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**Odongo, A. E.,[1*] & Muchelule, Y.[2]**

[1*] Msc. (Finance) Candidate, Jomo Kenyatta University of Agriculture & Technology [JKUAT], Kenya
[2]Ph.D, Lecturer, Jomo Kenyatta University of Agriculture & Technology [JKUAT], Kenya

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**ABSTRACT**

*The objective of this study was to investigate the effect of Islamic banking on financial performance of Commercial Banks Nairobi City County. The specific objectives were; to investigate the effect of interest free transactions on financial performance of commercial banks Nairobi City County and to assess the effect of sharing profit/loss with depositors on financial performance of commercial banks Nairobi City County. The research was carried out in ten commercial banks which were operational in Nairobi City County. The target population was the 195 employees in the ten commercial banks in Nairobi City County. The sample size was 129 employees. The employees were divided into two strata, the middle level and lower cadre staff. Stratified random sampling was used to determine the group that was to be issued with questionnaires'. The study adopted the descriptive survey design. The research instrument that was used during the study was a questionnaire. Both qualitative and quantitative data was collected and analyzed using inferential and descriptive statistics with the aid of Statistical Package for Social Science (SPSS) version 20. It was concluded that Islamic banking has a positive and significant effect on financial performance of commercial banks in Nairobi City County. It was recommended that there is need for creation of awareness on Islamic banking so that the unbanked population can also be captured and this would improve the financial performance of commercial banks. The results were presented in form of tables.*

***Key Words:*** *interest free transactions, profit and loss sharing, Islamic Banking*

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## INTRODUCTION

After the stable coinage era emerged, banking activities thus borrowing and savings quickly developed to accommodate the international trade. Bills of exchange and credit-based transactions deals began on early merchant banks. These new financing instruments system began to deal in bills of exchange and credit-based transactions. These new financing instruments eliminated the need for merchants to actually deliver the precious metals and coins to pay for transactions in distant ports (Grierson, 1999).

According to Shanmugam and Zahari (2009), Islamic banking is well known for promoting the sharing of risk and rewards between the financers and the borrowers, by so the degree of sharing the risks varies by the type of contract agreed upon by the parties involved. The basic principles underlying Islamic financial transactions and which are the guidelines to all Islamic finance practices are that the financing purpose should avoid all activities prohibited by Shari'a(Islamic Laws), should avoid gharar this involves; risks, uncertainty, and speculation activities and also must avoid Riba which involves; interest receiving and giving activities. These principles and the other doctrines of Muslim faith are incorporated in Islamic finance to meet the growing global demand for sharia-compliant investment and financing (Shanmugam & Zahari, 2009).

According at a publication by Bank Negara of Malaysia (2017), in many African countries Islamic banking and finance has become a showpiece and a number of market development and regulatory efforts have taken place in the recent years. Necessary legal and regulatory framework have been put in place by countries to enable Islamic Banking and Finance services to be offered in their respective jurisdiction(Negara Malaysia, 2017).

According to Dahir (2017), the financial regulatory agencies of Kenya are ready to allow Islamic finance and Banking to thrive in Kenya and plans are there to make Kenya a hub of Islamic finance in the Eastern region. Currently Kenya is the leading in Islamic Banking regionally and by so it has to fully operating Islamic Banks and the third once currently being authoresses to operate in Kenya (Dahir, 2017). Kenya has an Islamic Insurance company recognized as Takaful, a sharia- compliant mutual fund, and two Savings and Credit Cooperatives (SACCOs) also it has joined the Islamic Financial service Board (IFSB), a Malaysia based body that regulates and promotes transparent and sound Islamic finance services globally (Dahir, 2017).

### Statement of the Problem

In Sub- Saharan Africa, Kenyan Banking sector is one of the fast growing and competitive market with high returns which has eventually led to a lot of creativity and changes in the banking sector (KBA, 2015). The operational modes of most banks have changed in order to meet the market demands in a special and quick banking system. Islamic banking is one of the new services offered in both Islamic commercial and conventional banks in Kenya but not all convectional commercial banks offers this services (KBA, 2016). According to Malaysia World's Islamic Finance marketplace in their book Islamic finance in Africa (2017), in Africa, there is a clear set of potential for Islamic banking growth with intention to diversify their sources of funding. Islamic financial services have a strong demand in the current Africa due to the demographics. With the emerging of proper financial inclusion in Africa, Islamic finance stands a chance to offer a better solution in Africa (Islamic Finance in Africa, 2017). Islamic Banking is designed to meet specific religious requirements of Muslim customers but is not restricted to Muslims; it performs the same essential functions as banks do in the commercial system, except the need for them to carry out their transactions in accordance with the rules and principles of Islam (Iqbal & Mirakhor, 2007). Islamic Banking and finance initially evolved as a form of financial intermediation for Islamic community to conduct financial transactions that conform to Islamic law. It has now significant number of clients and thus it has grown since inception in Dubai in 1975 (Henry &Wilson, 2004). Over the last three decades Islamic banking has emerged as one of the fastest growing industries. It has spread to all corners of the globe and received acceptance by both Muslims and Non – Muslims (Iqbal & Molyneux, 2005).

