

COMPARATIVE FINANCIAL PERFORMANCE OF ISLAMIC BANKS
AND CONVENTIONAL BANKS IN KENYA

SIAT MOHAMED JAMAL

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DECLARATION

STUDENT

This research project is my original work and has not been presented for an award of any degree to any other University or Institution of Higher Learning.

Signed: _____

Date: _____

Name: **SIAT MOHAMED JAMAL**

REG. No. D61/68219/2011

SUPERVISOR

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

Signed: _____

Date: _____

Name: **MR. JAMES NG'ANG'A**

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DEDICATION

This study is dedicated to my parents, brothers and sister for believing in me, encouraging and supporting me throughout this great course. May God bless them.

ABSTRACT

Banks as financial institutions play an important role in the development of an economy. It functions as intermediary linking surplus and deficit units; facilitate funds for productive purpose and thereby contributes to economic development. Therefore, their financial performances are of concern to decision makers such as investors, borrowers and savers. In Kenya, both Islamic (interest free) banks and Conventional (interest based) banks operates offering various products and services. The study evaluated and compared financial performance of Islamic banks and conventional banks in Kenya during year 2010 to 2012 to establish whether there are significant differences between the financial performances of the two banking category. Data for the study were mainly extracted from financial statements of the sampled banks where Gulf African Bank and First Community represented the Islamic Banks while Giro Bank and K-Rep Bank represented the conventional Banks. CAMEL model, a financial ratio based model, representing Capital adequacy, Asset quality, Management quality, Earnings and Liquidity was employed in analysis of the financial performances and mean ratios of each category were compared through inter-bank analysis. Finally, T-test was carried out to establish whether there are significant differences between the financial performances of the two banking category. Ms-Excel was mainly used in carrying out the data analysis. The study revealed that Conventional banks outperformed Islamic banks in overall financial performances during the study period though there was no significant difference between the financial performances of the two banking categories.

TABLE OF CONTENTS

DECLARATION	ii
ACKNOWLEDGEMENT	iii
DEDICATION	iv
ABSTRACT.....	v
TABLE OF CONTENTS	vi
LIST OF TABLES	ix
ABBREVIATIONS.....	x
CHAPTER ONE	1
INTRODUCTION.....	1
1.1 Background.....	1
1.1.1 Financial performance of Islamic banks.....	2
1.1.2 Financial performance of Conventional banks	4
1.1.3 Financial performance of Islamic Banks and Conventional banks.....	5
1.2 Research Problem.....	6
1.3 Research Objective.....	7
1.4 Value of the Study.....	7
CHAPTER TWO	9
LITERATURE REVIEW.....	9
2.1 Introduction.....	9

2.2 Theoretical Review.....	9
2.3 Empirical Review	14
2.4 Summary/Conclusion	22
CHAPTER THREE.....	23
RESEARCH METHODOLOGY	23
3.1 Introduction.....	23
3.2 Research Design.....	23
3.3 Population	23
3.4 Sample Design	24
3.5 Data Collection.....	24
3.6 Data Analysis	25
CHAPTER FOUR.....	29
DATA ANALYSIS, RESULTS AND DISCUSSION	29
4.1 Introduction.....	29
4.2 Capital Adequacy	29
4.3 Assets Quality	31
4.4 Management Efficiency.....	33
4.5 Earnings Quality.....	35
4.6 Liquidity.....	37
4.7 Overall Financial performance.....	39

CHAPTER FIVE.....	41
SUMMARY, CONCLUSION AND RECOMMENDATIONS.....	41
5.1 Introduction.....	41
5.2 Summary.....	41
5.3 Conclusion and Recommendations	42
5.4 Limitations	42
5.5 Suggestions for Further Research	43
References.....	44
Appendix 1-Licensed Banks in Kenya	49

LIST OF TABLES

Table 1: Differences between Islamic Banks and Conventional.....	11
Table 2: Capital Adequacy Ratios for the Period 2010-2012, Compiled by MS-Excel....	30
Table 3: Two tailed T-test on Capital Adequacy Analysed by MS-Excel.....	30
Table 4: Net non-performing Assets/ Net Advances Ratios for the Period 2010-2012, Compiled by MS-Excel.....	32
Table 5: Two tailed T-test on Asset Quality Analysed by MS-Excel.....	32
Table 6: Operating Expenses/ Operating Incomes Ratios for the Period 2010-2012, Compiled by MS-Excel.....	34
Table 7: Two tailed T-test on Management Efficiency Analysed by MS-Excel.....	34
Table 8: Return on Asset Ratios for the Period 2010-2012, Compiled by MS-Excel.....	35
Table 9: Two tailed T-test on Earnings Quality Analysed by MS-Excel.....	36
Table 10: Liquidity Ratios for the Period 2010-2012, Compiled by MS-Excel.....	37
Table 11: Two tailed T-test on Liquidity Ratios Analysed by MS-Excel.....	38
Table 12: Overall Financial performance composite ranking, compiled by Ms-Excel....	39
Table 13: Two tailed T-test on Overall Financial performance Analysed by MS-Excel....	39

ABBREVIATIONS

CBK-Central Bank of Kenya

CBs-Conventional Banks

GCC-Gulf Cooperation Council

IBs-Islamic Banks

PBUP-Peace Be Upon Him

PLs-Profit Loss Sharing

CHAPTER ONE

INTRODUCTION

1.1 Background

Banking sector constitute a major financial service sector affecting economic development. The stability and growth of any economy to a great extent depend on the stability of its banking sector. It functions as intermediary linking surplus and deficit units; facilitate funds for productive purpose and thereby contributes to economic development. CBK (2013) as at May 31, 2013, the Kenyan banking sector comprised 43 commercial banks, 1 mortgage finance company, 8 deposit taking microfinance institutions, 106 foreign exchange bureaus and 2 credit reference bureaus.

