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"EFFECT OF INTEREST FREE ISLAMIC BANKING ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KAKAMEGA TOWN"

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Abstract

The study examined the effect of interest free transactions on financial performance of commercial banks Kakamega town. It targeted 195 employees, divided into two strata, the middle level and lower cadre, in the ten commercial banks in Kakamega town. The sample size was 129 employees. Stratified random sampling was used to determine the group that was issued with questionnaires. It adopted descriptive survey design and used questionnaires to gather data. Both qualitative and quantitative data was collected and analyzed using inferential and descriptive statistics with the aid of SPSS version 20.The analysis on the combined effect of interest free transaction on financial performance of commercial banks revealed that 34.2 % of the variations in the performance can be explained by interest tree transaction and 65.8% can be explained by other factors not captured in the study. It was concluded that interest free transaction have a positive and significant effect on financial performance of commercial banks in Kakamega town. 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 will improve the financial performance of commercial banks. The results were presented in form of tables.

Key Words: Free Transaction; Islamic Banking; Bank Performance

1. Introduction

1.1 Background of the Study

Islamic banking refers to banking activity that is consistent with the principles of Sharia or Islamic law and its practical application through the development of Islamic economics. As such, a more correct term for Islamic banking is Sharia compliant finance (Khan, 2007).While designed to meet the specific religious requirements of Muslim customers; Islamic banking is not restricted to Muslims only. Sharia prohibits acceptance of specific interest or fees for loans of money (known as riba or usury) whether the payment is fixed or floating. Investment in businesses that provide goods and services considered contrary to Islamic principles (such as pork and alcohol) is also known as haram (sinful and prohibited).

Although these prohibitions have been applied historically in varying degrees in Muslim Countries/Communities to prevent Islamic practices, only in the 20th century were a number of Islamic banks formed to apply these principles to private or semi-private commercial institutions within the Muslim Community (Rammal & Zurbruegg 2007; Saeed, 1996).The origin of Islamic banking system can be traced back to the advent of Islam when the prophet himself carried out trading operations for his wife. The "Mudaraba" or Islamic partnership has been widely appreciated by the Muslim business community for centuries but the concept of riba or interest has gained very little diligence in regular or day to day transactions.

The concept of Islamic banking has been described quite distinctly by very many scholars. However, there seem to be no difference in overall meaning of the concept as portrayed by each one of them. According to Rammal & Zurbruegg (2007), Islamic banking is based on Islamic sharia law, which follows Islamic rules. This explanation did not vary differently from that of Bello (2007) who convened that Islamic banking is a system of banking which is consistent with the practices and principles of Islamic sharia law and its application to the development of Islamic economics. A vigorous monetary economy was created on the basis of expanding levels of circulation of stable high value currency and the integration of monetary areas that were previously independent.

A number of innovative concepts and techniques were introduced in the Islamic banking and many of these early capitalist concepts were adopted and further advanced in medieval Europe from the 13th century onwards (Banaji, 2007). The involvement of institutions and various conferences and studies on Islamic banking were instrumental in applying theory to practice for the first interest-free banks (Gafoor, 1995). By 2008 Islamic banking was growing at a rate of 10-15 percent per year and with signs of consistent future growth. Islamic banks have more than 300 institutions spread over 51 countries, including the United States through companies, such as the Michigan- based University Bank, as well as additional 250 mutual funds that comply with Islamic principles and it is estimated that over US $822 billion worldwide sharia-compliant assets are managed (The Economist, 2009). This represents approximately 0.5 percent of the total world estimated assets as of 2005 (Joanna, 2007).

The total assets of the Islamic banks are estimated to be 3-4 trillion USD as at 2010 (Pena, 2011), which equals 3% of the total assets of conventional banks. Being a relatively new sector in local and international finance, Islamic banking is enjoying stable growth even in the world of financial crisis at an average rate of 15% -20 %(en.wikipedia.org/wiki/Islamic banking).The first modern experiment with Islamic banking was undertaken in Egypt under cover without projecting on Islamic image for fear of being seen as a manifestation of Islamic fundamentalism that was an abomination to the political regime of the time. The pioneering efforts in Islamic banking led by Ahmad Elnaggar, took the form of savings bank based on profit sharing in the Egyptian town of Mit Ghamr in 1963, by which time there were nine such banks in the country. The experiment was shut down in 1968 but was considered by many as a success, (Gilles, 2006).