Although Islamic banking has expanded so much beyond traditional boarders, the global environment has become increasingly challenging; an environment that is subject to powerful forces of demand from Muslim population in the country, unstable market conditions, misconceptions against Islamic banking, heightened competition, documentary complexity, lack of qualified and skilled personnel in Islamic finance, rising cost-to-income ratio and brand recognition, (Oundo, 2009).These challenges may have a negative effect on the financial performance of commercial banks

Recent researches done in Kenya which have focused on Islamic Banking and Financial performance of commercial banks have different views on Islamic banking and there effects in financial performance. Kipkorir (2012), did his research on effects of offering Sharia- compliant products on financial performance of commercial banks in Kenya, the researcher focused on all the commercial banks financial performance in Kenya at that time, a study done by Hassan (2012) on Evaluation of Islamic Banking products and financial performance of Islamic Banks in Kenya, the researcher focused on Islamic Banks only. Halkano(2012) in his study on Performance of Islamic and conventional commercial banks in Kenya: a comparative case study, the result of indicated that on the whole, the commercial banks performed better than the Islamic banks during the period under review. Ahmednoor (2012) in his studies on Evaluation of Islamic banking products and financial performance of Islamic banks in Kenya, in his conclusion and fieldwork, he focused on profit and financial performance and it was based on Islamic banks performance in Kenya. Kipkori failed to cover all commercial banks with Islamic banking window only, and by so his study generalized both Islamic and conventional commercial banks since all are categorized as commercial banks. A recent research done by Jaffar (2016) on impact of Islamic banking on the financial performance of conventional banks offering Islamic Banking Products in Kenya look on the convectional banks offering Islamic banking which he stated to be five banks Equity Bank Group being one of them, but according to information from CBK since Islamic banking was introduced in Kenya only five banks have only be authorized to have the Islamic banking widow to offer the service and Equity Bank Group is not included in the list.

Many studies have been conducted on Islamic banking and its effect on financial performance of commercial banks in other countries like Malaysia, Pakistan and Indonesia (Abdullah et al. 2012) yet not much has been done in Kenya, specifically Nairobi City County. With all these challenges facing Islamic banking, the researcher found it worthy to investigate whether Islamic banking had any effect on financial performance of commercial banks Nairobi City County. This study would be significant because it would bridge the knowledge gap.

**Study Objectives**

The general objective of the study was to investigate the effect of Islamic banking on Financial Performance of Commercial Banks in Nairobi City County. The specific objectives were:-

- To investigate the effect of interest free transactions on financial performance of commercial banks in Nairobi City County.
- To assess the effect of sharing profits and losses with depositors on financial performance of commercial banks in Nairobi City County.

## LITERATURE REVIEW

### Theoretical Review

### The Two Tier Mudaraba Model

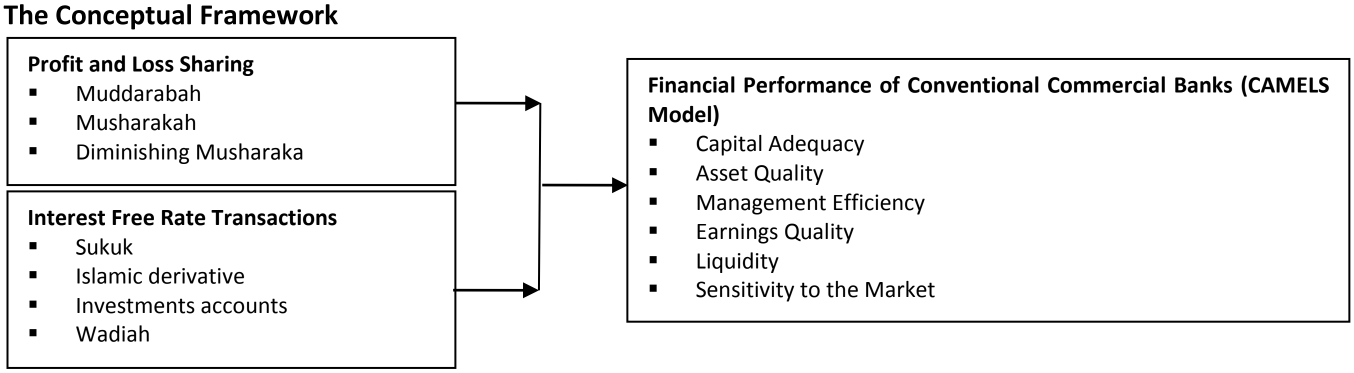
The main feature of this model is that it replaces interest by profit sharing on both the liabilities and the assets of the bank. The main business of the bank is to obtain funds from the public on the basis of Mudaraba and to supply funds to businessmen on the same basis. The bank can have general unrestricted investment deposits or restricted investment accounts in which deposits are made for investment in particular projects. A number of positive effects for the efficiency, equity and stability of banking system are expected from the application of this model, (Iqbal Zamir; Mirakhor, 2007).

