

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

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**A RESEARCH PROJECT SUBMITTED IN PARTIAL
FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD
OF THE DEGREE OF MASTER OF BUSINESS
ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF
NAIROBI**

OCTOBER, 2014

DECLARATION

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

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ACKNOWLEDGEMENT

I thank the Almighty God for giving me good health and guiding me through the entire course. I am greatly indebted to Mr. Joseph Barasa who was my supervisor for his effective supervision, dedication, availability, and professional advice. I extend my gratitude to my lecturers who taught me in the MBA programme, therefore enriching my research with knowledge. The various commercial banks, where data was collected, deserve my appreciation. My appreciation finally goes to my classmates, with whom I weathered through the storms, giving each other encouragement and for their positive criticism.

DEDICATION

This study is dedicated to my family my wife Linda Talam for the support and encouragement, my daughter Ivy for cheering me throughout my academic struggle thus realizing my long cherished dream. All parents for generous advice and other support my God bless you abundantly.

Finally to all my friends, workmates for their financial and moral support during the entire period of this project

ACRONYMS AND ABBREVIATION

CBK Central Bank of Kenya

DEA Data Envelopment Analysis

FCB First Community Bank

IBIs Islamic Banking Institutions

MOF Ministry of Finance

SFA Stochastic Frontier Approach

UAE United Arab Emirates

UK United Kingdom

TABLE OF CONTENTS

DECLARATION	ii
ACKNOWLEDGEMENT	iii
DEDICATION	iv
ACRONYMS AND ABBREVIATION	v
LIST OF TABLES.....	viii
ABSTRACT	ix
CHAPTER ONE: INTRODUCTION.....	1
1.1 Background of the Study	1
1.1.1 Islamic Banking	2
1.1.2 Financial Performance of Commercial Bank	3
1.1.3 Islamic Banking and Financial Performance.....	5
1.1.4 Islamic Banking in Kenya	6
1.2 Research Problem	7
1.3 Research Objectives.....	9
1.4 Value of the Study	9
CHAPTER TWO: LITERATURE REVIEW	11
2.1 Introduction	11
2.2 Theoretical Review	11
2.2.1 Theory of Islamic banking.....	11
2.2.2 Dialectic model	13
2.3 Determinants of Financial Performance.....	14
2.4 Empirical Review	17
2.5 Summary of Literature Review	20
CHAPTER THREE: RESEARCH METHODOLOGY	21
3.1 Introduction	21
3.2 Research Design	21
3.3 Population.....	21
3.4 Sample.....	22
3.5 Data Collection.....	22
3.6 Data Analysis.....	22
3.6.1 Conceptual Model	23

3.6.2 Analytical Model.....	23
3.6.3 Test of Significance.....	24
CHAPTER FOUR: DATA ANALYSIS, INTERPRETATION AND PRESENTATION.....	25
4.1 Introduction	25
4.2 Descriptive Statistics.....	25
4.2.1 Return on Assets	26
4.2.2 Islamic Banking ratio	26
4.2.3 Capital Ratio	26
4.2.4 Liquidity ratio	27
4.2.5 Efficiency ratio.....	27
4.2.6 Expenses management ratio	27
4.2.7 Bank size	28
4.3 Correlation Analysis	28
4.4 Regression Analysis and Hypotheses Testing.....	29
4.4 Discussion of Findings.....	33
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS...	36
5.1 Introduction	36
5.2 Summary of Findings.....	36
5.3 Conclusion.....	37
5.4 Recommendations.....	39
5.5 Limitations of the Study.....	40
5.6 Suggestions for Further Research.....	40
REFERENCES.....	42
APPENDICES	46
Appendix I: Raw Data Summary	46
Appendix II: List of Commercial Banks in Kenya	47
Appendix III: Commercial Banks Offering Islamic Banking in Kenya.....	49

LIST OF TABLES

Table 4.1 Summary of Study Variables.....	25
Table 4.2 Correlation Matrix	28
Table 4.3 Model Summary	30
Table 4.4 ANOVA	30
Table 4.5 Multiple Regression Analysis.....	31

ABSTRACT

Shari'ah compliant banking is viewed by many as the fastest growing segment of the banking sector in the world. The uptake of Islamic banking is projected to grow exponentially in sub-Saharan Africa (Ndung'u, 2011). The study sought to establish the effect of Islamic banking on financial performance of commercial banks in Kenya. This research was conducted through a descriptive survey design. The descriptive survey design was considered appropriate as it enables description of the characteristics of certain groups, estimation of the proportion of people who have certain characteristics and making of predictions. This study collected quantitative data. Secondary data was used in this study. The secondary data sources were obtained from the published annual reports of the 13 commercial banks under study over a period of 5 years (2009-2013). The data was collected based on the information about the variables. Quantitative data was analyzed by descriptive analysis while qualitative data through content analysis. The study may provide information to policy makers, managers of Islamic banks, scholars and academicians and investors on effect of Islamic banking on financial performance of commercial banks in Kenya. From the findings, the study found out that the banks' capital ratio, liquidity ratio, bank size and Islamic banking ratio had a positive influence on the commercial banks' financial performance. The study further established that the banks' efficiency ratio and the expenses management ratio had a negative influence on the commercial banks' financial performance. Thus, the study concludes that Islamic banking positively influenced the financial performance of the commercial banks in Kenya. The study recommends that the management of the commercial banks should strive to achieve an optimal capital structure, enhance their banks' liquidity, efficiency and expenses management levels as well as expand their market reach in order to enhance the financial performance of their commercial banks.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Islamic banking emerged as a practical reality and started functioning in 1970s. Since then it has been growing continuously all over the world. Global conventional banks like Standard Chartered Bank, Deutsche Bank, Citibank, etc. have also set up separate windows/divisions to structure Islamic financial products and are offering Islamic banking services to their Muslim clients and even to those non-Muslim clients who are interested in profit and loss sharing financial instruments. UK, France, China, Singapore and many other countries have developed special regulatory to facilitate the working of Islamic banking (Nazim, 2008).

Conventional banking, which has been operating for the last three centuries on strong footing, has started tumbling steeply in the last few decades while Islamic banking has been expanding all over the world particularly in Muslim countries with fast speed. The vertical growth of Islamic banking within short span of time has surprised everyone including western financial experts and analysts. Nazim (2008) disclosed that 970 books have been published on Islamic Finance recently while 2557 research articles on Islamic finance have been published in research journals. This small detail shows the growing interest of researchers in Islamic finance.

Sharia compliant banking is viewed by many as the fastest growing segment of the banking sector in the world. In Africa, Islamic banking is a fast growing financial sector attracting all customers even of different religious orientation. The uptake of Islamic banking is projected to grow exponentially in sub-Saharan Africa. Kenya is

among other African countries that are taking up the lead in Sharia compliant banking services (Ndung'u, 2011).

