EXTERNAL FINANCIAL ENVIRONMENT DRIVERS AND FINANCIAL PERFORMANCE OF ISLAMIC BANKS IN KENYA

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ABSTRACT

External financial environment is a major factor that affects the financial performance of Islamic banks. Making money in today's highly regulated and competitive markets is a lot harder and Islamic banks should be more customers centric in their propositions, delivery and service. Doing so will be challenging, especially since Islamic banks will need to focus on innovation and on improving their cost efficiency relative to their conventional counterparts. The risks in Islamic banking are not the same as other financial intermediaries therefore the absence of Shariah compliant legal framework needed to create sound financial institutions to reinforce bank's operating environment, internal governance, market discipline and the risks in the market.The objectives of the study was to investigate the effects of regulatory drivers, technological drivers, demographic drivers and economic drivers on financial performance of Islamic banks in Kenya. The study was anchored on economic theory of regulation, Schumpeter theory of innovation, and Mohsin theory. The study was conducted through the use of descriptive research design since it is concerned with finding out what, where and how financial external environment affects financial performance of Islamic banks. A census of all the Islamic banks was done the unit of analysis were top and middle level managers of 2 fully fledged Islamic banks. The unit of observation were top and middle level managers of Islamic banks and stratified random sampling was employed. A population of 110 was used for this study. A sample of 30% of 100 was applied which gives a total of 33 respondents. A questionnaire was constructed and used to collect data for this study. The instrument was validated through the use of professionals or experts, while split half method was applied to determine instrument reliability. Quantitative data was analysed using descriptive statistics, correlation coefficient and multiple linear regressions. The study realized that regulatory drivers, economic, technological, demographic and economic drivers significantly contributed to the financial performance of Islamic Banks in Kenya as indicated by a R2 of 0.915. The study concluded that the drivers are both challenges and opportunities to be exploited by the banks in their favour. It was recommended that the banks need to be compliant with Shariah banking and capitalize on the opportunities in the sector.

Key Words: *external financial environment drivers, financial performance, Islamic banks, Kenya*

INTRODUCTION

Today's international and domestic environments in which commercial banks operates is getting more challenging. Due to effects of structural reforms of the late 1980s that led to globalization, deregulation, innovation, technological advancement and information's revolution, it has become indispensable for local banks to remain focused in redesigning its processes and products offering to customers in order to match with unremitting financial innovations in the market that is driven by strong competition from both domestic and foreign financial institutions. Thus, the external environments in which banks compete for funds, customers, and financial services, have impacts on bank financial performance (Shaher, Kasawneh and Salem, 2011).

Furthermore, with the on-going globalisation there is an increase in the spread and exchange of information, cultures and values around the globe. This leads to people having a more open-minded attitude towards new business methods and alternative ways of doing business. In this changing environment, companies that provide options that go beyond the traditional intermediation easily become rooted onto new markets (Dicken, 2007). All these can be seen as some of the reasons why Islamic banking, an almost unknown financial system 30 years ago, has developed fast and become a unique and growing segment in the international banking market (Elgar, 2007). Throughout the development of Islamic banking, the system has been adopted differently between countries, targeting a previously left out clientele of the Muslim society. Kenya, a special case in terms of being a pioneer of Islamic finance in Africa, has been able to develop a dual system, where Islamic and conventional banking can co-exist. The dual system is considered of great importance when transferring Islamic banking to western markets since conventional banking is deeply rooted in these societies; thus it might be better for Islamic banks to function alongside conventional banks rather than trying.

The central banks subject Islamic banks to the same controls, conditions, and regulations that they apply to interest based banks. Azizul, (1999) noted that there are certain factors, that requires that Islamic banks be treated on a different footing. Some of these factors are the following; A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the rather inappropriate policies of central banks toward Islamic banks, Islamic banks like all other commercial banks are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic banks cannot accept, Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most Islamic banks function under the supervision of a central bank, they cannot benefit from such a facility because funds are usually provided on the basis of interest. Qadeeruddin, (2005) noted that CBK cautioned that Islamic Banks will operate within the existing legal and regulatory framework, a great challenge.

Financial External Environment

The success of banks improving the quality of services is all based on the impact the external environment has in the firm as a whole. Pierce& Robinson (2003) argue that organizations are not closed systems since they do not operate in a vacuum. Firm external environments that affect financial performance of a firm are technological factors, regulatory factors, demographic factors, Political and economic factors.

Regulatory factors refer to the regulatory parameters within which a bank must operate. They need legal, corporate and regulatory frameworks. The aim of these frameworks such BASEL capacity should be to reinforce bank's operating environment, internal governance and market discipline to help address moral hazard considerations, safeguard the interest of demand depositors, and systemic risk. Technological factors refer to changes financial innovation that reduces costs, reduces risks, or provides an improved product/service that better satisfies participant's demands. (Frame & White 2004).Financial innovations can thus be grouped as new products and services such on-line securities trading, bonds, Internet banking new production processes such as electronic record-keeping for securities or new organizational forms.

