AN ASSESSMENT OF THE DETERMINANTS OF FINANCIAL PERFORMANCE OF ISLAMIC BANKS AND CONVENTIONAL BANKS IN KENYA

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DECLARATION

This research project is my original work and has not been presented for award of a degree in any other university or institution for any other purpose.

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

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DEDICATION

I dedicate this project to my parents Francis Inyangala and Tecla Inyangala and my siblings Hellen, Josephine, and Gladys, who offered me unconditional love and support throughout the course of my studies.

ABSTRACT

Islamic banking is banking business whose aims and operations do not involve any element which is not approved by the religion of Islam. While the aim of both conventional and Islamic banks is profitability, the former heavily relies on interest for profits while the latter does not charge interest. The general objective of this study therefore was to evaluate the determinants of financial performance of conventional and Islamic banks in Kenya. This study adopted an explanatory research design. From the population of 43, a sample of 20 was selected comprising the commercial banks listed as small by the CBK bank supervision; this comprised the 2 fully Shari'ah compliant banks (Gulf African Bank and First Community Bank) and 18 other conventional banks. Secondary data was used for this study by reviewing both empirical and theoretical data from books, journals, dissertations, magazines and the internet. Data analysis involved multi-variate analysis using Statistical Package for Social Sciences (SPSS). The study findings indicated that capital adequacy and asset quality were high in most of the banks as indicated by their average means. The findings further show that conventional banks showed high means in all financial performance determinants as compared to Islamic banks. For instance; First community bank limited and Gulf African bank had the lowest Return on Assets as compared to other banks.The study recommends that Islamic banks should manage risks involved during their operation to minimize potential risks and loses involved. The study also recommends that dividends paid to shareholders should be well managed to maximize the profits, and that banks should maximize lending to customers and scrutinize their financial ability to repay before advancing loans to them to avoid default loans in order for them to maximize profits especially in the case of Islamic banks.

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ABBREVIATIONS

CBK	:	Central Bank of Kenya
DIB	:	Dubai Islamic Bank (DIB)
FCB	:	First Community Bank
GAB	:	Gulf African Bank
GCC	:	Gulf Cooperation Council
IBA	:	Islamic Banking Act
IBB	:	Islamic Bank of Britain
IDB	:	Islamic Development Bank
NPR	:	Net Profit Ratio
OER	:	Operating Expense Ratio
ROA	:	Return on Asset
ROE	:	Return on Equity
SPSS	:	Statistical Package for Social Sciences

CHAPTER ONE

INTRODUCTION

1.1Background of the Study

Commercial banking in many countries of the world is an industry in transition and Kenya is no exception. There are many people who believe that commercial banks are facing their greatest challenges since the Great Depression, including navigating the new tight regulatory framework imposed and dealing with the repercussions of the global financial crisis; which has seen many large multinational banks post losses across the globe while posting profits in Kenya (Filbeck et. al, 2011). The global financial crisis was as a result of bank failure brought about by rising interest rates that led to inability of debtors to service their loans (Allen and Carletti, 2009) . According to Siraj and Pillai (2012) Islamic banks were less affected during the economic crisis since they neither charge interest on loans nor pay interest on deposits.

Islamic banking is banking business whose aims and operations do not involve any element which is not approved by the religion of Islam (IBA,1983). According to Abd-Rahman (2007), the basic principles underlying Islamic financial transactions are that; the purpose of financing should not involve any activity prohibited by Shari'ah (Islamic law); the financing must not involve riba(the charging of interest), economic activities involving zulm (opression) should be avoided, economic activities involving gharar (speculation) must not be undertaken, zakat(Islamic tax)need to be paid and production of goods and services which contradict the Islamic value (haram) should be discouraged. On the other hand, conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on one hand and between the borrowers and the bank on the other and interest is considered to be the price of credit, reflecting the opportunity

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cost of money(Abd- Rahman (2007).Although interest-free financial transactions existed in various parts of the Muslim world several decades earlier, it was not until the early 1960s that the convergence of political and socioeconomic factors ignited interest in the revival of faith-based islamic financial practices, including prohibition of usury or the giving or receiving of interest (riba); thereby giving rise to modern Islamic finance (Iqbal and Molyneux, 2005).The earliest writings on the subject of Islamic banking and finance date back to the nineteen-forties (Siddiqi,1983), and the earliest practice can be traced to the early nineteen-sixties (Ahmad,1995).

According to Ahmad (1995), the nineteen-sixties saw the establishment of interest-free banks, such as one in Karachi, that of Tabung Haji in Malaysia and the Mit Ghamir Islamic Bank in Egypt, based on sharing of profits and avoided interest; this is often viewed as the starting point of modern Islamic banking and finance movement. However only Tabung Haji survived thanks to its roots in the community, its narrow focus, official blessings and clear structure as a business. According to Iqbal and Molyneux (2005), early nineteen- seventies saw the establishment of the first Islamic Bank, Dubai Islamic bank (DIB), followed by the Islamic Development Bank (IDB) in Jeddah-Saudi Arabia; and many private and semi-private Islamic banks that were established later. The IDB which started operations in 1975 was designed to serve Muslim countries and communities by arranging finance for trade and development on non-interest basis. Al-Hayat Al-Iqtisadiyah (2005) noted that the world has been witnessesing a rife of Islamic banks all over the world; in addition, several conventional banks have opened branches, windows or are providing Islamic financial products.

1.1.1 Financial performance

Like all business ventures, commercial banks' main goal is to make profit. The overall financial performance of a bank is the sum of the performance of the individual branches and units of the bank as measured by its net profit (Filbeck et.al, 2011).To measure the profitability of commercial banks there are variety of ratios used of which Return on Equity andReturn on Assest the major ones (Alexandru et al., 2008).

1.1.1.1 Return on Equity

According to Khrawish (2011),Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. It reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. A normal bank's situation margin of this indicator is appreciate to between the significant thresholds of 10% and 30% respectively (Alexandru et al., 2008).