### One Tier Mudaraba Model Combined with Multiple Investment Tools

According to one tier model early works on Islamic banking based on the traditional modes of finance such as Mudaraba and Musharaka. However in practice Islamic banks faced a number of difficulties in using these modes to a significant extend. Subsequent writings and practices of Islamic banking have made important contributions to the evolution of the new forms of Islamic business enterprises as well as the conceptual development of Islamic financial modes and instruments. The traditional modes of finance were based on either partnerships or the principle of deferred trading of goods and services, (Iqbal Zamir; Mirakhor, 2007) The practice of Islamic banking has led to the evolution of different types of permanent, temporary as well as declining partnerships based on the principle of Musharaka and Mudaraba with easily adaptable arrangements with respect to managerial responsibilities.

Though both models are relevant to this study the researcher will adopt the one tier Mudaraba Model combined with multiple investment tools because according to this model early works of Islamic banking based on the traditional modes of finance such as Mudaraba and Musharaka and the Islamic banks faced a number of difficulties but subsequent practices have made important contributions to the evolution of the new forms of Islamic business enterprises as well as the conceptual development of Islamic financial modes and instruments. This has prompted the researcher to determine whether the new developments in the Islamic banking according to this model have an effect on financial performance of commercial banks in Nairobi City County.

### The Conceptual Framework




**Dependent Variables** **Dependent Variable**

**Figure 1: Conceptual framework**

**Source: Author (2019)**

## Empirical Review

### Interest rate free Transactions

According to Hakan and Bengu ( 2011) in their research paper on The Impact of Interest Rates on Islamic and commercial Banks: The Case of Turkey, The researcher used Vector Error Correction (VEC) methodology in this which investigated the impact of interest rate shock upon the deposits and loans held by the and Islamic banks. It is theoretically expected that the Islamic banks, relying on interest-free banking, shall not be affected by the interest rates; but the article finds that the Islamic banks in Turkey are visibly influenced by rates. The research didn't look at the role of Interest free transaction on the performance of commercial banks.

According to Okumu (2005), in his research paper on Interest free banking in Turkey: A study of Customer Satisfaction and Bank Section criteria. This research paper particularly attempted to assess the degree of customer awareness and satisfaction with this type of banking as well as identifying the customers' profile for Special Finance Houses (SFHs). Its analysis revealed a certain degree of satisfaction with Special Finance Houses (SFHs) facilities despite them being aware of the number of specific products and services in Islamic banking; they indicated that they did not want to deal with them. Also the researcher did not look at the roles of Islamic banking on the performance of commercial Banks in Kenya instead he focused on customer satisfaction and bank section criteria and compared SFHs products with Islamic Bank interest free products.

### Islamic Banking Profit and Loses Sharing

According to Muhammad Hanif (2014) in his research paper on Profit & Loss Sharing in Islamic Banking and Finance the researcher conducted the study to analyze the issue based upon available literature and data. The finding fund that profit and loss sharing based modes of financing are very much practiced by Islamic finance industry in the form of deposits, house financing, Sukuk, equity funds and Mudaraba companies. While for direct financing by banks is concerned, the share of Profit and loss sharing based modes of financing is very negligible, primarily due to non-conduciveness of an existing business environment. Here, the researcher only focused on Islamic Banks and not the performance of commercial banks.

According to Khoutem and Hichem (2014) in their research on Profits and Losses sharing paradigm in Islamic banks: Constraints or solutions for liquidity management they Profits and Losses Sharing (PLS) involves specificities in the Islamic bank liquidity issue. They used hypothetic-deductive methodology to find their data and analyzed. Seeing maturity transformation, they conclude that Profit and Loss Sharing intermediation leads to a more exposition to liquidity risk since Islamic banks often use short-term deposits to allow financing of musharaka and mudarabah in the long term. However, for the risk transformation, the Profit and Loss sharing mechanism between the banks and its depositors on the one hand and the bank and entrepreneurs, on the other hand, permits less exposition to liquidity risk. The researchers majored their study on constraints and solution for liquidity in profit and loss sharing Islamic banking product while this research will deal with performance of commercial banks when subjected to profit and loss sharing Islamic bank products.