Economic factors refer to the nature and direction of the economy which the firm operates. It refers to all the factors within the economy that have a direct influence to the economy and affect strategic decision making by managers. This includes credit levels, interest rates, taxation rates and the propensity of people to spend money on certain products and services. Social factors are the effects that affect the organization and involve beliefs, values, attitude, opinions and lifestyles of persons in the firm's external environment as it is developed from cultural demographic, religion, educational and ethnic conditionality hence firm should align their strategies to counter changes within the social factor.

Demographics profiles include items such as age, gender, level of income and education, home ownership, employment status, and even location, religion (cooper, Gardener and Mills, 2000). Customer demographics also include all the measurements necessary to statistically describe the end-user base in a given market. This would include the measurement of parameters such as the total number of customers, customers by the size of production, customers by industry, customer segments by geographic area, customer budgets and expenditures. Understanding the demographics of the target customers is critical for the success of any bank. Not only does the bank need to understand them in order to decide exactly what their product and services mixes will include, but this information will also affect pricing, packaging, promotion and place.

Financial Performance

Performance is the state of yielding a financial gain. It is the capacity to make a profit whether accounting or economic. Performance is measured using bank profitability. Profitability is a primary goal of any business venture without which the business cannot survive in the long run. It measured using income and expenses, income being money generated from the activities of the business for example interest income for banks and expenses being costs incurred or resources consumed by the activities of the business for example interest paid on deposits by banks. Profitability is measured using an income statement and it is the most important measure of business success. Increasing profitability therefore is one of the most important tasks of business managers.

Research on the determinants of banks' profitability has been attentive to both the returns on bank assets and equity and net interest rate margins. Bank performance and bank interest margins can be seen as indicators of the efficiency or inefficiency of the banking system, as they drive a wedge between the interest rate received by savers on their deposits and the interest paid by borrowers on their loans Kunt et al., (2001). Profitability measure seems to be most significant for stockholders of a bank since it reveals what the bank is earning on their investments Rasiah, (2010).Two types of interest influence the profitability of a bank, interest expenses and interest income. Interest expenses and interest income affect net interest income and therefore bank profitability. Rasiah, (2010), Loans are the bank's assets whereas the deposits are the bank's liabilities. Though there are numerous other sources of income for banks such as account maintenance fees, cheque clearance fees, over the counter and ATM withdrawal charges etc, interests charged on bank loans are expected to be the main source of income and are expected to have a positive and greatest impact on a commercial banks' performance, Bennaceur et al. (2008).

Islamic Banks in Kenya

Currently, Kenya has a total of 43 commercial banks. The banking system in Kenya has very low Islamic banking representation. Only two banks are fully-fledged Islamic banks and eight others offer a window on Islamic banking (KBA online).First Community Bank Ltd and Gulf African Bank Ltd are the only fully fledged Islamic Banks. The ones with Islamic Banking window are; Barclays Bank limited, Chase Bank, Equity Bank Limited, Kenya commercial Bank, National Bank, Standard Chartered Bank, Middle East Bank Limited and Habib Bank Limited.There is a potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population (Muriri, 2009). Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shariah, known as Fiqh al-Muamalat (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba (usury/interest). Although Islamic banks in Kenya were established recently, short period of existence, Islamic banking has shown very commendable performance commanding combined market share of the banking sector in terms of gross assets of 0.8%.

STATEMENT OF THE PROBLEM

The Islamic banking industry in general has underperformed with average ROE's for major banks at roughly 7% versus 14% for conventional banks during that same period according to the central Bank of Kenya. A sound legal framework is a key precondition for a safe development of Islamic Banks. In order to provide the legal foundations for the supervision of Islamic banks, general banking laws (or specific laws related to Islamic banks) need to define the nature of these banks and their operating relationship with the central bank and other conventional banks. Making money in today's highly regulated and competitive markets is a lot harder and Islamic banks should be more customers centric in their propositions, delivery and service. Doing so will be challenging, especially since Islamic banks will need to focus on innovation and on improving their cost efficiency relative to their conventional counterparts. The risks in Islamic banking are not the same as other financial intermediaries therefore the absence of Shariah-compliant legal framework needed to create sound financial institutions to reinforce bank's operating environment, internal governance, market discipline and the risks in the market. Nader (2011) analyzed the profit efficiency of the Saudi Arabia Commercial banks during the period 1998- 2007. The results of his study indicated that availability of financial innovations had a positive effect on profit efficiency of Saudi banks. Agboola (2006), in his study on Information and Communication Technology

