

**THE EFFECTS OF MICRO ECONOMIC VARIABLES ON THE FINANCIAL
PERFORMANCE OF ISLAMIC BANKS IN KENYA**

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DECLARATION

This research project report is my original work and has never been submitted for the award of a degree in any other University or any other institution of higher learning for examination and academic purposes.

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DEDICATION

I dedicate this work to my family who provided me the motivation and support to keep working hard. For their interminable care and sacrifice throughout my studies, their love, concern, support, encouragement and enthusiasm are the inspirations I needed to achieve this goal.

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LIST OF ABBREVIATIONS

AA	Average Assets
AMFI	Association of Micro Finance Institutions in Kenya
AWF	Average Working Funds
CAMEL	Capital Adequacy, Asset Quality, Management Efficiency, Earnings Quality and Liquidity
CAR	Capital Adequacy Ratio
CBK	Central Bank of Kenya
DD	Demand Deposits
EBIT	Earnings before Interest Tax
HHI	Herfindahl- Hirschman Index
IOFC	International Offshore Financial Center
KBA	Kenya Bankers Association
LA	Liquid Assets
NNPA	Net Non-Performing Asset
NOI	Net Operating Income
PAT	Profit After Tax
ROA	Return on Assets
ROE	Return on Equity

RONW	Return on Net worth
SAIBBS	Stand Alone Islamic Banking Branches
SPSS	Statistical Package for Social Sciences
TA	Total Assets
TD	Total Deposits
TI	Total Income
WACC	Weighted Average Cost of Capital

ABSTRACT

During the last two decades, the banking sector all around the world has experienced major transformations in its internal and external environment, resulting in significant impacts on its performance. Islamic banking is one such transformation which can be termed as the the future of the banking industry since even the religion boundaries could not hold it back. It involves provision of banking services within the Islamic religious guidelines, hence the name islamic banking. However, though it is termed as the future of banking, very few people in Kenya know of this financial product and hence its use in the country is at its conception stage even though it has been in the country for the last seven years. There exists many studies directed towards explaining Islamic banking, but little is known on micro economic factors influence on the financial performance of Islamic banks in Kenya. This study aimed at providing more information about islamic banking by looking at the micro economic factors affecting performance of the banks pegged on the pecking order theory, adaptive market hypothesis theory and the trade-off theory. The study used a descriptive research design targeting the 10 banks in kenya with Islamic banking, 2 fully fledged and 8 have Islamic banking window, from whom information on assets, income, expenses, capital, and performance ratios were collected, from which the study findings were made. Islamic banking sector was observed to be attractive and highly profitable. It was found that capital adequacy, asset quality, management efficiency, earning quality and liquidity management all affected the performance of Islamic banking performance in Kenya. The study recommends that sensitization should be carried out to enhance the knowledge on Islamic banking in the Kenyan market, which many do not know. The study suggested further study to determine macro-economic factors affecting financial performance in Islamic banking in Kenya with a view to go beyond the study's scope.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Access to capital is a key requirement for the economic development of any given community and region. Banks are a major facilitator of capital access for both investors and governments in the world. They play an integral role in inter-mediating transactions between demanders and suppliers of money, based on certain considerations. The banking sector has grown and attracted very many players leading to heightened competition between the banks, which have led to competitive strategies and innovations being the order of the day in most banking institutions. One of the competitive strategies adopted is the inclusion of non-intermediating generated incomes. Banks earnings come from the intermediating transactions between demanders and suppliers of money, transactions that form banks' traditional income generating activities. However, a trend has emerged where banks' incomes are increasingly coming from other non-intermediating activities.

The growth of non-intermediation income activities suggests the traditional income gain through intermediation activities is becoming less important part of banking business strategies and strategically, banks have shifted their sales mix by diversifying their income sources. DeYoung and Rice, (2004) observed this situation when they found that financial institutions generate increased portion of their income from non-intermediation activities which they associated with financial liberalization policies. Deregulation and new technology have eroded banks' comparative advantages and made it easier for non-bank competitors to enter these markets, necessitating banks to shift their sales mix and diversify towards non-interest income sources (Angbazo, 1997). Findings from USA studies show that in 1990's non-interest income grew rapidly to be a large part of banks

operating profits. Non-interest income accounts for 43% of U.S.A commercial banks net operating income (Stiroh and Rumble, 2004). With this situation at hand, it is becoming more important for consumers to find financial products offering both revenues and the opportunity to make a good deal, with the meaning of the investment becoming more valuable than the actual profit.

Furthermore, with the ongoing globalisation there is an increase in the spread and exchange of information, cultures and values around the globe. This leads to people having a more open-minded attitude towards new business methods and alternative ways of doing business. In this changing environment, companies that provide options that go beyond the traditional intermediation easily become rooted onto new markets (Dicken, 2007).

All these can be seen as some of the reasons why Islamic banking, an almost unknown financial system 30 years ago, has developed fast and become a unique and growing segment in the international banking market (Elgar, 2007). Throughout the development of Islamic banking, the system has been adopted differently between countries, targeting a previously left out clientele of the Muslim society. Kenya, a special case in terms of being a pioneer of Islamic finance in Africa, has been able to develop a dual system, where Islamic and conventional banking can co-exist. The dual system is considered of great importance when transferring Islamic banking to western markets since conventional banking is deeply rooted in these societies; thus it might be better for Islamic banks to function alongside conventional banks rather than trying to conquer them out of the western markets (Warde, 2000).

Islamic banking is a service that gives depositors the assurance that their money will be invested well and ethically as directed by the Muslim religion. All the investments made

under Islamic Banking are never associated with any of the traditional ‘sin’ industries, such as alcohol, tobacco, gambling or pornography; as a result, the product stands on an individual’s faith, ensuring not only financial security but also moral and mental satisfaction (Wang and Heitmeyer, 2005). Islamic banking, in terms of account opening, is conducted in exactly the same manner as opening a conventional account. The only difference is in the product features as they are based on the Sharia principles while the costs associated with opening Islamic Banking accounts remain the same as those for conventional accounts.

1.1.1 Micro Economic Variables

Banking institution as part of the corporate world has been affected by both micro and macro factors in their operations and performance. The micro economic variables include the institutional factors that affect the performance of the firm. These factors are mainly influenced by a bank’s management decisions and policy objectives (Staikouras and wood, 2004); therefore, the management efficiency is one of the main factors. Management efficiency can be measured as a ratio of operational expenses and revenue generated. Liquidity risk as also a micro economic factor that may arise from the possible inability of a bank to accommodate decrease in liabilities, since it becomes hard to raise funds for increasing demand for loans. This implies that Liquidity risk is a serious factor that has an impact on the performance of commercial banks. It needs further investigation in country specific situations (Ilhomovich, 2009).

Another key factor is asset quality indicated by loan loss provision to total loans in commercial banks. This implies that an increase in non-performing loans leads to increase in loan loss provision and ultimately a negative impact of profitability, and hence an increase in credit risk. Capital adequacy refers to the sufficient amount of banks equity to absorb any shock that a bank may experience (Ong and Teh, 2013). Empirical

study of Garcia-Herrero et al., (2009) showed a positive impact of capital on bank profitability. On the other hand, studies of Hoffmann, (2011), showed a significant negative impact of capital on bank profitability. The contradicting empirical evidence suggests that higher capital ratio leads to lower profitability. The implication of the reviewed studies is that setting up high regulatory capital may have negative effects on profitability and ultimately bank performance.

Consequently, capital structure is among the main determinants of bank performance (Goddard, et al., 2004). The impact of growing banks size on profitability can be positive up to a certain limit; beyond which the impact becomes negative on profitability (Eichengreen and Gibson, 2001). Diversification through non-interest income enhances bank profitability (Yeh, 1996). However, study by Stiroh and Rumbie, (2006), indicated that greater diversification of the bank dealings does not necessarily transform into increased bank profitability, but may instead reduce profits, therefore optimum level of non-interest income activities must be set. The impact of inflation on bank profitability depends on whether inflation has been fully and correctly predicted by bank managers (Perry, 1992).

1.1.2 Financial Performance

A synthetic picture of the company's financial position and its performance is found in the annual financial statements, which therefore become the main information sources that allow the qualitative analysis of how resources are used during the process of creating value. Firm performance is a multidimensional construct that consists of four elements (Alam, et al., 2011). Customer-focused performance, including customer satisfaction, and product or service performance; financial and market performance, including revenue, profits, market position, cash-to-cash cycle time, and earnings per share; human resource performance, including employee satisfaction; and organizational

effectiveness, including time to market, level of innovation, and production and supply chain flexibility. Consistent with the theoretical foundations in the capabilities and resource-based perspectives, it is argued that organizational capabilities are rent-generating assets, and they enable firms to earn above-normal returns (Athanasoglou, et al., 2008).

Financial performance measures how well a firm is generating value for the owners. It can be measured through various financial measures such as profit after tax, return on assets (ROA), return on equity (ROE), earnings per share and any market value ratio that is generally accepted. Generally, the financial performance of banks and other financial institutions has been measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Ahmad, et al., 2011). The financial statements of financial institutions commonly contain a variety of financial ratios designed to give an indication of the corporation's performance. Simply stated, much of the current bank performance literature describes the objective of financial organizations as that of earning acceptable returns and minimizing the risks taken to earn this return (Alam, et al., 2011). Profit after tax has been widely used as measures of banks' performance. Regarding factors affecting bank performance, different factors have been used by researchers such as: shareholders' equity; liquid assets to total assets; total loans to total deposits; fixed assets to total assets; total borrowed funds to total assets; reserves for loans to total assets; market concentration; the market size; labour productivity; bank portfolio composition; capital productivity, bank capitalization; financial interrelation ratio; the level of capitalization; the cost to-income ratio and customer satisfaction (Athanasoglou, et al., 2008).

