PERFORMANCE OF ISLAMIC AND CONVENTIONAL BANKS IN KENYA:

A COMPARATIVE CASE STUDY

BY

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DECLARATION

This management research project is my original work and has not been submitted for a degree in any other university.

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

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DEDICATION

To my wife and children, for their encouragement, support and patience during this project.

ABSTRACT

Islamic banking is the system of banking consistent with principles of Islamic law (shariah) and guided by Islamic economics. Islamic economics is referred to that body of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teaching without unduly curbing individual freedom or creating continued macroeconomics and ecological imbalances. Islamic banking is grounded in the Islamic principles and all undertakings of the banks follow Islamic morals. Two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of usury, the collection and payment of interest, also commonly called Riba. Like conventional bank, an Islamic bank is an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositor a customer with some ownership rights in it, Dar and Presley (2000).

The aim of this study was to examine and compare performance of Islamic banks, the Gulf African Bank and First Community Bank, and five conventional banks in Kenya. Both the Islamic and conventional banks sampled are within fourth tier of bank ranking per Central Bank of Kenya and all have asset base of less than ten billion shillings. The analysis involved extraction of financial ratios from the banks' published accounts and comparing the means for each category against the industry averages. Four broad categories of financial performance measures were considered and for each category two financial ratios were calculated and

compared. The four broad categories of performance measures considered are profitability, liquidity, efficiency and risk and solvency of banks.

The result of the study indicates that on the whole the conventional banks performed better than the Islamic banks during the period under review. The study found Islamic banks to be more liquid than the conventional banks. This however may not necessarily be an indication of better performance because more liquidity leads to less return and therefore affects other aspects of performance.

Conventional banks on the other hand performed better in profitability, and efficiency. On risk and solvency, the Islamic banks seemed to perform better but while the trend for conventional banks was showing to be stable, the Islamic banks were showing increasing risks. And therefore considering that the Islamic banks have only been in Kenya for a short period, the fast increase in risk is an indicator they may be more risky than the conventional banks.

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CHAPTER ONE

INTRODUCTION

1.1 Background to Study

Whether to depositors, investors, bank managers, or regulators, performance evaluation of banks is important. In a highly competitive financial markets bank performance signal to depositor-investor whether to invest or withdraw funds from a bank. Depositors may also be interested in evaluating the performance of a bank as they are not entitled to fixed returns and the nominal values of their deposits are not guaranteed. Managers are keen to know the outcomes of previous management decisions as well as to evaluate whether to improve loan service or deposit service or both to improve its finance. Being responsible for safety and the soundness of the banking system and preserving public confidence, bank regulators monitor bank performance to identify banks that are experiencing problems as existing problems which may remain unnoticed can lead to financial failure.

The first modern experiment with Islamic banking was undertaken in Egypt, under cover without projecting an Islamic image for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit sharing in the Egyptian town of Mit Ghamr in 1963. The experiment lasted until 1967 by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry directly or in partnership with others and shared profit with their depositors (Siddiq, 1988). Thus they functioned essentially as savings-investment institutions rather than commercial banks.

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Since the emergence of modern Islamic finance in the 1970s, it has grown significantly in both volume and scope, attracting significant attention worldwide. There are now more than 300 Islamic financial institutions operating in around 75 countries. Over the years, the Islamic financial landscape has transformed into a vibrant and competitive mode of global financial intermediation. According to some estimate, total shariah compliant assets worldwide have grown to about US$ 700 billion – with annual growth exceeding 10. % during the past decade and are projected to grow to US$ 1.6 trillion by 2012(Dar 2007)

Following the financial crisis of 2007/2008, interest in Islamic banking and finance has increased even more due to the fact that Islamic banks were to a great extent unscathed by the crisis and the economies of the Muslim based on Islamic economics unaffected by the crisis. In Kenya, interest in Islamic banking was first manifested when Barclays of Kenya introduced an Islamic 'window' by introducing a current account that did not attract interest in 2006, the La Riba account. Other banks, including Kenya Commercial Bank Ltd., Chase Bank, Equity Bank, have also followed and introduced these 'windows'. The entry into the market of both Gulf African Bank and the First Community Bank has ushered in the first fully Shari'ah complaint financial institutions with an array of products for their customers. There is currently a lot of expectation from both Muslims and non Muslims for this alternative form of banking that will bring in a new form of partnership and interest- free banking.

1.1.1 Conventional Vs. Islamic Banking: an Overview

Like conventional bank, an Islamic bank is an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositor a customer with some ownership rights in it (Dar and Presley, 2000). Islamic banking and conventional banking differ in that while conventional banking follows conventional interest-base principle, Islamic banking is based on interest-free principle and the principle of profit-loss- sharing (PLS) in performing their business as financial intermediary (Arif,1988). Moreover, Islamic profit-loss sharing principle creates the relationship of financial trust and partnership borrower, lender and intermediary (Yudistira, 2003).

An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment as compared to conventional bank which is basically borrower and lender of funds. The difference between the two banking system also lies in terms of governance structure. Islamic banks must obey a different set of rule, i.e. compliance with shariah, and providing Islamically acceptable financing modes (Suleiman, 2001). According to Suleiman, there are four rules that govern Islamic investment behavior. These are the absence of interest-based transactions, the avoidance of economic activities involving speculation (Gharar), the introduction of Islamic tax (Zakat), and the discouragement of production of goods and services which contradict the value pattern of Islam.

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1.2. Statement of the Problem

The global financial crisis of 2007-2008 did not adversely affect the economies of the Muslim countries practicing Islamic banking and financial system as much as it affected the Western economies. In the face of the crisis Islamic banks appeared to be more resilient to the effects of global economic downturn and international financial crisis than the conventional because Islamic banks tended to avoid speculative investments such as derivatives that many analysts believe led to the financial crisis. Islamic banks also avoided sub-prime crisis due to the fact that they must balance their books, and so did not lend to sub-prime borrowers.

Islamic bank apparently did better to withstand the impact of the financial crisis than conventional banks which seem to suggest that Islamic banks may then be performing better than conventional banks. However, empirical evidence from research on comparative performance of the two banking systems does not necessarily lend credence to this. Jaffar and Manarvi (2011) compared and analyzed the performance of Islamic and conventional banks in Pakistan from 2005 to 2009 by analyzing CAMEL test standard factors such as capital adequacy, asset quality, management quality, earning ability and liquidity position. The source of their data was the banks' financial statements. They selected a sample of five Islamic and five conventional banks. Their study found that no one mode of banking performed better than the other in all performance measures employed.

Moin (2008) also carried out a study on comparative performance of Islamic and conventional banks in Pakistan. He compared the performance of the first Islamic bank,

Meezan Bank Ltd with a group of five Pakistani conventional banks. The study evaluates performance in terms of profitability, liquidity, risk and efficiency for the period 2003 to 2007. Twelve financial ratios, including return on assets, return on equity, loans to deposit ratio, loans to assets ratio, debt to equity ratio, income to expenses ratio, etc were used to asses banks performance. The study found the Islamic bank to be less profitable, less efficient and less risky but that there were no significant differences in liquidity, thus concluding that conventional banks performed better.

Samad (2004) examined the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during the post Gulf War period of 1991 to 2001. He used nine financial ratios in measuring the performance. The study found no significant difference in overall performance of the two sets of banks.

This study aimed at carrying out a comparative performance between two Islamic banks and five conventional banks in Kenya to see which mode of banking performs better than the other. The studies of Moin (2008), Samad (2004) majority of others in the literature review it has been found that there are no significant differences in performance of Islamic and conventional banks. This study sought to find if in Kenya the situation is different and addressed the question:' Is there a significant difference in performance between Islamic and conventional banks?' If so, which ones are better performing?

1.3. Objective of the Study

The objective of the study is to make comparison of financial performances of Islamic and conventional banking in Kenya to see if there is a significant difference between the two.

1.4. Significance of the Study

This study will give managers of commercial banks in Kenya an understanding of Islamic banking to help them come up products for their Muslim clientele.

To the general public and bank customers who are in need of Islamic sharia'h compliant products from banks it will help them understand the basics of Islamic banking.

For the Government and regulatory institutions such as the Central Bank of Kenya (CBK), Kenya Bankers Association (KBA) and Association of Micro Finance Institutions in Kenya (AMFI) it will help in understanding the operations of Islamic Banking requirements and therefore be able to put guidelines for monitoring Islamic banks.