### Commercial Banks Financial Performance

Various studies about Islamic Banking in Kenya have been carried out, these includes; Evaluation of Islamic banking products and financial performance of Islamic banks in Kenya (Hassan, 2012), A comparative analysis of the risk in Islamic and commercial banks in Kenya (Adam, 2012), The effect of offering sharia compliant products on financial performance of Commercial banks in Kenya by Kipkorir(2012), Performance of Islamic and commercial commercial banks in Kenya : a comparative case study (Halkano, 2012), The problems and challenges islamic banks face in Kenya (Abdulahi & Abdi, 2011), Factors affecting the adoption of Islamic Banking in Kenya by banks(Hemed, 2009), Analysis of shariah compliant banking in Kenya ( 2009), Factors Influencing the Growth of Islamic Banks In Kenya (Kasmani, 2014), and An empirical study of factors influencing financial performance of Islamic versus commercial banks in Kenya(Garo, 2013).

The study done by Kipkorir(2012), focused on financial performance of all commercial banks without distinguishing convectional commercial banks with Islamic banking window from the others, but this research will look at the effect of Islamic banking on financial performance of the commercial banks which have got Islamic banking window. A research work done by Jaffar (2016) on the impact of Islamic banking on the financial Performance of commercial banks offering Islamic banking products in Kenya, the banks studied one of them was not and has never offered Islamic banking services by so the findings of the research could be misleading to students, researchers and any other interested party on the impact of Islamic banking on financial performance of commercial banks.

## METHODOLOGY

The research design that was adopted in this study was the descriptive survey design. According to Mugenda and Mugenda (2003) descriptive survey design involves collection of data from a sample of population in order to determine the current status of that population with respect to one or more variables. The target population was 195 employees in the ten (10) commercial banks currently operating within Nairobi City County. The employees included were those in middle management level and lower cadre staff. The desired sample size thus comprised of 129 respondents. The study used stratified sampling technique to select the employees where the respondents were picked from the strata's. The main instrument of data collection in the study was a questionnaire which was issued to the respondents. Primary data was collected through a questionnaire. The study used descriptive and inferential statistics in analyzing data.

## FINDINGS

### Descriptive Analysis of the Variables in the Study

Descriptive analysis included an assessment of the interest free transactions, sharing of profit and losses with depositors, Islamic Tax and financial performance of commercial Banks. The statements were anchored on a five point Likert-type scale ranging from 1=Strongly Agree to 5= Strongly Disagree and respondents were asked to indicate the extent to which they agreed to the statements. Descriptive measures included percentage, frequency, mean and standard deviation. Mean is a measure of central tendency used to describe the most typical value in a set of values. Standard deviation shows how far the distribution is from the mean.

### Interest Free Transactions

Interest free transactions are one of the crucial factors of Islamic banking that affects financial performance. To measure interest free transactions, a set of six statements were formulated. The respondents were asked to indicate the extent of agreement with each of the interest free transactions statements. The pertinent results are presented in Table 1.

Table 1 revealed the customer awareness on the availability of interest free transactions, 2.2% (2) of the respondents strongly agreed that customers were aware about the interest free transactions available in the banks, 9.8% (9) agreed while 7.6% (7) of the respondents were neutral, 59.8%(55) of the respondents disagreed and, 20.7% (19) of the respondents strongly disagreed that customers were aware about tie interest free transactions (mean = 3.869, SD = 0.928). Majority, that was 80.5 % (74) of the respondents disagreed that customers were aware of the interest free transactions; this was a clear indication that most customers were not aware that interest free transactions were available in the organizations (banks).

The issue of whether Interest free transactions had increased lending was also sought by the researcher. 3.3% (3) of the respondents strongly agreed that Interest free transactions have increased lending, 5.4% (5) of the respondents agreed on the same and 20.7% (19) of the respondents were neutral. However, 40.2% (37) disagreed while 30.4 (28) of the respondents strongly disagreed that Interest free transactions had increased lending (mean = 3.891 SD = 1.010).Majority of the respondents who constituted 70.6 %( 65) disagreed that interest free transactions had increased lending.

In relation to interest free transactions increasing customer access; 5.4% (5) of the respondents strongly agreed that interest free transactions increases customer access to banking, 19.6% (18) agreed while 44.6% (4) of the respondents were neutral. However, 19.6% (18) of the respondents disagreed that interest free transactions have increased customer access to banking, while 10.9% (10) strongly disagreed to the same (mean = 3.108, SD = 1.021). On whether interest free transactions had increased customer access to banking, majority of the respondents 44.6% (41) were neutral on whether customers can easily access these services.

The respondents were also asked if Interest free transactions have increased financial stability. The results were such that 16.3% (15) of the respondents strongly agreed, 30.4% (28) agreed, 35.9% (33) were neutral, 13% (12) disagreed and 4.3% (4) strongly disagreed (mean = 2.587, SD = 1.0498).Majority of the respondents 46.7 %( 43) agreed that interest free transactions had improved the financial performance of the organization.

