IMPACT OF ISLAMIC BANKING ON THE FINANCIAL PERFORMANCE OF CONVENTIONAL BANKS OFFERING ISLAMIC BANKING PRODUCTS IN KENYA

BY

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DECLARATION

This research project is my original work and has never been presented for any academic award in any other university or learning institution.

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This research project has been submitted for examination purposes with my approval as the university supervisor.

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LIST OF ABBREVIATIONS AND ACRONYMS

CAGR   Compound Annual Growth Rate

CAMEL Capital adequacy, Asset quality, Management quality Earning ability Liquidity

CAR   Capital Adequacy Ratio

CBK   Central Bank of Kenya

KCB   Kenya Commercial Bank

NPL   Non Performing Loan

ROA   Return on Assets

ROE   Return on Equity

ABSTRACT

Islamic banking is a quickly developing segment of the financial sector in Kenya everer since its inception. The effect of Islamic banking on the budgetary performance of conventional banks is of great importance to investors in the industry. The study therefore, sought to determine the impact of the financial Islamic banking on performance of conventional banks in Kenya.The study adopted a descriptive research design. The study comprised of 6 conventional banks offering Islamic banking products. Secondary data on Islamic banking products for the financial years 2009-2015 was obtained from the financial statements of conventional banks that provide Islamic banking data and products was analyzed using Statistical Program for Social Sciences form (SPSS) and excel as the fundamental computer strategy for data analysis. The study found that Murabaha, Musharaka, Tawarruq, Mudaraba, Ijara, Bank size and Liquidity has positive and significant impact on the financial performance of the conventional banks in kenya. The study specifically found that bank size and liquidity had the most statisticall significance on the financial performance. The study also established that Murabaha and Musharakais the most influential Islamic banking product on conventional banks performance. Therefore, commercial banks should promote and market the Murabaha and Mudaraba products among its customers so as to foster bank performance. They should also market Tawarruq, Musharaka and Ijara, as they also have a positive and significant influence on financial performance.The study recommended that conventional banks in Kenya should sensitize its customers on the need to promote partnership through financing business ideas. Conventional banks should also diversify and increase their Islamic banking products to reach a larger market.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Islamic banking begun as a practical reality and began functioning in 1970s with the key idea of providing services to its clients free from interest, and prohibited the giving and taking of premium (Riba in all exchanges. Prohibition of interest (Riba) makes Islamic banking framework vary from the ordinary banking system. The primary distinction amongst Islamic and traditional banks is the utilization of cash. In customary banks, cash is utilized as a product that is purchased and sold through the premium's utilization (Al-Omar and Abdel-Haq, 1996). Ernst and Young's (2014) write about Islamic Banking has demonstrated that worldwide benefit pool of Islamic banks is set to triple by 2019 and that Islamic banking resources in six core markets, that include Qatar, Saudi Arabia, UAE, Indonesia, Malaysia and Turkey was on course to hit the US$1.8 trillion mark by the year 2019. It was likewise found that worldwide Islamic banking resources saw an compounded annual growth rate (CAGR) of about 17% from 2009 to 2013.

There are three theories underpinning this study. These are Agency Theory, Stakeholders' Theory and Theory of the Firm. An agency relationship in Agency Theory is one in which at least one person (the principal[s]) engage someone else (the agent) to play out some service for their benefit which includes assigning some basic leadership power to the specialist (Jensen&Meckling, 1976).Good examples of agency relationships are that of employer and employee; or shareholders (principal) and CEO. Stakeholder theory reflects and coordinates how directors work as opposed to primarily addressing

management economists and management theorists. The emphasis of stakeholder theory is explained in two principal questions (Freeman, 1994). Markowitz's (1952) in Modern Portfolio Theory contended that a portfolio's hazard could be lessened and the normal rate of yield expanded, when resources with dissimilar price developments were joined. The MPT permits investors to evaluate both the expected dangers and returns, as estimated statistically, for their investment portfolios.

Shariah- compliant or Islamic banking is a quickly developing fragment of financial sector in Kenya, since its inception. The impact of Islamic finance sent strong signals to Kenya's financial services sector to the point of being highlighted in the latest amendments to the Finance Act (2008), which was amended to include a requirement by all institutions to pay revenue on all investment accounts operated and kept as per the Islamic law. The change applied to organizations offering Islamic finance products which did not allow payment of interest (CBK, 2009). The totally Shariah complaint banks, First Community Bank and Gulf African Bank have made a solid advance, to the 8 million Muslim in Kenya, as well as to the rest of the conventional customers as witnessed by the numbers of conventional bank clients who switched over to these Islamic institutions (Financial Post, 2008). First Community Bank Limited was the first commercial bank operating entirely under Islamic Shariah principles to be licensed to operate in Kenya. In January 2008, Gulf African Bank commenced its operations in Kenya as the first fully fledged Islamic bank to operate in Kenya (Daily Nation, 2008). Conventional banks have not been left behind in offering Islamic banking products. These banks include KCB, Standard Chartered, Barclays Bank Kenya, National Bank Kenya, Equity bank and Chase Bank.

1.1.1 Islamic Banking

Islamic banking refers to a banking system that depends on the standards of Islamic law, also known as Shariah law (Hassan and Bashir, 2003). Islamic banking system has been growing quickly in the course of recent years. This framework has been expanding significantly around the globe including Middle Eastern nations, Southeast Asian nations; even in East Africa; and European nations, in North American (Guyo&Adan, 2013). The explanation behind establishing Islamic banks is to attract clients who wants to avoid premium. Since premium is restricted in Islam, Islamic banks need to refrain from it in any form. Therefore, Islamic banks established Profit-Loss Sharing System (PLS) and various sales contracts. The Islamic banking system needs to work as per Islamic rules and standards (Hassan and Bashir, 2003). The primary idea of Islamic banking is to services to its clients free from interest, and prohibits riba in all transactions. Preclusion of premium (riba) makes Islamic managing banking system contrast from the conventional banking system. The principle distinction amongst Islamic and ordinary banks is the utilization of money. In customary banks, money is utilized as a product that is purchased and sold through the premium's use (Al-Omar & Abdel-Haq, 1996).

While the sole purpose of conventional banks is profit, Islamic banks are established for religion motives besides making profit. Since they are founded on the bases of religion of Islam, they should agree to its standards, underscoring more on good values (Gerrard& Cunningham, 1997). Nevertheless, Islamic banks are expected to make benefit from their business operations at the same time. This implies that Islamic banks must create a balance between profit and religion to succeed. In their business goals, they should discover the equilibrium between religion and profit, on the grounds that in

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accomplishing one viewpoint and not the other, the banks are vanquishing the entire motivation behind their presence. By prevailing with regards to making profits just while disregarding the standards of Shariah compliance, the bank is a disappointment as an Islamic organization (Rosly, 2005). Then again, concentrating exclusively on Islamic law and neglecting the benefit making parts of the bank's operations would mean its failure as a business establishment, prompting to insolvency and the failure to proceed on. In this manner, a solid harmony between both of its key elements, profit and religion, is urgent to the achievement and survival of the bank as an Islamic financial institution (Chong & Liu, 2009).

