

**ADOPTION OF ISLAMIC BANKING ON FINANCIAL
PERFORMANCE OF COMMERCIAL BANKS IN KENYA**

WYCLIFFE MABONGA

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DECLARATION

This research project is my original work and has not been submitted for examination to any other university.

Signature _____ Date _____

WYCLIFFE MABONGA

Reg No : D61/77115/2012

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

Signature _____ Date _____

Dr Joshua Wanjare

Lecturer

School Of Business

University of Nairobi

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DEDICATION

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LIST OF ABBREVIATIONS/ACRONYMS

BIMB	Islamic banks Islam Malaysia Berhad
CBK	Central Bank of Kenya
CBs	Conventional Banks
CIS	Credit Information Sharing System
DEA	Data Envelopment Analysis
FCB	First Community Bank
GDP	Gross Domestic Product
IBs	Islamic Banks
IT	Information Technology
SFA	Stochastic Frontier Approach
TBs	Traditional Banks
UAE	United Arab Emirates

ABSTRACT

Islamic banking has continued to gain ground in the Kenya banking sector with 2 banks operating as fully fledged shariah compliant commercial banks and 7 being prototype opening a window for Islamic banking products. The uptake of Islamic banking products is expected to grow to US\$ 1.6 trillion by 2018. The study premeditated at determining the consequence of embracing of Islamic banking on financial performance of commercial banks in Kenya. The study was conducted through descriptive survey design. It employed the use of secondary data in which financial information from 9 commercial banks was analyzed. Results of the study were presented in a regression equation. The study found that Islamic banking ratio contributed most to the financial performance of commercial banks followed by liquidity ratio, efficiency ratio, capital ratio, and finally bank size. The study revealed that adoption of Islamic banking by commercial banks had a positive consequence on the financial performance of commercial banks in Kenya. The study recommends similar studies be undertaken in Eastern part of Africa for comparison purpose because most studies on Islamic banking has concentrated in West Africa and Asian countries.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Banking occupies the most significant places in current economic world. It is essential for doing business. For this reason it is one of the great agencies of trade. Even though banking in one appearance or another has been in existence from the very beginning, modern banking is of recent origin. It is one of the results of industrial revolution and an infant of necessity. Its presence is very supportive to the economic bustle and industrial development of a country. Siraj and Pillai (2012) affirm that the strength and development of any economy to a great degree depends on the strength of its banking sector.

Banking plays a momentous function in the economy of a country in that it encourages savings behavior amongst people and thereby making finances accessible for industrious use. It acts as a go between people having extra cash and those requiring capital for various business transactions. Hudgins and Rose (2013) allege that in the recent years, banks have experienced vibrant and extensive changes which are rapidly reshaping and revolutionizing the banking industry. One of the most enormous transformations in the field was the initiation of a new prototype of banking, Islamic banking which has gained the attention of both Islamic and non-Islamic economies worldwide. Today Islamic banks are operating in all areas of the globe, as a practical and feasible alternative system to the conventional banking system.

Srairi (2009) stress that although it was originally developed to satisfy the requirements of Muslims, at present Islamic banking has currently achieved

worldwide acceptance and is documented as one of the greatest rising areas in finance and banking as stated in the Global Finance Report (2012). Islamic economists went on to point out the deficiencies of capitalism and linking them to the institution of interest, among other things. With this went the argument showing that it was possible to have banking without interest and that it would not adversely affect savings and investment (Maududi, 1969). Some argued that abolishing interest would boost investment leading to increased production (Mannan, 1970).

1.1.1 Islamic Banking in Kenya

In Kenya the desire for financial products that comply with Sharia code is on the increase as the continent comes up to the philosophical and practical opulence and relevance of this form of alternative banking (Global Islamic Finance Report, 2010). Kenya was the first country in Eastern and Central Africa to allow the operations of Islamic banking when the Central bank of Kenya (CBK) formally approved First Community Bank (FCB) on may 29th 2007 to operate as a fully-fledged Sharia compliant commercial bank. This achievement was the culmination of concerted efforts spanning more than 20 years observed by Mr Nathif Adam, FCBs chief executive officer.

According to the banks official website the bank made huge tramp in many aspects opening more than 18,000 accounts and a remarkable growth in deposits which grew from over a billion ksh (Kenya shillings) at the end of September 2008 to over three billion ksh (Kenya shillings)at the end of September 2009. This shows the level of assurance that the bank receive in the market place. (<http://www.firtscommunitybank.co.ke>). The bank managed to have a branch net work of 17 branches by 2010. A number of these branches are located in the Northern Eastern parts of the country which is largely dominated by Muslim community.

During the year 2008, the bank made very significant strategic link up with development institutions such as the Youth Enterprise Development Fund which selected FCB as one of the only four banks in the country to work with the fund in dissemination of the funds financing portfolio. FCBs participation in the Fund was largely aimed at ensuring that the financing support available from the Fund reaches Muslim youth in the country in a Sharia compliant manner.

As a predecessor, the Central Bank of Kenya had earlier in 2005 allowed Barclays Bank of Kenya to run with an interest free current account. The account which was entitled 'LA RIBA' was intended to address the sensitivities of the customers of the bank who adhere to the Islamic faith. Other conventional Kenyan banks followed the Barclays example and have since established interest free current accounts particularly so in the light of competition from the new Islamic banks. These banks include: National Bank that first introduced Al-Mumin in 2009 which was rebranded in April 2013 to National Amanah, Kenya Commercial Bank introduced Sahl Banking, and Standard Chartered came up with Saadiq.

1.1.2 Financial Performance

Banking industry serves as the most crucial go between by conducting the key role in the economy (Alper & Anber, 2011). Banks direct funds from savers (surplus funds units) to borrowers (deficit funds units) and other diverse banking products to gratify the economic demands. Performance in terms of profitability is the major concern as it maintains the security and health of the banks, conserves the financial systems steadiness as well as advance the economic growth in the country. Thus, it is critical to examine the banks performance determinants for maintaining the stability of the economy and for the interest of bank management, stakeholders, government and other policy makers (Jamal, Karim & Hamidi, 2012).

Organizational performance encompasses three specific areas of a firm's outcome, first financial performance which is determined by profits, return on assets and return on investment. Second is product market which includes sales and market share and third is share holders which are measured by total shareholders return and economic value added, Richard et al (2009) . Studies have shown a number of determinants of banks financial performance for instance, Heffernan & Fu, (2010) found that some macroeconomic variables and financial ratios significantly influenced performance. The study also found that the type of bank was an influential determinant of bank financial performance.