Additionally, 9.8% (9) of the respondents strongly agreed that Interest free transaction has increased competition between banks, 9.8% (9) of the respondents agreed on the same, 27.2% (25) were neutral while 32.6% (30) disagreed that Interest free transaction has increased competition between banks while 20.7% (19) strongly disagreed (mean = 3.445, SD = 1.207).From the responses, majority 53.3%(49) disagreed that these transactions have increased competition in the banking industry..

Finally, 10.9% (10) of the respondents strongly agreed that Interest free transactions have drawn the unbanked population, 28.3% (26) agreed and 26.1% (24) of the respondents were neutral. However, 23.1% (22) of the respondents disagreed and 10.9% (10) strongly disagreed (mean = 2.913, SD = 1.272).The overall mean and standard deviation were 3.3025 and 1.0816 respectively. From the responses, majority 39.2% (36) agreed that this type of services have helped in capturing the" unbanked" population.

From the results of the study, it was evident that interest free transactions offered by the banks had helped in stabilizing their financial performance and drawing the "unbanked" population but the banks have not created awareness to the customers about these transactions by providing information to the customers about these products hence this reduces accessibility by many the customers and lending services by the bank which led to reduction in competition amongst commercial banks. When financial systems serve only a limited segment of the population, the society is likely to lose opportunities to grow (CBK, 2011)

**Table 1: Interest Free Transactions**

| Interest Free Transactions | SA (%) | A (%) | N (%) | D (%) | SD (%) | Mean | Std. Dev. |
|---|---|---|---|---|---|---|---|
| Customers are informed about the interest free transactions | 2.2(2) | 9.8(9) | 7.6(7) | 59.8(55) | 20.7(19) | 3.87 | 0.93 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Interest free transactions have increased lending | 3.3(3) | 5.4(5) | 20.7(19) | 40.2(37) | 30.4(28) | 3.897 | 1.01 |
| Interest free transactions have increased customer access to the services | 5.4(5) | 19.6(18) | 44.6(41) | 19.6(18) | 10.9(10) | 3.11 | 1.02 |
| Interest free transactions have led to increased financial stability | 16.3(15) | 30.4(28) | 35.9(33) | 13(12) | 4.3(4) | 2.59 | 1.05 |
| Interest free transactions have increased bank competition | 9.8(9) | 9.8(9) | 27.2(25) | 32.6(30) | 20.7(19) | 3.45 | 1.21 |
| Interest free transactions have drawn the" unbanked" population | 10.9(10) | 28.3(26) | 26.1(24) | 23.1(22) | 10.9(10) | 2.91 | 1.27 |
| **Interest Free Transaction** | | | | | | **3.30** | **1.08** |

**Sharing Profit and Losses**

Sharing profit and losses with depositor in Islamic banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries (Arif, 1988). To determine Sharing profit and losses, a set of six statements were formulated. The respondents were asked to indicate the extent of agreement with each of the sharing profit and losses statements. Their responses are summarized in Table 2.

From the table 2, 5.4% (5) of the respondents strongly agreed that the organization shares its profit or loss with the depositors, 8.7% (8) of the respondents agreed on the same while 27.2% (25) were neutral. However, 32.6% (30) of the respondents disagreed with this notion while only 26.1% (24) strongly disagreed (mean = 3.6522, SD = 1.123). Majority of the respondents 58.7% (54) disagreed that the organization does not share the profits or losses with the depositors. Since profit /loss is usually shared between the banks and the depositors but the majority of the respondents have denied that, this clearly indicated that most people did not understand much about how these interest free products operates.

On whether sharing of profit or loss had attracted customers to the bank, 8.7% (8) of the respondents strongly agreed, 29.3% (27) agreed, 42.4% (39) remained neutral, though 16.3% (15) of the respondents disagreed while 3.3% (3) strongly disagreed that sharing of profit or loss has attracted customers. (Mean = 2.7609, SD = .94194). Majority 42.4% (39) were neutral on whether sharing of profits and losses had attracted customers in the organization.

Further, whether sharing of profit/loss had increased the quality of the asset,12% (11) of the respondents strongly agreed that sharing of profit or loss has increased quality of assets, 34.8% (32) of them agreed, 39.1% (36) were neutral, though 10.9% (10) of the respondents disagreed while 3.3% (3) of strongly disagreed. On the issue of whether sharing of profit or loss had increased quality of assets (mean = 2.587, SD = .95102). Majority of the respondents 46.8% (43) agreed that sharing of profit/loss has increased the quality of the asset.

Whether sharing of profit /loss had created financial trust, 9.8% (9) of the respondents strongly agreed that sharing of profit or loss had created financial trust between lender and borrower, 26.1% (24) agreed, 43.5 %(40) were neutral, 16.3% (15) disagreed to the same. Only 4.3% (4) strongly disagreed that sharing of profit or loss had created financial trust between lender and borrower (mean = 2.489, SD 1.074). Majority of the respondents 43.5%

(40) were neutral that sharing of profit/loss had created financial trust.