Although Mudarabah and Musharakah are the two primary true Islamic methods of fund in Islamic banking system, the banking industry has not fully promoted these basic Islamic modes of finance. This means that nowadays, Murabaha and Ijara play a major role in Islamic banking (Ringim, 2013). Ijaracontract is an agreement in which a lessor (mu'ajjir) rents physical property or assets to a tenant (musta'jir) who gets the advantages connected with responsibility for resource against installment of predetermined rentals (ujrah). According to Ahmad and Haron (2002), Murabaha, a type of Islamic contract is a standout amongst the most broadly used methods of financing by the Islamic banks. This instrument is being utilized for financing of real estate, consumer durables and in the business for buying raw materials, equipment or machinery.

Mudarabahis is an agreement between a capital supplier (rabbul mal) and a business visionary (Mudarib) under which the rabbul mal gives capital to be overseen by the

Mudariband and any benefit produced from the capital is shared between the rabbul mal and Mudarib according to mutually settled profit sharing ratio (PSR) while losses are borne by the rabbul mal as long as those misfortunes are not due to the mudarib's carelessness (taqsir), delinquency (ta`addi), or breach of determined terms (mukhalafah al-shurut) (Rammal & Zurbruegg, 2007). Istisna'a gives medium term financing to meet the finance needed for supplying / manufacturing / sale of distinguished products, for example, construction / industrial machinery, equipment, load vessels, oil tankers, trawlers, locomotives and dredgers.

1.1.2 Financial Performance

This refers to how much financial targets have being or has been proficient. It is the way toward measuring the consequences of a company's approaches and operations in financial terms. Monetary performance is utilized to quantify company's overall financial health over a given timeframe and can likewise be used to analyze comparative firms over a same industry or to compare sectors or industries in aggregation (Capon, Farley & Hoenig, 1990). The financial performance will be the dependent variable in this study. A business' performance is estimated in monetary terms. A firm financial performance is revealed in its return on resources, value added and return on assets, among others. Profit is a definitive aim of commercial banks. To quantify the productivity of firms there are several financial ratios utilized whereby Return on Asset (ROA) is one of them (Khrawish, 2011).

ROE refers to how much profit an organization earned contrasted with the aggregate sum of shareholder value contributed or indicated on balance sheet. ROE is the thing that the shareholders look as a byproduct of their investment. But ROE can obscure a great deal of potential issues. In the event that investors are not watchful, it can redirect consideration from business essentials and prompt to problems. Organizations can turn to financial strategies to artificially keep up a healthy ROA, for some time, and stow away decaying performance in business basics. ROA represents a ratio of income to its aggregate resource (Khrawish, 2011). It gauges the capacity of the bank administration to generate income by using organization resources available to them. In this study, we are going use ROA as the measure of financial performance for the commercial banks.

1.1.3 Islamic Banking and Bank Financial Performance

As per Ayub (2002), Islamic banks performance is generally superior to that of conventional banks. Islamic banks are profitable, well capitalized, and stable because of their successful utilization of assets. In contrast with universal guidelines in banking Islamic banks are at standard with them in terms of profitability ratios yet their operations are not cost effective (Ayub, 2002). Campbell (2010) observed that at the onset of the global financial crisis of 2008, Islamic banks were seen as one type of financial institution that had fared well and they were viewed by some as a possible savior to fill the gap made by failed conventional banks. Islamic banking is grounded on the prohibition of being involved in interest-bearing activities. Taken to its logical end, this prohibition means that Islamic banks cannot hold any securitized assets, interest related derivatives or other assets that led to the 2008 global financial crisis. Hasan and Dridi

(2010) found that the Islamic banking business model shielded Islamic banks from adverse profit effects that befell many conventional banks in 2008.

Hamedian (2013) researched the financial performance of Islamic banks versus conventional banks in Malaysia. The experimental analysis uncovered that traditional banks performed superior to their Islamic partners regarding profitability. However, Islamic banks' performance amid 2008 financial crisis was much better when contrasted with conventional banks. Loghod (2010) found no huge contrasts as far as profitability amongst Islamic and conventional banks from Gulf Cooperation Council nations. Nonetheless, the study found that Islamic banks are less presented to liquidity risk and that traditional banks rely more on external liabilities compared to Islamic banks. Irfan and Zaman (2014) studied the efficiency of Islamic banks in South Asian Countries and established that Islamic banking's efficiency is around 98.19% as for return on asset ratio; around 91.4% regarding return on equity ratio and 77.03% as for n net profit ratio .

1.1.4 Commercial Banks in Kenya

According to CBK (2015), there are forty-three licensed commercial banks in Kenya. Among these 43, only two, the Gulf African bank and First Community bank are fully-fledged Islamic banks. Five conventional commercial banks have introduced Islamic banking products. According to CBK annual Report 2014, the banking sector in Kenya recorded enhanced performance in 2014 contrasted with that in 2013. The aggregate net assets raised by 18.5% from Ksh. 2.7 trillion in 2013 to Ksh. 3.2 trillion in 2014. On the other hand, Customer deposits ascended by 18.65% from Ksh. 1.93 trillion in 2013 to Ksh. 2.29 trillion in 2014. The expansion in assets was to a great extent driven by a higher interest for credit in 2014 than in 2013 while the increase in deposits resulted mainly from raised deposit

mobilization by banks as they extended their service networks and outreach to tap un-served portions of the market.

There are two fully Shariah complaint banks in Kenya; Gulf African Bank and First Community Bank which have created a strong appeal, not only to Kenya's 8 million Muslim population, but to the rest of the conventional customers as witnessed by the numbers of conventional bank clients who switched over to these Islamic institutions (Financial Post, 2008). First Community Bank Limited was the first commercial bank operating entirely under Islamic Shariah principles to be licensed to operate in Kenya. In January 2008, Gulf African Bank commenced its operations in Kenya as the first fully fledged Islamic bank to operate in Kenya (Daily Nation, 2008). Conventional banks have not been left behind in offering Islamic banking products. These banks include KCB, Standard Chartered, Barclays Bank Kenya, National Bank Kenya, Equity bank and Chase Bank.

1.2 Research Problem

The Kenyan banking industry has changed drastically over a relatively short period of time with a very competitive market. The deregulation of the financial sector associated with the wind of globalization has brought new players leading in the competition and important transformation and innovation taking place in banks. With lots of banks and a very strong competition among existing players, banks have had to find ways to attenuate the competition.