In 1972 the Mit Ghamr savings project became part of Nasr Social Bank which, currently is still in business in Egypt. In 1975, the Islamic Development Bank was set up with the mission to provide funding to project in the member countries (Warde, 2000). The first modern Commercial Islamic bank, Dubai Islamic Bank, opened its doors in 1975. In the early years, the products offered were basic and strongly founded on conventional banking products, but in the last few years the industry is starting to see strong development in new products and services. By 1995, 444 Islamic financial institutions had been established worldwide including 33 government- run banks, 40 private banks and 71 investment companies (Gilles, 2006).

Given this, financial services, products, contracts or transactions with Islamic banks must be structured to reflect these principles. Since its inception in Egypt in 1963 and sporadic progress in 1970s, Islamic banking has grown remarkably in size and number and since late 1980s and early 1990s, Islamic banking has been enjoying an unmatched support from the World Bank and the IMF which continued to more strategically and competitively position the hitherto infant industry to a serious player in the global financial system, catering not only for specific needs of Muslims but Non-Muslim communities alike who wish to pursue economic ventures that are devoid of interest (Daragwa, 2011& Joseph, 2011).

The First community Bank was the first bank to be approved by the Central Bank of Kenya under Cap 488 of the banking Act to operate as full-fledged Sharia compliant institution in Kenya. The bank revealed its formal approval from the Central Bank of Kenya on May 29th 2007 thereby opening the door for Sharia compliant banking not only in Kenya but indeed in the entire East and Central African region. The bank commenced official operations on 1st June 2008 after carefully laying all the ground work. Islamic banking services have been tried and tested in the most developed and the world's biggest Islamic banking markets for 20 years now.

The Standard Chartered Bank has introduced Islamic Banking in Kenya, and Kenya becomes the seventh market globally after Malaysia, United Arab Emirates, Pakistan, Bahrain, Indonesia and Bangladesh to offer Sharia Compliant products and the first market in Africa in the retail banking business. The bank aims to make Standard Chartered Saadiq to be recognized as the leading global provider of Islamic banking (en.wikipedia.org/wiki/Islamic banking). The Standard, Chartered global network already covers 50 percent of the Muslim world. The Standard Chartered Bank has been providing banking products and services on Sharia principles under the "Saadiq brand name" since 1993 in Malaysia and since 2003 in United Arab Emirates, Pakistan and Bangladesh. The word saadiq means "truthful" in Arabic.

The Standard Chartered Saadiq has been established as a dedicated Islamic window within Standard Chartered Bank and realizes that customers want products that are Sharia Compliant and by introducing this Islamic financial solution, they are fulfilling their promise. The Barclays Bank set up Islamic banking in Kenya in 2005; the National Bank also launched an Islamic banking window dubbed National Amanah in Kenya in 2009, it targets retail, corporate and small micro financing enterprises clients. The Kenya Commercial Bank rolled out Islamic banking operations in Kenya in July, (2014) (Source: KCB Management) targeting areas with high Muslim populations.

Two fully fledged Islamic banks operating in Kenya are the Gulf African Bank and First Community Bank which were licensed in 2008.Islamic banks, just like their western or conventional counterparts are in the business of financial intermediation and foot on profit motive also. They are market driven with ethical and moral dimensions that are based on Islamic Sharia dictates which prohibit receipt and payment of interest but rather advocates participatory banking on profit and loss sharing,(Ndugu,2010).

With the introduction of Islamic products in the banking industry in Kenya, the environment has become increasingly challenging in that there are misconceptions about Islamic products, the is high competition, Lack of qualified and skilled personnel and brand recognition and therefore the researcher seeks to determine whether Islamic banking has any effect on profitability of commercial banks in Kenya, (Oundo, 2009).

1.2 Statement of the Problem

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 conventional 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)

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 Kakamega. With all these challenges facing Islamic banking, the researcher found it worthy to investigate whether free interest transactions have any effect on financial performance of commercial banks Kakamega town. This study will be significant because it will bridge the knowledge gap

1.3 Objectives

To examine the effect of interest free transactions on financial performance of commercial banks in Kakamega town.

