ISLAMIC BANKING STRATEGIES AND PERFORMANCE OF SELECTED COMMERCIAL BANKS IN NAIROBI CITY COUNTY

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ABSTRACT

The study examined the strategies and performance of Islamic banking in selected commercial banks in Nairobi County. These strategies include Operations, Funds separation and Lending strategies in relation to the performance of these banks in terms of Customer base, Assets, Financial Viability and Relevance. The study employed descriptive research design and used structured questionnaires to gather data from the managers in the banks. A sample of 6 banks was selected with 8 managers from each bank, from a population of 43 commercial banks using proportionate stratified random sampling method. The study revealed that operational strategies have a positive impact in the performance of the commercial banks, although the government has not established a fully operational legal and supervisory framework to govern the Islamic banking. The study concludes that lack of these legal frameworks is a drawback to the progress in Islamic banking in Kenya. Funds separation was the major distinguishing factor in Islamic and conventional banking by having a reserve fund that absorbs losses in Islamic banking. The study concluded that conventional banks had not set up a reserve fund account but were in the process of setting up although the fully fledged already have. The study further concludes that most customers in Islamic banking have a high intake in the loans offered under the musharaka and mudaraba basis where the banks have a partnership with the clients thus sharing the risk. These aspects encourage the customers to have a high interest in loans and the accounts provided by the banks thus encouraging investors and improving the banks performance. The study recommends that serious marketing should be done to create awareness of Islamic products in the different banks to fill the knowledge gap in the market. Staff training was observed as a necessity since most of the employees in the conventional banks didn't have knowledge on Islamic products. The study raised the agency problem in mudaraba and musharaka contracts. The study concludes that to some extent, the agency problem in musharaka and mudaraba can be reduced by carefully specifying the sharing of profit and performance bonuses between the entrepreneur and the bank.

Key words: Islamic Banking and Performance

INTRODUCTION

The financial sector plays an important role in the development of the country hence for sustainable economic growth a country must have a strong banking sector. In the recent past the banking sector in Kenya has been experiencing changes in its marketing environment that has pushed them to change its ways of operations both internally and externally. Further due to intense competition, various commercial banks have engaged in seeking alternative strategies for survival in the industry. Porter (1996) argues that what really matters in a competitive environment is to have a sustainable competitive advantage in the market place. To achieve such a competitive advantage some commercial banks have introduced Islamic banking which is considered as a hub for deposit taking since most customers in the Arabic countries trade in oil which receive enormous deposits.

Islamic banking is a new concept in Kenya and the banking industry is slow on the uptake, particularly given that every new product is an expensive proposition because of the legal and regulatory issues which banks have to comply with before their introduction in the market. A study done by Ziubar (2007) on credit creation and control indicate that major difficulties including those of credit creation and control on the evolution of Islamic banking on the same pattern as its mainstream counterpart (conventional banking) and suggests some structural modifications. It finds the conventional weapons (interest charged on loans) of credit control inefficacious for use in an interest free banking system and suggests the inclusion of a ratio of cash to bank advances among them. According to the Institute of Islamic banking and insurance it is observed that despite the adoption of Islamic banking, the entire banking has not fully embraced this concept and do not consider it as a source of profitmaking venture since it operates on sharia law.

Kenya does not have a legal frame work for the regulation and supervision of Islamic banking. According to Ndung'u (2011) among the challenges facing Kenya's ambition to become a hub of Sharia compliant investment products, to compliment the Islamic banking, in the country are lack ofSharia compliant investment vehicles, an enabling legal and regulatory framework and awareness by majority of the populace that hinder the uptake of these investments. He argues that it is in this spirit that the Kenyan government through the Finance Act 2010, amended section 45 of the Central Bank of Kenya Act, to allow the central bank as the government's fiscal agent to recognize the payment of a "return" rather than "interest" on government securities. This amendment opens up the spectrum of Sharia compliant investments in the country.

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Sharia (Islamic rulings) and its practical application through the development of Islamic economics. Sharia prohibits the payment of interest charges (riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles (Aggarwal and Yousef, 2002). Islamic banking strategies can be defined as the major course of actions that commercial banks are using in order to relate themselves with the changes in the environment. These strategies are in line with the sharia laws from the Quran, Suna the consensus of Ijarfatur and the Qiyas which must be adhered to since Islamic banking relies more on religion than the laws of the land.

