

**EFFECT OF INTERNAL FACTORS ON THE FINANCIAL
PERFORMANCE OF COMMERCIAL BANKS OFFERING
ISLAMIC BANKING SERVICES IN KENYA**

BY

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DECLARATION

This research project is my original work and has not been presented to any other college, institution or any university other than the University of Nairobi for academic award.

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DEDICATION

This thesis is affectionately dedicated to my mother whose interest in this, as in all my ventures, was never less than my own.

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LIST OF ABBREVIATIONS

BMI	-	Bank Muamalat Indonesia
CAR	-	Capital Adequacy Ratio
CBK	-	Central Bank of Kenya
CMA	-	Capital Markets Authority
DJIMI	-	Dow Jones Islamic Market Index
GDP	-	Gross Domestic Product
GLS	-	Generalized Least Squares
MLR	-	Multiple Linear Regression
NIM	-	Net Interest Margins
NPLs	-	Non-Performing Loans
ROA	-	Return On Asset
ROE	-	Return On Equity
SCP	-	Structure-Conduct Performance
UAE	-	United Arab Emirates
UK	-	United Kingdom

ABSTRACT

Any financial institution aims at making good returns to its shareholders. They need to maintain their financial stability and continuous growth in order to experience continuous profitability. Therefore, understanding factors influencing performance of these banks is very crucial in mitigating any eventualities of economic stability. Different researches reveal that a commercial bank's financial performance is affected by both internal and external variables. The study aimed to look at variables that influence the financial performance of commercial banks offering Islamic banking services in Kenya between the years 2013 and 2017. The ROA represented the dependent variable of the study. The CAMEL framework model proxied the independent variables under the study. The research looked at six commercial banks offering Islamic banking services. The study employed descriptive statistics like the mean, the maximum and minimum values and the standard deviation to summarize the collected data into meaningful form. The study also employed correlation to establish the strength of interdependence among the study variables. The findings were presented in tabular form. The study found out that there was a strong positive relationship that existed between earnings ability and profitability of commercial banks offering Islamic banking services with a correlation coefficient of 0.968. The study showed an R square of 0.943 meaning that the ROA (dependent variable) was determined 94.3% by the independent variables with the remaining 5.7% being determined by other factors not covered within the study. The study concludes that earnings ability had the highest influence on ROA of commercial banks offering Islamic banking services. Therefore, the study recommends that, any financial institution offering Islamic banking services or intends to offer, must adopt strategies that will significantly increase their earnings ability.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Financial intermediaries such as commercial banks, have a very crucial part in the economic growth of a country (Malakolunthu & Rengasamy, 2012). As a country's economic backbone, bank performance can generate spillover effects on different sectors (UNDP, 2009). Understanding factors influencing performance of these banks is crucial in mitigating any eventualities of economic instability. Athanasoglou, Brissimis and Delis (2008) opined that this was due the fact that a stable and successful financial sector has an enhanced capacity to overcome risks hence will positively impact the perseverance of the financial system. Morttinen, Poloni, Sanders and Vesala (2005) found out that the sturdiness of a financial system is pegged on the profitability levels of a bank and its drivers. With the exception of size, all the other internal factors affect a bank's profitability level significantly as anticipated. In their research though, Ongore and Kusa (2013), found out that the general effect of macroeconomic factors to be moot at a significance level of five percent.

The risk theory of profit by Hawley (1893) is built on the concept that only those entrepreneurs who have the risk-taking ability in the dynamic production have a sound claim on the reward. Further, it has been argued that the more risky the business, the higher the expected profit rate (Economics, 2015). The dynamic hypothesis of profit characterizes profit as the distinction between the selling price and the cost of the creation of a given item. From Clark's perspective, the only profit that accrues to a firm in the short run is only the pure profit. Over the long haul, rivalry powers different firms to copy changes made by the main firms (Pisciotta and Ghandour, 1969). Only those firms that take advantage of the changing situations are in a better position of earning real profits only if they are more efficient compared to their competitors. Walker's theory of profit posits that profit is the differential surplus which accrues to the most efficient entrepreneur over the least efficient entrepreneur (Dwivedi, 2002). From the above definitions of profit, it is clear that profit accrues to those firms that take risk, have a huge positive difference between their service price and their cost of providing service, change their tact with the changing market situations and are efficient over their rivals.

The rampant globalization of the financial sector has placed Sharia-compliant financial institutions in vicious competition with conventional financial institutions. Kenya has significantly grown to become an example of those markets that experience a growing Islamic banking sector collocated with conventional banking. The Sharia-compliant banks therefore will learn to live with the stiff competition awaiting them. Hence, it is imperative for the management to know what elements influence their institutions to be successful. This will lead to evaluation of the bank's performance. Assessment a commercial bank's performance concentrates on the bank's operational and financial shape (Kamande, 2017).

1.1.1 Bank Internal Factors

Bank internal factors are individual bank characteristics, which exert influence on the financial performance of a commercial bank (Angela & Irina, 2015). These elements are controllable by the management as they are within their reach (Kamande, 2017). These elements or factors vary from one banking institution to another one. They include risk level management, ownership, credit portfolio, and labor (Dang, 2011).

The CAMEL framework is utilized when representing bank internal factors. These factors are used to review the operating and financial performance as well as the regulatory compliance of the financial institutions. A sixth component, Sensitivity to market risk was affixed to the CAMEL framework in 1996 in order to make the rating structure more risk-oriented. Each of the element is rated on a scale of 1 to 5. The numerals 1 represent best and 5 represent worst. This study will aim at explaining bank-specific elements that influence the profitability of fully-fledged sharia-compliant banks in Kenya.

1.1.2 Financial Performance

The determination of profitability is one of the many ways of measuring a bank's performance. Profitability is the income in excess of over expenditure, income from an investment or transaction or benefit derived from a financial activity (Ongore & Kusa, 2013).

Conventional banks earn their profits from service fees and the interests levied on assets. Islamic banks also charge fees for their services and engage in trade and partnership with their clients in business ventures that earn profits and at times losses. Aburime (2009) divides the importance of profitability to a commercial bank into two levels. The micro level, which is the first level, has profit as the crucial qualification of a competitive financial institution and an inexpensive source of debt, and the second being the macro level where he outlines that profitability necessitates a sound and beneficial financial sector that will have the capacity to insulate against negative financial shocks hence contributing positively to the solidness of a monetary framework.

A bank's profitability is measured by using profitability ratios. These ratios measure the general financial performance of a company. They measure the productivity in overseeing resources, liabilities, equity and expenses (Fraser, L. & Ormiston, A. 2013). Some of the most commonly used financial ratios are the R.O.A, Net Interest Income (NIM) and the R.O.E. We express the ROA as a percentage. We can also use ROE to determine a bank's profitability. The ROE is the ratio between Net Income and the Shareholder's equity.

1.1.3 Relationship between Bank Internal factors and Financial Performance:

The study will have to look at how each or some of the components of bank internal factors relate to profitability which is a measure of financial performance individually in order to fully understand the theoretically expected relationships. These variables are within the reach of the bank thus can be controlled to their advantage. The decisions made by the management and the board do influence these factors (Kamande, 2017).

According to Athanasoglou et al. (2008), capital adequacy represents capital needed by a financial institution as buffer for risks such that the banks are susceptible to, such as credit, market and operational risks, as well as help soak up any probable losses and shield the firm's shareholders as well as uphold lending during a downturn. Financial institutions are advised to keep good levels of capital within their reach to safeguard from financial distress.

Mulualem (2015) outlines that a CAR below the accepted CAR of 10 percent under the Basel III is critical in ensuring that banks have enough liquidity to deal with insolvency as well as a cushion from insolvency and eventually losing the depositor's money. Credit is one of the most sought after source of income for financial institutions. Li and Zou (2014) outline that credit-related risks affect the profitability levels of a bank and are among the most significant risks that a financial institution can face. Credit-related risks lead to increased cost of debt collection, disruption to cash flows of a business and the loss of principal and interests. Munyambonera (2011) in his research on commercial banks' profitability in Sub-Saharan Africa found out that higher loan provisions for loan losses could predict a possibility of future loss on loans advanced to clients as well as a forecast of a punctual recognition of bad loans by cautious commercial banks. Roman and Tomuleasa (2013) opine that higher NPLs and deteriorating credit portfolio quality will negatively affect commercial bank's profitability.