Sehrish et al (2012) banks as financial institutions play an important role in the development of an economy hence their financial performances are of concern to decision makers such as investors, borrowers and savers. Siraj and Sudarsanan (2012) a major tool used to assess the financial performance of any commercial organization is its Profitability reflected in various indicators that include Operating Profit Ratio (OER), Net Profit Ratio (NPR), Return on Asset (ROA), Return on Share capital (ROCA) and Return on Total Equity (ROE). The above-mentioned ratios indicate the relationship of profit on total income, total asset, share capital and total equity. The efficiency with which an organization manages its operating expenses is highlighted in Operating Expenses Ratio. Another major indicator of financial performance is capital adequacy and is measured

using Equity to Asset Ratio, calculated by dividing total equity by total assets. A higher ratio indicates low risk and represents a higher share of ownership fund in total asset of the bank.

In Kenya, both Islamic (interest free) banks and Conventional (interest based) banks operates offering various products and services. This study focused on a comparative financial performance evaluation of Islamic banks and conventional banks in Kenya.

1.1.1 Financial performance of Islamic banks

Moin (2008) defined Islamic banking as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid by Islamic Shariah (law). Islamic law prohibits the payment and collection of riba (interest or usury). The main argument against interest is that money is not used as a commodity with which to make a profit but that it should be earned on goods and services only, not on control of money itself. Features of Islamic Banking are based on ethical principles. Islamic Shari'ah allows all economic activities in the framework of protecting public interest and safeguarding it. Man may make profit from doing business. However, when this runs against Islamic ethics and morality, it is outlawed. Islamic banking is based on certain ideologies. Firstly, Islamic banking prohibits the individual to indulge in any transactions that bear interest. Secondly, Islamic banks should deal in trading or consumption of activities that are deemed to be allowed (halal) by Islam and should refrain from activities that are forbidden (haram). Lastly, Islamic banking should not indulge in any transaction that involves speculation (gharar)

& Islamic financial institutions should abide by financial and accounting standards that are in line with the Sharia.

Ansari and Rehman (2011) the concept of Islamic banking was accelerated in 1940's. By 1970's this concept reached to its climax particularly in middle east and generally in all over the Islamic world. With the passage of time all the Muslim countries made Islamic banks a major tool to their economy. In no time this concept flourished in Africa, North America, Asia and Europe as well. At the moment, in almost 70 countries, about 300 Islamic financial institutions are working efficiently with capital investments worth \$500-800 billion. Aggarwal & Yousef (2000) the market share of Islamic Banks has grown from around two percent in the 1970s to around fifteen percent in the 1990s. The growth of Islamic banking in short period of time has surprised everyone including western financial experts and analysts.

Harris (2012) Islamic banking in Kenya is fast growing with Barclays Bank of Kenya being the first to test the waters in 2005 when it offered current account products through its Islamic window. Subsequently two Islamic banks were licensed by the CBK in 2007, Gulf African Bank and First Community Bank which opened for business in early 2008. Both banks have grown to collectively command a market share of 1% of the banking sector over the last three years. They broke even in a relatively short period of time given the Kenyan and global scenario prevailing in 2008 and 2009. Gulf African Bank broke even in less than two years, while it took First Community Bank three years to break even. In addition, several conventional banks now offer Shariah compliant products as part of their product range through specifically created Islamic banking divisions or

windows. It is estimated that these windows command another 0.25% of the market, thereby bringing Islamic banking to approximately 1.25% of the banking sector.

1.1.2 Financial performance of Conventional banks

Parashar and Venkatesh (2010) Conventional banks are banks that follow the age old convention of interest-based mobilization of funds and lending. The charged interest reflects the price of credit and signifies the opportunity cost of capital. Thus, conventional banking is based on debtor-creditor relationship between depositor and the bank, on the one hand, and borrower and bank, on the other. Siraj and Sudarsanan (2012) conventional banking based on interest prevails across the world.

Conventional banks are the major players in the Kenyan banking sector commanding approximately 99% of the market share. CBK (2013) the Kenyan Banking sector registered improved growth in assets in the year to May 2013 driven by growth in deposits, injection of capital and retention of profits. The sector registered improved financial performance in earnings and capital and the level of non-performing loans reduced compared with a similar period in 2012. The banking sector's aggregate balance sheet rose by 15.4 percent from Ksh 2,168 billion in May 2012 to Ksh 2,501 billion in May 2013. The main items of the balance sheet were loans and advances, government securities and placements; which accounted for 55.4 percent, 22.1 percent and 5.7 percent of total assets, respectively. The banking sector registered 11.3 percent growth in pre-tax profits, from Ksh 43.8 billion in May 2012 to Ksh 48.7 billion as at end of May 2013.

1.1.3 Financial performance of Islamic Banks and Conventional banks

Parashar and Venkatesh (2010) the philosophy and fundamental tenets of Islamic banking are different from the conventional banking. The foundation of Islamic banking is based on the Islamic faith and Islamic banks must stay within the limits of Islamic law or the Shariah in all of its actions and deeds. Conventional banks on the other hand follow the age old convention of interest-based mobilization of funds and lending.

Mohamad et al (2008) conventional banks enjoy several advantages over Islamic banks. For example, conventional banks have very long history and experience, accept interest which is a major source of bank revenues, do not share loss with clients and ask for guaranteed collaterals in most transactions, enjoy very huge capital, spread interest (on borrowings/savings) widely, have much more developed technologies, and can enter Islamic banking market (*e.g.* Citibank, Bank of America, Deutsche Bank, ABN, AMRO, USB, HSBC, and ANZ Grindlays).

Moin (2008) compared the financial performance of first Islamic bank in Pakistan with a group of 5 conventional banks for a period of 2003-2007. He found that Islamic bank is less profitable, less risky and also less efficient compared to Conventional banks. However, there is no significant difference in liquidity between the two sets of banks. Johnes et al (2008) using financial ratios, found that Islamic banks are less cost effective while more profit and revenue effective as compared to conventional banks.

1.2 Research Problem

Sehrish et al (2012) banks as financial institutions play an important role in the development of an economy hence their financial performance are of concern to decision makers such as investors, borrowers and savers. In Kenya, both Islamic (interest free) banks and Coventional (interest based) banks operates offering various products and services.