Claire, (2004) found that the most important macroeconomic indicators were changes in interest rates, exchange rates, unemployment and aggregate demand. A study in china by Wong, Fong, Wong & Choi (2007) found that cost efficiency of a bank was a major determinant of banks profitability. No evidence was found for the effect of market structure (Market concentration and market share). Most of these banks were large and therefore efficient hence the conclusion that efficiency was indeed a major determinant of bank performance. Aburine carried out a study that exposed that range of credit, level of ownership concentration and capital size was significant in determining banks success in Nigeria, Aburine (2008). In the same study postulated that size of deposit liabilities, labor productivity, state of IT ownership, control – ownership disparity or structural affiliation were significant and the relationship between banks risk and profitability was not conclusive.

1.1.3 Islamic Banking & Financial Performance

The findings of Nami (2012) showed that Shariah compliant banks have a lower risk and high profit than conventional banks in Malaysia. They statistically guarantee that Shariah compliant banking system is more secure and sound than conventional

banking system in Malaysia. They also assert that the risk management and discretion are well established in Islamic finance because of its focus on the need for transactions to be maintained by important economic activity. They however point the effectiveness of Islamic finance to Sharia (Islamic law) code, which require financial transactions to be accompanied by a fundamental productive activity.

Rashwan (2010) similarly carried out a study to test the financial performance of both Shariah compliant and conventional banks before and after 2008 financial catastrophe. They discovered that there is momentous difference between IBs and CBs in 2007 and 2009, while there are no major differences in 2008. Their study pointed out that the crisis hit both banking sectors a like, but the Islamic banks out perform their counter parts in 2007, while the traditional banks perform better in 2009 when the crisis effects starts to reach the real economy which in turn is the only way of investment for Islamic banks. Hassan and Dridi (2010) likened how Shariah compliant banks performed and conventional banks during the latest financial disaster, finds that Shariah compliant banks, on average are stronger resilience during global financial crunch. Samad (2004) went further to examine the performance of Shariah compliant banks and conventional banks in Bahrain, specifically after the first Gulf conflict and he came to a close that there is no major difference in performance between Shariah compliant and Conventional bank with respect to profitability and liquidity. But, found that there existed a significant difference in credit performance which Shariah compliant banks are exposed to less risk compared to traditional banks.

Samad and Hassan applied financial ratios analysis to test the financial performance between a Malaysian Islamic bank and a group of eight conventional banks in Malaysia. Samad and Hassan (1999). From the analysis they finished off that Shariah compliant banks have more money and less risky han the selected group of

conventional banks. Abu Bakr (2003) carried out tests to determine the performance of Shariah compliant bank and traditional banks in Malaysia. While they documented that return on assets (ROA) is higher in Shariah compliant banks but does not entail higher efficiency. They confirm that Islamic banks that thrive on interest like products (credit finance) are less likely to outshine traditional banks on efficiency terms. In the perspective of talking about the related reviews, Lee and Ullah (2007) is one of these reviews which call for cooperation between Islamic banking and traditional banking.

1.1.4 Commercial Banks in Kenya

According to Cytonn investment (2015) Kenya has a total of 42 commercial banks, 10 micro finance banks and 1 mortgage financial institution. All banks are regulated by the Central Bank of Kenya. The Capital Markets Authority has an additional oversight over the listed banks. All banks are required to adhere to certain prudential regulations such as minimum liquidity ratios and cash reserve ratios with the central bank. Kenya has a high relative ratio of banks to the total population, with the 42 commercial banks serving 44 million people.

Commercial banks in Kenya play a major role. They contribute to economic growth of the country by making funds available for investors to borrow as well as financial deepening in the country. Commercial banks therefore have a key role in the financial sector and the whole economy. The share of non regulated financial institutions reduced from 39% to 25% in 2013, indicating a rise in financial knowledge among the general population and also a reduction of fraudulent institutions. Credit Information Sharing System. (CIS), agency banking, revised prudential guidelines and mobile banking are some of the new developments in banking that have spurred increased efficiency thus improved financial performance (Cytonn Investments,. 2015).

1.2 Research Problem

Ndungu (2010) reveal that Kenya was the first country in East and Central Africa region to introduce Islamic banking in the year 2007. In this short period, two banks were licensed to exclusively offer Shariah compliant products with many other conventional banks establishing a window specifically for Shariah compliant products. The concept of shariah compliant banking has emerged as an alternative vehicle for mobilizing and supply of finance. Within a short period of existence, shariah compliant banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. Currently there are two Islamic banks operating in Kenya; Gulf African and First Community bank, which have a loan portfolio of 4.9 billion shillings, deposits totaling 7.5 billion and 27,270 deposit accounts. These indicators point to the tremendous potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of the Kenya's population of 36 million (Muriri, 2009)

Kenya Commercial Bank Group Chief Executive Officer, Mr Joshua Oigara while launching the Kenya Commercial Bank Islamic banking unit on 9th April 2015, appreciated the truth that shariah compliant type of banking which aims to reach people who profess Muslim faith and those who are not Muslims has continued to increase in attraction. Latest data indicate that worldwide Shariah compliant financial assets have increased significantly over the past three decades, reaching US\$ 1 trillion in 2010 up from US\$ billion in the late 1980's. It is expected that Islamic banking assets will grow at 19.7% over 2013 to 2018 to reach US\$ 1.6 trillion by 2018. Thus shariah compliant remains one of the fastest growing segments in the global financial

services sector. Presently 2% of the Kenya banking sector is made up of shariah compliant products.

There is a gap in Islamic banking related literature with regard to the financial performance studies. Fewer financial performance studies have been conducted on Islamic banks compared with conventional banks in Kenya. Ahmednoor (2012) did an evaluation of Islamic banking products while Josephat (2012) investigated on Shariah compliant products in Kenya's financial institutions. Salah, (2009) in his study to investigate the main factors that led to the emergency of Islamic banking in Kenya appreciated market demand coupled with worldwide trends towards Islamic banking, amendments to the banking act and shareholder expectation of returns as the main factors that led to the emergency of Islamic banking in Kenya. The findings obtained from financial performance studies conducted on conventional banks cannot be applied to Islamic banks due to the operational differences between Islamic and conventional banks. The theoretical implications of the study will fill the above mentioned gap in Islamic banking related literature by analyzing the consequence of internal factors on the financial performance of Islamic banks in Kenya.