1.1.3 Micro- Economic Variables and Financial Performance

At microeconomic level, performance is the direct result of managing various economic resources and of their efficient use within operational, investment and financing activities. Financial performance considers the Return on Assets (ROA) indicator that express the company's ability to generate profit as a consequence of the productive use of resources and of the efficient management, and it's used as a dependent variable in the assessment of economic performance. It is computed as a ratio between Net Income and Total Assets (Burja, 2010).

Recent literature analyzes the profitability of companies from various countries and economy sectors through indicators like net operating profitability (NOP) (Raheman, et al., 2010), (Dong and Su, 2010), return on total assets (ROTA) (Deloof, 2003), (Padachi, 2006), return on invested capital (ROIC), return on assets (ROA) (Narware, 2010). In these cases, the elements considered by profitability analysis as independent variables are financial indicators that express the working capital.

Profitability at microeconomic level has been studied depending also on indicators such as current ratio, liquid ratio, receivables turnover ratio and working capital to total asset (Singh and Pandey, 2008). Other studies consider performance assessment expressed by earnings before interests and taxes (EBIT) and the associated risk resulted from the influence of using a certain financing structure (Akintoye, 2008) or expressing it though economic value added (EVA), return on equity (ROE), operating profit margin (OPM), earnings per share etc (Ryan, 2008).

Nosa and Ose (2010) found that effective funding required for the growth and development of the corporations in Nigeria. They suggested enhancing the regulatory framework for increasing the firm's performance by focusing on risk management and

corporate governance. Onaolapo and Kajola (2010) found a significant and negative relationship between debt ratio and firm's financial performance. Jensen (1976) found two types of agency cost; agency cost of equity holders and agency cost of debt holders. They concluded that a conflict of interest arises between the management and the shareholders when management take decision against the interest of shareholders and another conflict arises when the shareholder act against the interest of debt holders. Williamson (1988) found that decision for high leverage by the management decreases the conflict between management and shareholders. The leverage can work as disciplinary device that controls the management from wasting their firm's resources (Seiford and Zhu, 1999).

1.1.4 Islamic Banks in Kenya

Currently, Kenya has a total of 43 commercial banks. The banking system in Kenya has very low Islamic banking representation. Only two banks are fully-fledged Islamic banks and eight others offer a window on Islamic banking (KBA online). Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shariah, known as Fiqh al-Muamalat (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba (usury/interest). Common terms used in Islamic banking include; profit sharing (Mudharabah), safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijarah). An interest free Islamic bank in relation to its clients plays the role of partner, investor and trader. The interest free modes of operation designed by Islamic financial institutions satisfy the criteria "God permits trading and forbid riba." Keeping in view of the Islamic injunctions against taking and giving of interest, the Islamic banks have organized their operations based on profit /loss sharing which is permitted in Islam. Islamic banks accept demand deposits and time deposits.

Demand deposit are fully repayable on demand and do not get any return, holder of time deposits are given a share in the profit earned by the bank according to a profit sharing rates made known in advance.

Although Islamic banks in Kenya were established recently, short period of existence, Islamic banking has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. 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 totalling 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 (Muriri, 2009). This study thus seeks to establish the factors, which influence the performance of the banks in Kenya. This is because the mode of operation of the banks is based on the Islamic law and the Kenyan law.

1.2 Research Problem

Sound financial health of a bank is the guarantee not only to its depositors but is equally significant for the shareholders, employees and whole economy as well. As a sequel to this maxim, efforts have been made from time to time, to measure the financial position of each bank and manage it efficiently and effectively. In Kenya, Islamic banks have organized their operations based on profit /loss sharing which is permitted in Islam. Islamic banks accept demand deposits and time deposits, (Kinyanjui, 2013). In this context, it is crucial to know what drives bank profitability. Higher profitability not only allows banks to generate funds to grant more credit to the economy, but is also important for regulators as it guarantees more flexible capital ratios, even in a riskier business environment. In addition, bank profitability must also lead to fair returns for its

shareholders. During the last two decades, the banking sector all around the world has experienced major transformations in its environment, resulting in significant impacts on its performance. Both external and internal factors have been affecting the profitability of banks over time. Identifying the key success factors of commercial banks allows formulating policies for improving the profitability of the banking industry. Therefore, the determinants of bank profitability have attracted the interest of academic research as well as of bank management, financial markets and bank supervisors. Finally, the study of bank performance becomes even more important also in view of the Islamic banking, which operates under the dictates of the Islam and that of profitability motive.

Benamraoui (2008) did a study to examine the performance of the sole bank offering Islamic financial products in Algeria, Banque Al Baraka d'Algérie. The study revealed that Banque Al Baraka d'Algérie offered only a few Islamic financial products to its customers; most of the instruments were geared towards short-term financing; the bank's overall performance had improved since its operations in Algeria; and credit risk remained the main obstacle facing the bank's performance. Amin, *et al*, (2011) did a study to investigate the effects of the attitude; social influence; religious obligation; government support; and pricing, on the intention to use Islamic personal financing. They found that three determinants were significant in influencing the intention to use Islamic personal financing, namely, attitude, social influence and pricing of Islamic personal financing. Religious obligation and government support were found to be insignificant predictors. Amin (2013) explored the factors, which influenced Malaysian bank customers in choosing Islamic credit cards. He found that attitude, subjective norm and perceived financial cost significantly influenced the intention to choose Islamic credit card.

In Kenya, Oundo (2009) suggested that there was poor supply of Shariah compliant products in Kenya's financial institution. The challenges in the supply side of Shariah compliant financial services was illustrated by one bank that wrote Cheques to suppliers for their Muslim clients who were uncomfortable with receiving credit in cash against the Shariah. There was high demand for Islamic financial products against a negligible supply of the same meaning that Islamic finance clients had few options and financially neglected by the microfinance sector. According to Ndung'u (2008) Kenya was the first country in the East and Central African region to introduce Islamic banking in the year 2007. He noted that the concept of shariah compliant banking has emerged as an alternative vehicle for mobilization and supply of finance. Muriri, (2009) did a study on two Islamic banks operating in Kenya: Gulf African and First Community bank, which had a loan portfolio of 4.9-billion shillings, deposits totalling 7.5billion shillings and 27270 deposit accounts. He noted that 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.

This study is motivated by the need to bridge this gap in knowledge by determining the micro economic factors influencing the financial performance of the Islamic banking in Kenya. This will be achieved by answering the question, what are the micro economic factors influencing the financial performance of Islamic banks in Kenya?

1.3 Research Objective

To determine the effect of microeconomic variables on financial performance of Islamic banks in Kenya

1.4 Value of the Study

In this study, we examine a series of variables by introducing internal and external factors that may significantly influence the Islamic banks' financial performance. The study can be used as a reference for Islamic banks to focus and control over the variables that bring negative influence to its financial performance. The study creates a better understanding on the micro economic factors that highly contribute to success of Islamic banking in Kenya financial sector.

Therefore, this study is of importance to commercial banks in Kenya in their endeavour to grow their Islamic banking portfolio hence increasing their profitability. It is also useful to customers who are in need of Islamic compliant products from banks, Government and regulatory institutions such as the Central Bank of Kenya (CBK), Kenya Bankers Association (KBA) and Association of Micro Finance Institutions in Kenya (AMFI). The study enhances their understanding of the operations of Islamic Banking, its requirements, and the extent to which they can sustain the market segment by contributing to the literature of what is known about Islamic banking in Kenya.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter will first presents review of theoretical issues, practices and empirical studies underlying factors influencing financial performance of Islamic banking. The chapter will finally conclude by providing theoretical solutions to the factors influencing financial performance of Islamic banking.

2.2 Theoretical Review

Advances in theory and methodology on performance have been noted over the years with more and more improved theories coming up. The financial sector has been under influence of various theoretical backings that have influenced decision makers. This study has looked at some of these theories and has come up with the following views.

2.2.1 Pecking Order Theory

In corporate finance, pecking order theory (or pecking order model) postulates that the cost of financing increases with asymmetric information. Financing comes from three sources, internal funds, debt and new equity. Companies prioritize their sources of financing, first preferring internal financing, and then debt, lastly raising equity as a “last resort”. Hence, internal financing is used first when that is depleted, then debt is issued and when it is no longer sensible to issue any more debt, equity is issued. This theory maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available, and debt is preferred over equity if external financing is required (equity would mean issuing shares which meant 'bringing external ownership' into the company). Thus, the form of debt a firm chooses can act as a signal of its need for external finance (Matemilola and Bany-Ariffin, 2011).

The pecking order theory is popularized by Myers and Majluf (1984) when they argue that equity is a less preferred means to raise capital because when managers (who are assumed to know better about true condition of the firm than investors) issue new equity, investors believe that managers think that the firm is overvalued and managers are taking advantage of this over-valuation. As a result, investors will place a lower value to the new equity issuance.