Conventional banks have succeeded into offering Shari'ah compliant products and services to customers. However, they confront difficult issues to practice Islamic laws as

legitimate interbank currency market is not accessible for administrative structure for premium free banking. In Kenya, two types of commercial banks offer Islamic banking products. Conventional banks, apart from concentrating on interest financing also offer Islamic banking products that follow the rules of Islamic Shariah. These banks were established as normal banks but later on introduced Islamic banking products in their portfolio. Studies on the effect of Islamic banking on performance of banks have produced mixed results. Hamedian (2013) found that conventional banks' profitability was better compared to that of Islamic counterparts. But Islamic banks' performance was better during 2008 financial crisis when contrasted with conventional banks. Loghod (2010) found no significant differences in terms of profitability between conventional and Islamic banks from Gulf Cooperation Council countries.

Irfan and Zaman (2014) found that Islamic banking efficiency is about 98.19% in term of return on asset ratio; about 91.4% regarding return on equity ratio and 77.03% as for net profit ratio. Locally, Tuitoek (2012) found that offering new products such as Shariah compliant products has a positive effect on financial performance of banks. Thomi (2014) found that there was a strong positive significant relationship between bank performance and Bank size, Liquidity, Murabaha, Mudaraba and Tawarruq. The present study will go further and investigate the effect of Islamic banking on financial performance of conventional banks in Kenya. None of the above studies has focused on the effect the introduction of Islamic banking has on the performance of conventional banks, a gap that the present study aimed to fill by asking what is the effect of Islamic banking on financial performance of conventional banks in Kenya?

1.3 Research Objective

To decide the effect of the money related Islamic depending on execution of ordinary banks in Kenya

1.4 Value of the Study

The study will benefit financial institutions in Kenya in that they will be able to understand in depth the effect of Islamic banking on financial performance and thus come up with shariah compliant products in order to realize more revenue from the Islamic banking.

To the government through the Central Bank revamp its efforts in promoting financial deepening and inclusion in Kenya to cater for people who have excluded themselves due to religious sensitivities. This will allow even economic development in the county and hence reduce cases such as radicalization and cases of session as has been happening at the coastal region. The Central Bank as the main regulator of commercial banks will come up with policies on how to regulate Islamic banking to ensure financial health of banks offering Islamic banking products.

The findings will also be valuable to future researchers and academicians as it will extent the existing knowledge besides acting as a source of reference. The study will also contribute to theory especially on the determinants of bank performance. In addition, the study would propose areas for further research that future researchers and academicians can advance their knowledge on.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviewed three theories underpinning this study as well as discussed the determinants of commercial banks performance. The chapter also reviewed similar studies.

2.2 Theoretical Foundation

In this part, the theoretical foundation of the study is discussed where the theories underpinning the study are reviewed. For each theory, the originator is mentioned, what it espouses and the relationship with the study. The three theories are agency theory, stakeholder's theory and the modern portfolio theory.

2.2.1 Agency Theory

The first researchers to explicitly propose that a theory of agency be made, and to actually start its creation, were Mitnick (1971) and Ross (1973), independently and roughly simultaneously. Ross (1973) is credited as the origin agency economic theory whereas Mitnick (1971) for agency institutional theory. But it is Jensen and Meckling(1976) who expounded on the theory as we know it today. An agency relationship is perceived to occur when at least one person (the principal[s]) engage someone else (the operator) to carry out some service for their benefit which includes delegating some basic leadership power to the agent. Good examples of agency relationships are that of employer and employee; or shareholders (principal) and CEO (Eisenhardt, 1989). Agency theory portrays the principal conflict between self-intrigued

managers and owners, when the managers have the control of the firm yet the proprietors bear the greater part of the riches impacts. Jensen's and Meckling's (1976) original model shows this by depicting how lower administrative stakes prompt to increments in non-monetary spending by the managers as they do not internalize the expenses fully. Agency issues of this kind lead to agency costs. A vital component in their theory is that outside shareholders cannot watch the managers' managers 'activities without a cost. While the model makes numerous confining suppositions, the outcomes are relevant to a more broad setting as revealed by the various empirical and theoretical articles that have taken after Jensen's and Jensen's (1976) work.

According to Sarker (1999), study in Agency Theory in Islamic Financial Institutions (IFIs) was infrequently reflected in writing until 1994 when Banaga et al. (1994) distributed a book covering Corporate Governance in IFIs, in spite of the fact that it concentrating more on accounting and auditing parts of Corporate Governance. Iqbal and Mirakhor (2004) clarify that the IFIs are utilizing an alternate model of Corporate Governance in light of the guideline of consultation where stakeholders have a similar objective of Tawhidor the unity of Allah. Karim, Archer and Al-Deehani (1998) reasoned that corporate governance in IFIs is based on the epistemological aspect of Shari'ah, Tawhid and ethics. Mirakhor and Iqbal (2004) clarify that managers are considered as trustees and not as managers, in this manner getting the idea of trusteeship and IFIs secure the rights and interest of all stakeholders instead of the shareholders as such.

The contractual connections in IFIs depend on Shariah principles and on money related contracts. This is to guarantee the foundation of justice in contracts and the evasion of unjust exploitative components such as the components of gharar (uncertainty), riba, speculation, maysir (gambling) (Sarker, 1999).The extra component of relationships in view of Shariah law has particular ramifications for the agency issue and can take diverse forms. The agency connections are precisely indicated in the Islamic standards of Shariah. Hence, the agency issue has an extra measurement when managers deviate from the Islamic standards of Shariah. Nevertheless, it is trusted that the Islamic ethical values and moral code that relate governance and accountability through religion contribute to good agency relationships. Agency relations in IFIs are to a great extent characterized by the underlying contract, which is gotten from one or more of the base Islamic monetary contracts (Archer, Karim& Al-Deehani, 1998).

2.2.2 Stakeholder Theory

Freeman (1994) is credited with originating with stakeholder theory. This theory starts with the suspicion that qualities are explicitly and fundamentally a part of undertaking business (Freeman, 1994). It requests that managers to express the mutual feeling of the esteem they create, and what unites its core stakeholders. Additionally, it pushes managers to be clear about how they need to work together, particularly what sorts of relationships they want and require building with their stakeholders to convey on their purpose (Ackermann and Eden, 2011). This theory also directs and reflects how managers work as opposed to basically tending to economists and theorists. The focal point of stakeholder theory is expressed in two crucial questions (Freeman, 1994).

Taking a look at the stakeholder theory from an Islamic Finance point of view, when the characteristics of the Islamic banks are seen, it can be viewed that the impact of various stakeholders' decreases and the identity of the banks is clear and imparted through a vast body of networks in both outside and inside the bank (Lewis &Algaoud, 2001).The stakeholder's interpretation of Islamic bank can be derived from this. These banks comprise of multiple networks that exist among customers, employees, businesses, communities, and the Shariah board. If managers inside Islamic banks decides to keep up a remote position from their external environments and stakeholders, they will have endanger themselves as well as the bank and they may fail to function productively (Lewis &Algaoud, 2001).

The expansion of Islamic banks all over the globe represents a noteworthy and persuasive pattern in the banking industry. The Islamic banking and finance have experienced significantly growth and success during the past twenty years, particularly for stakeholders investing into abroad Islamic undertakings (Al-Salem, 2008).The stakeholder theory founds responsibility and awareness that banks have towards both internal and external stakeholders. Subsequently, the banks obligation is not constrained to the focus of expanding of annual incomes, but for the prosperity of all stakeholders (Hasan, 2009).