On the issue of whether sharing of profit or loss with depositors had increased the degree of risk to the banks, 26.1% (24) of the respondents strongly agreed, 16.3% (15) of the respondents agreed, 41.3%(38) were neutral and 15.2% (14) disagreed and 1.1% (1) strongly disagreed to this (mean = 2.4891, SD = 1.074) Majority 42.4% (39) agreed that sharing of profit/loss has increased the degree of risk in the banks.

Finally, 18.5% (17) of the respondents strongly agreed that sharing of profit or loss had improved the Islamic financing, 25% (23) agreed and 42.4% (39) of the respondents were neutral. However, 6.5% (6) of the respondents disagreed and 7.6% (7) strongly disagreed (mean = 2.598, SD = 1.10005).Sharing of profit or loss summed up to a mean of 2.8134 and standard deviation of 1.02805. Majority of the respondents 43.5% (40) agreed that sharing of profit/loss has improved Islamic financing in banks in Nairobi City County.

From the results of the study, it was evident that sharing of profit and loss had improved Islamic financing but it had also increased the degree of risk since banks get their income from the interest charged on their services so that they could get capital to lend and make profits and yet Islamic banking does not allow the interest to be charged and yet they expect a profit which should be shared with depositors. In the achieved results, most of the respondents were neutral on whether sharing of profit /loss with the depositors has increased the degree of financial trust and this did not agree with results of the study which was carried out by other researchers where the conclusion was that sharing of profit /Loss creates a relationship of financial trust and partnership between the borrower and lender, (Yudistria, 2003).

**Table 2: Sharing Profit or losses**

| Sharing Profit or Losses | SA (%) | A (%) | N (%) | D (%) | SD (%) | Mean | Std. Dev. |
|---|---|---|---|---|---|---|---|
| shares profit or loss with the depositors | 5.4(5) | 8.7(8) | 27.2(25) | 32.6(30) | 26.1(24) | 3.65 | 1.12 |
| sharing of profit or loss has attracted customers | 8.7(8) | 29.3(27) | 42.4(39) | 16.3(15) | 3.3(3) | 2.76 | 0.94 |
| sharing of profit or loss has increased quality of assets | 12(11) | 34.8(32) | 39.1(36) | 10.9(10) | 3.3(3) | 2.59 | 0.95 |
| sharing of profit or loss has created financial trust between lender and borrower | 9.8(9) | 26.1(24) | 43.5(40) | 16.3(15) | 4.3(4) | 2.79 | 0.98 |
| sharing of profit or loss with depositors has increased the degree of risk | 26.1(24) | 16.3(15) | 41.3(38) | 15.2(14) | 1.1(1) | 2.49 | 1.07 |
| sharing of profit or loss has improved the Islamic financing | 18.5(17) | 25(23) | 42.4(39) | 6.5(6) | 7.6(7) | 2.60 | 1.11 |
| **Sharing of profit or Losses** | | | | | | **2.81** | **1.03** |

**Financial Performance**

Financial performance was measured using non-financial indicators which comprised of profit realization, asset levels, level of deposits, organization income/sales, increase in customers and return on investments. To measure the non-financial indicators of commercial bank performance, each respondent was asked to evaluate the financial performance with respect to the following six dimensions: bank profits, asset level, customers' deposits, organization income/sales, number of customers and return on investment. The results were presented in Table 3.

Table 3 revealed that, 5.43% (5) of the respondents Strongly agreed that there had been an increase in profits in the organization since inception of Islamic banking, 9.8% (9) of the respondents agreed on the same though 19.57(18) were neutral and 40.28% (37) of the respondents disagreed and 25% (23) strongly agreed (mean = 3.70, SD = 1.12). Majority of the respondents, 65.25% (60) disagreed that there had an increase in profits in the organization since inception of Islamic banking

The finding also indicated that 6.52% (6) of the respondents strongly agreed that the assets level has increased with the introduction of Islamic banking, 10.87(% (10) of the respondents agreed on the same and 27.17 (25) were neutral. However, 28.26% (26) of the respondents disagreed and 27.17% (25) strongly agreed (mean = 3.59, SD = 1.19). Over half of the respondents, 55.43(51) did not agree that the assets level has increased with the introduction of Islamic banking.