The introduction of Islamic banking in the commercial banks as a competitive advantage is growing at a first rate that most of these banks have adopted various strategies in its adoption. This is in line with the thoughts of Rahma (2010) who states that Islamic finance is growing and potentially lucrative industry, not only in Kenya, but across East African community (EAC) (Rahma, 2010). Mbogo (2011) supports this argument that the emerging data indicates a growing appetite for Islamic finance in Kenya across the board, from both the dominant Christian population which makes up seventy eight percent of the estimated 40m Kenyans as well as the country's 4m Muslims. Kenya's banking sector is facing stiff completion from the existing market and the new entrants in the market. International Islamic banks are opening branches in Kenya and coming up with new ideas and products, the likes of Habib Bank which is currently rolling out its branches in various parts of the country

Islamic banking dictates on separation of funds which is a rule for most banks, whereby they have a different pool, deposits from Islamic accounts are only used for profit sharing and not on interest basis. This strategy is compulsory for all the conventional banks operating the Islamic banking, deposits from the conventional banking may not be used for Islamic banking business and vice versa. This is considered as the backbone of Islamic banking that any bank that do not separate its funds will fail in Islamic banking. KCB had introduced the Islamic banking department in 2007 but failed due to lack of this strategy and had to reintroduce in 2015. Islamic religions do not consider money as a commodity but as a means of exchange of products and thus lending is viewed as a contract between the bank and the customer. This is referred to as diminishing Musharaka that the bank is in partnership with the customer which complies with the sharia principles. The banking operations vary on different banks, some commercial banks operate as a window, subsidiary while others are fully fledged Islamic banks. The modes of operation depend on various factors like availability of personnel, market environment and the legal systems in the industry.

The introduction of the balanced scorecard by Kaplan and Norton (1992) as a performance measurement combines both quantitative and qualitative measures of the selected strategy and acknowledges the different expectations of the various stakeholders and attempts to link the scorecard performances measures to the chosen strategy. It does this by dividing measures into four different inter-related perspectives, the Financial, Customer, Internal Business Processes and Innovation and Learning. The main benefit of the balanced scorecard lie in its focus to turning strategy into implementation and the development of objectives that goes beyond financial measures as a method of translating abstract strategy into specific areas of a company action.

An efficient banking sector contributes positively to economic development by promoting capital accumulation through supply of credit to the investors through mobilizing and allocating savings, supporting trade, helps in diversification and hedging of risk, and to contributes to overall economic growth of a country through provision of credit to the private sector Levin, (1998).The performance of commercial banks can be affected by internal and external factors ,these factors can be classified into the banks specific internal and macro-economic variables. The internal factors are individual bank characteristics which affect the banks performance that are basically influenced by the internal decisions of management and board. The external factors are sector wide or country wide factors which are beyond the control of the company and affect the profitability of banks.

Statement of the Problem

Commercial banks` performance in Kenya over the last decade has not been impressive. Several reforms have been implemented in the financial sector since 1990s aiming at increasing performance, stability, productivity, financial access and efficiency. However, bank profitability on average has been erratic. In the period 2008-2013, increases in Profits before Tax (PBT) has been below 20% on average terms. In the year 2013 PBT of the Kenyan commercial banks increased by 16.6% as compared to the year 2012 when PBT increased by 20.6%. In the year 2009, PBT of the Kenyan banks increased by 12.9% as compared to the year

2008 when PBT increased by 13.4%. The year 2010 is the only year that PBT increased by around 52 percent according to the CBK report for 2013

This trend is not impressive given that a lot of reforms have been done to enhance performance of the banking sector. Also there has been a lot of changes in technology and several financial innovations have been developed in Kenya`s financial sector. All these changes have reorganized the banking sector in terms of management, interactions with clients and relationships with other institutions. All these developments are likely to affect banks` performance and their total cost of operations. It is, therefore, important to know the factors that affect bank performance so as to influence policy making and management decisions that can improve profitability in Kenya`s banking sector.

Empirical findings done by Saud (2011) on performance analysis of Islamic banking showed that large banks performance has reached the mature growth unlike medium size banks. The results of the study indicated that banks size has a negative impact on financial performance while assets utilization has a positive impact on Saudi banks. The measures used on this research were based on the size of the bank and not the other parameters that this study will address on the measurement of performance. Bashir 2003 from Grambling state university findings on his research, assessing performance of Islamic banks elaborated the determinants of Islamic banks performance across eight middle eastern countries between 1993 and 1998.The banks used a variety of internal and external banking characteristics to predict profitability and efficiency for example macroeconomic environment, Financial market structure taxation, the results indicate that high leverage and large loans to assets ratio leads to high profitability. In view of the above empirical findings, it is clear that the previous studies did not consider the strategies being used by commercial banks in relation to performance of Islamic banking, the effect of these strategies on the banks profitability and their performance in general. Therefore, this study will examine these strategies being used by commercial banks, their impact in the adoption of Islamic banking in Kenya using a sample of the commercial banks in Nairobi County, and how these strategies affect the performance of these banks in terms Customer base, Growth in assets and liabilities, financial validity and the relevance of the Islamic banking in the banking sector.