Pecking order theory starts with asymmetric information as managers know more about their companies' prospects, risks and value than outside investors do. Asymmetric information affects the choice between internal and external financing and between the issue of debt or equity. There therefore exists a pecking order for the financing of new projects (Brealey, Myers and Allen, 2008). Asymmetric information favours the issue of debt over equity as the issue of debt signals the board's confidence that an investment is profitable and that the current stock price is undervalued (were stock price over-valued, the issue of equity would be favoured). The issue of equity would signal a lack of confidence in the board and that they feel the share price is over-valued. An issue of equity would therefore lead to a drop in share price. This does not however apply to high-tech industries where the issue of equity is preferable due to the high cost of debt issue as assets are intangible (Brealey, Myers, and Allen, 2008).

2.2.2 Trade-Off Theory

The trade-off theory of capital structure refers to the idea that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. The classical version of the hypothesis goes back to Kraus and Litzenberger (1973) who considered a balance between the dead-weight costs of bankruptcy and the tax saving benefits of debt. Often agency costs are also included in the balance. This

theory is often set up as a competitor theory to the pecking order theory of capital structure.

An important purpose of the theory is to explain the fact that corporations usually are financed partly with debt and partly with equity. It states that there is an advantage to financing with debt, the tax benefits of debt and there is a cost of financing with debt, the costs of financial distress including bankruptcy costs of debt and non-bankruptcy costs (e.g. staff leaving, suppliers demanding disadvantageous payment terms, bondholder/stockholder infighting, etc.). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing.

Many have questioned the empirical relevance of the trade-off theory. Miller (1977) for example compared this balancing as akin to the balance between horse and rabbit content in a stew of one horse and one rabbit. Taxes are large and they are sure, while bankruptcy is rare and, according to Miller, it has low dead-weight costs. Accordingly, he suggested that if the trade-off theory were true, then firms ought to have much higher debt levels than we observe in reality. Myers (1984), was a particularly fierce critic in his Presidential address to the American Finance Association meetings in which he proposed what he called 'the pecking order theory'. Fama and French (2002) criticized both the trade-off theory and the pecking order theory in different ways. Brealey, Myers and Allen, (2008) has argued that firms do change the impact of stock price shocks as they should under the basic trade-off theory and so the mechanical change in asset prices that makes up for most of the variation in capital structure.

However, despite such criticisms, the trade-off theory remains the dominant theory of corporate capital structure as taught in the main corporate finance textbooks. Dynamic version of the model generally seem to offer enough flexibility in matching the data so, contrary to Miller's verbal argument, dynamic trade-off models are very hard to reject empirically. The analysis of wide known trade off theory has been made within modern theory of capital structure and capital cost by Brusov-Filatova-Orekhova. It is shown that suggestion of risky debt financing (and growing credit rate near the bankruptcy) in opposite to waiting result does not lead to growing of weighted average cost of capital, WACC, which still decreases with leverage. This means the absence of minimum in the dependence of WACC on leverage as well as the absence of maximum in the dependence of company capitalization on leverage. Thus, it seems that the optimal capital structure is absent in famous trade off theory (Fama and French, 2002).

2.2.3 Adaptive Market Theory

The adaptive market hypothesis, as proposed by Lo (2004), is an attempt to reconcile economic theories based on the efficient market hypothesis (which implies that markets are efficient) with behavioural economics, by applying the principles of evolution to financial interactions: competition, adaptation and natural selection. Under this approach, the traditional models of modern financial economics can coexist with behavioural models. Lo argues that much of what behaviourists cite as counterexamples to economic rationality—loss aversion, overconfidence, overreaction, and other behavioural biases—are, in fact, consistent with an evolutionary model of individuals adapting to a changing environment using simple heuristics. According to Lo (2004), the adaptive market hypothesis can be viewed as a new version of the efficient market hypothesis, derived from evolutionary principles.

Prices reflect as much information as dictated by the combination of environmental conditions and the number and nature of species in the economy. By species, he means distinct groups of market participants, each behaving in a common manner—pension fund managers, retail investors, market makers, hedge fund managers, etc. If multiple members of a single group are competing for rather scarce resources within a single market, then that market is likely to be highly efficient, which reflects most relevant information very quickly indeed). On the other hand, if a small number of species are competing for rather abundant resources, then that market will be less efficient. Market efficiency cannot be evaluated in a vacuum, but is highly context-dependent and dynamic. Shortly stated, the degree of market efficiency is related to environmental factors characterizing market ecology, such as the number of competitors in the market, the magnitude of profit opportunities available, and the adaptability of the market participants.

The adaptive market hypothesis has several implications that differentiate it from the efficient market hypothesis in that to the extent that a relation between risk and reward exists, it is unlikely to be stable over time. There are opportunities for arbitrage, investment strategies - including quantitatively, fundamentally and technically based methods - will perform well in certain environments and poorly in others, the primary objective is survival; profit and utility maximization are secondary. The key to survival is innovation: as the risk/reward relation varies, the better way of achieving a consistent level of expected returns is to adapt to changing market conditions (Amin, 2013).

2.3. Determinants of Financial Performance of Islamic Banks

They are bank specific variables, which influence the profitability of specific bank. These factors are within the scope of the bank to manipulate them and that they differ from bank to bank. These include capital size, size of deposit liabilities, size and composition of credit portfolio, interest rate policy, labour productivity, and state of information technology, risk level, management quality, bank size, ownership and the like. CAMEL framework often used by scholars to proxy the bank specific factors (Dang, 2011). CAMEL stands for Capital Adequacy, Asset Quality, Management Efficiency, Earnings Ability and Liquidity. Each of these indicators is further discussed below.

2.3.1 Capital Adequacy

Capital is one of the bank specific factors that influence the level of bank profitability. Capital is the amount of own fund available to support the bank's business and act as a buffer in case of adverse situation (Athanasoglou, et al. 2005). Banks capital creates liquidity for the bank because deposits are most fragile and prone to bank runs. Moreover, greater bank capital reduces the chance of distress (Diamond, 2000). However, it is not without drawbacks that it induce weak demand for liability, the cheapest sources of fund capital adequacy is the level of capital required by the banks to enable them withstand the risks such as credit, market and operational risks they are exposed to in order to absorb the potential losses and protect the bank's debtors. According to Dang (2011), the adequacy of capital is judged on the basis of capital adequacy ratio (CAR). Capital adequacy ratio shows the internal strength of the bank to withstand losses during crisis. Capital adequacy ratio is directly proportional to the resilience of the bank to crises. It has also a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas (Sangmi and

Tabassum, 2010). The following ratios will measure capital adequacy: Capital Adequacy Ratio (CAR) - the capital adequacy ratio is developed to ensure that banks can absorb a reasonable level of losses occurred due to operational losses and determine the capacity of the bank in meeting the losses. Debt-Equity Ratio (D/E) - This ratio indicates the degree of leverage of a bank. It indicates how much of the bank business is financed through debt and how much through equity; Advance to Assets Ratio (Adv/Ast) - This is the ratio indicates a bank's aggressiveness in lending which ultimately results in better profitability.

2.3.2 Asset Quality

The bank's asset is another bank specific variable that affects the profitability of a bank. The bank asset includes among others current asset, credit portfolio, fixed asset, and other investments. Often a growing asset (size) related to the age of the bank (Athanasoglou, et al., 2005). More often than not, the loan of a bank is the major asset that generates the major share of the banks income. Loan is the major asset of commercial banks from which they generate income. The quality of loan portfolio determines the profitability of banks. The loan portfolio quality has a direct bearing on bank profitability. The highest risk facing a bank is the losses derived from delinquent loans (Dang, 2011).

Thus, nonperforming loan ratios are the best proxies for asset quality. Different types of financial ratios used to study the performances of banks by different scholars. It is the major concern of all commercial banks to keep the amount of nonperforming loans to low level. This is so because high nonperforming loan affects the profitability of the bank. Thus, low nonperforming loans to total loans shows that the good health of the portfolio a bank. The lower the ratio the better the bank performing (Sangmi and Tabassum, 2010). The ratios necessary to assess the assets quality are: Net NPAs to

Total Assets (NNPAs/TA): This ratio discloses the efficiency of bank in assessing the credit risk and, to an extent, recovering the debts; Net NPAs to Net Advances (NNPAs/NA): It is the most standard measure of assets quality measuring the net non-performing assets as a percentage to net advances; Total Investments to Total Assets (TI/TA): It indicates the extent of deployment of assets in investment as against advances; Percentage Change in NPAs: This measure tracks the movement in Net NPAs over previous year. The higher the reduction in the Net NPA level, the better it is for the bank.

2.3.3 Management Efficiency

Management Efficiency is one of the key internal factors that determine the bank profitability. It is represented by different financial ratios like total asset growth, loan growth rate and earnings growth rate. Yet, it is one of the complexes subject to capture with financial ratios. Moreover, operational efficiency in managing the operating expenses is another dimension for management quality. Some financial ratios of the financial statements act as a proxy for management efficiency. The capability of the management to deploy its resources efficiently, income maximization, reducing operating costs can be measured by financial ratios. One of this ratios used to measure management quality is operating profit to income ratio (Rahman, et al. in Ilhomovich, 2009; Sangmi and Tabassum, 2010).