1.1.1 Islamic Banking

The establishment of the Dubai Islamic Bank in 1975 ushered in the era of Islamic banking in earnest. Initial attempts to establish Islamic Banking Institutions (IBIs) were made in Egypt (Zaman and Movassaghi, 2001). Some of the IBIs operate in countries where no other financial institutions are allowed to operate like Iran, Pakistan and Sudan. In the other Islamic countries, these institutions represent only a slice of the total banking sector. Even in the Arab world where the demand for the services of IBIs is the strongest, only 20 percent of the populace currently participates in the use of these facilities. However, the collapse of the Dubai Islamic Bank in 1998 for multi-million dollar fraud did not help the image of IBIs. Further, the memory of the collapse of the Ar-Ryan investment bank in Egypt a few years earlier, also because of fraud, was not lost. To the advocates of Islamic banking, however, IBIs are revolutionary and their speed of growth is “unprecedented in modern financial history.”(Siddiqi, 1999).

Shariah (or Islamic) law is meant to regulate all aspects of a Muslim's way of life. It is broadly divided into two sets of rules: one relates to the obligatory worship of God (ibadah) and the other relates to daily life outside the context of obligatory worship (muamalat), including commercial and financial dealings. There are a number of key Shari'a principles and prohibitions relevant to finance and commercial transactions which distinguish Islamic finance from the conventional finance. For completeness, it should be noted that there are two main branches within Islam: sunnism and shiaism.

Most importantly, the Shariah does not recognize the time value of money and it is therefore not permissible to make money by lending it. Money must be used to create real economic value and it is only permissible to earn a return from investing money in permissible commercial activities which involve the financier or investor taking some commercial risk. This prohibition is the main driving force behind the development of the modern Islamic finance industry. The supply of Islamic finance is highly concentrated in a few countries, with the top three countries (Indonesia, Bangladesh, and Afghanistan) accounting for 80 percent of global outreach (Farah, 2008).

Islamic or Shariah-compliant banking is a fast-growing segment of the financial sector in Kenya, since its inception. The impact of Islamic finance sent strong signals to Kenya's financial services sector to the point of being highlighted in the latest amendments to the Finance Act (2008), which was amended to include a requirement by all institutions to pay a return on all savings accounts kept and operated in accordance with the Islamic law. The amendment applied to institutions offering Islamic finance products which did not permit payment of interest (CBK, 2009).

1.1.2 Financial Performance of Commercial Bank

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items

such as loans and advances, deposits, total interest income, total interest expense, other costs and other indicators are used in measuring performance of a commercial bank. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt.

The profitability of commercial banks depends heavily on the net of income generating activities and the related activities expense. Due to the problem of profitability and stiff competition in the industry, commercial banks have changed their behavior of income sources, by increasingly diversifying into non-intermediation income generating activities as opposed to the traditional inter-mediation income generating activities.

For a commercial bank to remain competitive in all of the above areas there is need to develop and adopt new products and technology. Such products include adoption of Islamic products, use of technology i.e. internet banking and mobile banking. This study therefore looks at the effect of Islamic products on financial performance of commercial banks. Financial performance encompasses change in number or value of loan granted and profit level. Lending is risky to most banks because repayment of loans can seldom be fully guaranteed. According to Brown et al., (2006), implicit contracts between lenders and borrowers, thus, banking relationships can motivate high effort and timely repayments. Foluso (1998), also confirm that long-term relationships are a powerful disciplinary device. Credit markets are dominated by short-term interactions, borrowers may only be motivated to repay if they know that, due to credit reporting, their current behavior is observable by other lenders.

The work of Foluso (1998) indicates that the impact of credit reporting on repayment behavior and credit market performance is highly dependent on the potential for relationship banking. Therefore, when bilateral relationships are not feasible, the credit market essentially collapses in the absence of acceptable borrower behavior. As repayments are not third-party enforceable, many borrowers default and lenders cannot profitably offer credit contracts (Brown et al, 2006). Therefore, by repeatedly interacting with the same borrower, lenders establish long-term relationships that enable them to condition their credit terms on the past repayments of their borrower. As only a good reputation leads to attractive credit offers from the incumbent lender, borrowers have strong incentives to repay.

1.1.3 Islamic Banking and Financial Performance

Metwally (1997) concluded that the two groups of banks may be differentiated in terms of liquidity, leverage and credit risk, but not in terms of profitability and efficiency. Samad and Hassan (1999) found that liquidity risk arises because of premature withdrawal by account holders due to a mismatch between investor's expectations of return and the actual return. Therefore Islamic banks are required to keep adequate cash or cash equivalents to meet the demand.

Ibrahim and Vijaykumar (2003) revealed that the profitability of Islamic banks is low due to short term investments and low equity base. In case of Islamic banks, short term Debt financing includes Murabaha, Salam, and Qard fund and long term debt financing includes Sukuk, leasing and Istisna. According to Safiullah (2010) Islamic banks are not suffering from excess liquidity and are more cost effective and profitable than their Conventional counterparts. Hassoune (2002) argues that Islamic

banks are certainly more profitable than their conventional peers enjoying the same balance sheet structure. The main reason for such a difference is that Islamic banks benefit from a market imperfection.

1.1.4 Islamic Banking in Kenya

In Kenya Islamic banks are not separately defined in the Banking Act. All banks including those operating pursuant to Islamic Banking principles are subject to the requirements of the Banking Act. We should thus talk about Sharia compliant banking products. Indicators in the first year of operations of the two fully-fledged Islamic banks pointed to potential for Islamic banking in Kenya. There is still room to grow this market niche given tremendous expansion of Kenya's banking sector for instance, the number of bank accounts tripled from 2.6 million in 2005 to 6.4 million in 2008 (Gulf African Bank, 2009). Currently there are eight (8) commercial banks that operate Islamic banking in Kenya (CBK, 2014)

Islamic Banking prohibits interest but allows profit sharing. Therefore Sharia compliant lending products have element of "trading" and "holding of fixed assets" as the bank has to buy and sell financed assets. However, Section 12 of the Banking Act restricts trading and holding of fixed assets and thus the Banking Act was amended in 2006 to enable exemption of innovative products such as Sharia compliant banking lending products from trading and holding of fixed assets restrictions. Section 16 of Banking Act requires banks to pay interest on savings accounts so long as the minimum balance is maintained but Sharia compliant banking principles prohibit receipt of interest. Consequently, the Banking Act was amended effective 1st January 2009 to incorporate concept of "return" for Sharia compliant savings products.

Barclays' La Riba account was the first-ever Shari'ah-compliant account in Kenya. The account was set up in December 2005. However, Kenya's first Islamic bank, First Community Bank (FCB) was granted a banking license in May 2007. The bank started operations in May 2008. Apart from FCB, Gulf African Bank is the other bank in Kenya with a license to operate as a fully-fledged Islamic bank. Other banks in Kenya are increasingly applying to include Islamic windows in their businesses, for instance the latest entry by Standard Chartered bank.

Ndung'u (2011) highlighted that among the challenges facing Kenya's ambition to be a hub of Sharia compliant investment products to compliment the Islamic banking in the country are lack of; Shari'ah compliant investment vehicles, an enabling legal and regulatory framework and awareness by majority of the populace that hinder the uptake of these investments. For the country to fully embrace Islamic Finance, there is need to extend beyond the offering of Sharia compliant products by introducing such investment vehicles like unit trusts, corporate bonds (sukuks) and insurance (takaful) products and Sharia compliant treasury bills and bonds (government Sukuk).