For academics, this study will also be contribute to the literature of what is known about Islamic banking.

CHAPTER TWO

LITERATURE REVIEW

2.1. Theoretical Framework

Islamic banking model is developed with respect to Islamic law (Shari'ah) and thus consistent with Islamic economics. Shari'ah is clearly against usury which entails gains made through interest. In addition, Islamic law condemns businesses that involve risk such as gambling as well as business practices that are not allowed in law (Faisal, 2005). The global impact on the Muslim community has heightened their need to have a banking system that is observant of the laws and principles prescribed by the Islamic faith. This need has contributed to the rapid growth of the Islamic banks both in Muslim and western countries within the last three decades. However, the Islamic bank has outgrown itself to become not only the bank for the Muslim community but also the non-Muslim community who want to try out an alternative form of banking. According to Iqbal and Molyneux (2005), Islamic bank industry has grown to a market value of not less than $400 billion which is projected to grow at 15% per annum. The tremendous growth of the Islamic banks has prompted other global financial institutions to develop products and services that are Shari'ah compliant in order to tap the potential of the Muslim finance.

2.2 Islamic Banking: The Global Scope

Basically, the economic boom in most Muslim countries as a result of oil wealth was and still is a significant impetus in the establishment of Islamic finance as thus Islamic banking.

According to Bashir and Hassan (2004), there has been a concerted effort by probably unrelated forces to implement the concept of Islamic banking on a country wide basis in different countries. Bashir and Hassan (2004) observed that both assets and liabilities in the Islamic banking sector have significantly grown which is a good sign of the expansion of Islamic banks in both money and capital market transactions.

Studies in the Gulf Cooperation Council (GCC) indicate a trend where Islamic banks and financial institutions operate side by side with the conventional financial systems. On this aspect; Bahrain tops the list of the GCC members that have experienced the fastest pace in the growth of the Islamic banking. The country is home to at least 26 Islamic financial institutions and thus boasts the largest concentration of Shari'ah compliant financial institutions in the Middle East. Notably, the Islamic financial institutions in Bahrain are involved in wide range of activities including but not limited to commercial banking, offshore banking and investment banking (Faisal, 2005). The banking industry in Bahrain managed by Bahrain Monetary Agency (BMA) has adopted a dual banking system that provides a uniform operation platform for both Islamic banks and conventional banks.

The factor of hosting the largest concentrations of Islamic banks has given Bahrain the preference to be the headquarters of the Liquidity Management Centre (LMC) as well as the International Islamic Financial Market (IIFM). The two bodies have the responsibility of coordinating the Islamic banks around the globe and ensure smooth operations.

On this aspect; the BMA has sought to fulfill its mandate by way of introducing the necessary regulatory mechanism that is supported by thorough and comprehensive reporting system (Faisal, 2005). In addition, the BMA has overseen the introduction of other innovative ideas aimed at expanding the Islamic financial markets for the greater good of Islamic banks.

Malaysia also comes as striking example of the performance of the Islamic banking sector. The country provides a favorably competitive environment for both conventional and Islamic financial institutions. According to Bashir and Hassan (2004), Islamic banking in Malaysia has gradually developed from negligible level in the early 1980s to acquire an 8% market share by 2003. This is truly a significant growth which has in turn prompted the optimistic projection of 20% market by the year 2010 (Bashir & Hassan, 2004). The Malaysian Islamic banking sector is characterized by a diversified interpretation of the Islamic banking concept on such issues as relating to sale and purchase of debt instruments contract as well as gifts on savings and financial papers contracts.

Sudan is another country that has adopted the system of Islamic banking and finance. Basically, this system is well spread to the areas that are largely populated by people of Islamic faith. The Sudanese Islamic banking system has been largely operating with the *Murabaha* model of financing (Bashir & Hassan, 2004). However, the *Musharakah* and *Mudarabah* models have been gradually increasing on their popularity and they currently make up about 40% of the total banking contracts.

Sudan has had its fair share of political, social and economic problems for the better part of its independence and thus the environment has not been very conducive for the growth of the financial sector. As a result, there still remain very significant aspects to be looked in to for the Islamic banking system to flourish.

The wave of Islamic banking phenomena was also experienced in Iran and became nation wide as early as March 1984. However, Islamic banking system adopted by Iran differed in concept from other Islamic banking systems established in other countries (Houssane, 2002).

It is imperative to note that in as plausible as the rapid growth of Islamic banking is, there is an equally significant need for the development of the necessary infrastructure that can support their long term development. This is basically due to their enormous and continually growing capital as well as client base. According to Faisal (2005), Islamic scholars have been involved in development of viable strategies for refining of the existing Islamic financing models in a number of Middle East countries. The more established Islamic financial institutions and banks are now involved in simple as well as complex financing deals that span from basic retail products to highly structured financing models. For example, it is now common to find Islamic finance in areas such as road and bridge construction, power projects, just to name but a few. On this aspect; Bahrain tops again this time as the central hub of Islamic finance in Middle East an aspect that has been largely complimented by the presence of Prudential Information and Regulatory Framework for Islamic banks (PIRI) alongside AAOIFI.

This has also enabled Bahrain to a greater extent overcome most of the risks attributed to the uncertainty in the Islamic banking financing models (Faisal, 2005). Notably, the BMA was involved in a move to expand the Shari'ah compliant instruments that can be traded in the Islamic banking Industry by signing a Memorandum of Understanding with the London Metal Exchange (LME). This is an indicator that Islamic banking is making effort to integrate their system in the global financial system in a way that upholds the Shari'ah laws and principles.

The move by BMA strategically places Bahrain as the pace setter in Islamic compliant commodity trading in the Middle East as well as the world at large. Moreover, the BMA has formulated policy guidelines that are very crucial in the regulation on issuance of Islamic bonds and securities mainly from Bahrain. The Bahranian government also went ahead to launch a US$ 250 MILLION Sukuk using the Liquidity Management Centre (LMC).

In an equal measure, Saudi Arabia through its National Commercial Bank has invested in an Advanced Card that is almost similar to the conventional credit only that operates on the basis of a prepaid rather than credit financing. More important, the advanced card does not incur interest and this makes it a fully Shari'ah compliant (Bashir & Hassan, 2004). The covers a wide range of market segments that traditionally had been sidelined by the financial system including women, youth and the self-employed. This shows that Islamic banking is ready to move away from conservative banking to fully realize the full potential of the community.

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Saudi Arabia enjoys one of the best and economically viable Takaful sectors in the world. The Arabian government has approved a policy that is compliant with Islamic laws and principles to be applied in the regulation of the sector. Furthermore, the show of interest by the world renowned Standard & Poor credit rating company on Islamic banking proves that they have made a significant impact on the global economy. The firm was involved in assigning a $600 million Shari'ah compliant trust certificates (Sukuk) from Malaysia Global Sukuk Inc a BBB+ rating. It is therefore evident that the Islamic banking system is gaining acceptance not only in countries led by Muslim ideology but also in the global capitalist societies. Equally important, the Malaysian banking sector is now open to foreign players in line with the countries liberalization of both the banking and insurance sectors.

In the Western world, the United Kingdom through its Financial Services Authority (FSA) has already issued a license to Islamic Bank of Britain on one hand. Whilst on the other hand, the United States of America was involved in a fact finding mission about the nature of Islamic finance and banking with the assistance of Mahmoud El Gamal as early as 2004.

2.3 Empirical Studies

Samad and Hassan (2000) evaluated inter-temporal and inter-bank performance in profitability, liquidity, risk and solvency, and community involvement of Islamic bank (Bank Islamic Malaysia Berhad (BMIB) over a fourteen year period. To evaluate inter-bank performance the study compared BMIB with ten conventional banks.

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Using financial ratio to measure these performance and F-test and T-test to determine their significance, the result showed that BMIB made statistically significant improvement in profitability during 1984 to 1997. However, this improvement when compared with conventional banks was found to be lagging behind. This result is consistent with that of Samad (1999) and Hassan (1999). The study also revealed BMIB to be relatively less risky and more solvent as compared to conventional banks.

Adus Samad (2004) in his paper examines the comparative performance of Bahrain's interest-free Islamic bank with the interest-based conventional banks during the post Gulf War period of 1991 t0 2001. Using financial ratios in measuring the performance with respect to profitability, liquidity risk, and credit risk and applying student T-test to these ratios, the paper concludes that there exists a significant difference in credit performance between these two sets of banks. However, the study finds no major difference in profitability and liquidity performance between Islamic and conventional banks.