(ICT) in Banking operations in Nigeria using the nature and degree of adoption of innovative technologies; degree of utilization of the identified technologies; and the impact of the adoption of ICT devices on banks, found out that technology was the main driving force of competition in the banking industry. Baelerman,M.(2014) has done a study on the effect of demographic drivers on Banks profitability and found out that one of the main findings is that the effects of population will partially offset the impact of shrinking customer bases. While the decline in the size of the population reduces the customer base hence profitability of the banks. Widely adopted approach by the players in the Islamic finance industry is to have internal and independent Shari'ah entities that certify their compliance with the Shari'ah tenets. Some jurisdictions like Malaysia, Indonesia, Pakistan and Sudan have central Shari'ah supervisory boards at the financial regulator's level to play the significant role in the harmonization and standardization of Shari'ah scholars' rulings and edicts (fatwas) and exercising oversight over the industry players. Fewer studies have been conducted on Islamic banks compared with conventional banks in Kenya. Ahmednoor (2012), did an evaluation of Islamic banking products while Josephat (2012) investigated on sharia compliant products. Oundo (2009) suggested that there was poor supply of Shari'ah compliant products in Kenya's financial institution. Kinyanjui (2013),noted that one of the main challenges facing the industry has been the absence of shariah-compliant legal framework .Islamic banking industry has been trying for the last two decades to extend its foothold to the level of conventional banks but the absence of a legal frame work has stood on its way, making expansion to be slow. In other words, there is no legal framework necessary to make interest-free banking acceptable, thus making it difficult to create sound financial institutions. Banks in Kenya are mainly regulated by the Banking Act and the Central Bank of Kenya Act. This increases the risk of operating in this industry without a legal framework. These studies were too broad and did not address issues of external environment drivers in relation to financial performance Islamic banks in Kenya. This study therefore sought to fill this gap by establishing the relationship between external environment drivers and financial performance of Islamic banks in Kenya.

GENERAL OBJECTIVE

The main objective of this study was to investigate the effects of external environment on financial performance of Islamic Banks in Kenya.

SPECIFIC OBJECTIVES

1. To determine the effect of the regulatory drivers on the financial performance of Islamic banks in Kenya.
2. To establish the extent to which technological drivers affect the financial performance of Islamic Banks.
3. To investigate the effects of demographic drivers on the financial performance of Islamic banks in Kenya.
4. To investigate the effects of economic drivers on the financial performance of Islamic banks in Kenya.

RESEARCH HYPOTHESIS

Ho_1: Regulatory drivers have no effect on financial performance of Islamic Banks.

Ho_2: Technological drivers have no effect on financial performance of Islamic Banks

Ho_3: Demographic drivers have no effect on financial performance of Islamic Banks.

Ho_4: Economic Drivers have no effect on financial Performance of Islamic Banks.

THEORETICAL REVIEW

Economic Theory of Regulation

This theory was proposed by Litan and Nordhaus in 1983. The general theories Economic regulation, namely, the public interest approach and the self-interest theory, attempt to explain why regulation is relied upon in market systems. The public interest approach to regulation suggests that regulatory measures are designed to protect against market failure, notably natural monopoly, imperfect information, and externalities. Under the public interest approach, bank regulation, such as deposit insurance and limitations on investment activity, exist for the benefit of the consumer.

Chesaina, (2010) opines that bank regulation, for example, protects the consumer's assets and reduces depositor exposure to the risk of bank failure and insolvency. A major challenge to social theory is to explain the pattern of government intervention in the market, what is called economic regulation .The term refers to taxes and subsidies of all sorts as well as to explicit legislative and administrative controls over rates, entry, and other facets of economic activity. This theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. This theory holds that regulation is supplied in response to the demands of interest groups struggling among themselves to maximize the incomes of their members. This theory explains how regulation is important for the financial performance of banks for the interest of shareholders, customers and the general public (Kibicho, 2011).

Schumpeter Theory of Innovation

This theory was proposed by Schumpeter in 1934. The theory argues that entrepreneurs, who could be independent inventors or R&D engineers in large corporations, created the opportunity for new profits with their innovations. In turn, groups of imitators attracted by super-profits would start a wave of investment that would erode the profit margin for the innovation. However, before the economy could equilibrate a new innovation or set of innovations, conceptualized by Schumpeter (1934) as Kondratiev cycles, would emerge to begin the business cycle over again. He emphasized the role of entrepreneurship and the seeking out of opportunities for novel value generating activities which would expand and transform the circular flow of income, but it did so with reference to a distinction between invention and discovery on the one hand and innovation, commercialization and entrepreneurship on the other.