1.2 Research Problem

Financial institutions generate increased portion of their income from non-intermediation activities and this could be associated to financial liberalization initiatives (DeYoung and Rice, 2004). Financial liberalization of early 1990s in Kenya opened the banking industry to a number of players leading to stiff competition and weakening of financial performance of a number of commercial banks leading to collapse of some. In response, commercial banks have changed their behavior of income sources by diversifying as a possible way of improving performance.

Although the number of Islamic banking initiatives remains limited, that is, less than 1% of total global financial outreach (Bent, 2008), there is a number of reasons for increasing interest in developing financial products based on Islamic financing principles.

In Kenya Islamic banks are not separately defined in the Banking Act. All banks including those operating pursuant to Islamic Banking principles are subject to the requirements of the Banking Act. Indicators in the first year of operations of the two fully-fledged Islamic banks pointed to potential for Islamic banking in Kenya (Gulf African Bank, 2009). There is high demand for Islamic financial products against a negligible supply of the same (Ndungu (2010). In their short period of existence, Islamic banking in Kenya has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%. Currently there are two Islamic banks operating in Kenya: Gulf African and First Community bank, which had a loan portfolio of 4.9-billion shillings, deposits totaling 7.5 billion shillings and 27270 deposit accounts (Muriri, 2009).

There is a gap in Islamic banking related literature with regard to the financial performance studies. Fewer financial performance studies have been conducted on Islamic banks compared with conventional banks in Kenya. Ahmednoor (2012) did an evaluation of Islamic banking products while Josephat (2012) investigated on sharia compliant products. Oundo (2009) suggested that there was poor supply of Shari'ah compliant products in Kenya's financial institution. The findings obtained from financial performance studies conducted on conventional banks cannot be applied to Islamic banks due to the operational differences between Islamic and conventional

bank. The theoretical implications of this study will fill the above mentioned gap in Islamic banking related literature by analyzing the effect of internal factors on the financial performance of Kenyan Islamic banks.

The entry of Kenyan banks into the new Shariah-compliant products has perhaps been one of the most critical developments in the banking sector in the recent past. The academic discourse in the literature regarding the impact of Islamic banking, notwithstanding the past efforts, does not fill all the theoretical, methodological and practical gaps. Thus, the present study is justified by the lack of academic investigation regarding Islamic banking, especially, in the local setting. By studying the change in financial performance due to adoption of Islamic banking by commercial banks the study sought to enrich the literature in Islamic Banking in Kenya. This leads to the question: what is the effect of Islamic Banking on Financial Performance of commercial banks offering Shariah compliant products on Kenya's banking industry?

1.3 Research Objectives

The objective of this study was to establish the effect of Islamic banking on financial performance of commercial banks in Kenya

1.4 Value of the Study

The emergence of Islamic banking in Kenya's financial services sector has played a key role in increasing financial access by ensuring that the more than 8 million Muslim population have financial options and, at the same time, are not left out by virtue of their socio-religious orientation hence contributing greatly to the First

Medium Term plan (2008 – 2012) of the Kenya Vision 2030. Accordingly, it is hoped that the adoption of this study's findings and recommendations would contribute to the efforts towards the financial inclusion of the Kenyan Muslims, who because of their socio-religious values, have shunned conventional financial products.

The study findings would further contribute to Kenya's economic development agenda as envisaged in the vision 2030 First Medium Term Plan (2008-2012), more so the economic pillar of the development blueprint, by reducing the gap of the unbanked Muslims in the country and augmenting economic development of all the socioeconomic segments. The management of financial institutions, who oversee the daily operations of their institutions, would be able to understand the factors likely to enhance or hinder the full operationalization of Islamic banking policies. Managers of Islamic banks, by knowing the factors and how they affect the financial performance of their banks, would be able to change internal factors for increased financial performance

The government at large and specifically the Ministry of Finance (MoF) through policy formulation and institutional infrastructure would ensure that they an enabling environment that would help the Islamic banking sub-segment grow. In addition, the researchers would gain insight on the various aspects of Islamic related principles on banking, and forming the basis for more advanced quantitative studies on the same, with this study's findings providing reference material.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This section reviews literature under the following themes; Theoretical underpinning of the study, the empirical studies, loan policies adopted by commercial banks in Kenya and the summary of the chapter.

2.2 Theoretical Review

The study was based on the theory of Islamic banking and dialectic model.

2.2.1 Theory of Islamic banking

The theory of Islamic banking is based essentially on the premise that interest which is strictly forbidden in Islam, is neither a necessary nor a desirable basis for the conduct of banking operations, and that Islamic teachings provide a better foundation for organizing the working of banks. Muslim economists have pointed out that it is a historical accident that interest has become the kingpin of modern banking. The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Muslim scholars recognize the important role banks play in the economy of a country in modern times. Banking institutions act as financial intermediaries between savers and investors. They can be of significant help in assisting the process of capital formation and development (Ayub, 2002).

The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental teachings of the Qur'an and the Sunnah. Since banks perform a useful service of financial intermediation, they are wholly acceptable in a Muslim society.

What is not acceptable, however, from the *shari'ah* point of view, is the use of interest rate mechanism in the process of financial intermediation. Theoretical work by Muslim scholars has sought to demonstrate that it is possible to run an economy without interest even in modern times. Replacement of interest based banking by interest-free banking has received the greatest attention in this endeavor (Bessis, 1998).

The basic postulate that has guided all theoretical work on Islamic banking is that while interest is forbidden in Islam, trade and profit is permissible. Muslim scholars have developed a radically different model of banking which does not make use of interest. It relies instead on profit/loss sharing for purposes of financial intermediation. The earliest references to the reorganization of banking on the basis of profit/loss sharing are found in the writings of certain Muslim scholars in the late forties and early and mid-fifties of this century. The sixties and seventies saw more elaborate formulations of the concept of Islamic interest free banking. The subsequent period has witnessed further refinements in the theory of Islamic banking (DeYoung and Rice, 004).

Theoretical work on Islamic banking encompasses several aspects related both to the operating procedures of Islamic banks and the possible socioeconomic consequences of the adoption of the new system. The theoretical underpinnings of Islamic banking rests on equity, fairness and making allowable monetary gains through risk-taking, trade and asset usage. In its purest form, Islamic banking distinguishes itself from conventional banking by using profit and loss-sharing schemes as a means of dispensing financial capital (Gerrad and Cunningham, 1997).

2.2.2 Dialectic Model

The study is based on the Dialectic model (Takeuchi & Nonaka, 2004) for overcoming difficulties, eliminating constraints and solving the problem of creating new product within Islamic Bank. The justifications of the selection is that Dialectic approach takes verbal communication, direct conversation and dialog in its process, where all these have been a normal practice within banking institutions. Dialectic approach is proposed to strengthen and to formalize the current practice.