1.1.1.2 Return on Assets

Return on Assets (ROA) is a ratio of Income to its total asset (Khrawish, 2011). It measures the ability of the bank management to generate income by utilizing company assets at their disposal; it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the management of a company in generating net income from all the resources of the institution (Khrawish, 2011). A higher ROA shows that the company is more efficient in using its resources (Wen, 2010).

1.1.2 Determinants of Financial Performance

In assessing financial performance, it is possible to touch on changing revenue, bank deposits, bank revenue, asset base and mix, as well as prospects for future shareholders

value creation and executive compensation (Murphy, 2010). Commercial banking continues to adapt to the ever changing financial environment, with early signs of changes being evident in many banks, both small and large. Available literature suggests that, when it comes to banks, size matters. According to Filbeck et. al (2011), size plays a significant role in a bank's ability to outperform the industry standards particularly during economic contraction.

According to Al-Tamimi (2010), the determinants of bank performance can be classified into bank specific (internal) and macroeconomic (external) factors. He defined Internal factors as individual bank characteristics which affect the banks performance while external factors as countrywide variables that are beyond the control of the bank. According to Dang (2011) the CAMEL framework is normally used by scholars to proxy the bank specific factors. CAMEL in this case stands for Capital Adequacy, Asset Quality, Management Efficiency, Earnings Ability and Liquidity. The macoeconomic determinantsof bank performance include macroeconomic policy stability, Gross Domestic Product, Inflation, Interest Rate and Political instability (Ongore and Kusa, 2013).

1.1.3 Relationship between Determinants and Financial Performance

According to Ongore and Kusa (2013), bank specific factors significantly affect the performance of commercial banks in Kenya, except for liquidity variable but the overall effect of macroeconomic variables is inconclusive at 5% significance level. In the UAE, the bank specific variables also affect performance of commercial banks significantly as opposed to macroeconomic variables in both conventional banks and Islamic banks (Al-Tamimi, 2010). According to Al-Tamimi (2010), liquidity and concentration are the most

significant determinants of conventional banks' performance. On the other hand, cost and number of branches are the most significant determinants of Islamic banks' performance.

1.1.4 Commercial Banks in Kenya

A commercial bank is a company carrying on, or proposing to carry onbanking business (Banking Act, 2009). Further, Commercial Banks are licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines. Close attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with set laws and regulations. This regulatory structure creates transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things (CBK,2013).

The CBK licenses, supervises and regulates commercial banks as manadated by the Banking Act, Cap 488. Currently there are there are 43 licensed commercial banks in Kenya. Out of the 43 licenced institutions, there are 41 conventional banks 5 of which operate Islamic windows and 2 fully shariah compliant banks- Gulf African Bank (GAB) and First Community Bank. (CBK, 2013).According to CBK (2009), inquiries into Islamic Banking began in the late nineteen-nineties and early 2000's but first serious expression of interest was lodged with CBK in 2004. Further, in order to develop capacity in this banking niche, a study tour was carried out in UAE and UK in 2005 and extensive research was carried out on legal and regulatory framework of other jurisdictions carrying out Islamic finance in Malaysia, Indonesia, Bahrain and Kuwait. Following the tour and research, CBK wrote recommendations to the Ministry of Finance to regulate banks operating under Islamic Banking principles within existing legal and regulatory framework, a policy position that was approved by Treasury in late 2005.

The tenets of CBK policy on Islamic banking provide that: 'Islamic Banks' are not separately defined in the Banking Actand all banks can offer Shari'ah compliant banking products subject to statutory and prudential requirements. Applications for two institutions consisting of; Gulf African Bank (GAB) and First Community Bank (FCB) proposing to operate under Islamic principles were received in late 2006 and early 2007, were reviewed in 2007 and began operations in December 2007 and May 2008 respectively. Since then other commercial banks began offering Shari'ah compliant banking products alongside conventional products (CBK, 2009).

1.2 Research Problem

Commercial banks exist to facilitate the flow of funds from surplus spending units to deficit spending units through financial intermediation, such as taking deposits and issuing them as loans (Pierre,2001). According to to Abd- Rahman (2007), both Conventional and Islamic banks aim to maximize profits with the difference being that the former operates without restrictions while the latter must be guided by Shari'ah (Islamic law) restrictions. Conventional banks' main source of income is issuing of loans at an interest which ensures their survival and competitiveness. Qureshi (1946) notes that unlike conventional banking, Islamic banking should be looked at as a social service that should be sponsored by the Government like public health and education. The basic principles of Islamic banking highlighted by Abd-Rahman (2007); prohibition of riba, gharar, avoidance of opression and paying of zakat; do not allow the making of unjustified income. Regardless, uptake of Islamic Banking is steadily increasing in Kenya with the establishment of two fully shari'ah compliant banks (Gulf African Bank (GAB) and First Community Bank (FCB), and conventional banks setting up Islamic windows. In addition, Islamic banks

have managed to post profits in the highly competitive banking industry in Kenya registering triple digit rise in profit in 2012; GAB 154% and FCB 238% (Mwaniki, 2013).

Financial performance analysis of commercial banks has been of great interest to academic research. In the last two decades studies have shown that commercial banks in Sub-Saharan Africa (SSA) are more profitable than the rest of the world (Flamini et al., 2009). A number of studies have been done to establish the determinants of financial performance both locally and internationally and have determined that bank specific factors significantly determine financial performance as opposed to the macroeconomic factors (Al-Tamimi,2010; Olweny and Shipho,2011; Ongore and Kusa,2013). Al-Tamimi (2010) attributed financial performance of Islamic banks to cost and number of branches while that of conventional banks was attributed to liquidity and concentration. CAMEL factors were considered to be significant contributors of banks' financial performanceby various authors (Olweny and Shipho,2011; Ongore and Kusa,2013)

Although studies have been done to assess the determinants of financial performance of commercial banks locally (Olweny and Shipho,2011; Ongore and Kusa,2013), the period of research used has excluded Islamic banks in the analysis. Due to the operational differences between Islamic banks and conventional banks, it was presumed that the determinants of financial performance between the two banks would differ. It is for this reason that this study sought to fill this gap and assess the determinants of financial performance in Islamic banks as well as conventional banks.

