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Abstract:

This study examines the impact of market interest rate fluctuations on the profitability of Islamic banks in Kenya. Kenya is fast developing as the Islamic finance hub of East Africa. Gulf African Bank and the First Community Bank have operated in Kenya as fully fledged Islamic banks since the year 2007. The Central Bank of Kenya has also licensed several conventional banks to offer Islamic banking products. Most studies done on the profitability determinants of Islamic banks have been mainly focusing on the Middle East countries. This study therefore contributes to literature by examining the Islamic banks within the East African region. Islamic banking financial model does not involve the charging or receiving of interest which is prohibited under the *shariah* rules. As opposed to the conventional banks which derive their profits mainly from interest charged on borrowings, islamic banks derive their income from arrangements that include joint ventures *(musharakah)* as well as cost-plus *(murahaba)* and profit-sharing *(mudharabah)* undertakings. Though these financial institutions do not charge or receive interest, they exist in an economy characterized by market interest rates which quite often fluctuate. This study therefore sought to establish whether such market interest rate fluctuations directly or indirectly affect the profitability of the Islamic banks. The study adopted a longitudinal survey design in which the banks‟ financial data and the average central bank rates (CBR) over a five-year period (2009-2013) were analyzed. The study concluded that there is a positive relationship between the market interest rate changes and profitability of Islamic banks in Kenya.

Keywords: Islamic banks, Islamic finance, Interest rate variations, Profitability