The findings revealed that 9.78 % (9) of the respondents strongly agreed the level of deposits had increased since inception of Islamic banking while 11.96% (11) of the respondents agreed on the same statement and 15.22% (25) remained neutral. Nonetheless, 48.91% (45) of the respondents disagreed with statement and 14.13% (13) strongly agreed (mean = 3.46, SD = 1.17). Majority of the respondents, 63.02(58) did not agree that level of deposits has increased since inception of Islamic banking

From the findings, 6.53% (6) of the respondents strongly agreed the Islamic banking has significantly increased the organization's income/sales while 13.04% (12) of the respondents agreed on the same with 34.78 % (32) remained neutral. It was further revealed that 28.26% (26) of the respondents disagreed with statement and 17.39% (16) strongly agreed (mean = 3.37, SD = 1.12). Majority of the respondents, were undecided whether with the effect of the Islamic banking on the increase of organization's income/sales.

The findings also indicted that, 8.70% (8) of the respondents strongly agreed and agreed that there had been an increase in the number of customers since inception of Islamic banking with 27.17 % (25) decided to remain neutral. However, 35.87% (33) of the respondents disagreed with statement and 19.57% (18) strongly agreed (mean = 3.49, SD = 1.16). Over half of the respondents indicated that there has been no increase in the number of customers since inception of Islamic banking.

Lastly, The findings revealed that, 8.70% (8) of the respondents strongly agreed that the Return on Investment has increased since inception of Islamic banking while 12 % (11) agreed on the same statement with 35.4 %(33) decided to remained neutral. Furthermore, 29.35% (27) of the respondents disagreed with statement and 14.13% (13) strongly agreed (mean = 3.28, SD = 1.11). Majority of the respondents were undecided whether the Return on Investment has increased since inception of Islamic banking.

**Table 3: Financial Performance**

| Financial Performance | SA (%) | A (%) | N (%) | D (%) | SD (%) | Mean | Std. Dev |
|---|---|---|---|---|---|---|---|
| There has been an increase in profits in the organization since inception of Islamic banking. | 5.43 (5) | 9.78(9) | 19.57(18) | 40.28(37) | 25(23) | 3.70 | 1.12 |
| The assets level has increased with the introduction of Islamic banking | 6.52(6) | 10.87(10) | 27.17(25) | 28.26(26) | 27.17(25) | 3.59 | 1.19 |
| The level of deposits has increased | 9.78 (9) | 11.96(11) | 15.22(14) | 48.91(45) | 14.13(13) | 3.46 | 1.17 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| since inception of Islamic banking | | | | | | | |
| Islamic banking has significantly increased the organization's income/sales | 6.52 (6) | 13.04(12) | 34.78(32) | 28.26(26) | 17.39(16) | 3.37 | 1.12 |
| There has been an increase in the number of customers since inception of Islamic banking | 8.70(8) | 8.70(8) | 27.17(25) | 35.87(33) | 19.57(18) | 3.49 | 1.16 |
| The Return on Investment has increased since inception of Islamic banking. | 8.70(8) | 12.00(11) | 35.87(33) | 29.35(27) | 14.13(13) | 3.28 | 1.12 |

**Inferential Statistics**

**Correlation Analysis**

**Table 4: Correlation between Interest Free Transactions and Financial Performance.**

| | | Interest Free Transactions | Financial Performance |
|---|---|---|---|
| **Interest Free Transactions** | Pearson Correlation | 1 | |
| | Sig. (2-tailed) | | |
| | N | 92 | |
| **Financial Performance** | Pearson Correlation | .585** | 1 |
| | Sig. (2-tailed) | .000 | |
| | N | 92 | 92 |

**. Correlation is significant at the 0.01 level (2-tailed).

**Table 5: Regression Results of Interest Free Transaction and Financial Performance**

| Model | R | $R^2$ | Adj. $R^2$ | B | SE | β | T | df | F | Sig. |
|---|---|---|---|---|---|---|---|---|---|---|
| (Constant) | | | | .750 | .409 | | 1.836 | | | |
| Interest free transactions | .585[a] | .342 | .335 | .827 | .121 | .585 | 6.843 | (1,91) | 46.820 | .000 |

a. Predictors: (Constant), Interest_free_transactions

b. Dependent Variable: Financial performance

**Table 6: Correlation between Interest Free Transactions and Financial performance**

| | | Sharing Profits and Losses with Depositors | Financial Performance |
|---|---|---|---|
| **Sharing profits and losses with depositors** | Pearson Correlation | 1 | |
| | Sig. (2-tailed) | | |
| | N | 92 | |
| **Financial Performance** | Pearson Correlation | .233* | 1 |
| | Sig. (2-tailed) | .026 | |
| | N | 92 | 92 |

*. Correlation is significant at the 0.05 level (2-tailed).