2.2.3 The Modern Portfolio Theory (MPT)

This theory was founded by Markowitz (1952) in which he described how to consolidate resources into productively enhanced portfolios by showing that investors neglected accounting for the high correlation among investments returns correctly. It was Markowitz's (1968) view that a portfolio's risk could be decreased and the normal rate of

return expanded, when resources with different value movements were consolidated. Agreeing to Markowitz (1952), expansion diminishes the unpredictability since a diversified portfolio is less unstable than the mean of the volatilities of its elements. The MPT permits investors to assess both the expected dangers and returns, as estimated statistically, for their venture portfolios. In managing their portfolio, the investors try to maximize the overall portfolio return for a given portfolio (Elton, Gruber, Brown&Goetzmann, 2009).

The problem of bank diversification has been discussed in many papers and the relationshipbetween the diversification and the performance studied. Most of these studies highlightthe positive effect of diversification on the performance and on the decrease of the risks.Acharya, Saunders and Hasan(2002) argue that diversification,based on traditional portfolio theory wisdom, leads to greater safety for Financial Institutions and banks. Bank's financial performance can be explained by diversification. Chatti, Kablan and Yousfi (2010) analyzed the performance and the choice of portfolio in Islamic banks by considering a sample of 8 Malaysian Islamic banks between 2004 and 2008. To determine the efficient frontier and the optimal portfolio, the study used the Modern Portfolio Theory (MPT).The results showed that the corporate and investment activity increases significantly returns on assets. However, retail and commercial activity improves the results and performance of these banks.

2.3 Determinants of Commercial Bank Performance

CAMEL is a rating system usually applied by central banks, government policy makers and non-governmental policy analysts with the end goal of evaluating the soundness of financial institutions. It was initially embraced by the controllers of North American

banks and covers five sectors of performance namely, Asset quality, Earning ability, Management Quality, Capital Adequacy and Liquidity (Nazir, 2010). In the mid-1970s, US government regulators created CAMEL rating system to evaluate how well commercial banks are running. By 1979, the uniform monetary institution's rating system was embraced to give government regulatory agencies a system for rating individual banks and financial condition. The use of CAMEL has spread up significantly since then in terms of inspecting the financial strengths of one of the fundamental constituents of currency market, that is, commercial banks. Consistent with Kabir and Dey (2012), CAMEL Rating has been contemplated as one of the broadly utilized tools for judging asset quality, capital adequacy, liquidity, profit capacity, and management capacity of the financial organizations including commercial banks by the main regulators worldwide.

2.3.1 Capital Adequacy

Capital ampleness is the capital anticipated to keep up adjusting with the risks exposure of the monetary organization such as market risk, credit chance, adve and operational risk to assimilate the potential misfortunes and secure the financial organization's debt holder. Meeting a nation's statutory least capital requirement is the key factor when determining the capital adequacy and keeping up a satisfactory level of capital is a basic component. Mitchell (1984) illustrates capital ampleness in terms of capital-deposit ratio due to the fact that the essential risk is depository risk resulting from the considerably large scale and sudden deposit withdrawals. In 1930, FDIC founded a new capital model referred to as as capital-asset ratios because the default on credits came to uncover the most serious risk rather than deposit withdrawals (Mitchell, 1984).

To estimate the capital adequacy, bank managers nowadays utilize the c capital-risk asset ratio. The ampleness of capital is gauged based upon the two most essential measures namely, the ratio of capital to assets and Capital to Risk-weighted Assets ratio or Capital Adequacy Ratio (CAR). This capital proportion is required to meet at least 8% set by the Bank for International Settlement (BIS). Nevertheless, it is imperative to note that in a few countries the minimum capital required may shift depending on local controllers; and the bank may jump at the chance to have as high a capital proportion as possible (Grier, 2007). Each of elements in the CAMEL model is recorded from a sore of 1 to 5. With regards to capital sufficiency, a rating of 1 shows a solid capital level in respect to the money related organization's risk. The rating of 5 demonstrates a basic lacking level of capital, which requires a prompt help from shareholders or outer assets (Blum &Hellwig, 1995). In this study, the calculation of capital adequacy ratio is completed by taking loan loss provisions and ratio of equity capital less the non-performing loans to aggregate assets. Articulated as a percentage, the proportion demonstrates the capacity of a bank to withstand losses in the value of its properties.

$$\text{Capital Adequacy Ratio} = \frac{\text{Equity capital}}{\text{Loan loss provision}} \quad \frac{\text{Non performing loans}}{\text{Total assets}}$$

OR

$$\text{Capital Adequacy Ratio} = \frac{\text{Gross Capital}}{\text{Total Assets}}$$

2.3.2 Asset Quality

Asset quality shows the degree of financial strength and risk level of assets within a bank. As per Grier (2007), inferior asset quality is the primary reason why the failure of many

banks. A standout amongst the most critical resource classifications is the loan portfolio. The most serious threat confronting the bank is the loan losses arising from loan defaults. Credit investigation ought to be done by surveying the asset quality. This should be possible by performing credit risk management and assessing the nature of peer comparison and loan portfolio by making use trend analysis. Frost (2004) clarifies that the asset quality indicators underline the utilization of NPLs or non-performing loans ratios which are the intermediary of asset quality, and the provision or allowance to advance losses reserve.

As characterized in general classification system, credits incorporate five classes: standard, substandard, special mention, loss and doubtful. NPLs are viewed as the three most minimal classes which are past due or for which premium has not been paid after a worldwide standard of 90 days. Regulators in some countries permit a more drawn out period, commonly 180 days (Frost, 2004). The bank is directed to support the bad debts by giving sufficient provisions to the account holding the loan loss reserve. The recompense for loan loss and provision for loan loss to aggregate advances need to be considered when gauging the quality of loan portfolio (Grier, 2007).

$$\text{Asset Quality Ratio} = \frac{\text{Provision for Loans}}{\text{Total Loans}}$$

2.3.3 Management Quality

The management limit of commercial banks can be ascribed to various factors such as profit per employee, operating ratio, costs per worker and gross gaining assets to aggregate assets, among others (Hays, De Lurgio& Gilbert, 2009). Management quality denotes adherence to set standards, capacity to plan and be proactive in leadership,

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inventiveness, the dynamic environment, and administrative competence necessary in the bank. In the standard CAMEL system, management is assessed by: leadership, technical competence, and managerial capacity; consistence with banking statutes and regulations; capacity to plan and react to evolving conditions; ampleness of and consistence with internal approaches; propensities toward self-managing; and showed readiness to serve the legitimate needs of the society.