Saleh and Rami (2006) in order to evaluate the Islamic bank's performance in Jordan examined and analyzed the experience with Islamic banking for the first and second Islamic bank, Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB) in Jordan. Conducting profit maximization, capital structure, and liquidity tests as performance evaluation methodology, the paper finds several interesting results. First, the efficiency and ability of both banks have increased and both banks have expanded their investment activities. Second, both banks have played an important role in financing projects in Jordan.

Third, these banks have focused on the short term investment. Fourth, Bank for finance and investment (JIBFI) is found to have high profitability. Finally, the study concludes that Islamic banks have high growth in the credit facilities and in profitability.

Kader and Asarpota (2007) utilize bank level data to evaluate the performance of the UAE Islamic banks. Balance sheets and income statements of 3 Islamic banks and 5 conventional banks in time period 2000 to 2004 are used to compile data for the study. Financial ratios are applied to examine the performance of the Islamic banks in profitability, liquidity, risk, solvency and efficiency. The results of the study show that in comparison with UAE conventional banks, Islamic bank of UAE are relatively more profitable, less liquid, less risky and more efficient. They conclude that there are two important implications associated with this finding: First, attributes of the Islamic profit and loss sharing banking paradigm are likely to associate it as a key reason for the rapid growth is Islamic banking in UAE. Second, UAE Islamic banks should be regulated and supervised in a different way as the UAE Islamic banks in practice are different from UAE conventional banks.

Basher (2000) examines the determinants of Islamic banks' performance across eight Middle Eastern countries between 1993 and 1998. Using cross- country bank level data on income statements and balance sheets of 14 Islamic banks in eight Middle Eastern countries for each year in the 1993-1998, the study closely examines the relationships between profitability and the banking characteristics.

After controlling for economic and financial structure indicators such as macro-economic environment, financial market ·structure and taxation, the study shows some very important and interesting results. First, the profitability measures of the Islamic banks react positively to the increases in capital and loan ratios, which is intuitive and consistent with previous studies. Second, the study highlights the empirical role that adequate capital ratios and loan portfolios play in explaining the performance of Islamic banks. Third, the results indicate that customer and short term funding, non-interest earning assets, and overhead are also important for profitable than their domestic counterparts. Fifth, keeping other things constant, there is evidence that implicit and explicit taxes affect the bank performance measures negatively. Sixth, favorable macro-economic conditions have positive effect performance measures of the bank. Finally, the results of the study show that stock markets are complementary to bank financing.

A similar study performance by Hassan and Bashir (2003) analyzes how the performance of the Islamic banks is affected by bank characteristics and the overall financial environment. They utilize cross- country bank level data on Islamic banks in 21 countries for each year in 1994-2001 to closely examine the performance indicators of Islamic banks. In general, they find their analysis of determinants of Islamic banks profitability consistent with previous findings. The study indicate that controlling for macro-economic environment, financial market structure, taxation, the high capital and loan to asset ratios lead to higher profitability.

Everything remaining equal, the regression result of the study reveals that there is negative effect of implicit and explicit taxes on the bank performance measures, while there is positive impact of favorable macro-economic conditions on bank performance measures. That is, favorable macroeconomic environment appears to kindle higher profit margins.

Yudistira (2003) in his study makes an empirical analysis on efficiency and provides new evidence on the performance of 18 Islamic banks over the period 1997-2000.panel data set for the time period is extracted from non-consolidated balance sheets and income statements of these Islamic banks, with specific purpose of seeing the impact of recent financial crises on efficiency of Islamic banks. This study is different from previous studies in that it utilizes non- parametric approach, Data Envelopment Analysis (DAE) to analyze the technical efficiency, pure technical efficiency, and scale efficiency of Islamic banks. Being in line with the principles of Islamic financing system, the intermediation approach is used to specify input-output variables of Islamic banks.

The study finds several results. First, the overall efficiency results indicate that there is a small (at just over 10%) inefficiency across 18 Islamic banks, which is considerable as compared to many conventional counterparts. Similarly, global crisis in 1998-1999 badly affected the performance of Islamic banks; however, they performed better Afterwards. Second, the results show that small and medium sized Islamic banks faced diseconomies of scale which suggests that mergers and acquisition should be encouraged.

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Moreover, as compared to their non-listed counterparts, publicly listed Islamic banks are found to be less efficient. Lastly, Country specific factors mainly determined the efficiency differences across sample data.

Sufian (2007) performed a similar study to provide new evidence on the relative efficiency between the domestic and foreign banks Islamic banking operation in Malaysia during the period of 2001-2004. Non-parametric Data Envelopment Analysis (DEA) methodology has been utilized to distinguish between three different types of efficiency: technical, pure technical and scale efficiencies. The study also used intermediation approach to specify input-output variables of Islamic banks. A series of Parametric and non-parametric tests were performed to examine whether the domestic and foreign banks were drawn from the same population, as most of the results could not reject the null hypothesis at 5% level of significance. Finally, Spearman Rho Rank-Order and Parametric Pearson correlation coefficient were employed to examine the association between the efficiency scores derived from the DEA results with the traditional accounting ratios.

Several results are drawn are drawn from the study. The results from the DEA show that efficiency of Malaysian Islamic banks recovered slightly in years 2003 and 2004 after declining in year 2002. The domestic Islamic banks are found marginally more efficient that foreign Islamic banks. The study examines that operating at the wrong scale of operation has been the main reason for the Malaysian Islamic banks inefficiently.

The dominance of scale in determining the technical efficiency of Malaysian Islamic banks is further confirmed from the results of the correlation coefficients. The results of the study also indicate that profitability is significantly and positively correlated to all efficiency measures.

Bourkes' study inspired Molyneux and Thornton (1992) in the study of what determines the profitability of the European conventional banks. Therefore, this chapter shows how profitability study in the banking sector has steadily developed and how they have spanned to cover other crucial variables that have impacted on the performance of the banking industry.

Molyneux, Goddard and Wilson (2004), set to investigate the dynamic factors that influenced the profit margin in the European banks during the period of early 1990s. Sureshchnader *et al.* (2002), sought to evaluate the level of customer care and satisfaction in the Pakistan banking system. His study was inspired and used the SERVQUAL research model developed by Parasuraman et al. (1988, 1991). In addition, Ben Naceur (2003) added his 'leaf' in the 'theatre' of banking system researchers by studying the performance of the Tunisian banking system.

The fact that Islamic banking is relatively a new concept serves to constrict profitability studies more so because this kind of studies relies heavily on concrete data. However, this does not in any way spell the impossibility of the study. Notably, there is a paper on volatility of profits in the Islamic banking system by Houssane (2002).

The study applied the Return on Equity (ROE) mechanism to measure the banks' efficiency and Return on Assets (ROA) to evaluate the banks profitability. Moreover, Faisal (2005) investigated the comparative profitability between Islamic banks and conventional banks in the GCC with the application of a multiple variables including but not limited to ROE, ROA and Liquidity. Accordingly, Bashir (2000) had studied how Islamic banks in the Middle-East perform by way of evaluating core internal and external variables. In addition, Bashir joined hands with Hassan (2004) to examine the influence of profitability in the Islamic banks and they focused on the macroeconomic and financial conditions of the countries in Middle-East.

Bourke (1989) observed that credit financing to households and firms has greater return prospects compared to other bank assets like government securities regardless its high risk. On this aspect; it is fairly objective to expect a positive correlation between liquidity and profitability. Eichengreen and Gibson, (2001) suggested that profitability is most probable in a situation where funds steadily decline in liquid investments.

Cooper et al., (2003) suggested the existence of a relationship between changes in credit risk and the performance of a bank's loan portfolio. The change has the potential to interrupt the performance of the bank. Equally important, Duca and McLauglin (1990) studied the relationship between variations in the bank profitability and variations in the credit risk. They concluded that greater exposure to credit risk has a negative impact on the profit levels in the banking sector. Their study brought to the limelight the issue of the quality and viability of loans offered by banks.

A study on commercial bank profit levels and how they relate with banking concentration was conducted in Canada, Western Europe as well as Japan by Short (1979).