The adoption of shariah compliant products by Kenya's commercial banks perhaps has been one of the most critical changes in the financial sector a couple of months ago. The academic discourse in the literature regarding the adoption of Islamic banking notwithstanding the past efforts does not fill all the theoretical, methodology and practical gaps. Thus the study is justified by the lack of academic investigation regarding Islamic banking, especially in the local setting. The study is also geared to enrich the literature in Islamic banking in Kenya. The study will address the pertinent

question of what impact has adoption of Islamic banking had on financial performance of commercial banks in Kenya?

1.3 Research Objectives

The overall objective of the study is to establish the effect of adoption of Islamic banking on financial performance of commercial banks.

1.4 Value of the Study

The study will provide invaluable proposition for the theory, practice and policy implementation. The study endeavors to add on to the knowledge and theory in the understanding the impact of adoption of Islamic banking of financial performance of commercial banks.

Secondly, the research will provide invaluable policy proposition in the banking sector to come up with policies and strategies that will enable conventional banks survive the competition.

The study will likewise deliver a stage for additional inquiry in the field of understanding the impact of adoption of Islamic type of finance on commercial banks performance in Kenya.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

Reviews of both theoretical literature and empirical literature related to the study are done in this chapter and go further to develop the study's theoretical framework. Specifically the literature review has centered on theories on Islamic banking and determinant of financial performance.

2.2 Theoretical Literature

This section reviews the theoretical literature related to the study and develops the study's theoretical framework.

2.2.1 Theories Underpinning Islamic Banking

What can be described as the 'theory' of Islamic banking was, till the end of the nineteen – seventies, largely a prayer for substituting interest in bank loans by profit distribution. Conventional banking uses interest rate system to execute its tasks of financial intermediation. Muslim academicians have developed a fundamentally different form of banking which does not rely on interest. It instead uses profit/loss sharing for reason of financial intermediation and has argued that doing a way with interest would advance investment leading to increased production (Mannan, 1970). The two forms of profit/loss distribution principally in use are known as mudarabah and musharakah. In mudarabah one individual provides the capital while the business is managed by the other party. Profit is distributed in pre-agreed ratios and loss, if any, unless caused intentionally or breach of the terms of agreement is borne by the supplier of capital. In musharakah associates bring together their capital to carry out business. All suppliers of capital are permitted to take part in management but it is not necessarily a requirement that they to do so. Profit is disseminated among the partners in ratios agreed in advance while loss is borne by each member strictly in proportion

to the individual capital contribution. Academic work by Muslim intellectuals has sought to reveal that it is feasible to run an economy with no interest even in the recent times. Substitution of interest based banking has received the greatest endeavor (Bessis, 1998)

Gerrad and Cunningham (1997) postulate that the theoretical foundation of Islamic banking rests on equity, justice and making permissible economic gains through risk taking, trade and asset usage. In its chaste form Islamic banking differentiates itself from conventional banking by using profit loss allotment schemes as a means of giving out capital.

2.3 Determinants of Financial Performance

Ongore and Kusa (2013), divulge that determinants of bank performance can be categorized into bank specific (Internal) and macroeconomic (external) factors. There is a common concurrence that bank performance is a function of internal and external factors, (Haron, 1996; Bashir, 2003; Ben Nacaur,2003; Pasiouras & Kosmidou,2007; Anthanasoglou, et al 2008; Sufian & Habibullah, 2009; Wasiuzzaman & Tarmizi, 2010 ; Dietrich & Wanzenried, 2011; Ramadan et al ; 2011, Yap et al, 2012; Rao & Lakew 2012, Muda et al, 2013; Ameer & Mhiri, 2013; Dietrich & Wanzenried, 2014). Internal factors generally refer to the individual bank uniqueness which influences how the bank performs. These factors are mostly managed by the bank management and vary from bank to bank. On the hand, external factors are industry wide or country wide factors that are outside the power of the bank management. There are a number of variables that have been used as internal factors namely; capital, asset quality, expenses, bank size, management quality, liquidity management, loan portfolio and income diversification. External factors have identified as market concentration, inflation, tax rate, GDP and interest rate.

Since the products and services are of intangible nature, it is hard to measure the efficiency and competitiveness of financial institutions. Researchers have attempted to measure the productivity and efficiency of the banking industry using various methods. Banks performance provides a signal to depositors and investors whether to invest or withdraw funds from the banks. Supervisory body need to know also the banks performance for regulation purposes on the other hand, the banks managers needs to know the how well the bank has worked towards attaining its objective or goals by looking at the banks performance. However how can we measure banks performance, (Mang'eni, 2009).

Many ways have been advanced to measure banks performance for instance using financial ratios and advanced statistical method such as Stochastic Frontier Approach (SFA) and Data Envelopment Analysis (DEA). Existing literature in this area can be classified into two areas of study that have been used in Malaysia. Financial performance is a management initiative to upgrade the accuracy and timeliness of the financial institution to meet the set standards while supporting day to day operation (Bessis, 1998). Financial performance key measures are determined by three critical issues namely; business size, profitability and expansion of the business over time. Consequently, financial performance measures that assess profitability, size and growth rate critical to monitor overall financial performance and progress, (Ronald, 2011)

James (2005) defines liquidity ratio “as a measure of a firm’s ability to pay back short term obligations. Much insight can be obtained into the present cash solvency of the firm and the firm’s ability to remain solvent in harsh economic conditions. Liquidity ratio can be measure by current ratio and quick ratio. Steve et al. (2006) defined current ratio ‘as a measure of an entity’s liquidity. Current ratio equal current

assets divide by current liabilities. A higher the current ratio means the firm is in a better position to settle its obligations. Liquidity measures the ability of managers to fulfill their immediate commitments to policy holders and other creditors without having to increase profit on underwriting and investment activities and liquidate financial assets. (Adams and Buckle, 2003)

Jose (2010) defined total asset turnover (asset utilization ratio) as the ratio that measures the efficiency of a firm to get incomes or revenues by using its assets. This ratio also indicates pricing strategy of the business. Business with low profit margins tends to have a high asset turnover and those with high margins tend to have a low turnover.