Objectives of the study

i. To establish the effect of Islamic operational strategies on the performance of commercial banks.
ii. To determine the influence of funds separation on performance of commercial banks

LITERATURE REVIEW

Theoretical Literature

The first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Ross and Mitnick (1993). Ross is responsible for the origin of the economic theory of agency and Mitnick for the institutional theory of agency, though the basic concepts underlying these approaches are similar. Indeed, the approaches can be seen as complementary in their uses of similar concepts under different assumptions. In short, Ross introduced the study of agency in terms of problems of compensation contracting agency was seen, in essence, as an incentives problem.

Mitnick introduced the now common insight that institutions form around agency, and evolve to deal with agency, in response to the essential imperfection of agency relationships: Behaviour never occurs as it is preferred by the principal because it does not pay to make it perfect but society creates institutions that attend to these imperfections, managing or buffering them, adapting to them, or becoming chronically distorted by them. Thus, to fully understand agency, we need both streams to see the incentives as well as the institutional structures. Agency theory holds the view that there should be proper synergy between the management and its stakeholders in order to work towards a common goal. However lately several authors among others in Islamic banking Kirimi (2011) raised the agency problem in mudaraba and musharakah contracts. When a business is run by professional managers, as opposed to the owner or supplier of capital (shareholder), conflict of interest may arise. Manager is the business owner's agent, As the utility increases, managers will seek to maximize their own utility instead of maximizing the wealth or utility of the shareholders or the business owners.

They have an incentive to increase their own salaries, fringe benefits, and other perks, all of which represent a conflict of interest that may lead them to place personal interest ahead of such corporate goals as maximizing the shareholders' profit margin. This conflict is the most common problem in all businesses or corporations managed by agents rather than the shareholders or debt holders. Given its prevalence, it is important to see how it applies to mudaraba and musharaka. In musharaka mode of financing, a joint venture profit-sharing business of two or more parties in which the Islamic bank is an important partner or shareholder. Under musharaka, the bank relies on the other partner(s) to manage the business and make the day-to-day decisions.

Even though the bank could monitor the management of the business by hiring external auditors and consultants, such measures would incur additional costs. Therefore, the bank must rely on professional managers or other partners to manage the businesses, even though these managers may have an incentive to maximize their own utility at the business owner's expense. Under mudarabah/ musharakah financing, the Islamic bank does not participate directly in management decisions. Rather, it relies completely on the business venture's trustee or entrepreneur. This trustee is clearly an agent of the Islamic bank and, therefore is inherently subject to the agency conflict of interest. Thus, under both musharakah and mudarabah, the Islamic bank experiences the agency problem with its associated costs.

The agency problem becomes more acute when banks have little access to dependable accounting information, due to a lack of standardized financial reporting requirements and procedures. The difficulties presented by this agency problem, together with the lack of verifiable financial data, complicate the profit-sharing characteristics of these forms of Islamic financing and actually encourage debt financing (murabahah and ijarah) over equity financing (musharakah and mudarabah). To some extent, the agency problem in musharakah and mudarabah can be reduced by carefully specifying the Sharing of profit and performance bonuses between the entrepreneur and the bank. Also, in the case of musharakah, the bank participates in the election of the company's board and officers, a factor that should further reduce the agency problem.

Empirical Review

The empirical review examined the literature that developed a framework for this study in strategies that commercial banks are using in adopting Islamic banking and their performance. It is organized under the following subheadings; Operational strategies and performance, Funds separation and Performance. The section will also highlight the gaps on issues raised and issues reviewed as well as the conceptual framework of the study and the summary of the whole literature reviewed.

Islamic Operational strategies and performance

Porter (1996) defined strategy as the creation of a unique and value position involving a different set of activities and thus a company that strategically positioned performs different set of activities from its rivals or performs similar activities in different ways. He has taken his view on the basis of the assumption that many companies believe that they can establish a long lasting competitive advantage by performing similar activities better than its competitors. The banking sector has been changing from time to time and thus the need for the commercial banks to formulate new strategies in order to survive. Most banks have started embracing Islamic banking a market that was not concentrated on a few years back, commercial banks have realized that Islamic banking will be beneficial to them in terms of deposits and loans thus they are in the rush of adopting this concept and aggressively marketing it through various advertising models. The early contributions on the theory of Islamic banking were only discussed as part of the subject in Islamic economic system.