According to Hezra, (2011) the separation of invention and innovation marked out the typical nineteenth century institutional model of innovation, in which independent inventors typically fed discoveries as potential inputs to entrepreneurial firms. The author further saw innovations as perpetual gales of creative destruction that were essential forces driving growth rates in a capitalist system. Schumpeter's thinking evolved over his lifetime to the extent that some scholars have differentiated his early thinking where innovation was largely dependent on exceptional individuals/entrepreneurs willing to take on exceptional hazards as an act of will. This theory explains how technological drivers increase the profit margin for firms and therefore affecting their financial performance.

Constraint-Induced Financial Innovation Theory

American economist Silber (1983) advanced constraint-induced financial innovation theory. This theory pointed out that the purpose of profit maximization of financial institution is the key reason of financial innovation. There are some restrictions (including external handicaps such as policy and internal handicaps such as organizational management and leadership style in the process of pursuing profit maximization in an organization.

According to Silber (1983), these restrictions and limitations not only guarantee the stability of management, they reduce the efficiency of financial institution, and so financial institutions strive toward casting them off. Constraint-induced innovation theory discussed the financial innovation from microeconomics, so it is originated and representative. But it emphasized innovation in adversity excessively. So it can't express the phenomenon of financial innovation increasing in the trend of liberal finance commendably. This theory also explained how financial innovation is made for profit maximization.

Mohsin Theory

Mohsin (1982) model was designed to fit into a capitalist environment. Many of the activities listed certainly go beyond the realm of commercial finance and are so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. In addition, he stated that riba-free banks could coexist with interest-based banks. Mohsin (1982) states that his model incorporates the characteristics of commercial, merchant, and development banks, blending them and adding various non-banking services such as trust business, factoring, real estate, and -consultancy, as though interest free banks could not survive by finance business alone. This theory explains how commercial banks that have Islamic banking window can improve their financial performance by incorporating Islamic services.

EMPIRICAL REVIEW

Regulatory Factors and Financial Performance

The banking industry is among one of the most heavily regulated industries in the world. The main reason for regulation is to provide a sound, stable and healthy financial system. Effective legal and regulatory framework and supervisory oversight needs to take into account the difference between the risk profile of a typical Islamic bank and conventional banks (Njiru, 2010). The differences arise from Shariah law prescriptions, which include factors such as the prescribed legal form and construction of the transactions, the assets and liabilities arising from the transaction, the risks that are undertaken, and the party absorbing the risk.

Accordingly to Abdul, (2012) an Islamic bank is required to take account of the specific Islamic banking factors that may impact on its risk profile. Effective legal and regulatory framework and supervisory oversight is needed to strengthen early detection of risks in Islamic banking. In addition, both centralized and integrated risk management framework are needed to manage different risks. The disclosure regime with a focus on risk profiles, risk-return mix and internal governance needs to become more comprehensive and transparent (Inwon Song and CarelOosthuizen 2014).

The effective prudential regulation of banks is as necessary and desirable in Islamic banking as it is in conventional banking. The risks of Islamic banking are those typical of financial intermediation. Accordingly, the objectives of applying prudential regulation and supervision to Islamic financial activities are the same as the case of conventional banks: namely to pursue and maintain financial stability by ensuring the safety and soundness of banks, thereby preventing problems from having systemic repercussions. An important objective underlying the regulatory framework for Islamic banking should be to avoid undermining the stability of the financial system. Current trends indicate that specific elements relating to Islamic banking are being increasingly encapsulated into the regulatory framework.In this regard, regulatory authorities where Islamic banks are present should adopt IFSB standards as far as possible to avoid regulatory arbitrage. Transparency should be enhanced by the effective enforcement of AAOIFI’s financial reporting standards. In addition, the prudential framework of Islamic banking needs to remain in line with the global financial environment. Risk-based supervision framework needs to be reinforced and stress testing needs to be appropriately conducted to proactively identify risks with improved data (Inwon Song and Carel Oosthuizen, 2014).

Kinyanjui (2013) noted that one of the main challenges facing the industry has been the absence of shariah-compliant legal framework. Islamic banking industry has been trying for the last two decades to extend its foothold to the level of conventional banks but the absence of a legal frame work has stood on its way, making expansion to be slow. In other words, there is no legal framework necessary to make interest-free banking acceptable, thus making it difficult to create sound financial institutions. Banks in Kenya are mainly regulated by the Banking Act and the Central Bank of Kenya Act. This increases the risk of operating in this industry without a legal framework.

Technological Factors and Financial Performance

Studies from the early period of research on innovation have typically reported a positive relationship between innovation and measures of firm performance. In a new generation of

Models studying the impact of innovative activities on firm performance, the focus have shifted to the complex innovation process and channels through which the innovation inputs are transformed into better performance (Loof, et al., 2006; Kemp, et al., 2003; Bessler, et al., 2008). The significance of financial innovation is described by Roberts and Amit (2003) as a means leading to a competitive advantage and superior financial performance.