Leverage ratios are intended to address the firm's long term ability to meet its obligations when a firm has debt; it has the obligation to repay the interest. Holding debt will increase the firm's riskiness. The level of firms leverage shows the ability of listed firms to manage their economic exposure to unexpected losses. (Adams and Buckle, 2003). The evaluation of earnings performance depends upon key profitability measures such as (Return on equity and return on assets) to industry bench mark and peer group norms (Federal Bank, 2002). Profitability as a measure of performance is widely accepted by banks, financial institutions management, company owners and other stakeholders as they are interested in knowing whether or not the firm earns more than it pays by way on interest. (Sadakkadulla & Subbaiah, 2002)

Analyst apply metrics like cash exchange cycle, the return on asset ratio and fixed asset turnover ratio to compare and assess a company annual asset performance, an enhancement in asset performance denotes that the company can either earn a high

return using the equal amount of asset or is sufficiently competent to generate same amount of return using less assets. (Adams and Buckle, 2003)

2.4 Empirical Literature

This section reviews the empirical literature related to Islamic banking and financial performance. An assessment by Samad and Hassan (1999) on the individual and interbank performance of Shariah compliant banks Islam Malaysia Berhad (BIMB) for the period between 1984 and 1997 in interbank comparison found that BIMB is relatively more liquid and less risky compared to a group of 8 conventional banks. They acknowledged the other reason for liquidity risk can be the lack of confidence on the banking system, reliance on few large depositors, reliance on current accounts and restrictions of Islamic banks on sales of debt.

A study by Vijaykumar and Badr – El – Din, Ibrahim (2003) divulged that the success of Islamic banks is stumpy owing to short term investment and low equity base. The performance of Islamic banks has been appraised using both trend and ratio analysis. Hence Islamic banks as a group performed better than the former in approximately all areas and in almost all years. The conventional banks profitability theories that also do survive in Islamic banking, established that determinants such as capital ratio, liquidity, interest rate and money supply have similar effects on Islamic banks. Capital ratio, interest rate and inflation are positively associated with the profitability of Islamic banks. On the overall Islamic banking as an up and coming concept has a positive impact on the profitability of present day banks.

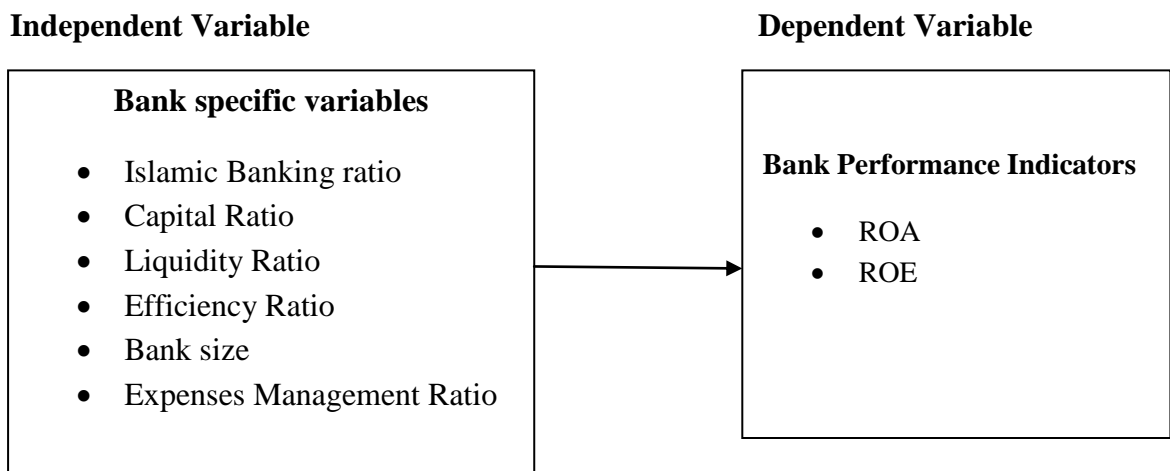
. Ahmednoor (2012) did an assessment of Shariah compliant products and how Kenya's commercial banks performed financially. The outcomes indicated a strong positive connection between product dimension and a mount and financial

performance of Islamic banks in Kenya. As a result any change in the dimension of shariah compliant product will have a consequence on the earnings of the bank.

2.5 Conceptual Framework

The conceptual framework of this study is to examine the adoption of Islamic banking on financial performance of commercial banks in Kenya. The focus will be on six determinants of financial performance. According to Ongore and Kusa (2013), determinants of bank performance can be classified into bank specific (Internal) and macroeconomic (external) factors. In fact, there is a common agreement that bank performance is a function of internal and external factors. The internal factors to be considered in this study are: Islamic banking ratio, Capital ratio, Liquidity ratio, Efficiency ratio, Bank size and Expense management ratio.

Figure 2.1 Conceptual Framework



Adapted from: Ongore, V.O & Kusa, G.B (2013)

Determinants of Financial Performance of Commercial Banks in Kenya.

CHAPTER THREE: METHODOLOGY

3.1 Introduction

Methodology refers to application of the principles of data collection method and procedure in any field of knowledge. It is the system of methods or procedure used in sampling and collecting data required for a particular research. This chapter describes the research methodology adopted for the study; it provides details on the research design of the research, target populace, size of the sample, procedure for collecting data and the technique applied in analyzing data

3.2 Research Design

According to Trochim (2005), research design provides the glue that holds the research project together. A design is used to structure the research, to show all the major parts of the research project work together to try to address the central research question. The research design to be employed in this research project will be descriptive in nature inform of a survey. Descriptive research entails congregating data that illustrate events then organizes, tabulates, depicts and describes the data collection. (Glass and Hopkins, 1984). It often uses visual aids such as graphs and charts to aid the reader in understanding the data distribution. Because the human mind cannot extract the full import of a large mass of raw data, descriptive statistics are very important in reducing the data to manageable form. The design is appropriate since it will aid to express the state of affairs as they exist without manipulation of variable which is the aim of the study, (Kothari, 2004). For this study, the design will involve determining adoption of Islamic banking (Independent variable) on fiscal outcome of Kenya's conventional banks (dependent variable)

3.3 Population

According to Mugenda (2008) the target population comprises of all individuals, objects or things that the researcher can reasonably generalize his or her findings to. The target population for this study was all the 9 commercial banks in Kenya. The choice of these banks was informed by the fact that they are either fully fledged Islamic banks or operate Islamic windows within them.

