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Bank Specific Factors and Financial Performance of Islamic Banks in Kenya

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Abstract: **The purpose of this study was to examine factors affecting employee financial performance in the Islamic banks. Basic questions surround the main objectives which were asset quality, liquidity management, management efficiency and capital structures. The study was conducted through a samplings survey using existing employee, ex-employees, and department heads. Random and purposive sampling techniques were used to select the sample size from the population. Questionnaires, interview, and document analysis techniques were used for data collection. Descriptive statistics such as, cross tabulation were employed for data analysis. Based on the data analysis the following findings were recorded that major activities of the banking organization were affected by capital structure, followed by management competencies, regulations and Islamic culture also influenced to a great extent the performance of the banks**

Keywords: **capital structure, management competencies, regulations and Islamic culture.**

1. INTRODUCTION

The basic practices and principles of Islamic banking date back to the early part of the seventh century. The origin of the modern Islamic bank can be traced back to the very birth of Islam when the Prophet himself acted as an agent for his wife's trading operations. Western commercial banks date from about two and a quarter centuries ago, when the western world was dispensing with moral and ethical considerations in economics. The first Islamic financial institution was a mutual savings bank formed in Egypt in 1963. Since then, Islamic finance has evolved into adaptive system of international practices and regulations capable of harmonizing classical religious precepts, social responsibility, and traditionalism with the modern experiences of globalized banking. Today according to International Monetary Fund (IFM), there are over 300 Islamic financial institutions in more than 75 countries with total assets worldwide exceeding $700 billion and growths exceeding 15 percent a year. Recent surveys have shown that 37 per cent of Muslims in the United States and 67 per cent of Muslims in the Kingdom of Saudi Arabia prefer to deal with Islamic banks and financial product providers. However, in many countries modern Islamic finance has little or no presence; indeed, it is only now establishing itself as a competitive force in the countries where it does have a presence.

Statement of the problem:

Despite this scope and imprint on the global economy, Islamic finance remains poorly understood at both theoretical and practical level. Moreover, despite a number of recent optimistic trends, Islamic finance faces several ideological and structural challenges to full integration in the globalized economy. (Karasik et al., 2005) Islamic banks come in all shapes and forms: banks and non-banks, large and small, specialized and diversified, traditional and innovative, national and multi-national, successful and unsuccessful, prudent and reckless, strictly regulated and free-wheeling, etc. Some, particularly the "Islamic windows" of conventional banks, are virtually identical to their conventional counterparts, while others are markedly different. Some are driven by real religious considerations, while others use religion only as a way of attracting customers.

There are considerable disagreements among scholars as to which institutions and instruments are religiously acceptable. For some, their legal structure does not allow them to carry out real Islamic business such as trading, leasing or construction activities and hence they end up doing only conventional financial operations with slight changes to appear

Islamic. There is a risk that Islamic banking ideals may get diluted with conventional banking unless Islamic banks do something to establish their distinctness as "Islamic banks". Non-sharing Islamic modes such as murabaha, salam, istisna'a and ijarah also provide a link between financial transactions and real economic activities, such as trading in tangible assets.

Although this is the case, Islamic banks need to give special ca1re to their integrity and credibility. Some critics are disappointed that Islamic banks have deviate to a great extent from the philosophic and idealistic basis that inspired their originators in the 1970s. Article 46 of the Constitution of Kenya (2010) sets out laws and acceptable practices that the providers of goods and services should adopt when engaging their consumers. In addition to the Constitution, the Consumer Protection Bill was enacted in 2012 with clauses pertaining to the provision of financial services. Therefore both banks as well as their customers should familiarize themselves with these laws.(Mugambi, 2012) Lastly, there has been serious lack in researches in Islamic banking, especially in the area of customer preference and satisfaction around the world and even in Kenya. (Rashid and Hassan, 2008)

Islamic banking because of its value-orientated ethos enables it to draw finances from both Muslims and non-Muslims alike. Islamic banks are evolving financial and investment instruments that are not only profitable but are also ethically motivated. The ever-increasing application and innovation of the methodologies associated with derivative instruments that revolutionized the global financial industry have also led to a global financial crisis because of the excess greed for profit and the immense uncertainty and risk associated with these types of transactions. There are 6 doubts associated with the permissibility of derivative instruments under Islamic finance generally.

Objectives:

i. To determine how capital adequacy affects financial performance of Islamic banks in Kenya.

ii. To ascertain the effect of Asset quality on financial performance of Islamic banks in Kenya.

iii. To examine how management efficiency determines financial performance of Islamic banks in Kenya.

iv. To find out how liquidity management determines financial performance of Islamic banks in Kenya.