Operating costs are expenses associated with the daily operations of an institution other than the cost of obtaining funds e.g. repair and maintenance and administration of the business daily. Expenses incurred on the bank's operational activities have an inverse relationship with the profit earned by the bank and they specify a fraction of the bank's earnings (Tariq et al., 2014).By harnessing the economies of scale in their transactions, big banks tend to enjoy high profits than small banks. This is influenced by their size (Sehrish, Irshad & Khalid, 2010). Cull et al. (2007) posits that the economies or diseconomies of scale are determined by the size of an institution. Empirical evidence from Pakistan, on what determines a financial institution's profitability, by Tariq et al, (2014) found out that a bank's size reduces or increases the cost of raising capital. Therefore big banks will reduce their cost of raising capital significantly as compared to smaller banks thereby increasing their profit margin.

Liquidity is a term used in reference to mean the aptness of an institution to meet its short term financial obligations easily (Ongore & Kusa, 2014). In order for banks to fulfill the demands of its stakeholders, they must maintain some liquidity in their assets.

Chinoda (2014) observes that, having sufficient liquidity to meet the demands of loan holders and depositors shows that banks are financially sound hence earn their clients' trust. Small liquidity levels serve as ground reality of failure of a bank. Liquidity problems in commercial banks lead to a myriad of problems including poor financial performance (Alamayehu & Ndung'u, 2012), high cost of borrowing and in extreme cases it leads to insolvency and bank failure (Alamayehu & Ndung'u, 2012). In determining the liquidity position of a bank and the total assets used to provide loans, a loan asset ratio is usually calculated. The Asset and Liability tool is an effective tool used by commercial banks to manage their liquidity. The tool aims at reducing a bank's assets and its liabilities in order to optimize their returns.

1.1.4 Commercial Banks in Kenya

The CBK is the regulatory authority tasked with the issuance of regulations and guidelines as outlined by the Banking Act, Cap 488. The regulatory body is tasked with establishing transparency between financial institutions and other stakeholders. Some of its main objectives include formulation of monetary policy and implementation while boosting liquidity, solvency and the proper operation of the financial system (CBK Act, 2014).

Many regulatory and financial reforms have been introduced into the Kenyan banking sector in the near past. Reforms such as the amendment of the banking Acts to accommodate Islamic banking operations has catalyzed entrance of many players into the Kenyan scene. This has ensured the majority of the once unbanked Muslim population can now access a financial service that is in consonant with their religious laws. Such amendments have inspired the entrance of foreign banks to tap into the lucrative Islamic banking sector.

The latest entrant into the banking sector, Dubai Islamic Bank Kenya Limited (DIBKE), which offers sharia-compliant financial instruments, is a subsidiary of DIB, the largest sharia-compliant financial institution in the UAE with total assets of \$56.45 billion and customer deposits totaling \$40.08 billion according to their end of year financial report.

Sharia has identified interest, uncertainty, gambling investment in non-permissible economic activities such as narcotics, pornography, pork and intoxicants as components which must be avoided in all business transactions. The rewards and risks of the economic activities have to be shared by all parties involved, and every financial transaction must be upheld by a tangible asset. According to Islamic law, money should be utilized in a productive way. In this unique circumstance, profit-making is not precluded, but conceptualized as a just reward (Dusuki & Abdullah, 2014).

Islamic banking is offered in three models namely: fully-fledged, window or as a subsidiary (Dusuki & Abdullah, 2014). The Kenyan banking sector offers Islamic banking services in two models. One is the fully-fledged model and the second is the window model. Fully-fledged Islamic banks offer sharia-compliant financial services in entirety e.g. Gulf African Bank (GAB), First Community Bank (FCB) and the latest entrant Dubai Islamic Bank Kenya Limited (DIBKE). The window models offer sharia-compliant financial services side by side with the conventional financial services. Examples of banks using the window model include Barclays Bank of Kenya (BBK), Kenya Commercial Bank (KCB), National Bank of Kenya (NBK), and Standard Chartered Bank (SCB). SBM (formerly Chase Bank), will be offering only conventional products in all their branches effective twentieth of August of 2018 (SBM Bank, 2018). DIBKE has been in operation for less than two years; hence its effect will be negligible. The research will therefore look at all the commercial banks offering Islamic banking products with the exception of DIBKE and SBM.

1.2 Research Problem

Profitability of commercial banks and their performance has become an important topic of research. Muralidhara and Lingam (2017) posit that it is difficult for the management and shareholders to find the right measure to evaluate their banks given the availability of many variables that decide the efficiency and effectiveness of these banks. An increased profitability level may mean increased financial stability (Flamini, Schumacher & McDonald, 2009).

Most commercial banks, both conventional and sharia-compliant banks, look for innovative ways to reduce their operational costs and maximize on their profitability. The Kenyan banking sector capital and reserve evidenced an increase of 7.81 percent between 2016 and 2017 heavily supported by growth in investments in government securities. However, there was a decline of 9.6 percent in profitability associated with a reduction in income levels (Bank Supervision Report, 2017). The banking sector also evidenced a decline in its performance in the year ended December 2017. Commercial banks in 2017 experienced a decline on the quality of their loans and advances. The decline in the asset quality was majorly attributed to uncertainties due to the 2017 elections in the country, poor weather conditions experienced and delayed payments from their clients. There was a decline of 9.6 percent in pre-tax profits. The banks' asset quality declined with the NPLs increasing by 23.4 percent in December 2017. The banking sector had an overall satisfactory rate in 2017 as compared to a strong rating which was achieved in 2016. The decline in the industry rating was attributed to a decline in capital adequacy and deterioration in the quality of the assets held by the banks in 2017 (Bank Supervision Report, 2017).

Several studies (Izhar & Asutay, 2007; Wasiuzzaman & Tarmizi, 2010) looked at factors that determine the degree of profitability in commercial banks offering Islamic banking services as well as factors that influence their profitability. Most of the early studies concentrated on the United States, Middle East and Malaysia. Izhar and Asutay (2007) found out that profit dominantly came from the bank's financing activities, whereas its service activities did not contribute considerably to the profitability of BMI.

Wasiuzzaman and Tarmizi (2010) in their research concluded that capital and asset quality had an inverted relationship with a bank's profitability whereas operational efficiency and liquidity portrayed a positive effect. Macroeconomic variables in their study showed that both inflation and GDP positively influenced bank profitability.

In Kenya, a study by Ongore and Kusa (2014) focused on the determinants of a commercial bank's financial performance. They found out that the position of ownership identity on a commercial banks' financial performance was not extraordinary.

Their research concentrated more on the influence of commercial bank's ownership structure. In another study by Tsuma and Gichinga (2016), they examined the factors that affect a bank's financial performance with their focus on NBK and found out that interest rate, credit risk, inflation and capital adequacy affected financial performance. Their study may not be a mirror of the whole Kenyan banking sector as they focused solely on one single commercial bank. Majority of the readily available literatures amalgamate internal, external and macroeconomic factors. Few of these researches concentrated on the internal factors.

This study intended to look at how internal factors influenced financial performance of commercial banks offering Islamic banking services in Kenya. Different studies (Guru et al., 2001; Mercia et al., 2002; Panayiotis et al., 2006; Toddard et al., 2004) have categorized determinants of a commercial bank's profitability into: internal factors, external factors and macroeconomic factors. This study concentrated solely on the internal variables that affect a bank's profitability. Hence the research question; what is the effect of bank-specific factors on the profitability of commercial banks offering Islamic banking services in Kenya?

1.3 Research Objective

To analyze bank internal factors influencing financial performance of commercial banks offering Islamic products in Kenya.

1.4 Value of the Study

Sharia-compliant commercial banks within the country are going to face fierce competition; hence different stakeholders have to recognize what factors motivate them to be profitable. Additionally, the policy-makers and other stakeholders will be able to benefit by understanding their operations, products and what factors influence their profitability.

The outcome of the research project will be necessary and helpful to the below stakeholders: The CBK as the regulator will be provided with guide on regulatory and supervisory programs that will support the growth of Islamic banks' operations.

The management will benefit more by understanding the importance and influence of internal profitability factors on the profitability of their institutions by concentrating on the recommendations that this study will provide. Future researchers will benefit from this research as their point of reference for their studies as well as for areas that need further research.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The chapter entails an evaluation of literatures interconnected to the study and will be discussed under the following themes: theoretical reviews done, determinants of financial performance of Islamic banks and empirical studies. Later sections of the chapter provides the conceptual framework upon which the study is based and the chapter ends with a summary of literature review and identifies the research gaps to be addressed by the current study.