1.4 Research Questions

What is the effect of interest free transactions on financial performance of commercial banks in Kakamega town?

2. Literature Review

2.1 Theoretical Review

The distinguishing features of an Islamic bank are that Islamic financial system excludes riba (interest) from its operations. This is because riba is prohibited in Islam in very strong terms (Otiti 1999). Islam forbids interest in all its forms, and, it is not only Islam that prohibits interest, all major religious and ethical systems have prohibited interest; so whether you look at Christianity, Buddhism, or Hinduism, interest was originally forbidden.

Some studies have shown that Islamic models can perform the functions of Islamic banking in a better way. Some of those models include;

2.2 The Two Tier Mudaraba Model

This 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.

2.3 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. 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.

2.4 The Conceptual Frameworks

The independent variable is "Islamic banking" which is interest free transactions. The dependent variable is financial performance of Commercial Banks Kakamega town.

Figure 2.1: The Conceptual framework

2.5 Interest Free Transactions

Islamic banking is based on interest free principle and principle of Profit-and-Loss (PLS) sharing in performing their businesses as intermediaries (Ariff, 1988). Islamic

Banking products refer to products that are consistent with the principles of sharia and its practical application in the development of Islamic economics. As such, a more correct term for 'Islamic banking' is 'Sharia Compliant Finance'. Sharia prohibits acceptance of specific interest or fees for loans of money (known as riba, or usury. The word "riba" means interest, usury, excess, increase or addition, which according to Sharia terminology, implies any excess compensation without due consideration (consideration does not include time value of money). Investment in businesses that provide goods or services considered contrary to Islamic principles (e.g. pork or alcohol) is also haram ("sinful and prohibited").

Although these prohibitions have been applied historically in varying degrees in Muslim countries/communities to prevent non-Islamic practices, only in the late 20th century were a number of Islamic banks formed to apply these principles to private or semi-private commercial institutions within the Muslim community. The lending rates that represent the cost of credit continue to be high and the tendency has been for lending to be skewed in favor of large private and public enterprises in urban areas. In this way Kenya's financial system has failed to provide adequate access to banking services for the bulk of the population (Kenya Economic Report, 2010). Yet research indicates that a financial system becomes more efficient and functions better when it is more inclusive.

Financial inclusion aims at drawing the "untapped" population into the formal financial systems so that they have the opportunity to access a variety of financial services (CBK Newsletter, 2011). In addition, according to the United Nations, in order to achieve the objective of economic growth, it is imperative that infrastructure is developed with increased financial inclusion (CBK Newsletter, 2011).These study contents that the introduction of facilitation of interest free Islamic banking products is one way of enhancing financial inclusion and the increased number of customers will lead to superior performance by commercial banks. As a financial system becomes more inclusive, it provides more growth opportunities to more individuals and entrepreneurs.

However when the financial system serves only a limited segment of the population, the society is likely to lose opportunities to grow (CBK, 2011). When this happens commercial banks also lose the opportunities to enhance their performance. Therefore, to achieve equitable economic growth and development, it is necessary that the majority of a nation's people have access to appropriate and affordable financial services and products in order to enhance their quality-of-life and ultimately economic development which includes the commercial banking sector. (CBK, 2011). The introduction of interest free Islamic banking Kakamega town has been eagerly awaited by the Muslim community. Current market surveys indicate that a large section of the Muslim community remains untapped by the banking industry due to non-availability of riba-free banking on low incomes.

The research also indicates that the potential of increasing markets for interest free Islamic banking product will be the business community in Nairobi, Mombasa and other towns with sizeable Muslim communities. Both Muslim and non-Muslim look forward to interest-free banking service that is efficient, modern, solid, and transparent and customer friendly (Farhaanah, 2014). Some of the interest free products include Mudaraba which stands alongside with Musharaka as preferred financing method. Classified as an equity fund agreement whereby the bank provides the necessary funds and the entrepreneur the skills to manage the business undertaking (Usmani, 2002).Mudaraba is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The capital investment should normally come from both partners. The first partner is called rabb-ul-mal and the other is called Mudarib (Usman, 1998). Both should have some skinin the game. This is a partnership where the bank contributes 100 percent of the financing and the client contributes the knowhow.(Rajesh & Tarik, 2000). Profit is in turn shared on an agreed ratio and if there is any loss, the bank absorbs it fully.