According to Zaman (2000), it is doubtful that non-Muslims, and often the Muslims themselves, will understand that Islamic banks are not really following Islamic commands for justice and fair play, and that usury and interest are not always synonymous the way the proponents of the Islamic banks claim them to be. This study will focus on six commercial banks that have already adopted the Islamic banking concept. We have four commercial banks that operate both conventional banking and Islamic banking but the difference comes on the mode of operation and thus Kenya commercial bank and Barclays bank have the same strategy of having the Islamic banking as a window. Barclays bank was the first bank to open its doors to Islamic banking when it was launched in December 2005 to meet the discerning needs of its thousands of customers.

Mbogo (2011) contributes to this argument by saying that, Islamic scholars in Kenya are hired as consultants by conventional banks when they are developing Shari'a compliant products. In Islamic banking system, there is a shortage of scholars and qualified managers. Unfortunately, the managers are not well trained in the use of Islamic financial practices, (Iqbal, Ahmad and Khan, 1998). Bokhari (2007) asserts that, Islamic financial institutions are facing various difficulties and challenges in which the main and important one is the lack of skilled and trained professionals to fulfill the requirements of this fast-growing industry (Ahmad, 2008).

Zaman (2000) asserts that in order for the Islamic banks to serve the Muslims in an efficient manner, in accordance with the Islamic percepts of justice and fair play, it is imperative that the Islamic banks be brought under the supervision of regulatory bodies and governed by some clear-cut standards cited at length in the study. According to Delwin (1991) initially, Islamic banks were refused authorization to operate because commercial banks and central banks could not accept the idea of interest-free banking. Under public pressure, special laws were passed that exempted Islamic banks from existing banking rules and occasionally, from the control of central banks altogether.

As Islamic banks became as successful as some conventional banks, the central banks insisted that they are put under their control. According to Rahma (2010) the United Kingdom has set itself up to be the Islamic financial hub of Europe. It has done this by accommodating Islamic finance into its regulatory system under the Financial Services Act (FSA). Rahma (2010) acknowledges that Islamic finance has arrived in Kenya and has been a growing phenomenon in the Muslim community in the past three years. In a rather different perspective, Timberg (2011) argues that although U.S and other banking supervision authorities have accommodated Islamic banking with few changes in procedures, some countries consider that this is not enough. They have moved to develop national and international Islamic institutions – money markets, bank regulators, deposit protection, bank accounting and so on. Centers have been developed for all these matters – for bank supervision in Malaysia, for accounting in Bahrain, and several academic centers, including centers at Harvard and Oxford University's (Timberg, 2011).

According to Ndung'u (2011) among the challenges facing Kenya's ambition to become a hub of Sharia compliant investment products, to compliment the Islamic banking, in the country are lack of; Sharia 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, he suggests that 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 sukuks)

Ndung'u (2011) argues that it is in this spirit that the Kenyan government through the Finance Act 2010, amended section 45 of the Central Bank of Kenya Act, to allow the central bank as the government's fiscal agent to recognize the payment of a "return" rather than "interest" on government securities. This amendment opens up the spectrum of Sharia compliant investments in the country (Ibid). He concludes by affirming that the government of Kenya, on its part will eventually continue to pursue policies that create an enabling environment that will eventually culminate in Kenya establishing itself as the regional financial hub as envisaged in the Vision 2030.

Islamic Funds Separation Strategy and Performance

According to the Institute of Islamic banking and insurance, Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Sharia (Islamic rulings) and its practical application through the development of Islamic economics. Sharia prohibits the payment of interest charges (riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles (Aggarwal and Yousef, 2002).

This is a strategy that is applied to the conventional banks having the Islamic department especially those operating as a window having the same board the governing the two departments. Deposits from Islamic accounts are not supposed to be mixed with deposits from the conventional transactions; Islamic deposits must have a different pool where Islamic loans are drawn from. They believe that the deposits from the conventional banking might have come from activities which are Haram that is against their faith. A bank that does not separate its funds will fail in Islamic banking.KCB had initially introduced the Amana banking back in 2007 but failed since they had not separated the funds, when the scholars of Islam consulted about the separation of funds pool KCB had not created it and the product failed since the Islamic customers pulled out for fear of being involved in haram transactions.