2.2 Theoretical Review

Athanasoglou et al, 2008 identify the late 1980's period as the time when the research on commercial banks' financial performance began. All this time, there has been a long standing controversy on the actual sources of profits. Hence the development of many theories aimed at elucidating this phenomenon. This review will only examine four theories and their criticisms.

2.2.1 Islam and the Theory of Interest

Many contributions done on the subject of Islamic finance have been somewhat casual in nature. Scholars in the near past concentrated their efforts on issues relating to the Islamic economic system as a whole. Many of the early scholars did not delve deep into the issues they were presenting forth. Qureshi (1946), for example, in his book on Islam and the Theory of Interest, viewed finance as a social service just like health and education and hence should be sponsored by the government of the day. He had such a view because Islamic banks could neither give interest to their clients nor charge any interest on the loans they advance to their clients. He advocated for business partnership between commercial banks and its clients as an alternative. This is based on the Musharakah and Mudarabah financing models.

In 1968, Siddiqui attempted to provide a detailed outline of Islamic finance in Urdu. He based his Islamic finance model on two Islamic financing models; Mudarabah and Musharakah. The English version of the document was published later in 1983 (Boyante, 2014). In his presentation, he classified the operations of a commercial bank into three: fee-based services, commission-based services and services with no fees charged. He concluded that interest-free banks could be a better alternative to the interest-based banks.

2.2.2 Profit and Loss Sharing (PLS) Theory

Two of the main PLS instruments, Mudarabah and Musharakah, are treated by Sharia scholars as the focal point of Islamic banking model. In a Mudarabah contract, the bank, as the Mudarib, receives funds from its depositors, who are the capital providers, and invests these funds in profitable and halal ventures or advances these funds to its clients (entrepreneurs) on a profit-sharing basis (Dusuki & Abdullah, 2014). In a Mudarabah contract, according to Dusuki and Abdullah (2014), when the bank realizes profits, it will share with the depositors in conformity with their pre-agreed profit ratio. In case of a loss, the capital provider carries all the financial loss incurred by the business venture. The mudarib (entrepreneur) bears loss of effort put in that venture. In a Musharakah contract, the bank and its client get into a partnership form of contract. They both invest in a business venture and share the profit or loss realized at the end of the financial period per their pre-agreed profit ratio.

Normally, in a PLS arrangement, the Islamic commercial bank supplies investment capital to a business where professionals manage and run its daily operations. The bank share in the profits realized and is fully liable to any financial loss realized as long as the loss was not due to negligence on the part of the professionals running the business.

2.2.3 The Risk Theory of Profit

Hawley (1893) predicates that, risk-taking is the most important function that an entrepreneur can undertake. He proposed that the entrepreneur receives a reward in the form of profit for exposing his business to risk.

It is understood that, in actual sense, no individual will be willing to invest in risky ventures if he is going to get normal profit as their return. The returns associated with taking risk must exceed the definite value of the risk. Further, it has been argued that the more risky the business, the higher the expected profit rate. Damodaran (2018) objected to this misplaced belief that markets reward all risk taking, when the truth is that senseless risk-taking delivers more risk with no reward. The amount of profit is not in any way associated with the dimensions of the risk undertaken. If this was the case, then every individual would involve himself with huge risks in order to earn larger profits. He concludes that, markets have no reason to reward you more for taking more risk when the risk is you being stupid. Daring to take high risks in certain business may not necessarily earn high profits. This theory disregards many other factors attributable to profit and concentrates only on risks and risks alone.

2.2.4 Walker's Theory of Profit

This theory was developed by Walker (1891), an American Economist. He opined that profit is the result of exceptional abilities that an entrepreneur may have over his competitors. In his research, he made a comparative study between different grades of land and entrepreneur's different abilities. He compared the industry managed and run by the unproductive entrepreneur to an unproductive land. Just as the land which is unproductive earns no returns, similarly, the marginal entrepreneur earns no profit. He concludes that an essential nature of profit is not different from rent because rent is a differential surplus accruing to the superior land over the marginal or no-rent land; similarly, profit is a differential surplus which accrues to the most efficient entrepreneur over the least efficient entrepreneur (Dwivedi, 2002).

The important criticism to Walker's theory of profit as fronted by economists include: his view of profit as a surplus like rent is unrealistic; unlike rent that can earn positive or zero profit, entrepreneurs may have losses or profits; profits can only be realized in a dynamic state and his opinion that profit is the gift of ability. Profit does not always arise due to the superior abilities of an entrepreneur. It may be as a result of monopoly, uncertainty, risk and innovation (Economics, 2015).

2.3 Determinants of Financial Performance

Different researches (Aburime, 2005; Al-Tamimi, 2010) classify factors influencing a bank's performance into internal (bank) and external (macroeconomic) factors. This study briefly looked at both but will afterwards concentrate on the internal factors affecting profitability of commercial banks.

2.3.1 Internal Factors

These factors can be manipulated to the advantage of an organization (Ongore & Kusa, 2013). Examples include size and structure of credit portfolio, size of deposits risk level, asset quality, earnings ability, labor productivity, management efficiency, location of the banks and liquidity (Dang, 2011). The CAMEL framework is often used by industry practitioners and scholars alike to measure bank internal factors. Each of the factors is further discussed below.

Capital adequacy is defined as the amount of fund readily available to a bank as support to its financial services and acts as a cushion in cases of unfavorable situations (Athanasoglou et al., 2005). Capital creates extra liquidity for the banks given that deposits are most vulnerable and prone to bank runs. The more the capital a bank has, the lower the profitability of distress. Dang (2011) posits that the effectiveness of a bank's capital is decided on the grounds of its capital adequacy ratio.

A bank's asset impacts the profitability of a bank. A bank's assets comprise of current assets, credit portfolio, fixed assets like building, and other investments. The highest risk facing a commercial bank is delinquent customers defaulting on their loans. Loan portfolio quality has a direct effect on the profitability of a commercial bank. Thus, NPLs ratios are used to assess a bank's asset quality. Commercial banks strive to bring NPLs to low levels. This is because high NPLs influence a bank's profitability negatively. Management efficiency is one of the most complex subjects to using financial ratios (Ongore & Kusa, 2013).

The management's performance is often demonstrated in qualitative terms through subject assessment of quality of staff, organizational discipline, control systems, management systems and others. Management's ability to marshal its available resources efficiently, minimizing operating costs and income maximization, can be calculated using financial ratios. Operating profit to income ratio is one of the ratios used to evaluate management quality. Management is said to be efficient in terms of its operations and income generation when the ratio is higher. According to Athanasoglou et al. (2008), management quality influences the level of operating expenses which in turn affects profitability. Liquidity is defined as the ability of a bank to fulfill its short term obligations. It is another factor that affects the level of bank performance. An adequate level of liquidity is positively related with bank profitability (Dang 2011.)

Customer deposit to total asset and total loan to customer deposits is a commonly used financial ratio in depicting the liquidity position of a commercial bank. An additional different financial ratio used in the measure of liquidity is the cash to deposit ratio to measure the liquidity level of banks in Malaysia (Ilhomovich, 2009). However, the study conducted by Said and Tumin (2011) in China and Malaysia concluded that there was no existing relationship between the liquidity levels of commercial banks and the performances of those banks.

2.3.2 External Factors/Macroeconomic Factors

Some of the macroeconomic factors that influence the financial performance of commercial banks include GDP, Interest Rate, Political instability, Inflation among others. For example, when GDP declines, there is a fall in demand for credit from commercial banks which in turns affects the profitability of these banks negatively. On the contrary, when there is growth in the GDP of a country, the bank's profit increases given the high demand for credit at that time.

Athanasoglou et al. (2005) postulates that during the boom period the demand for credit facilities is higher than during the recession period even though in their research on Greek commercial banks, the connection between Inflation level and bank profitability remained debatable. Vong and Chang (2009) conclude that the direction of the relationship of the two variables (inflation and bank profitability) is not clear.