3.4 Sampling

The sample size comprised of all the 9 banks that patronized Islamic banking in Kenya.

3.5 Data Collection

Secondary data was used to collect data and was gotten from the published annual reports for the years 2011 to 2015 from the sampled commercial banks.

3.6 Data Analysis

The assembled data was modified, coded and categorized into different elements to facilitate a good and well organized investigation. Islamic banking by commercial banks will be analyzed using capital ratio, liquidity ratio, efficiency ratio, capital adequacy ratio, and bank size using descriptive statistics. Financial performance will be measured using return on assets. A statistical method of Regression analysis will be employed in this study project.

The conceptual model will be : $Y = f (X_1, X_2, X_3, X_4, X_5, X_6)$

Where Y = Financial Performance, X_1 = Islamic Banking Ratio, X_2 = Capital Ratio, X_3 = Liquidity Ratio, X_4 = Efficiency Ratio, X_5 = Expenses Management Ratio while X_6 = Bank size.

FP = Return on assets (ROA) =(Net Income / Total Assets)

$X_1 = \text{Islamic Banking Ratio} = (\text{Income from Islamic Banking} / \text{Total Income})$

$X_2 = \text{Capital Ratio} = (\text{Total Equity} / \text{Total Assets})$

$X_3 = \text{Liquidity Ratio} = (\text{Total Loans} / \text{Total Deposit})$

$X_4 = \text{Efficiency Ratio} = (\text{Total Operating Expense} / \text{Total Income})$

$X_5 = \text{Expenses Management Ratio} = (\text{Operating Expenses} / \text{Total Assets})$

$X_6 = \text{Bank Size} = (\text{Value of total banking assets})$

This will be analyzed as

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

Where Y = Financial Performance

$X_1 = \text{Islamic Banking Ratio}$

$X_2 = \text{Capital Ratio}$

$X_3 = \text{Liquidity Ratio}$

$X_4 = \text{Efficiency Ratio}$

$X_5 = \text{Expenses Management Ratio.}$

$X_6 = \text{Bank Size}$

$\epsilon = \text{Error Term}$

$\beta = \text{Coefficient of Independent variable.}$

$\alpha = \text{Constant}$

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

Findings of the study and interpretation of data collected are discussed in this chapter. The chapter is guided by the research objective of the study which is to establish the effect of adoption of Islamic banking on the performance of commercial banks in Kenya financially. Data was collected from seven proto type commercial banks and 2 fully shariah compliant banks for a period of five years from 2011 to 2015. The data sources were published annual reports from 9 commercial banks. Data was collected based on the variables; Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expense management ratio and bank size.

4.2 Descriptive Statistics

Table 4.1 elucidates the statistical analysis of the variables under of the study (return on assets, Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, and expense management ratio and bank size) of the 9 banks that were considered for this study and summarizes them in terms of Median, mean and standard deviation.

Table 4.1 Summary of Study Variables

	Return on Assets (ROA)	Islamic Banking Ratio	Capital Ratio	Liquidity Ratio	Efficiency Ratio	Expense Management Ratio	Bank size Ksh – million
Median	2.32	22.90	17.30	67.70	54.90	5.40	111,523
Mean	2.24	16.22	17.32	67.85	49.68	5.22	98,562.2

Highest (2015)	2.48	23.34	21.13	84.98	57.92	6.13	147,407
Lowest (2011)	1.78	0.23	12.544	49.69	34.76	3.97	8,571
Std Dev	0.26	12.78	3.68	15.37	10.25	0.845	47,812

4.2.1 Return on Assets

Return on Assets is considered to be an indicator of how effectively a company is using its assets to generate earnings before contractual obligations must be paid. The higher the Return on Assets the better the company is in performance because it is earning more money on its assets.

Table 4.1 depicts that Return on Assets had lowest mean value of 1.78 in 2011 while highest mean was 2.48 in 2013. This shows a rise in performance of the 9 commercial banks over the years. This indicates the contribution of Islamic banking window to commercial banks.

4.2.2 Islamic Banking Ratio

From table 4.1 Islamic banking ratio had lowest mean 0.23 in 2011 and highest mean of 23.34 in 2015. This shows a steady rise in Islamic banking ratio from 2011 to 2015. This indicates that espousal of Islamic banking has a progressive effect on how commercial banks under study performed in Kenya.

4.2.3 Capital Ratio

Capital ratio gauges the amount of wealth a bank retains in contrast to its risk. A bank that repetitively takes additional risks than it can realistically sustain leaves probable

shareholders with sagacity that their equity investment are more at risk. A bank must uphold a professional level of risk administration and sound lending practice to draw the resources that operate as its first line of protection against loss, both anticipated and unpredicted.

Capital Ratio had a stumpy mean of 12.54 in 2011 and a superior mean of 21.13 in 2014. This denotes a rise in Capital ratio of the 9 commercial banks from 2011 to 2015. This has a favorable consequence on how commercial banks under study performed.

4.2.4 Liquidity Ratio

The fundamental purpose of the liquidity ratio is to determine a company's capacity to clear up all current debts with present available assets. The strength and financial fitness or lack thereof a company and its effectiveness in paying off debts is pointed out by liquidity ratio and is of immense significance to market analyst, creditors and possible investors. The lower the liquidity ratio the better is the chances the bank may soon be experiencing financial difficulties.

The study exposed that the conventional banks under study had lowest mean of liquidity ratio of 49.69 in 2011 and highest mean of 84.98 in 2015. This demonstrates an increase in liquidity ratio from 2011 to 2015.

4.2.5 Efficiency Ratio

This ratio permits analysts to evaluate the performance of conventional and investment banks. For a bank, an efficiency ratio is a simple way to gauge the capacity to turn assets in to revenues.

Table 4.1 demonstrates a raise in the drift of efficiency ratio of conventional banks from 2011 to 2015. The banks had smallest efficiency ratio of 34.76 in 2011 and biggest efficiency ratio of 57.92 in 2015.

4.2.6 Expense Management Ratio

The findings indicate a steady increase in expense management ratio demonstrating a negative effect on how commercial banks performed in Kenya .A lowest mean of 3.97 was registered in 2011 whereas 2015 recorded a highest mean was 6.13.