Beck et al (2010) compared the two types of banking and their financial performance across many countries, during recent crisis and conclude that though both types of banking were affected by the crisis, Islamic banks had higher capitalization coupled with higher liquidity reserves resulting in better financial performance of Islamic banks. Parashar and Venkatesh (2010) during the global crisis, Islamic banks suffered more in terms of capital ratio, leverage and return on average equity, while conventional banks exhibited a poor financial performance in return on average assets and liquidity. Halkano (2012) Islamic banks in Kenya are more liquid and less risky than the conventional banks. Conventional banks on the other hand performed better in profitability and efficiency.

Globally, various empirical studies have been conducted to compare the financial performance of Islamic banks with that of Conventional banks in different regions during different periods. However, the volume of such researches is limited due to the fact that the data of Islamic banks have been unavailable due to their recent growth (Merchant, 2012).

Locally, comparative studies on Islamic and Conventional banks financial performance are also few due to recent emergence of Islamic banking in Kenya. Harris (2012) Islamic banks were licensed by the CBK in 2007, Gulf African Bank and First Community Bank, which opened for business in early 2008.

Comparative studies on financial performance of Islamic and conventional banks are limited both globally and locally. Therefore, this study sought to fill the research gap especially locally by answering the research question “Is there any significant difference between Islamic banks’ financial performance and the conventional banks financial performance in Kenya?”

1.3 Research Objective

The objective of the study was to compare the financial performance of Islamic banks and conventional banks in Kenya. Specifically, the research sought to establish if there is significant difference in the financial performance of the two banking categories.

1.4 Value of the Study

The evaluation of bank financial performance is very useful for decision making, whether by investors, savers, borrowers or policy makers. Investors shall benefit by understanding the financial performance dynamics of both Islamic and conventional banks thus making appropriate investment decision. Savers and Borrowers shall also appreciate the mode of operations of both Islamic and conventional banks hence enabling them to choose where to save or borrow. Managers and regulatory agency shall use this study to understand

better Islamic and conventional banking models so as to set appropriate policies or strategies. As for students and researchers in finance and banking, this study shall be an invaluable reference for studies and further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This section focuses on and highlights the researches that have been conducted on the subject. This gives an idea on Islamic and conventional banks and their financial performances in different regions during different periods.

2.2 Theoretical Review

Islamic banking and conventional banking approach business differently and traced its origin to specific focus groups. Beck et al (2010) conventional banking is often traced as ‘western banking’ while Islamic banking rooted its origin in Middle East (Wilson, 2009).

Ansari and Rehman (2011) Islamic banking has distinct modes of operations as compared to conventional banks and was started in the 1970s to address the problem of Riba. The committed and resourceful individuals, professional bankers, Islamic economists and religious scholars are attributed to be pioneer of Islamic banking. Its philosophies and principles are, however, not new having been outlined in the Holy Qur’an and the Sunnah of Prophet Muhammad (p.b.u.h.) more than 1,400 years ago. The emergence of Islamic banking is often related to the revival of Islamic financial system which is totally usury (Riba) free. There was no initial working model to act upon, except the thought that interest-based banking might be replaced by banking on the basis of profit-and-loss

sharing. The basic purpose of Riba-free financial system was the elimination of all interest based transactions. Effort for the establishment of this system took place when the financial system at large, as also the regulatory environment, was Riba-based.

Sehrish et al (2012) the main objective of Islamic Banking is to develop an environment of interest (Riba) free financing. The reason of interest free financing is to eliminate the fixed return on capital. Islamic Shariah prohibits the effort less and risk free transactions. In this regard, Islamic banking offers different products on the basis of profit and loss sharing principle of Shariah. Islamic modes of finance are used for leasing and other financial contracts. Islamic banks are mainly concerned to eradicate Interest based financing by promoting risk sharing practices for the welfare of economy.

Zaharuddin and Abdirahman (2007) one must refrain from making a direct comparison between Islamic banking and conventional banking (apple to apple comparison). This is because they are extremely different in many ways. The key difference is that Islamic banking is based on Shariah foundation. Thus, all dealing, transaction, business approach, product feature, investment focus, responsibility are derived from the Shariah law, which lead to the significant difference in many part of the operations with as of the conventional. The table below summarises the unique features of the two banking groups for better understanding of the conventional and Islamic banking:-

Table 1¹ Differences Between Conventional and Islamic Banking

	Conventional Banks	Islamic Banks
1.	The functions and operating modes of conventional banks are based on fully Manmade principles.	The functions and operating modes of Islamic banks are based on the Principles of Islamic <i>Shariah</i> .
2.	The investor is assured of a Predetermined rate of interest.	In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
3.	It aims at maximizing profit without any restriction.	It also aims at maximizing profit but subject to <i>Shariah</i> restrictions.
4.	It does not deal with <i>Zakat</i> .	In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a <i>Zakat</i> Collection Centre and they also pay out their <i>Zakat</i> .
5.	Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.	Participation in partnership business is the fundamental function of the Islamic banks. Hence the need to understand the customer's business very well.

¹ Zaharuddin and Abdirahman (2007), Difference between Islamic & Conventional Banks: <http://zaharuddin.net>

6.	It can charge additional money (penalty and compounded interest) in case of defaulters.	The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion.
7.	In it very often, bank's own interest becomes prominent. It makes no effort to ensure growth with equity.	It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
8.	For interest-based commercial banks, borrowing from the money market is relatively easier.	For the Islamic banks, it must be based on a Shariah approved underlying transaction.
9.	Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.
10.	The conventional banks give greater emphasis on credit-worthiness of the clients.	The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
11.	The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller.