As indicated by Nazir (2010), Management capacity's performance is typically subjective and can be comprehended through the qualitative assessment of Management frameworks, control mechanisms and organization culture et cetera. However, the management ability of a bank can also be measured with the assistance of specific ratios of off-site assessment of a bank. Management abilities to deploy its assets, forcefully to boost the income, use the available facilities productively and decrease costs. This can be assessed with reference to different ratios. The success of management can be judged in the way it regulates the bank's growth rate in its net and operating profits, however, holding the aggregate costs under control. The management's efficiency can also be clarified by the increase of revenue per share. The management ability can explained with the assistance of several productivity rates like credit deposit, expenditure to income, non-interest expense to loans, expenditure per employee, earnings per employee and diversification ratio (Hays, De Lurgio& Gilbert, 2009). In this study, management quality will be measured by non-interest expense to loans.

$$\text{Management Quality} = \frac{\text{Non} \quad \text{interest expense}}{\text{Total Loans}}$$

2.3.4 Earning Ability

As indicated by Hays, De Lurgio and Gilbert (2009), income is a conventional parameter of gauging financial performance. In the pre-progression stage (before 1991), earning from the interest used to be figured on accrual basis with insignificant variation in that. Without any uniform standard on provisioning against deterioration in investment and bad debts, the discrepancy in accounting profit was largely contributed by contingencies and provisions. Some similarity of consistency was initially presented in 1992-93 with the phased usage of prudential accounting principles which however achieved a significant variation in the income during the current period, as income from interest was henceforth required to be calculated on a realization basis.

The criteria set for profitability and earnings in the standard CAMEL rating structure are for the most part relevant to the Islamic banks. Financial losses would first result in a deterioration of the estimation of the investor's wealth and afterward influence the bank's equity position if it had utilized its own particular assets to back the economic loses making investment project (e.g., through a Musharakah game plan). Such risks to deposits, in the event that they materialize, may also bring about reputational loss and damage of contributor base, prompting to liquidity and, perhaps, solvency issues (Nimalathasan, 2008).

$$\text{Earning Ratio} = \frac{\text{Net interest income}}{\text{Total interest income}}$$

2.3.5 Liquidity Ratio

The capacity of a bank to give liquidity requires the presence of an exceptionally fluid and promptly transferable stock of financial resources (Hays, De Lurgio& Gilbert, 2009).

Transferability and liquidity are the key elements for such exchanges. The requirement for liquidity implies that financial resources must be accessible to proprietors on short notice like a day or less at average. The requirement of transferability implies that proprietorship rights in financial resources must be compact, at average, to other financial agents, and in a form adequate to the other party. Investment securities and other Liquid assets empower a bank to react rapidly to unexpected requests for money and usually reflect moderately conservative economic procedures, while unpredictable liabilities like vast certificates of deposits, typically reflect generally aggressive economic procedures that force high premium costs, and are liable to quick withdrawal. Therefore, it is expected that higher values of venture securities to lessen the possibility of failure, while higher values of huge certificates of deposit ought to build the likelihood of failure (Nazir, 2010).

As indicated by Nazir (2010), liquidity management is a standout amongst the most critical elements of a bank. On the off chance that funds tapped are not used properly, the organization ought to endure loss. Keeping idle cash in hand balance will generate no yield. Then again, if the bank does not main balanced cash in liquid form, it cannot have the capacity to pay the request withdrawal of investors, as well as the eventually payment for unexpected liabilities and installment of creditors. These will place the institution at an overtrading position and force it to get reserves at high rate. Appropriate adjusted liquidity need to be sustained by avoiding both inadequate and excess funds position. Commercial banks need to manage a noteworthy dilemma which is the liquidity versus profitability. In response they need to pay regard to various elements in order to resolving this dilemma, particularly (a) maintenance of statutory reserve ratio (SLR) and cash

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reserve ratio; (b) sufficient loan-deposit ratio; (c) reliance on inter-band deposit; and (d) profitability (Nimalathasan, 2008). This study will use loan to deposit ratio to present the liquidity position of commercial banks

$$\text{Liquidity Ratio} = \frac{\text{Total Loans}}{\text{Total Deposits}}$$

2.4 Empirical Review

This part reviews local and international empirical studies related to the current study. It discusses the objective of each study, methodology and findings before exposing the research gap that the present study aims to fill.

2.4.1 Global Studies

Irfan and Zaman (2014) analyzed the effectiveness of Islamic banks in South Asian Countries and discovered that Islamic banking efficiency is about 98.19% in terms of return on asset proportion; around 91.4% regarding return on equity ratio and 77.03% concerning net profit ratio. Hamedian (2013) explored the budgetary performance of conventional bank versus Islamic banks in Malaysia. The experimental analysis uncovered that conventional banks performed superior to their Islamic counterparts when it comes to profitability. However, the performance of Islamic banks amid 2008 economic crisis was better when contrasted with customary banks. Loghod (2010) discovered no significant contrasts as far as profitability amongst conventional and Islamic banks from Gulf Cooperation Council nations. Yet the study revealed that Islamic banks are less presented to liquidity risk and that customary banks depend more on external liabilities compared to Islamic banks.

Al-Gazzar(2014) concentrated on the financial performance of conventional versus Islamic banks on the North Africa Region and Middle East. The empirical discoveries of the study suggested that Islamic banks beat conventional banks regarding capital sufficiency, resource quality, earnings quality and management quality. On the other hand, they had a vulnerable liquidity position in contrast with ordinary banks. Moreover, the survey discovered significant statistical differences existing amongst conventional and Islamic banks in management quality, capital adequacy and asset quality. Al-Fawwaz and Alawneh (2014) researched the effect of Islamic bank on various macro-economic variables; taking the contextual study of Jordan Islamic Bank. The examination demonstrates a considerable positive relationship between Islamic fund and GDP. In particular, the study noted a significant positive relationship between Islamic bank and both domestic investment and economic growth.

2.4.2 Local Studies

In Kenya, Thomi (2014) researched the impact of Islamic banking on economic performance of commercial banks in Kenya over a time of five years (2009 to 2013). The study found that there was a noteworthy positive huge relationship between bank performance and Bank size, Liquidity, Murabaha, Mudaraba and Tawarruq. Although Ijara had a positive relationship with return on assets it was not significant. Ng'ang'a (2013) investigated the impact of economic structure on the financial performance of traditional and Islamic banks in Kenya. The study discovered that conventional banks displayed a clear relationship between all the financial structure variables and financial performance whereas for Islamic banks only the assets had a relationship with the

financial performance. The study revealed that Islamic banks did not have debt to equity ratio in their financial structures mix, unlike conventional banks. Wang'oo (2013) investigated the relationship between monetary advancement and financial inclusion in Kenya. The findings suggested that there is a positive relationship between economic development and financial inclusion such that an expansion in m financial inclusion prompts to an expansion in economic development.