The principle of mudarabah was appealed systematically by Uzair (l982). His main contribution lay in suggesting mudaraba has the main premise for' interest less banking'. However, his argument that the Islamic bank should not make any capital investment with its own deposits rendered his analysis somewhat impracticalAl-Arabi (2004) also suggested a banking system with mudaraba as the main pivot. However, he advanced further the idea of a two-tier mudaraba which would enable the Islamic bank to mobilize savings on a mudaraba basis, allocating the funds also on a mudaraba basis.

According to Irshad (2008) all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.Ahmad (1995), proposes the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his proposition, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi (1996), Ahmad (1995) also suggests of possible partnership arrangements with the entrepreneur who seek capital from the Islamic banks. However, the partnership principle was not left undefined, nor was it clear who would bear the loss if any. It was also suggested that Islamic banks should cash bills of trade without charging interest, using the current account funds. From here, Islamic banks only charge fee to entrepreneur.

RESEARCH DESIGN AND METHODOLOGY

This study used descriptive research design which was cross-sectional in nature. Descriptive study according to Gall et al (1996) enables the researcher to collect information from a cross-section of a given population. According to the CBK Report 2015 Kenya has 43 licensed commercial banks inclusive of Islamic banks that formed the target population. The sample of the study was selected from the target population which included fully Islamic banks and conventional banks which operate an Islamic window like Barclays KCB National and Chase Bank which operate as a subsidiary. The target population was limited within Nairobi area. The sample size was a total of 6 banks in which 2 branches were selected in each bank. We had selected 8 managers in each of these banks.

The primary tool for data collection in this study was the questionnaire. This method was importantly relevant in this study because it goes along with the research design, the survey and it is both cost and time effective. The study was to use a mixture of open ended and closed ended questions to help in collecting the relevant information from the informants.

The study used the existing literature on Islamic banking for theoretical study from resources such as, academic and scholarly journals, text books and newspapers. Another quite important source of data was the Internet publications from the relevant web sites. the study employed both qualitative and quantitative analysis approaches for data analysis. Data was analyzed using descriptive statistics including percentages and frequencies for diagrammatic presentations. Data from the interviews was follow the criteria of themes but will be analyzed in descriptive words. This was to capture the words used by the interviewees assuming that this will bring out the findings clearly. The multi linear regression model includes;

$$y_i = \beta_0 + \beta_{1}x_{i1} + \beta_{2}x_{i2} + \dots \beta_{p}x_{ip} + \varepsilon_i \text{ for } i = 1,2, \dots n.$$

The model was linear because it was linear in the parameters β_0, β_1 and β_2. The model described a plane in the three-dimensional space of Y, x_1 and x_2. The parameter β_0 was the intercept of this plane. Parameters β_1 and β_2 are referred to as partial regression coefficients. Parameter β_1 represented the change in the mean response corresponding to a unit change in x_1 when x_2 was held constant. Parameter β_2 represented the change in the mean response corresponding to a unit change in x_2 when x_1 was held constant.

Where,
Yi= was the value of the dependent variable –the performance of the Islamic banks
Beta or β the coefficient of x; the slope of the regression line how much Y changes for each change in x
X was the value of the independent variable (x) what is predicting or explaining Y in this case we have; x1-Operational strategies
x2- Funds separation strategies

The error term e was predicting the value of Y, given the value of x.

DATA ANALYSIS, INTERPRETATION AND PRESENTATION

The study had a sample size of 48 managers from the selected commercial banks. Out of the 48 managers 40 responses were obtained giving a response rate of 83.33%. The study did not achieve a 100% response rate as some of the questionnaires were halfway filled by the respondents and hence could not be used in the study. However according to Kothari (2004) any response of 50% and above is adequate for analysis thus 83.33%was much better. On gender distribution, the ratio of the male to the female was 7:9 making the females in dominant in the banking sector. In relation to the Christians were 18(45%) the Muslims were 22(55%) making them the majority in the study. The mean age of the respondents was 36.29 years making it a young generation working in the banks for a competitive strategy. The respondent with the highest age was 56 meaning that he had a good experience in the industry and that his information could be benchmarked. The minimum age was 26 years meaning that it was possible that the employees were fresh graduates.

Operational Strategies

The first objective of the study was to establish the effect of Islamic Operational strategies on the performance of commercial banks. Performance was of key interest during the study. The study used a likert scale of 1- 5 whereby by; 1= Not at all, 2= Some extent, 3= Moderate extent, 4= large extent and 5= very large extent to weigh the opinion of the respondents.