12.	A conventional bank has to guarantee all its deposits.	Islamic bank can only guarantee deposits for deposit account, which is based on the principle of <i>al-wadiah</i> thus the depositors are guaranteed repayment of their funds, however if the account is based on the <i>mudarabah</i> concept, client have to share in a loss position.
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Mohamad et al (2008) state that conventional banks generate income from the spread amid the interest rate charged to the debtors and the interest rate paid to the depositors. There are other set of conventional banks that indulge in the non-traditional approaches that are in the form of deposit and lending principle. Deposit and lending activities are carried out by institutions such as credit card institutions or mortgages dealing institutions. Earning generated by undertaking such activity is through selling loans and then earning profits by charging the debtors with fees. In contrast, the Islamic method of banking and its associated ideologies are resulting from the Holy Quran, the traditions of Prophet Muhammad (PBUHP) and through the narrations of followers of different Fiqh. Fiqh is well-defined as the presentation of sharia that is assumed to be of different schools of thought. The maturity of Islam with time led to development of diverse schools of thoughts i.e. Hanafi, Maliki, Shafi'I, Hanbali and Ja'afariya. Islamic banking arrangement is a lone and dynamic execution of the Islamic legal code or Sharia. Islamic banks are repeatedly branded as a banking system that forbids interest on loans and deposits. But this is not the only difference between Islamic and conventional bank.

Though Islamic bank rejects and disallows the notion of interest on transactions, Islamic banks do not discard the time value of money. It provides the financier the benefits of a suitable income on money. The following explains the idea: Firstly, the benefit received by the institution by lending the fund to the borrower for a specific time is not predetermined. This means that the benefit received by the lender will be a share in the revenue that has been earned from the undertaking carried out by the borrower. Secondly, in event of financing for acquiring tangible goods by the investor through sales or lease, the investors might compensate themselves for the opportunity sacrificed. Profits that are therefore derived from the sale or the lease reflect the time value. The fundamental justification of Islamic banking is that individuals are not considered as creditors; relatively they are associates in any undertakings. As per the Islamic code of conducts individuals are refrained from dealing in any kind of transactions that comprise of Riba (interest).

Khan (2012) Islamic banks lend funds to the debtors on the basis of Profit and Loss sharing system (PLs). Under this arrangement, the associates agree to share the profits and losses on the basis of share in the capital and the efforts undertaken. Hence, PLs concept does not favor the fix rate of return on the asset. This theory therefore rejects the notion of conventional bank system as Islamic banks do not commit any rate of return.

2.3 Empirical Review

Samad and Hassan (2000) analyzed the financial performance in terms of profitability, liquidity, risk and solvency, and community involvement of a Malaysian bank, Bank Islamic Malaysia Berhad, compared to eight (8) conventional banks for the period 1984-

1997. Financial ratios were applied in measuring these financial performances while T-test and F-test were used in determining their significance. The findings described that the bank was a liquid bank and it was supposed not to have any liquidity issues i.e. the liquidity shortage. The study established that Bank Islamic Malaysia Berhad was comparatively less risky, less profitable and more solvent as compared to conventional banks. Analysis of the primary data identified reasons why the supply of loans under profit sharing and joint venture profit sharing is not popular in Malaysia. 40% to 70% bankers surveyed indicated that lack of knowledgeable bankers in selecting, evaluating and managing profitable project is a significant cause.

Iqbal (2001) analyzed the financial performance of Islamic banks and conventional banks by comparing both types of 12 banks of same size during 1990-1998. The financial performance measures were in terms of Profitability, liquidity, risk, capital adequacy and deployment efficiency. The banks' financial performance was evaluated using both trend and ratio analyses. This work concluded that Islamic banks performed very well as compared to conventional banks in almost all years. Moreover, the study explained that Islamic banks are more cost effective, more profitable, well capitalized and stable than their Conventional counterparts.

Hassoune (2002) in his study, Islamic banks' profitability in an interest rate cycle, found that Islamic banks were undoubtedly more profitable than conventional banks, their profitability less volatile over interest rate cycle, but are constrained by several recurrent weaknesses in terms of liquidity, concentration risks and operational efficiency.

Hassan and Bashir (2003) analyzed how bank characteristics and the overall financial environment affect the financial performance of Islamic banks. They utilized cross-country bank level data on Islamic banks in 21 countries over the period of 1994-2001. A variety of internal and external banking characteristics (macroeconomic environment, financial market structure, and taxation) were used to predict profitability and efficiency. According to the findings, the profitability of Islamic banks was positively influenced by high capital, loan-to-asset ratios and favorable macroeconomic conditions. On the other hand taxation influenced Islamic banks financial performance negatively.

Yudistira (2004) empirically analyzed efficiency and financial performance of 18 Islamic banks over the period 1997-2000. Technical, pure technical, and scale efficiency measures were calculated by utilizing non-parametric technique, Data Envelopment Analysis. The overall efficiency results indicated that the inefficiency level across 18 Islamic banks was just above 10% and this ratio was considerably low as compared to the conventional banking sector. Islamic banks in the sample suffered from the global crisis in 1998-1999 but performed very well after the difficult periods. The findings also indicated that there are diseconomies of scale for small-to-medium Islamic banks.

Samad (2004) examined the comparative financial performance of Six (6) interest-free Islamic banks and Fifteen (15) interest-based conventional banks in Bahrain during the post Gulf War period 1991-2001. Profitability, liquidity and credit risk ratios were analyzed to measure the financial performance. The financial performance comparison of

Bahrain's conventional banks with Islamic banks established that there was a significant difference in credit financial performance between the two sectors. However, no difference in the profitability and liquidity financial performances of both banking segments was found.

Saleh and Rami (2006) examined financial performance of Islamic banks in Jordan. They took a sample of two Islamic banks to evaluate the financial performance in terms of profitability, capital structure and liquidity. Financial ratio analysis was used to carry out profit maximization, capital structure, and liquidity tests. The results of the financial ratio analysis suggested that there had been an increase in the efficiency of both banks and both banks had focused on their short term investments. Both the banks experienced an increase in profitability.

Sufian (2007) analyzed the efficiency of domestic and foreign Islamic banking operations in Malaysia during 2001-2005. Several efficiency estimates of individual banks were evaluated using non-parametric Data Envelopment Analysis (DEA). Two different approaches were employed to differentiate how efficiency scores vary with changes in inputs and outputs. To examine the impact of risk factor on Islamic bank efficiency, they incorporated problem loans as a nondiscretionary input variable in their analysis. The findings suggested that during the period of study, scale inefficiency dominates pure technical inefficiency in the Malaysian Islamic banking sector. They found that foreign banks exhibited higher technical efficiency compared to their domestic peers. The inclusion of risk factors has mixed impact on Malaysian Islamic banks' efficiency. The

results suggested that while potential economies of scale may be overestimated when risk factors are excluded, pure technical efficiency estimates on the other hand, tend to be much more sensitive to the exclusion of risk factors.