Tuitoek (2012) investigated the effect of offering Shariah compliant products on economic performance of business banks in Kenya. The study found that offering new products such as Shariah compliant products has a positive effect on financial performance of banks and that this broadened investment/innovation opportunities for the banking sector in Kenya. Adano (2010) investigated the factors affecting improvement of Islamic banking in Kenya. The study exposed that conforming to Islamic banking was driven by religious compliance and clients need being met. It additionally uncovered that continuous survey and developments of shariah compliant services together with expanding market specialty will prompt to drastic improvement and marketing of the product offered by the Islamic banking. Salah (2009) examined the factors that encouraged the rise of Islamic banking in Kenya and the regulatory difficulties confronting the business. The outcome demonstrated that Islamic Banking rose as a financial innovation as a result of worldwide patterns towards Islamic Banking, demand from the Muslim population, changes to the Banking Act and shareholder expectation of profits. The study disclosed that the legislative system in the legislative militates against the full improvement of Islamic Banking in Kenya.

CHAPTER THREE

RESEACH METHODOLOGY

3.1 Introduction

This chapter outlinedthe methods to be used in carrying out this study. Here, the research design to be used is discusses and justified, population of the study explained, data collection method presented as well as data analysis.

3.2 Research Design

The study assumed a descriptive research design that targeted at exploring the effect of financial Islamic banking on performance of conventional banks in Kenya. A descriptive design is focused with defining the frequency with which something happens or the relationship between factors (Bryman& Bell, 2007). In response, this approach is relevant for this study since the study expects to gather comprehensive data through descriptions which will be helpful for identifying variables. Bryman and Bell (2011) attest that a descriptive design tries to get data that portrays existing phenomena by making inquiries relating to individual attitudes and perceptions.

As per Aggarwal (2008), descriptive research is dedicated to the gathering of information about prevailing situations or conditions with the end goal of depiction and interpretation. This research method is not just collecting and tabulating facts but rather incorporates proper examinations, comparisons, interpretation, determination of relationships and trends. The elements and variables that were studied were observed without making any attempt to control or manipulate them. The variables in this study were earnings management, firm size and market to book value ratio.

3.3 Population of Study and Sample

The target population consists of a group of objects, items or individuals from which samples are extracted for measurement (Mugenda&Mugenda, 2008). Target population is the particular populace that the researcher has an interest in. The Target population of this study will be all the conventional banks offering Islamic products in Kenya. According to the Central Bank of Kenya (2015), 6 conventional banks offer Islamic banking products. The study will use census since the population is small (6).

3.4 Data Collection

Secondary data on Islamic banking products for the financial years 2009-2015 was obtained from the financial statements of conventional banks that offer Islamic banking products. The data was collected from annual financial and quarterly financials.

3.5 Data Analysis

Descriptive analysis was employed. The Statistical Program for Social Sciences adaptation (SPSS) and excel were used as the fundamental computer technique in analyzing the data. Descriptive statistics was utilized largely to summarize the data. This included frequencies and percentages. Diagrams such as tables and pie diagrams were used where suitable to present the collected data for simplicity of analysis and understanding. The regression model is as below.

$$Y=\beta_0+Y=\alpha+Mus\beta_i+Mud\beta_{ii}+Mur\beta_{iii}+Ija\beta_{iv}+Taw\beta_v+LQ\beta_{vi}+BS\beta_{vii}+\varepsilon$$

Where:

Y= Return on Assets

α= constant term (Y intercept)

Beta (β) = Beta coefficients

ε= Error term

Mus= Musharakah (partnership) financing as measured by the natural logarithm of amount invested.

Mud= Mudaraba (finance by way of trust) financing as measured by the natural logarithm of amount invested.

Mur= Murabaha (cost-plus financing) financing as measured by the natural logarithm of amount invested.

Ija= Ijara (leasing) financing as measured by the natural logarithm of amount invested.

Taw= Tawarruq (advance purchase) financing as measured by the natural logarithm of amount invested.

AQ= Asset Quality as indicated by the ratio of total non-performing loans to overall loan portfolio

LQ= Liquidity as indicated by short term investments of the bank in relation to total assets

BS= Bank Size as measured by the natural logarithm of the book value of assets

3.6 Test of Significance

The coefficient of determination, denoted as R^2 was used to indicate how well data fit into the statistical model. F-statistics (also known as fixation indices) was used to undertake further analysis. Analysis of variance (ANOVA) tests was used in the analysis of experimental data to test the variables for statistical significance.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This part shows analysis and findings of the study as indicated in the research objective and methodology. The main aim of the study was to identify the impact of the financial Islamic banking on performance of conventional banks in Kenya. The data was accumulated entirely from the auxiliary source which included records at banks audited financial report. Data was collected from a total of 7banks. Section 4.2 presents descriptive statistics and section 4.3 presents the inferential statistics.

4.2. Descriptive Statistics

Descriptive statistics are the measures that describe the general nature of the data under study. They define the nature of response from primary data and/or secondary data. Descriptive statistics for this study were: mean and standard deviation. Graphic data analysis was performed on the Return of Assets, Murabaha, Musharaka, Tawarruq, Mudaraba, Ijara, Bank size and Liquidity. Since the study was carried from 2009 to 2015. Descriptive statistics was carried out for different years as shown below.

Table 4.1: Financial Performance of the Banks offering Islamic Products

ROA	2009	2010	2011	2012	2013	2014	2015
Kenya Commercial (KCB)	0.0357	0.0517	0.0498	0.052	0.0591	0.06442	0.06442
Equity Bank Limited	0.0566	0.0695	0.0684	0.074	0.0799	0.08709	0.08709
Barclays Bank	0.0326	0.0361	0.0368	0.048	0.0501	0.05461	0.05461
Standard Chartered Bank Ltd	0.0539	0.0537	0.0503	0.059	0.0572	0.06235	0.06235
Chase Bank Limited	0.0391	0.0504	0.0418	0.0514	0.0543	0.0578	0.0593
NBK	0.0233	0.0237	0.0307	0.027	0.0307	0.03346	0.03346

Source: Researcher (2016)

The table shows the financial performance of the 6 conventional banks offering Islamic banking products in Kenya. The results show that, KCB performance from the year 2009 has been on a steady increase till 2013. 2014 and 2015 depicted a sharp increase in performance from 5.9% in 2013 to 6.4% in 2014. This could be as a result of the introduction of Islamic banking products to their Muslim customers.

The trend is quite the same with the performance of Equity bank. Since the bank introduced Islamic banking in 2012, the rate of the improvement in financial performance has been higher compared to the year 2009 to 2011. This impressive improvement in performance could be attributed by the increase in the intake of Islamic products like Murabaha, Ijara and Mudaraba which have become more popular among the customers.

Barclays bank and chase bank also introduced Islamic banking in 2010. From the analysis, the study established that Barclays bank recorded the highest performance since the introduction of Islamic banking till 2015. However, the performance of Chance bank improved greatly and this would have been contributed by the introduction of Islamic banking products. Overall, all the banks under the study recorded improvement in financial performance with the introduction of Islamic banking.

Table 4.2: Year 2009 Descriptive Statistics Variable

	Mean	**Std. Deviation**
ROA	0.0420	0.13738571
Liquidity	0.25525	0.019414

Source: Researcher (2016)

As at 2009, all the banks under the study had not started offering Islamic banking products to their customers. The overall performance of the banks was 4.2 % with a liquidity ratio of 2.56%.

