

**OPERATIONS MANAGEMENT IN BANKING: - COMPARATIVE STUDY OF
ISLAMIC AND CONVENTIONAL BANKS IN KENYA**

LAWRENCE M. MIRITI

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DEDICATION

This work is dedicated to my family, my spouse Lucy, son Brian and daughter Laura, without whose support it would not have been possible. Additional dedication goes to my late parents, Mr. Romano Miriti and Mrs. Veronica Nyoroka, who found it fit to enroll me in school in the first instance.

ABSTRACT

The study was set to analyse operations management in banking: - comparative study of Islamic and conventional banks in Kenya. The objectives of the study were to compare and document unique operational management practices between Islamic and conventional banks in Kenya and to identify differences in service capacity, internal layout and technology, between Islamic and conventional banks in Kenya. The study was guided by the following research questions; Are product and service designs for Islamic Bank similar to those of Conventional Bank?, Are there disparities in quality of operations between Islamic Banks and Conventional Banks?, Are products offered by Islamic Banks similar to those offered by Conventional Banks?, What are the unique operational processes and practices between Islamic Bank and Conventional Bank?, Are there differences in Information Technology platform for Islamic Bank as compared to that of Conventional Bank? and Are supply chains in terms of correspondent banking networks the same for Islamic Bank as those of Conventional Bank

The study adopted a case study method to achieve the research objectives. This method was appropriate for this particular phenomenon where details and uniqueness were emphasized. Islamic banks in Kenya constitute a small population and it's a relatively new phenomenon. Descriptive statistics such as frequency and percentages were used to analyze the responses and the findings were presented using charts and tables.

The study found that both Islamic and conventional banks had operation policies in place. There was a significant difference in terms of auditing, that is, 90.9% of the respondents from the Islamic bank were of the opinion that their bank carry out regular audit to ensure specific faiths based compliance in operations and processes while none of the convention bank carries out regular audit to ensure specific faiths based compliance in operations and processes.

Majority of the respondents further expressed the opinion that all operation management practices were not similar across the banking industry.

In terms of differences in service capacity, internal layout and technology, the study found out that; functionality of IT used in Islamic bank differs from those used by other banks while those from conventional banks indicated that the functionality of IT used in their organization do not differ from those used by other banks, IT designed in the Islamic bank supported Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction while IT designed for convention bank does not to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction, the office layout for Islamic bank also differs from those of the convention banks and both Islamic and convention bank had correspondent banking networks in terms of service delivery.

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CHAPTER ONE: INTRODUCTION

1.1.0 Background of the Study

1.1.1 How conventional banks make money

Banks are businesses. They "buy" and "sell" money, of course, some banks do provide other services related to finances, including selling insurance and sometimes offering access to securities. They "buy" money from depositors. Then, they can lend that money out, "selling" it to borrowers. Conventional banks often pay interest on deposit accounts.

Loans made to other bank customers (and sometimes to other banks) provide a bank with a way to earn more money. A bank may pay interest on a deposit, but the interest a bank receives on a loan is much higher. The difference between the amounts of money a bank pays out in interest, and the money it earns from loans, makes it a rather profitable business.

1.1.2 How conventional Banks Set Interest Rates

Banks decide on interest rates by using a number of different factors. These factors include, number of people who want to borrow money, amount of money the bank has available to loan out and the rate that banks charge each other for short-term loans.

Banks also set interest rates on loans with help from individual customers' credit situations. When a bank loans out money, there is a risk that the borrower won't repay it. This means that the bank is out of pocket on the original amount of money it loaned - and it won't make money on interest. In some cases, a borrower may pay back part of the loan, and then default on the rest. In order to ensure that the bank gets as much of its

money back as possible before a default, those who appear to be higher credit risks are often charged higher interest rates.

1.1.3 Faith based banking

There is no such thing as Buddhist, Christian or Hindu banking. Originally, the Catholics used to believe the same thing as the Muslims that "Creating" something out of nothing, in this case, interest, is against the teaching. Only "God" is allowed to "create", anything else is the works of the devil. What is interesting is that according to Judaism, the same concept applies as well, but it's allowed to lend and charge interest on the condition that it's to another non-Jew. (Ferguson Neil, 2009)

1.1.4 History and evolution of Islamic Banks

The first instance of Islamic banking came into the picture in Egypt in 1963. The pioneering efforts by Ahmad El Najjar brought this bank into existence, whose key principle was profit sharing (non-interest based philosophy of Shariah). By the end of 1976 there were 9 such banks in the country. These banks neither charged nor paid interest but their activities were mostly limited to trade and industries where these banks invested directly or as partners of depositors. The true phase of development of Islamic financial institutions actually occurred in the 1980s. Earlier initiatives were more inclined towards interest free Islamic banking, but the emergence of financial systems has evolved in the 80s. However, nonpayment of interest still remains the pivotal part of Islamic banking, whereas principles of Islamic finance such as property rights, sanctity of contracts and the rules of sharing risk are also supported. (Shariah-fortune .com)

1.1.5 Developments of Islamic banking

In recent years, financial institutions have experienced a dynamic, fast-paced, and competitive environment at a cross-border. Banks are competing on a global market rather than at a confined locality. One of the most growing areas in financial markets is the new paradigm of Islamic Banking, which has remarkably captured the interest of both Islamic and contemporary economists. The recent survey states that there are more than 160 Islamic financial institutions existing around the world (Par, 2003).

Despite the fact that most Islamic Banks are found within the Emerging and/or Middle-East countries, many universal banks in developed countries have begun to value the massive demand for Islamic financial products. This is partly an inspiration towards good finance, because, good finance is about trust, and trust is a cornerstone of stability, and this is the heart of Islamic banking. (Institute of Islamic banking and insurance, 1990)

1.1.6 Development of Islamic banking in Kenya

In Kenya, for instance, there are potential lucrative markets for Islamic banking among the business community in Nairobi, Mombasa and other towns with sizeable Muslim communities. Both the Barclays Bank of Kenya Limited and Kenya Commercial Bank Limited operate Islamic windows with the former branding its services, "LARIBA Banking and the later AMANA". Other conventional banks have Islamic banking product windows with varied names (Kenya institute of bankers' newsletter, June 2009)

Secondly, it is believed that Islamic finance can help break the vicious cycle of boom and bust that has come to characterize global finance, (Islamic banking news - Malaysia, May 2009). Islamic finance could therefore provide one possible way out of the current malaise and become an important foundation in a new, more stable world economic order. Thirdly, Rose Detho, in charge of banking supervision at CBK reported that Islamic banking had managed to bring more of the unbanked population into banking halls meaning that the concept has largely succeeded (Daily Nation, 19 April 2009)

Current market surveys indicate that a large section of the Muslim community remains untapped by the banking industry due to non availability of riba-free banking on low incomes. Hazrat Shah Waliullah Dehlvi, a great scholar and leader of the 18th century define 'Riba' thus, "a loan with the condition that the borrower will return to the lender more than and better than the quantity borrowed.". Riba (usury) is prohibited in various verses in the Holy Quran.

1.1.7 Islamic verses conventional banking

The main difference between Islamic banks and the contemporary banks is that, while the latter is based on the conventional interest-based principle, the former follows a principle of interest free financing and profit and loss sharing (PLS) in performing their business as intermediaries (Ariff, 1988). Many Islamic economic studies have discussed in depth about the rationale behind the prohibition of interest (Chapra, 2000) and the importance of PLS in Islamic banking (Par and Presley, 2000). Furthermore, under the term of Islamic PLS, the relationship between borrower, lender and intermediary are rooted in financial trust and partnership. The importance of the interest-free financing in Islamic

Banking has created an innovative environment among practitioners in which the alternative of interest is anticipated. (Par, 2003) classified four types of financing acting as alternatives of interest; investment-based, sale-based, rent-based and service-based.

Islamic banking refers to a financial system which is consistent with principles of Islamic law (or 'Sharia') and guided by Islamic economics. In particular, Islamic law prohibits 'riba' or usury, the collection and payment of interest. Additionally, Islamic law prohibits investing in businesses considered unlawful ('haram') or contrary to Islamic values. In recent years, a number of Islamic banks have been created to cater to the growing demand, driven by globalization and the vast wealth of some Muslim states in the Middle East and Southeast Asia, and Islamic finance has moved from a niche position to become a mainstream component of the global banking system. (Abd-el-Kader, 2005.)

If the terms and conditions of Islamic transactions differ too much from those of conventional institutions they become hard to sustain. The terms and conditions of Islamic institutions therefore tend to converge with conventional ones (El-Gamal, 2000). Islamic instruments are simply a narrow group of familiar financing instruments. Any transaction, with any distribution of proceeds, can be conducted as a lease, a sale, a partnership, a fee-generating transaction, or a loan. Islamic instruments generally avoid loans. Though the scheduled distribution of proceeds may be the same as for a conventional loan, the legal risk in case of default is often different in the different forms of financing.

Although U.S. and other banking supervision authorities have accommodated Islamic banking with few changes in procedures, some countries consider that this is not enough. They have moved to develop national and international Islamic institutions - money markets, bank regulators, deposit protection, bank accounting, and so on. Centers have been developed for all these matters - for bank supervision in Malaysia, for accounting in Bahrain, and several academic centers, including centers at Harvard and Oxford universities. (Sunderarajan, 2003.)

