interest rate. The study found out that indeed that mark-up risk affected
Islamic banking products and hence negatively affecting the economy. The nature of the Islamic products is that the mark-up is fixed for the duration of the contract. Consequently, if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. Banks should heavily invest in research and development so as to adequately manage the Mark up risk. Nathalie Hilmi and Alain Safa (2010) stated that bank lending where the interest rates are favorable and causes economic growth

According to Tahir and Haron (2010), Banks are exposed to the risk of non-compliance with the Shari’ah rules and principles determined by the Shari’ah board or the relevant body in the jurisdiction. The study found that Legal risk highly influenced the Islamic banking products. The bank’s risk is higher in non-binding cases and it may lead to potential litigation problems in case of unsettled transactions. In case where the bank is unable to maintain this trust and the bank’s actions lead to non-compliance with the Shari’ah, the bank is exposed to the risk of breaking the confidence of the investors/depositors. Breaching the trust and confidence of the depositors/investors will lead to serious consequences, including the withdrawal and insolvency risk. Further Rashwan (2012), states that lack of Islamic courts that can enforce Islamic contracts increases the legal risks of using these contracts. From the study, majority of the respondents felt that Islamic banking was highly affected by legal risk associated with the Shari’ah law.

5.4 Conclusions

5.4.1 Islamic Banking Theories and Economic Growth

From the findings the study concludes that the Islamic Banking theories among them Profit and Loss sharing theory, Interest theory and Trust financing theory affected the economy. Banks in the country should adopt Islamic Banking theories, so as to influence more people in investing through the attractive and friendly packages under Islamic Banking.

More-ever the study also concludes that the Islamic profit sharing concept helps to foster economic development by encouraging equal income distribution and which results in greater benefits for social justice and long-term growth. Islamic banking enhances economy growth through better integration of the real and financial sectors of the economy, better business ethics since banks will only entertain economically viable financing requests, instead of being lenders and Islamic banks will stay away from financing prohibited activities
e.g. producing alcohol among others. From the study majority of the respondents agreed that Profit and Loss sharing contributes to economy growth.

The study also concludes that banks in the country should embrace an Interest Free environment which ensures a level playing field among market participants, thereby allowing the economy to expand and helping to alleviate poverty. The study concludes that an increase in savings stirs economic growth since Islamic banks get more deposits which they advance to their customers. From the study majority of the respondents agreed that the Interest Free theory contributes to economy growth.

Finally, on Islamic banking theories the study concluded that convectional banks should embrace the Trust Financing theory since it ensures close monitoring of the project hence reducing any associated risks. From the study, majority of the respondents agreed that they were able to acquire intensive capital assets for their businesses through Trust Financing.

5.4.2 Islamic Banking Instruments and Economic Growth

The study concludes that the Islamic Banking Instruments among them Murabaha,Ijarah, Bai Salam & Bai Istisna and Diminishing Musharaka affected the economy. The study further concluded that, lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered.Banks should be more flexible so as to maximize on business opportunities and provide necessary assistance to their clients, so that they don’t loose on business opportunities.

The study concludes that Murabaha enables customers to own goods at a preferred time even in instances when the customer has no capital. This enables customers not to miss business opportunities in the event that they don’t have adequate capital and this positively contributes to the growth of the economy. From the study majority majority of the respondents agreed that indeed Murabaha enabled them to acquire goods more easily and conveniently.

On Ijarah, as an Islamic banking instrument, the study concludes that the instrument contributes to economy growth as customers have been able to acquire assets for their
businesses more easily. Moreover, banks should enable customers to acquire high capital intense assets more easily and affordable which contributes to economy growth. The study found that majority of the respondents agreed that through Ijarah, customers were able to acquire assets for their businesses easily.

From the study it was concluded that Bai Salam and Bai Istisna instruments are that are best suited to meet the financing needs of the farming and manufacturing industries in the Islamic banking. Through the instruments dimensions such as price, quantity and quality of goods, are clearly determined without involving any features of interest. This enables customers to maximize on their profits and even reinvesting the same towards the growth of the economy. The study found that majority of the respondents were of the opinion that the products met their financing needs of the farming and manufacturing industries.