Johnes et al (2008) examined efficiency in Islamic and conventional banks in the GCC region (2004-2007) using Financial ratio analysis (FRA) and data envelopment analysis (DEA). Using financial ratios, the results suggested that Islamic banks are less cost effective while more profit and revenue effective as compared to conventional banks. On the other hand, using Data Envelopment Analysis (DEA), they found that total efficiency in conventional banks is significantly higher than Islamic banks.

Moin (2008) compared the financial performance of first Islamic bank in Pakistan with a group of 5 conventional banks for a period of 2003-2007. The study evaluated the financial performance in terms of profitability, liquidity, risk, and efficiency. Financial ratios (12 in total) such as Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit ratio (LDR), Loan to Assets ratio (LAR), Debt to Equity ratio (DER), Asset Utilization (AU), and Income to Expense ratio (IER) were used to assess banking financial performances. T-test and F-test were used in determining the significance of the differential financial performance of the two groups of banks. The study found that the selected Islamic bank is less profitable, less risky and also less efficient compared to the average of the 5 Conventional banks. However, there was no significant difference in liquidity between the two sets of banks.

Parashar and Venkatesh (2010) compared 6 Islamic banks and 6 conventional banks in the GCC region for a period of 2006 – 2009 utilizing 6 ratios namely capital asset ratio, cost to income ratio, return on average assets, return on average equity, equity to total assets and liquid assets to total assets. Their study shows that during the global crisis Islamic banks suffered more in terms of capital ratio, leverage and return on average equity, while conventional banks exhibited a poor financial performance in return on average assets and liquidity. Further, during the 4 year period of 2006 – 2009, Islamic banks have outperformed conventional banks in the region.

Ansari and Rehman (2011) conducted a study on the financial performance analysis of Islamic and conventional banks based in Pakistan for the period of 2006 – 2009. Three (3) Islamic & Three (3) Conventional banks were selected for the study. Eighteen (18) different financial ratios, which represented profitability, liquidity, risk and solvency, capital adequacy, deployment and operational efficiency, were utilized. Independent sample t-test and ANOVA was used to determine the significance of mean differences of these ratios between and among banks. They found out that in comparison to conventional banks, Islamic banks were highly liquid, less risky and operationally efficient.

Zeitun (2012) carried out a study on the GCC for a period of 2002 – 2009, to assess the factors that affect the Islamic bank and conventional banks. The study included a sample of 38 conventional banks, and 13 Islamic banks. The factors that were studied were foreign ownership, bank specific variable and macroeconomic variables. Some

interesting results were found. Foreign ownership does not improve Islamic and conventional banks financial performance. Cost to income ratio held a negative correlation for Islamic and conventional banks financial performance. Equity was found out to be important factor in maximizing the profitability of Conventional banks. The size of the banks supported the economies of scale utilizing the ROE for Islamic banks while it is not significant for conventional banks. Bank's age and banking development have no effect on bank financial performance. Finally, GDP was found to be positively related, while inflation negatively related to the banks financial performance.

Sheikh (2009) Islamic banking in Kenya emerged as a financial innovation because of worldwide trends towards Islamic banking, market demand from the Muslim population in the country, shareholder expectation of returns and amendments to the Banking Act. However, Islamic banking in Kenya faces challenges mainly from the regulatory environment. The study revealed that the legislative framework currently limits the full development of Islamic Banking in the country. Goumandakoye' (2010) Islamic banking in Kenya is still a new concept and fully-fledged Islamic banks tend to present more features than Islamic banking windows. However, stiff competition, growth in the sector, strategic diversification, and economic potential in the sector are the main reasons that pushed conventional banks into offering Shari'a compliant banking. Kadubo (2010) Islamic banking products are driven by religious compliance and customers need being met.

Miriti (2011) conducted a study to compare and document unique operational management practices between Islamic and conventional banks in Kenya. The

respondents of this study were drawn from top management of Gulf African Bank Limited and African Banking Corporation. These included heads of operations and their immediate managers and heads of four other departments plus their immediate managers. The researcher found out that there were unique operational management practices between Islamic and conventional banks in Kenya in terms of; operations procedure manuals to back operations policies, existence of specific guidelines to support faith-based banking and frequency of carrying out regular audits to ensure specific faith-based compliance in operations and procedures.

Halkano (2012) examined and compared financial performance of Islamic banks, the Gulf African Bank and First Community Bank, and five conventional banks in Kenya. 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 financial performance measures considered were profitability, liquidity, efficiency and risk and solvency of banks. The result of the study indicated 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. Conventional banks on the other hand performed better in profitability, and efficiency. On risk and solvency, the Islamic banks seemed to perform better.

2.4 Summary/Conclusion

Both Islamic and Conventional Banks are financial intermediation that helps to transfer the funds from investors, depositors or savers to borrowers or investors. However, the modes of operations between Islamic banks and conventional banks are different.

There are various comparative studies in the existing literature that have been carried out in respect to financial performance of Islamic banks and conventional banks in various regions as seen above. However, the volumes of search studies are limited especially locally, in Kenya, hence the motivation to carry out this study.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research methodology that was used in the study which includes the research design, population and sample of study, data collection and analysis methods.

3.2 Research Design

The main objective of this study was to compare financial performance between Islamic banks and conventional banks in Kenya. Specifically the study sought to establish whether there exists significant difference between the financial performances of the two banking categories. To achieve this, descriptive research design was employed and the study was mainly quantitative.

3.3 Population

The 43 Commercial banks in Kenya was the population for the study. CBK (2013) as at May 31, 2013, the Kenyan banking sector comprised 43 commercial banks, 1 mortgage finance company, 8 deposit taking microfinance institutions, 106 foreign exchange bureaus and 2 credit reference bureaus.