2. THEORETICAL REVIEW

Market power 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. Market power implies a firm's control upon volume or price of production. A firm with MP has the ability to individually affect either the A a 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. 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)..

The Modern Portfolio Theory (MPT):

This theory was founded by Markowitz (1952) in which he described how to consolidate resources into productively enhanced portfolios by showing that investors neglected accounting for the high correlation among investments returns correctly. 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

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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).

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 and technologies, 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 not due to differences in management quality, but to differences at the level of scale efficiency (Zerbe, 2001).

Conceptual Framework

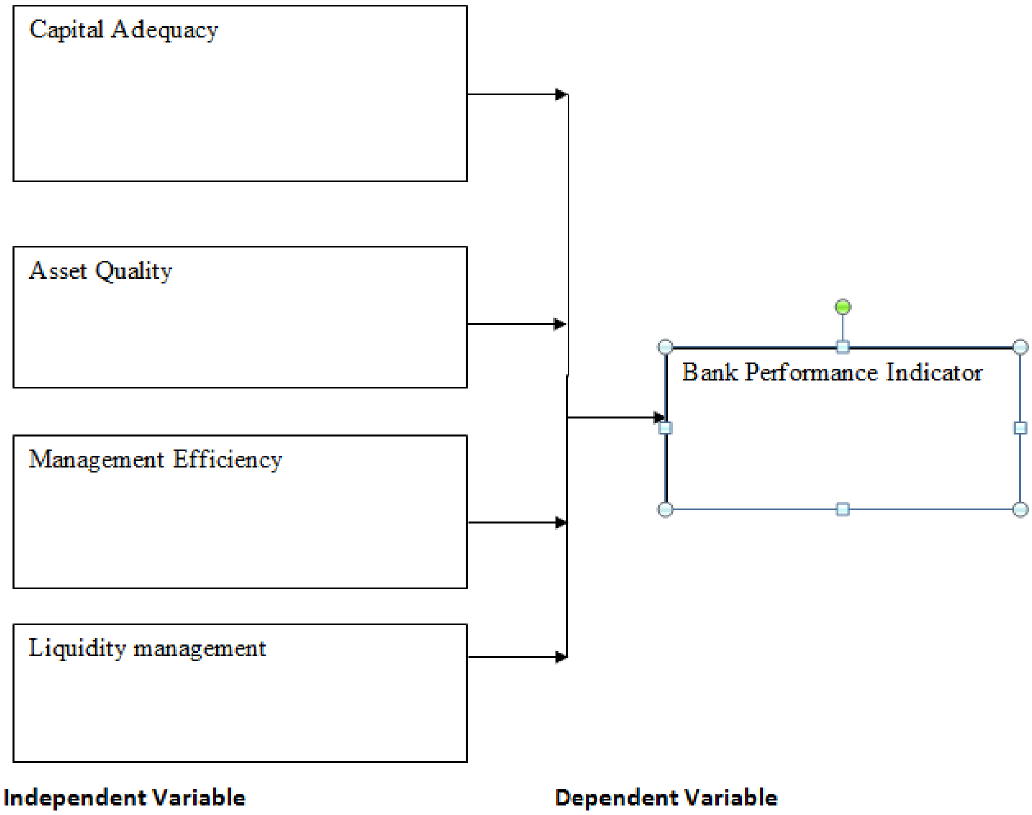

Figure 2.1: Conceptual Framework

3. RESEARCH METHODOLOGY

The research design used in this study was descriptive research design. The Target population of this study was all the banks offering Islamic products in Garissa County. According to the Central Bank of Kenya (2015), there are 2fully fledged Islamic banks in Garissa. The study therefore used census since the population is small. The statistical Package for Social Sciences (SPSS) was used for data analysis purpose.

Model:

The study employed time series multiple regression method. In this study the following was the regression equations that were used to test the significance of the study hypotheses:

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$$y = \beta\mathbf{o} + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where:-

Y is the dependent variable (financial performance) as measured by ROA and ROE,

β0 is the regression constant,

β1, β2, β3and β4 are the coefficients of independent variables,

X1 is Capital Adequacy as measured by the CAR,

X2 is Asset quality as measured by ratio of non-performing loans to total loans,

X3 is Management efficiency as measured by ROR

X4 is liquidity management as measured by loans to deposits ratio

ε is an error term.