The higher the operating profits to total income (revenue) the more the efficient management is in terms of operational efficiency and income generation. The other important ratio is that proxy management quality is expense to asset ratio. Management quality in this regard, determines the level of operating expenses and in turn affects profitability (Athanasoglou, et al. 2005). The ratios that will be used to evaluate management efficiency are : Total Advances to Total Deposits (TA/TD): This ratio

measures the efficiency and ability of the bank's management in converting the deposits available with the bank excluding other funds like equity capital, etc. into high earning advances; Profit per Employee (PPE): This shows the surplus earned per employee. It is known by dividing the profit after tax earned by the bank by the total number of employees; Return on Net worth (RONW): It is a measure of the profitability of a bank. Here, PAT is expressed as a percentage of Average Net Worth.

2.3.4 Earning Quality

The quality of earnings is a very important criterion that determines the ability of a bank to earn consistently. It determines the profitability of bank and explains its sustainability and growth in earnings in future (Adebayo and Hassan, 2013). The following ratios explain the quality of income generation. Operating Profit to Average Working Funds (OP/AWF) is a ratio that indicates how much a bank can earn profit from its operations for money spent in the form of working fund. Percentage Growth in Net Profit (PAT Growth) is the percentage change in net profit over the previous year. Net Profit to Average Assets (PAT/AA) ratio measures return on assets employed or the efficiency in utilization of assets.

2.3.5 Liquidity Management

Liquidity is another factor that determines the level of bank performance. Liquidity refers to the ability of the bank to fulfil its obligations, mainly of depositors. According to Dang (2011) adequate level of liquidity is positively related with bank profitability. The most common financial ratios that reflect the liquidity position of a bank according to the above author are customer deposit to total asset and total loan to customer deposits. Other scholars use different financial ratio to measure liquidity. For instance, Ilhomovich (2009) used cash to deposit ratio to measure the liquidity level of banks in Malaysia. However, the study conducted in China and Malaysia found that liquidity level

of banks has no relationship with the performances of banks (Said and Tumin, 2011). The following ratios will be used in the study to measure the liquidity: Liquid Assets to Demand Deposits (LA/DD): This ratio measures the ability of bank to meet the demand from depositors in a particular year. To offer higher liquidity for them, bank has to invest these funds in highly liquid form: Liquid Assets to Total Deposits (LA/TD): This ratio measures the liquidity available to the total deposits of the bank; Liquid Assets to Total Assets (LA/TA): It measures the overall liquidity position of the bank. The liquid asset includes cash in hand, balance with institutions and money at call and short notice. The total assets include the revaluation of all the assets.

2.4 Empirical Review

Dusuki and Abdullah (2007) examined the main factors that motivate customers to deal with Islamic banks particularly in a dual banking environment in Malaysia. The study used primary data collected by self-administered questionnaires involving a sample of 750 respondents from four different regions in Malaysia. The Islamic banking criteria ranking as perceived by the respondents were analysed using Friedman Test. To further explore the customers' understanding of the banking criteria, an exploratory factor analysis was employed. The study found that the selection of Islamic banks appears to be predominantly a combination of Islamic and financial reputation and quality service offered by the bank. Other factors perceived to be important include good social responsibility practices, convenience and product price.

Baba and Amin (2009) did a study in Labuan to determine the viability of Islamic banking as a niche for the Labuan International Offshore Financial Center (IOFC). Labuan was declared an IOFC by the Malaysian Government in 1990, with the goal of developing it as a financial “supermarket” offering a wide range of offshore financial products specializing in Islamic finance. The study used mail survey method to ensure

the anonymity of the respondents and the whole population of banks were used, which enabled the researchers to ignore the problems of bias in the sampling. Data collected from the survey were analyzed using descriptive statistics, mean, standard deviation, and frequency counts. The study found that Labuan offshore bankers did not have a clear notion of Islamic banking principles and practices. In addition, most of the offshore banks did not have officers and staff who were conversant with Islamic banking. Further, the findings indicated that Islamic banking was a viable niche for the Labuan IOFC. However, the results showed that Labuan did not have competitive advantages over Bahrain and London, which were the leading Islamic finance centres in the world by then.

Kadubo, (2010) did a study to determine the factors influencing development of Islamic banking in Kenya. The study concluded that the following are the key factors that influence respondents to keep an account with their current respective banks: religious compliance products offered, branch network, responsiveness to the needs of the clients, minimum requirement to open an account, service efficiency and convenience to the clients. The study also concluded that the following were the major factors that influenced the respondents to borrow or save money in the same banks, key among them is compliance are Islamic shariah, cost/charges of borrowing/saving, repayment period, security / collateral requirement for the loans, risks of borrowing and earning on savings. Data was collected through self-administered questionnaire and the data analysis method was quantitative in nature. Descriptive statics based on mean, mode, median and factor analysis was used to analyse the data and make comparisons among desired variables. The findings were presented using tables and graphs.

Estiri, *et al.* (2011) did a study in Iran to clarify and extend the conceptualization and measurement of customer satisfaction in the Islamic banking sector in Iran. The authors performed a review of the set of attributes, which were capable of being incorporated in the measure of customer satisfaction for Islamic banks. Later, the possibility was posed of grouping these attributes into dimensions of quality, proceeding to value various alternative structures by means of confirmatory factor analysis methodology and testing their reliability and validity. The study found that service quality in Iranian banking adopting the commercial format of Islamic services had a two-factor structure: Value proposition quality and Service delivery quality.

Teimet, Ochieng and Aywa (2011) did a study on income source diversification and financial performance of commercial banks in Kenya. Secondary data was mainly used - audited financial statements of commercial banks and validated by Primary data achieved through key-informant method. The researcher employed longitudinal approach to study the 5 years trends of income source diversification. Census of all registered 44 operational commercial banks in Kenya as per Central Bank of Kenya (CBK) record for the study period 2005-2009. However commercial banks which were not operational for the entire 5 year period or under receivership were dropped due incomplete records or missing data. Close-ended Questionnaires were used and two separate interviews were conducted once for both CBK staff and Commercial banks respondents and the response rate was 81%. Diversification and focus were analyzed using Herfindahl- Hirschman Index (HHI). HHI is the sum of squares of exposures as a fraction of total exposure. According to Stiroh and Rumble (2006) the sum is squared in order to give due weight on the size of a bank. Findings from the results of regression indicate that all financial performance measures (NOI, EBIT, ROA, and ROE) reveal linear relationship with HHI level, implying they increase with increase in diversification level.

Mirza and Riaz (2012) did a study in Pakistan to explain the training and development function in the Islamic banking sector and how the needs assessment of Islamic banking fits into the process, followed by an in-depth look at the core concepts and levels involved in conducting a training needs assessment. The study used using the cross-sectional way of obtaining responses as it saves time and cost, and the strategy adopted for data collection was “survey questionnaire technique”. In this study, Performance Analysis, Job Analysis, Career Development and Knowledge, Skills, and Abilities were taken as independent variables and Training Needs Assessment as the dependent variable. The sample size of 100 employees was selected without any preference among the employees. The authors found that the process of needs assessment identified more than one training need; the training manager, working with management, prioritizes the training based on the urgency of the need (timeliness); the extent of the need (how many employees need to be trained); and the resources available. Also, the authors learned that training needs assessment was more crucial for performance analysis and for job analysis.

Ongore and Kusa (2013) looked at the Determinants of Financial Performance of Commercial Banks in Kenya. This explanatory study was based on secondary data obtained from published statements of accounts of all commercial banks in Kenya, CBK, IMF and World Bank publications for ten years from 2001 to 2010. It uses panel data due to the advantage that it has. It helps to study the behaviour of each bank over time and across space. A multiple linear regression model and t-statistic were used to determine the relative importance (sensitivity) of each explanatory variable in affecting the performance of banks. The moderating effect of ownership identity was also evaluated by using ownership as a dummy variable. It was concluded that bank specific factors (factors under the control of managers) are the most significant determinants of

the financial performance of commercial banks in Kenya. This evidence supports and is in line with the Efficiency Structure theory, which states that enhanced managerial efficiency leads to higher performance.

Kinyanjui (2013) examined the challenges facing the development of Islamic banking in Kenya. This study employed use of primary data, and obtained from bank employees and bank customers, by use of questionnaire. The use of questionnaire was justified because they provide an effective way of collecting information from a large literate sample in a short period of time and at a reduced cost than other methods. Moreover, questionnaires facilitate easier coding and analysis of data collected. The findings found out that 87.9% of the respondents were Muslims and only 12.1% were non-Muslims. The researcher concluded that other than providing Islamic compliant products and services, factors such as: offering product and services that meet the customer's needs, reduced borrowing cost, minimum requirements to open an account and service efficiency influences the development of Islamic banking. The Islamic banks should put these priorities at forefront and strengthening it. There should also be an amendment to the existing Banking Law. By doing so, they can also win a great number of customers from both Muslims and non-Muslims community. Above all, they should invest in branch expansion thus enabling the marketing Islamic banking products at the grassroots level. Lastly, there are future market potentialities for the Islamic banking products. Many younger generations were seen going for these products and services. For this banking, system to develop and grow the banks should create awareness through seminars, workshops, and advertisement and prayer sermons quoting verses from Quran and sayings of the prophet (hadith) that concern Islamic Banking system.