1.3 Research Objectives

1.3.1 General Objective

To assess the determinants of financial performance of Islamic and conventional banks in Kenya.

1.3.2 Specific Objectives

i.   To establish how capital adequacy determines financial performance of Islamic and conventional banks in Kenya.

ii. To find out how Asset quality determines financial performance of Islamic and conventional banks in Kenya.

iii. To determine how management efficiency determines financial performance of Islamic and conventional banks in Kenya.

iv. To ascertain how liquidity management determines financial performance of Islamic and conventionalbanks in Kenya.

1.4 Value of the Study

It will enable Islamic Banks to know what determines their performance and put more efforts to improve on the key variables. Similarly, conventional Banks with Islamic windows will be able to know the key determinants of financial performance in Islamic banks which will enable them to improve on the performance of the Islamic windows.

This study will add onto the existing body of knowledge of Islamic Banking and finance. It will facilitate academicians/researchers in carrying out future studies related to Islamic Banking and finance by facilitating in review of literature of their studies.

The Government, as a beneficiary of this study will be able to assess the need for separate regulation of Islamic Banking in form of Islamic Banking Act as opposed to being under the same regulation with conventional banks under the Banking Act.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The aim of this section is to establish what literature, academic and otherwise is available to help get a better understanding of the financial performance of Islamic banks and conventional banks and the determinants of financial performance of commercial banks.

2.2 Theoretical Framework

2.2.1 Market Power (MP) Theory

According to Athanasoglou et al, (2006) the MP hypothesis posits that the performance of bank is influenced by the market structure of the industry. There are two distinct approaches within the MP theory; the Structure-Conduct-Performance (SCP) and the Relative Market Power hypothesis (RMP). According to the SCP approach, the level of concentration in the banking market gives rise to potential market power by banks, which may raise their profitability. Banks in more concentrated markets are most likely to make "abnormal profits" by their ability to lower deposits rates and to charge higher loan rates as a results of collusive (explicit or tacit) or monopolistic reasons, than firms operating in less concentrated markets, irrespective of their efficiency (Tregenna, 2009). Unlike the SCP, the RMP hypothesis posits that bank profitability is influenced by market share. It assumes that only large banks with differentiated products can influence prices and increase profits. They are able to exercise market power and earn non-competitive profits.

A firm with MP has the ability to individually affect either the total quantity or the prevailing price in the market. The firm usually has market power by virtue of controlling a large portion of the market. In extreme cases - monopoly and monopsony - the firm

controls the entire market. However, market size alone is not the only indicator of market power. According to Vatiero(2010), highly concentrated markets may be contestable if there are no barriers to entry or exit, limiting the incumbent firm's ability to raise its price above competitive levels.Market power gives firms the ability to engage in unilateral anti-competitive behavior. If no individual participant in the market has significant market power, then anti-competitive behavior can take place only through collusion, or the exercise of a group of participants' collective market power. Market power maybe measured using the Lerner index and Herfindahl index (Vatiero, 2010).

2.2.2 Efficiency Structure (ES) Theory

The ES hypothesis, on the other hand posits that banks earn high profits because they are more efficient than others. There are also two distinct approaches within the ES; the X-efficiency and Scale–efficiency hypothesis. According to the X-efficiency approach, more efficient firms are more profitable because of their lower costs. Such firms tend to gain larger market shares, which may manifest in higher levels on market concentration, but without any causal relationship from concentration to profitability (Athanasoglou et al, 2006). The scale approach emphasizes economies of scale rather than differences in management or production technology. Larger firms can obtain lower unit cost and higher profits through economies of scale. This enables large firms to acquire market shares, which may manifest in higher concentration and then profitability.

The costs incurred by banks with efficient management andtechnologies,according to the x-efficiency hypothesis,are lower resulting in higher profitability. Under the scale-efficiency hypothesis, the difference in performance between two firms is notdue to differences in management quality, but to differences at the level of scale

efficiency(Zerbe, 2001). Banks whose costs are lower thantheir competitors result in higher profitability, and these banks may acquire extended market shares which increasesmarket concentration.Besides the two types of efficiencies, there are other measures of efficiency which are technical efficiency, allocative efficiency and scale efficiency. According to Zerbe(2001), it isparticularly interesting in that it allows situating of a banking institution under a new version of relative market powerhypothesis and extending the Efficient Structure hypothesis under the Allocative Efficient Structure (AE).

2.2.3 The balanced portfolio Theory

The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Nzongang and Atemnkeng, 2006). According to the Portfolio balance model of asset diversification, the optimum holding of each asset in a wealth holder''s portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio. A balanced portfolio can reduce risk associated with the portfolio in a manner that does not reduce returns as much as use of a single low risk investment would. The diversity reduces risk in a manner greater than it reduces returns.It implies portfolio diversification and the desired portfolio composition of commercial banks are results of decisions taken by the bank management. Further, the ability to obtain maximum profits depends on the feasible set of assets and liabilities determined by the management and the unit costs incurred by the bank for producing each component of assets (Nzongang and Atemnkeng, 2006).

Balanced portfolio can include a wide array of investments ranging from stocks to bonds to real estate. In fact, a well balanced portfolio should cover both small and large

companies as well as domestic and foreign companies. Nzongang and Atemnkeng (2006) note that the value of minimizing risk for these portfolios is huge since the returns are used to finance scholarships.Balanced portfolios require both sufficient quantities and types of investments. According to Sharpe(1964), one of the easiest ways for an investor with limited funds to utilize the theory is by creating a portfolio of exchange traded funds (ETFs). These ETFs represent large indices of stocks, bonds, and commodities. Balanced portfolios can be created by using a combination of ETFs to cover a broad reach of investment types and simultaneously many entities within each investment type.