4. RESULTS AND DISCUSSION

Multivariate Regression Analysis:

This section presents the results on the combined effects of all the independent variables which are Capital structure, asset quality, management efficiency and Liquidity management on the dependent variable (financial performance). A multiple linear regression model was used to test the significance of the influence of the independent variables on the dependent variable. Therefore the overall model for the study was;Y = $\beta_0+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_{4+}e$ where:

Y = Financial performance

X_1 = Capital structure

X_2 = Asset quality

X_3 = Management efficiency

X_4 = Liquidity management

Table 4.1 shows the analysis of the fitness of the model used in the study. The results indicate that the overall model was satisfactory as it is supported by coefficient of determination also known as the R-square of 0.705. This means that all the independent variables influence70.5% of the dependent variable.

4.1 Overall model fitness

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.840[a]	.705	.179	.407	1.324
a. Predictors: (Constant), Liquidity management, Management efficiency, Asset quality, Capital structure					
b. Dependent Variable: Financial performance					

Table 4.2 provides the results on the analysis of the variance (ANOVA). The results indicate that the overall model was statistically significant. This was supported by an F statistic of 2.961and the reported p value (0.034) which was slightly higher than the conventional probability of 0.05 significance level. These results suggest that the independent variables are good influencing factors of financial performance.

Table 4.2 Analysis of Variance (ANOVA)

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.964	4	.491	2.961	.034[b]
	Residual	5.306	32	.166		
	Total	7.270	36			
a. Dependent Variable: Financial performance						
b. Predictors: (Constant), Liquidity management, Management efficiency, Capital structure, Asset quality						

Regression of coefficients results in Table 4.3 shows that there is a positive and significant relationship between financial performance (dependent variable) and Liquidity management, Management efficiency, Capital structure, Asset quality (independent variables). From the finding, the overall model obtained is expressed as:

$$Y=2.729+0.170X_1+-0.273X_2+-0.318X_{3+}0.330X_4$$

These were supported by beta coefficients of0.192, -0.281, -0.298 and 0.238respectively. This result shows that a change in either of the variables will definitely lead to a positive change in financial performance.

Table 4.3 Overall Regression coefficient

		B	Std. Error	Beta			Tolerance	VIF
	(Constant)	2.729	.684		3.992	.000		
	Capital structure	.170	.139	.192	1.227	.229	.933	1.072
	Asset quality	-.273	.158	-.281	-1.726	.094	.861	1.161
	Management efficiency	-.318	.164	-.298	-1.948	.060	.974	1.026
	Liquidity management	.330	.221	.238	1.494	.145	.899	1.112
a. Dependent Variable: Financial performance								

5. CONCLUSIONS

The study concludes that there exist a number of factors affecting financial performance in Islamic banking in Kenya. The findings indication on the several effects on capital adequacy that had a positive relationship on financial performance and showed that it is relevant for banks to understand the effects of capital adequacy on financial performance. This variable was also found to have a statistically significant effect on financial performance.

It was revealed that asset quality were of concern and closely related to financial performance; the basis of all the determinants on asset quality offered is grounded on capital availability and the ability to satisfy customers and withstand stiff competition from other firms or organizations offering the same products and financial services, hence asset quality and financial performance have a significant relationship and therefore affected financial performance.

The study also concludes that there exist a significant relationship between management efficiency and financial performance, since the findings reveals how management skills are necessary and finds its way into financial activities and has shown that by the overall statistics. The responses from the field indicated that management efficiency and effectiveness could be employed to improve financial management

6. RECOMMENDATIONS

It is important to note that financial performance is often insufficient in ensuring organizational performance without the support of other strategies in place, particularly when people engaged in such activities lack basic knowledge and skills related to business /banking management. More so, extending credit/money lending to them with limited business knowledge is riskier proposition for such organizations.

The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices also to consider the ability of management to properly administer its assets, including the timely identification and collection of problem assets.

It is also important to consider the adequacy of internal controls and management information systems which will provide a backup in keeping information on liquidity status of a bank.

The study also recommend best practices by banks to ensure efficient and effective management this can be achieved through employing professionals in banking sectors in particular Islamic banking, the rule of law and policies regulating the banking operations to help curb money laundering and frauds within the baking sectors.

Areas for Further Research:

For the substantial body of research into financial performance, an important implication of this study is that differences in management structures from different business places may account for the mixed findings of the empirical tests of the financial performance on financial performance linkage. The study suggests that management structures may be of significant .Therefore, management structures, besides banks, and their influence in other areas, besides financial performance, could be promising directions for future research.

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