The Islamic finance industry is seeking to grow outside its main centres in the Gulf Arab region and South East Asia to tap into Muslim minorities in Western and African countries. Its banks cater for customers who want to follow Islamic rules on avoiding direct payment or earning of interest, which are viewed as usury under Islamic law. Central Bank Governor reported that the two Islamic banks operating in Kenya - Gulf African and First Community - had a loan portfolio of 4.9 billion shillings, deposits totaling 7.5 billion shillings and 27,270 deposit accounts (Gulf news, September 03, 2009).

Under Sharia law, Islamic banks are not allowed to lend money on interest because it is seen as exploitative. First Community Bank grew its deposits by more than 24% from Sh2 billion (US\$26 million) in December 2008 to Sh2.6 billion (\$34 million) in June 2009. Its total asset base increased by 8% from Sh3.1 billion (\$40.6 million) to Sh3.4 billion (44.6 million). Gulf African Bank, grew its total asset book by more than 144% from Kshs 2.5 billion in June 2008 to Kshs 6.1 billion in June 2009, has opened 12 branches in Kenya's major towns, as well as in the Muslim-dominated regions. According to Najmul Hassan, Gulf African Bank chief executive officer, Islamic banking is about

providing useful goods and services to society and not trading money in the way conventional banks do (Trade Invest Newsletter, August 24, 2009).

1.1.8 Operations Management in an Islamic Bank

In addition to the usual operational structures available with conventional banks, Islamic banks have to contend with additional operational frameworks, in an effort to mitigate Shariah non-compliance risks. Shariah non-compliance risk is the risk that arises from Islamic banks failure to comply with the Shariah rules and principles prescribed by individual Shariah boards. Shariah compliance is critical to Islamic banks operations and such compliance requirements must permeate throughout the organisation and their products and services.

Contract documentation compliance to Shariah rules and principles, with regard to formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations should always be put into account. Islamic banks undertake Shariah compliance review at least annually, performed either by Shariah audit department or as part of existing internal audit function by persons having the required knowledge and expertise for the purpose. The objective is to ensure, firstly ,that the nature of the banks financing and equity investment and secondly, that their operations are executed in adherence to the applicable Shariah rules and principles as per the fatwa, policies and procedures approved by the Islamic banks Shariah board(Operations Procedure manual -GAB, 2008).

The Islamic bank should track income not recognized arising out of Shariah non - compliance and assess the probability of similar cases arising in the future. Based on

historical reviews and potential areas of Shariah non - compliance, the bank may assess potential profits that cannot be recognized as ineligible Islamic banks profits (Product development and Shariah compliance paper - GAB, 2008)

1.1.9 Operations Management risk in Islamic verses conventional banks

Whereas conventional banks are exposed to risks from failures in their controls involving processes, people and systems, the threshold acceptable for Islamic banks is much higher. This is because the controls should provide reasonable assurance of the soundness of operations and reliability of reporting. To an Islamic bank , "the step by step" way of doing things is critical , because the end result may not be as important if the Shariah acceptable steps are not taken.(GAB Link , issue No 8 ,March 2010)

According to Imam Mohamed Swalihu, chairman, Kenya council of Imams and Ulamaa, at seminar Jamia Mosque 2010, Islamic banks are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the Islamic banks business practices, particularly relating to Shariah non-compliance in their products and services could have an impact upon their market position and liquidity.

Additionally, Sheikh Esam Ishaq, a member of GAB Supervisory board, advises that a reliable IT system is a must for profit sharing mechanism, failure of which may lead to Shariah non-compliance risk. The bank should identify key risk indicators and should place key control activities like code of conduct, delegation authority, segregation of duties , succession planning , mandatory leave, staff compensation, recruitment and

training , dealing with customers , complaint handling, record keeping , Management Information Systems , physical controls etc.

1.1.10 Deposits in Islamic Banking

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

1.1.11 Current Accounts

Current accounts are an interest-free loan by the account holder to the Islamic bank, which maintains these funds and pays them to the customer on demand. These accounts are similar to a loan in guarantee and the payment of the same amount. An Islamic Financial Institution has the right to invest the funds it is holding in current accounts without the customer bearing any loss. For this reason, the customer does not get any profit on this type of account, but he also does not bear any loss.

1.1.12 Investment Savings Accounts

Many Islamic banks offer savings accounts to their customers. This account allows the account holder to place funds in a safe environment till such time when they may wish to withdraw them. Profits and losses under investment savings accounts accrue on the

minimum monthly balance. Profits are paid, or losses are deducted, after the expiry of the financial year and the net profits are determined.

The balances under investment savings accounts are invested on the basis of unrestricted Mudharaba. An Islamic bank has the right to do everything necessary to realize common interest. An account holder authorizes the Islamic bank to invest the profits made from the moment they are registered in his own account with the Islamic bank.

1.2 Statement of the Problem

Islamic banking and therefore operations management in Islamic banks is a fairly new phenomenon in Kenya, with no evidence of any studies having been carried out. However, we can rely on studies done elsewhere to draw differences between operations management at a conventional bank Vis-a- Vis operations management within an Islamic bank setting. This can be done by looking at operational risks in Islamic banks as compared to those of conventional banks.

Islamic banks face similar challenges as conventional banks, to the extent that they offer financial services. However, the challenges are more sophisticated for Islamic banks than their conventional counterparts, since financial activities and the features of the financial contracts are substantially different. Operational risk in Islamic banks is associated with the loss resulting from inadequate or failed internal processes, people and system or from external events, including losses resulting from Shariah non - compliance and the failure by fiduciary responsibilities (The Islamic Financial Services Board- IFSB).

While operational risk according to Basel II, is the risk of loss resulting from inadequate or failed internal processes or systems or from external events. Therefore, the distinctive difference is Shariah non - compliance risk and fiduciary risks. (Sharia-fortune .com)

Shariah non-compliance risk arises from Islamic banks failure to comply with the Shariah rules and principles determined by its Shariah board. This could result in the transaction being cancelled and hence the income or loss cannot be recognized. Fiduciary risk on the other hand is the risk that arises from Islamic banks failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. Failure to maintain fiduciary responsibility will result in the deterioration of Islamic banks reputation and this could result in withdrawals of funds causing liquidity crisis as well as customers may also stop requesting for finance from the Islamic bank, reducing profitability.

In addition to Shariah non -compliance and fiduciary risks, other elements of operational exposures in Islamic banks could also appear, such as people, technology and legal risk. The dimension of people risk in Islamic banks is understandably wider than in conventional banks because people in Islamic banks are required to be well versed both in conventional banking products and Islamic finance requirements .Generally , there is lack of people who are adequately trained in modern financial transactions as well as fiqh al-muamalat(Islamic law relating to financial transactions)

In conclusion, it's apparent that the dimension of operations management in Islamic banks is more sophisticated than in conventional banks. Operational risk is now recognized as a type of risk that can contribute to significant losses in all financial

institutions. For this reason, various techniques are being applied by banks today in order to measure and manage operational risk. The methods set out by the Basel committee on banking and supervision help Islamic banks determine their capital in order to absorb operational losses.

The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision, in the expectation that member authorities and other nations' authorities will take steps to implement them through their own national systems, whether in statutory form or otherwise.

However, due to the small size of Islamic banks compared to the overall financial industry, more advanced methods in calculation of operational risk based capital are still not feasible to be implemented. The absence of a significant amount of loss data is also one of the problems that hinder Islamic banks from implementing more sophisticated methods.

Previous studies in Kenya have not documented operations management in Islamic Banks as this is a new phenomenon in the country. The studies that exist on Kenyan firms, however, reflect little emphasis on operations management. Ombura (2003), for instance, did a survey on improvement methods applied in operations management by firms listed in Nairobi stock exchange. Nengo (2004) did a study on proactiveness of the operations management function: The case of Kenya Power and Lighting Company.

Islamic banking is a new area and the operations are fundamentally different from those adopted by conventional counterparts .This study investigated the differences in operations between Islamic Banks and their conventional counterparts.

1.3 Objectives of the study

1.3.1 General objective

Comparative examination of Operations Management in Islamic Banks and conventional banks in Kenya.

1.3.2 Specific objectives

1. To compare and document unique operational management practices between Islamic and conventional banks in Kenya.
2. To identify differences in service capacity, internal layout and technology, between Islamic and conventional banks in Kenya.

1.4 Research Questions

1. Are product and service designs for Islamic Bank similar to those of Conventional Bank?
2. Are there disparities in quality of operations between Islamic Banks and Conventional Banks?
3. Are products offered by Islamic Banks similar to those offered by Conventional Banks?
4. What are the unique operational processes and practices between Islamic Bank and Conventional Bank?
5. Are there differences in Information Technology platform for Islamic Bank as compared to that of Conventional Bank?

6. Are supply chains in terms of correspondent banking networks the same for Islamic Bank as those of Conventional Bank?

1.5 Importance of the Study

The first beneficiaries of this study's findings would be the policy makers who would have an opportunity to get information on a relatively new phenomenon in Kenya. The Central Bank of Kenya, as the regulatory authority for banks, would find the findings of this study useful in providing information of Islamic banking. The government as a major stakeholder in the banking industry would also find the findings of this study invaluable. It would be in the best interest of any government to have her citizens get access to financial services. This would impact their financial development positively and hence that of the state in general.

