

**MACRO ECONOMIC VARIABLES AND FINANCIAL PERFORMANCE  
OF ISLAMIC BANKS IN KENYA**

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## **DECLARATION**

### **Student Declaration**

I absolutely affirm that this project is wholly original and that neither I nor any other individual from any other institution, whether knowing or unbeknownst to me, has submitted it for credit toward a degree.

Signed.....Date .....

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**D53/CTY/PT/31544/2015**

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I certify that I oversaw the student as she conducted this research study.

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## **DEDICATION**

I dedicate this research project to my dear Father Mzee Ombaso

## ACKNOWLEDGEMENT

First, I thank, honor and give glory to God, for his grace that He that enabled me commence this research study to this end of the proposal. I have seen the Hand of God in all stages and phases of this study as I have worked closely with my supervisor Mr. Joseph Theuri. The power and strength received from God cannot be underestimated. Indeed He is God.

I would also like to extent my special appreciation to my supervisor Mr. Joseph Theuri for always being therefore to review my work and provide comments on a timely manner. Indeed it has been a pleasure working with you sir. The guidance received from you cannot be measured and expressed in words. “*Ahsante sana Mwalimu.*”

Further appreciation is to my family at large specifically my sister Linet for always encouraging me to keep my head high despite the happening in my immediate environment. The support received from you sister to financially support my studies is highly appreciated. Blessings.

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## **ABBREVIATIONS AND ACRONYMS**

<b>AAOIFI</b>	Accounting and Auditing Organization for Islamic Financial Institutions
<b>CBK</b>	Central Bank of Kenya
<b>IFSB</b>	Islamic Financial Services Board
<b>ROA</b>	Return on assets
<b>ROE</b>	Return on equity

## OPERATIONAL DEFINITION OF TERMS

**Exchange rate:** The worth of one currency in terms of another. For this study USD against the KES

**Financial performance:** The level of a business performance measured in either through profit or losses resulting from business operations within a given period of time. For this inquiry, the gross profit margin will be used to gauge financial health.

**Inflation rate:** a representation of an economy's overall change in the cost of goods and services at a particular moment. For this study the KNBS data on cost of goods and services which is computed mostly in terms of percentage will be used.

**Interest rate:** The cost charged by a lender on an amount given out as a loan normally expressed in terms of percentage of principal.

**Islamic bank:** A commercial bank whose operations adhere to Islamic law principles.

**Macroeconomic variables:** Indicators of the general state of an economy, for the purpose of this research, three macroeconomic variables are particularly important: exchange rate, interest rate, and the inflation rate.

**Sharia law or Islamic law:** A set of religious beliefs and principles that dictate how Islam is practiced.

## ABSTRACT

Islamic banks are commercial banks that operate under the Islamic principles and guidelines (*sharia* law). Following the economic theories and other practical considerations, Interest rates and inflation rates complement one another on the effects of the financial results posted by banks. Exchange rates have been found to have negative effects on performance outcomes posted by Islamic banks in Kenya. The study focuses on these three variables and their effects on the financial performance of Islamic banks. This study aimed to identify the effect of the macroeconomic variable i.e. exchange rate, inflation rate and interest rate on the financial performance of Islamic banks in Kenya. Specific objectives entailed: determining the effect of interest rate, inflation rate and exchange rate on the financial performance of Islamic banks in Kenya. The findings of this study would assist persons in management among banks in Kenya to develop appropriate risk mitigation policies. It would help the Islamic banks regulatory body (*sharia* compliance board) to be able to set appropriate guidelines that will assist in managers in these banks. Finally, it will be useful to the Islamic banking customers especially on the profit sharing. Three theories served as the study's foundation; demand pull theory, Purchasing power parity theory, Productivity Theory and Irving Fisher's theory. The study shall focus on three licensed Islamic banks. A descriptive design was adopted for this research. Secondary data was used to collect data for the study. Research instrument was data collection schedule with information being obtained on a period of 13 years (2009-2021). Analytical software capable of undertaking the inferential tests used in analysing data. The Descriptive data statistics such as mean; standard deviation were used to analyse quantitative data. Inferential statistics shall be used to draw conclusions on the link between macroeconomic variables and performance. There result was presented using tables, graphs and charts. The study noted that interest rate, inflation rate and exchange rate fluctuation all had statistically significant effect the financial performance. It was concluded that macro-economic variables are significant predictors of financial performance of Islamic banks in Kenya. The study recommends that policy makers working at the Central Bank of Kenya should leverage the existing monetary policies in order to manage inflationary pressure in the country. It is necessary for CBK's policymakers to review the existing monetary policies to counter interest rates which have been found to have significant implication on financial performance. The senior managers working among Islamic banks in Kenya should leverage the macroeconomic variables in order to enhance the financial positions of their banks.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of Islamic Banking