The term “dialectic” originates from Greek *dialektos*, meaning discourse or debate. Plato (428-324 BC) referred dialectic as binary opposites, tensions and contradictions among ideas. The principle developed to include the idea that all levels of knowledge advance through a process of Thesis, Antithesis and Synthesis (Singer, 2003). According to Hegel’s dialectic, it comprises three dialectical stages of development: a thesis giving rise to its reaction, an antithesis which contradicts or negates the thesis and the tension between the two being resolved by means of a synthesis.

According to Tekeuchi & Nonaka (2004) dialectics emphasizes two characteristics. The first is its emphasis on change in which it talks about process and movement. Secondly, it emphasizes on opposites. Change takes place through conflict and opposition. It is looking for contradictions within people or situations as the main guide to what is going on and what is likely to happen.

The core in dialectics is the notion of the world as being full of contradictions (Skirbekk & Gilje, 2001). The dialectical movement begins with thesis as the original state. The next stage is for this thesis to show itself to be inadequate or inconsistent. It

is the opposite or negation of the first stage and hence is known as antithesis. It is the reaction against the thesis. The second stage also shows to inadequate or inconsistent. So, it results in third stage known as synthesis. It solves the oppositions between the thesis and the antithesis. The previous thesis and antithesis are reconciled and transcended (Takeuchi & Nonaka, 2004). The synthesis is a combination of the best thesis and the best of antithesis.

Knowledge creation in dialectic thinking accepts what appear to be opposites and tries to synthesize them by transforming and uniting them. Thesis represents the products and services of Islamic bank which are interest free and have an equitable distribution of income and wealth and to increase equity participation in the economy (Chapra, 1982). Second component is antithesis, which represents the market forces. In this case thesis and antithesis always negate each other and there is a contradiction between those interests. The bank's interest is always driven by high profitability with low cost meanwhile the customers are driven by a high return from their savings and investments. They will deposit their money to banks that offer a high return (Gerrad & Cunningham, 1997).

2.3 Determinants of Financial Performance

The efficiency of the banking system has been one of the hot issues in financial environment. Since their products and services are of an intangible nature, it is hard to measure their efficiency and competitiveness of financial institutions. Many researchers have attempted to measure the productivity and efficiency of the banking industry using outputs, costs, efficiency and performance. Bank's performance able to provides signal to depositor and investors whether to invest or to withdraw funds from

the bank and whether to buy or sell the bank's securities. In addition, regulators also need to know the bank's performance for regulation purposes. On the other hand, the bank's manager needs to know how well the bank has performed towards its objective or goal by looking at the bank's performance. However, how can we measure bank's performance? (Mang'eni, 2009).

There are many ways to measure bank's performance for example using financial ratios and advanced statistical method such as Stochastic Frontier Approach (SFA) and Data Envelopment Analysis (DEA). The existing literature in this area can be classified into two area of study. Studies concerning Malaysia specifically have adopted two approaches. The first area of study is investigating the performance of Islamic banks over a certain time frame, and then testing whether they exhibit improving performance (Samad and Hassan, 1999). The second approach, the most popular one is comparing the performance of Islamic banking operations with conventional ones both at a point in time and using time-series analysis.

Financial performance is a management initiative to upgrade the accuracy and timeliness of the financial institution to meet the required standard while supporting day to day operation (Bessis, 1998). Financial performance key measures are driven by three critical issues as follows profitability, size of the business, and growth of the business overtime. Consequently, financial performance measures that assess profitability, size, and growth rates are essential to monitor overall financial performance and progress (Ronald, 2011).

According to James (2005), liquidity ratios are defined as a measure of a firm's ability to pay back short-term obligations. Much insight can be obtained into the present cash solvency of the firm and the firm's ability to remain solvent in the event of adversity. Liquidity ratios can be measure by current ratio and quick ratio. Steve et al. (2006) defined current ratio as a measure of an entity's liquidity. Current ratio equal current assets divide by current liabilities. The higher the current ratio, the greater ability of the firm pays its bills. Liquidity measures the ability of managers in firms to fulfill their immediate commitments to policyholders and other creditors without having to increase profits on underwriting and investment activities and liquidate financial assets (Adams and Buckle, 2003).

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

Leverage ratios are intended to address the firm's long-term ability to meet its obligations. When a firm has debt, it has the obligation to repay the interest. Holding debt will increase the firm's riskiness. The level of financial leverage shows the ability of listed firm to manage their economic exposure to unexpected losses (Adams and Buckle, 2003). According to Johnson & Scholes (2007) many managers find a process for developing a useful set of performance indicators for the organization. One reason for this is that many indicators give a useful but only partial view of overall picture also some indicators are qualitative in nature ,whilst the hard quantitative end of assessing been dominated by financial analysis. The evaluation of

earnings performance depend upon key profitability measures such as (return on equity and return on assets) to industry bench mark and peer group norms (Federal Reserve Bank, 2002). Profitability as a measure of performance is widely accepted by Banks, financial institutions management, company owners and other creditors as they are interested in knowing whether or not the firm earns sustainability more than it pays by way of interest (Sadakkadulla &Subbaiah, 2002).

Analyst use metrics like cash conversion cycle, the return on assets ratio and fixed asset turnover ratio to compare and assess a company annual asset performance, an improvement in asset performance means that accompany can either earn a higher return using the same amount of assets or is efficient enough to create same amount of return using less assets (Adams and Buckle, 2003).

2.4 Empirical Review

Metwally (1997) evaluated the performance of 15 interest-free banks and 15 conventional banks in terms of liquidity, leverage, credit risk, profitability and efficiency. He concluded that the two groups of banks may be differentiated in terms of liquidity, leverage and credit risk, but not in terms of profitability and efficiency. Interest-free banks rely more heavily on their equity in loan financing and face more difficulties in attracting deposits than interest-based banks. Interest-free bank hold a higher Cash/deposit ratio because they tend to be relatively more conservative in using their loan-able funds and lack lending opportunities. The profit/loss sharing principle has made it difficult for interest-free banks to finance personal loans and pushed interest-free banks to channel a greater proportion of their funds to direct investment (using Musharaka and Mudaraba tools of finance). Both banks offer their

depositors similar returns and direct the largest proportion of their funds towards the financing of durables.

Samad and Hassan (1999) evaluated the inter-temporal and interbank performance of Islamic bank Islam Malaysia Berhad (BIMB) for the period 1984-1997. In interbank comparison the study found that BIMB is relatively more liquid and less risky compared to a group of 8 Conventional banks. A study conducted on five Islamic banks from MENA region analyzed their financial statements over the period 1993 – 2002 found that liquidity risk arises because of pre mature withdrawal by account holders due to a mismatch between investor's expectations of return and the actual return. Therefore Islamic banks are required to keep adequate cash or cash equivalents to meet the demand. They identified the other reasons of liquidity risk can be the lack of confidence on the banking system, reliance on few large depositors, reliance on current accounts and restrictions of Islamic banks on sales of debt.

Badr-El-Din, Ibrahim and Vijaykumar (2003) revealed that the profitability of Islamic banks is low due to short term investments and low equity base. In case of Islamic banks, short term Debt financing includes Murabaha, Salam, and Qard fund and long term debt financing includes Sukuk, leasing and Istisna.