Banks' financial information based on their audited financial statements from year 2010-2012 of selected Islamic and conventional banks was analyzed to compare the financial performance of the two banking categories.

3.4 Sample Design

In Kenya, some banks operate with both conventional and Islamic banking products. To compare and contrast financial performance of Islamic and conventional banks, only banks which can be either classified as conventional or Islamic banks was selected.

There are only two fully fledged Islamic banks licensed by the central bank of Kenya considered as the pioneers i.e. Gulf African Bank and First Community Bank which represented the Islamic banks.

Banks' in Kenya are mainly categorized as Large, Medium or Small based on the asset base of the respective banks. The Islamic banks are currently categorized as small size banks and as such conventional banks considered of equivalent size was selected i.e. Giro Bank and K-Rep Bank.

Convenience sampling was employed in this study.

3.5 Data Collection

Secondary data, mainly from audited financial statements of the selected Banks, was used in carrying out this study. Both Gulf Bank & First community Bank broke even by year 2010 hence the financial performances for years 2010 to 2012 was analyzed.

3.6 Data Analysis

Collected data was analyzed using CAMEL model. Reddy & Prasad (2011) CAMEL is basically ratio based model for evaluating the financial performance of banks. It is a management tool that measures Capital Adequacy, Assets Quality, efficiency of Management, quality of Earnings and Liquidity of financial institutions.

Capital Adequacy measures the shock captivating capability of a bank during times of risk. Capital adequacy ratio was measured using Capital Adequacy Ratio (CAR). The capital adequacy ratio helps decision makers in ensuring that banks can absorb a reasonable level of losses occurred due to operational losses and determine the capacity of the bank in meeting the losses. The higher the ratio, the more will be the protection of investors. Therefore higher ratio depicts better bank's financial performance.

$CAR = \frac{\text{Total Capital}}{\text{Total risk weighted assets}}$

Asset quality reflects the risk with respect to the exposure of a bank to the debtors. It is an indicator of the value of loans by a bank. It is the most standard measure of assets quality measuring the net non-performing assets as a percentage to net advances. Net non-performing assets are gross non-performing assets minus net of provisions on Non-performing assets and interest in suspense account. Asset quality was measured by Net non performing advances to Net Advances ratio (NPAs/NA). The smaller this ratio is, the better the financial performance of the bank.

$$\text{NPAs/NA} = \frac{\text{Net Non Performing accounts (NPAs)}}{\text{Net Advances}}$$

Management quality sheds light on the superiority of the management. The duty of the management is to safeguard that the banks operation runs in a smooth and decent manner. Very often, the banks superiority in terms of management is decided by the skill and ability of the management to control the cost and increase productivity, ultimately achieving higher profits. Operating Expense to Operating Income (OEOI) ratio which measures the level of efficiency of the bank in conducting its operations was used for this study. The smaller this ratio is, the better the financial performance of the bank.

$$\text{OEOI} = \frac{\text{Operating Expense}}{\text{Operating Income}}$$

Earnings being one of the financial performance parameters highlights on the banks prevailing and forthcoming activities with respect to its earnings. It essentially aids the bank in concentrating on the loss gripping capacity, determining the level of its earnings and revenue as well as the funds available for rewarding its shareholders. This study employed return on assets (ROA) ratio. ROA fundamentally sheds light and specifies the ways that management exploits its assets to generate earnings. Return on Assets (ROA) measures the effectiveness of the company in utilizing all resources in order to generate profits. The higher the ratio is, the better the financial performance of the bank.

$$\text{ROA} = \frac{\text{Net Income}}{\text{Total Asset}}$$

Liquidity can aid the banks and establishments to evaluate the risk faced by the banks in case of an unprecedented and unforeseen circumstance that can be the main reason for an insolvency of bank. Therefore higher ratio depicts better bank's financial performance. Current Asset ratio (CA) was used to assess the liquidity of the banks.

$$\text{CA} = \frac{\text{Liquid assets}}{\text{Short term Liabilities}}$$

The overall financial performance of the banks was measured using composite CAMEL ratios considering the relationship of each ratio to bank's performance

$$\text{Overall Financial performance} = W_1X_1 + W_2X_2 + W_3X_3 + W_4X_4 + W_5X_5$$

Where: W_1 - W_5 : Weights of Ratios where each ratio carries equal weight

X1: Capital Adequacy Ratio

X2: Asset Quality Ratio

X3: Management quality Ratio

X4: Earnings quality Ratio

X5: Liquidity Ratio

Arithmetic Mean was used to rank and compare the financial performance of the two banking categories through inter-bank analysis while t- test was employed to test the significance of differences between the financial performances of the Islamic and Conventional Banks. The significance of the differences between the financial performances was measured at 95% confidence level.

Microsoft excel was mainly employed to carry the above analysis.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

Various ratios measuring capital adequacy, asset quality, management efficiency, earnings quality and liquidity were analysed and tested under the following hypothesis.

H0: There is no significant difference between Islamic Banks' (IBs) and Conventional Banks' (CBs) Financial performances in Kenya

H1: There is a significant difference between Islamic Banks' (IBs) and Conventional Banks' (CBs) Financial performances in Kenya

4.2 Capital Adequacy

It is important for a bank to maintain depositors' confidence and preventing the bank from going bankrupt. Capital adequacy reflects the overall financial condition of banks and also the ability of management to meet the need of additional capital. The capital adequacy ratio was developed to ensure that banks can absorb a reasonable level of losses occurred due to operational losses and determine the capacity of the bank in meeting the losses. The higher the ratio, the more will be the protection of investors hence the performance of the bank.

In Kenya, banks are required to maintain a minimum capital adequacy ratio of 8% for core capital to Total risk weighted assets ratio and 12% for Total capital to Total risk weighted assets ratio. Total capital to Total risk weighted assets ratio was used in this study.