The Islamic banks would benefit from the findings of this study by focusing on recommendations of the study. The banks would improve on the factors that impact their growth positively and mitigate the factors that retard their growth.

This study would also act as a reference point for future research. Scholars and other researchers would find the descriptive information needed to carry out further research. Areas that need further research would also be recommended by this study.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The barriers to communication and transportation are crumbling and the global marketplace is revolutionizing into a playing field that has never been so equal. These revolutions have not spared the banking industry either. Reduction of internet costs and introduction of various savvy innovations in the telecommunication arena means that majority can now transact business electronically, in the comfort of their offices or homes, substantially reducing travel costs. This therefore means that distance to the banking hall is no longer a competitive advantage. Efficiency and effectiveness are two of the most powerful words that have surfaced in this new era of business where maintaining a competitive edge is the difference between succeeding and faltering to bankruptcy. At the forefront of this expanding new frontier is an innovative management strategy known as operations management.

According to Heizer and Render (2007) "operations management is the set of activities that creates value in the form of goods and services by transforming inputs into outputs." This definition can be used to explain two types of outputs; tangible and intangible. A tangible output or good is something physical that can be inventoried, resold, transportable, selling is distinct from production and is often easy to automate. Examples of tangible products could be cars, televisions, baseball hats or even log homes. Whereas an intangible output or service is something that cannot be physically touched but provides something of value to the consumer. Services usually cannot be inventoried, selling is often part of the service, they are produced and consumed simultaneously, and the site of the facility is essential for customer contact. Buying airplane tickets, seeing a

physician, getting a haircut and having an investment manager are all situations where the service is unique and is not tangible.

In order to create goods and services all businesses have to execute three functions: marketing, production/operations, and finance/accounting. When an organization markets to a larger target audience its goal is to stimulate demand to relieve some of the surplus supply. In some simplistic cases it merely means taking the order for a product. Marketing can appear in several forms from commercials to coupons. Production and or operations creates the product, whether it be a good or service. Finally, Finance and or /accounting tracks how well the company is doing, where money is being allocated, and collects money from consumers (Adam and Ebert, 1982 Wild, 1980).

In today's business world, the field of Operations Management has been strongly influenced by a number of major trends, such as global competition, rapid evolution of information technology, fast information flows, and increased demand for rapid response and product variety. As a result, Operations Management is changing from being mathematical modeling-based, manufacturing-focused to become more closely linked with other business disciplines, such as Management Information Systems, marketing, management, and strategy. Operations management is a mission-critical managerial function in all kinds of organizations - from private manufacturing sectors to public service sectors, where Operations Management impacts each step in the process of providing a product or service.

The importance of operations management has increased dramatically in recent years due to the intensified global competition, shorter product/service lifecycles, increasingly

demanding consumers, and significant advancement of information and process technology. These trends have driven business organizations to focus on their operations function to improve efficiency and productivity while providing a wider variety of high-quality products and services. As a result, Operations Management is situated at the core of business and its interaction with other business functions has become increasingly important. The Operations Management discipline is historically dominated by design, planning and control issues. While this focus is still important to the field today, there is also a need to adopt a multidisciplinary approach and incorporate perspectives of other business functions.

Operations Management practices in Islamic Banks could be different as compared to Operations Management in conventional banks. Islamic Banking draw their authority from the Holy Quran and fiqh (the practices of Prophet Muhammad - peace be upon him), such practices put a lot emphasis on processes (the route taken) to achieve results. On the other hand, Conventional banks are more concerned with the end result and therefore methodology is not as important. The research therefore seeks to establish that there exist distinct difference in Operations Management between Islamic Banking and their counterparts.

2.2 History of banking in general

The financial industry has historically played an important role in the economy of every society. The history of banking is long and varied, with the financial system as we know it today directly descending from Florentine bankers of the 14th - 17th century. However, even before the invention of money, people used to deposit valuables such as

grain, cattle and agricultural implements and, at a later stage, precious metals such as gold for safekeeping with religious temples. Around the 5th century BC, the ancient Greeks started to include investments in their banking operations.

Temples still offered safe-keeping, but other entities started to offer financial transactions including loans, deposits, exchange of currency and validation of coins. Financial services were typically offered against the payment of a flat fee or, for investments, against a share of the profit.

2.3 History of Islamic banking

Modern banking system was introduced into the Muslim countries at a time when they were politically and economically at low ebb, in the late 19th century. The main banks in the home countries of the imperial powers established local branches in the capitals of the subject countries and they catered mainly to the import export requirements of the foreign businesses. The banks were generally confined to the capital cities and the local population remained largely untouched by the banking system. The local trading community avoided the foreign banks both for nationalistic as well as religious reasons. However, as time went on it became difficult to engage in trade and other activities without making use of commercial banks. Even then, many confined their involvement to transaction activities such as current accounts and money transfers. Borrowing from the banks and depositing their savings with the bank were strictly avoided in order to keep away from dealing in interest which is prohibited by Islamic religion.

With the passage of time, however, and other socio-economic forces demanding more involvement in national economic and financial activities, avoiding the interaction with

the banks became impossible. Local banks were established on the same lines as the interest-based foreign banks for want of another system and they began to expand within the country bringing the banking system to more local people. As countries became independent, the need to engage in banking activities became unavoidable and urgent. Governments, businesses and individuals began to transact business with the banks, with or without liking it. This state of affairs drew the attention and concern of Muslim intellectuals. The story of interest-free or Islamic banking begins here.

2.4 The Productivity Challenge and Operations Management.

In today's international business climate, competition has become fierce with competitors in every corner of the globe vying for the same share of the market. The underlying factor of a successful company is how it handles productivity. Productivity defined in its most rudimentary form is the ratio of outputs (goods and services) divided by the inputs (resources) (Hayes *et al*). The sole objective of the operations manager is to increase the ratio of outputs relative to inputs. In other words, increased productivity is being able to produce the most goods and services with the least amount of resources feasible. By allocating a smaller portion of resources to each output, you are cutting costs per good/service, saving valuable resources that can be used to produce more outputs, and in the long-run increasing the net profit that an organization gains from producing that output (Skinner, 1974, 1985).

One can further break-down the productivity challenge by analyzing the three variables that an operations manager can utilize to increase the productivity for their organization. Labor is the first variable and by providing adequate training, a balanced diet and social

conveniences (such as transportation and sanitation) worker morale, health and overall productivity will increase. These are very basic elements of increased labor productivity, more advanced variables are incentive strategies, team building, and higher levels of education (Ritter *et al.* 1999).

Capital is the second variable and is often in a tug-of-war with labor. The more the economy invests in capital the less labor is used and the inverse is true when capital investment is decreasing. When the capital investment per employee drops, society can expect that productivity per employee will also decrease. The final variable in the productivity equation is management. An Operations Manager can carefully balance the capital to labor ratio, which will enable their business to stay afloat if the economy takes a turn towards the red. By using knowledge and innovative applications of technology managers can improve the effectiveness of the labor and capital to increase the overall productivity of a company.

More specifically Ritter *et al.* 1999 says an Operations manager acts as the "productivity catalyst." They have the duty of selecting the best new capital investments and deciding which current investments are still profitable. To excel as an operations manager, you need to exclusively use the highest quality of inputs which will produce the highest quality outputs. A company cannot succeed if its operations manager is using inadequate inputs such as poorly educated workforce and antiquated technology. This explanation of productivity challenge is summarized by the figure below.

Fig 2.1- Productivity relationship between labour, capital and management (Irving Gershenberg, 1986)

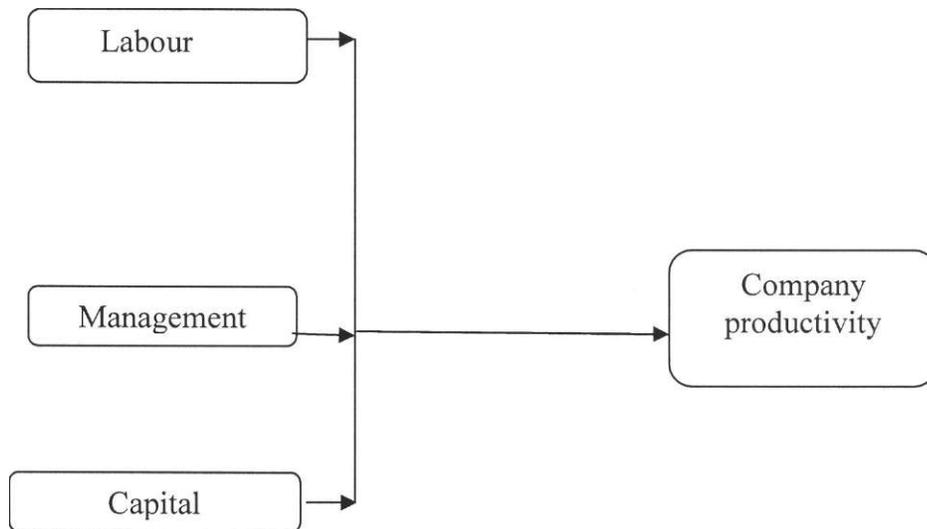


Fig 2.1 indicates that for an organisation to thrive, a combination of labour, capital and good management need to be employed. Whereas capital and labour may easily be employed and costed, management of company operations, though being core to any business, is not easily quantifiable, yet it is the single most important determining factor that defines an enterprises success or failure.