**Table 7: Regression Results of Sharing Profits/ Losses and Financial Performance**

| Model | R | $R^2$ | Adj. $R^2$ | B | SE | β | T | df | F | Sig. |
|---|---|---|---|---|---|---|---|---|---|---|

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Constant) | | | | 2.496 | .446 | | 5.592 | | | |
| sharing profits and losses | .233[a] | .054 | .044 | .350 | .154 | .233 | 2.268 | (1,91) | 5.146 | .026 |

a. Predictors: (Constant), sharing profits and losses

**DISCUSSION**

This study established that a single variable of Islamic banking has a small effect on the financial performance of commercial banks in Nairobi City County. Increasing the number of variables enhances relationship between financial performance and Islamic banking. This was depicted by the fact that the coefficient of correlation between financial performance and Islamic banking became stronger in the multiple linear regression models as compared to the relationships in the simple linear regression models where each variable was considered individually. This showed that due to diversification in the banking industry, Islamic Banking is actually contributing to the improvement in the performance of commercial banks.

The study revealed that Interest free transactions have a significant effect on financial performance of commercial banks in Nairobi City County .This was because the absence of the interest on transactions encouraged clients to take more loans which ultimately lead to more transactions for the bank. These transactions were usually accompanied by other services that the customer might want, therefore opening the bank to more varied business. In so doing, banks had diversified for enhanced and superior performance (Farhaanah, 2014). This agreed with (Collins, 2005) who concluded that interest free transactions enhances and expands the markets that would otherwise have been closed.

Further, the study results revealed that sharing of profit or loss had a significant relationship with the financial performance of commercial banks in Nairobi City County, showing that the sharing of profit /loss encouraged the customers to embrace the Islamic banking services. The sharing of profit or loss has a relationship with the financial performance because it helps in the creation of financial trust and partnership between the borrower and the lender (Yudistira, 2003). Though ordinarily sharing of profit or loss affects the performance of a bank as this may affect the profit negatively and this may affect economic growth.

**SUMMARY**

The results on interest free transactions revealed that there is a positive and significant relationship between the interest free transactions and financial performance of commercial banks. The coefficient of correlation was 0.585** that is (r=.585**, $p<0.01$). The regression results revealed that the coefficient of determination was 0.342 that is ($r^2$ =0.342) meaning interest free transactions individually can explain 34.2% of the changes in the financial performance of commercial banks in Nairobi City County

From the results of the study it was revealed that sharing of profit /loss has positive and significant relationship with financial performance. The coefficient of correlation was 0.233* that is (r=.233*, $p<0.05$). The regression results revealed that the coefficient of determination was 0.054 that is ($r^2$ =0.054) meaning sharing of profit/loss individually can explain 5.4% of the changes in the financial performance of commercial banks in Nairobi City County.

**CONCLUSION**

Despite numerous efforts by banks to diversify their services by introducing Islamic products which are interest free, the organizations had not done much on informing the customers about these interest free transactions. As a result, lack of awareness by customers had resulted into reduced lending (financing) in the organizations while using these services, it had also become difficult for the customers to access services easily, competition in the organizations as a result of diversification had not really been experienced and as such, it was doubtful as to whether these transactions has helped in capturing the unbanked population. The linear relationship between the interest free transactions and financial performance of commercial banks is fair (r=0.585), the interest free transactions explained 34.2% of the changes in the financial performance of commercial banks.

From the results of the study the organizations are aware about Sharing of profit and loss with depositors. It was noted that although this had improved the Islamic financing and the quality of the asset, the sharing of the profit /loss has not really attracted many customers, the degree of risk has increased and the sharing of profit /loss has not created financial trust between the lender and the borrower. The linear relationship between the sharing of profit/ loss and financial performance is positive and weak (r=0.233) and the Sharing of profit /loss can only explain 5.4% of the financial performance.

**RECOMMENDATIONS**

In light of the aforementioned findings, the study established that Islamic banking wass new and that banks had tried to diversify their products whereby they have included the interest free transactions amongst their products. From the results of the study it was observed that the level of customer's awareness on Interest free transactions was low, hence we recommended that the organizations should create awareness to the customers through trainings, advertisements and other ways of promotion of the products because this is key for the customers' knowledge and can also help in drawing the untapped population and this will enhance financial inclusion.

The research was a case study that looked at a specific area in that it only focused on 10 commercial banks in Nairobi City County which may not be a representative of the entire sector but we recommended that future researchers should look at all the commercial banks that have Islamic products in the entire country so that the results can be a representative of the entire financial sector. Longitudinal study should be done looking at the effect of Islamic banking for a period of five years. The banks should keep records which can be of importance to those carrying out studies on Islamic banking so that they can come up with better conclusions on Islamic banking

**Areas of Further Research**

Future researchers may consider looking at other factors which may include; environmental variables that may intervene or moderate the relationship between the Islamic products and performance of commercial banks, demographic characteristics of the customers, cultural affiliation of customers' differences and effect of the size of the bank on financial performance of commercial banks. Finally, there is need for a comparison study between Islamic banking and conventional banking to identify how Islamic banks can increase its market share by keeping in line with the regulations of Sharia advisory board.

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