Table 1 Operational strategies

	Operational strategies	Mean	S.D	Kurtosis
1	The legal framework in Kenya supports Islamic banking	2.02	0.385	4.402
2	The Islamic scholars in Kenya approval of Islamic products are fair.	4.0	0.0	0
3	The Islamic *sharia* laws are fully adhered to in terms of banks operations	3.1	0.805	-1.424
4	Islamic banking has a positive impact in the performance of the organization.	3.19	0.394	0.764
5	The supervisory framework supports the Islamic banking operations in commercial banks	1.42	0.647	0.595

From the findings, the respondents indicated with a mean of 2.02 and standard deviation of 0.385 that the legal framework in Kenya supports Islamic banking. The respondents also indicated with a mean of 4.0 and a standard deviation of 0.0 that Islamic scholars in Kenya approval of Islamic products are fair. The respondents further indicated with a mean of 3.1 and standard deviation of 0.805 that the Islamic sharia laws are fully adhered to in terms of bank operations. A mean of 3.19 and standard deviation of 0.394 that Islamic banking has a positive impact in the performance of the organization. They also indicated with a mean of 1.42 and standard deviation of 0.647 that the supervisory framework supports the Islamic banking operations in the commercial banks. From the above results the respondents' level of agreements on the Islamic scholars approval of Islamic products was rated very high with a mean of 4.0 and the impact of Islamic banking had on the performance having a mean of 3.19.The supervisory framework supporting the commercial banks was rated very low as shown by a mean of 1.42

Funds Separation Strategies

The second objective of the study was to determine the influence of Funds Separation on performance of commercial banks. The study used a likert scale of 1- 5 whereby by; 1= Not at all, 2= some extent, 3= Moderate extent, 4= large extent and 5= very large extent to weigh the opinion of the respondents.

Table 2 Funds separation

	Funds separation	Mean	S.D	Kurtosis
1	Funds separation being a requirement in Islamic banking, is it being fully adhered to, having a separate pool for Islamic deposits	3.52	0.652	-0.12
2	The deposits from Islamic banking are used for business that are only *halal* according to the Islamic *sharia* laws	3.56	0.649	3.639
3	Deposits from Islamic banking have a positive effect in the performance of the organization	3.31	0.748	-0.961
4	Is the bank mobilizing for savings on *mudarabah* basis?	2.29	0.824	0.573
5	Does your organization have a reserve fund that absorbs all losses in case of any from the depositors?	4.0	0.0	0.0

The respondents indicated with a mean of 3.52 and standard deviation of 0.652 that the Funds separation being a requirement in Islamic banking was being fully adhered to and that the banks have a separate pool for Islamic deposits. They also indicated with a mean of 3.56 and standard deviation of 0.649 that the deposits from Islamic banking were used for business that were only halal according to the Islamic sharia laws.

The respondents further indicated with a mean of 3.31 and standard deviation of 0.748 that deposits from the Islamic banking have a positive impact in the performance of the organization. A Mean of 2.29 and a standard deviation of 0.824 was indicated when the respondent were asked if the banks are mobilizing savings on mudarabah basis. Finally, the respondents further indicated with a mean of 4.0 and standard deviation of 0.0 that their organizations have a reserve fund that absorbs all losses in case of any from the depositors.

From the above results it is clear that all the commercial banks adhere to the sharia law's requirement that a reserve fund should be in place in case of any losses thus scored highly with a mean of 4.0. It is clear that the respondents level on the banks mobilization of deposits was rated very low by a mean of 2.29

Performance

The respondents were requested to evaluate the organizations performance. The results were as shown in the table below. The study used a likert scale of 1- 5 whereby by; 1= Not at all, 2= Very Little Extent, 3= Little extent, 4= Large extent and 5= Very large extent to weigh the opinion of the respondents.

Table 3 Banks Performance

	Performance.	Mean	S.D	Kurtosis
1	Through this strategy the organizations customer base has increased in terms of accounts and loans.	3.56	0.823	-0.454

2	These strategies have made Islamic banking become relevant in the banking sector by having a positive impact in performance.	3.56	0.823	-0.454
3	The financial viability has improved by use of these strategies	3.58	0.846	-0.559
4	These strategies have improved the organizations Assets and liabilities in the industry.	3.58	0.846	-0.559
5	There is a huge potential for growth of Islamic banks in Kenya	3.58	0.846	-0.559

According to the findings, the respondents indicated with a mean of 3.56 and standard deviation of 0.823 that the customer base had increased in terms of accounts and loans. The respondents also indicated with a mean of 3.56 and standard deviation of 0.823 that Islamic banking has become relevant in the banking sector by having a positive impact in the performance of the banks. The financial viability was given a rating mean of 3.58 and standard deviation of 0.846 and the same applied on the improvement of organizations assets and liabilities in the industry which was rated with a mean of 3.58 and standard deviation of 0. 846.They respondents also indicated that with a mean of 3.58 and standard deviation of 0.846 that there is a huge potential for growth of Islamic banks in Kenya.