Innovation would appear in product, process, market, factor and organization (Kao, 1989), but the first three dimensions are more familiar in the innovation literature (Johne and Davies, 2000; Otero-Neira et al., 2009). Innovation generally does seem to have positive effects in raising financial performance of innovators (Boot & Thakor, 2007). Crepon, et al. (1998) used a four-equation model, to link the innovation decision of firms to their performance through the impact of innovation input on innovation output and the innovation output on productivity and better performance. Their findings confirm the positive relationship between innovation activities and productivity at the firm level and provide further evidence on the relationship between size and innovation activities.

Islamic banks to study the issue of having to remain innovative in the Nader (2011) analyzed the profit efficiency of the Saudi Arabia Commercial banks during the period 1998- 2007. The study was conducted using a sample of 6 commercial banks (out of 11). The results of his study indicated that availability of phone banking, number of ATMs and number of branches had a positive effect on profit efficiency of Saudi banks. On the contrary he found that the number of point of sale terminals (POSs), availability of PC banking and availability of mobile banking did not improve profit efficiency. Agboola (2006), in his study on Information and Communication Technology (ICT) in Banking operations in Nigeria using the nature and degree of adoption of innovative technologies; degree of utilization of the identified technologies; and the impact of the adoption of ICT devices on banks, found out that technology was the main driving force of competition in the banking industry. The study covered 36 out of the 89 banks in the country as at the end of 2005.He indicates that adoption of ICT improves the banks' image and leads to a wider, faster and more efficient market. He asserts that it is imperative for bank management to intensify investment in ICT products to facilitate speed, convenience, and accurate services, or otherwise lose out to their competitors.

Mabrouk & Mamoghli (2010) analyzed the effect of the adoption of two types of financial innovations namely; product innovation (telephone banking and SMS banking and so on) and process innovation (Magnetic strip card (debit, ATM and credit card), Automatic cash dispenser; (Automatic teller machine; Electronic payment terminal and so on) on the performance of banks. Their analysis included two adoption behaviors, first mover in adoption of the financial innovation and imitator of the first movers. They found out that first mover initiative in product innovation improves profitability while process initiative has a positive effect on profitability and efficiency. Banks that imitate are less profitable and less efficient than first movers. Babatunde &Adebisi (2011) studied the importance of innovation by taking a research study on "innovation management and organizational development", using United Bank for African Plc as a case study. Primary source of data collection was adopted and one hundred questionnaires were distributed. The study revealed that for any organization to achieve the purpose of its establishment of profit maximization and going concern, and to increase its level of productivity, service delivery and sales turnover and remain in the market as leader such company must be able to introduce new innovation and manage effectively changes that occur in their industry and environment. They deduced that innovation management is very important for organization development. It is true that acquisition of modern technology will help an organization to boost if productivity and hence help in retaining its market share.

Irechukwu (2000) lists some banking services that have been revolutionized through the use of Information and Communication Technology (ICT) as including account opening, customer account mandate, and transaction processing and recording. ICT has provided self-service facilities (automated customer service machines) from where prospective customers can complete their account opening documents direct online. It assists customers to validate their account numbers and receive instruction on when and how to receive their cheque books, credit and debit cards. Communication technology deals with the physical devices and software that link various computer hardware components and transfer data from one physical location to another (Laudon & Laudon, 2001). ICT products in use in the banking industry include Automated Teller Machine, Smart Cards, Telephone Banking, Electronic Funds Transfer, Electronic Data Interchange,

Studies by Aduda & Kingoo (2012) showed that there exists a positive relationship between electronic banking and bank performance. They established that the adoption of electronic banking has enhanced Kenyan banking industry by making it more productive and effective. For example, banks build up sophisticated databases containing information about their consumers, and through data mining they are then able to target their commercial efforts more precisely, knowing which range of products individual consumers might be interested in buying. Technology also affects the very products that banks sell. Sumiyu (2013) study established that the new market innovation strategies adopted by commercial banks were availability of resources and capabilities, creating and nurturing strong brands, aggressive anti-competitors marketing campaigns, creating value through pricing, environmental analysis and response to changes, customer satisfaction and retention. The study also established that commercial banks adopted product innovation strategies which helped the banks to earn more profit, faster business growth, invest more and also in improving the firm's productivity. Absence of sufficient degree of financial innovation may pose a serious risk to the competitiveness of interest free banks in the fast changing financial market (Naser & Moutinho, 1997).

Demographic Factors and Financial Performance

Demographics profiles include items such as age, gender, level of income and education, home ownership, employment status, and even location, religion (cooper, Gardener and Mills, 2000). Customer demographics also include all the measurements necessary to statistically describe the end-user base in a given market. This would include the measurement of parameters such as the total number of customers, customers by the number of employees, customers by the size of production, customers by industry, customer segments by geographic area, customer budgets and expenditures. Understanding the demographics of the target customers is critical for the success of any bank. Not only does the bank need to understand them in order to decide exactly what their product and services mixes will include, but this information will also affect pricing, packaging, promotion and place (Berger, Miller, Petersen, Rajan& Stein, 2005).