2.3 Emprical Evidence

Kahf (2004) points out that Islamic banks are profit oriented organizations with the difference that they have enjoined on themselves to conduct their affairs within the limits of the rulings of shari'ah and to comply with its overall objectives. These objectives imply that the Islamic banks would be eager to boost all forms of deposits, improve quality of customer service, expand the base of banking services, protect capital, provide humanitarian and social services, as well as work towards the other factors that raise profit margins. The paper analyzes the experience of 7 Islamic banks (Dubai Islamic Bank, Arab Banking Corp Islamic Bank, Qatar Islamic Bank, Shamil Bank-Bahrain, Kuwait Finance House, Jordan Islamic Bank and Bahrain Islamic Bank) in achieving its objectives and measures the banks' performance in assets growth, growth of invested assets, growth of cash and deposits in other banks, growth of customers' deposits in Islamic banks, changes in earnings, expenses and net profits and the commitment to Shari'ah and charitable and social contributions. The selection of the 7 banks was based on the financial information available at the time. The study analyzed information obtained from financial reports of the banks for three years, 1999-2001. The performance measures depicted an upward

trend in the 7 banks apart from expenses which were either dropping or remaining relatively constant.

Olweny and Shipho (2011) in an effort to determine the effect of bank sectoral factors on bank profitability used the CAMEL factors and market structure factors; foreign ownership and market concentration to achieve their objectives. The study adopted an explanatory approach by using panel data research design to fulfill the objectives. Annual financial statements of 38 Kenyan commercial banks from 2002 to 2008 were obtained from the CBK and Banking Survey 2009. The data was analyzed using multiple linear regressions method. The analysis showed that all the bank specific factors had a statistically significant impact on profitability, while none of the market factors had a significant impact. Based on the findings the study recommended policies that would encourage revenue diversification, reduce operational costs, minimize credit risk and encourage banks to minimize their liquidity holdings.

In order to identify the determinants of financial performance amongst commercial banks in Kenya, Ongore and Kusa (2013) used the CAMEL factors, Macroeconomic factors; GDP and inflation and a moderating variable; ownersip identity. The study adopted an explanatory approach by using panel data research design to fulfill the objectives. Annual financial statements from 37 Kenyan banks from 2001 to 2010 were used. The authors used linear multiple regression model and Generalized Least Square on panel data to estimate the parameters. The findings showed that bank specific factors significantly affect the performance of commercial banks in Kenya, except for liquidity variable. But the overall effect of macroeconomic variables was inconclusive at 5% significance level. The moderating role of ownership identity on the financial performance of commercial banks

was insignificant. Thus, it was concluded that the financial performance of commercial banks in Kenya is driven mainly by board and management decisions, whilemacroeconomic factors have insignificant contribution.

Al-Tamimi (2010) study intended to investigate some influential differences in UAE's Islamic and conventional national banks during the period 1996-2008. UAE Islamic banks had a small market share at the time though there was an increasing demand for their services. This gave rise to an examination of the factors that influence the performance of the Islamic banks compared with conventional banks. A regression model was used in which ROE and ROA were used alternatively as dependent variables. A set of internal and external factors were considered as independent variables including: GDP per capita, size, financial development indicator (FIR), liquidity, concentration, cost and number of branches. The results indicated that liquidity and concentration were the most significant determinants of conventional national banks' performance. On the other hand, cost and number of branches were the most significant determinants of Islamic banks' performance.

According to Siraj and Pillai (2012) study review and comparison of performance of conventional banks and Islamic banks operating in GCC region during 2005-10. The study investigated the presence, if any, of similarity in growth of chosen performance indicators of Conventional Banks and Islamic Banks in GCC region. The study selected six Islamic banks and six conventional banks. A comparative study was undertaken based on performance indicators such as OER, NPR, ROA, ROE, operating expense, profit, assets, operating income, deposits and total equity that were obtained from financial statements. Inferences based on analysis revealed better performance of Islamic banking during the

study period. Conventional banks registered growth in revenue during the period, but could not achieve improved profitability on account of higher provisions towards credit losses and impairment losses. The performance indicators were affected by financial crises since 2007 but Islamic banks were less affected as compared to Conventional Banks since Islamic banks carry higher capitalization plus higher liquidity reserves.

Molu (2012) in his study seeking to compare financial performance of Islamic banks and conventional banks in Kenya, selected 2 Islamic banks (GAB and FCB) and 5 conventional banks with asset base of less than ten billion shillings. Four categories of financial ratios were used that are; profitability, liquidity,efficiency and risk and solvency ratios from the financial statements of the various banks. The study revealed that Conventional banks performed better than Islamic banks in all aspects except for liquidity but this was not attributed to good performance since liquidity leads to less return and affect other aspects of performance. Islamic banks were also showing increasing risks as opposed to their counter parts.

2.4 Determinants of financial performance

2.4.1 Capital Adequacy

Capital provides buffer against losses and thus it ensures safety and soundness of the financial institutions (Wachiuri,2012). Banks capital creates liquidity for the bank due to the fact that deposits are most fragile and prone to bank runs. In addition, greater bank capital reduces the chance of distress (Diamond, 2000). However, Beckmann (2007) argues that high capital lead leads to low profits since banks with a high capital ratio are risk-averse, they ignore potential (risky) investment opportunities and, as a result, investors demand a lower return on their capital in exchange for lower risk.All in all,

banks need to maintain a minimum amount of capital to prevent bank failure. According to Dang (2011), the adequacy of capital is judged on the basis of capital adequacy ratio (CAR). Capital adequacy ratio shows the internal strength of the bank to withstand losses during crisis. Capital adequacy ratio is directly proportional to the resilience of the bank to crisis situations. It has also a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures or areas (Sangmiand Nazir, 2010).