Another interest free product is Murabaha. This refers to a sale agreement that is based on cost plus margin and is typically used for trade finance. The term Murahaba comes from the Arabic word "rabh" which means profit (short term trade financing). Client identifies goods which he wishes to buy and requests a bank to finance the transaction. The Bank buys the solid goods and resells them to clients for at a predetermined price which includes cost and added negotiated profit margin (Aggarwal & Yousef, 2000). The asset is first purchased by the bank so the bank incurs the risk of loss or damage to the asset as long as the asset remains under its ownership. Ownership remains with the bank until all payments are made. Upon sale of the asset, this is an obligation of the Islamic bank to inform the client the original cost incurred in the purchase of the asset and the profit margin incorporated in the sale price. The client then repays within agreed timeframe; the bank is compensated for the time value of its money in the form of the profit margin. Murabaha is the classic Islamic financing instrument for the trade financing (Aggrarwal &Yousef, 2000)

Another interest free product is Musharaka. This refers to a partnership agreement whereby the bank and the entrepreneur provide the capital needed to finance the project (Usmani 2002 & Taylor 2003).In the eyes of Sharia; Musharaka is the most desired form of financing. It satisfies all the essential elements promoted by Sharia such as the absence of interest, the absence of risk, the spirit of profit and loss sharing and the direct linking of capital investments to underlying asset based transactions. This is a joint enterprise formed for business where all the partners (Bank and Customer) contribute capital and share the profit according to a specific ratio while any possible loss is in turn shared according to the capital contribution by the two parties. Both the Bank and the client contribute capital. Profits/losses are thus shared on agreed ratios. Assets in the venture are jointly owned in proportion to each partner's contribution. Losses are shared in the proportion to the capital contributed by each partner while the proportions of profits are negotiated freely, usually on a pre-agreed ratio. Musharaka is a kin to western style general partnership and closer to traditional equity stake with rights of control (Aggrarwal & Yousef, 2000).

Ijara is another interest free product and it is usually referred to as Islamic leasing. It's a contract in which the bank purchases the asset and first owns the asset which then it leases to its customer or the Bank gets a tangible asset on lease from a third party and subleases it to the customer (Samad, 2004).The client either just pays rental costs or the client enters into an agreement to buy the shares from the bank over an agreed timeframe. Generally, the Ijara concept refers to selling the benefit of use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipment such as plant, office automation, motor vehicle for a fixed period and price.

2.6 Financial Performance

According to Richard et al. (2009), organizational encompasses three specific areas of firm outcomes: profitability (profits, return on assets, return on investment; product market performance (sales, market share; and shareholder return (total shareholder return, economic value added. According to Mitchel (2002), organizational performance can be measured using four main indicators; measures in efficiency, effectiveness, relevance to stakeholders and financial viability. Specialists in many fields are concerned with organizational performance including strategic planners, operations, and finance, legal and organizational development. In recent years, many organizational including banks have attempted to manage organizational performance using the balanced scorecard methodology where performance is tracked and measured in multiple dimensions such as; profitability (e.g. shareholder return), customer service, social responsibility (e.g. corporate citizenship, community outreach) and employee stewardship.

Performance is a measure of the results achieved. Performance efficiency is the ratio between effort expended and results achieved. The difference between current performance and the theoretical performance limit is the performance improvement zone. Performance also refers to the accomplishment of a given task measured against preset known standards of accuracy, completeness, cost and speed,(business dictionary.com).Several studies that have been devoted to assess the performance of Islamic banks generally, examine the relationship between profitability and banking characteristics. Bashir (1999) and Bashir (2001) performed regression analysis to determine the underlying determinants of Islamic performance by employing different data levels.