Iqbal (2001) made comparison of performance of Islamic banks with conventional banks. He compared performance of both types of 12 banks of equivalent size during 1990-1998. In addition to profitability, liquidity, and risk some more variables such as capital adequacy and deployment efficiency were also studied. The performance of Islamic banks has been evaluated using both trend and ratio analysis. Thus, Islamic

banks as a group out-performed the former in almost all areas and in almost all years. In addition, Islamic banks are not suffering from excess liquidity and are more cost effective and profitable than their Conventional counterparts. Kader, Janbota, Asarpota and Anju (2007) and Safiullah (2010) found the same results in UAE and Bangladesh respectively.

The conventional banks profitability theories exist in Islamic banking. It is found that determinants such as capital ratio, liquidity, interest rate and money supply have similar effect on Islamic banks. Capital ratio, interest rate and inflation are positively related with the profitability of Islamic banks. On the overall, Islamic banking as an emerging banking concept has a positive impact on the profitability of modern day banks. However there is negative relationship between market share and profitability (Haron and Ahmad, 2001).

Islamic banks are certainly more profitable than their conventional peers enjoying the same balance sheet structure. The main reason for such a difference is that Islamic banks benefit from a market imperfection. Islamic banks lose on the grounds of liquidity, assets and liabilities concentrations and operational efficiency (Hassoune, 2002). The NIM another indicator of performance measure indicate that Conventional banks are operationally efficient than Islamic banks. The profitability of interest-free banks is positively influenced by high capital and loan-to-asset ratios, favourable macroeconomic conditions, and negatively to taxes (Hassan & Bashir, 2003).

Ahmednoor (2012) did an evaluation of Islamic banking products and financial performance of Islamic banks in Kenya. The results indicate a strong positive

relationship between product size and amount and financial performance of Islamic bank in Kenya. The relationship between Islamic bank products and profit before tax is statistically significant. As a result, any change in the size of Islamic bank's product will have an effect of the earnings of the bank.

Josephat (2012) investigated the effect of offering sharia compliant products on financial performance of commercial banks in Kenya. The study concluded that indeed offering new products such as Shariah compliant products really has a positive effect on financial performance of the bank. It has also broadened investment/innovation opportunities for the banking sector in Kenya.

2.5 Summary of Literature Review

In summary, introduction of Islamic finance by a commercial bank increases the amount of products available to customers. The number of customers also increase and by extension the income and competitive advantage of the financial institution. In general, adoption of new products has a positive effect on the financial performance of a commercial bank.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section presents the methods in data collection and analysis and forms the blue print for conducting the research. It covers the research methodology, research design, population of study, data collection and processing methods and data analysis.

3.2 Research Design

This study adopted a descriptive survey research design. This is because descriptive survey research design is appropriate where the study seeks to describe the characteristics of certain groups, estimate the proportion of people who have certain characteristics and make predictions (Cooper and Schindler, 2003). The design is also suitable since it will help to describe the state of affairs as they exist without manipulation of variables which was the aim of the study (Kothari, 2004). For this study, the design involved determining the causal effect of Islamic banking (independent variable) on financial performance of commercial banks in Kenya (dependent variable).

3.3 Population

Target population in statistics is the specific population about which information is desired. According to Denscombe (2008), a population is a well-defined or set of people, services, elements, events, group of things or households that are being investigated. The target population of this study was all the 43 commercial banks in Kenya (CBK, 2014).

3.4 Sample

The sample design of this study was mainly based on Kothari's (2004) hypotheses. According to Kothari (2004) a sample of 10-30% of the target population is usually representative and generalizable. Therefore, the sample size for the study was 13 commercial banks. The study area was stratified into two sampling sectors namely: international and local commercial banks. Therefore, the study used stratified random sampling technique to obtain a sample size of 13 commercial banks from a target population of 43 commercial banks in Kenya. The study also used simple random sampling technique across strata. According to Mugenda and Mugenda (2008), stratified sampling technique is useful for heterogeneous samples such as commercial banks that will be grouped into sectors of local and international commercial banks while random sampling technique accords each element in a sample an equal probability of being sampled hence eliminating representative biasness.

3.5 Data Collection

For the purpose of this study, the researcher used secondary data. Secondary data was obtained from the published annual reports spanning five years (2009-2013) for the sampled commercial banks.

3.6 Data Analysis

Data collected was edited, coded and classified into different components to facilitate a better and efficient analysis. Islamic banking by commercial banks has various components. For the purpose of this study, Islamic banking was analysed using capital ratio, liquidity ratio, efficiency ratio, capital adequacy ratio and bank size. They were analysed using descriptive statistics. The financial performance was measured using

return on assets. Regression analysis was used to test the relationship between Islamic banking and financial performance of commercial banks in Kenya.

3.6.1 Conceptual Model

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

Where Y=financial performance; X_1 = Islamic Banking ratio; X_2 = capital ratio; X_3 = liquidity ratio; X_4 = efficiency ratio X_5 = expenses management ratio while X_6 = bank size.

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

X_1 = Islamic Banking ratio = [Income from Islamic banking/Total income]

X_2 = capital ratio = [total equity/total assets]

X_3 = liquidity ratio = [total loans/total deposits]

X_4 = efficiency ratio= [total operating expenses/total income]

X_5 = expenses management ratio = [operating expenses / total assets]

X_6 = bank size = [value of total banking assets]

3.6.2 Analytical Model

The analytical model specification is as follows

$$Y=\alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\beta_5X_5+\beta_6X_6+\varepsilon.$$

Where Y = financial performance; X_1 = Islamic Banking ratio, X_2 = capital ratio; X_3 = liquidity ratio; X_4 = efficiency ratio; X_5 = expenses management ratio while X_6 = bank size ε = error term β =coefficient of independent variable α = constant.

3.6.3 Test of Significance

The multiple linear regression model and t-statistic was used to determine the relative importance (sensitivity) of each independent variable (Islamic Banking) in affecting the financial performance of commercial banks which was measured using Return on Asset of commercial banks. The results are said to be statistically significant within the 0.05 level, which means that the significance value must be smaller than 0.05. The significance was determined by the t-value, which indicates how many standard error means the sample diverges from the tested value (Kothari, 2004).

CHAPTER FOUR

DATA ANALYSIS, INTERPRETATION AND PRESENTATION

4.1 Introduction

This chapter presents data analysis and interpretation. The objective of the study was to establish the effect of Islamic banking on financial performance of commercial banks in Kenya. Data was collected from 13 commercial banks for a period of five years from 2009 to 2013. The data sources were published annual reports spanning five years (2009-2013) for the sampled 13 commercial banks as well as other publications. Data was collected based on the variables of the study, that is, return on assets depicted by Islamic banking, capital ratio, liquidity ratio, efficiency ratio, expenses management and bank size.