Table 2: Capital Adequacy Ratios for the Period 2010-2012, Compiled by MS-Excel

Ratio	Bank	2010	2011	2012	Mean	Mean Difference	Rank
CAR (%)	IBs	15.12	14.12	15.26	14.83	8.84	2
	CBs	23.45	21.85	25.70	23.67		1

Table 3: Two tailed T-test on Capital Adequacy Analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	0.148300000	0.236666667
Variance	0.000038298	0.000374083
Observations	3	3
Hypothesized Mean Difference	0	
df	2	
t Stat	-7.537023414	
P(T<=t) two-tail	0.017151954	
t Critical two-tail	4.30265273	

Table 2; the average Capital adequacy ratio of Islamic Banks and Conventional Banks are 14.83% and 23.67% respectively with mean difference of 8.84%. Therefore conventional banks performed better than Islamic Banks, in terms of Capital adequacy, during the study period.

From table 3, the sample absolute t-value is 7.537 while the p-value is 0.02. Since the sample absolute t-value is greater than 4.303 (the t-critical value) and the p-value is less 0.05 (the critical p-value), the null hypothesis is rejected i.e. there is a significant difference between the capital adequacy of Islamic banks and Conventional banks.

4.3 Assets Quality

The quality of assets is an important parameter to gauge the strength of the bank. The prime aim behind measuring the assets quality is to ascertain the component of non-performing assets as a percentage of the total assets. This indicates what types of advances the bank has made to generate interest income. Net Non-performing Advances to Net Advances (NNPAs/NA) ratio is the most standard measure of assets quality measuring the net non-performing assets as a percentage of net advances. Net non-performing assets are gross non-performing assets minus net of provisions on Non-performing assets and interest in suspense account. The smaller this ratio, the better financial performance of the bank.

**Table 4: Net non-performing Assets/ Net Advances Ratios for the Period 2010-2012,
Compiled by MS-Excel**

Ratio	Bank	2010	2011	2012	Mean	Mean Difference	Rank
NPAs/NA (%)	IBs	4.47	8.78	7.48	6.91	2.80	2
	CBs	5.54	3.38	3.41	4.11		1

Table 5: Two tailed T-test on Asset Quality Analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	0.069076559	0.041073585
Variance	0.000488828	0.000153618
Observations	3	3
Hypothesized Mean Difference	0	
df	3	
t Stat	1.91357907	
P(T<=t) two-tail	0.151591337	
t Critical two-tail	3.182446305	

Table 4; the average NPAs to Net Advances of Islamic Banks and Conventional Banks are 6.91% and 4.11% respectively with mean difference 2.80%. Therefore, conventional banks performed better than Islamic Banks, in terms of Asset quality, during the study period.

From table 5, the sample absolute t-value is 1.914 while the p-value is 0.15. Since the sample absolute t-value is less than 3.182 (the t-critical value) and the p-value is greater than 0.05 (the critical p-value), the null hypothesis is accepted i.e. there is no significant difference between the asset quality of Islamic banks and Conventional banks.

4.4 Management Efficiency

Management efficiency is another important element of the CAMEL Model. The ratio in this segment involves subjective analysis to measure the efficiency and effectiveness of management. The management of bank takes crucial decisions depending on its risk perception. Operating Expense to Operating Income (OEOI) ratio which measures the level of efficiency of the bank in conducting its operations was used for this study. The smaller this ratio is the better financial performance of the bank.

**Table 6: Operating Expenses/ Operating Incomes Ratios for the Period 2010-2012,
Compiled by MS-Excel**

Ratio	Bank	2010	2011	2012	Mean	Mean Difference	Rank
OE/OI (%)	IBs	112.14	87.51	77.90	92.52	11.50	2
	CBs	74.91	80.64	87.51	81.02		1

Table 7: Two tailed T-test on Management Efficiency Analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	0.925182987	0.810175054
Variance	0.031202090	0.003978817
Observations	3	3
Hypothesized Mean Difference	0	
df	3	
t Stat	1.062025421	
P(T<=t) two-tail	0.36614172	
t Critical two-tail	3.182446305	

Table 6; the average Operating Expenses to Operating Incomes of Islamic Banks and Conventional Banks are 92.52% and 81.02% respectively with mean difference 11.50%. Therefore, conventional banks performed better than Islamic Banks, in terms of Management efficiency, during the study period.

From table 7, the sample absolute t-value is 1.062 while the p-value is 0.37. Since the sample absolute t-value is less than 3.182 (the t-critical value) and the p-value is greater than 0.05 (the critical p-value), the null hypothesis is accepted i.e. there is no significant difference between the Management efficiency of Islamic banks and Conventional banks.

4.5 Earnings Quality

The quality of earnings is a very important criterion that determines the ability of a bank to earn consistently. It basically determines the profitability of bank and explains its sustainability and growth in earnings in future. This study employed return on assets (ROA) ratio. ROA fundamentally sheds light and specifies the ways that management exploits its assets to generate earnings. Return on Assets (ROA) measures the effectiveness of the company in utilizing all resources in order to generate profits. The higher the ratio, the better financial performance of the bank.

Table 8: Return on Asset Ratios for the Period 2010-2012, Compiled by MS-Excel

Ratio	Bank	2010	2011	2012	Mean	Mean Difference	Rank
ROA (%)	IBs	-1.01	1.24	2.85	1.03	1.98	2
	CBs	3.82	2.77	2.45	3.01		1

Table 9: Two tailed T-test on Earnings Quality Analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	0.010291711	0.030105421
Variance	0.000375584	0.000051648
Observations	3	3
Hypothesized Mean Difference	0	
df	3	
t Stat	-1.660329666	
P(T<=t) two-tail	0.195431845	
t Critical two-tail	3.182446305	

Table 8; the average Return on Assets of Islamic Banks and Conventional Banks are 1.03% and 3.01% respectively with mean difference 1.98%. Therefore, conventional banks performed better than Islamic Banks, in terms of Earnings quality, during the study period.

From table 9, the sample absolute t-value is 1.660 while the p-value is 0.20. Since the sample absolute t-value is less than 3.182 (the t-critical value) and the p-value is greater than 0.05 (the critical p-value), the null hypothesis is accepted i.e. there is no significant difference between the Earning Quality of Islamic banks and Conventional banks.