Performance of banks in terms of profits is mostly generated from overhead, customer short term funding and non-interest earning assets. Furthermore Bashir (2001) claims that since deposits in Islamic banks as treated as shares, reserves held by banks propagate negative impacts such as reducing the amount of funds available for investment in the previous studies only a few touching on Islamic banking financing schemes related on the impact in the output. Islamic banking is still considered a new thing in the world of Islamic finance. But there were previous studies that only touched on conventional financing sector and its effect on the output of a state, Meizer (2007). For the purpose of this research, performance will be measured in terms of profitability and the measures to be used are Return on Assets (ROA) and Return on Equity (ROE).

2.6.1 Profitability

Many researchers utilize traditional accounting measures of profit. One of the most common indices, for example, is return on assets (Wan and Hoskisson, 2003). Payne (2003) noted that in the long run, the single most important factor affecting business unit's performance is the quality of its products and services, relative to those of its competitors. He further notes that there is a relationship between the customer perceived quality of service, market share and profitability, measured as return on investment (ROI). He suggests that relative perceived quality is positively related to a company's financial performance.

In this study we shall use profitability in measuring the financial performance. In order to find out profitability of the bank, in this research, CAMEL system that is a useful tool to investigate performance of banks will be applied. The most important ratio measurements that can be properly used are Return on Assets (ROA) and Return on Equity (ROE). These two variables are frequently being used for analyzing financial performance of banks.

2.6.2 Return on Assets

Return on Assets ratio is calculated from Net Income divided by Total Assets. This ratio shows how well management is using assets to make profit. According to Naceur (2003) profit earned for every one dollar of assets can be measured by Return on Assets ratio.

2.6.3 Return on Equity

Return on Equity is equal to Net Income over the Total Equity of the bank. This ratio is an indicator of bank profitability in terms of management of shareholder's Equity. According to these ratio bank managers understand how well they are utilizing Equity to generate profit. It indicates how profitable a bank is from every unit of capital invested by shareholders (Gul et al. 2011).

3. Research Methodology

The study adopted descriptive survey design as it has protection on the issue of biasness and maximizes reliability (Kothari, 2008).This helped to answer questions that had been asked, solved problems and met objectives of the study (Kraemer, 1991). The target population was 195 employees in the ten (10) commercial banks currently operating within Kakamega town. The employees included are those in middle management level and lower cadre staff.

Table 3. 1: Target Population and Sample size

The sampling frame was derived from the list of licensed commercial banks in operation in Kakamega town (Central Bank of Kenya website database, December, 2012).

The desired sample size comprised of 129 respondents obtained by stratified sampling technique where respondents were picked from the strata's. The employees were stratified into two strata's where the sample size was distributed according to Neyman allocation formula (1934), to maximize survey precision, given a fixed sample size. With Neyman allocation, the best sample size for stratum h would be:

$$n_h = \left(\frac{N_h}{N}\right) n$$

Where, nh - The sample size for stratum h,

n - Total sample size,

Nh -The population size for stratum h,

N - The total population

Hence, distribution will be as follows;

Table 3. 2: Sample Size

The main instrument was a questionnaire which was issued to the respondents where the researcher dropped and picked after giving them time to respond leading to increased the response rate (Kothari, 2010). The likert-scale was used in the study to measure variables where the respondent was required to express opinion on the statements in terms of degrees. A pilot study was conducted in one of the selected commercial banks in Kakamega town before the final research to test Validity and reliability of the instruments that was used in the study. The objective of piloting was to detect any ambiguities in the questionnaire.

The study used regression analysis to determine the relationship between variables (independent and dependent variables). The results were presented in form of tables.

Equation one:

$$Y=a+b_1x_1 + b_2x_2 + b_3x_{3+e}$$

Y-dependent variable which is financial performance

a- a constant, b_i- slope coefficients

x_1 - Interest free transactions

x_2 - Sharing of profit and loss

x_3 - Islamic tax, Zakat

e - error term

4. Research Findings And Discussion

4.1 Response Rate

In this study, a total of 129 questionnaires were administered to the commercial banks in Kakamega, 92 were successfully completed by the respondents which is a response rate of 71.5% of the total questionnaires. Richard (2005), observed that the Australian Vice Chancellors' committee and graduate careers council of Australia (2001) regarded an overall institutional response rate for the course experience questionnaire of at least 70% to be both desirable and achievable but concluded in his comments that a response rate of 60% or more was both desirable and achievable for students who have satisfactory assessment and evaluation. The response rate of 71.5% which was attained during this study is acceptable because it is above the 60%.