Guyo and Adan (2013) did a study on the determinants of retail consumer choice of Islamic banking in Kenya. The study adopted a descriptive research design since it is more investigative and focuses on particular variable factors. The study considered only the fully-fledged Islamic banks and did not include the Islamic bank branches (Stand alone Islamic banking branches-SAIBBS) of conventional banks for sake of precision. Statistical Package for the Social Sciences (SPSS) was used for the results. The reliability of each constructs was presented using the Cronbach alpha generated using the Kuder Richardson-20 formula recommended for the internal consistency techniques for measuring reliability. Correlation analysis was also drawn to show the relationship among the variables and the regression analysis to show the confidence level, significance and beta values. Regression analysis also showed the model summary. The most important fact revealed by this study is that customers of Islamic banks view the industry much more favourably by the social and ethical goals that it serves, rather than the mechanics of its operationalization and functions.

A study by Ullah (2014) sought to evaluate the Shariah compliance status of the Islamic banks in Bangladesh. The research was based on both primary and secondary materials. The primary data were gathered through sample questionnaire survey and personal interviews by the researcher; the secondary data were obtained from Qur'an, Hadiths, different circulars/letters, manuals, research books and journals, annual reports, Web sites of the sample banks. Statistical tools and techniques like weighted average, percentage, SD, variance and correlation between Shariah violation score and bank-specific attributes were used applying statistical software Statistical Package for Social Science. The study found that Shariah compliance status of the Islamic banks in Bangladesh was in a vulnerable condition, Shariah compliance status highly varied among the Islamic banks, and Shariah violation was high in investing activities because

of lack of knowledge, lack of sincerity in complying Shariah, poor attention in Shariah audit and Shariah research and lack of strong Shariah supervisory board comprising full-time skillful members.

2.5 Summary of Literature Review

This chapter looked at the theoretical and empirical studies that dwelt on the concept of financial performance and Islamic banking. The study looked at theories related to financial performance. The pecking order theory looks at the linkage between financial performance and information asymmetry. This theory informs the study on the management efficiency, earning quality, and liquidity management aspects of financial institutions that are opined to affect the financial performance of the institutions. Another theory is the trade-off theory, which looks at the cost and benefits side of the institutions operations especially on debt and equity financing. The theory supports some of the study variables such as liquidity management, capital adequacy and asset quality. The third theory is the adaptive market theory, which relates to the efficient market hypothesis and behavioural economics applied through financial interactions. The theory informs the study on the management efficiency aspect of financial performance.

The literature review also considered various studies that have looked at the concept of financial performance. The study found that the area has been widely researched. However, there are very few researchers that have gained interest in researching the area of Islamic banking, especially in Kenya where Islamic Banking was introduced just recently. The literature review adopted the CAMEL model with selected factors that affect financial performance that are defined as by capital adequacy, Asset quality, Management efficiency, Earning quality, and Liquidity management. The study will consider these selected factors in meeting its objective.

CHAPTER THREE: METHODOLOGY

3.1 Introduction

This chapter presents the methodology that was employed in the study. In this chapter, the researcher discussed the research design, study population and sample, data collection methods, and how the collected data was analyzed giving details of any models or programmes that were used in the analysis.

3.2 Research Design

Research design is defined by Copper and Schindler (2003) as, “the blueprint for fulfilling objectives and answering questions.” Accordingly, Kothari (2004) contends that research design describes the arrangement of conditions for collection and analysis of data, bringing together the relationship and rationale of the study as a means to achieve the research objectives using empirical evidence obtained economically. This study employed a descriptive research design. Descriptive studies describe characteristics of a population or phenomenon. A descriptive study provide answers to the questions, “who, what, when, where and sometimes how,” (Copper and Schindler, 2003). This design was appropriate for the study since the study is investigative in nature and hence required to describe fully the observations that were made from the study population when assessing the financial performance of Islamic banks in Kenya.

3.3 Study Population

Mugenda and Mugenda (2003) described a population as “the entire group of people, individuals, events or objects that have a common observable characteristic”. This study targeted all the Islamic banking financial institutions in Kenya. The financial sector in Kenya has 43 financial institutions where 2 are fully fledged Islamic banks and 8 have provided an Islamic banking window (CBK, 2013). The study target population was

therefore the 10 banking institutions offering Islamic banking in Kenya as given in appendix 1. This being a census survey, all the financial institutions offering Islamic banking were included in the study.

3.4 Data Collection

This study employed secondary data in meeting the study objectives. This data was acquired from financial statements, and other relevant internal financial documents of the banks between 2007 and 2013 and any other relevant financial materials such as the banking survey (2009). The information that was required included information on assets, income, expenses, capital, and performance ratios. Prior permission from the banks to collect the data was sought from the relevant authorities.

3.5 Data Analysis

The study collected both quantitative and qualitative data. The data was collected and examined for completeness and comprehensibility. The data was then coded and keyed into the Statistical Package for Social Sciences (SPSS) for analysis. This is a computer-aided tool for the analysis that helps to generate descriptive statistics such as means, standard deviations and percentages. It was used in analyzing the data.

3.5.1 Study Model

The study also employed inferential statistics such as multiple regression and correlation models to test the relationship between the selected factors affecting performance and financial performance of the banks. The study adopted the following regression model:

$$P = \beta_0 + \beta_1 LM + \beta_2 ME + \beta_3 AQ + \beta_4 EQ + \beta_5 CA + \varepsilon$$

Where: P: Financial Performance measured using ROA;

β_0 : Constant of the model;

LM: Liquidity Management;

ME: Management Efficiency;

AQ: Asset Quality;

EQ: Earning Quality;

CA: Capital Adequacy;

β : Coefficients of the variables;

ε : Error term;

3.5.2 Measurement of Variables

Financial performance (P): This was measured by considering the firm's Return on Assets (ROA).

Liquidity Management (LM): This was measured using the ratio of Liquid Assets to Total Assets (LA/TA): It measures the overall liquidity position of the bank.

Earning Quality (EQ): This was measured by Operating Profit to Average Working Funds (OP/AWF) ratio.

Management Efficiency (ME): This will be measured by determining the Total Advances to Total Deposits (TA/TD) ratio.

Asset Quality (AQ): this was measured from financial reports by the ratio Net NPAs to Total Assets (NNPAs/TA).

Capital Adequacy (CA): This was measured using the Advance to Assets Ratio (Adv/Ast).

3.5.3 Test of Significance

A test of significance among the study variables was carried out to determine their relationships. This study applied ANOVA test. ANOVA tested the overall significance of the model and the relationship among the factors in the study.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the findings of the study. The section provides the data analysis, results and discussion of those results. It includes subsections such as data collection, response rate, data validity, descriptive statistics, correlation analysis, regression analysis and Discussion.

4.2 Data Collection

The study collected data from all the financial institutions in Kenya, which have Islamic banking (10 Institutions). Data collected was secondary data from heads of department concerned with Islamic banking, and the annual overall financial reports from each of the institutions. The data collected was mainly financial data for Islamic banking and the firm's overall financial report for the period 2007 to 2013. Since some of the financial had not yet adopted Islamic banking between 2007 and 2009, the study relied on the data collected after the institution adoption of Islamic banking. The study therefore did not consider the institutions as part of the study at that period when the institutions had not adopted Islamic banking, but only considered them at the time the institutions adopted Islamic banking. The study therefore found the collected data to be sufficient in measuring the study variables and was observed to inform the study well.

4.3 Response Rate

The study target population was all the financial institutions in Kenya offering Islamic banking, which are 10 institutions in total. The study visited all the financial institutions' headquarters in the country to collect data and the following response rate as presented in figure 4.1 was acquired.

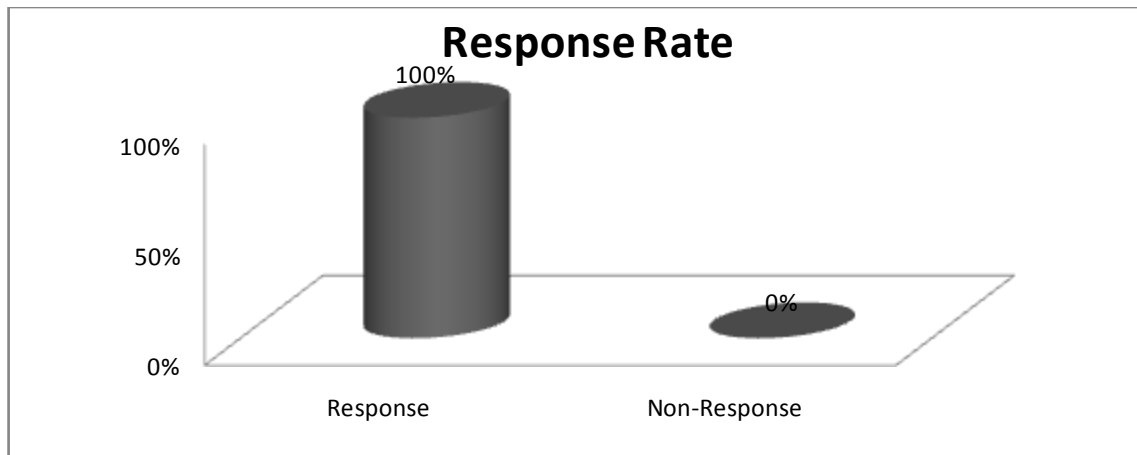


Figure 4.1: Data Collection Response Rate

The study response rate was at 100% (10 Institutions) with all the targeted financial institutions providing the requisite information. The data that the study collected was found sufficient to answer the study objectives and meet the information needs of the study. The financial institutions provided financial information related to Islamic banking for the institutions, which were not fully-fledged Islamic banking (8) while those that are fully-fledged Islamic banking institutions (2) provided the institutions' financial reports from which the study acquired the desired data to meet the study needs.