4.2.7 Bank Size

Larger banks can mean greater efficiency, profitability and diversification. The findings in table 4.1 reveal the lowest value of bank size was a mean of ksh 8,571million in 2011 whereas the maximum value of bank size was a mean of ksh 147,407 million in the year 2015. Hence the bank size positively affects the fiscal performance of the various commercial banks in Kenya.

4.3 Correlation Analysis

Table 4.2 Correlation Table

	Islamic Banking	Capital ratio	Liquidity Ratio	Efficiency Ratio	Expense Management ratio	Bank size
Financial Performance	0.833	0.236	0.061	0.0954	0.706	0.831

From table 4.2 there is a positive and high correlation 0.833 between Islamic banking and financial performance. A correlation of 0.236 between capital ratio and financial

performance, 0.061 degree of correlation between liquidity and financial performance, 0.0954 degree of correlation between efficiency and financial performance ,0.706 between expense management and financial performance and 0.831 degree of correlation between Bank size and financial performance. Hence the results depict a progressive association between financial performance and Islamic banking, capital ratio, efficiency ratio, expense management ratio, liquidity ratio and bank size.

4.4 Regression Analysis

Multiple regression analysis was used to define the consequence of adoption of Islamic banking on fiscal outcome of Kenya's conventional banks. The model was as follows: $Y = f(X_1, X_2, X_3, X_4, X_5, X_6)$

Where $Y =$ Financial Performance, $X_1 =$ Islamic Banking Ratio, $X_2 =$ Capital Ratio, $X_3 =$ Liquidity Ratio, $X_4 =$ Efficiency Ratio, $X_5 =$ Expenses Management Ratio while $X_6 =$ Bank size.

$FP =$ Return on assets (ROA) $=$ (Net Income / Total Assets)

$X_1 =$ Islamic Banking Ratio $=$ (Income from Islamic Banking/ Total Income)

$X_2 =$ Capital Ratio $=$ (Total Equity / Total Assets)

$X_3 =$ Liquidity Ratio $=$ (Total Loans / Total Deposit)

$X_4 =$ Efficiency Ratio $=$ (Total Operating Expense / Total Income)

$X_5 =$ Expenses Management Ratio $=$ (Operating Expenses / Total Assets)

$X_6 =$ Bank Size $=$ (Value of total banking assets)

This will be analyzed as

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

Where Y = Financial Performance

X_1 = Islamic Banking Ratio

X_2 = Capital Ratio

X_3 = Liquidity Ratio

X_4 = Efficiency Ratio

X_5 = Expenses Management Ratio.

X_6 = Bank Size ϵ = Error Term

β = Coefficient of Independent variable.

α = Constant.

Table 4.3 Model Summary

Model	R	R Square	Adjusted R Square	Std Error of the estimate
1	.886 ²	.7850	.746	00122

(a) Predictors (constant), Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expense management ratio & bank size.

(b) Dependent variable: Financial performance.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the changes in the independent variable.

From table 4.3, the six predictors that were studied explicate 78.50% of variance in performance of the 9 banks. This implies that other dynamics not carried out in this

project add to 21.50% discrepancy in the reliant variable. Consequently further research need to be undertaken to scrutinize the other factors that impinge on the fiscal outcome of Kenya’s conventional banks.

Table 4.4 ANOVA

Model		Sum of squares	Df	Mean square	F	Sig
1	Regression	1.343	2	0.204	7.46	0.004 ^a
	Residual	6.508	3	0.264		
	Total	7.889	9			

Analysis of variance (ANOVA) is a test that provides a global assessment of a statistical difference in more than two independent means and consist computations that give information about level of inconsistency within a model of regression and form a foundation for test of significance. The F column provide a statistics for testing the hypothesis that all $\beta \neq 0$ against the null hypothesis that $\beta = 0$ (Weisberg 2005). From the findings the significance value is 0.006 which is less than 0.05 thus the model is statistically significant in predicting how Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expense management ratio and bank size influence the fiscal performance Kenya’s conventional banks. The results demonstrated the importance of the model as reflected by an F value of 7.46 which is higher than 3.43 at 5% level of significance.

Table 4.5 Multiple Regression Analysis

Model	Un standardized		Standardized	T	Sig
	Coefficients		coefficients		
	B	Std Error	Beta	B	
Constant	3.774	0.846		3.41	0.000
Islamic Banking Ratio	0.814	0.586	0.326	2.32	0.0025
Capital Ratio	0.618	0.384	0.218	1.84	0.0006
Liquidity Ratio	0.722	0.864	0.179	7.84	0.0022
Efficiency Ratio	0.643	0.680	0.147	5.56	0.0024
Expense Management Ratio	0.560	0.640	0.172	1.38	0.0031
Bank Size	0.532	0.732	0.154	1.47	0.0018

From the regression equation:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

and substituting the above

$$Y = 3.774 + 0.814X_1 + 0.618X_2 + 0.732X_3 + 0.643X_4 + 0.560X_5 + 0.532X_6 + \epsilon$$

Where Y represents financial performance and X1, X2, X3, X4, X5, X6, represents Islamic banking ratio, Capital ratio, liquidity ratio, efficiency ratio, and expense management ratio and bank size respectively. According to the equation financial performance will be at 3.774. The data also depicts that a unit increase in Islamic

banking ratio will result in to a 0.814 unit upward change in financial performance, a unit increase in capital ratio will result to 0.618 unit upward changes in financial performance. A unit increase in liquidity ratio will result to 0.722 unit upward change in financial performance, a unit increase in efficiency ratio will result to 0.643 a unit upward change in financial performance, a unit increase expense management ratio to 0.560 unit negative change in financial performance and unit upward change in bank size will lead to 0.532 a unit increase in financial performance. From the analysis Islamic banking ratio contributes the highest followed by liquidity ratio and efficiency management ratio.

At 5% level of significance and 95% level of confidence, Islamic banking ratio had a significance level 0.0025, capital ratio 0.0006, liquidity ratio 0.0022, efficiency ratio 0.0024, expense management ratio 0.0031 and bank size 0.0018

4.5 Discussion of Findings

The aim of the study was to establish the consequence of adoption of shariah compliant banking on the commercial banks performance in Kenya and was evaluated through application of audited financial records running for 5 successive years from 2011 to 2015 of the 9 commercial banks under study. The ensuing analysis was based on the following items Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, bank size and expense management ratio.