The findings above give a general implication that Islamic banking has a positive impact in the performance of the banks since the rating were high on all the performance parameters. The Gulf African bank and the First Community bank were the only two leading banks which had a high performance contributed by the Islamic banking concept. The two are fully fledged to provide Islamic banking services. The least of all was KCB with 4% of the respondents. This was good evidence that the only banks that had fully focused on Islamic banks recorded a positive performance.

Inferential Statistics

Regression Analysis

A multi linear regression model was used for the analysis to determine the relationship between the dependent and independent variables. The multi linear regression model was

$$\mathbf{y_i = \beta_0 + \beta_{1Xi1} + \beta_{2Xi2} + \ldots \beta_{pXip} + \varepsilon_i \text{ for } i = 1,2, \ldots n.}$$

The model summary is shown as below

Table 4 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.764[a]	.653	.685	.73993

a. Predictors: (Constant), Operational strategy, Funds separation, Lending Strategy,

The R-Squared is the proportion of variance in the dependent variable can be explained by the independent variables. The R-squared in this study was 0.685 which shows that the three independent variables Operational strategies, Funds separation strategies and Lending strategies can explain 68.5% of the dependent variable. This shows that the other factors not studied in this study explain 31.5% of the dependent variable (organization performance)

Table 5 Analysis of Variance

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	9.577	2	3.192	5.831	.002[b]
Residual	24.090	44	.547		
Total	33.667	47			

a. Dependent Variable: Performance
b. Predictors: (Constant) Operational strategy, Funds separation, Lending Strategy,

The analysis of variance in this study was used to determine whether the model is a good fit for the data. From the findings, the P-Value was 0.002 which is less than 0.05 and hence the model is good in predicting how the three independent variables (Operational strategies, Lending strategies, and Funds separation strategies.) influence performance of the commercial banks in the county of Nairobi. Further the F- calculated (5.831) was more than the F critical (2.46) which shows that the model was fit in predicting the influence of the independent variables on the dependent variable.

Relationship between bank's Performance and Islamic banking strategies

A multiple regression was carried out to determine the relationship between the dependent variable which in our case was the Operational performance of the banks that practiced Islamic banking with the operational strategies, funds separation and lending strategies that are used in the operation of the Islamic banking as the independent variables

Estimated Model Coefficients

The equation for the regression line was:

$$\mathbf{Y=\beta o + \beta_1 X_1 + \beta_2 X_2 + \varepsilon}$$

Where Y= Performance

βo = Constant factor

X1 - Operational strategy

X2 – Funds separation

βi = coefficient

ε = error term

Y= 0.301X1+0.665X2

Predicted operational performance(Y) = (0.301*operational strategy) + (0.665*Funds separation).

This is obtained from the Coefficients table, as shown below:

Table 6 Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
	B	Std. Error	Beta			Lower Bound	Upper Bound
(Constant)	-4.023	3.051		-1.319	.194	-10.172	2.126
Operational strategy	.301	.209	.189	1.440	.157	-.120	.723
Funds Separation	.665	.224	.394	2.972	.005	.214	1.115

According to the intercept β_0 when the three independent variables are held constant, the value of performance of Islamic banking will be -4.023. In addition, holding the other independent variables constant, a unit increase in operational strategies would lead to 0.301 increases in organizational performance. The relationship was significant by the P value of 0.157. Further, holding on the other independent variables constant, a unit increase in funds separation would lead to a 0.665 increase in performance of the commercial banks.

The relationship was significant as shown by the P-value of 0.005In addition holding all other variables constant, a unit increase in Lending strategies would lead to an increase of 1.092 to performance of the commercial banks. From the findings it is clear that the lending strategies affect performance of Islamic banking in commercial banks followed by the funds separation strategies then the operational strategies.

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Summary

The first objective of the study was to establish the effect of Islamic operational strategies on the performance of commercial banks. The study revealed that the legal framework in Kenya supports Islamic banking although not to a large extent since the country has no proper legal framework for Islamic banking. The study also found out that Islamic scholars in Kenya approval of Islamic products were fair and in line with the needs of the commercial banks. The study further revealed that the Islamic banking has a positive impact on the performance of the commercial banks. The study also established that the supervisory framework supports but not to a large extent the Islamic banking operation in the commercial banks.