4.2 Descriptive Statistics

Table 4.1 Summary of Study Variables

	Return on assets (ROA)	Islamic Banking	Capital ratio	Liquidity ratio	Efficiency ratio	Expenses management ratio	Bank size
Std. Dev	0.690	1.016	0.418	0.180	1.035	0.724	1859
Mean	3.17	0.066	0.282	2.804	0.598	0.286	2515.4
Lowest	2.14	0.03	0.14	2.68	0.54	0.25	2016
Highest	4.12	0.11	0.42	2.97	0.67	0.32	3220
Median	3.16	0.07	0.28	2.80	0.59	0.28	2440

4.2.1 Return on Assets

The findings as shown in Table 4.1 above shows the distribution of Return on Assets values over a period of 5 years. The lowest mean value for ROA was 2.14 in year 2009 while the highest mean value for ROA was 4.12 in 2013. The steady rise in the Return on Assets values over the 5 year period indicates that the financial performance of the 13 commercial banks have been on the increase over the last 5 years. On the other hand, the different scores of standard deviation indicate variation in the financial performance for the various commercial banks. Thus, Islamic banking enhanced the financial performance of commercial banks in Kenya.

4.2.2 Islamic Banking Ratio

The findings as shown in Table 4.1 above indicate the trend of Islamic banking over the 5 year period. From the findings, the lowest value of Islamic banking was a mean of 0.03 in year 2009 while the highest value of Islamic banking was a mean of 0.11 in year 2013. This shows a steady increase in the Islamic banking of the 13 commercial banks over the 5 year period. In addition, the different standard deviation values depict a variation in the Islamic banking levels of the different commercial banks in Kenya. Thus, Islamic banking had a positive impact on the financial performance of the various commercial banks in Kenya that were implementing the same.

4.2.3 Capital Ratio

The findings as shown in Table 4.1 above indicate the trend of capital ratio over the 5 year period. From the findings, the lowest value of capital ratio was a mean of 0.14 in year 2009 while the highest value of capital ratio was a mean of 0.42 in year 2013. This shows a steady increase in the capital ratio of the 13 commercial banks over the

5 year period. In addition, the standard deviation depicts a variation in the capital ratio of the different commercial banks in Kenya. Thus, capital ratio positively affected the financial performance of the various commercial banks in Kenya.

4.2.4 Liquidity Ratio

The findings as shown in Table 4.1 above further indicate the trend of liquidity ratio over the 5 year period. From the findings, the lowest value of liquidity ratio was a mean of 2.68 in year 2009 while the highest value of liquidity ratio was a mean of 2.97 in year 2013. This shows a slight increase in the liquidity ratio of the 13 commercial banks over the 5 year period. Thus, the liquidity ratio positively impacted on the financial performance of the various commercial banks in Kenya.

4.2.5 Efficiency Ratio

The findings as shown in Table 4.1 above indicate the trend of efficiency ratio over the 5 year period. From the findings, the lowest value of efficiency ratio was a mean of 0.54 in year 2013 while the highest value of efficiency ratio was a mean of 0.67 in year 2009. This shows a steady decrease in the efficiency ratio of the 13 commercial banks over the 5 year period. In addition, the standard deviation depicts a variation in the efficiency ratio of the different commercial banks in Kenya. Thus, the efficiency ratio negatively affected the financial performance of the various commercial banks in Kenya.

4.2.6 Expenses Management Ratio

The findings as shown in Table 4.1 above also indicate the trend of expenses management ratio over the 5 year period. From the findings, the lowest value of

expenses management ratio was a mean of 0.25 in year 2009 while the highest value of expenses management ratio was a mean of 0.32 in year 2009. This shows a steady decrease in the expenses management ratio of the 13 commercial banks over the 5 year period. Thus, the expenses management negatively affected the financial performance of the various commercial banks in Kenya.

4.2.7 Bank Size

In addition, the findings as shown in Table 4.1 above indicate the trend of bank size over the 5 year period. From the findings, the lowest value of bank size was a mean of Kshs. 2016 million in year 2009 while the highest value of bank size was a mean of Kshs. 3220 million in year 2013. This shows a steady increase in the bank size of the 13 commercial banks over the 5 year period. In addition, the high standard deviation scores depict a variation in the bank size of the different commercial banks in Kenya. Thus, the bank size positively affected the financial performance of the various commercial banks in Kenya.

4.3 Correlation Analysis

Table 4.2 Correlation Matrix

	Financial performance	Islamic Banking	Capital ratio	Liquidity ratio	Efficiency ratio	Expenses management ratio	Bank size
Financial performance	1.0000	0.466	0.472	0.653	0.487	0.724	0.737
Islamic Banking	0.466	1.000	0.289	0.163	0.161	0.271	0.271
Capital ratio	0.472	0.289	1.000	0.216	0.233	0.348	0.347
Liquidity ratio	0.653	0.163	0.216	1.000	0.462	0.454	0.454
Efficiency ratio	0.487	0.161	0.233	0.462	1.000	0.543	0.543
Expenses management ratio	0.724	0.271	0.348	0.454	0.543	1.000	0.622
Bank size	0.737	0.271	0.347	0.454	0.543	0.622	1.000

Based on the correlation matrix on Table 4.2 above, there is a positive relationship between Islamic banking, capital ratio, liquidity ratio, efficiency ratio, expenses management ratio and bank size and financial performance of commercial banks in Kenya.

4.4 Regression Analysis and Hypotheses Testing

In determining effect of Islamic banking on financial performance of commercial banks in Kenya, the study conducted a multiple regression analysis to determine the nature of relationship between the variables. The regression model specification was as follows;

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

Where; Y= financial performance = Return on Assets

X₁ = Islamic Banking ratio, X₂ = capital ratio; X₃ = liquidity ratio; X₄ = efficiency ratio; X₅ = expenses management ratio while X₆ = bank size

α =constant,

ϵ = error term,

β =coefficient of the independent variables.

This section presents a discussion of the results of the multiple regression analysis. The study conducted a multiple regression analysis to determine the relative importance of each of the variables with respect to financial performance of the 13 commercial banks in Kenya. The study applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study. The findings are as presented in the following tables;

Table 4.3 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.899 ^a	.8082	.786	0.0125

a. Predictors: (Constant), Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expenses management ratio, bank size

b. Dependent Variable: financial performance

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the changes in the independent variables or the percentage of variation in the dependent variable (financial performance) that is explained by all the five independent variables (capital ratio, liquidity ratio, efficiency ratio, capital adequacy ratio and bank size).

The five independent variables that were studied, explain 80.82% of variance in financial performance of the 13 commercial banks as represented by the R^2 . This therefore means that other factors not studied in this research contribute 19.18% of variance in the dependent variable. Therefore, further research should be conducted to investigate the other factors that affect the financial performance of commercial banks in Kenya.

Table 4.4 ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.323	2	.202	8.64	.004 ^a
	Residual	5.408	3	.246		
	Total	6.898	64			

a. Predictors: (Constant), Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expenses management ratio, bank size

b. Dependent Variable: financial performance

Analysis of Variance (ANOVA) consists of calculations that provide information about levels of variability within a regression model and form a basis for tests of significance. The "F" column provides a statistic for testing the hypothesis that all $\beta \neq 0$ against the null hypothesis that $\beta = 0$ (Weisberg, 2005). From the findings the significance value is .004 which is less than 0.05 thus the model is statistically significant in predicting how Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expenses management ratio and bank size affect financial performance of commercial banks in Kenya. The F critical at 5% level of significance was 3.23. Since F calculated (value = 8.64) is greater than the F critical (3.23), this shows that the overall model was significant.