2.5 Competitive Advantage

When a company exhibits a competitive advantage, "it implies the creation of a system that has a unique advantage over competitors ... via differentiation, low cost, and response." (Heizer and Render, 2007). Not only does an operations manager have to develop a competitive advantage in their domestic environment but also in the international environment as well. This increases the complexity to achieve an edge over your competitors both near and far due to fact that certain regions of the world may have

advantageous inputs that your region may not have, i.e. cheaper labor, vast natural resources or efficient transportation. When an operations manager optimizes the differentiation approach to gaining a competitive advantage, they are concerned with providing an output that is unique and sets them apart from the competition. Their goal is to "distinguish the offerings of the organization in any way that the customer perceives as adding value."(Hill, 1985, 1989)

Another avenue that an operations manager can move towards is becoming a low-cost leader. A company that employs this strategy is "achieving maximum value as defined by your customer.. .by examining each of the ten Operations Management decisions in a relentless effort to drive down costs while meeting customer expectations of value."(Hill, 1985, 1989). To execute this competitive advantage an operations manager needs to have first a turnover of products/services, decreasing overhead costs, and by matching capacity to demand.

Two US companies that illustrate being a low-cost leader are Southwest Airlines and the mega-superstore giant Wal-Mart (Beck, et.al 2000). When a company cannot compete with the previous two strategies they can opt for the third option, response. A response approach entails a company to have the ability to provide flexible, reliable and quick replies to "sudden changes in a marketplace where design innovations and volumes fluctuate substantially." (Heizer & Render, 2007) More specifically quickness refers to the speed in design, production and delivery of a good/service. A company that can implement an effective response advantage can penetrate any market because of its ability to conform and assimilate to meet the needs of its new consumer base. All three of these concepts of competitive advantage can be actualized by the operations manager

either individually or sometimes in unison to allow a company to increase productivity and in the end, profitability.

Operations management revolves around responsiveness, flexibility and agility. These are key elements in gaining competitive edge. Therefore operations management is a way of becoming competitive

Because of their very nature, Islamic Banks offer more sound operations management, but in the process also affect responsiveness and flexibility. This is because transactions are usually more complicated; because they involve more documentation, hence more paper work than with their conventional counterparts, to conclude transactions. These complications mean that human resources employed need to be much more knowledgeable than those serving with Conventional Banks. Efficiencies in completing tasks, as a result of these complications, are also seriously interfered with and this does not afford IBs any competitive advantage.

2.6 The Ten Decision Making Areas

The foundation of operations management relies heavily on the operation manager's ability to make effective and timely assessments in the ten strategic decision areas. The ten areas include: goods and service design; quality management; process and capacity design; location; layout design; human resources and job designs; supply-chain management; inventory; material requirements planning, and Just in time; Intermediate and short-term scheduling and Maintenance (Browner *al.* 1994). These ten decision making criteria are an integral facet of an operations manager's job and more importantly

how these decisions are made will affect how a company will fare in the global and domestic marketplace.

2.6.1 Product and Service Design

Product and service design are fundamental to the structuring of an organization and affect every aspect of the organizations strategy (Brown *et al.* 1994). The design of the output is the primary prerequisite for the costs, quality, and human resource decisions that accompany that output. For instance when an operations manager is debating the design of a product/service they must take into consideration what will be the lower limits of cost and the upper limits of quality (Adam and Ebert, 1982). In addition, making sure that the company can allocate the appropriate amount of funds to produce or provide such an output.

It is essential that the operations manager fastidiously decides which design to produce because the implications of a poor decision could resonate throughout all of the operations functions. Another component of product/service design entails the development of strategies to propel outputs that are already in existence. Outputs progress through a life cycle that is segregated into four categories: introductory, growth, maturity, and decline. Operations managers not only have to create new product designs they also have to generate strategies for outputs that are in various stages of their life cycle.

Although certain products are similar in both conventional and Islamic banks, most are not. The studies will answer the question "are financial products offered by Islamic banks

similar to those offered by conventional banks". On the other hand, design and layout of offices are similar in both instances and no different outcome is expected.

2.6.2 Quality Management

According to Heizer & Render, 2007, quality is the ability of a product or service to meet customer needs. Quality management has become such an influential element of doing business that companies have adopted the cost of quality (COQ) model to predict the possible financial burdens of selling a product that is flawed. The COQ recognizes prevention costs, appraisal costs, internal failure, and external costs as foreseeable quality management issues that could not fulfill the needs of the customer (Adam and Ebert, 1982). Furthermore, an international body has come forward to create a unifying single quality standard known as the ISO 9000, which published a series of quality assurance standards. For a company to become a member of ISO 9000, they must be observed for 9 to 18 months and must meet rigorous quality standards on their goods and services (Heizer & Render, 2007).

However, quality control cannot just focus on individual products, in order for an operations manager to be successful they need to implement total quality management (TQM) (Chase, 1996). TQM embodies the entire organization, from supplier to consumer, to follow a stringent quality management emphasis. TQM incorporates a wide range of methods from the plan, do, check, act circular flow model which provides a company a template to have continuous improvement to the six sigma process. Six sigma is a statistical tool that aims to help reduce defects to a 99.9997% capability rate (Chase, 1996). Quality in its most basic sense is making the consumer content with their

good/service and it is the obligation of the operations manager to ensure that quality awareness is involved with each of the ten decision areas.

Quality expectations are the same in both conventional as well as Islamic banks. Other than the issue of faith, clients getting services at an Islamic Financing institution are not expected to do with poorer quality than they would get from conventional banks. The study will reinforce this known fact.

2.6.3 Process and Capacity Design

Process and capacity design or "process strategy" is taking that designed good/service and deciding the most profitable way to produce it. This decision area focuses on the transformation of an idea into an actual output (Shulver and Slack, 1997). The process needs to meet customer requirements while at the same time satisfying product specifications in regards to costs and labor. There are four directions an operations manager can pursue as a process strategy: process focus, repetitive focus, product focus, and mass customization (Clark and James (1997); Thompson, 1996). Process focus is when a production facility organizes around processes to facilitate low-volume, high-variety production.

A major benefit of process focus is that it allows for a large degree of flexibility because products can move intermittingly between processes, whereas repetitive focus is more structured and consequently less flexible than process focus. Repetitive focus is essentially a traditional assembly line that utilizes modules that are prepared before production begins. The third option, product focus, is a high-volume, low -variety process where the facilities are organized around the products. In order for a firm to

effectively use this option it must operate with high levels of standardization and immense quality control benchmarks. Lastly, an operations manager can pursue mass customization as process strategy. This entails rapid, low-cost production that caters to unique customer desires. Mass customization is the most intricate of the four processes and bestows upon the operations manager to make imaginative and aggressive use of organizational resources to accommodate the unique needs of their consumers (Clark and James 1997).

Processes taken to achieve a particular outcome are key in Islamic banks. Whereas the end result could be similar as that of a conventional bank, an incorrect process (method route and means not prescribed by Shariah board may negate Sharia spirit and hence make the transaction Sharia non-compliance. This would eventually make proceeds or benefits accruing thereto, haram and therefore cannot be recognized as income. For instance, Islamic banks deal with money as a medium of exchange and therefore only necessary to facilitate an underlying transaction. The underlying transaction must be in line with approved Shariah compliant products and usually, trade related. This study will outline operational differences in processes between Islamic banks and conventional banks.

2.6.4 Location

When analyzing a company's potential fixed and-variable costs the chosen location is a monumental predictor of the profitability and overall risk of the company (Shulver and Slack, 1997)). An operations manager has a myriad of criteria that needs to be addressed in order to determine where the plant will be situated domestically or globally. The cost drivers for this decision can range from labor costs, transportation costs, strength of the

economy, utility expenses, taxes, demographics, etc (Lewis and Chambers, 1997). In addition the type of company weighs on where to set up shop ranging from low cost orientated manufacturing firms to highly trafficked areas for retail and professional service organizations. The location of a company has crucial repercussions if the operation manager decides poorly in where to establish the company. It is a long-term decision that is not easily reversed.

The location decision by Islamic banks is similar to those of a conventional bank and the study will focus into this area.

2.6.5 Layout Design

Efficiency should be the principal concern of operation managers when they are designing the layout of their company (Goodale and Tunc, 1998). Like the rest of the 10 OM decision areas, the layout depends on the type of firm that you work for. Heizer & Render described seven types of layouts: office, retail, warehouse, fixed-position, process-orientated, work-cell, and product orientated layouts. Each of the above layouts has characteristics that are advantageous to their specific industries. For instance an office layout has to position workers, their equipment and the actual offices in such a way that the flow of information is seamless. Alternatively, a warehouse layout has to balance space allocation and the relatively ease it takes to handle the materials. When operation managers meticulously craft layouts they are increasing productivity, increasing efficiency, which decreases costs and culminates to increased profitability.

Good looking offices with appealing colours and as well as being located in a strategic area within the market, are as desirable to an Islamic bank as it would be by the conventional counterparts. The realm of this study will not focus on this area.