(Haque, Osman and Ismail, (2009) explored that the demographic factors such as religion & knowledge are playing a significant role to select a bank. Researcher found that customers do not have so much knowledge about the Islamic banking products such as Muderaba, Mushaaraka and Murabaha but they buy these products for the reason of religion. The study concluded that availability of service and social, as well as religious perspective at higher level could make Islamic Banking easier and comfortable. If the customers are educated on the products and their advantages they will buy this services which also increases their profits and general financial performance of Islamic compliant banks.

One of the main findings is that the effects of population will partially offset the impact of shrinking customer bases. While the decline in the size of the population reduces the customer base.Demographics factors affect the bank choices of the products. In order to properly evaluate bank product performance a business must know the demographic profile of its customers. To see if the demographic traits necessary to support the performance of the business, it must look at the customers purchasing power, the degree of disposable income within the various demographic categories, whether residences are homes rented or owned, means of transportation of the customers (Nguyen, 2007).

Islam is the primary reason behind choosing Islamic banking. Customers in Islamic banks seriously consider whether the bank complies with Islamic Shari ‘ah rules in all stages of banking activities (Kader, 1993). The variables deemed important under religious (Islamic) construct include compliance to Shariah rules, offering of Shariah compliant services, offering interest free loans etc. However, studies have showed that Islamic belief is neither the only reason, sometimes, nor the primary reason behind choosing Islamic banking. Although the idea of Islamic banking comes from the desire of conducting financial activities in accordance with Islamic Sharia principles (Naser and Moutinho, 1997), A study conducted in Jordan has also found that religion does not play significant role to select an Islamic bank but profit motivated criteria is an important factor to choose a bank opening new branches.

Economic factors and Financial Performance

Annual gross domestic product (GDP),is the measurement that represents the economic activity and capability of an economy (Kok et al., 2012). Empirical results show that GDP has a positive and significant effect on the performance of Islamic banks (Bashir, 2003; Smaoui & Salah, 2012; Wasiuzzaman & Tarmizi, 2010), because favorable macroeconomic conditions within the country create a good environment for the banking sector. In the present study, GDP is expected to have a positive effect on the performance of Islamic banks, because if GDP decreases it would badly affect the banking industry by decreasing the credit quality which in the end could reduce the profits of Islamic banks (Wasiuzzaman & Tarmizi, 2010). This variable will be included as an independent external variable to the current study as any change in GDP could cause changes in the macroeconomic environment that could affect Islamic banks that engage in highly risky operations such as PLS loans. The GDP is expected to influence numerous factors related to the supply and demand for loans and deposits. Empirical results show that GDP has a positive and significant effect on the performance of Islamic banks (Bashir, 2003)

The inflation rate is widely used as an external variable in the profitability studies conducted on Islamic banks (Asutay & Izhar, 2007; Bashir, 2003; Haron, 1996; Karim, Mohamed Sami & Hichem, 2010; Kok et al., 2012; Smaoui & Salah, 2012; Srairi, 2009; Wasiuzzaman & Tarmizi, 2010; Zeitun, 2012). Inflation may have a negative impact on the performance of Islamic banks if overhead costs increase faster than the inflation rate. For instance, Kok et al. (2012) found the inflation rate negatively affected the performance of Malaysian Islamic banks. The effect of inflation depends highly on whether it has been predicted or not (Srairi, 2009). When inflation has been predicted, then banks can adjust returns of their PLS loans, and by doing so could increase profits. However, if it is not predicted, then banking costs could increase, which could eventually decrease the net profits. Empirical results show a positive impact of the inflation rate on Islamic bank performance, which shows that in most cases Islamic banks were able to predict the inflation rate (Bashir, 2003; Smaoui & Salah, 2012; Wasiuzzaman & Tarmizi, 2010). The inflation rate will be included in this study as an external variable because it could affect the profitability of Islamic banks if not predicted.

Money supply represents the amount of money in the country, and how it affects the performance of Islamic banks. It could be used as a proxy for macroeconomic conditions in the Malaysian economy (Kok et al., 2012). Kok et al. (2012) and Srairi (2009) found a positive and statistically significant effect of this variable on the performance of Islamic banks. The same positive effect of the money supply is expected here, and will therefore be included in this study as an external variable because money supply reflects the macroeconomic conditions within a country, which influences the performance of Islamic banks by affecting the financial situation of customers.