Table 4.5 Multiple Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta	B	
(Constant)	3.374	.836		3.61	.000
Islamic banking ratio	0.614	.386	0.317	2.42	.0018
Capital ratio	0.811	.412	0.228	1.81	.0008
Liquidity ratio	0.732	.854	0.159	8.41	.0011
Efficiency ratio	0.543	.580	0.151	4.56	.0028
Expenses management ratio	0.580	.620	0.172	1.45	.0022
Bank size	0.632	.723	0.164	1.37	.0015

From the regression findings, the substitution of the equation

$(Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon)$ becomes;

$$Y = 3.374 + 0.614 X_1 + 0.811 X_2 + 0.732 X_3 + 0.543 X_4 + 0.580 X_5 + 0.632 X_6 + \varepsilon$$

Where Y is the dependent variable (financial performance), X_1 is the Islamic banking ratio, X_2 is the capital ratio, X_3 is the liquidity ratio, X_4 is the efficiency ratio, X_5 is the expenses management ratio and X_6 is the bank size.

According to the equation, taking all the factors (Islamic banking ratio, capital ratio, liquidity ratio, efficiency ratio, expenses management ratio and bank size) constant at zero, financial performance will be 3.374. The data findings also show that a unit increase in Islamic banking ratio will lead to a 0.614 unit increase in financial performance; a unit increase in capital ratio will lead to a 0.811 unit increase in financial performance; a unit increase in liquidity ratio will lead to a 0.732 unit increase in financial performance, a unit increase in efficiency ratio will lead to a 0.543 unit increase in financial performance, a unit increase in expenses management ratio will lead to a 0.580 unit increase in financial performance while a unit increase in bank size will lead to a 0.632 unit increase in financial performance. This means that the most significant factor is capital ratio followed by liquidity ratio.

At 5% level of significance and 95% level of confidence, capital ratio had a 0.0008 level of significance; liquidity ratio had a 0.0011 level of significance, bank size had a 0.0015 level of significance; Islamic banking ratio had a 0.0018 level of significance, expenses management ratio had a 0.0022 level of significance while efficiency ratio had a 0.0028 level of significance, implying that the most significant factor is capital ratio followed by liquidity ratio, bank size, Islamic banking ratio, expenses management ratio and efficiency ratio, respectively.

4.4 Discussion of Findings

The objective of the study was to determine the effect of Islamic banking on financial performance of commercial banks in Kenya. The objective was assessed by use of secondary data and the subsequent analysis based on the variables of the study.

From the findings, financial performance of the 13 commercial banks under study increased over the 5 year period as depicted by the ROA values. The mean increase in the ROA values from a mean of 2.14 in year 2009 to a mean of 4.12 in year 2013 indicates a steady increase in the commercial banks' financial performance over the 5 year period. Thus, Islamic banking enhanced the financial performance of commercial banks in Kenya. These findings are consistent with Hassoune (2002) who observed that Islamic banks are certainly more profitable than their conventional peers enjoying the same balance sheet structure. The main reason for such a difference is that Islamic banks benefit from a market imperfection. Islamic banks lose on the grounds of liquidity, assets and liabilities concentrations and operational efficiency. The findings are also in line with Josephat (2012) who investigated the effect of offering Shariah compliant products on financial performance of commercial banks in Kenya and found out that indeed offering new products such as Shariah compliant products really had a positive effect on the financial performance of the banks.

The study findings revealed that Islamic banking ratio steadily increased from a mean of 0.03 in year 2009 to a mean of 0.11 in year 2013. Thus, Islamic banking positively affected the financial performance of the various commercial banks in Kenya. These findings are in line with Haron and Ahmad (2001) who observed that Islamic banking

as an emerging banking concept had a positive impact on the profitability of modern day banks.

The study findings revealed that capital ratio steadily increased from a mean of 0.14 in year 2009 to a mean of 0.42 in year 2013. Thus, capital ratio positively affected the financial performance of the various commercial banks in Kenya. These findings are in line with Haron and Ahmad (2001) who observed that capital ratio, interest rate and inflation are positively related with the profitability of Islamic banks.

The study findings revealed that liquidity ratio slightly increased from a mean of 2.68 in year 2009 to a mean of 2.97 in year 2013. Thus, the liquidity ratio positively impacted on the financial performance of the various commercial banks in Kenya. The findings are consistent with previous studies done by Kader, Janbota, Asarpota and Anju (2007) and Safiullah (2010) where they all concluded that Islamic banks are not suffering from excess liquidity and are more cost effective and profitable than their conventional counterparts.

The study findings revealed that efficiency ratio steadily decreased from a mean of 0.67 in year 2009 to a mean of 0.54 in year 2013. Thus, the efficiency ratio negatively impacted on the financial performance of the various commercial banks in Kenya. The findings are consistent with Hassoune (2002) who concluded that Islamic banks are certainly more profitable than their conventional peers enjoying the same balance sheet structure. The main reason for such a difference is that Islamic banks benefit from a market imperfection and that Islamic banks lose on the grounds of liquidity, assets and liabilities concentrations and operational efficiency. The findings

are also in agreement with Hassan & Bashir (2003) who also found out that the NIM as another indicator of performance measure indicated that conventional banks are operationally efficient than Islamic banks.

The study findings indicated that expenses management ratio decreased from a mean of 0.32 in year 2009 to a mean of 0.25 in year 2013. Thus, the expenses management had an inverse relationship with the financial performance of the various commercial banks in Kenya. The findings are consistent with Hassan & Bashir (2003) who observed that the profitability of interest-free banks is positively influenced by high capital and loan-to-asset ratios, favourable macroeconomic conditions, and negatively to taxes. The findings are also in line with Iqbal (2001) who made comparison of performance of Islamic banks with conventional banks with respect to profitability, liquidity and risk. Expenses management and deployment efficiency were also studied. He concluded that Islamic banks as a group out-performed the former in almost all areas and in almost all years.

The study findings revealed that bank size steadily increased from a mean of Kshs. 2016 million in year 2009 to a mean of Kshs. 3220 million in year 2013. Thus, the bank size positively affected the financial performance of the various commercial banks in Kenya. The findings are consistent with Ahmednoor (2012) who did an evaluation of Islamic banking products and financial performance of Islamic banks in Kenya and observed that there exist a strong positive relationship between product size and amount and the financial performance of Islamic bank in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the data findings on the effect of Islamic banking on financial performance of commercial banks in Kenya. The conclusions and recommendations are drawn there to. The chapter is therefore structured into summary of findings, conclusions, recommendations and areas for further research.

5.2 Summary of Findings

The study established that the financial performance of the 13 commercial banks under study as represented by ROA values increased by a mean ratio of 1.98 over the 5 year period. This is as represented by the difference between the lowest mean of 2.14 in year 2009 and the highest mean of 4.12 in year 2013 for the return on assets ratio. Therefore, Islamic banking enhanced the financial performance of commercial banks in Kenya. The study found out that there was a steady increase in the commercial banks' Islamic banking ratio as reflected by the increase in mean values from 0.03 in year 2009 to 0.11 in year 2013. Therefore, Islamic banking positively affected the financial performance of the various commercial banks in Kenya over the 5 year period.