The findings showed enhanced in ROA over the time of the study which reflected improvement in financial performance of commercial banks. The mean improved in the ROA value from a mean of 1.78 in 2011 to a mean of 2.48 in 2015. This indicates a steady increase in the commercial banks financial performance over the 5 years. Hence Islamic banking enhanced the commercial banks financial performance in

Kenya. The findings match with those of Hassoune (2002) who revealed “that shariah compliant banks are certainly more profitable than the conventional peers enjoying the same balance sheet structure. The main rationale of such a difference is that Shariah compliant banks benefit from a market deficiency. Islamic banks lose on the ground of liquidity, assets and liabilities concentration and operational efficiency”. Further the findings are in concurrence with those of Josephat (2012) who investigated the effect of offering Shariah compliant products on fiscal outcome of conventional banks in Kenya and concluded that indeed offering new products such as shariah compliant products really had a positive effect on the commercial banks financial performance.

The results of the study showed a steady increase in Islamic ratio from a mean of 0.23 in 2011 to a mean of 23.23 in 2015. This implies Islamic banking had a progressive effect on the fiscal outcome of various conventional banks that operate in Kenya. Haron (2001) drew similar conclusion when they observed that Islamic banking as an emerging banking concept had a positive impact on the profitability of modern day banks”.

From the study capital ratios steadily increased from 12.54 in 2011 to 21.6 in 2014. Hence Capital ratio positively affected the fiscal outcome of the various commercial banks that operate in Kenya. These findings go hand in hand with those of Haron and Ahmad (2001) who observed that capital ratio, interest rate and inflation are positively related with the profitability of Islamic banks.

It was observed that liquidity ratio increased from a mean of 49.69 in 2011 to a mean of 84.98 in the year 2015. Consequently the liquidity of ratio had an impact on the commercial banks performance in Kenya. The findings are supported with previous

studies done by Asarpota, (2007) and Safiullah (2010) where they all concluded that Islamic banks are not suffering from surplus liquidity and are more cost effective and profitable than the conventional counter parts. The study findings revealed that expense management ratio increased from a mean of 3.97 to 6.13 in 2015. As a consequence the expense management had un favorable relationship with the fiscal outcome of various conventional banks operating in Kenya. The findings are in concurrence with Igbal (2001) who made a contrast of outcome of Shariah compliant banks with conventional banks with respect to profitability, liquidity, and Risk. He concluded that Islamic banks as a group outperformed the commercial banks in almost all areas and in almost all years.

The findings of the study shows that bank size steadily moved from ksh 8,571 million mean in 2011 to ksh 147,407 million in 2015. Hence the bank size has an effect on the performance of commercial banks under the study. The findings are in line with Ahmednoor (2012) findings that did an evaluation of Islamic banking products and financial performance of Islamic banks in Kenya and observed that there exists a strong positive relationship between product size and amount and the financial performance of Islamic banks in Kenya.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The summary of the data and findings on the consequence thereon of adoption of Shariah compliant banking on how commercial banks performed financially in Kenya is discussed in this chapter. The chapter brings out conclusion and recommendations structured into summary of findings, conclusion, recommendation and areas of further research.

5.2 Summary of Findings

The study has examined the effect of adoption of Islamic banking on the financial performance of commercial banks in Kenya for a period of 5 years from 2011 to 2015.

On ROA the banks posted a lowest mean of 1.78 in 2011 and highest mean of 2.48 in 2015, indicating a steady growth in financial performance contribution brought about by the banks embracing Islamic banking.

The results show a tremendous growth in Islamic banking ratio from the lowest mean of 0.23 in 2011 to a highest mean of 23.34 in 2015. Therefore adoption of Islamic banking positively affected how various commercial banks performed in Kenya during the 5 years that the study took in to consideration.

On capital ratio, it was noted from the research study that capital ratio of 9 conventional banks under investigation registered a lowest mean of capital ratio at 12.54 in 2011 and highest mean of 21.13 in 2014, hence a rise in capital ratio of the 9

conventional banks. This implies embracing shariah compliant banking had a progressive effect on the fiscal out of Kenya's conventional banks.

The study revealed that liquidity ratio of various commercial banks increased from 2011 to 2015. They registered a lowest mean of 46.69 and highest mean of 84.98 in 2015. This shows that embracing Islamic banking improves the stability and financial health of commercial banks.

Efficiency ratio of commercial banks grew over the 5 years of study. The banks registered a mean of 34.76 in 2011 and highest mean of 57.92 in 2015. The findings also indicated a steady increase in expense management ratio of commercial banks as a result of adopting Islamic banking.

The bank size of the commercial banks as reflected above increase in mean values from Kshs 8,571 million in 2011 to Kshs 147,407 million in 2015. Therefore the bank size had a positive effect how commercial banks performed financially.

The findings indicate that there is a progressive and significant relationship between Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expense management ratio and bank size and financial performance of commercial banks that embraced shariah compliant banking in Kenya.

5.3 Conclusion

Basing on the results of this study it can be concluded that embracing Shariah compliant banking by conventional banks had a positive impact on how conventional banks in Kenya performed financially. This is because a unit increase in Islamic banking ratio led to 0.814 unit positive changes in fiscal outcome and the results also showed a tremendous growth in Islamic banking ratio from a lowest mean of 0.23 in 2011 to a highest mean of 23.34 in 2015.

On capital ratio, the study revealed a stable growth of capital ratio as a unit increase in capital ratio resulted into 0.618 increase in financial performance of Kenya's commercial banks. Further capital ratio had a stumpy mean of 12.54 in 2011 and a superior mean of 21.13 in 2014. This has a favorable consequence on how commercial banks performed financially.

The study also concludes that embracing shariah compliant banking improves the stability and financial health of commercial banks where a unit increase in liquidity ratio led to 0.722 unit increase in fiscal performance of commercial banks. Similarly the study revealed that liquidity ratio of various commercial banks increased from 2011 to 2015 as it reported a lowest mean of 46.69 and highest mean of 84.98 respectively.

The study further concludes that embracing Shariah compliant banks impacted positively on the performance of commercial banks as it revealed that a unit upward change in efficiency ratio led to 0.643 unit increase in fiscal outcome of conventional banks. The study also showed an increase of registered mean from 34.76 in 2011 to 57.92 in 2015.