2.6.6 Human Resources

Without people the transformation of raw resources into a finished product and especially a service would be impossible (Goodale and Tunc, 1998). That is why companies around the world are developing human resource strategies that manage labor and design jobs so employees are utilized effectively and efficiently. The key to improving the quality of work for an organization, employees depend on the design of the job (Berry, 1995; Schneider and Bowen, 1995). Job design is a multifaceted approach that combines employee empowerment and method analysis. In order to get the greatest output per worker the operations manager wants to foster an environment where the "associate" has a highly specialized job in which they are allowed freedom from the centralized policies to contribute to the company in their own way.

Additionally, the management team wants to create a framework of incentives that coincides with their employee's job enrichment. There are multiple types of motivational rewards such as bonuses, profit sharing or even gain sharing (Berry, 1995; Schneider and Bowen, 1995). Of course employee empowerment is a loosely regulated method of management but it is the job of the operations manager to shadow their employees to ensure that they are meeting benchmarks and accomplishing company objectives. The second fork of developing an effective and efficient job design is by improving the interface between human and machine and/or facility. This encompasses appropriate

lighting for the skill at hand, or diminishing the amount of distracting noise penetrating the work place (Chase and Bowen, 1991).

Islamic banks expect that their Human capital will have both conventional banking knowledge as well as Islamic banking knowledge in order to deliver effectively. The challenge facing Islamic banks is the lack of experienced personnel with the necessary qualifications. This study will attempt to bring out such expectations in Islamic banks.

2.6.7 Supply-Chain Management

The most difficult aspect of operational manager's responsibilities is creating a reliable, sustainable and most importantly, efficient supply chain. According to Heizer and Render, "supply-chain management are the activities that procure materials and services, transforming them into intermediate goods and final products and delivering the products through a distribution system." (Heizer and Render, 2007). The complexity of supply-chain management involves making critical decisions all along the chain. From deciding whether to outsource a certain part of production to an external entity to save costs or what method of inventory response you want your organization to utilize. Furthermore, as technology progresses so do the advances in supply-chain management.

Radio Frequency ID Tags (or RFID) could revolutionize inventory management in every sector. The tags provide real-time data on the products in the warehouses inventory and can increase supply orders if the store suddenly experiences a surge in demand (Harland, 1996). This enables the store with just the right amount of products on the shelves to ensure full capacity. Another phenomenon that is spreading globally is internet purchasing (or e-procurement). Internet purchasing can range from meaning the

communicating in a supply-chain via internet to having the end-users purchasing goods or services directly from the manufacturing and bypassing several stages in a company's supply-chain.

In the realm of international business the ability of an operations manager to create an affective supply-chain is even more pivotal. Not only do they have to navigate the tumultuous waters of coordinating between suppliers, manufacturers and distributors, operation managers have to understand country variances in regulations, tariff and quota policies and numerous other factors that can inhibit the transit of goods and services across borders. An example of one of these hurdles an operations manager might have to face could be a Keiretsu Network, which is a "Japanese term to describe suppliers who become part of a company coalition." (Heizer and Render, 2007) Keiretsu Networks are an important component of Japanese business and would be a difficult obstacle for a foreign company who is looking to capitalize on that supply-chain.

Banks rely on correspondent bank network to access international markets. This enables its clientele access global markets and trade in those markets seamlessly. Various products are available with banks for facilitation of international trade. These include letters of credit, documentary collections, letters of guarantee and international settlement methods, usually using SWIFT. International trade products are similar to both Islamic banks and conventional banks

2.6.8 Inventory Management

Inventory Management is three-tiered element of operations management that is vital to the success of a company. It consists of independent demand, dependent demand and JIT

and lean systems. The principal reasons for inventory management are to "decouple" various parts of the production process to capitalize on cyclical influxes in demand and relinquish some of the power that suppliers and distributors have over the manufacturer (Clark and James, 1997). There are four types of inventory management: raw material; work-in-process; maintenance/repair/operating; and final goods inventories. All four of these inventory strategies are located in various stages in the supply-chain. In order for inventories to be profitable for a company, they have to be meticulously accurate to guarantee that there are not any discrepancies that could result from shrinkage or pilferage. Furthermore, independent demand is centered around when to order and how much to order. The primary objective of independent demand is minimizing holding, ordering and setup costs while balancing the amount of products needed to keep the shelves stocked (Steinherr and Huveneers, 1993).

Dependent demand (or a material requirements plan) is a factor of inventory management that revolves around the storing of components that are dependent on others (Steinherr and Huveneers, 1993). Such as the ordering of screws for a furniture company, the quantity of screws is directly correlated to the number of chairs produced. In some instances this process of inventory management is more crucial to success because without the tools and parts needed to produce a good, there wouldn't be a good. That is why Operation managers have to develop detailed ordering schedules, minimize lead times and create comprehensive bill of materials. The more dependable a purchasing system is the greater the probability of profitability not only for the company but also for the Operation manager.

Lastly, Just-in-time (JIT) and lean production are two concepts in inventory management that heavily rely on waste minimization. JIT is a fast past method of management that depends on goods to only be pushed through the inventory when needed thus reducing holding costs by maintaining the minimum amount of inventory necessary to keep a perfect system running (Clark and James ,1997). JIT takes an internal focus to reduce waste, whereas lean production "begins externally with a focus on the customer." The operations manager has to find what the customer values and then must optimize on inventorying those goods in order to minimize wasted holding costs on unnecessary goods. When JIT and lean production are utilized in unison it creates a very profitable supply chain.

Generally, the commodity traded by banks is cash, both local and hard currency. The cash holding requirement by banks is stipulated by central Bank, usually as a ratio to total deposits. Cash held per branch office is a function of the operations manager and is directly related to insurance cover on cash requirements. These requirements are similar in both Islamic banks and conventional banks.

2.6.9 Scheduling

The ability of a company to plan out its short and long-term objectives is imperative to its effectiveness and efficiency. Scheduling is the timing of operations and can be delineated down into aggregate and short-term scheduling. Aggregate scheduling incorporates consolidating all the functions of a firm into a single schedule that map out the long-term goals of the company; ranging from determining the size of the work-force to changing prices to influence demand(Clark and James ,1997). Many operations

managers prefer to use charts or graphs to simplify sales and ordering forecasts while others prefer linear programming format.

The essence of short-term scheduling is the capacity of a firm to meet possible surges in demand that were not seen in the long-term forecasts. Forward and backward scheduling defer in terms of when to start the scheduling to meet demands. The former starts as soon as the requirements are shown while the latter start with the due date and works in reverse. Additionally, operations managers need to decide whether to focus on projects with the longest processing time or the first job that comes through the system.

The number of cashiers, the length of queues, and the seating arrangement are functions of the operations manager in attempt to make the service environment friendlier to customers. Back office operations in relation to how cheques are handled, how payments are routed, how treasury deals are booked etc are all functions of the operation manager. These scheduling functions may resemble each other both in Islamic as well as conventional banks. However detail documentations are substantially different because whereas conventional banks make transactions simpler, Islamic banks are guided by Shariah law, hence making documentation very complicated.

2.6.10 Maintenance

Maintenance is the final Operations Management strategy decision and is often the most overlooked decision. Ensuring the equipment needed to produce a good/service is functioning efficiently without devastating breakdowns is crucial to the long-term stability of a company (Harland, 1996). The longevity of capital is dependent on "employee involvement and good procedures." If the proper protocols are followed the

mean time between failures (MTBF) will increase allowing for more productive capital. Moreover, if the operations manager maintains diligent preventative maintenance measures through routine inspections and can provide remedial maintenance, the probability of equipment downturn diminishes drastically.

Most banks have core banking IT systems that handle all banking needs of the bank. These core banking systems are expected to handle a wide range of transactions i.e. ranging from ATM networks, Customer relationship management, Treasury function, Trade Finance modules, liability modules, credit and credit administration functions, browser based transactions like the internet /email platform etc. Due to the nature of operations in an Islamic bank, core banking systems used are fundamentally different. This study will highlight major types of IT systems used by Islamic banks and their maintenance needs.

2.7 Operations Management; A case of Nordea Bank, Sweden.

"Making it Possible," is Nordea Financial Group's vision and mantra in its everyday operations. Nordea is a melting pot of banks that started 187 years ago in Sweden, under the name *Sparekassen for Kjobenhavn og Omegn*, and since then has consolidated 250 banks into one massive Nordic bank giant. Currently, the bank consists of approximately 1,300 branch offices in 19 countries and 32,000 employees all of which serve around 10 million customers. However, Nordea excels in e-banking with 4.9 million customers, the highest in the world in terms of usage at a staggering 200million payments/year. (nordea.com). The services that Nordea provides to its valued customers consist of: retail banking, corporate/institutional banking, asset management, and life insurance. (Nordea.com).

In regards to operations management, Nordea Bank excels. When examining any company, the first thing that needs to be accessed is the product they are selling (Sabani, 1994). Nordea is a highly diversified bank that specializes into catering to all of their customers' needs. The company prides themselves on "creating superior value for customers and shareholders" (corporate statement) through its products. Nordea's numerous acquisitions have enabled the company to excel in a wide range of banking services while still maintaining the Nordea's umbrella philosophy of providing an exceptional banking product, which has resulted in a 2006 revenue growth of 169.60%. (Nordea.com). In order to sustain increasing growth, Nordea adheres to an intensive quality management regiment considering that they provide a service that's main goal is to increase wealth. If a customer is not satisfied on their banking or investing experience, there are myriad other financial institutions for them to do business with. According to Nordea's corporate statement, they act with the customer in mind, understanding individual customer needs in order to exceed those expectations and deliver professionalism in every transaction to ensure lasting long-term relationships with their clients. Nordea understands the ramifications of poor quality management and instills all their employees to follow these guidelines.