4.4 Data Validity

The study relied on valid data to form its findings. The data validity was determined by the involved offices at the institutions as reliable and confidential and it was collected from the respective officials. The study data was collected from the senior officials in each of the target sections of the banks, hence ensuring its reliability. The overall performance data was further cross checked against data from other sources, in this case the Nairobi Securities Exchange (NSE) for the financial institutions trading in NSE and bank's website for non-trading institutions, to assess its validity. However, part of the data validity was not assessed this way since there lacked a different source of data to

crosscheck with. The study found that the annual financial reports collected from the financial institutions, those collected from NSE, and other sources were similar and provided enough information that the study required. From this financial data, the study acquired information required for the study that includes assets, liabilities, income, Total expenditure, loss on advances and loans, operating profits, average working funds, total deposits, and capital of Islamic banking sections.

4.5 Descriptive Statistics

The study analysis provided various descriptive statistics in meeting the study objectives. Data analysis involved intensive analysis of the secondary data sourced from the banking sector in the 10 institutions that have Islamic banking. The study findings from this data were presented using tables, charts, graphs and simplified discourse. A brief explanation accompanied each figure to make the findings more user-friendly and easy to understand. Table 4.1 the summary of study variables while table 4.2 shows the Islamic banking descriptive statistics for the study.

Table 4.1: Summary of study variables (annual averages)

YEAR	ROI	ROA	Capital Adequacy	Asset Quality	Management Efficiency	Earning Quality	Liquidity management
2007	.240	.024	.297	.179	.378	.508	.248
2008	.200	.032	.319	.165	.424	.495	.345
2009	.260	.028	.382	.221	.415	.516	.268
2010	.290	.034	.422	.264	.454	.534	.298
2011	.310	.037	.442	.252	.484	.567	.315
2012	.280	.038	.398	.215	.478	.546	.334
2013	.320	.036	.469	.228	.532	.579	.324

Table 4.2: Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
ROI	.200	.320	.27143	.041805
ROA	.024	.038	.03271	.005122
Capital Adequacy	.297	.469	.38986	.062964
Asset Quality	.165	.264	.21774	.035820
Management Efficiency	.378	.532	.45209	.051205
Earning Quality	.495	.579	.53500	.031016
Liquidity management	.248	.345	.30457	.035515

The tables above shows the summary of study variables and the descriptive statistics of the financial institutions involved in Islamic banking for the institutions' composed of annual average ROI, ROA, capital adequacy, asset quality, management efficiency, earning quality and liquidity management. The study found that Islamic banking has realized a high return on investment with all the institutions realizing an ROI value of more than 20% with a mean ROI of 27% (0.27143) and a minimum value of 0.20 and a maximum of 0.32. A low standard deviation indicated that the there is low variance within the study period of ROI. This shows that there is a chance of acquiring a higher return when one invests in Islamic banking where an investment of a shilling has the potential of rewarding the investor with 27 cents. An increasing trend line created from the annual ROI in the study revealed that the return on investment in the study is expected to increase in the future given the current operational conditions are maintained.

The study also mined data that assisted in determining the return to assets ratio that financial institutions can attribute to their Islamic banking undertaking. The return on assets of Islamic banking in Kenya was found to indicate an increasing trend from a low of 2.4% (0.024) in 2007 to a high of 3.80% (0.038) in 2012. The mean ROA was observed to be at 3.27% (0.03271), indicating a higher ROA for Islamic banking than that observed for the whole banking sector. A very low standard deviation was observed in the study to indicate low variability of the study outcomes. The trend line indicates that better ROA should be expected for the future as it indicates a moderately increasing trend.

The study considered the capital adequacy of Islamic banking, which was calculated, by considering the total advances to total assets ratio of Islamic banking institutions. The study realized very low advances to assets ratio in Islamic banking with a mean of 38.99% (0.38986), which is below 50%. However, an increasing trend was observed in the analysis showing that capital adequacy is increasing at a relatively high rate within the Islamic banking institutions, which is indicated by a large standard deviation of 0.062964. This shows that there is a low relationship between advances and the total assets in Islamic banking in the period. However, a low number of institutions, which were involved in Islamic banking in 2007 and 2008, contributed to the low ratio realized in the period. This shows a relatively low aggressiveness in lending among the Islamic banks during the start-up period, though the situation can be observed to be changing as indicated by increasing trend line.

The study also considered the asset quality of Islamic banking institutions, which was measured by the ratio between net non-performing assets and total assets to show the efficiency of the Islamic banks in assessing the credit risk and, to an extent, recovering

their debts. The study found that the assets quality in Islamic banking is relatively low net non-performing assets to total assets ratio with a low of 16.50% in 2008 and a high of 26.40% in 2010. The study shows that the ratio is increasing moderately, though a decline in the last three consecutive years has been observed, indicating a potential of future decline trend if the decline is maintained. A mean of 21.77% (0.21774) was observed indicating that the net non-performing assets in Islamic banks are 21.77% of the total assets in the financial institutions showing a very significant amount of unused capacity in the institutions. An increasing trend shows that the situation may worsen in future.

The study also considered the management efficiency observed in Islamic banking since it is expected to affect financial performance. This factor was measured by determining the Total Advances to Total Deposits (TA/TD) ratio, which measures the efficiency and ability of the bank's management in converting the deposits available with the bank excluding other funds like equity capital, etc. into high earning advances. The study found an increasing trend in management efficiency in Islamic banking from the total advances to total deposits (TA/TD) ratio. A mean of 45.21% (0.45209) shows that even though the total advances are more than half the deposits in the Islamic financial institutions, the situation is not dire, and an increasing trend shows decreasing total advances and/or an increasing total deposits. This view is enhanced by the observation that TA/TD increased from 37.8% in 2007 to 53.2% in 2013. Further, considering that some of the financial institutions are very young in the market while others have very new departments dealing with Islamic banking, the ability of the Islamic banking institutions to turn deposits into high earning advances must be considered as average.

The study also considered the earning quality of Islamic banking institutions determined by Operating Profit to Average Working Funds (OP/AWF) which is a ratio that indicates how much a bank can earn profit from its operations for money spent in the form of working fund. The study found an average of 53.50% as the earning quality in Islamic banking in Kenya. The operating profit to average working funds in the financial institutions related to Islamic banking was found to have a low of 49.50% in 2008 and 57.90% in 2013, indicating a high profit-earning propensity of the working fund.

The study also considered the liquidity management realm of Islamic Banking in Kenya. The study considered the ratio of Liquid Assets to Total Assets (LA/TA) which is a measure of firms' overall liquidity. The study found an average ratio of liquid assets to total assets as 30.46% with a low of 24.80% in 2007 and a high of 33.40% in 2012. However, the study found an increasing trend in liquidity management with future expectations of increased liquidity in the Islamic banking in Kenya. The study found that at liquidity levels of between 24.8% to 32.4% in the institutions within the 2007 - 2013 period, the firm liquidity management is at a very efficient stage and an increasing trend shows improved future liquidity that might be an indicator of short term risk evasion.

4.6 Correlation Analysis

The study carried out a correlation analysis to find the relationship among the study factors and the following outcomes were observed as presented in table 4.1.

Table 4.3: Correlation among study variables

	<i>ROA</i>	<i>Capital Adequacy</i>	<i>Assets Quality</i>	<i>Management Efficiency</i>	<i>Earning Quality</i>	<i>Liquidity Management</i>
ROA	1					
Capital Adequacy	0.756907	1				
Assets Quality	0.531651	0.839298	1			
Management Efficiency	0.876123	0.899968	0.557676	1		
Earning Quality	0.725941	0.913086	0.683622	0.90769	1	
Liquidity Management	0.817354	0.356683	0.015752	0.646138	0.321373	1

A correlation was carried out between all the study variables. The study found significant relationship between the dependent variable and the independent variables. The study found a significant positive relationship between ROA (the dependent variable) and capital adequacy (the independent variable) with a coefficient of 0.757 with a p-value of 0.049, which is less than the maximum p-value of 0.05, to indicate the statistical significance of the relationship. Likewise, a p-value of 0.0419 was observed indicating that the relationship is statistically significant between ROA and assets quality with a coefficient of 0.532. A statistically significant relationship was observed between management efficiency and ROA with a coefficient of 0.876. The relationship between ROA and Earning quality was also found to be statistically significant at 0.726 and a p-value of 0.045. Liquidity management had a positive and statistically significant relationship to the dependent variable at a coefficient of 0.817 and a p-value of 0.025. The relationship among the independent variables on the other hand was observed to be

positive though some indicated that they were not statistically significant since they showed p-values above 0.05, though all showed positive relationship. This indicates that the study had very little or no autocorrelation with each other.

4.7 Regression Analysis

The study carried out a regression analysis to determine how the factors affect performance of the Islamic banks in Kenya and the following outcomes presented in table 4.4 were observed.

Table 4.4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.989 ^a	.979	.873	.001824

a. Predictors: (Constant), Liquidity management, Asset Quality, Earning Quality, Capital Adequacy, Management Efficiency

The outcomes showed a high correlation 0.989, between the dependent and the independent variables. A very high R square value of 0.979 was also observed which shows that the independent variables are able to explain 97.9% of the dependent variable, a very high value that shows that the study variables are acceptable in relation to assessing the performance of Islamic Banks in Kenya. The regression analysis also came up with a regression model's coefficients are presented in table 4.5.