The researcher investigated approximately sixty banks spread in twelve countries. His paper sought to examine whether bank concentration had any direct influence on profitability. In his study, Short (1979) used autonomous variables that corresponded to situations in specific countries. For example, the study examined the impact of government ownership and concentration on profitability. Although the results were not uniform, they unanimously indicated a negative relationship between government ownership and profitability (Short, 1979). In addition, through the use of H index to analyze concentration, the study identified a pattern of high profit levels in areas of concentration.

Another study on concentration was conducted by Bourke (1989). The study was done on ninety banks in twelve countries including Europe, North America and Australia in the period between 1972 and 1981. Bourke (1989) findings on the impact of government ownership coincided with Short's (1979) results. Furthermore, Bourke (1989) formulated a plausible mechanism to be used in the identification of regulation structures by using matrices. The mechanism involves highlighting the differences in barriers of entry, restrictions on interest rates and credit ceiling. Further, Bourke (1989) found that capital, total assets reserves, cash as well as total asset deposits, had positive influence on the profit levels of banking institutions. According to Bourke (1989) it is much easier for heavily capitalized banks to access cheaper financing because they are well 'insulated' from risk than banks with small capitalization.

The work by Bourke (1989) inspired Molyneux and Thornton (1992) to further explore the subject of profitability in European banks. Their study covered eighteen European countries in the period between 1986 and 1989. Moreover, Molyneux and Thornton (1992) were more comprehensive as their study involved a total of 4,213 banks during the three years of study. However, their paper employed the same category of determinants developed by Bourke (1989). In contrast, Molyneux and Thornton (1992) found out that government ownership had a positive impact on banks' profitability and overall performance. However, the findings on the other determinants corresponded to Bourke's (1989) findings.

The review of literature has revealed that various studies on banking profitability have comprehensively explored on the multiple variables that determine profitability levels. This has in turn built a plausible platform for future studies to be conducted. Accordingly, research in this field of study is moving deeper to identify and cover new determinants such as bank size, risk management strategies, product and service diversification as well as newer forms of banking. For example, the introduction of a new form of banking is heavily influenced on entry barriers, policy and infrastructure. Fair entry barriers imply that it will be possible for newer and alternative forms of banking to join the industry. According to Berger and Humphrey (1997), the size of the banks determines the ease with which it can access capital.

In a more recent study, Goddard, Molyneux and Wilson (2004) sought to further their study on determinants of profitability of banks in Europe. The study was conducted on 665 banks within six European countries that included Denmark, France, Germany, Italy Spain and United Kingdom. Moreover, the study applied panel models that used cross-sectional datasets (Goddard, Molyneux & Wilson, 2004). Interestingly, the study findings corresponded to study results by Molyneux and Thornton (1992).

The study used regression analysis in the examination of variables that included return on equity (ROE), Off Balance Sheet (OBS) dividends as well as logarithmic of total assets and Capital Asset Ratio (CAR). The study by Goddard, Molyneux and Wilson (2004) reinforced previous study findings that total asset size and profitability are positively related. Furthermore, whilst OBS has a neutral or negative relationship in most European banks, it was positively related to profitability in UK banks (Goddard, Molyneux & Wilson, 2004). Equally important, CAR also positively influences profit rates in European banks. The paper explored further to address the aspect of ownership and its impact on competition in the banking industry. The study results indicated that presence of foreign banks in the domestic market heightened the level of competition. Further results indicated the absence of relationship between ownership and profitability (Goddard, Molyneux, and Wilson, 2004).

2.4. Performance of Islamic Banking

The historical existence of Islamic banking system is relatively young and thus there is not much literature on the subject.

However, research done on conventional banks has been very vital in shedding light on the banking industry and consequently a deductive analogy of Islamic financial systems. Dar and Presley (2000) established that the absence of interest earnings in Islamic banking system gives it the attribute of high financial risk in its operations.

Islamic banking operations are primarily based on sharing profit and loss (PLS) between the banks and the investor emanating from any risk related transaction or project. Therefore, this section addresses some of the major research findings and discussions on the issue of profitability in Islamic banks.

It is worth noting that most studies on Islamic banking system have been concentrated in countries in the Middle East region. On this aspect; Bashir (2000) conducted a study to evaluate how Islamic banks performed in eight selected countries in the Middle East. The study involved the analysis of bank characteristics that made them vulnerable to changes in overall economic and financial structure.

To comprehensively cover the subject area, Bashir (2000) sampled fourteen Islamic banks for study mainly from Qatar, Turkey, United Arab Emirates (UAE), Kuwait, Bahrain, Egypt, Sudan and Jordan. Furthermore, the study used the data collected from the banks within the period between 1993 and 1998. Equally important, Bashir (2000) employed four significant performance indicators to evaluate the banks' profit rates including Pre-Tax Profit, Return on Assets (ROA), Non Interest Margin (NIM) and Return on Equity (ROE).

The paper divided the profitability determinant variables into internal and external. First, the internal variables examined included bank size (in terms of capitalization), loan products, ownership structure, leverage, overhead as well as short term funding. Second, external variables were defined as macroeconomic factors, regulatory factors and finally the financial market environment.

The results from Bashir (2000) study largely corresponded to other studies on Islamic banking that indicated a positive relationship between banks' equity and loans on one hand and banks' profitability on the other hand. Therefore, this finding implied that, the higher the level of bank equity and loan products the higher its profit rates would be. In addition, more profits would be realized if the bank enjoyed high leverage alongside increased loans to assets. The findings by Bashir (2000) overwhelmingly pointed to the crucial role played by stable macroeconomic environment in the performance of individual banks as well as overall banking industry.

Hassoune (2002) carried out a comparative study on three regions in the Gulf Cooperation Council (GCC) to determine the profit rates level by comparison of a cycle of interest rate. The paper acknowledges the major differences between Islamic and conventional banking systems as operational based where Islamic banks are based on PLS and conventional banks on interest. In his study, Hassoune (2002) examined the volatility of two performance indicators including ROE and ROA. The paper suggests that the management in Islamic banking system has to be very innovative to make profit since it is unlikely for investors to expect no returns at any particular time.

Bashir and Hassan (2004) statistical analysis revealed that in relation to capital asset ratio, Islamic banks had out paced their conventional commercial counterparts an indication of their heavy capital base. In the measurement of the Islamic bank profitability, Bashir and Hassan (2004) expanded the set of variables to be used in the study to include economic measures, financial structure, and country variables in addition to previously used internal and external variables. Moreover, they replicated performance indicators from Bashir (2000) such as Non Interest Margin (NIM) with special focus on banking fees and foreign exchange. The paper also used Pre-Tax Profit in relation to total assets (PTP/TA) as well as return on assets (ROA) and return on equity (ROE).

The rapid development of Islamic banks especially in the Middle East in the last three decades has largely been facilitated by the economic boom due to increased oil revenues. This indicates that profitability is positively related to economic growth most probably because there are less or no non-performing loans (Bashir & Hassan, 2004).

In addition, Islamic banks' profitability was found to withstand inflation. Profit levels in Islamic banks were also positively influenced by overhead costs (Faisal, 2005).

2.5. Kenya's Banking Sector

In the post independence Kenya, the financial sector has been characterized by both positive and negative growth intervals. Basically, in the first 20 years or so in to the independence the sector was in a state of recession as well as repression. Kamau (2009) has explored the progress of banking industry reforms in Kenya for the last three decades.

According to Kamau (2009), the growth of the financial sector since independence up to early 1980s constrained by severe restrictions of interest rate, control of domestic credit, high bank reserve requirements, financial markets that were highly segmented, undeveloped money and capital markets as well as poor exchange rate and international capital policies. All these were as a result of poor policy framework and lack of visionary leadership in the financial industry. However, with the advice of international financial institutions a reform process was instituted in the late 1980s with the objective liberalizing the financial sector to enhance fair and creative competition, efficiency and productivity (Kamau, 2009). Notably, the reforms were largely targeted towards the central bank to make it more efficient as a supervisory authority and more effective in managing the monetary policy in a free market (Brownbridge & Harvey, 1998). According to Kamau (2009), not until the late 1980s did Kenya's financial sector experience substantial and notable reforms.

2.5.1 Impact of Reforms on Kenyan Financial Sector

The study by Kamau (2009) indicated that financial reforms have had a very positive impact on the banking industry in Kenya especially for the last one decade. The banks have seemingly become more stable and more profitable. Equally important, the reforms have acted as incentives for new entrants in to the industry and consequently improving banking access even to the people in the low income bracket (Kamau, 2009). For example, people seeking small scale financing have options such as K-Rep bank, Family and Equity banks just to name but a few. The exploitation of this market segment has proved to be very rewarding to the emerging financial and banking institution.