2.4 Empirical Studies

This section highlights both global as well as local empirical researches on the influence of internal variables on the profitability of commercial banks. Jha and Hui (2012) in their study utilized the CAMEL model in identifying the determinants Nepal's commercial banks' performance. In their study, they compared the financial performance of different of bank structures based on their financial characteristics. For a period of six years, they analyzed eighteen commercial banks. They formulated two regression models in order to evaluate the influence of CAR, interest expenses ratio, NIM ratio, NPL ratio, and credit to deposit ratio on ROA and ROE on the equity of the respective banks. They found out that commercial banks in the public sector were significantly less efficient when juxtaposed with domestic and foreign-owned commercial banks. Local banks however, were as efficient as the foreign-owned banks. The estimation results revealed that the R.O.E was notably determined by CAR, interest expenses and NIM. Capital adequacy ratio had a considerable influence on the ROE. A research by Kosmidou et al., (2008) employed the use of ROAA and NIM to measure their effects on profitability of those banks. The research covered a period of eight years with their econometric analysis involving a panel data set of 224 unbalanced observations. They found out that equity to asset ratio, which represents capital strength, significantly influences profitability of the UK commercial banks.

On their research of Greek banks that was conducted between the years 1985-2011, Athanasoglou et al. (2008) employed an empirical framework that used the SCP hypothesis to assess the impact of internal, external and macroeconomic factors on bank profitability. They used several independent variables such as business ownership, inflation, capital, expense management, credit risk and productivity.

They found out that that capital significantly influenced bank profitability. Their findings also showed that capital precipitated a bank's exposure to credit risk hence lowering its profits.

In their research on the influence of internal and a few macroeconomic factors on the profitability of banks in the Southern African banking sector, Ifeacho and Ngalawa (2014), employed the CAMEL model. In their study, they used annual data from ABSA, First National Bank, Nedbank, and Standard Bank. They used the ROA and ROE in their bid to measure the banks' performance. They discovered that capital adequacy depicted a noteworthy negative relationship with ROA, while its relationship with ROE is significant and positive as anticipated.

Bashir and Hassan (2004) carried out a research on 21 countries on the variables that determined Islamic banking profitability of 43 Islamic banks between 1994 and 2001. They used both the external bank factors and macroeconomic in their study to determine profitability in these banks. Some of the profitability indicators used in their research to identify profitability include the ROA, ROE, NIM, Before Tax Profit divided by total assets (BTP/TA). Their outcome revealed that CAR in Islamic commercial banks is better juxtaposed with CAR in conventional commercial banks. This showed that there is more capitalization in Islamic commercial banks compared to conventional commercial banks.

Locally, a study by Okoth and Gemechu (2013) on the determinants of financial performance of commercial banks in Kenya, between the periods 2001 to 2010, utilized the MLR model and GLS on panel data. They used internal, external and macroeconomic factors as their independent variables. The dependent variables that they used included the ROA, the ROE, and the NIM. They found out that internal factors significantly influenced a commercial bank's performance in the Kenyan context.

Issa (2010) took a study on the Implications of Islamic Banking Features in Kenyan Commercial Banks. The population of his study comprised of 186 respondents from all the banks which offer Islamic banking services. The study revealed that Islamic banking was recent and taking shape in the Kenyan banking industry. The main features that characterized Islamic banks and Islamic banking windows were in existence in Kenya. These banks did not associate their operations with interest earning and speculation. Transactions were conducted according to the Sharia, and there was a strict vigilance by the Sharia Supervisory Boards on the banks' operations.

Concerning factors that push conventional banks to offer Sharia-compliant products, various factors were identified. These included conventional banks facing stiff competition both from the Islamic banking system and from conventional banking, as it was discovered that conventional banks opened Islamic windows as a strategic response to changes and opportunities that were readily available in the Islamic mode of banking.

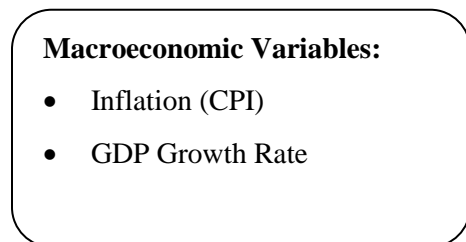
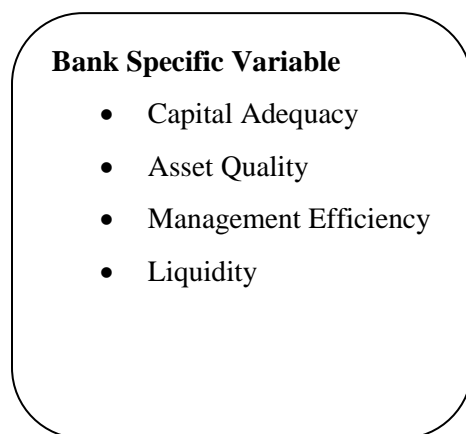
Miriti (2011) in his comparative study of Islamic and conventional banks in Kenya based on management of their operations activities. The aim of the study was to compare and contrast operational activities in both Islamic and conventional banks in Kenya and then document them. The target population of the study was fully sharia-compliant banks and other banks in a similar tier. The result of study was that both Islamic and conventional banks had operations policies in place. There was a significant difference witnessed in auditing procedure between the two modes of banking system. Majority of the respondents from the Islamic bank, 90.9 percent, supported the opinion that their banks carried out regular audits to ensure sharia compliance in their daily operations and processes while none of the conventional banks carried out such activities. Mkumba (2011) in her study on the Strategies adopted by Islamic banks to attract Non-Muslim clients, found out that Islamic banks used a combination of a few strategies to attract them including lost strategy, differentiation, distribution, pricing and delivery strategies. The banks did not use focus strategy because they did not want to concentrate on any particular market niche.

The banks achieved the strategy through formulating policies and procedures on low-cost, continuous innovation of new client-friendly products, and arrangement of group-based microfinance products to draw in low income clients. In his study consisting of 33 clients with accounts domiciled in Islamic banks as well as 11 managers from the respective banks, Kadubo (2010) researched on the factors that influence the development of Islamic banking in Kenya. He used both census as well as probability sampling in his study. He found out that, the main catalyst for Sharia-compliance in the banks studied was driven by the desire to meet their clients' demand. The main driver of Islamic banking growth in Kenya according to the study was mainly religious and client influence.

2.5 Conceptual Framework

The study had the CAMEL model as the independent variables while the ROE as the dependent variable. The study incorporated inflation, exchange rate and interest rate as control variables.

Independent Variables



Dependent Variable

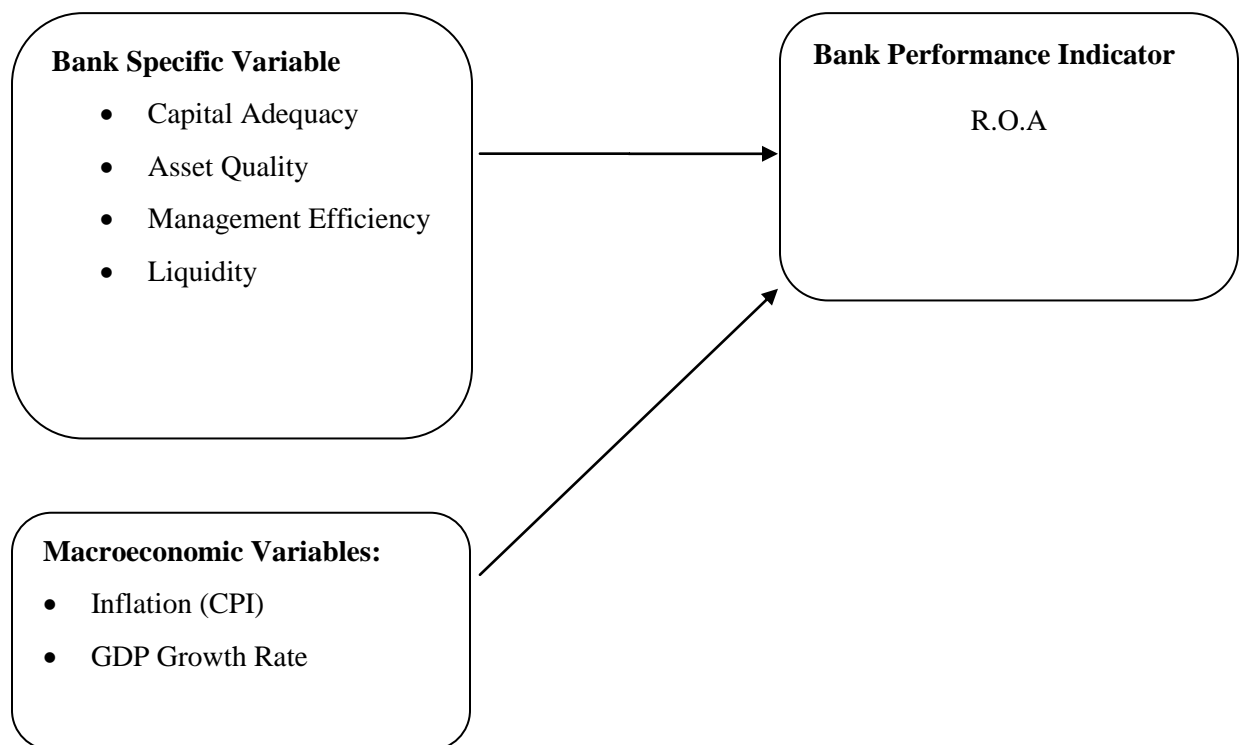
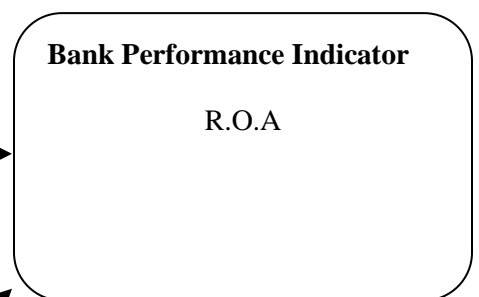