4.6 Liquidity

Risk of liquidity is a danger to the image of the bank. Bank has to take a proper care to hedge the liquidity risk; at the same time ensuring good percentage of funds are invested in high return generating securities, so that it is in a position to generate profit with provision of liquidity to the depositors. To offer higher liquidity for them, bank has to invest these funds in highly liquid form.

Liquidity ratio measures the ability of bank to meet the demand from depositors in a particular year. Current Asset ratio (CA) was used assess the liquidity of the banks. A higher ratio depicts better bank's financial performance. In Kenya, Banks' are required to maintain a statutory liquidity ratio of 20%.

Table 10: Liquidity Ratios for the Period 2010-2012, Compiled by MS-Excel

Ratio	Bank	2010	2011	2012	Mean	Mean Difference	Rank
CA (%)	IBs	34.45	43.00	34.49	37.31	0.94	2
	CBs	36.90	36.35	41.53	38.26		1

Table 11: Two tailed T-test on Liquidity Ratios Analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	0.373133333	0.382583333
Variance	0.002425403	0.000807896
Observations	3	3
Hypothesized Mean Difference	0	
df	3	
t Stat	-0.287852159	
P(T<=t) two-tail	0.792200251	
t Critical two-tail	3.182446305	

Table 10; the average Liquidity of Islamic Banks and Conventional Banks are 37.31% and 38.26% respectively with mean difference 0.94%. Therefore, conventional banks performed better than Islamic Banks, in terms of Liquidity, during the study period.

From table 11, the sample absolute t-value is 0.288 while the p-value is 0.79. Since the sample absolute t-value is less than 3.182 (the t-critical value) and the p-value is greater than 0.05 (the critical p-value), the null hypothesis is accepted i.e. there is no significant difference between the Liquidity position of Islamic banks and Conventional banks.

4.7 Overall Financial performance

In order to assess the overall financial performance of two banking categories, composite ratios of Capital adequacy, Asset quality, Management quality, Earnings quality, and Liquidity ratios were calculated, based on their relationship to performance, for each banking categories and results are presented in table below:

Table 12: Overall Financial performance composite ranking, compiled by Ms-Excel

	Capital Adequacy	Asset Quality	Management Quality	Earnings Quality	Liquidity	MEAN	RANKING
IBs	14.83%	-6.91%	-92.52%	1.03%	37.31%	-9.25%	2
CBs	23.67%	-4.11%	-81.02%	3.01%	38.26%	-4.04%	1

Table 13: Two tailed T-test on Overall Financial performance analysed by MS-Excel

	Islamic Banks	Conventional Banks
Mean	-0.0925069	-0.040378644
Variance	0.244818698	0.213301484
Observations	5	5
Hypothesized Mean Difference	0	
df	8	
t Stat	-0.172214015	
P(T<=t) two-tail	0.867546158	
t Critical two-tail	2.306004133	

Table 12; the composite ratio reveals that overall financial performance of Conventional Banks exceeds that of Islamic Banks. From table 13, the sample absolute t-value is 0.172 while the p-value is 0.87. Since the sample absolute t-value is less than 2.306 (the t-critical value) and the p-value is greater than 0.05 (the critical p-value), the null hypothesis is accepted i.e. there is no significant difference between the overall financial performance of Islamic banks and Conventional banks in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter provides the study summary, conclusion and recommendations, limitation and suggestions for further research.

5.2 Summary

The study was conducted to evaluate the financial performance of Islamic banks and Conventional banks in Kenya. Specifically, the study sought to establish whether there exists a significance difference between the financial performances of the two banking categories. CAMEL model was employed in the financial performance evaluation through various financial ratios measuring Capital adequacy, Asset quality, Management quality, Earnings quality and Liquidity position. Arithmetic mean was used to compare the performance of the two banking categories while T-test was carried out to establish whether there exists a significant difference between the financial performances of the two banking categories.

The study revealed that Conventional banks performed better than Islamic banks in terms of Capital adequacy, Asset quality, Management quality, Earnings and Liquidity position. However, except for Capital adequacy, there were no significant differences between the two banking categories in terms of Asset quality, Management quality, Earnings and Liquidity position.

5.3 Conclusion and Recommendations

Conventional Banks outperformed Islamic Banks financially during the study period though there was no significant difference between the financial performances of the two banking categories. Both banking categories provide equal opportunities and are recommended to Investors, savers, borrowers among other decision makers.

5.4 Limitations

The study was limited in terms of small sample size and short period of study owing to recent emergence of fully fledged Islamic banks in Kenya. Harris (2012) Islamic banks were licensed by the CBK in 2007, Gulf African Bank and First Community Bank, which opened for business in early 2008.

5.5 Suggestions for Further Research

A further study in the same area is recommended in future with increased sample size and expanded period of study as more data on Islamic Banking becomes available.

Comparative study on Efficiency of Islamic Banks and Conventional Banks in Kenya is also considered an area of interest and is recommended for further research

A study on comparative financial performances of Private and Public owned Banks in Kenya is also recommended as a research area.

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Appendix 1-Licensed Banks in Kenya

1. Kenya Commercial Bank
2. Equity Bank
3. Cooperative Bank
4. Barclays Bank
5. Standard Chartered Bank
6. CFC Stanbic Bank
7. Commercial Bank of Africa
8. Diamond Trust Bank
9. Investment & Mortgage Bank
10. Citibank Bank
11. NIC Bank
12. National Bank of Kenya
13. Bank of Africa
14. Bank of Baroda
15. Chase Bank
16. Prime Bank
17. Imperial Bank
18. Ecobank Bank
19. Bank of India
20. Family Bank
21. ABC Bank
22. Consolidated Bank of Kenya

23. Fina Bank
24. Equatorial Bank
25. Gulf African Bank
26. Development Bank of Kenya
27. Charter House Bank
28. Giro Bank
29. Fidelity Bank
30. Guardian Bank
31. Victoria Bank
32. First Community Bank
33. K-Rep Bank
34. Habib AG Zurich
35. Transnational Bank
36. Paramount Bank
37. Habib Bank
38. Credit Bank
39. Oriental Bank
40. Middle East
41. Jamii Bora Bank
42. UBA Bank
43. Dubai Bank