For example, within four years of becoming a commercial bank in 2008, Equity bank had already captured 35% of the overall banking sector (Kamau, 2009). Equally important, the last decade has experienced fewer cases of banks going under statutory compared to the period of 1980s and 1990s which saw the collapse of significantly large banks.

In Kamau (2009) findings the only banks that were placed under statutory management by the Central Bank of Kenya included Prudential Bank and Charterhouse Bank. Therefore, the reforms have created a stable financial environment in Kenya. Accordingly, at the helm of the global financial crisis in 2007, the CBK conducted a survey in the Kenyan banking sector and came up with some very interesting findings. First, the banking sector has undergone a radical paradigm shift with major focus turning to the middle level and small scale consumer. This has in turn prompted the banks to come with very innovative retail products and services specific to the new market segment. On this aspect; more and more salaried individuals have become eligible for financial lending on fronts such as mortgages and personal loans (Kamau, 2009).

Second, the traditional banks have been forced to accept the reality of the existence of substantial business opportunities in the retail banking and have thus engaged in an aggressive expansion campaign. Equally important, Kenya as a country has experienced transformation in public governance and this has increase the confidence of foreign financial institutions to take part in the public sector lending.

A CBK (2007) survey found out that, despite some commercial banks opening up to small and medium size enterprises in urban and rural areas, a significantly large percentage of the population were still not banked. In addition, the survey indicated that players in the financial industry were overly uncooperative with each other even on matters of mutual benefits. The CBK (2007) reported the development of Islamic oriented financial services in Kenya. The survey identified a steady growth from conventional offering a window of Shari'ah compliant products and services, to the establishment of full fledged Islamic banking system.

The conventional banks had focused on Islamic banking as a segment market aimed at giving them a competitive edge in the overall banking sector. Such banks included Barclays Bank of Kenya, Kenya Commercial Bank, K-Rep Bank and Dubai Bank.

Therefore, study by the CBK (2007) point out to a banking sector that has become responsive to the consumer needs as well as changing market trends. Accordingly, the political reforms experienced in the country since 2002 have facilitated the growth of the private sector which have exposed the inefficiencies and failures of the public sector. Consequently, this has improved people demands for stable and versatile financial sector.

2.6 Conclusion

This chapter has drawn from previous research significant amount of knowledge on the performance of Islamic banking system since inception. The literature has also identified profitability as the most viable measure and benchmark to compare performance between Islamic and conventional banking systems.

It has been very informative to study literature on different regions of the globe which will be very instrumental to draw an analogy. On this note; previous studies on Islamic banking have cast it as a very viable system of banking which has a lot of compliments to the conventional and traditional system.

Equally important, literature has shown that there is no system of banking that is superior to the other, but rather their difference can only be identified in their mode of operation and time in existence.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Introduction

This chapter provides a discussion of the research methodology which was used in the study. It discussed the research design identifying the population of study, sample and data collection methods as well as data analysis and data presentation methods employed in the study.

3.2. Population

The population of this study comprise the forty-three commercial banks in Kenya as given in appendix 2.

3.3. Sample

The sample of this study was two fully shariah compliant Islamic banks, the Gulf African Bank and First Community Bank on one hand , and five conventional banks in Kenya. The condition for selection of the conventional banks was that they had to be Kenyan bank without branches in other countries. They also each had to be within the fourth tier of Central Bank of Kenya bank classification and each bank had asset base of less than ksh.10 billion.

3.4. Data Collection

Data for the study was sourced from secondary sources including published financial statements of the selected banks and 'The Banking Survey 2011'.

3.5. Data Analysis

The study was aimed at comparative financial performance of Islamic banking vis-à-vis conventional banking in Kenya. Specifically, the study made comparison of the performance of Gulf African Bank and First Community Bank (Islamic banks) and a group of five conventional banks for the period 2008 to 210. Data for each year have been compiled from the income statements and balance sheets of these banks. In the bank performance study, this type of inter-bank analysis is pretty common (Sabi, 1966). In today's competitive financial market, one can better understand the performance of a bank by analysis of inter-bank comparison.

Various indexes have been provided by financial management theories for measuring bank's performance. Using accounting ratios is one of them. To measure performance, financial ratios have been used quite extensively in the literature review. In order to see how Islamic banks have performed in comparison with the conventional banks over the three year period, the study used financial ratios for performance comparison. The bank's performance was compared in four broad areas. These were profitability, liquidity, risk and solvency, and efficiency. Under each measure two ratios were `calculated for each bank in each category and an average for each category. The respective ratios for each bank are compared and then the average for each category compared against the industry averages. The industry averages were extracted from the Banking Survey 2010.

Profitability ratios are used to assess the ability of the business to generate earnings in comparison with all expenses and costs doing business. Profitability ratios are generally considered to be the basic bank financial ratio in order to evaluate how well a bank is performing in terms of profit. For most part if a profitability ratio is relatively higher compared to the competitors, industry averages or previous years, then it is taken as indicator of better performance of the bank. Liquidity ratios indicate the ability of the firm to meet recurring financial obligations. Liquidity is important for a firm to avoid defaulting on its financial obligations and thus avoid financial distress. Bank can get into liquidity problem especially when withdrawals exceed new deposits significantly over a short period of time.

Risk and solvency ratios determine the probability that the firm will become unable to fulfill its contractual obligations. For banks, whether Islamic or conventional, deposits constitute a major liability. To gauge risk and solvency of banks the study used debt to equity and debt to total assets ratios. Efficiency ratios indicate the overall effectiveness of the firm in utilizing its assets to generate sales. Higher values of these ratios are good indications of the firm doing well.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1. Introduction

This study is aimed at comparative financial performance of fully Islamic shariah compliant banking vis-à-vis conventional banking in Kenya. The study specifically makes comparison of Gulf African Bank and First Community Bank (Islamic banks) and five conventional banks performance for the period 2008 to 2010. All the sampled banks are within the fourth tier of the Central Bank of Kenya classification of commercial banks and all had total asset base of less than kshs.10 billion. Data for each year have been compiled from the published financial statements of the banks and the results of the banking survey 2010.

In order to see how the two Islamic banks performed in comparison with the five conventional banks for the three year period, the study used four broad categories of ratios. These are profitability ratios, liquidity ratios, risk and solvency ratios and efficiency ratios.

4.2. Summary of Statistics

Tables 1, 2 and 3 in the appendices show various ratios and figures for 2008, 2009 and 2010, respectively, for each bank in the sample. For both categories of banks a mean for each ratio is indicated as well. The ratios for each bank were compared and comparison also done for the means for each category.

The ratios were then compared against the industry averages. The industry averages were extracted from the banking survey 2011. A summary of the ratios under the broad categories now follows:-

4.2.1. Profitability ratios

4.2.1.1 Return on assets

Return on assets indicates the profitability on the assets of a firm and is a common measure of managerial performance. It indicates how much a firm is earning for each unit of asset invested in the firm. Generally, a higher ratio means better performance.

The tables below show the returns on assets for each bank and the means for each category of banks against the industry averages for the period of the study.