Figure 2.1: Conceptual Framework

Source: Author (2018)

2.6 Summary of Literature Review

The theoretical literature discussed unveils the presence of multiple knowledge gaps with respect to the internal factors influencing profitability of Kenyan banks. Most of the other studies were on Islamic banks and conventional commercial banks in the United States, Europe and the Middle East.

The studies identified various factors that significantly influenced banks' profitability. Many of the studies however, heavily concentrated on conventional banks. Little research is available on the internal determinants of profitability of commercial banks offering Islamic products locally. This study hopes to bridge this knowledge gap.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

The chapter concentrates on the research design, population, sample design, data collection method, diagnostic tests and data analysis techniques used in this study.

3.2 Research Design

This research adopted descriptive research design to investigate the bank internal factors influence on the financial performance of commercial banks offering Islamic banking services in Kenya. Grooves (2004) posit that descriptive techniques give accurate data of persons, events or situations. Using a descriptive research design enables the researcher to expand their focus on the ‘what’ questions that describe a single variable to ‘who’, ‘when’ and ‘where’ questions that describe the variable’s relationship to other variables. Descriptive methods determine the relationships between two or more variables but they cannot help one to infer causality, rather one can only establish the correlation between variables (Gill & Johnson, 2006).

3.3 Population

The study used secondary data to probe the effect of internal factors on the financial performance of commercial banks offering Islamic banking services in Kenya. 6 commercial banks were used for this purpose. SBM bank (formerly Chase bank) was left out given it has been under receivership for the last three years and stopped offering Islamic banking products after its takeover. DIBKE, a new entrant, is still in its nascent stage; hence it would not have affected the results significantly.

3.4 Data Collection

The study utilized secondary data drawn from the readily available financial statements of the individual Islamic banks for a five year period between 2013 and 2017. This data was used to calculate internal measures of profitability. The study used annual secondary data that covered 5 year period (2013-2017). The data collected was quantitative in nature.

The study collected the following data to measure independent variables: total shareholder's equity to total risk weighted assets for capital adequacy, NPL's to total financing for asset quality, operating expenses to operating margin for management efficiency, net profit to total assets for earnings ability, yearly gross domestic product for GDP, and finally the yearly average inflation for Inflation. For Liquidity, the figures were provided in the financial statements.

3.5 Data Analysis

The study employed descriptive statistics like the standard deviation, the mean and the maximum and minimum value to summarize the collected data into meaningful form. The study also employed correlation to establish the strength of interdependence among the study variables.

3.5.1 Analytical Model

The R.O.A was the major dependent performance indicator used. The major independent variables were proxied by CAMEL framework. The GDP growth rate and the average annual inflation rates are the two macroeconomic variables used as independent variables. The study used the regression model presented below:

$$Y = \alpha + \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 GDP + \beta_6 INF + \epsilon it$$

Where:

Y=Financial performance of Bank *i* at time *t* as expressed by ROA

B_n: regression coefficients

$$X_1: \text{Capital Adequacy} = \frac{\text{Total Shareholder's Equity}}{\text{Total risk weighted assets of bank } i \text{ at time } t}$$

$$X_2: \text{Asset quality} = \frac{\text{NPL's}}{\text{Total Financing of bank } i \text{ at time } t}$$

$$X_3: \text{Management efficiency} = \frac{\text{Operating Expenses}}{\text{Operating Margin of bank } i \text{ at time } t}$$

$$X_4: \text{Earnings ability} = \frac{\text{Net Profit}}{\text{Total assets of bank } i \text{ at time } t}$$

$$X_5: \text{Liquidity} = \frac{\text{Net liquid assets}}{\text{Total deposits of bank } i \text{ at time } t}$$

GDP_{*t*}: the total expenditures for all final goods and services produced within the country in time *t*

INF_t : Average annual inflation rate at time t

ε_{it} : Error term

$\alpha_1 - \alpha_6$: Constant term

3.5.2 Tests of Significance

The coefficient of determination denoted by R^2 was used to indicate how the collected data fits well into the statistical model above. ANOVA tests were employed in the analysis of the data to determine the result that independent variables had on dependent variables.

3.6 Diagnostic Tests

Diagnostic tests ensure that the assumptions are not violated. Various tests were used to check the inferences of the regression model that was utilized in this research. The study therefore undertook the multicollinearity test, the autocorrelation test, homoscedasticity test, the linearity test and normality test. The normality of the data was tested using skewness and kurtosis and plotting of a histogram and any variable that was not normally distributed was transformed using the natural log transformation method. In addition, the study also assessed multicollinearity, which arises due to very high inter-associations between the independent variables. Multicollinearity is said to occur when there is a nearly exact or exact linear correlation among two or more of the independent variables. This was tested by the determinant of the correlation matrices, which varies from zero to one. Orthogonal independent variable is an indication that the determinant is one while it is zero if there is absolute linear dependence between them and as it approaches to zero then the multicollinearity becomes more intense. Variance Inflation Factors (VIF) and tolerance levels were also carried out to show the degree of multicollinearity (Burns & Burns, 2008).

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND INTERPRATATION

4.1 Introduction

The chapter outlines the study findings and its objectives. The study analyzed the influence of internal factors on the financial performance of commercial banks offering Islamic banking services in Kenya. This chapter therefore presents in details the analysis undertaken and the outcome which include; the response rate, data validity, descriptive statistics, correlation analysis, regression analysis and interpretation of the findings.

4.2 Response Rate

The study applied secondary data extracted from fully-fledged Islamic Banks in Kenya (Gulf African Bank and First Community Bank) and conventional banks that have Islamic Banking (Barclays Bank of Kenya La Riba, Kenya Commercial Bank-Sahal, National Bank of Kenya Amaanah, and Standard Chartered Bank –Sadiq) windows in Kenya. The study managed to access complete and relevant information from all the 6 banks. This translated into 100% response rate which was sufficient and excellent for the study in line with recommendation by Mugenda and Mugenda (2003.)

4.3 Descriptive statistics

The study described the range, minimum, maximum mean, standard deviation, the skewness and the kurtosis of both the dependent variable and the independent variables. The study categorized the variables into internal and external bank characteristics as follows;

4.3.1 Internal Bank Characteristics

The study explained the internal characteristic of Islamic banks as shown in table 4.1

Table 4.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
ROA	30	-2.00	10.00	4.6333	3.29559	-.408	.427	-.916	.833
Capital Adequacy	30	2.00	6.00	3.7667	.81720	.063	.427	1.557	.833
Asset Quality Management	30	1.00	9.00	3.0000	2.27429	1.828	.427	2.323	.833
Efficiency	30	-10.00	11.00	4.0667	4.85609	-1.348	.427	3.380	.833
Earnings Ability	30	-1.00	10.00	4.5667	3.27670	-.330	.427	-1.166	.833
Liquidity	30	1.00	8.00	3.7667	1.86960	.771	.427	.097	.833
Inflation	20	5.00	12.00	7.4000	1.53554	1.082	.512	3.391	.992
GDP	5	3.00	10.00	6.6000	2.88097	.038	.913	-1.804	2.000
Valid N (listwise)	5								

Table 4.1 showed the ROA for the 6 Islamic banks in Kenya had a mean of 4.6333 and a standard deviation of 3.29559 over the study period from 2013 to 2017 with a range of 12 from a minimum of -2 and a maximum of 10 an indication that some of the banks were making losses. The ROA was negatively skewed (-0.408), the ROA also showed negative kurtosis of -0.916 that is closer to 0 meaning that the ROA had a distribution with a tail lighter than the normal distribution.