2.4.2 Asset Quality

Asset quality is one of the most critical areas in determining the overall condition of a bank. Loans are the most critical assets to any commercial bank since they comprise a majority of banks's assets and carry the highest risk. Infact Dang (2011) asserts that the highest risk facing a bank is the losses derived from delinquent loans. According to (Sangmi and Nazir, 2010) banks should strive to maintain the level of non-performing loans at minimum in order to improve financial performance. The ratio of non-performing loans to total loans was thus be used to measure the asset quality of commercial banks.

2.4.3 Management Efficiency

One of the major aspects of measuring management efficiencyof banks is to assess the efficiency in cost management. Banks continually try to keep their operating costs (expenses) under control which is usually a significant challenge with increased technology needs, IT management expense, regulatory compliance requirements, competitive pressures and information security concerns (Berger and DeYoung, 2001). In relatively uncompetitive markets where banks enjoy market power, costs are passed on to customers; hence there would be a positive correlation between overhead costs and profitability (Flamini *et al*, 2009). The Return on Revenue (ROR) was used to assess cost

efficiency in this case for which increasing ROR depicted efficiency in cost management and decreasing ROR depicted inefficiency.

2.4.4 Liquidity Management

Liquidity refers to the ability of the bank to fulfill its obligations when they fall due. According to Dang (2011) adequate level of liquidity is positively related with bank profitability. However, Molu (2012) disregards liquidity as a measure of good performance since liquidity leads to less return and therefore affects other aspects of performance. A study conducted in China and Malaysia also found that liquidity level of banks has no relationship with the performances of banks (Said and Tumin, 2011). This study used loans to deposit ratio (LTD) to determine the relationship between liquidity and financial performance of commercial banks in Kenya.

2.5 Conclusion

This chapter has attempted to bring about the findings of related literature from other studies carried out in the field. Effort has been made to highlight the main research findings in order to bring about the basis of this research. Although studies have been done on the determinants of financial performance of commercial banks in Kenya as provided by the empirical evidence, non has been done to examine the determinants of financial performance of Islamic banks in Kenya despite the continuous growth of this niche in Kenya and the profits posted by the fully shari'ah compliant banks. Studies done on performance of Islamic banks vis a vis conventional banks have also given contradicting results as to which of them perform better. Due to the differences in principles and performance, this study looked intofour independent variablesderived from the CAMEL model; Capital Adequacy, Asset quality, Management efficiency and liquidity

management. The research aims at studying the various variables in order to assess how they determine financial performance of Islamic banks and similar sized conventional banks in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the research methodology used to meet the objectives of the study. It explains the research design used in this study, the composition of the target population, population sampling design, data collection techniques and procedures as well as data analysis criteria that the researcher used to assess the determinants of financial performance in Islamic banks and conventional banks in Kenya.

3.2 Research design

Research design refers to the way the study is designed and the method used to carry out the research (Kothari, 2004). This study adopted an explanatory research design which according to Maxwell and Mittapalli (2008)is research intended to explain, rather than simply to describe, the phenomena studied.They note that such kind of research is usefull for quantitative research. Explanatory research design is fundamental in this study since it seeks to explain how the various bank specific factors affect financial performance of both Islamic and conventional banks in Kenya.

3.3 Population

Mugenda and Mugenda (2003) define population as a well defined set of people, services, elements, events, group of things or households that are being investigated. According to CBK bank supervision, there are 43 commercial banks in Kenya which formed the study population.

3.4 Sample design

From the population of 43, a sample of 20was selected comprising all the commercial banks listed as small by the CBK bank supervision(Appendix I: List of commercial banks in Kenya). This comprised the 2 fully Shari'ah compliant banks (Gulf African Bank and First Community Bank) and 18 conventional banks in order to facilitate comparison of the determinants of financial performance in Islamic banks and conventional banks in Kenya. According to Kombo and Tromp (2010), an effective sample should possess diversity, representativeness, reliability, accessibility and knowledge. Thus, the sample of 20 would be able to fulfill the requirements of representativeness, diversity, reliability and flexibility.

3.5 Data collection

Secondary data was used for this study byreviewing both empirical and theoretical data from books, journals, dissertations, magazines and the internet. Financial statements for the banks from the year 2008 to 2013were also used to compute the various ratios fundamental for this study. The period was chosen to facilitate usage of the model used in this study. It was also guided by the fact that the Shari'ah compliant banks were licenced in late 2007 and early 2008.

3.6 Data Analysis and presentation

Quantitative datawasmajorly used in this study and various ratios were computed for the four independent variables and one dependent variable including Return on Assets (ROA), Capital Adequacy Ratio (CAR), Non performing loans to total loans, Return on Revenue (ROR) and Loans to Deposits ratio (LTD). Data analysis involved multi-variate analysis using Statistical Package for Social Sciences (SPSS).

The multivariate analysis involved simultaneous analysis of more than two variables in a multi-way classification, for instance regression (Kothari, 2004). Multiple regression analysis was done as there are more than two variables in the study and the relationship between the dependent and independent variables need to be analyzed. The data was presented using tables to make it reader friendly. The regression equation is:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where Y is the dependent variable (financial performance) as measured by ROA, β_0 is the regression constant, β_1, β_2, β_3 and β_4 are the coefficients of independent variables, X_1 is Capital Adequacy as measured by the CAR, X_2 is Asset quality as measured by ratio of non performing loans to total loans, X_3 is Management efficiency as measured by ROR and X_4 is liquidity management as measured by loans to deposits ratio while ε is an error term. Correlation of the various independent variables in relation to the dependent variable wasalso performed.