The second objective of the study was to determine the influence of funds separation on the performance of commercial banks. The study revealed that funds separation being a requirement in Islamic banking, was being fully adhered to having a separate pool for the Islamic deposits and thus the deposits from these pools are used for business that are only legal (halal) and not illegal (haram) according to the Islamic sharia laws. The study revealed that these deposits from Islamic banking have a positive impact in the performance of the organization, although the bank was not mobilizing savings on mudarabah basis as expected on Islamic banking. The study revealed that most of these banks had a reserve fund that absorbs all losses in case of any from the depositors.

Conclusion

The study concludes that the operations strategies currently being used by the banks have a positive influence in the performance of the banks. Commercial banks operate as a window, a subsidiary and those banks that are fully fledged banks. The legal framework in Kenya does not fully support Islamic banking in Kenya although the government is still working on this to establish a legal and supervisory framework that supports Islamic banking in Kenya. Islamic scholars are still very few to date but most banks are using the sheikhs and imams from different parts of the world in giving directions in regard to Islamic banking and in decision making. The study concludes that most commercial banks are still trying to adopt these concepts of Islamic banking although they are not complying with the sharia laws to the later. Funds separation is the major distinguishing factor in Islamic and conventional banking and having a reserve fund that absorbs losses in Islamic banking.

Most commercial banks ventured in Islamic banking on order to get deposits and meet the unmet market of the Muslims thus the adherence to the sharia laws will have a positive impact in the Islamic banking department. Most conventional banks had not set up a reserve fund account but were in the process of setting up although the fully fledged already have one in place. The study further concludes that most customers in Islamic banking have a high intake in the loans offered under the musharaka and mudaraba basis where the banks have a partnership with the clients thus sharing the risk. The banks have also embraced this but are depending on the agents appointed by them to negotiate on their behalf. Islamic banking does not value money as a commodity thus they buy a commodity on behalf of the customer and gives him a loan inform of the commodity so that the customer can sell at his own will. This aspect encourages the customers in Islamic banking to have a high interest in loans and the accounts provided by the banks thus encouraging investors and improving the banks performance. The study concludes that Islamic banking has had a positive impact in terms of the performance of different banks; there are those banks that really had an increase in the number of customers with large deposits through Islamic banking, while others their financial viability has drastically improved. Loans that are being given on profit sharing basis have made most banks acquire assets from different parts of the world. Despite all the strategies that have been put in place, the study found that there is still a slow uptake of Islamic banking in Kenya.

Most managers agreed that most banks have not educated the public on Islamic banking that the market perceive it as a product for the Muslims only but in real sense it’s a product for everybody Christians and Muslims both alike. The study concludes that apart from the highlighted strategies lack of trained personnel in the banks might also contribute to the slow uptake of Islamic banking. The managers in conventional banks acknowledged that most of the staff working on the lower level and other departments seems not interested in Islamic banking department, unlike those in fully fledged Islamic banks. In regard to the customers the manager’s views were that the slow uptake might be due to the link of Islamic banking to terrorism, they fear being linked and suspects of supporting terrorism. This is a drawback in Islamic banking.

Recommendations

The study revealed the raised agency problem in mudarabah and musharakah contracts. When a business is run by professional managers, as opposed to the owner or supplier of capital (shareholder), conflict of interest may arise. To some extent, the agency problem in musharakah and mudarabah can be reduced by carefully specifying the Sharing of profit and performance bonuses between the entrepreneur and the bank. Also, in the case of musharakah, the bank participates in the election of the company's board and officers, a factor that should further reduce the agency problem.

The study found that the gap in the market is due to lack of marketing and advertising of the Islamic products in the market. The banks should carry out awareness through media adverts, making fliers that can be stationed in the banking halls for publicity, and also having road show to sensitize the market on the Islamic products available. Lack of trained personnel in the banks especially the conventional banks was clearly evident, and thus the study recommends regular training of staff at least quarterly and targets to be set on achievement of certain products that ought to be measured in individual performance, and constant reminder of the products through mails and internal learning platforms provided by the banks.

Islamic banking could easily be enhanced if the regulatory challenges are dealt with. This is by the capital markets authority act; banking act and the central bank act being amended to bring Islamic banking into the proper regulatory environment. The bank needs to sensitize the market and encourage them to distinguish between Islam and terrorism, that Islam is a religion that does not support terrorism.

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