Finally, the study concludes that Diminishing Musharaka is commonly preferred for financing of fixed assets, plants and machinery, homes and automobiles. Banks should use the product to increase their asset base through and generally contributing to the country’s economy. The product has enabled the banks to compete with other well-established bank not necessarily Islamic banks but also conventional banks. From the study, majority of respondents were of the opinion that Diminishing Musharaka was commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles.

5.4.3 Islamic Banking Risks and Economic Growth

The study concludes that the Islamic Banking risks among them Credit risk, Mark-Up risk, and Legal risk affected the economy. The study further concluded that Islamic banking lacks uniform standards of credit analysis as banks have no appropriate standard of credit analysis hence heavily exposing their products. Banks should be more aware of the related banking risks associated with the Islamic Banking. The study concludes that banks should heavily invest in research and development so as to adequately manage the risks.

On Credit risk, the study concluded that the risk highly affects Islamic banking. This result from the fact that bank is not in the position to know and decide how the business activities can be monitored accurately, especially if claims of losses are made, since the nature of the
Mudarabah contract does not give the bank appropriate rights to monitor or participate in the management of the project. Thus, it makes the assessment and management of credit risk difficult and the risk especially present in markets where information asymmetry is high and there is lack of transparency in financial disclosure. This possesses as high risk to banks which results to them shying away from Islamic banking products. From the study, majority of the respondents felt that Islamic banking instruments had high potential of credit risks due to delayed, deferred and default payments.

The study also concluded that, Islamic banking was highly exposed to Mark-up risk because of shifts in market interest rate. The study concludes that banks should heavily invest in research and development so as to adequately manage the Mark up risk. The study found out that indeed that mark-up risk affected Islamic banking products and hence negatively affecting the economy.

Finally, the study concludes that, Legal risk highly influenced the Islamic banking products. The banks should fully abide to the Shari’ah rules and principles so as to avoid breaching the trust and confidence of the depositors/investors will lead to serious consequences, including the withdrawal and insolvency. From the study, majority of the respondents felt that Islamic banking was highly affected by legal risk associated with the Shari’ah law.

5.5 Recommendations
5.5.1 Recommendation for Improvements
5.5.1.1 Islamic Banking Theories and Economic Growth

Islamic banking industry has been trying for the last over two decades to extend its outreach to bring it at least to the level of conventional banking. But the absence of Shariah-compliant legal framework needed to make interest-free banking acceptable is the major snag behind its low penetration in the financial market.

It is the time to take stock of challenges faced by the Islamic banks as they need a number of supporting institutions/arrangements to perform functions which are being carried out by various financial institutions in the conventional framework. Attempts should be made to
modify the existing structure to provide better products and quality service within the ambit of Islamic laws.

5.5.1.2 Islamic Banking Instruments and Economic Growth

Islamic banking has been growing at an impressive rate. Its presence in Kenya as a financial intermediary can be viewed positively as a compliment to conventional banking. It has created an environment of competition and we expect that there will be an improvement of the overall services provided by the banks. The government has to come up with improved policies for an enabling environment to foster for a friendly investment conditions. There are lot of opportunities to be tapped with rich oil producing Middle-East countries were the hub of Islamic banking is concentrated. The government can immensely benefit through the issue of Islamic bonds (Sukuk) which they can be used to finance various infrastructures projects. Islamic banking also provides for an opportunity for those pious individuals who will find their conscience at peace when banking with Islamic banks.

I recommend CBK to put in place a policy to establish a universal Shari’ah Boards to oversee Islamic banking operation in Kenya. Conventional banking system in Kenya are compelled to have a uniform financial reporting standard thus mixing their funds that are both conventional and Islamic compliant.

5.5.1.3 Islamic Banking Risks and Economic Growth

It is necessary that special laws for the introduction and practice of Islamic banking be put in place To ensure a proper, speedy and supporting Islamic legal system, amendments in existing laws,which are repugnant to injunctions of Islam, are required to promulgate Shariah compliant law for resolution of disputes through special courts. There is no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah.