3.7 Data validity and reliability

3.7.1 Validity of the research instruments

Validity test of a data collection instrument enables a researcher to ascertain that he or she is measuring the correct concept and not something else. The research ensured validity by using data from financial statements that have been prepared according to the various International Accounting Standards andwere consistent across all the banks used in the study.

3.7.2 Reliability of the research instruments

To ensure the reliability, the research used audited financial statements obtained from the various banks for the period of study.

4.1 Introduction

This chapter presents analysis and findings of the research. Findings in this chapter have tried to fulfill the objective of this study which is an assessment of the determinants of financial performance of Islamic banks and Conventional banks in Kenya. The areas of interest with respect to data collection and analysis were Capital Adequacy as measured by the CAR, Asset quality as measured by ratio of nonperforming loans to total loans, Management efficiency as measured by ROR and liquidity management as measured by loans to deposits ratio. Correlations and regressions of the various independent variables in relation to the dependent variable were performed.

4.2 Descriptive statistics

Table 4.1 below gives summary statistics where mean, standard deviations, minimum and maximum were considered.

Table 4.1: Overall Descriptive statistics

	Observations	**Mean**	**Median**	**Std.Dev**
ROA	20	1.95	1.06	2.08
Capital Adequacy	20	17.36	13.77	11.53
Asset Quality	20	15.52	9.71	15.88
Management Efficiency	20	72.23	71.59	18.65
Liquidity Management	20	77.50	66.35	97.24

Table 4.1 presents the descriptive statistics of determinants of financial performance of Islamic banks and Conventional banks in Kenya. As indicated in the Table 4.1, the average capital adequacy of Banks categorized as small Banks in Kenya was 17.36. The figure is above the 8% statutory requirement set by CBK (Olweny and Shipho, 2011). This shows that the Kenyan commercial banks categorized as small hold more capital than required. This could imply that banks could prefer less risky investment, which results in lower profit. The average asset quality of the sample banks in the sector in the stated period was as high as 15.52. This shows the existence of high exposure to credit risk and the relationship is expected to be negative with profit. Another important factor, management efficiency, proxied by operating income to total income was 72.23 on average. It shows that in Kenya more than 70% of commercial banks categorized as small, income is derived from the conventional intermediation (operating) function. The Table also shows that the average total loans to total deposit (liquidity management) were 77.50%. This indicates that commercial banks categorized as small in Kenya use 77.50% of customer deposit for on lending. This shows that banks keep more than the statutory liquidity requirement. Customer deposit is one of the cheapest sources of fund due to the high margin between deposit and lending rate that banks utilize to generate income. Moreover, the figure shows that commercial banks categorized as small in the country target domestic resources, mainly customer deposit, for their banking business. Further the average ROA, for the sector as a whole was 1.96. Compared to other countries bank performances as expressed by the above ratios, the Kenyan banks' performance is average. This is consistent with the findings of Flamini et al. (2009.) According to the above author the average ROA in Sub-Saharan Africa (SSA) was about 2%. Thus, the average ROA of Kenyan banks is about average of the SSA.

The study then carried out analysis on individual banks taking in to account the variables considered on the model i.e. Return on Assets, capital adequacy, asset quality, management efficiency and liquidity management. The average means were as indicated in Table 4.2

Table 4.2: Determinants of financial performance per bank

Institution	ROA	Capital adequacy	Asset quality	Management efficiency	Liquidity management
African Banking Corporation Ltd	0.69	14.89	10.87	9.06	34.83
Consolidated bank of Kenya Ltd	1.71	23.84	17.63	13.45	53.82
Credit Bank Ltd	1.42	14.46	12.28	8.61	34.45
Development Bank of Kenya Ltd	1.33	21.01	16.20	13.39	26.02
Dubai bank Kenya Ltd	1.21	31.49	24.16	16.74	21.48
Equitorial Commercial Bank Ltd	1.65	16.04	12.08	6.93	26.05
Fidelity Commercial Bank Ltd	1.19	20.16	9.99	7.92	30.15
Fina Bank Ltd	1.91	12.85	9.23	6.93	22.84
First Community Bank Ltd	0.50	8.56	6.90	15.81	67.55
Giro Commercial Bank Ltd	1.05	29.89	32.11	20.78	39.84
Gulf African Bank	0.62	5.48	3.62	16.32	58.44
Habib bank AG Zurich	0.53	18.71	17.02	13.46	28.73
Habib bank Ltd	0.89	15.74	9.65	7.81	25.72
Jamii Bora Bank Ltd	0.79	20.56	11.17	9.5	30.52
K-Rep Bank Ltd	0.93	14.43	6.45	5.19	24.44
Oriental Commercial Bank Ltd	1.18	34.09	23.60	15.81	24.03
Paramount Universal bank Ltd	0.92	15.92	13.75	10.83	25.91

Transnational Bank Ltd	0.97	34.66	15.45	13.05	34.64
UBA Kenya Bank Ltd	0.13	21.54	16.64	13.29	26.53
Victoria Commercial Bank Ltd	1.22	15.67	14.09	10.93	25.66

The study findings indicated in Table 4.2 reveals that capital adequacy and asset quality were high in most of the banks as indicated by their average means. The finding further shows that conventional banks showed high means in all financial performance determinants as compared to Islamic banks except for management efficiency and liquidity where Islamic banks indicates higher means. For instance First community bank limited and Gulf African bank had the lowest Return on Assets of 0.5 and 0.62 respectively as compared to other banks. This may be due to differences in their operations where conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money. Islamic law considers a loan to be given or taken, free of charge, to meet any contingency.

In Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, it leads to some kind of injustice. The first Islamic principle underlying for such kind of transactions is "deal not unjustly, and ye shall not be dealt with unjustly" which explain why commercial banking in an Islamic framework is not based on the debtor-creditor relationship. This study concurs with Molu (2012) in his study seeking to compare financial performance of Islamic banks and conventional banks in Kenya, he selected 2 Islamic banks (GAB and FCB) and 5 conventional banks with asset base of less than ten billion shillings. Four categories of financial ratios were used that are; profitability, liquidity, efficiency and risk and solvency ratios from the financial statements of the various

banks. The study revealed that Conventional banks performed better than Islamic banks in all aspects except for liquidity but this was not attributed to good performance since liquidity leads to less return and affect other aspects of performance. Islamic banks were also showing increasing risks as opposed to their counter parts.

The study further carried a descriptive analysis per category in order to determine the performance of determinants of financial performance per sector. That is, conventional and Islamic banking.

Table 4.3: Descriptive Analysis per sector

	N	ROA	Capital adequacy	Asset quality	Management efficiency	Liquidity management
Conventional banks	18	1.37	18.84	14.63	12.45	24.23
Islamic banks	2	0.56	11.56	8.90	14.81	36.78

The study findings reveals that conventional banks performs well in all the determinants i.e. Return on Assets 1.37 with Islamic banks registering 0.56, Capital adequacy for conventional banks stands at 18.84 against 11.56 for Islamic banks. Further conventional banks have a higher asset quality standing at an average of 14.63 against 8.9 for Islamic banks. However management efficiency and liquidity management showed higher mean for Islamic banks as indicated by a mean of 14.81 against 12.45 for conventional banking and 36.78 against 24.23 respectively. This implies that on average conventional banks outperform Islamic banks which may be due to high interests charged to debtors and also the requirements from the central bank whereas Islamic law considers a loan to be given or taken, free of charge, to

meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, it leads to some kind of injustice. However Islamic banks are seen to perform better in management as compared to conventional banks.

4.3 Correlation Matrix

The Pearson product-moment correlation coefficient (or Pearson correlation coefficient for short) is a measure of the strength of a linear association between two variables and is denoted by r. The Pearson correlation coefficient, r, can take a range of values from +1 to -1. A value of 0 indicates that there is no association between the two variables. A value greater than 0 indicates a positive association, that is, as the value of one variable increases so does the value of the other variable. A value less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases. Table 4.3 below gives a summary of the correlation between the dependent variables and the explanatory variables.

Table 4.4: Correlation Matrix

		Capital adequacy	Asset quality	Management efficiency	Liquidity management	Return on Assets
Capital adequacy	Pearson Correlation	1				
Asset quality	Pearson Correlation	-.258**				
	Sig. (2-tailed)	.003				

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Management efficiency	Pearson Correlation	.830*	-.3022	1		
	Sig. (2-tailed)	.023	.368			
Liquidity management	Pearson Correlation	.605*	.653	.357	1	
	Sig. (2-tailed)	.0833	.0234	.070		
Return on Assets	Pearson Correlation	.775**	.570	.635	.425	1
	Sig. (2-tailed)	.004	.458	.0311	.002	

Capital adequacy shows strong and positive correlation (R= .775) with the Return on Assets. Asset quality has strong and positive relationship with Return on Assets (R=0.570). Liquidity management is moderately and positively related to return on assets (R=0.425). Management efficiency has a strong and positive correlation with the return on assets (R=0.635). This implies that all the determinants considered in the model are significant predictor of financial performance of both conventional and Islamic banks.

4.4 Analysis of Variance

The study used ANOVA statistics to establish the significance of the relationship between financial performance and the explanatory variables. The regression model is significant given the level of significance 0.0021 which is below the p value of 0.05; therefore the model is declared fit for estimation.

Table 4.5: Analysis of Variance

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	12.810	16	16.55021	7.511828	.0021
Residual	.8355	4	2.20322		
Total	**13.6455**	**20**			

4.5Model summary

Determination coefficient (R^2) was carried out to determine the proportion of the variation in dependent variable that is attributed to the changes in the explanatory variables.

Table 4.6: Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson(DW)
.8823	.7785	.7052	.25841	1.977

The study established R^2 of 77.85%which implies that 77.85% of the variation in financial performance is attributed to the changes in explanatory variables. The Durbin-Watson test statistic tests the null hypothesis that the residuals from regression are not auto correlated. The Durbin-Watson statistic ranges in value from 0 to 4. A value near 2 indicates non-autocorrelation; a value toward 0 indicates positive autocorrelation; a value toward 4 indicates negative autocorrelation. Since the DW value of 1.977 was close to 2, then it can be concluded that there was no autocorrelation among the model residual.

4.6 Regression coefficients

Multiple regression analysis was used to determine the significance of the relationship between the dependent variable and all the independent variables pooled together.

Table 4.7: Regression coefficients

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	3.255	67.676		-.083	.510
Capital adequacy	-3.281	1.390	2.377	-3.360	.021
Asset quality	-6.156	6.236	0.258	-4.987	.047
Management efficiency	8.271	7.875	0.3147	5.050	.035
Liquidity management	-.213	.155	0.2012	-5.007	.011

The results are given in the model summary in Table 4.7above. The estimated model becomes:

The study model $Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$ becomes

$ROA = 3.255 + 2.377 X_1 + 0.258 X_2 + 0.3147 X_3 + 0.2012 X_4$

All the explanatory variables are statistically significant at 5% level of significance in explaining the variation in the return on assets of the conventional and Islamic banking.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the study and makes conclusion based on the results. The implications from the findings and areas for further research are also presented. This section presents the findings from the study in comparison to what other scholars have said as noted under literature review.

5.2 Summary

Findings in the previous chapter have tried to fulfill the objective of this study which is an assessment of the determinants of financial performance of Islamic banks and Conventional banks in Kenya. The areas of interest with respect to data collection and analysis were Capital Adequacy as measured by the CAR, Asset quality as measured by ratio of nonperforming loans to total loans, Management efficiency as measured by ROR and liquidity management as measured by loans to deposits ratio.