The capital adequacy for the Islamic banks showed a mean of 3.7667 with a range of between the minimum of 2 and the maximum of 6 an indication that capital adequacy of all the banks was sufficient. Capital adequacy was positively skewed with positive kurtosis value of 1.577 an indication that the capital adequacy distribution was heavier to the right. The asset quality of the Islamic banks had a range of 8 from a minimum of 1 and a maximum of 9. The asset quality had a mean of 3.000 and was positively skewed (1.8) with a kurtosis value of 2.323 an indication that the distribution was heavier to the positive side.

The management efficiency of Islamic banks showed a range of 21 with a minimum of -10 and a maximum of 11 an indication of inefficiency of some Islamic banks. The management efficiency showed a mean of 4.0667 and a standard deviation of 4.85609 with a range of 21. The study noted management efficiency of -10 that was common when ROA was negative (-2). The earnings ability showed a mean of 4.5667 and a standard deviation of 3.27670 with range of 11 from a minimum of -1 which was common where ROA was negative (-2) and a maximum of 10. The earnings ability was negatively skewed (-0.330) and the distribution also had a kurtosis of -1.116. The negative earning ability showed that some of the Islamic banks had negative net profits (making losses) over the study period. The liquidity showed a mean of 3.7667 and a standard deviation of 1.86960 with a range of 7 from a minimum of 1 and a maximum of 8. The liquidity was positively skewed (0.771) with positive kurtosis of 0.097.

4.3.2 External Bank Characteristics

The study explained the external characteristics of banks that is inflation and GDP as shown in table 4.1. Inflation had a mean of 7.4 with a standard deviation of 1.53554 and a range of 7 from a minimum of 5 and a maximum of 12. The inflation was positively skewed with a value of 1.082 and a positive kurtosis of 3.391. The GDP showed a mean of 6.6000 and standard deviation of 2.88097 with a range of 7 from a minimum of 3 and a maximum of 10. The GDP was positively skewed 0.038 however; the kurtosis was negative at 1.804 meaning that the data had a normal distribution.

4.4 Correlation matrix

Table 4.2 indicates the correlation between ROA, the CAMEL model variables, inflation and GDP in relation to the Islamic banks within the study period.

Table 4.2 Correlations

		ROA	Capital Adequacy	Asset Quality	Management Efficiency	Earnings Ability	Liquidity	Inflation	GDP
<i>ROA</i>	Pearson Correlation	1	.569**	-.672**	-.031	.968**	.495**	-.066	-.665
<i>Capital Adequacy</i>	Pearson Correlation	.569**	1	-.668**	-.022	.605**	.302	-.301	-.824
<i>Asset Quality</i>	Pearson Correlation	-.672**	-.668**	1	.031	-.662**	-.316	.123	. ^b
<i>Management Efficiency</i>	Pearson Correlation	-.031	-.022	.031	1	-.067	-.055	-.093	-.824
<i>Earnings Ability</i>	Pearson Correlation	.968**	.605**	-.662**	-.067	1	.484**	-.060	-.283
<i>Liquidity</i>	Pearson Correlation	.495**	.302	-.316	-.055	.484**	1	.248	-.160
<i>Inflation</i>	Pearson Correlation	-.066	-.301	.123	-.093	-.060	.248	1	-.788

<i>GDP</i>	Pearson Correlation	-.665	-.824	. ^b	-.824	-.283	-.160	-.788	1
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** . Correlation is significant at the 0.05 level (2-tailed).

This study undertook the correlation test to determine the correlation that existed between the dependent and the independent variables. From table 4.2, the entire variable showed correlation coefficient of 1 meaning that each variable was perfectly related with itself. ROA showed significant correlation with earnings ability with correlation coefficients of 0.968 at 95% confidence level for commercial banks offering Islamic banking services in Kenya over the study period.

4.5 Regression analysis

The study carried out a regression analysis of the study variables based on the objectives of the study which was to analyze the effect of internal factors on the financial performance of commercial banks offering Islamic banking services in Kenya. The study then undertook multicollinearity test, the autocorrelation test, heteroscedasticity test, the linearity test and normality test to confirm the validity of the estimated results.

4.5.1 Multicollinearity test

The study undertook multicollinearity test by used of the variance inflation factors (VIF). Multicollinearity is where independent variable in a multiple regression model can be linearly projected from others with substantial precision. The presence of this problem may lead to unstable estimate hence making it difficult to assess the effect of explanatory variable on dependent variable. VIF of more than 10 and tolerance level of less than 0.10 shows presence of multicollinearity

Table 4.3 Multicollinearity Coefficients^a

Model	Collinearity Statistics	
	Tolerance	VIF
(Constant)		
Capital Adequacy	.506	1.975
Asset Quality	.449	2.227
Management Efficiency	.994	1.006
Earnings Ability	.444	2.254
Liquidity	.765	1.307
Inflation	.694	1.442
GDP	.746	1.341

a. Dependent Variable: ROA

From table 4.3, the study showed lack of collinearity and validity of the estimated results since all the variables showed VIFs less than 10 and tolerance levels greater than 0.10.

4.5.2 Heteroscedasticity test

Heteroscedasticity is manifested where variance is different across the observation and may lead to biased estimations. The researcher used test Glejser in SPSS to determine the consistency of variance cross the observation. If the significance value is greater than 0.05, then there is no heteroscedasticity.

Table 4.4 Heteroscedasticity (Coefficients^a)

Model	t	Sig.	Collinearity Statistics	
			Tolerance	VIF
(Constant)	.225	.826		
Capital Adequacy	-.352	.731	.325	3.076
Asset Quality	-.776	.453	.434	2.305
Management Efficiency	-.195	.848	.852	1.174
Earnings Ability	-1.097	.294	.266	3.765
Liquidity	2.901	.013	.695	1.438
Inflation	-.100	.922	.694	1.442
GDP	-.670	.516	.746	1.341

a. Dependent Variable: AbsUt (ROA)

The study showed in table 4.4 that there was lack of heteroscedasticity at 95% confidence level. All the variable significance values were more than 0.05 meaning that there was no heteroscedasticity.

4.5.3 Linearity test

The study undertook linearity test to ascertain the existence of linear relationship between the independent variables as shown in table 4.5. If the significance value of deviation from linearity is greater than the common alpha 0.05, then the relationship between the independent variables and dependent variable are linearly dependent. However, if the significance value of deviation from linearity is less than 0.05, then the relationship between independent variables with the dependent variable is not linear.

Table 4.5 Linearity test

			Sum	ofdf	Mean	F	Sig.
			Squares		Square		
		(Combined)	69.127	28	2.469	56.738	.105
ROA	Between Groups	Deviation from Linearity	62.092	27	2.300	52.852	.108

From table 4.5, this study showed deviation from linearity significance of 0.108 which is greater than the common alpha (0.05) at 95% confidence level ($0.108 > 0.05$) hence proving existence of linearity between the dependent and independent variables.

4.5.4 Regression Test

Table 4.6 Model Summary^b

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.971 ^a	.943	.932	.86112

a. Predictors: (Constant), Liquidity, Management Efficiency, Capital Adequacy, Asset Quality, Earnings Ability, inflation, GDP

b. Dependent Variable: ROA

From table 4.6, this study showed a coefficient of determinant (R square) of 0.943, which showed the extent in changes in the independent variables (Liquidity, Management Efficiency, Capital Adequacy, Asset Quality, Earnings Ability, inflation, GDP) that affect the dependent variable (ROA) of Islamic banks in Kenya. The study showed an R square of 0.943 meaning that the ROA (dependent variable) was determined 94.3% by the independent variables with the remaining 5.7% being determined by other independent factors not covered within the study.