Further training and Islamic finance education should be given to bank personnel to up skill them to offer quality service and appropriate advice to bank customers. I recommend banks to organize regular training and workshops by inviting well-versed Islamic scholars to educate bank personnel about Islamic banking and financing.
5.5.2 Recommendations for further studies

The concept of Islamic banking is still new in Kenya and is yet to take root thus this study suggests a further study on the challenges facing Islamic banks in Kenya with a view of providing recommendation on how to deal with the challenges.

This study covered the role of Islamic banks on economic growth thus an additional study on the role of conventional banks in economic growth would be vital to establish whether they play similar roles.
REFERENCES


Allen & Overy (2009), “Global Infrastructure Development and Delivery. The Stimulus for Debate”.


Ernst & Young (2008), Bridging the Gap: Private Investment in Middle East Infrastructure. http://www.ey.com/Global/assets.nsf/Middle_East/Middle_East_Infrastructure/$file/Middle_East_Infrastructure.pdf


APPENDICES

APPENDIX I: INTRODUCTORY LETTER

Dear Sir/Madam,

RE: REQUEST TO PARTICIPATE IN A RESEARCH STUDY

I am a Graduate student at School of Business at United States International University-Africa. I am carrying out a research project which is a partial requirement for the degree of Masters in Business Administration (MBA). The purpose of this research is to examine the impact of Islamic Banking on economic growth.

I will need to collect appropriate information from your bank to complete my study. Therefore, I am kindly requesting permission to collect and use your company’s information which will be collected using the attached questionnaire.

Kindly note that any information you give will be treated with confidentiality and at no instance will it be used for any other purpose other than for academic purposes only. Your support will be highly appreciated.

I look forward to your prompt response.

Regards

Said Mohamed Ali
Dear respondent,

I am an MBA student at USIU, Chandaria School of Business.

I am currently conducting a study on impact of Islamic Banking on economic growth and First Community Bank as the case study. I am therefore requesting for your assistance by filling the attached questionnaires to the best of your knowledge.

The information provided will be used purely for academic purposes and it will be treated in strict confidence. Do not include your name. Any additional information you might feel is necessary for this study is welcomed. You can write at the back side of the questionnaire.

Your cooperation in this regard will be highly appreciated. Thanking you in advance.

Yours faithfully,

Said Mohamed Ali
APPENDIX III-QUESTIONNAIRE

This study is a requirement for the partial fulfillment for the award of a Masters degree in Business Administration (MBA). The purpose of this research is gather information on the effectiveness of using modern technology in marketing communication.

Please note that any information you give will be treated with extreme confidentiality and at no instance will it be used for any other purpose other than for this project. Your assistance will be highly appreciated. I look forward to your prompt response.

Section A.

1. Gender ........................................................................................................................................

2. What is your education level? (Tick as applicable)
   
   i. Secondary [ ]     College [ ]
   
   ii. Bachelor’s degree [ ]     Master’s [ ]
   
   iii. Others-specify……………………………………………………………..

3. Years of service/working period (Tick as applicable)
   
   Less than 1 year [ ]     6-10 years [ ]
   
   1-5 years [ ]     Over 10 years [ ]

4. Please indicate your department
   
   Marketing [ ]     Sales [ ]
   
   Research and Development [ ]     Risk [ ]
   
   Operations [ ]     Customer Service [ ]
   
   Other (specify)……………………………………………………………………….
**PART B**

**SECTION A-ISLAMIC BANKING THEORIES AND ECONOMY GROWTH.**

_Guiding scale in each statement -Strongly Disagree (1), Disagree (2), Not Sure (3), Agree (4), Strongly Agree (5)._