RESEARCH METHODOLOGY

Research Design

A research design is the structure of research. Orodho (2003) defines it as the scheme outline or plan that is used to generate answers to research problems. This study was conducted through the use of a descriptive research design. Descriptive survey is useful because it secures evidence and describes situations the way they are thus helping to determine the necessary steps to be taken in order to solve societal problems. Descriptive survey studies can be used to demonstrate association or relationships between variables in a population Mugenda and Mugenda (2003). It enables the researcher to collect in depth information about the population being studied (Chadran, 2004).

Target Population

Newing (2011) describes a population as the set of sampling units or cases that the researcher is interested in. The unit of analysis was 2 fully fledged Islamic banks in Kenya. The unit of observation was top and middle level managers of banks with Islamic banks. The main reason for choosing senior managers is because they are responsible for the performance of their respective banks. The target population was 110.

Sampling Design

The sample size for the study was calculated using Mugenda and Mugenda (2003) which is 30% of the target population. The sample size was 33 and the sampling procedure in this study was stratified random sampling.

Data Collection

Primary data was used in the study. The data was collected from respondents using closed ended and open ended questionnaire. Drop and pick method was used to administer the questionnaire. Hence each respondent received the same set of questions in exactly the same way. The respondents were made aware of purpose of the research and were assured of their confidentiality. Questionnaires are suitable to obtain important information about the population and are said to reach large number of subject who are able to read and write independently (Orodho, 2004).

Data Analysis

Collected data was chronologically arranged with respect to the questionnaire outline to ensure that the correct code was entered for the correct variable cleaned and tabulated. The tabulated data was analyzed using descriptive, correlation and regression statistics in with the aid of Statistical Package for Social Sciences (SPSS 21.0). Multiple regression statistics was used to establish the relationship between the external environment drivers and financial performance among Islamic banks based on the regression model shown here below

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

Where: Y= Financial Performance; X1= Regulatory drivers; X2= Technological drivers; X3= Demographic drivers; X4= Economic drivers; $\beta_0 \beta_1$ β_2 β_3 β_4 is the coefficient of the variables; e is the error term.

RESEARCH RESULTS

Regulatory Drivers and Financial Performance

The study revealed that the most of the banks had a system to early detect risks involved in Islamic banking; a centralized and integrated risk management framework, internal governance that is averagely more comprehensive and transparent and they adhered to the Shariah law prescriptions at a mean of more than 3. The study further revealed that the banks complied with the IFSB standards of Islamic Banking, adhered to the AAOIFI’s financial reporting standards and also complied with the Banking Act and the Central Bank of Kenya Act at a mean of 4.844. This shows that the Islamic Banks were compliant with most of the banking industry regulations internally, locally and internationally. Shariah principles were found to prohibit the use of interest and gambling in the transactions and this ate into the profits of the banks. All Islamic financial activities were being conducted by financial institutions authorised by the financial sector regulators to operate in accordance with laws of the country.

Demographic drivers and Financial Performance

The banks' clients and their background characteristics were found to greatly influence performance of the banks. The total number of customers the banks had influenced financial performance to a very great extent while customers by the number of bank employees and customers by industry influence to an averagely lower extent to financial performance. Customers by the size of productivity of the bank, customer segments by geographical area and customers by budgets and expenditure influence to a great extent the financial performance of the Islamic Banks in Kenya. The demographic trends of customers were found to greatly influence productivity of the Islamic banks given that the clients were evenly spread across the Kenyan market. The age, wealth level, gender, geographical distribution and concentration all influenced the performance of the bank given its catchment. This indicates that for the banks to thrive, there is need to capitalize the customer niche, background and potential.

Technological drivers and Financial Performance

The study realized that ATMs influenced reduction in cost of operation and increased the income and profitability of the banks as indicated by a mean of 4.741. The debit and credit cards, mobile banking, internet banking and electronic funds transfer to a great extent reduced the cost of doing business and increased bank income and profitability. This indicated that technological advancements in the banking industry like the establishment of auto branches, debit and credit cards, online, internet and electronic banking cut on the cost of operation and influenced profitability of the Islamic banks in Kenya.

Economic drivers and Financial Performance

The Islamic banks' performance was found to greatly dependant on the national and internal economic drivers and trends. The national Gross Domestic Product influenced to a great extent the financial performance of the Islamic banks as indicated by a mean of 4.11 while country inflation rate, tax policy and money supply as the key macro-economic indicators significantly influenced financial performance of Islamic Banks in Kenya. Global economic trends like the global economic crisis, fuel prices and exchange rate fluctuations influenced to a great extent the profitability and income of banks

REGRESSION ANALYSIS

The researcher conducted multiple regression analysis to establish the influence of external financial environment drivers on financial performance of Islamic Banks in Kenya. The findings are indicated in subsequent sections;

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.968	0.951	0.818	0.595

The table above indicates the model summary. From the findings, R was 0.968, R square was 0.951 and adjusted R squared was 0.818. An R square of 0.951 implies that 95.1% of changes in financial performance of Islamic banks in Kenya is explained by the independent variables of the study. There are however other factors that influence performance of Islamic Banks in Kenya that are not included in the model which account for 4.9%. An R of 0.968 on the other hand signifies strong positive correlation between the variables of the study.