From table 4.1, 63 % (58) were male and 37% (34) were female which indicates that the banking industry employs high proportions of male than female. This may be attributed to individual related factors that affect women career advancement in the banking industry. This is in agreement with the study carried out by Afande, (2015) on factors affecting women career advancement in the banking industry which concluded that most women are affected by individual factors in their career.

Table 4. 1: Gender

4.3.2 Job experience of the Respondents

In terms of job experience, 47.8% (44) employees have worked between 1-5 years, 44.6% (41) employees have worked between 6-10 years, 5.4% (5) employees between 11-15 years and 2.2% (2) for over 15 years at the bank. This illustrates that majority of the respondents have worked in the bank for between 1and 10 years hence they offered reliable information that was used in the study. This concurs with the results of Mahinda, (2012) in his study on determination of occupational fraud in commercial banks in Kenya where the duration of the respondents who were employees in the organization was less than 10 years and was the majority with 61.77%. The results are presented in Table 4.2.

Table 4. 2: Job Experience

4.4 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 4.5.

Table 4.5 revealed the customer awareness on the availability of interest free transactions, 2.2% (2) of the respondents strongly agreed that customers are 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 are aware about tie interest free transactions (mean = 3.869, SD = 0.928). Majority, that is 80.5 %(74) of the respondents disagreed that customers are aware of the interest free transactions, this is a clear indication that most customers are not aware that interest free transactions are available in the organizations (banks).

The issue of whether Interest free transactions have 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 have 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 is evident that interest free transactions offered by the banks have 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 leads 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 4. 3: Interest free transactions

4.5 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 are presented in Table 4.8

Table 4.8 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 remained 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 4. 4: Financial Performance

4.6 Inferential Statistics

4.6.1 Effect of interest free transactions and financial performance

The objective was to investigate the effect of interest free transactions on financial performance of commercial banks in Kakamega town. Respondents had been asked to indicate the extent to which they agreed on the interest free transaction. The non-financial indicator were determined by bank profits, asset level, customers' deposits, organization income/sales, number of customers and return on investment.

(i) Correlation between interest free transactions and financial performance

The Pearson correlation analysis was used investigate the relationship between interest free transaction and financial performance, Table 4.4

Table 4.4: correlation between Interest free transactions and financial performance.

The results indicated a positive and statistically significant (R = .585, p< 0.001) with 99.0% confidence level. This showed that interest free transactions have significant positive effect on the financial performance of commercial banks. An increase in interest free transaction as a result of Islamic banking would result to an increase in financial performance of commercial banks in Kakamega.

4.6.2 Regression analysis: Interest Free transaction

The results are as shown in Table 4.5

Table 4.5: Regression results of Interest Free transaction and financial performance

There was established a coefficient of correlation (R) as 0.585 and a coefficient of determination (R Square) equal 0.342, meaning there is a fair and positive linear relationship between interest transactions and financial performance of commercial banks (58.5%) and interest free transactions can explain 34.2 % of the financial performance of commercial banks in Kakamega town. The ANOVA results revealed that the percentage variation that is been accounted by interest free transaction is statistically significant with F (1, 91) = 46.82, P<0.001, implying there is a significant relationship between the predictor variable (interest free transaction) and financial performance.

The unstandardized regression coefficient (β) value of interest free transaction was 0.827 with a t-test of 6.843 and significance level of p < .001. This indicated that a unit change in interest free transaction will result to change in financial performance by 0.827. The regression equation to estimate the financial performance was hence stated as:

Financial Performance = 0.750 +0.827*Interest Free Transactions.

The findings are in agreement with the study that was carried out on 43 commercial banks in Kenya on the effect of sharia compliant products by Tuitoek, in (2012) and the researcher concluded that Sharia compliant products have a positive effect on performance of commercial banks in Kenya (Tuitoek,2012).The same conclusion was arrived at by Thomi who carried out a study to determine whether Islamic products have an effect on the financial performance of commercial banks in Kenya, and it was concluded that that Islamic banking products have a positive and significant relationship with financial performance of commercial banks (Thomi,2012).