Table 4.3: Year 2010 Descriptive Statistics Variable

	Mean	**Std. Deviation**
ROA	0.0496	0.77282394
Murabaha	2030140640	821588239.7
Musharaka	1649288635	530734243.5
Tawarruq	27300000	.0000
Mudaraba	153000000	.0000
Ijara	202818437.5	135626375
Bank size	21.1644	2.55936
Liquidity	0.030425	0.070178

Source: Researcher (2016)

Table 4.3 shows an improvement of Islamic banks performance in the year 2010 since banks had an average performance of 4.96% which shows a great improvement from the previous year. This can be attributed to sensitization and awareness of the customers in regard to Islamic financial services. Murabaha and Ijara were the most common Islamic financial products since they had the highest average. Since the standard deviations of Mudaraha and Tawarruq were 0 it implies that all the banks experienced equal demand for the two products.

Table 4.4: Year 2011 Descriptive Statistics Variable

	Mean	**Std. Deviation**
ROA	0.0499	0.78584471
Murabaha	964023170.7	1656536423
Musharaka	1078798047	2042931496
Tawarruq	24975000	4650000
Mudaraba	116000000	74000000
Ijara	83805562.5	39615647.55
Bank size	21.2729	2.01286
Liquidity	0.0324	0.103228

Source: Researcher (2016)

Table 4.4 shows that in the year 2011 commercial banks had an average return on assets of 4.99% and the Islamic financial products had very high averages. A closer scrutiny of the bank size depicted that there was a persistent upward trend in the bank size which implies that the bank's assets base increased with increase in commercial banks performance. The banks liquidity in the year 2011 averaged at 3.24% which showed an

upward trend. Thus, the management should ensure that their commercial banks adhere to the minimum required liquidity ratios.

Table 4.5: Year 2012 Descriptive Statistics Variable

	Mean	Std. Deviation
ROA	0.05448	1.38750449
Murabaha	1498452617	2408100139
Musharaka	1214572654	2168069412
Tawarruq	21850000	10900000
Mudaraba	153000000	.000
Ijara	72005062.5	42904143.74
Bank size	21.6949	1.91503
Liquidity	0.032808	0.06645

Source: Researcher (2016)

Table 4.5 shows that during the year 2012 commercial banks offering Islamic banking experienced an increase in assets which averaged at 5.448% compared to the previous year and the liquidity ratio was 3.28% while the banks had an average size of 21.7. Murabaha was still the most common Islamic financial product while the demand for Mudaraba remained at constant level of 153 million per annum.

Table 4.6: Year 2013 Descriptive Statistics Variable

	Mean	Std. Deviation
ROA	0.0586	1.16860917
Murabaha	1739317664	2164517873
Musharaka	1699774723	2784348596
Tawarruq	35075000	26971883.51
Mudaraba	190000000	177499295.8
Ijara	163023562.5	58477077.35
Bank size	22.3124	1.65134
Liquidity	0.03495	0.047676

Source: Researcher (2016)

Table 4.6 shows that there was an improvement on the return on assets among the banks offering Islamic financial services with an average of 5.86% while their liquidity increased to 3.495%. Murabaha was still the most common Islamic financial product while the demand for Mudaraba remained at constant level of 153 million per annum.

Table 4.7: Year 2014 Descriptive Statistics Variable

	Mean	Std. Deviation
ROA	0.0647	1.17258244
Murabaha	1735496521	2171877234
Musharaka	1692984586	2793815381
Tawarruq	34359687	27063587.9
Mudaraba	192049034	178102793
Ijara	156569021.9	58675899.4
Bank size	21.71808	1.65695456
Liquidity	0.0371519	0.0478381

Source: Researcher (2016)

Table 4.7 shows that during the year 2014 commercial banks offering Islamic banking experienced an improvement in assets which averaged at 6.47%% compared to the previous year and the liquidity ratio was 3.71% while the banks had an average size of 21.7. This shows that the bank returns on assets was high in the year 2014. Murabaha was still the most common Islamic financial product followed by Mudaraba at 192 million per annum.

Table 4.8: Year 2015 Descriptive Statistics Variable

	Mean	Std. Deviation
ROA	0.0647	1.16877278
Murabaha	1783452347	2164820906
Musharaka	1714563452	2784738405
Tawarruq	35659560	26975659.6
Mudaraba	1910872	177524146
Ijara	167106899.7	58485264.1
Bank size	23.7180	1.65157119
Liquidity	0.3715	0.04768267

Source: Researcher (2016)

Table 4.8 shows that during the year 2015 commercial banks offering Islamic banking experienced an increase in assets which averaged at6.47% compared to the previous year and the liquidity ratio was 3.715% while the banks had an average size of 23.7. This shows that the bank returns on assets had a consistent increase from the year 2013 to the year 2015. This could be attributed to the consistent improvement on performance and the demand of the Islamic products offered by these banks. The investors must have been injecting their money in these banks owing to the fact that the banks are doing better financially.

4.3. Inferential Statistics

Having carried out the descriptive statistics the study employed inferential statistics so as to draw conclusions and recommendations. Multi regression analysis was done to identify the nature of the relationship between the independent and dependent variables.

4.3.1 Regression Analysis

The following chapter presents the outcomes of regression analysis. A multiple regression analysis was done to test the correlation among predictor variables. The research utilized statistical package for social sciences (SPSS V 21.0) to code, enter and calculate the estimations of the multiple regressions.

Table 4.9: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.872	0.766	0.751	0.573

Source: Researcher (2016)

Coefficient of determination discloses the degree to which changes in the dependent variable can be illuminated by the adjustment in the independent variables or the rate of variation in the dependent variable (ROA) that is clarified by all the seven independent variables (Murabaha, Musharaka, Tawarruq, Mudaraba, Ijara, Bank size and Liquidity).The seven independent variables that were studied, explain only 76.6% on the relationship between Islamic banking and financial performance of the conventional banks represented by the R^2.

Table 4.10: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta	t	Sig.
1	(Constant)	1.376	0.415		3.316	1.61E-03
	Murabaha	0.471	0.151	0.615	3.119	2.86E-03
	Musharaka	0.338	0.0883	0.151	3.828	3.28E-04
	Tawarruq	0.362	0.0798	0.236	4.536	3.07E-05
	Mudaraba	0.426	0.062	0.172	6.871	5.65E-09
	Ijara	0.247	0.248	0.239	0.996	3.24E-01
	Bank size	0.783	0.093	0.14	8.419	1.59E-11
	Liquidity	0.612	0.154	0.201	3.974	2.04E-04

Source: Researcher (2016)

As per the SPSS generated table above, the equation ($Y=\alpha+Mur\beta_i+Mus\beta_{ii}+Taw\beta_{iii}+Mud\beta_{iv}+Ijr\beta_v+BS\beta_{vi}+LQ\beta_{vii}$) becomes:

$Y= 1.376+ 0.4711\beta_i+ 0.338\beta_{ii}+ 0.362\beta_{iii}+ 0.426\beta_{iv}+ 0.247\beta_v+ 0.783\beta_{vi}+ 0.612\beta_{vii}$

The above regression equation has indicated that, considering all components (Murabaha, Musharaka, Tawarruq, Mudaraba, Ijara, Bank size and Liquidity) constant at zero financial performance of conventional banks in Kenya will be 1.376. The findings presented also show that taking all other independent variables at zero, a unit increase in the annual amount of Murabaha would lead to a 0.471 increase in the scores of financial

performance of conventional banks in Kenya, a unit increase in the scores of Musharaka would lead to a 0.338 increase in the scores of financial performance of conventional banks in Kenya.