Table 2: ANOVA

Model	SS	df	MS	F	Significance
Regression	638.04	6	560.4	676.015	0.0912
Residual	281.40	341	0.950		
Total	919.44	347			

From the ANOVA table above, the value of F calculated is 676.015 while F critical is 489.465. Since the value of F calculated is greater than F critical, the overall regression model was significant and therefore a reliable indicator of the study findings. In terms of p values, the study indicated 0.000 which is less than 0.05 and therefore statistically significant.

Table 3: Regression Coefficients

Model	Unstandardized coefficients		Standardized Coefficients	t	Sig
	B	Std Error	Beta		
Constant	9.49	0.674		8.012	0.000
Regulatory drivers	0.955	0.022	0.811	14.15	0.00
Demographic drivers	0.876	0.033	0.120	11.04	0.000
Technological drivers	0.745	0.029	0.127	1.15	0.000
Economic drivers	0.860	0.031	0.384	4.42	0.000

The resultant regression equation becomes:

$$\mathbf{Y = 9.49 + 0.955X_1 + 0.876X_2 + 0.745X_3 + 0.860X_4}$$

Where: Y is the financial performance of Islamic banks in Kenya; β_0, β_1, β_2, $\beta 3$ and β_4 are the regression coefficients and $X_{1,}$ X_2, X_3 and X_4 represent regulatory, demographic, technological and economic drivers respectively.

This implies that when all the variables of the study are held constant, performance of Islamic banks in Kenya will be at the intercept which is 9.49. A unit improvement in regulatory drivers while all other factors held constant results in 0.955 increase in performance of the Islamic banks, a unit increase in demographic drivers with other factors ceteris paribus leads to 0.876 increase in performance of the Islamic banks. Similarly a unit increase in technological drivers while other factor ceteris paribus, translates to a 0.745 increase in performance of Islamic banks in Kenya while a unit increase in economic drivers with other factors held constant leads to a 0.860 improvement in performance of Islamic banks in Kenya.

CONCLUSIONS

The study concluded that institutional framework, information technology and global economy were factors influencing the performance of Islamic banking in Kenya, under extent to which industry specific challenges affect performance of Islamic banks in Kenya, results indicated that bad loans, substitute products and supplier IT systems were factors influencing the performance of Islamic banks, under bank specific challenges risk asset management, weak corporate governance and poor human resource practices were identified as challenges influencing the performance of Islamic banks. It was concluded that the government has not eliminated limitations and extra rules for Islamic banking Government has not been effective in creating a regulatory framework to encourage the formation of Islamic banking services and the least factor affecting the performance of Islamic bank is there is no Government policy on raising awareness to population about Islamic banking.

Digital technology has already transformed how businesses interact with customers and is now revolutionizing how banks serve and interact with theirs. However, this ‘new way to bank’ not only requires a change in process, but also a change in culture from banks and customers alike and although banks can’t change customer culture overnight, they can start pushing them in the right direction.

Banks are still recovering from the global banking crisis, both financially and in terms of their relationship with customers. However, by fixing the latter, they can address the former, and new technologies are key to this.

By utilizing innovative technology, banks can do more to service shareholders and customers, as the two are intertwined. In the long run all parties will benefit – but only if the customer user experience and security remain front of mind.

RECOMMENDATIONS

It was recommended that in order to operate in global markets effectively, it is desirable that the size of operations of Islamic banks be substantially increased, serious consideration should be given to mergers, build bridges between existing Islamic banks and those conventional banks that are interested to do banking on Islamic principles and factor in the customers’ dynamic and varied demographics.

Islamic banking at the international level has grown exponentially over the last three decades thus necessitating the need for Islamic banking institutions that are able to meet the needs of Islamic banks and local counterparts need to adhere to international requirements to remain competitive.

Implementation by the CBK of prudential guidelines that are helpful to Islamic banks shows goodwill on the part of the government to ensure that Islamic banks are governed properly and therefore the banks need to focus on other drivers to Shariah banking to remain afloat.

Nevertheless, though efforts have been made by the Central Bank to strengthen the financial system in Kenya through establishing the KDIC, the former needs to make greater strides with regard to the development of financial institutions which are Sharia compliant. This will ensure that Islamic banks are able to be on equal footing with conventional banks, which will enable them to compete effectively. This is underlined further in the challenges facing Islamic banking are outlined with the lack of an efficient legal and regulatory framework limiting growth and development.

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