Table 4.7 ANOVA^a

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	297.170	7	59.434	80.151	.000 ^b
Residual	17.797	24	.742		
Total	314.967	31			

a. Dependent Variable: ROA

b. Predictors: (Constant), Liquidity, Management Efficiency, Capital Adequacy, Asset Quality, Earnings Ability, inflation, GDP

From table 4.7, the study showed a significance value of 0.000 which is less than the common alpha 0.05 an indication that the model is statistically significant in predicting the effect of internal factors on the financial performance of commercial banks offering Islamic banking services in Kenya.

The study showed that at 95% confidence level indicating high reliability of the analysis results. The overall ANOVA results indicated that the model was significant at $F=80.151$, $p=0.000$.

Table 4.8 Regression Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
	B	Std. Error				Beta	Lower Bound
	(Constant)	1.334	1.246				1.070
Capital Adequacy	.257	.275	.064	.936	.359	.825	.310
Asset Quality Management	.123	.105	.085	1.173	.252	.340	.094
Efficiency	.024	.033	.036	.732	.471	-.044	.092
Earnings Ability	.941	.073	.935	12.840	.000	.790	1.092
Liquidity	.065	.098	.037	.661	.515	-.137	.266
Inflation	.602	.366	.920	1.645	.242	-.973	2.177
GDP	.011	.106	.060	.107	.925	-.446	.469

a. Dependent Variable: ROA

From table 4.8, the study regression model of;

$$Y = \alpha + \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 GDP + \beta_6 INF + \epsilon it$$

Becomes;

$$Y=1.334 + 0.257X_1+ 0.123X_2+ 0.024X_3+ 0.941X_4+0.065X_5+0.602 INF + 0.011GDP.$$

From the regression model, assuming all other factors are held constant 1.334 units of ROA are not affected by any variable in the study.

The table showed that if all the other variables are held constant, a unit increase in capital adequacy leads to 0.257 units increase in ROA for Islamic banks in Kenya. A unit increase in asset quality leads to 0.123 units increase in ROA for Islamic banks in Kenya assuming all other factors are held constant.

The study showed that a unit increase in the management efficiency leads to a 0.024 units increase in ROA assuming all other factors effecting ROA are held constant. A unit increase in Earnings Ability leads to 0.941 units increase in ROA assuming all other factors are held constant. The study demonstrated that a unit increase in liquidity leads to 0.065 increase in ROA assuming all other factors are held constant. Further, a unit increase in the inflation rate leads to 0.602 units increase in ROA and a unit increase in GDP leads to 0.011 increase in ROA assuming all other factors affecting ROA are held constant.

4.6 Discussion of findings

The study showed the ROA for the 6 Islamic banks in Kenya had a mean of 4.6333 and a standard deviation of 3.29559 over the study period from 2013 to 2017. All the variables under study were perfectly correlated with each other having a correlation coefficient of 1. The study showed that ROA had significant correlation with earnings ability with correlation coefficients of 0.968 respectively at 95% confidence level. The study showed lack of collinearity and validity of the estimated results since all the variables showed VIFs less than 10 and tolerance levels greater than 0.10 and lack of heteroscedasticity at 95% confidence level.

The study further showed deviation from linearity significance of 0.040 which is less than the common alpha (0.05) at 95% confidence level hence proving existence of linearity between the dependent and independent variables. The overall ANOVA results showed that the regression model was significant at $F=80.151$, $p=0.000$. The study showed an R square of 0.943 meaning that the ROA (dependent variable) was determined 94.3% by the independent variables with the remaining 5.7% being determined by other factors not covered within the study. All the independent variables were statistically significant in predicting the dependent variable.

The study finds that capital adequacy, management efficiency and liquidity had a very small significance on the commercial banks' ROA. This is in tandem with Ifeachi and Ngalawa's (2014) study. In the study, earnings ability was statistically significant and this is supported by the study done by Athanasoglou et al. (2008) who identified management efficiency as a variable that affects the financial performance of commercial banks.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary

The study used an empirical model to analyze the effects of internal factors on the financial performance of banks offering Islamic banking services in Kenya. Islamic banking has been offered in two models since the inception of Islamic banking in 2008 in Kenya: fully-fledged model and the window model. While looking at banks in both models, the study used the ROA as a measurement of profitability. The internal factors consisted of the CAMEL model variables and covered the periods between 2013 and 2017.

A strong relationship has been recorded between earnings ability and profitability of commercial banks offering Islamic banking services with a correlation coefficient of 0.968. Therefore, it can be concluded that for any bank offering Islamic banking services that wants to increase its ROA must pay keen attention to their earnings ability and diverse on their ways of creating appropriate returns to its shareholders.

5.2. Conclusions

The results from the study showed that financial performance of commercial banks that offered Islamic banking services in Kenya were affected by the different internal bank characteristics. However, the ROA had a significant correlation with earnings ability.

Using the regression equation used in this study, taking all factors into consideration, earnings ability was the biggest contributor to the model with a standardized coefficient of 0.935. From table 4.8, it is evident that earnings ability has a very significant effect on the financial performance of commercial banks offering Islamic banking services in Kenya.

5.3. Recommendations

The study concluded that there was a significant relationship between the different internal factors on ROA. Therefore, any financial institution offering Islamic banking services or intends to offer, must always look and evaluate these factors if they are to significantly increase their returns. The study showed a significant relationship between inflation and ROA. Considering the high inflations in the country, the government, through the CBK, should tighten the monetary policy by reducing the lending rates. Another alternative would be to fix the exchange rate. These will aid in reducing inflation and help reduce the losses faced by these institutions.

The relationship between ROA and GDP was insignificant. Nonetheless, it is prudent for the policy makers to work on ways of increasing our GDP, which will eventually lead to increased profitability in commercial banks offering Islamic banking services and all the other sectors of the economy. The government can also increase the GDP by pushing for improved efficiency and production of more goods and services locally.

The financial statements of Islamic commercial banks are very dissimilar to those offering conventional banking services. Given that the local banks offering Islamic banks do not share their prepared financial statements with the public, it would be very difficult for researchers, policy makers as well as prospective investors to access them for their personal use. The policy makers should come up with recommendations of enforcing this and making Islamic financial institutions provide financial statements of their Islamic window models when they are sharing their grouped financial statements or for their conventional side.

5.4. Limitations of the Study

This study concentrated on the bank internal factors that influence the financial performance of commercial banks offering Islamic banking services in Kenya. It heavily concentrated on the CAMEL model of evaluating internal performance and left out other variables used in the measure of bank performance.

The understanding of all factors that influence the financial performance of these banks is very essential to all the stakeholders involved from the management, customers, and the regulatory authority. Another major weakness of the study was data constraints. Most of the commercial banks offering Islamic banking services on the window model do not publish their financial statements for external consumption. Some of the banks under study flatly refused to share their data making the researcher use the financial statements of both the conventional and Islamic windows presented as a group. This distorts the analysis done due to misrepresentation of the figures.

5.5. Suggestions for Further Research

This study concentrated generally on the commercial banks offering Islamic banking services in Kenya. Future studies could concentrate on looking at the influence of these same internal factors on the financial performance of fully-fledged Islamic banks. This will enable the researchers to determine the magnitude of the effect of these factors on the profitability of full-fledged Islamic banks.

The study looked at commercial banks. Other studies can look at other forms of financial institutions that offer both the Islamic and conventional services in tandem e.g. insurance, microfinance institutions and investments companies.