Table 4.5: Regression Coefficients ^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	-.053	.035		-1.529	.0369
Capital Adequacy	.033	.103	-.407	-.321	.0402
Asset Quality	-.078	.084	.543	.923	.0425
Management Efficiency	.012	.156	-.125	-.080	.0449
Earning Quality	.093	.117	.566	.796	.0472
Liquidity management	.123	.069	.853	1.792	.0324

a. Dependent Variable: ROA

The regression model coefficients were found to be statistically significant with p-values that were less than the acceptable upper ceiling of 0.05, with each showing significant coefficient on the dependent variable. Capital adequacy had a p-value of 0.0402 hence upholding its statistical significance, and a negative coefficient of 0.033 showing that it negatively affects firm performance, i.e. an increase causes an increase in profitability, though the factor showed a high variability indicating that its effect is bound to change frequently. The asset quality variable showed nearly similar outcomes with a less than 0.05 p-value of 0.0425 though it showed a negative coefficient of 0.078, since the ratio used in determining this factor has a negative impact on performance. An increase in Net non performing assets to total assets ratio is bound to decrease profitability of the firm

since it shows lesser amount of the firm assets are being invested. Management efficiency on the other hand had a p-value less than 0.05 and a positive coefficient of 0.012 to indicate a positive impact on the performance of the firm, though with a negative standard error. Earning quality showed a positive coefficient as well of 0.93 and a p-value less than 0.05. The liquidity management was also found to have a positive coefficient of 0.123 and a p-value that was less than 0.05 at 0.0324 indicating that the variable is statistically significant. The regression model realized a negative constant of -0.053, which was found to be statistically significant. These outcomes indicates that all the variables are statistically significant in determining the dependent variable, though with varying strengths, where the study confirms the five variables as determinants of performance of Islamic banking. The regression model realized from the study analysis can therefore be presented as shown below.

$$P = -0.053 + 0.123LM + 0.012ME + (-) 0.078AQ + 0.093EQ + 0.033 CA + \varepsilon$$

Where:

- P: Financial Performance measured using ROA;
- LM: Liquidity Management;
- ME: Management Efficiency;
- AQ: Asset Quality;
- EQ: Earning Quality;
- CA: Capital Adequacy;
- ε : Error term

This model is shows that financial performance of Islamic banking is affected by liquidity management, management efficiency, asset quality, earning quality, and capital adequacy, all which are micro economic factors.

4.8 Discussion of Study Findings

Islamic banking has been introduced recently in the Kenyan market where two banks have adopted Islamic Banking only while 8 others have adopted Islamic as well as the other forms of banking. The study found Islamic banking in Kenya to have a very high potential for improved performance in future. The study found that the return on income of the sector is high with the institutions realizing an ROI value of more than 20% with a mean ROI of 27% indicating a return of 0.27 shilling on 1-shilling investment. The return on assets on the other hand was a bit low which was very similar to what was observed on the overall banking sector in Kenya with a low of 2.4% in 2007 to a high of 3.80% in 2012 and a mean of 3.27%. The ROA is observed to be still very low especially due to the fact that the innovation is very young and therefore capital intensive.

Capital adequacy measured by total advances to total assets ratio of Islamic banking institutions in Kenya indicates aggressiveness in lending that shows the internal strength of the bank to withstand losses during crisis. The ratio was found to be at a relatively high average rate of 38.99%. An increasing trend line for the capital adequacy was observed in the study indicating aggressive lending. From these ratios, the study considered the impact of capital adequacy on performance of Islamic banking, which was found to have an impact through correlation analysis and regression analysis. The regression provided the value of its impact on the banks' performance with a positive correlation of 0.757 and regression coefficient of 0.033 in a regression model, which showed a capability to explain 97.9% of the dependent variable. Capital adequacy ratio is directly proportional to the resilience of the bank to crises and the study therefore confirms findings by Sangmi and Tabassum, (2010) that it has a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas.

The assets quality in the banking sector on the other hand was analysed from the ratio between net non-performing assets and total assets, which shows the efficiency of the Islamic banks in assessing the credit risk where a low of 16.50% in 2008 and a high of 26.40% in 2010 was observed and a mean of 21.77%. However, increasing net non-performing assets to total assets ratio have a negative impact on the firm performance since it shows that the amount of net non-performing assets in relation to total assets is increasing hence a decline in profitability is likely to be observed. The study found a positive correlation between Islamic banking performance and asset quality with a correlation coefficient of 0.532. However, increasing net non-performing assets to total assets ratio indicates a declining asset quality and therefore a declining ratio would indicate a better asset quality and better performance. This issue is observed in the regression analysis where the study finds a negative coefficient for the variable at -0.078, which is confirmed as statistically significant since it shows a p-value, which is less than 0.05. Therefore, the study does find the factor influential on Islamic bank performance. Sangmi and Tabassum, (2010) found similar outcomes that the lower the asset quality ratio the better the bank performance.

The study suspected management efficiency to affect Islamic banking performance. The factor was measured by determining the Total Advances to Total Deposits (TA/TD) ratio, which measures the efficiency and ability of the bank's management in converting the deposits available with the bank excluding other funds like equity capital, etc. into high earning advances. The ratio showed an average ratio of 45.21% and an increasing trend from 37.8% in 2007 to 53.2% in 2013. An increasing total advances to total deposits shows improving management efficiency that translates to better profitability. The variable's relationship to firm performance was found to be high and positive with a correlation coefficient of 0.876. However, management efficiency was observed to have

a low coefficient in the regression analysis at 0.012 to indicate that it has a lower impact compared to the other factors considered in the study, though the variable was found statistically significant. Therefore, the factor was observed to have a positive impact on financial performance. These findings are in line with Athanasoglou, *et al.*, (2005) findings that management quality determines the level of operating expenses and in turn affects profitability.

Earning quality was also one of the factors that were suspected to have an impact on Islamic banking performance. The variable was measured by considering the Operating Profit to Average Working Funds (OP/AWF) which shows how much a bank can earn profit from its operations for money spent in the form of working fund. A high OP/AWF shows a better earning quality of the firm. The study found a mean of 53.50% in the ratio with an increasing trend line with a low of 49.50% in 2008 and 57.90% in 2013. The variable correlation to firm performance represented by firm ROA was found to be positive with a correlation coefficient of 0.726. The factor was confirmed by a coefficient of 0.095 and a p-value that was less than 0.05 at 0.0472 to indicate that the factor was statistically significant. Hence, this factor should be considered as impactful on Islamic banking Performance. The study outcomes are as were observed by Adebayo and Hassan (2013) who found that earning quality determines the profitability of the bank and explains its sustainability and growth in earnings in future.

Liquidity management was also considered whether impactful on financial performance of Islamic banking institutions. The variable was measured by evaluating the ratio of Liquid Assets to Total Assets (LA/TA) which is a measure of overall firm liquidity. The ratio shows how easy a firm is able to access assets in liquid form if need be, and an increasing ratio show a better liquidity management and eventual improvement in firm performance. The ratio was found to give a moderately increasing trend with an average

of 30.46%, a low of 24.80% in 2007, and a high of 33.40% in 2012. The variable indicated a high positive correlation with institutions' financial performance where it showed a positive correlation coefficient of 0.817 with ROA. The factor was observed to have the biggest coefficient in the regression analysis with a coefficient value of 0.123, which was agreed upon when a p-value that was less than 0.05 was realized in the regression model. Therefore, the factor was found to have some effects on Islamic banking performance. This confirms Dang (2009) findings that adequate level of liquidity is positively related with bank profitability.

The regression model showed all the factors are statistically significant and had very high determination power. A 0.989 correlation coefficient was realized and a probability that the independent variables (liquidity management, management efficiency, asset quality, earning quality and capital adequacy) can explain 97.9% of the dependent variable (performance presented as return on investment). The study therefore confirmed that the factors affect Islamic banking performance as presented in the equation below.

$$P = -0.053 + 0.123LM + 0.012ME + (-) 0.078AQ + 0.093EQ + 0.033 CA + \varepsilon$$

Therefore, Islamic banking performance was found to be influenced by liquidity management, management efficiency, asset quality, earning quality, and capital adequacy.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter covers the summary of findings, conclusion and recommendations of the study. The chapter brings out the main issues of interest from the analysis. The chapter discusses the summary of findings, conclusion, recommendations, and limitations of the study and offers suggestions for further research.

5.2 Summary of Findings

This study was done with an objective to find out the effects of microeconomic variables on performance of Islamic banking in Kenya. The study found that Islamic banking is a highly lucrative sector in Kenya with great chances of gaining profits from the sector. A high return on investment was observed in the sector at an annual average of 27%, which indicates that an investment of Ksh. 100 has an ability to bring returns of Ksh. 27, more than quarter of the investment. The sector also showed high return on assets at 3.27% and considering the sector is young in Kenya, this performance is expected to be better in future. This notion is enhanced by the look at the financial outcomes such as assets, liabilities, income, expenditure and profits, which were all seen to increase over the study period of 2007-2013, indicating that the sector is growing and better outcomes should be expected in future.