The study found out that there was a steady increase in the commercial banks' capital ratio as reflected by the increase in mean values from 0.14 in year 2009 to 0.42 in year 2013. Therefore, capital ratio positively affected the financial performance of the various commercial banks in Kenya over the 5 year period. The study found out that there was a slight increase in the commercial banks' liquidity ratio as reflected by the

increase in mean values from 2.68 in year 2009 to 2.97 in year 2013. Therefore, liquidity ratio positively impacted on the financial performance of the various commercial banks in Kenya over the 5 year period.

The study found out that there was a slight decrease in the commercial banks' efficiency ratio as reflected by the decrease in mean values from 0.67 in year 2009 to 0.54 in year 2013. Therefore, the efficiency ratio had a negative relationship with the financial performance of the various commercial banks in Kenya over the 5 year period. The study found out that there was a steady decrease in the commercial banks' capital expenses management ratio as reflected by the decrease in mean values from 0.32 in year 2009 to 0.25 in year 2013. Therefore, the expenses management ratio negatively affected the financial performance of the various commercial banks in Kenya over the 5 year period.

The study found out that there was a steady increase in the bank size of the commercial banks as reflected by the increase in mean values from Kshs. 2016 million in year 2009 to Kshs. 3220 million in year 2013. Therefore, the bank size positively affected the financial performance of the various commercial banks in Kenya over the 5 year period.

5.3 Conclusion

Given that the Islamic banking ratio of the commercial banks steadily increased over the 5 year period and the commercial banks' financial performance also steadily increased over the same period, the study concludes that Islamic banking ratio positively affected the financial performance of the commercial banks in Kenya.

Given that the capital ratio of the commercial banks steadily increased over the 5 year period and the commercial banks' financial performance also steadily increased over the same period, the study concludes that capital ratio positively affected the financial performance of the commercial banks in Kenya.

Given the increase in the liquidity ratio of the commercial banks over the 5 year period and the corresponding increase in the commercial banks' financial performance over the same period, the study concludes that liquidity ratio positively impacted on the financial performance of the various commercial banks in Kenya.

Given the decrease in the efficiency ratio of the commercial banks over the 5 year period and the corresponding increase in the commercial banks' financial performance over the same period, the study concludes that efficiency ratio negatively affected the financial performance of the commercial banks in Kenya.

Given the steady decrease in the expenses management ratio of the commercial banks over the 5 year period and the corresponding increase in the commercial banks' financial performance over the same period, the study concludes that expenses management ratio negatively affected the financial performance of the various commercial banks in Kenya. Given the steady increase in the bank size of the commercial banks over the 5 year period and the corresponding increase in the commercial banks' financial performance over the same period, the study concludes that the bank size positively affected the financial performance of the various commercial banks in Kenya.

5.4 Recommendations

From the findings, the study established that Islamic banking ratio positively affected the financial performance of the various commercial banks in Kenya. Therefore the study recommends that the management of the commercial banks should aggressively market their Islamic banking product in order to increase their Islamic banking clientele so as to enhance their firms' financial performance.

From the findings, the study established that capital ratio positively affected the financial performance of the various commercial banks in Kenya. Therefore the study recommends that the management of the commercial banks should strive to achieve an optimal capital structure for their firms in order to enhance their firms' value hence leading to an increase in their firms' financial performance.

From the findings, the study established that the liquidity ratio positively affected the financial performance of the various commercial banks in Kenya. Therefore the study recommends that the management of the commercial banks should strive to achieve a stable liquidity position in order to enhance their firms' financial performance.

From the findings, the study established that both the efficiency ratio and the expenses management ratio had a negative influence on the financial performance of the various commercial banks in Kenya. Thus, the study recommends that the management of the commercial banks should strive to enhance operational efficiency and expenses management of the banks in order to enhance their firms' financial performance.

From the findings, the study established that bank size of the commercial banks positively affected the financial performance of the commercial banks in Kenya. Therefore the study recommends that the management of the commercial banks should strive to expand target markets for the growth of their commercial banks which in turn enhances their financial performance.

5.5 Limitations of the Study

The study was faced with lack of availability of information. This was because banks level of information disclosure differed where some of the banks did not disclose all the information on Islamic banking due to the fact that it is not compulsory regulatory requirement to disclose the information to the public.

The study was limited by lack of co-operation by the study respondents owing to their busy work schedule when the researcher sought clarification from the commercial banks. The descriptive research design also has inherent limitations. The limitation includes the risk of non-response rate because it is conducted on the basis of voluntary participation.

The study was further limited by the inconsistency of financial information where all published sources seemed to have different figures from the other. Documents heavily relied on statistical reports and annual reports by the CBK disregarding any other source that differed with the figures in these documents.

5.6 Suggestions for Further Research

Since this study explored the effect of Islamic banking on financial performance of commercial banks in Kenya, the study recommends that; similar study should be done

in other countries for comparison purposes and to allow for generalization of findings on the effect of Islamic banking on the financial performance of commercial banks.

Since this study explored the effect of Islamic banking on financial performance of commercial banks in Kenya, the study recommends that similar study should be done to explore the challenges that face Islamic banking and their impact on the financial performance of commercial banks in Kenya. A comparative study between Islamic banking and conventional banking in Kenya should be conducted.

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APPENDICES

APPENDIX I: RAW DATA SUMMARY

	Return on assets (ROA)	Islamic banking	capital ratio	liquidity ratio	efficiency ratio	expenses management ratio	bank size
2009	2.14	0.03	0.14	2.68	0.67	0.32	2016
2010	2.58	0.04	0.21	2.70	0.63	0.31	2218
2011	3.16	0.07	0.28	2.80	0.59	0.28	2440
2012	3.85	0.08	0.36	2.87	0.56	0.27	2683
2013	4.12	0.11	0.42	2.97	0.54	0.25	3220

APPENDIX II: LIST OF COMMERCIAL BANKS IN KENYA

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank (Kenya)
6. CfC Stanbic Holdings
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Eco Bank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. First Community Bank
22. Giro Commercial Bank
23. Guaranty Trust Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich
28. Housing Finance Company of Kenya

- 29.I & M Bank
- 30.Imperial Bank Kenya
- 31.Jamii Bora Bank
- 32.Kenya Commercial Bank
- 33.K-Rep Bank
- 34.Middle East Bank Kenya
- 35.National Bank of Kenya
- 36.NIC Bank
- 37.Oriental Commercial Bank
- 38.Paramount Universal Bank
- 39.Prime Bank (Kenya)
- 40.Standard Chartered Kenya
- 41.Trans National Bank Kenya
- 42.United Bank for Africa
- 43.Victoria Commercial Bank

Source: CBK (2014)

**APPENDIX III: COMMERCIAL BANKS OFFERING ISLAMIC BANKING
IN KENYA**

1. Barclays bank
2. First Community Bank
3. Gulf African Bank
4. Standard Chartered bank
5. National bank
6. Dubai bank
7. Kenya Commercial Bank
8. Middle East Bank Kenya