The study similarly concludes that acceptance of Shariah compliant banking by convention banks had a negative effect on their performance as exemplified by a unit increase in expense management ratio led to an increase in 0.560 change in fiscal outcome of conventional banks. It further revealed that lowest mean was 3.97 in 2011 and improved to a mean of 6.13 in 2015.

Finally the study concludes that bank size has a significant effect on fiscal outcome of conventional banks. A unit change in bank size led to 0.532 positive changes in fiscal outcome. It further registered a lowest mean of Ksh 8,571 million in 2011 and highest

mean in 2015. Hence it is crucial that management endeavor to enlarge target market for growth of commercial banks.

5.4 Recommendations

Given the research study has established that Islamic banking ratio positively affected the financial performance of commercial banks in Kenya. Therefore the study recommends that commercial banks should embrace Islamic banking and aggressively markets the Islamic products in order to increase the Islamic banking clientele so as to improve the banks financial performance.

Given the study has established that capital ratio positively affected the financial performance of commercial banks in Kenya. The study does recommend that the management of commercial banks should strive to achieve an optimal capital structure for their banks in order to reap from the benefits of optimal capital ratio.

Given the study has established that the liquidity ratio positively affected the financial performance of various commercial banks in Kenya. The study recommends that management of commercial banks should endeavor to achieve a stable liquidity position in order to enhance the banks fiscal performance.

Given the study has established efficiency ratio had a positive impact on the financial performance of commercial banks in Kenya. The study recommends that management should strive to operational efficiency in order to enhance the banks fiscal performance

Given the study has established that expense management ratio negatively influences the financial performance of commercial banks. The study recommends that management should take keen interest to ensure that they attain optimal expense level.

Given the study has established that bank size of the commercial banks positively affected the fiscal performance of the commercial banks. Management should strive to expand target markets for growth of the commercial banks which in turn enhance the financial performance.

5.5 Limitation of the Study

Secondary data of published financial statements formed the basis upon which the research got its information and the banks level of information disclosure differed where some of the banks did not disclose all the information on Islamic banking due to the fact that it is not a compulsory regulatory requirement to disclose all the information to the public.

The study was also limited by the inconsistency of financial information where all published sources seemed to have different figures.

5.6 Suggestion for Further Research

The focus of the study was to explore the consequence of adoption of Islamic banking on financial performance of commercial banks in Kenya. The study suggests that similar studies be undertaken especially in Eastern part of Africa for assessment purposes.

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APPENDICES

Appendix 1: Introduction Letter



UNIVERSITY OF NAIROBI SCHOOL OF BUSINESS KISUMU CAMPUS

Telephone: 732160 Ext. 208
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 19134-40123
Kisumu, Kenya
0202659307 / 0720348080

Ref: CHSS-SOB D61/77115/2012

October 7, 2016

TO WHOM IT MAY CONCERN

The bearer of this letter Wycliffe Mabonga

REGISTRATION NO: D61/77115/2012

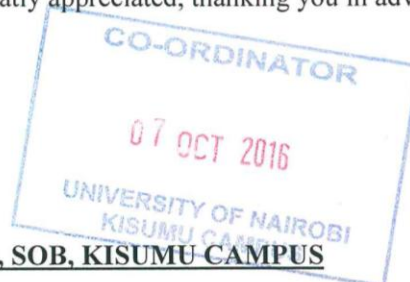
The above named student is in the Master of Business Administration Degree Program. As part of requirements for the course, he is expected to carry out a study on "**Adoption of Islamic banking on financial performance of Commercial banks in Kenya**". He has identified your organization for that purpose. This is to kindly request your assistance to enable him complete the study.

The exercise is strictly for academic purposes and a copy of the final paper will be availed to your organization on request.

Your assistance will be greatly appreciated, thanking you in advance.

Sincerely,

for: **DR. NIXON OMORO**
ASST. COORDINATOR, SOB, KISUMU CAMPUS



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Appendix 2: List of Commercial Banks In Kenya

1. ABC Bank
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank of Kenya
6. CFC Stanbic Holdings
7. Chase Bank Kenya (in receivership)
8. Citi Bank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Eco Bank Kenya
16. Equity Bank
17. Family Bank
18. Fidelity Commercial Bank Kenya Limited
19. First community Bank
20. Giro Commercial Bank
21. Guaranty Trust Bank of Kenya
22. Guardian Bank
23. Gulf African Bank
24. Habib Bank
25. Habib Bank AG Zurich
26. Housing Finance Company of Kenya
27. I&M Bank
28. Imperial Bank Kenya (in receivership)
29. Jamii Bora Bank
30. Kenya Commercial Bank
31. Middle East Bank Kenya
32. National Bank of Kenya

33. NIC Bank
34. Oriental Commercial Bank
35. Paramount Universal Bank
36. Prime Bank Kenya
37. Sidian Bank
38. Spire Bank
39. Standard Chartered Bank
40. Transnational Bank Kenya
41. United Bank for Africa
42. Victoria Commercial Bank

(Source Wikipedia 2016)

Appendix 3: List of fully Shariah Compliant Commercial Banks in Kenya

1. First Community Bank.
2. Gulf African bank

(Source Wikipedia 2016)

Appendix 4: List of Commercial Banks with Islamic windows in Kenya

1. ABC Bank Kenya
2. Barclays Bank of Kenya
3. Chase Bank (in receivership)
4. Diamond Trust Bank
5. Kenya Commercial Bank
6. Middle East Bank Kenya
7. National Bank of Kenya
8. Standard Chartered Bank

(Source Wikipedia 2016)

Appendix 5: Originality Report

project corrected

ORIGINALITY REPORT

%6
SIMILARITY INDEX

%7
INTERNET SOURCES

%1
PUBLICATIONS

%4
STUDENT PAPERS

PRIMARY SOURCES

1 Submitted to University of Northumbria at Newcastle
Student Paper **%1**

2 www.bue.edu.eg
Internet Source **%1**

3 Submitted to Kenya College of Accountancy University
Student Paper **%1**

4 ijsse.org
Internet Source **%1**

5 www.researchgate.net
Internet Source **%1**

6 www.slideshare.net
Internet Source **%1**

7 www.jkuat.ac.ke
Internet Source **<%1**

8 researchkenya.or.ke
Internet Source **<%1**

9 Submitted to University of Birmingham
Student Paper **<%1**