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APPENDICES

APPENDIX I: LIST OF BANKS PROVIDING ISLAMIC BANKING SERVICES IN KENYA

Bank	Address
Barclays Bank of Kenya Limited (La riba)	Barclays Bank of Kenya Ltd, Barclays West End Building, Off Waiyaki Way, PO Box 30120 – 00100Nairobi, Kenya.
First Community Bank Limited	Prudential Building, 1st floor, Wing A,Wabera Street, P.O. Box 26219-00100, Nairobi Kenya.
Gulf African Bank Limited	Geminia Insurance Plaza P.O. Box 43683 -00100 Nairobi.
Kenya Commercial Bank Limited(Sahal)	Kenya Commercial Bank Limited, Kencom Building, P.O Box 48400-00100 Nairobi, Kenya.
National Bank Limited (National Amanah)	National Bank Building, Harambee Avenue,P.O BOX 72866-00200 Nairobi.Tel:020-2828000,Fax: 020-311444/222304 Mail:corporateaffairs@nationalbank.co.ke
Standard Chartered Bank Limited (Saadiq)	48 Westlands Road, Nairobi, Kenya, P.O. Box 30003 – 00100 GPO, Nairobi

Source: (Author, 2018)

APPENDIX II: DATA FROM FINANCIAL STATEMENTS

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax					
Total Assets					
Total Shareholder's Equity					
Total Risk Weighted Assets					
NPL's-Facilities					
Total Financing					
Operating Expenses					
Operating Margin					
Liquidity ratios					
Net Profit					

Source: (Author, 2018)

APPENDIX III: GDP AND INFLATION RATES

ITEM/YEAR	2013	2014	2015	2016	2017
GDP(Billions)	55.10	61.45	64	70.88	74.94
Inflation rates	5.72	6.88	6.58	6.23	8.11

Source: (Kenya National Bureau of Statistics, 2018)

APPENDIX IV: DATA FROM FINANCIAL STATEMENTS (F.C.B)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	132,202,000	50,437,000	(12,114,000)	(55,734,000)	151,797,000
Total Assets	11,305,398,000	15,278,026,000	14,564,631,000	14,962,089,000	17,359,968,000
Total Shareholder's Equity	1,210,095,000	1,517,722,000	1,611,608,000	1,557,408,000	1,709,205,000
Total Risk Weighted Assets	7,702,126,000	12,652,344,000	13,249,172,000	14,070,693,000	13,173,341,000
NPL's-Facilities	503,978,000	1,470,474,000	2,566,084,000	3,495,479,000	3,966,687,000
Total Financing	7,211,504,000	9,765,509,000	10,940,003,000	10,939,122,000	9,726,807,000
Operating Expenses	911,448,000	1,205,686,000	1,323,481,000	1,493,057,000	1,069,708,000
Operating Margin	200,472,000	102,329,000	10,683,000	(41,488,000)	216,493,000
Liquidity ratios	28.70%	29.60%	22.40%	24.20%	43.60%
Net Profit	132,202,000	50,437,000	(12,114,000)	(55,734,000)	151,797,000

Source: (Financial Statements, 2018)

APPENDIX V: DATA FROM FINANCIAL STATEMENTS (G.A.B)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	285,477,000	402,196,000	728,619,000	498,321,000	153,653,000
Total Assets	16,053,971,000	19,750,030,000	24,706,595,000	27,156,264,000	31,316,228,000
Total Shareholder's Equity	2,685,926,000	3,147,507,000	3,876,126,000	4,375,707,000	4,419,463,000
Total Risk Weighted Assets	14,804,171,000	23,284,797,000	24,592,935,000	22,788,106,000	29,847,177,000
NPL's	621,550,000	896,328,000	1,299,174,000	1,494,067,000	1,799,940,000
Total Financing	10,665,498,000	13,790,646,000	15,427,705,000	16,193,046,000	19,384,156,000
Operating Expenses	1,117,900,000	1,305,483,000	1,764,729,000	1,694,090,000	2,376,647,000
Operating Margin	433,700,000	616,458,000	1,090,592,000	753,922,000	253,955,000
Liquidity ratios	34.00%	28.70%	35.80%	41.00%	34.90%
Net Profit	285,477,000	402,196,000	728,619,000	498,321,000	153,653,000

Source: (Financial Statements, 2018)

APPENDIX VI: DATA FROM FINANCIAL STATEMENTS (B.B.K)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	7,622,642,000	8,387,346,000	8,400,582,000	7,399,396,000	6,926,319,000
Total Assets	206,736,932,000	225,845,434,000	240,877,020,000	259,692,012,000	271,177,377,000
Total Shareholder's Equity	32,370,886,000	38,186,091,000	39,716,371,000	42,388,242,000	44,099,136,000
Total Risk Weighted Assets	191,652,230,000	207,154,473,000	224,120,795,000	239,299,450,000	243,728,272,000
NPL's	3,579,909,000	4,554,426,000	3,881,678,000	8,782,749,000	9,358,657,000
Total Financing	118,361,911,000	125,423,371,000	145,378,553,000	168,509,529,000	168,397,417,000
Operating Expenses	16,000,500,000	15,994,964,000	17,388,180,000	20,831,705,000	19,897,572,000
Operating Margin	10,852,407,000	10,360,979,000	12,073,580,000	10,852,407,000	10,360,979,000
Liquidity ratios	42.00%	44.20%	34.10%	28.30%	33.40%
Net Profit	8,209,545,000	7,328,962,000	7,746,073,000	8,209,545,000	7,328,962,000

Source: (Financial Statements, 2018)

APPENDIX VII: DATA FROM FINANCIAL STATEMENTS (K.C.B)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	14,341,382,000	16,848,862,000	19,623,069,000	19,722,447,000	19,705,131,000
Total Assets	390,851,579,000	490,338,324,000	558,094,154,000	595,239,643,000	646,668,939,000
Total Shareholder's Equity	63,354,967,000	75,633,557,000	81,253,607,000	96,565,775,000	105,965,873,000
Total Risk Weighted Assets	272,565,071,000	338,877,072,000	467,246,047,000	513,145,932,000	554,302,907,000
NPL's	17,027,588,000	15,815,859,000	20,166,659,000	27,202,975,000	32,371,150,000
Total Financing	227,721,781,000	283,732,205,000	345,968,686,000	385,745,331,000	422,684,637,000
Operating Expenses	29,986,506,000	34,162,425,000	33,547,133,000	40,385,525,000	42,271,381,000
Operating Margin	14,341,382,000	16,848,862,000	26,537,571,000	29,091,125,000	29,114,202,000
Liquidity ratios	33.30%	31.30%	48.30%	37.50%	29.00%
Net Profit	14,035,587,000	17,646,146,000	12,704,524,000	19,809,913,000	21,664,339,000

Source: (Financial Statements, 2018)

APPENDIX VIII: DATA FROM FINANCIAL STATEMENTS (N.B.K)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	1,112,803,000	870,702,000	(1,153,477,000)	70,953,000	410,783,000
Total Assets	92,555,717,000	123,091,996,000	125,440,316,000	112,086,130,000	109,873,141,000
Total Shareholder's Equity	11,888,399,000	12,224,023,000	11,053,549,000	6,910,450,000	7,233,908,000
Total Risk Weighted Assets	45,332,793,000	80,433,021,000	75,266,075,000	87,076,098,000	87,997,708,000
NPL's	4,169,649,000	7,048,129,000	9,963,684,000	26,768,991,000	23,878,080,000
Total Financing	39,566,678,000	65,641,491,000	67,803,990,000	55,019,784,000	52,361,043,000
Operating Expenses	6,682,984,000	7,502,509,000	11,193,078,000	10,569,028,000	8,368,519,000
Operating Margin	1,812,168,000	2,431,685,000	(1,637,985,000)	79,891,000	785,082,000
Liquidity ratios	42.00%	31.50%	30.70%	32.60%	36.30%
Net Profit	1,789,348,000	887,699,000	(1,170,474,000)	25,453,000	323,455,000

Source: (Financial Statements, 2018)

APPENDIX XI: DATA FROM FINANCIAL STATEMENTS (S.C.B)

ITEM/YEAR	2013	2014	2015	2016	2017
Total Profit After Tax	9,262,921,000	10,436,180,000	6,342,427,000	9,049,307,000	6,914,098,000
Total Assets	220,391,180,000	222,495,824,000	233,965,447,000	250,482,000,000	285,724,441,000
Total Shareholder's Equity	36,206,401,000	40,658,174,000	41,251,785,000	44,603,828,000	45,664,537,000
Total Risk Weighted Assets	147,682,332,000	183,104,659,000	189,747,429,000	201,320,647,000	228,112,212,000
NPL's	3,106,826,000	8,887,564,000	11,681,664,000	10,166,807,000	11,317,708,000
Total Financing	129,672,004,000	122,749,233,000	115,125,427,000	122,711,038,000	126,294,470,000
Operating Expenses	10,472,412,000	11,728,697,000	16,205,217,000	14,696,970,000	17,266,900,000
Operating Margin	13,354,965,000	14,345,981,000	9,159,932,000	13,288,119,000	10,071,293,000
Liquidity ratios	38.00%	46.00%	53.74%	56.93%	58.73%
Net Profit	9,486,260,000	10,561,072,000	6,055,753,000	9,442,239,000	7,564,637,000

Source: (Financial Statements, 2018)