Table 4.2.1(a)

	2008	2009	2010
First Community Bank	-19.32%	-4%	-2.65%
Gulf African Bank	-11%	-2.55%	-0.65%
Fidelity Bank	13.24%	11.98%	14.34%
Transnational Bank	16.15%	16.78%	16.54%
Guardian Bank	13.54%	12.14%	12.12%
Credit Bank	12.13%	13.51%	21.86%
Victoria Commercial Bank	10.84 %	11.96%	11.86%

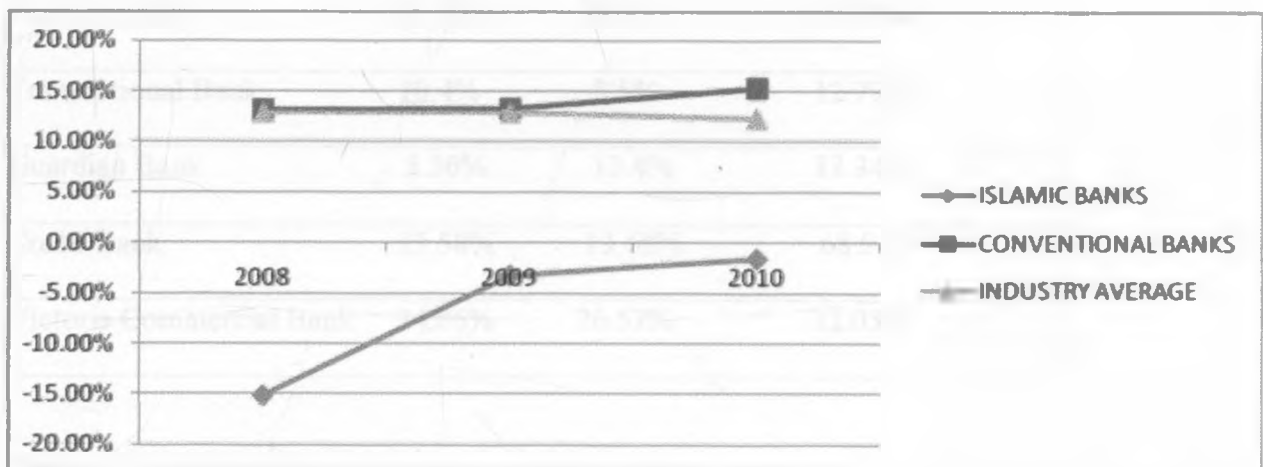The means for each category against industry average was as follows

· Table 4.2.1(b)

	2008	2009	2010
Islamic banks	-15.16%	-3.275 %	-1.6%
Conventional banks	13.18 %	13.27 %	15.34%
Industry average	12.94%	12.91%	12.29%

Table 4.2.1(a) shows that both Islamic banks had negative returns on assets although the there was indication that both banks were showing signs of improvement. The conventional banks were however having positive returns and some even registering returns higher the industry averages in some years. Table 4.2.1(b) shows the average returns on assets for each category against industry averages for each. Again the Islamic banks' were performing poorly compared to the conventional banks although they were showing signs of improvement.

The bar chart and graph below show the comparative means against industry averages.

Returns on assets: Category means against industry averages

Chart 1 (bar chart):
- Y-axis: 20.00%, 15.00%, 10.00%, 5.00%, 0.00%, -5.00%, -10.00%, -15.00%, -20.00%
- X-axis: 2008, 2009, 2010
- Legend: ISLAMIC BANKS, CONVENTIONAL BANKS, INDUSTRY AVERAGE

Chart 2 (line chart):
- Y-axis: 20.00%, 15.00%, 10.00%, 5.00%, 0.00%, -5.00%, -10.00%, -15.00%, -20.00%
- X-axis: 2008, 2009, 2010
- Legend: ISLAMIC BANKS, CONVENTIONAL BANKS, INDUSTRY AVERAGE
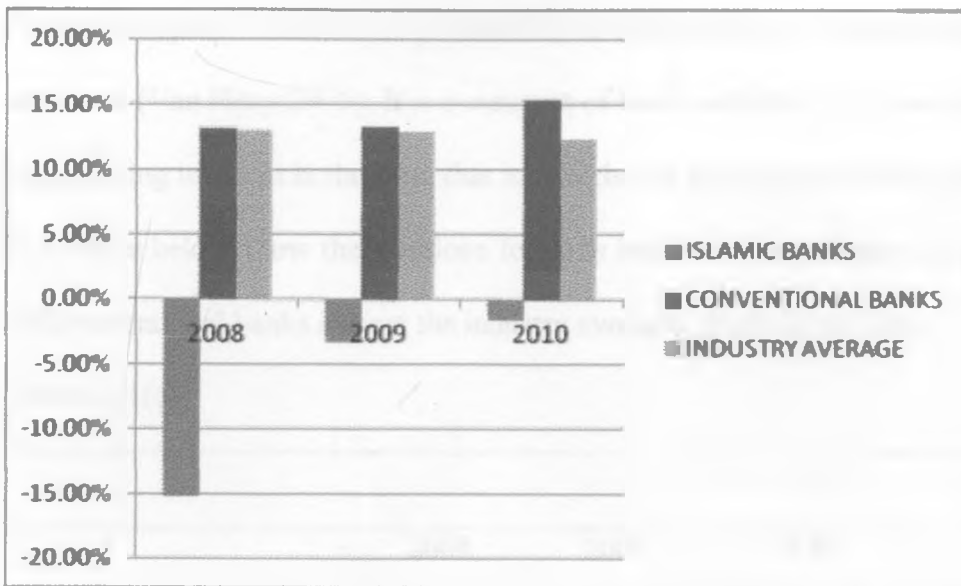
4.2.1.2 Return on equity

Return on equity indicates the profitability to shareholders of the firm after all expenses and taxes (Van Horne2005). It is a measure of how much the firm is earning after tax for each shilling invested in the firm, that is, it is the net earnings per shilling equity capital. The tables below show the positions for each bank and means each category of Islamic and conventional banks against the industry averages for the three years.

Table4.2.1(c)

	2008	2009	2010
First Community Bank	-79.25%	-21.2%	-25.39%
Gulf African Bank	-27.04%	-13.67%	-4.98%
Fidelity Bank	21.31%	12.3%	11.24%
Transnational Bank	10.4%	8.5%	12.79%
Guardian Bank	5.36%	13.4%	37.34%
Credit Bank	13.58%	13.68%	68.91%
Victoria Commercial Bank	24.86%	26.57%	32.03%

Table 4.2.1(d) Means for each category against industry averages

	2008	2009	2010
Islamic banks	-53.1%	-17.45%	-15.2%
Conventional banks	15.19%	14.89%	32.46%
Industry average	34.7%	31.8%	34.5%

The Islamic banks were in the three years making losses and consequently the negative returns on equity. For the conventional banks sampled the returns on equity were below the industry averages although in 2010 the variance was smaller than in the previous two years.

The bar chart below is representation of the results in table 4.2.1(d)
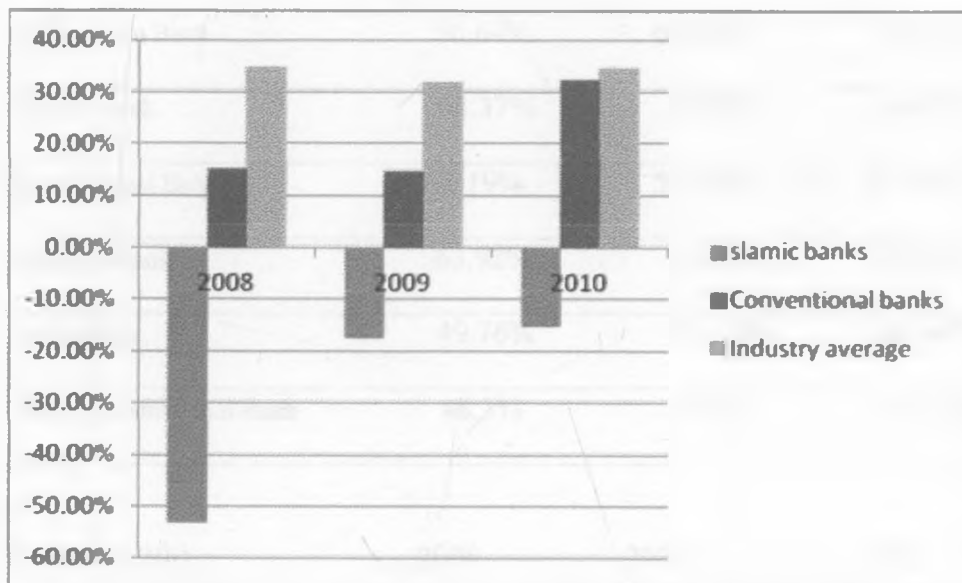
It can be concluded that based on the above data, the conventional banks were more profitable than the Islamic banks for the period of the study

4.2.2. Liquidity ratios

4.2.2.1 Loans (net) to asset ratio

The loan to asset ratio measures liquidity of a bank in terms of its total assets. This is the percentage of total assets that the bank has invested in loans and the higher the ratio the less liquid the bank is. Although a lower ratios mean more liquidity for a bank it may result in less income if the surplus funds are not invested elsewhere to earn more income.

The tables below show the positions for each bank and the average of each category against industry averages for the three years.