<table>
<thead>
<tr>
<th>Please indicate to what extents do you agree or disagree with the following statements keeping in mind change management in your organization.</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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</thead>
<tbody>
<tr>
<td>Customers are highly attracted to the Profit and Loss concept as they view it as a partnership.</td>
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<tr>
<td>Some major infrastructure projects in the country like construction of roads, industries and large-scale farming have been funded through the Profit and Loss concept.</td>
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<tr>
<td>Banks shy away from the Profit and Loss sharing concept due to its high-risk nature.</td>
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<td>Islamic principles call for ensuring a level playing field especially through the interest free concept among market participants, thereby allowing the economy to expand and helping to alleviate poverty.</td>
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<td>Investors are more attracted to interest-free loan facilities and feel conventional banks charge interest at very high rates that are exploitative.</td>
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<td>Facilities offered on free interest rates are well performing and less of a burden to customers.</td>
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<td>Trust Financing has contributed largely to economy growth due to its partnership nature between the bank and clients.</td>
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<td>Through the Trust Financing, customers have been able to acquire intensive capital assets for their businesses.</td>
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<td>Islamic banks are reluctant to offer the Trust financing product to non-Muslims due to differences in religion and faith.</td>
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</table>
SECTION B - ISLAMIC BANKING RISKS AND ECONOMY GROWTH.

_Guiding scale in each statement -Strongly Disagree (1), Disagree (2), Not Sure (3), Agree (4), Strongly Agree (5)._  

<table>
<thead>
<tr>
<th>Please indicate to what extents do you agree or disagree with the following statements keeping in mind change management in your organization.</th>
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<tbody>
<tr>
<td>The Murabaha product enables traders to acquire goods more easily and conveniently.</td>
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<td>Due to its high demand, Murahaba generates quite a substantial income, which is regenerated to the economy.</td>
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<td>Murahaba is quite common in the importation of goods to the country.</td>
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<td>Through Ijarah, customers have been able to acquire assets for their businesses easily.</td>
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<td>Ijarah provides considerable time for repayment to customers hence making it more attractive to them.</td>
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<td>Banks are able to expand their business through the assets that are leased to the customers hence gaining monetary value from the asset</td>
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<td>Bai salam and bai istisna are best suited to meet the financing needs of the farming and manufacturing industries in the Islamic economy.</td>
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<td>Bai salam and bai istisna help investors to curb issues of inflation while buying goods.</td>
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<td>Musharaka is commonly preferred by customers for financing fixed assets, plants and machinery, homes and automobiles.</td>
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<td>The Islamic Banks with Musharaka product have been able to increase its asset base through generating income.</td>
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</table>
SECTION C- ISLAMIC BANKING RISKS AND ECONOMY GROWTH.

Guiding scale in each statement -Strongly Disagree (1), Disagree (2), Not Sure (3), Agree (4), Strongly Agree (5).

Please indicate to what extents do you agree or disagree with the following statements keeping in mind change management in your organization.  

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<tr>
<th></th>
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<tr>
<td>Islamic Banks are largely affected by credit risks due to the</td>
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<td>nature of their products like Mudarabah, Ijarah and Musharaka.</td>
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<td>The Islamic banking instruments have high potential of credit</td>
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<td>risks due to delayed, deferred and default payments.</td>
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<td>In contracts like Mudarabah, Islamic banking is highly exposed</td>
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<td>to mark-up risks arising from movements in market interest rate.</td>
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<td>Islamic banking is highly affected by Shari’ah risk since there</td>
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<td>exist no standard practices.</td>
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<td>Different adoption of Shari’ah rules results in differences in</td>
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<td>financial reporting, auditing and accounting treatment by Islamic</td>
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<td>banks.</td>
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<td>The legal framework in the country does not have specific</td>
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<td>laws/statutes that support the unique features of Islamic</td>
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<td>financial products.</td>
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<td>Non-standardization of contracts makes the whole process of</td>
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<td>negotiating different aspects of a transaction more difficult</td>
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<td>and costly.</td>
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<td>Use of standardized contracts could make Islamic banking</td>
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<td>transactions easier to administer and monitor after the contract</td>
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<td>is signed.</td>
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<td>Lack of Islamic courts that can enforce Islamic contracts</td>
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<td>increases the legal risks.</td>
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THANK YOU FOR YOUR TIME.