Due to Nordea's beneficial location in Sweden, it enjoys a government that provides a safety net, through a high taxation system, for risky research and development decisions that spur innovation. This allows Nordea's process strategy to take dicey ideas and turn them into a reality. The bank excels in mass customization, which is evident through its highly profitable online banking division that without the initial R & D costs would not have been as successful. Furthermore, an enormous component of providing a service is

being accessible to your clientele since your intangible product cannot be shipped. In this regard, not only has Nordea Bank capitalized on the extremely lucrative growth in e-banking but also has implemented an intense network of branch offices and ATMS throughout the Nordic region, Northern Central Europe, and even parts of Russia and Asia (Sabani,1994).

In their *Human Capital Development 2007* project presented by the Global HR Manager, Marianne Siig, the company as a whole wants to foster team values, a popular belief among most Nordic organizations, but within this team create value for the entire organization. "Nordea wants to unfold the full potential of the organization through each individual employee" (Sigg). The company has realized that in order to provide the greatest return for its clients and shareholders, each employee needs to be empowered and challenged at the same time and at every threshold they cross. For example, instead of firing the lowest 10% of performers in the company, the HR department will engage in Personal Development Dialogue, which approaches the struggling employees and re-evaluates where they would be the most productive. This can either be accomplished through job rotation or a reallocation of responsibilities, both of which would optimize employee output and thus increasing the net profit for the company (Dar, 2003).

Although Nordea bank is a conventional bank, the case represents classical benefits of effective use of operations management to gain competitive advantage and remain ahead of the pack. The study reinforces this known belief and further introduces the Islamic aspect to operations management with the inherent benefits and/or pitfalls.

2.8 Designing the Islamic financial system

Financial economists have classified the financial system to be a bank-based and a market-based design. The market-based system emphasizes the importance of financial markets. Firms obtain external financing either from bank borrowing, from issuing bond or from issuing new shares (equity financing). While in the bank-base design, focus would be on the extensive role of the bank. The bank not only provide loan and at the same time holding the equity stake of the firm and be in the main board of directors.

Whether funds are to be derived from the market or bank, the design of Islamic financial system as compared to its conventional counterparts, the bank-base or market-base design, has two major distinctions. First it will devise the profit-and-loss sharing (PLS) mechanism and second, the mark-up financing. PLS is formed from mudarabah funds (investible funds) and Musharakah funds (equity funds). Murabaha (mark-up financing) and Ijarah (capital leasing financing) are loanable funds with Islamic features. The conventional bank loans operate under the credit system, whereby financial interest is compounded and is subject to fluctuation. On the contrary, the Islamic financing, murabahah or Ijarah, the concept of profit is in place of interest and agreeable by the borrowers as mark-up financing.

Some of the economic rationale for the superiority of PLS over the use of interest, quoted by Aggrawal and Yousef (2000), are described by International Association of Islamic Banks (1995, pp. 3-4). If interest is replaced by profit sharing, some imbalances are expected to be reduced. First, the return on capital will depend on productivity. Allocation of investable funds will be guided by the soundness of the project. This will in

effect improve the efficiency of capital allocation. Second, the creation of money by expanding credit will be created only when there is strong likelihood of corresponding increase in the supply of goods and services. In case the enterprise loses, repayment of capital to the bank is diminished by the amount of loss. Thus, in the profit-sharing system, the supply of money is not allowed to overstep the supply of goods and services. This will eventually curb inflationary pressures in the economy.

Third, the shift to profit-sharing may increase the volume of investments that translates into job creation. This is because the interest mechanism makes feasible only those projects whose expected profit is sufficiently high to cover the interest rate plus added income. This filters out projects which otherwise would be accepted in the profit-sharing system. Fourth, the new system will also ensure more equitable distribution of wealth. Wealth would bring more wealth to its owners only when its use has actually resulted in the creation of additional wealth. This would in time reduce the unjust distribution of wealth which continued for decades during the interest regime.

Fifth, the abolition of interest, together with the restriction of forward transaction, as prescribed by the Sharia (Islamic Law), will curtail speculation measurably. But still, there will be secondary market trading of common stocks and investment certificates based on profit-sharing principles. This will bring sanity back to the market and allow rising of funds for enterprises and liquidity to equity holders.

2.9 Summary

Operations management, whether in Islamic or conventional banks, mainly focus on the ten decision areas. It is these ten decision areas that define success or failure of any banking institution. Difference in faith may not necessarily affect the ways services and goods are delivered in banks, because how services are delivered bounder on success or failure.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction.

This chapter outlines the methods and techniques used to realize the set objectives of the study. It starts with research design and the target population. The data collection and processing techniques were also addressed. The chapter concludes with data analysis and presentation of the research findings.

3.2 Research Design.

This study used a case study method to achieve the research objectives. This method was appropriate for this particular phenomenon where details and uniqueness were emphasized. Islamic banks in Kenya constitute a small population and it's a relatively new phenomenon. This study took the case of Gulf African bank and African Banking Corporation, both tier three banks. (CBK prudential guidelines).

3.0 Target population and Sample.

The target population of this study was Islamic banks that were fully Shariah compliant and other banks in similar tier. There are only two banks that are Shariah compliant in Kenya; Gulf African Bank and First Community Bank. The respondents of this study were drawn from top management of Gulf African bank limited and African Banking Corporation. This included Head of operations and his immediate manager, and Heads of other four departments plus their immediate managers. Four employees were randomly picked from each of the five departments.

The use of random sampling reduced biasness and gave each member a fair chance of being selected. Randomness is especially important in this type of study, where unique areas will be covered. Because of the homogeneity nature of the population, for instant, all respondents were currently working within the banking industry, a total of 30 respondents were considered sufficient. 15 respondents were drawn from each institution under study.

Table 3.1 Sample size

	HOD & their Manager	Employees
Operations Manager/Head of Operations	2	4
Head of Information Management	2	4
Head of Finance	2	4
Head of Risk/Credit	2	4
Human Resources Manager	2	4
Total	10	20
Overall Total	30	

3.4 Data collection techniques

The data was collected through primary data. The primary data was collected using semi structured questionnaire comprising of both open and closed ended questions. The questionnaire was divided into three parts; the first focused on the respondent's background, the second on unique operations practices and finally, the third section focused on contribution of service capacity, layout and IT to operation.

The questionnaires were administered through drop-and-pick later method.. Before commencement of the study, a pilot study was conducted to test the instruments and corrections done.

3.5 Data analysis and presentation

Descriptive statistics such as mean, deviations and percentages were used to analyze the responses and the findings were presented using charts, bar graphs, and tables. Content analysis was also used to analyze qualitative data.

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1: Introduction

The research objectives were; to compare and document unique operational management practices between Islamic and conventional banks in Kenya and to identify differences in service capacity, internal layout and technology, between Islamic and conventional banks in Kenya. This chapter presents the analysis and findings with regard to the objective and discussion of the same. The data was collected from the sample of 30 respondents.

4.2: Characteristics of respondents

4.2.1: Response rate

A total of 30 questionnaires were issued out. The completed questionnaires were edited for completeness and consistency. Of the 30 questionnaires used in the sample, 25 were returned. The remaining 5 were not returned. The returned questionnaires' represented a response rate of 83.33%, which the study considered adequate for analysis.

4.2.2: Distribution by Years worked in the banking industry

As shown in table 4.2.1, most of the respondents (68%) have worked in the banking industry for more than 5 years, followed by 24% who have worked for 2 to 5 years and 8% for less than 2 years respectively.

Table 4.2.1: Years worked in the banking industry

Years worked	Frequency	Percent	Cumulative Percent
Below 2 years	2	8.0	8.0

Between 2 - 5 years	6	24.0	32.0
More than 5 yrs	17	68.0	100.0
Total	25	100.0	

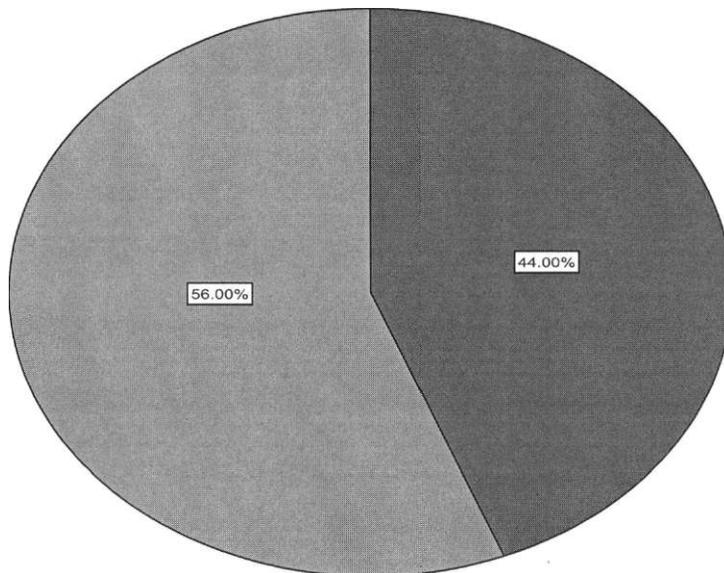
Source: Author (2011)

Majority of the respondents are experienced and therefore the expected outcome will be more authentic.