A unit increases in the scores of Tawarruq would lead to a 0.362increase in the scores of financial performance of conventional banks in Kenya and a unit increase in the scores of Mudaraba would lead to a 0.426 increase in the scores of financial performance of conventional banks in Kenya. The study also found that a unit increase in the scores Ijara would lead to a 0.647 increase in the scores of financial performance of conventional banks in Kenya, a unit increase in the scores of Bank size would lead to a 0.783increase in the scores of financial performance of conventional banks in Kenyawhile a unit increase in the scores of Liquidity would lead to a 0.612 increase in the scores of financial performance of conventional banks in Kenya.

Overall, bank size and liquidity had the greatest effect on financial performance of conventional banks in Kenya, followed by the Islamic products like Murabaha and Mudaraba with Ijara product having the least effect on financial performance of the conventional banks under the study. All the variables were significant (p<0.05).

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This part gives a synopsis, conclusion and recommendations of the main outcomes on the relationship between stock market returns and earnings management among companies recorded in Nairobi Securities Exchange. Area 5.2 presents summary of the study, part 5.3 explains conclusions, while section 5.4 discusses the suggestions.

5.2 Summary of the Findings

From the above regression model, the study found out that Murabaha, Musharaka, Tawarruq, Mudaraba, Ijara, Bank size and Liquidity influences the financial performance of the conventional banks in Kenya. All of the variables influenced it positively. The study findings are in tandem with Tuitoek (2012) who investigated the effect of offering Shariah compliant products on financial performance of commercial banks in Kenya.

The study found that offering new products such as Shariah compliant products has a positive effect on financial performance of banks and that this broadened investment/innovation opportunities for the banking sector in Kenya. The study also found that the most significant variables were bank size and liquidity since they had the most statistically significant regression coefficient. Therefore, commercial banks offering Islamic banking services in Kenya should increase their size by acquiring more assets.

Over the 6 year period, the study found that the five products offered by the conventional banks had a consistent increase. The study also established that Murabaha and Mudaraba

products recorded the highest figures as compared to Tawarruq, Musharaka and Ijara. Therefore, commercial banks should promote and market the Murabaha and Mudaraba products among its customers so as to foster bank performance. They should also market Tawarruq, Musharaka and Ijara, as they also have a positive and significant influence on financial performance.

5.3 Conclusions

Although the study variables explain 76.6%, it means there are other factors which explain conventional banks financial performance. A close scrutiny of the commercial banks return on assets depicts that the average return on assets declined in year 2013, thus economic and political stability plays a greater role in promoting the use of Islamic banking products in Kenya. Another factor which can influence the presence of Islamic banking products in Kenya is customer's awareness of their existence therefore commercial banks should sensitize members of the public on Islamic banking products. This is mainly because many deserving cases of financial resources are unaware of the existence of banking products which are compliant with Shariah law.

Islamic banking products are vital banking services in the rapid economic growth of the capital markets. Lack of access to cheap and affordable capital especially loan capital or working capital for startup has been identified as a major constraint to economic growth and development of many countries and since commercial banks are key pillars of economic development through financial intermediation. Islamic financial products such as Musharaka (partnership finance) may promote sharing of financial knowledge especially to investors who may be having inadequate financial training.

5.4 Recommendations from the Study

On the basis of the findings, the following recommendations arose. The survey showed that Murabaha and Musharaka is the most influential Islamic banking product on conventional banks performance. Therefore, commercial banks in Kenya should sensitize its customers on the need to promote partnership through financing business ideas. Also among the most recommended measures put in place is by selecting key financial and other indicators to monitor programs based on the statutory requirements on Islamic banking products. Developing systems for managing future performance based on the statutory requirements is also highly recommended.

Since access to finances is a vital tool for economic development there is need for the development faith based financial products which can be used by investors at different stages of investment such as seed, start-up, expansion, development or bridge finance and working capital finances. Commercial banks should diversify and increase their Islamic banking products since currently there are very few Shariah compliant products. Also conventional banks should set up education platforms geared towards making its customers aware of the benefits and costs associated with Islamic banking products.

5.5 Suggestions for Further Research

This study was done only on the commercial banks operating Islamic banking in Kenya. A further study can be extended to other areas such as the Islamic and diaspora banking in order to understand the influence of the overall Islamic financial market in Kenya.

The study also suggests that future studies could involve looking for the reasons behind the use of Islamic banking by the banks. Is it for profitability enhancement or for other

reasons like competitiveness, liquidity? Hence, future studies should focus on the relationship between financial innovations and liquidity of banks offering Islamic banking services.

The role of Islamic banking on economic development should be researched. It would be important to know if the presence of banking that is consistent with faith has encouraged those that had shunned away from the conventional banking system to join the Islamic banking system and therefore have access to all the financial services that joining a bank affords.

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APPENDICES

Appendix I: Conventional Banks Offering Islamic Banking Products

Bank	Address
Barclays Bank Kenya	Nairobi
Chase Bank	Nairobi
Equity Bank Ltd	Nairobi
KCB	Nairobi
National Bank of Kenya	Nairobi
Standard Chartered Bank	Nairobi

Appendix II: Data Collection Sheet (Mean)

	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
ROA	-0.7002	-0.1971	0.3197	0.7112	0.5226	0.6488	0.7020
Mura baha	1910000000.0000	2030000000.0000	964000000.0000	1500000000.0000	1740000000.0000	1370000000.0000	1480000000.0000
Mush araka	1500000000.0000	1650000000.0000	1080000000.0000	1210000000.0000	1700000000.0000	1100000000.0000	1190000000.0000
Tawa rruq	273000000.0000	273000000.0000	249750000.0000	218500000.0000	350750000.0000	199337550.0000	215659500.0000
Muda raba	153000000000.0000	153000000000.0000	116000000000.0000	153000000000.0000	190000000000.0000	140000000000.0000	151000000000.0000
Ijara	1810000000.0000	2030000000.0000	83805563.0000	72005063.0000	1630000000.0000	65690219.0000	71068997.0000
Bank size	21.0552	21.1644	21.2729	21.6949	22.3124	23.7181	23.7181
Liqui dity	0.2553	0.3043	0.3246	0.3281	0.3495	0.3715	0.3715