The study findings indicated that capital adequacy and asset quality were high in most of the banks as indicated by their average means. The finding further shows that conventional banks showed high means in all financial performance determinants as compared to Islamic banks. For instance; First community bank limited and Gulf African bank had the lowest Return on as compared to other banks. This may be due to differences in their operations where conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money. Islamic law considers a loan to be given or taken, free of charge, to meet any

contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, it leads to some kind of injustice. The first Islamic principle underlying for such kind of transactions is "deal not unjustly, and ye shall not be dealt with unjustly" which explain why commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The study further carried a descriptive analysis per category in order to determine the performance of determinants of financial performance per sector. That is, conventional and Islamic banking. The study findings reveals that conventional banks performs well in all the determinants i.e. Return on Assets 1.37 with Islamic banks registering 0.56, Capital adequacy for conventional banks stands at 18.84 against 11.56 for Islamic banks. Further conventional banks have a higher asset quality standing at an average of 14.63 against 8.9 for Islamic banks. This implies that on average conventional banks outperform Islamic banks which may be due to high interests charged to debtors and also the requirements from the central bank whereas Islamic law considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, it leads to some kind of injustice.

5.3 Conclusion

This empirical study showed that capital adequacy, asset quality and management efficiency significantly affect the financial performance of both the conventional and Islamic banks in Kenya. However, the effect of liquidity on the financial performance of banks is not strong. The relationship between bank performance and capital adequacy and management efficiency was found to be positive and for asset quality the relationship was also positive. This indicates that poor asset quality or high non-performing loans to total asset related to poor

bank performance. Thus, it is possible to conclude that banks with high asset quality and low non-performing loan are more profitable than the others.

Liquidity management represented by liquidity ratio was found to have moderate significant effect on the performance of both conventional and Islamic banks in Kenya. This shows that performance is not as such about keeping high liquid asset; rather it is about asset quality, capital adequacy, efficiency and others. But, this doesn't mean that liquidity status of banks has no effect at all. Rather it means that liquidity has lesser effect on performance of commercial banks in the study period in Kenya. Thus, it is possible to conclude that those bank managers who invest their liquid assets can generate income and boost their performance.

5.4 Recommendations

From the findings the study recommends that Islamic banks should manage risks involved during their operation to minimize potential risks and losses involved during the operation. From the findings the study also recommends that dividends paid to shareholders should be well managed to maximize the profits. From the findings the study further recommends that banks should maximize lending to customers and also scrutinize their financial ability to repay before advancing loans to them to avoid default loans in order for them to maximize their profits especially in the case of Islamic banks.

5.5 Limitations of the Study

Although this study helped to shed light on the determinants of financial performance of conventional and Islamic banks in Kenya, it was subject to a number of limitations. These mainly related to the setup of the study relative to the resources available within the research

period. As such the constraints influenced the scale of the study but did not affect the conduct of the research once the design was arrived at. Since the main purpose of this study is to identify the determinants of financial performance of conventional and Islamic banks in Kenya, banks considered some information sensitive and confidential and thus the researcher had to convince them that the purpose of information is for academic research only and may not be used for any other intentions.

5.6 Recommendations for further study

This study considered only determinants of profitability of conventional and Islamic banks in Kenya. Further studies should incorporate other economic, political and social factors that affect profitability of commercial banks. Other studies should also be carried out on the same to determine the extent to which the considered factors influence the profitability of micro finance institutions in Kenya.

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APPENDIX I: LIST OF COMMERCIAL BANKS IN KENYA.

	Commercial Bank		**Peer Group**
1)	Barclays Bank of Kenya Ltd	1953	Large
2)	CFC Stanbic Bank Ltd	1955	Large
3)	Cooperative Bank of Kenya Ltd	1965	Large
5)	Equiy Bank Ltd	2004	Large
4)	Kenya Commercial Bank Ltd	1896	Large
6)	Standard Chattered Kenya Ltd	1910	Large
7)	Bank of Africa Kenya Ltd	1980	Medium
8)	Bank of Baroda Kenya Ltd	1953	Medium
9)	Bank of India	1953	Medium
10)	Chase Bank (K) Ltd	1991	Medium
11)	Citibank N.A Kenya	1974	Medium
12)	Commercial Bank of Africa	1967	Medium
13)	Diamond Trust Bank Kenya Ltd	1946	Medium
14)	Ecobank Kenya Ltd	2005	Medium
18)	Family bank Limited	1984	Medium
19)	Guardian Bank Ltd	1992	Medium
16)	I & M Bank Ltd	1974	Medium
15)	Imperial Bank Ltd	1992	Medium
17)	Middle East Bank (K) Ltd	1980	Medium
20)	National bank of Kenya Ltd	1968	Medium
21)	NIC Bank Ltd	1959	Medium
22)	Prime Bank Ltd	1992	Medium

23)	African Banking Corporation Ltd	1984	Small
24)	Charterhouse bank Ltd	1996	Small
25)	Consolidated bank of Kenya Ltd	1989	Small
26)	Credit Bank Ltd	1986	Small
27)	Development Bank of Kenya Ltd	1973	Small
28)	Dubai bank Kenya Ltd	1982	Small
33)	Equitorial Commercial Bank Ltd	1995	Small
34)	Fidelity Commercial Bank Ltd	1992	Small
35)	Fina Bank Ltd	1986	Small
36)	First Community Bank Ltd	2008	Small
37)	Giro Commercial Bank Ltd	1992	Small
38)	Gulf African Bank	2007	Small
29)	Habib bank AG Zurich	1978	Small
30)	Habib bank Ltd	1956	Small
31)	Jamii Bora Bank Ltd	1984	Small
32)	K-Rep Bank Ltd	1999	Small
39)	Oriental Commercial Bank Ltd	1991	Small
40)	Paramount Universal bank Ltd	1993	Small
41)	Transnational Bank Ltd	1985	Small
42)	UBA Kenya Bank Ltd	2009	Small
43)	Victoria Commercial Bank Ltd	1987	Small