Table 4.2.2(a)

	2008	2009	2010
First Community Bank	27.3%	51.45%	46.76%
Gulf African Bank	36.64%	63.68%	65.36%
Fidelity Bank	64.37%	59.89%	54.49%
Transnational Bank	42.19%	50.19%	41.82%
Guardian Bank	63.92%	60.82%	58.93%
Credit Bank	49.76%	51.32%	42.54%
Victoria Commercial Bank	48.3%	50.2%	41.53%

Table 4.2.2(b)	2008	2009	2010
Islamic banks	31.97%	57.67%	56.06%
Conventional banks	53.71%	54.48%	47.86%
Industry average	53.79%	52.03%	51.98%

Both Islamic banks had loans to assets ratios, individually and average for both, in 2008 but in 2009 both had higher than industry average ratios. Table 4.2.2(b) shows that except for their first of operation, the Islamic banks' average loans to assets ratio were higher the average for the conventional banks and higher than industry averages. However the variance was not very significant. The following chart demonstrates this:-

Loans to assets (%)
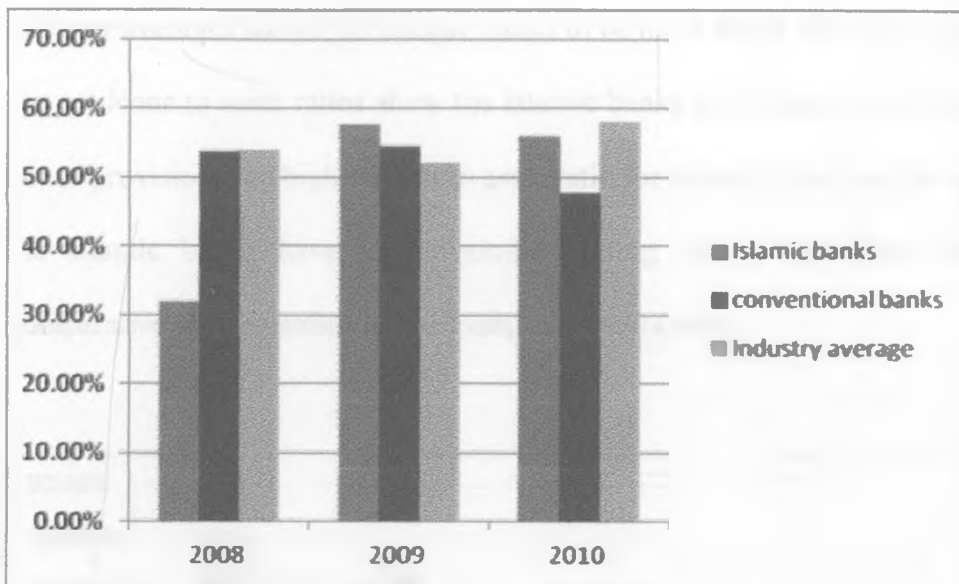
4.2.2.2 Loans to Deposit Ratio

This is the most important ratio to measure the liquidity condition of a bank. Here, loans mean the advances for conventional banks and financing for Islamic banks. Generally, banks with low loans to deposit ratio are considered to have excessive liquidity, potentially lower profits and hence less risk compared to the banks with high loans to advances ratio. However, high loans to deposit ratio indicates that a bank has taken more financial stress by making excessive loans.

The following table shows the comparative positions for loans to deposit ratios:

	2008	2009	2010
Islamic banks	48.88%	70.23%	64.3%
Conventional banks	80.93%	73.68%	69.64%
Industry averages	71.83%	68.67%	69.16%

40

The lower ratios for the Islamic banks compared to the conventional banks and the industry averages shows the Islamic banks to be more liquid. However, in 2009 and 2010, the net loans to asset ratios show the Islamic banks to be less liquid. Since the loans are net of provisions the higher loans to asset ratio for Islamic bank may be an indication that the Islamic banks have lower non-performing loans. The chart below shows the comparative representation of the loans to deposits ratios.
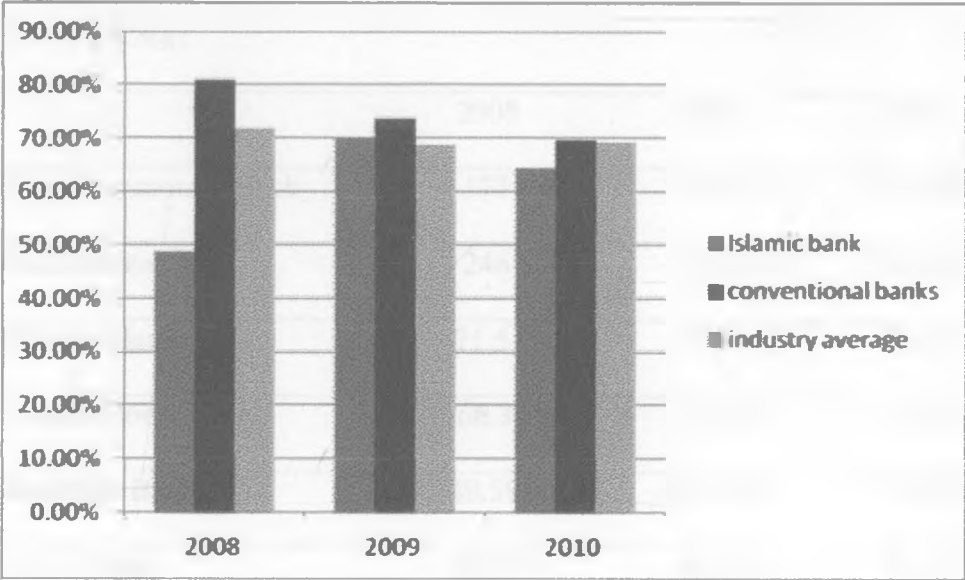
4.2.3. Effeiciency ratios

These ratios measure how effectively and efficiently the firm is managing and controlling its assets. These ratios indicate the overall effectiveness of the firm in utilizing its assets to generate sales, quality receivable, and how successful the firm is in its collection, the promptness of payment, etc. Higher values of these ratios are taken as good indicator which means the firm is doing well.

4.2.3.1 Cost to income ratio

This ratio measure the amount of expense incurred for every shilling of income generated. This is the most commonly and widely used ratio in banking sector to assess the managerial efficiency in generating total income vis-a-vis controlling its operating expenses. Lower ratio is indicative of better the performance.

The following table shows the position for each bank and averages for each category against the industry averages:

Table 4.2.3(a)

	2008	2009	2010
First Community Bank	177.9%	145.1 %	130.95%
Gulf African Bank	246.8%	246.56%	131.24%
Fidelity Bank	71.51%	79.64%	56.1%
Transnational Bank	66.39%	93.1%	66.2%
Guardian Bank	49.59%	45.95%	60.77%
Credit Bank	46.74%	46.93%	44.56%
Victoria Commercial Bank	45.7%	46.21%	39.78%

Table 4.2.3(b)

	2008	2009	2010
Islamic banks	212.4%	195.84%	131.1%
Conventional banks	55.99%	61.77%	54.48%
Industry average	56.56%	60.23%	54.44%

The above figures shows Islamic banks to be far less efficient than the conventional bank going by this ratio. In 2008 the Islamic banks had to spend sh.21.2 to generate sh.1 in income while the conventional banks incurred fifty seven cent in expense to generate sh.1 in revenue. The conventional banks were operating well within the industry averages.

4.2.3.2 Asset utilization

How effectively the bank is utilizing all of its assets is measured by asset utilization ratio. The bank is presumably said to be using its assets effectively in generating total revenues if the asset utilization ratio is high.

If the ratio is low the bank is not using its assets to their capacity and may even have to dispose off some idle/underutilized assets. This is a measure of how much in revenue is generate for every shilling investment in assets.

The comparative ratios for each bank and averages for each category against industry averages were as follows:

	2008	2009	2010
First Community Bank	0.8%	7.7%	8.56%
Gulf African Bank	5.4%	8.09%	8.84%
Fidelity Bank	13.23%	11.97%	14.36%
Transnational Bank	16.15%	16.78%	15.45%
Guardian Bank	13.54%	12.14%	12.12%
Credit Bank	12.11%	13.51%	14.36%
Victoria Commercial Bank	10.94%	11.96%	11.6%

	2008	2009	2010
Islamic banks	3.1%	7.9%	8.7%
Conventional bank	13.9%	13.27%	13.58%
Industry average	15.2%	14.86%	15.89%

In all the three years Islamic banks asset utilization ratio was both low and far below the industry average and the sampled conventional banks in the same tier.