4.7 Discussion of the findings

This study established that interest free transactions have an effect on the financial performance of commercial banks in Kakamega town.

Interest free transactions have a significant effect on financial performance (p= 0.000, p < 0.001).This is because the absence of the interest on transactions encourages clients to take more loans which ultimately lead to more transactions for the bank. These transactions are usually accompanied by other services that the customer might want, therefore opening the bank to more varied business. In so doing, banks have diversified for enhanced and superior performance (Farhaanah, 2014). According to, Collins, (2005) interest free transactions enhances and expands the markets that would otherwise have been closed..

5. Summary, Conclusions and Recommendations

5.1 Summary

The correlation results show that there is a positive and significant relationship between Islamic banking and financial performance in commercial banks in Kakamega town. This results are in agreement with the studies carried out in previous researches by other researchers on the same topic but with different variables in 2012 (Tuitoek, 2012) and (Thomi, 2012) .

5.2 Conclusion

The independent variable is interest free transaction. Despite numerous efforts by banks to diversify their services by introducing Islamic products which are interest free, the organizations have not done much on informing the customers about these interest free transactions. As a result, lack of awareness by customers has resulted into reduced lending (financing) in the organizations while using these services, it has also become difficult for the customers to access services easily, competition in the organizations as a result of diversification has not really been experienced and as such, it's doubtful as to whether these transactions have helped in capturing the unbanked population. The interest free transactions can explain 34.2% of the changes in the financial performance of commercial banks and the relationship is significant. The linear relationship between the interest free transactions and financial performance of commercial banks is fair (58.5%)

5.3 Recommendations

In light of the aforementioned findings, the study established that Islamic banking is new and that banks have tried to diversify their products whereby they have included the interest free transactions amongst their products but it is recommend 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 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. The sample was drawn from only Kakamega town, thus this study may be limited in its generalizability of the findings. So, future researchers should draw samples of respondents on more number of commercial banks in the western region for the sake of generalizing the results of the study.

This study included only interest free transactions, but there could be some other relevant factors that may be perceived as important but were excluded from this study. Future researches, therefore, may consider more other factors like the sharing of profit and loss, Islamic tax (Zakat) and effect of cultural differences in the performance of Islamic banking in Kenya.

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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Appendix : Tables And Figures

Table 3. 1: Sample Size

Respondents	**sample**	**Procedure**	Sample
Middle Level	33	33/195*129	22
Lower cadre staff	162	162/195*129	107
Total	195		129

Table 3. 2: Target Population and Sample size

Respondents	**No. of Employees**	**Sample**
Middle level	33	22
Lower level cadre	162	107
Total	**195**	**129**

Table 4. 1: Gender

Gender	Frequency	Percent
Male	58	63
Female	34	37
Total	92	100.0

4.2 Job Experience

Job Experience	Frequency	Percent
1-5yrs	44	47.8
6-10yrs	41	44.6
11-15 years	5	5.4
15 years and above	2	2.2
Total	92	100.0

4.3 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**

4.4 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 since inception of Islamic banking	9.78 (9)	11.96(11)	15.22(14)	48.91(45)	14.13(13)	3.46	1.17
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

4.5 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).

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

Figures

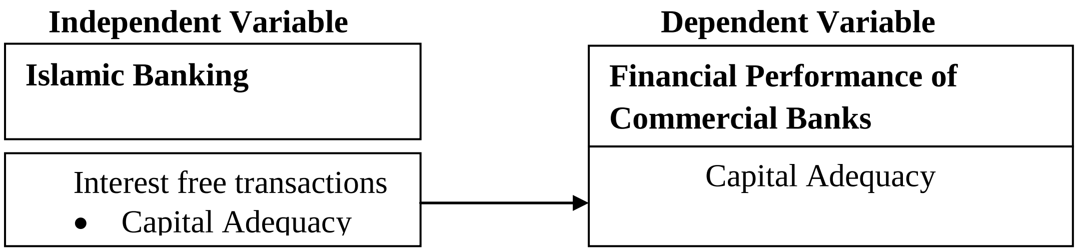

Figure 2.1: The Conceptual framework