4.2.3: Distribution by having worked with an Islamic bank

The findings presented in figure 4.2.1, indicates that 44% of the respondents have worked in the Islamic bank while 56% had never worked in the Islamic bank, that is, they belong to conventional banks.

Figure 4.2.1: Management level



Source: Author (2011)

Almost half of the respondents have not worked with an Islamic bank, with the other half having had some experience with an Islamic bank. This therefore gives a fair comparison of the two different systems of banking.

4.2.4: Distribution by number of years worked in the Islamic banking

Of those who had worked in the Islamic bank. The number of years worked varied from less than one year to more than 3 years. Specifically majority (63.6%) of the respondents had worked in the Islamic banks for more than 3 years, 27.3% for less than one year and 9.1% for a period of 2 to three years. The significant proportion who had worked for more than 2 years indicates that the respondents are conversant with the operations of the Islamic banking and as such the information obtained from them could be relied on.

Table 4.2.2: Have you worked with an Islamic bank? * If yes, number of years. Cross tabulation

Have you worked with an Islamic bank?		If yes, number of years.			Total
		< 1 year	2 - 3 years	> 3 years	
Yes	Count	3	1	7	11
	%	27.3%	9.1%	63.6%	100.0%
Total	Count	3	1	7	11
	%	27.3%	9.1%	63.6%	100.0%

Source: Author (2011)

The data received is credible because majority had worked with an Islamic bank for periods longer than 3 years. Three years is considered adequate to grasp and understand most of the operations in any institution.

4.3: Unique operations practices

This section covers the question posed to the respondents on unique operations practices in the respective banks in terms of; operations policies, operations procedure manuals to back operations policies, specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations, carrying out regular audit to ensure specific faiths based compliance in operations and processes and possibilities of similarity of operation management practices across the banking industry. Tables, frequencies and percentages were used to present the findings.

4.3.1: Existence of operations policies in the bank

The respondents were asked to state whether their respective banks had operations policies in place. The results are as shown in table 4.2.3 below. The respondents across the divide (type of bank) unanimously agreed that their banks had operation policies in place.

Table 4.2.3: Type of bank? * Does your bank have operations policies? Cross tabulation

Type of bank	Does your bank have operations policies?		Total
		Yes	
Islamic bank	Count	11	11
	%	100.0%	100.0%
Conventional bank	Count	14	14
	%	100.0%	100.0%
Total	Count	25	25
	%	100.0%	100.0%

Source: Author (2011)

The outcome indicates that all the institutions under review placed importance to operations management and hence the reason all of them had operations policies in place. Operations management with proper structures are used for best practice because it's possible to documents and audit loopholes , using such events as reference points for future improvements.

4.3.2: Does your bank have operations procedure manuals to back operations policies

The respondents were asked to state whether their respective banks had operations procedure manuals to back operations policies. The results are as shown in table 4.2.4 below. It was evident from the result that all the Islamic banks had operations procedure manuals to back operations policies, while 71.4% of the convention banks also had operations procedure manuals to back operations policies. It is significant to note that 28.6% of the respondents from the conventional bank were not sure that their banks had operations procedure manuals to back operations policies.

It therefore means that operational structures are more important to an Islamic bank than it would be with the conventional bank. The reason why all respondents with Islamic bank were aware of existence of operations procedure manual with their institutions merely reinforces the fact that Islamic banks put a lot of emphasis on the step -by-step process flow when undertaking transactions.

Table 4.2.4: Type of bank? * Does your bank have operations procedure manuals to back operations policies? Cross tabulation

Type of bank	Does your bank have operations procedure manuals to back operations policies?			Total
		Yes	Not sure	
Islamic bank	Count	11	0	11
	%	100.0%	.0%	100.0%
Conventional bank	Count	10	4	14
	%	71.4%	28.6%	100.0%
Total	Count	21	4	25
	%	84.0%	16.0%	100.0%

Source: Author (2011)

Again, the result further augments the importance placed by Islamic Banks to the process.

The result of an event is not as important as the route taken, hence the overwhelming knowledge exhibited by employees, in regard to operations.

4.3.3: Does your bank have specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations)

The respondents were asked to state whether their respective banks had specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations). The results are as shown in table 4.2.5 below.

Table 4.2.5: Type of bank? * Does your bank have specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations)? Cross tabulation

Type of bank	Does your bank have specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations)?				Total
		Yes	No	Not sure	
Islamic bank	Count	11	0	0	11
	%	100.0%	.0%	.0%	100.0%
Conventional bank	Count	6	2	6	14
	%	42.9%	14.3%	42.9%	100.0%
Total	Count	17	2	6	25
	%	68.0%	8.0%	24.0%	100.0%

Source: Author (2011)

As shown in table 4.2.5, all the respondents from the Islamic bank were of the opinion that their banks had specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations), 42.9% from the convention banks had specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations). While 14.3% of the respondents from the convention bank did not have specific guidelines to support faith based banking (for Shariah Compliance to operations)

It's overwhelmingly agreed that Islamic banks have policies to support Shariah compliance in line with the doctrines of the faith. However, it also implies that increasingly, conventional banks are adopting Shariah compliant windows to offer Shariah compliant products to the ever expanding Muslim population.

4.3.4: Does your bank carry out regular audit to ensure specific faiths based compliance in operations and processes

The findings in table 4.2.6, indicates that 90.9% of the respondents from the Islamic bank were of the opinion that their bank carry out regular audit to ensure specific faiths based compliance in operations and processes. On the other hand it was evident that none of the convention bank carries out regular audit to ensure specific faiths based compliance in operations and processes

This implies that conventional banks do not care about processes involved in attaining ends , whereas processes is central to Islamic banking

Table 4.2.6: Type of bank? * Does your bank carry out regular audit to ensure specific faiths based compliance in operations and processes? Cross tabulation

Type of bank	Does your bank carry out regular audit to ensure specific faiths based compliance in operations and processes?				Total
		Yes	No	Not sure	
Islamic bank	Count	10	0	1	11
	%	90.9%	.0%	9.1%	100.0%
Conventional bank	Count	0	2	12	14
	%	.0%	14.3%	85.7%	100.0%
Total	Count	10	2	13	25
	%	40.0%	8.0%	52.0%	100.0%

Source: Author (2011)

Whereas conventional banks have windows to cater to the ever expanding Muslim population, they do not mind over stepping the important role of audit to ensure Shariah compliance. It will therefore be increasingly difficult for most conventional banks to make inroads in Shariah banking. Islamic banks have a head start to leverage on and

remain ahead of competition in that niche.

4.3.5: Are all operation management practices in your bank similar across the banking industry?

The respondents were asked to state whether all operation management practices in were similar across the banking industry. The results in table 4.2.7, shows that majority of the respondents were of the opinion that all operation management practices were not similar across the banking industry, that is, 60% said no and 16% were not sure. Of those who said no, the unique / or the different operations management practices in the bank were; we do not support any particular faith since we practice western banking, In some banks credit approval is done at the branch level meaning the business banker and branch managers have some level of autonomy while at my banks there is centralization of many operations issues like credit, cheques and account opening, All facilities/products must be approved by the Shariah Board through the Shariah Advisor. In this regard, there is an approval board i.e. the Shariah Board which is different and separate from the normal Management Credit Committee as is the case in most conventional banks, Shariah compliance calls for a separate and additional step(s) in management different from the conventional banking system, and also calls for a more vigorous and progressive process in terms of execution per product, There is a higher volume of documentation to be processed with regard to Shariah /Islamic Banking separate from the legal documentation hence creating two sets of documentation as opposed to one set as characterized in most conventional banks, no Islamic banking tool to analyze risk in operations but is based on principles of Shariah only and looks at aspects of breaching the Shariah law but not at the

actual risks such as mitigation of frauds, Ours do not support i.e. Islamic banking which is the fashion in the industry.

This implies that firewalls put in place to guard against Shariah non - compliance, not necessarily mitigants to operational risk.

Table 4.2.7: Are all operation management practices in your bank similar across the banking industry

	Frequency	Percent	Cumulative Percent
Yes	6	24.0	24.0
No	15	60.0	84.0
Not sure	4	16.0	100.0
Total	25	100.0	

Source: Author (2011)

4.4: Contribution of service capacity, layout and IT, to operations

This section covers the question posed to the respondents on contribution of service capacity, layout and IT, to operations. Tables, frequencies and percentages were used to present the findings.

4.4.1: Is functionality of IT used in your organization any different from those used by other banks

The respondents were asked to state whether or not functionality of IT used in their organization differs from those used by other banks. The results are shown in table 4.3.