The microeconomic factors considered in the study include capital adequacy, asset quality, management efficiency, earning quality and liquidity management. Capital adequacy was included in the study as a measure of the company's aggressiveness in lending, which is the primary profit making mechanism and was found to be relatively high. The factor was found to have a positive impact on Islamic banking performance with a positive correlation to the ROA and a positive regression coefficient, hence

confirming the fact that capital adequacy have a positive effect on the performance of financial institutions. The assets quality in the banking sector was analysed where a positive correlation coefficient was observed and a negative regression coefficient. The study therefore found the factor to have a negative impact on the financial performance of Islamic banking institutions. Management efficiency was also confirmed to have an impact on financial performance. A statistically significant positive correlation and regression coefficients confirmed the positive impact of management efficiency on Islamic banking financial performance. Earning quality showed similar outcomes with a positive correlation and regression coefficients to indicate that the factor has an impact on the institutions' financial performance. Similar findings for liquidity management were found where the factor had high positive correlation to ROA, study's measure of firm performance, and a positive regression coefficient. Therefore, liquidity management, management efficiency, asset quality, earning quality, and capital adequacy are the microeconomic factors that were confirmed to have an impact on firm performance.

5.3 Conclusion

In conclusion, the study found that Islamic banking in Kenya is a young innovation that is yet to be adopted by many customers, nine years after the first fully-fledged Islamic bank offering Islamic banking services started its operations in Kenya. The study found Islamic banking profitability to be increasing over the study period and shows a high probability through future increments which shows that more and more people are being able to access the service through the banks. The growth in profitability of Islamic Banking is a sure sign that with more marketing of the service, they services will reach more of the Kenyan population hence future improvement are expected and the banking sector will be boosted further by this growth.

Islamic banking was found to be affected by five micro-economic factors at varying magnitude. These include capital adequacy, asset quality, management efficiency, earning quality, and liquidity management, all of which were determined by indicative financial ratios. All these variables were found to be statistically significant and were given a very high capability to predict financial performance in Islamic banking. The study found that financial performance of Islamic banking is impacted by the five factors.

Capital adequacy, which ensures there is enough capital to make investments in the firm which injects income to the firm, has a direct impact on the Islamic banking institutions' financial performance where a positive regression coefficient of 0.033 was observed, thus upholding Sangmi and Tabassum (2010) findings that the factor has direct effect on profitability of banks.

Assets quality looks at the ability of the assets to inject income to the firm and was found to have a negative impact on financial performance of the Islamic banking institutions, as was found by Sangmi and Tabassum (2010) who claim that the lower the asset quality ratio the better the bank performance.

Management efficiency dwells on the usage of assets by the firm management hence better usage translate to better performance. The study upheld these views and those of Athanasoglou *et al.*, (2005) when the financial performance of Islamic banking institutions was found to have a statistically significant relationship to the firm performance.

Earning quality on the other hand looks at the ability of firm to create capital, whose improvement enhances income generation. The study found a positive and strong impact of earning quality to the financial performance of Islamic banking institutions where a

positive regression coefficient was realized in the study model, thus upholding the views of Adebayo and Hassan (2013) that earning quality determines the profitability of the bank and explains its sustainability and future growth in earnings.

Finally, liquidity management was found to have a positive impact on institutions' financial performance where the financial institutions where a positive relationship was observed between ROA and the factor, hence upholding the views of Dang (2009) who reported similar views that adequate levels of liquidity is positively related with bank profitability. Liquidity management affects the ability of the firm to cushion from risk of lacking quick assets and being unable to make quick investments in case such need arise. Such ability would translate to more profitability and better performance.

Therefore, the study concludes that the microeconomic factors that affects financial performance of Islamic banking institutions in Kenya includes capital adequacy, management efficiency, liquidity management, assets quality and earning quality.

5.4 Recommendations

Financial performance in Islamic banking was found to be impacted by various microeconomic variables of capital adequacy, management efficiency, liquidity management, assets quality and earning quality. Therefore, so as to optimize the institution's financial performance, these factors ought to be taken into consideration in the firm operations. The study recommends that the financial institutions ought to ensure they maintain profit optimizing levels of capital adequacy indicated by total advances to total assets ratio, liquidity management indicated by liquid assets to total assets ratio, management efficiency indicated by total advances to total deposits ratio, and earning quality indicated by operating profit to average working funds ratio, while they strive to

keep assets quality given by net non-performing assets to total assets ratio at its minimal level.

Islamic banking is a new area of investment in the Kenyan financial sector and is found to be highly lucrative. The study therefore recommends that more investments be directed to the sector. The investors will greatly benefit from their investments in this area since though a young area, the banks that were involved in the study showed great performance and high profitability, unlike the other innovations where the firms take time before they can reap profits from their investments. Therefore, more attention ought to be given to this form of banking so as to utilize a very large potential available in its market.

However, since the Islamic banking instruments are being introduced, more ought to be done to enhance information access by customers about the available opportunities so as to give them a reason to join the sector. The study recommends the intervention of key players in marketing drives of the Islamic banking products in order to ensure that there is more awareness of these products in the market and there is greater communication among stakeholders about further innovations in the sector.

The study also recommends that the financial sector regulators, Central Bank of Kenya and the Kenyan government, to improve access to regulations and guidelines surrounding the usage of Islamic banking in Kenya in a bid to enhance the awareness of the sector players so as to allow increased investment in this new area of financial innovation.

5.5 Limitations of the Study

The study was limited in that most of the financial institutions involved in the study were not into fully-fledged Islamic banking and therefore performance data was only

considered for the Islamic banking section only. This might be a problem since the section share some of the firm utilities with other sections, which may or may not be included in the section's financial reports. However, the study was able to avoid the problem that might arise from this by avoiding section's capital but rather looked at the direct investments of the institutions and standardized measures, hence ensuring that the institutions are assessed from a similar viewpoint.

The study was limited to the Kenyan financial sector. Therefore, outcomes might differ in other areas, and hence the study outcomes cannot be generalized in the global or regional arena, as they are only applicable in the Kenyan sector. The study outcomes therefore ought to be done in other areas for the study outcomes to be generalized to the area.

5.6 Suggestions for Further Research

Islamic banking is only 7 years old in the Kenyan market and very few studies have been directed to it. More therefore ought to be done to provide greater awareness of Islamic banking in the country. Specifically, one such study should be done to differentiate the fully-fledged and non-fully fledged Islamic banking institutions in terms of their profitability, so as to bring out the more preferable of either adopting the fully fledged Islamic banking or mix Islamic banking with the conventional products.

Another area of further research should be on the customers composition attracted to the Islamic banking services. A study ought to be done to find out the characteristics of the customer composition within the financial institutions with Islamic banking products. This would go a long way in ensuring that financial institutions are able to know whom to target when introducing their Islamic banking products in the Kenyan financial markets.

In addition, more should be done to add on the factors affecting financial performance in Islamic banking to now include the macro economic factors. This would enhance the findings of the current study that dwelt on the internal characteristics, while such study would provide a look at Islamic banking from an external perspective and therefore combining the two outcomes would be wholly informative of the situation at hand.

Further research on how Islamic banking is affecting the general banking practices in the Kenyan financial market is also very recommendable. Some of the financial institutions have introduced Islamic banking products in line with the conventional products, where the two might be contradictory to each other. The study therefore recommends a study that looks at the impact of Islamic banking products on the other financial products in the Kenyan financial institutions.

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APPENDICES

Appendix i: Commercial banks offering Islamic Banking products

1. First community Bank Limited, (Fully Fledged)
2. Gulf African Bank Limited (Fully Fledged)
3. Standard Chartered Bank Kenya Ltd
4. Chase Bank Kenya,
5. Dubai Bank Kenya Ltd,
6. Fidelity Commercial Bank Ltd,
7. Habib Bank Ltd
8. Kenya Commercial Bank Ltd
9. National Bank of Kenya Ltd
10. Barclays Bank of Kenya Ltds

Appendix ii: List of all Commercial banks in Kenya

1. ABC Bank (Kenya)
2. Bank of Africa Kenya
3. Bank of Baroda (K) Ltd
4. Bank of India Kenya. O.
5. Barclays Bank of Kenya Ltd
6. CFC Stanbic Bank Kenya
7. Chase Bank Kenya
8. Charterhouse Bank Ltd
9. Citibank N.A Kenya
10. Commercial Bank of Africa Ltd
11. Consolidated Bank of Kenya Ltd
12. Co-operative Bank of Kenya Ltd
13. Credit Bank Ltd
14. Development Bank of Kenya Ltd
15. Diamond Trust Bank (K) Ltd
16. Dubai Bank Kenya Ltd
17. Ecobank Kenya Ltd
18. Equatorial Commercial Bank Ltd
19. Equity Bank of Kenya Limited
20. Family Bank Ltd
21. Fidelity Commercial Bank Ltd
22. Fina Bank Ltd
23. First community Bank Limited
24. Giro Commercial Bank Ltd

25. Guardian Bank Ltd,
26. Gulf African Bank Limited
27. Habib Bank Ltd,
28. Habib Bank A.G Zurich Postal
29. I & M Bank Ltd-Kenya
30. Imperial Bank Ltd Postal
31. Jamii Bora Bank Ltd
32. Kenya Commercial Bank Ltd
33. K-Rep Bank Ltd
34. Middle East Bank (Kenya) Ltd
35. National Bank of Kenya Ltd
36. NIC Bank Ltd
37. Oriental Commercial Bank Ltd
38. Paramount Universal Bank Ltd
39. Prime Bank Ltd
40. Standard Chartered Bank Kenya Ltd
41. Trans-National Bank Ltd
42. UBA Kenya Bank Ltd
43. Victoria Commercial Bank Ltd

Source: Central Bank of Kenya Banking Services Delivery Report (2013).