The low asset utilization ratio for Islamic banks may be indicative of idle capacity as the banks are still infancy stages which with time and the banks get a foothold in the market may improve as can be seen from the upward trend over the three years.

4.2.4. Risk and Solvency Ratios

These ratios are indications of the probability of a firm defaulting on its debt obligations. The higher the level of debt, the higher the chance of default on debt obligation and therefore, financial distress.

4.2.4.1 Debt to Total Assets ratios

This is an indicator of financial strength of a bank and provides information about the solvency and the ability of the firm to obtain additional financing for potential investment. The higher the ratio the higher the proportion of bank assets financed through debt and therefore the riskier the bank.

The tables below show the comparative positions of each bank and average for each category against the industry averages:

	2008	2009	2010
Islamic banks	75.25%	85.14%	89.19%
Conventional banks	80.43%	80.15%	81.48%
Industry average	86.13%	85.96%	84.32%

Except for the year 2008, Islamic banks had higher ratios compared to the conventional banks and in 2010 the Islamic banks even had ratio which was even higher than the industry average.

The variance between the two however was not so big to give a clear indication of which category of bank was less solvency and therefore riskier.

4.2.4.2 Non-performing loans as percentage of total loans

As banks lend money there is the inevitable consequence of some loans and advances going bad and becoming uncollectible. Banks have therefore to constantly monitor their loan portfolio and make provisions for any possible losses. Higher percentage of non-performing loans means higher provisions and more possibility of eventual write-offs of some of the loans.

The risk associated with non-performing loans is the single most likely cause of any bank collapse. The following table shows the percentage of non-performing loans in comparison to total loans and advances with industry average for each year.

	2008	2009	2010
Islamic banks	0	0.2%	4.79%
Conventional banks	9.35%	9.67%	9.22%
Industry average	7.02 %	6.82 %	5.27%

The above results show Islamic banks to have lower percentage of non-performing loans compared to the conventional banks. The years 2008 and 2009 do not provide accurate positions because these were the very initial years when Islamic banks started operating. It is worth noting that by the third year of operations Islamic banks were just slightly lower than the industry average in percentage of non-performing loans. Indeed the sudden increase from 0.2% in 2009 to 4.79% in 2010 may be a pointer that Islamic banks may be likely to face more problems of no-performing loans and advances than the conventional banks.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Summary

Analysis of the results makes it possible to shade light on the findings and draw some conclusions. The analysis of profitability measures indicates that conventional banks are more profitable and significantly different from Islamic banks in both return on equity and return on assets. However, on both returns the Islamic banks are showing markedly improvements although even by the third year of operation they were still making losses and having negative returns on assets and equity. One possible explanation for the significant differences in profitability is that Islamic banks still have to absorb huge amounts of startup expenses which are eroding their incomes.

Islamic banks are more liquid than the conventional banks. The loans to deposit ratio for Islamic banks was lower than for conventional banks and remained below the industry average except in 2009. The loan to assets ratio for Islamic banks, on the other hand, was higher than the conventional banks and industry average in 2009 and 2010. Generally however, the loans to deposit ratio is better indicator of liquidity than loans to assets ratio. Islamic banks, would, because of limited avenues of investing idle funds in a conventional environment, be expected to be more liquid than conventional banks which can invest in many interest- bearing instrument. Higher liquidity is not necessarily a measure of better performance because it would in turn lead to less profitability as is the case with the Islamic banks.

The measures operating efficiency show conventional banks to be doing better than Islamic banks. An analysis of risk and solvency ratios shows conventional banks to be more risky although more stable than Islamic banks which, although less risky are showing increasing risk levels.

5.2. Conclusion

The comparison of the performance of the Islamic banks and conventional banks has been based on their performances with regard to profitability, liquidity, operating efficiency and risk and solvency of the banks.

Two ratios in each broad category of performance measures were considered in the analysis. Ratios for individual banks have been calculated from the published financial statement and for each category means for each ratio is also calculated. For purpose of performance comparisons the means for Islamic and conventional banks are what is used. These means are also compared against industry averages.

The results indicate that Islamic banks in Kenya performed poorly compared to conventional counterparts in two out of the four measures used. The Islamic banks are more liquid than the other banks but less efficient, and less profitable than the conventional banks. On risk and solvency, there is not a significant difference between the two. While in two of the three years the Islamic banks higher debt to asset ratio indicating more reliance on debt and therefore more risky, the difference was not very significant.

The percentage of non-performing loans in the years 2008 and 2009 may be misleading because the Islamic banks, having just started operating did not have significant amounts of loans. However by 2010 there was huge increase in the ratio for Islamic bank but the conventional banks' ratio remained fairly stable. This may be an indication that in future Islamic banks are likely to experience more problems of non-performing loans than conventional banks.

One possible reason why the Islamic banks are more liquid than conventional banks is the fact that the Islamic banks have limited avenues through which to invest funds in a conventional environment because of Shariah compliance requirements. For example, Islamic banks cannot participate in the interbank overnight lending and cannot invest in treasury bills and bonds as these instruments are interest bearing which shariah prohibits. These therefore make the Islamic banks to be holding surplus funds which in turn make them less profitable.

Islamic banking in Kenya is still in infancy stage as well as operating in conventional environment which impose limitations. This notwithstanding, on the whole, the results of the analysis show conventional banks to be better performing than the Islamic banks.

5.3 Limitations of the Study

The study covered a period of only three years which may not be long enough for trend·analysis. Further, the Islamic banks had merely started operating in Kenya and being a new concept in banking they are yet to be understood and accepted as a possible alternative to conventional banks. The study has also used four broad measures of performance and under each considering two ratios as indicators of performance using a model commonly referred to as *CAMEL* rating. This model only looks at financial performance and ignoring non-financial measures. Other performance measures one could consider may include but not limited to corporate social responsibility, staff morale and loyalty, and customer satisfactions.

The sample for the study was seven banks out of the forty-three commercial banks in Kenya. The size of the sample may also be a limitation as possibly with larger sample different results could have been achieved.

5.4. Suggestion for future research

For future studies, as time goes by, when there will be more Islamic banks to study and for longer period of time, a similar study would generate better insight on the performance of Islamic and conventional banks in Kenya and provide solid evidence. A future study could also consider large samples and carry out performance comparison using a combination of models.

Possible areas of study would include the concept of Profit and Loss Sharing (PLS) in Islamic banking vis-à-vis the conventional banking charging of interest on loans and advances.

One may also be interested in how to come up with innovative Islamic financing products in a conventional environment, including Islamic bonds (sukuk) and other financing products. Of interest may also be how to regulate Islamic banks in a conventional environment in compliance with shariah.

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Appendix 1: Commercial Banks in Kenya

1 Kenya Commercial Bank Ltd

2 Standard Chartered Bank Ltd

3 Barclays Bank of Kenya Ltd

4 Co-operative Bank of Kenya Ltd

5 CFCStanbic Bank Ltd

6 Equity Bank Ltd.

7 Bank of India

8 Bank of Baroda Ltd

9 Commercial Bank of Africa Ltd

10 Prime Bank Ltd

11 National Bank of Kenya Ltd

12 Citibank N.A.

13 Bank of Africa Kenya Ltd

14 Chase Bank Ltd

15 Imperial Bank Ltd

16 N I CBank Ltd

17 Ecobank Ltd

18 I & M Bank Ltd

19 Diamond Trust Bank Kenya Ltd

20 Family Bank Ltd

21 Habib Bank Ltd

22 Oriental Commercial Bank Ltd

23 Habib A.G. Zurich

24 Middle East Bank Ltd

25 Dubai Bank Ltd

26 Consolidated Bank of Kenya Ltd

27 Credit Bank Ltd

28 Transnational Bank Ltd

29 African Banking Corporation Ltd

30 Giro Commercial Bank Ltd

31 Equatorial Bank Ltd

32 Paramount Universal Bank Ltd

33 Jamii Bora Bank Ltd

34 Fina Bank Ltd

35 Victoria Commercial Bank Ltd

36 Guardian Bank Ltd

37 Development Bank of Kenya Ltd

38 Fidelity Commercial Bank Ltd

39 Charterhouse Bank Ltd

40 K-Rep Bank Ltd

41 GulfAfrican Bank Ltd

42 First Community Bank Ltd

43 UBA Bank Ltd