Table 4.2.8: Type of bank? * Is functionality of IT used in your organization any different from those used by other banks Cross tabulation

Type of bank	Is functionality of IT used in your organization any different from those used by other banks			Total
		Yes	No	
Islamic bank	Count	6	5	11
	%	54.5%	45.5%	100.0%
Conventional bank	Count	0	14	14
	%	.0%	100.0%	100.0%
Total	Count	6	19	25
	%?	24.0%	76.0%	100.0%

Source: Author (2011)

As indicated above 54.5% of the respondents from the Islamic bank were of the opinion that the functionality of IT used in their organization differs from those used by other banks. On the other hand all respondents from convention banks indicated that the functionality of IT used in their organization do not differ from those used by other banks

The different IT platforms mean that the systems cannot be the same when the processes are not similar. Different processes require different IT structure lay out and platform.

4.4.2: Our IT is designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction.

The respondents were asked to indicate whether their IT has designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction. The results are shown in table 4.2.9.

Table 4.2.9: Type of bank? * Our IT is designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction Cross tabulation

Type of bank	Our IT is designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction			Total
		Yes	No	
Islamic bank	Count	11	0	11
	%	100.0%	.0%	100.0%
Conventional bank	Count	0	14	14
	%	.0%	100.0%	100.0%
Total	Count	11	14	25
	%?	44.0%	56.0%	100.0%

Source: Author (2011)

It was apparent that all respondents from the Islamic bank felt that their IT has been designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction while their counter parts from the convention bank were of the opinion that their IT has not been designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction,

This supports earlier argument that conventional banks are ill prepared to offer Shariah compliant products. Merely because conventional banks have some of the best IT

software and hardware platforms, does not mean that such systems are good for all products. Specific IT systems need to be designed to cater for the Islamic niche

4.4.3: Our IT does not allow step- by- step processes in transaction as advocated by Shariah

The respondents were asked to indicate if their IT did not allow step- by- step processes in transaction as advocated by Shariah. The findings are shown in table 4.2.10.

Table 4.2.10: Type of bank? * Our IT does not allow step- by- step processes in transaction as advocated by Shariah Cross tabulation

Type of bank	Our IT does not allow step- by- step processes in transaction as advocated by Shariah			Total
		Yes	No	
Islamic bank	Count	9.1%	90.9%	100.0%
	%	1	10	11
Convention bank	Count	14.3%	85.7%	100.0%
	%	2	12	14
Total	Count	3	22	25
	%?	7.2%	88.0%	100.0%

Source: Author (2011)

Majority of the respondents both from the Islamic bank (90.9%) and convention bank (85.7%) indicated that their IT allowed step- by- step processes in transaction as advocated by Shariah

Similarity in respondents means that IT systems are designed to process work progressively, which is in line with how most banking IT systems function.

4.4.4: Is office layout in your organization different from those found with other banks

The respondents were asked to state whether their organization office layout differs from those found with other banks. The results are shown in table 4.2.11

Table 4.2.11: Type of bank? * Is office layout in your organization different from those found with other banks? Cross tabulation

Type of bank	Is office layout in your organization different from those found with other banks?			Total
		Yes	No	
Islamic bank	Count	11	0	11
	%	100.0%	.0%	100.0%
Conventional bank	Count	100.0%	.0%	100.0%
	%	14		14
Total	Count	25	0	25
	% ?	100.0%	.0%	100.0%

Source: Author (2011)

The respondents unanimously agreed that their organization office layout differs from those found with other banks. This difference has come as a result of the fact that most Islamic banks had just been started and as such have incorporated the modern office layout structure as compared to the convention banks which were designed many years ago.

The other reason is that each bank wants to portray different image and hence not possible to have all bank designs looking similar.

4.4.5: In terms of service delivery, does your organization have correspondent banking networks

The respondents were asked to state whether their organization have correspondent banking networks in terms of service delivery. The findings are shown in table 4.2.12 below.

Table 4.2.12: Type of bank? * In terms of service delivery, does your organization have correspondent banking networks? Cross tabulation

Type of bank	In terms of service delivery, does your organization have correspondent banking networks?		Total
		Yes	
Islamic bank	Count	11	11
	%	100.0%	100.0%
Conventional bank	Count	14	14
	%	100.0%	100.0%
Total	Count	25	25
	%?	100.0%	100.0%

Source: Author (2011)

As shown in table 4.3, all the respondents indicated that their organization had correspondent banking networks in terms of service delivery.

It means that of all the products offered by banks, correspondent banking is one such product which is universally offered across the board irrespective of the nature of the other products.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The objectives of the study were to compare and document unique operational management practices between Islamic and conventional banks in Kenya and to identify differences in service capacity, internal layout and technology, between Islamic and conventional banks in Kenya.

Foremost, the study found that the respondents had worked with both the Islamic and convention banks. More specific majority of those who had worked in the Islamic bank had done so for a period of more than three years and therefore they had enough knowledge in the Islamic banking as their counterparts from the convention bank.

In terms of unique operational management practices, the study found that both Islamic and conventional banks had operation policies in place. It was also noted from the result that all the Islamic banks had operations procedure manuals to back operations policies, while only 71.4% of the convention banks had operations procedure manuals to back operations policies. There was a significant difference in terms of auditing, that is, 90.9% of the respondents from the Islamic bank were of the opinion that their bank carry out regular audit to ensure specific faiths based compliance in operations and processes while none of the convention bank carries out regular audit to ensure specific faiths based compliance in operations and processes.

majority of the respondents further expressed the opinion that all operation management practices were not similar across the banking industry, that is, we do not support any particular faith since we practice western banking, In some banks credit approval is done at the branch level meaning the business banker and branch managers have some level of autonomy while at other banks there is centralization of many operations issues like credit, cheques and account opening, All facilities/products must be approved by the Shariah Board through the Shariah Advisor. In this regard, there is an approval board i.e. the Shariah Board which is different and separate from the normal Management Credit Committee as is the case in most conventional banks, Shariah compliance calls for a separate and additional step(s) in management different from the conventional banking system, and also calls for a more vigorous and progressive process in terms of execution per product, There is a higher volume of documentation to be processed with regard to Shariah /Islamic Banking separate from the legal documentation hence creating two sets of documentation as opposed to one set as characterized in most conventional banks.

In terms of differences in service capacity, internal layout and technology, the study found out that; functionality of IT used in Islamic bank differs from those used by other banks while those from conventional banks indicated that the functionality of IT used in their organization do not differ from those used by other banks . IT designed in the Islamic bank supported Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction while IT designed for convention bank does not to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction, the office layout for Islamic bank also differs from those of the convention banks and

both Islamic and convention bank had correspondent banking networks in terms of service delivery.

Most of the findings correlate what other scholars, especially studies done in the Muslim dominated East, have found. The surprising things were the knowledge gaps which exist with conventional banks in respect to Islamic financing.

5.2 Conclusion

From the findings of the study, it can be concluded that there are unique operational management practices between Islamic and conventional banks in Kenya in terms of; operation procedure manuals to back operation policies, existence of specific guidelines to support faith based banking, and frequency of carrying out regular audit to ensure specific faith based compliance in operations and procedures.

Finally, it can be concluded that there also exist differences in service capacity, internal layout and technology, between Islamic and conventional banks in Kenya with regards to information technology functionality, information technology design and office layout.

5.3 Recommendations

5.3.1: Recommendation with policy implications.

Based on the study findings, it is recommended that conventional banks intending to open Shariah windows will require thorough structuring of their operations to guard against loopholes as a result Shariah non adherence. This especially to the Kenya Institute of Bankers, the Kenya Association of Bankers and the central bank of Kenya.

5.3.2: Recommendation for Further Research

This study focused on only two banks in the third tier, it is therefore recommended that further research work should be done for banks in the first and second tiers and the results be compared to aid general conclusion in the entire banking industry.

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APPENDICES

Appendix I: Questionnaire

Section A: General Characteristics of the Respondent

1. Department
2. Years worked in the banking industry

Below 2 years

Between 2 - 5 years []

More than 5 yrs []
3. Have you worked with an Islamic bank?

Yes []

No []
4. If yes , number of years.

Below 1 year

Between 2 - 3 years []

More than 3 years []

Section B: unique operations practices

5. Does your bank have operations policies? Tick one

Yes []

No []

Not sure []

6. Does your bank have operations procedure manuals to back operations policies?

Yes []

No []

Not sure

7. Does your bank have specific guidelines to support faith based banking (i.e. for Shariah Compliance to operations)?

Yes []

No []

Not Sure []

8. Does your bank carry out regular audit to ensure specific faiths based compliance in operations and processes?

Yes []

No []

Not sure []

9. In your opinion, are all operation management practices in your bank similar across the banking industry?

Yes []

No []

Not sure []

10. If your answer to No. 9 above is No ,please list the unique / or the different operations management practices in your bank

SECTION C: Contribution of service capacity, layout and IT, to operations

11. Other than differences in brand name, is functionality of IT used in your organisation any different from those used by other banks?

Yes []

No []

Not sure []

12. Answer following questions by ticking the appropriate choice.

a. Our IT is designed to support Islamic Financing by providing firewalls to guard against Shariah Breach in a transaction.

Yes []

No []

b. Our IT does not allow step- by- step processes in transaction as advocated by Shariah

Yes []

No []

13. Is office layout in your organisation different from those found with other banks?

Yes []

No []

Not sure []

14. In terms of service delivery, does your organisation have correspondent banking networks?.

Yes []

No []

Not sure []

Thank you for participating