Banking system that utilizes Islamic (*Shariah*) law principles have gained prominence both in Kenya and the world at large. Islamic finance is based on two major tenets: division of profit and loss between the bank and the borrower (customer) and the prohibition on payment and collection of interest. Islamic banking contains conformity of the norms and values prophesied by the Islam religion. Apart from the laid down rules in relation to management of risks and governance, additional rules have been drafted to align their operations to Islamic *Shari'ah* (Iqbal and Mirakhor, 2007). The key principle is their prohibition of charging interest on amounts extended as loans which is the primary means of funding for the conventional banks. To enable Islamic banks assess their financial performance, a new way of measuring their performance was designed taking into account the provisions of Islamic law. Therefore, their financial services are operated outside the framework of interest. As such interest based financial services do not exist in these banks. Additionally, Islamic law prohibits unethical practices especially those that go against the provisions of Islamic economy (Henry and Wilson, 2004).

In addition to the typical corporate management and portfolio management guidelines, it is governed by a regulatory agency in conformity with Islamic Shari'ah (Henry and Wilson, 2004; Iqbal and Mirakhor, 2007). A limited set of banking practices or mechanisms that did not charge interest were examined by interest-free banking. The common method was anticipated to take part in achieving the goals and objectives of an Islamic economy, avert immoral conduct, and refrain from interest-based operations, which are forbidden by Islamic Shari'ah. It promotes the concept of risk-sharing where in case a bank makes a

loss, the same is shared with their customers. The Islamic law has provisions on how individuals need to handle physical commodities, their stock, contracts related to leasing and general constructions. Different financial products for each of these categories have been developed to support customers prophesying Islamic faith. Therefore, Islamic banks Obtained their income from asset management. The banks had established different sources of income that were considered *Halal* (lawful) while at the same time the customers who put their deposits in the bank also received *Halal* income that was stable.

Another key variable in performance of Islamic banks is the exchange rate because they deal in international business where they send and receive money internationally. As noted by Mansur and Elyasia (1995), the effect of the rates in which currencies exchanged for another was limited effect on amount of money that the banks extended as loans to their customers. However, pronounced effect felt on the activities that involved financing within the banks as it affected stock prices and real output. Another observation by Adebola et al. (2011) showed an association between real effective rate at which currencies exchanged and the level of financing among Islamic banks. The relationship was however established to be insignificant in the long run. From the above findings and explanations, there is an important concern on the Islamic banks operations in Kenya which will help in determining whether their profits were really affected by the macroeconomic variables. Therefore, this research focused primarily on the effects of the macroeconomic variables on performance of Islamic banks in Kenya.

### **1.1.1 Macroeconomic Variables**

According to Huybens and Smith (1999), inflation rate affected credit market fluctuations negatively in financial sector performance. Also, in conclusion they stated that as the

amount of loans extended by banks together with performance decreases, the general price of commodities increase. According to Uma, (2014) in his study on the effects that inflation and general commodity price changes has on performance of banks, it was established that banks had the capacity to withstand shocks arising from inflation in the immediate to short term. This was attributed to banks operating in conjunction with interest rate and maturity of instruments. The banks put less emphasis on purchasing power of money in general. In long run, the shocks affected bank performance significantly,

According to Hall (2018) in her investigation on how exchange rate shifts impact the banking industry's revenue sector, it was found that the banking sector's profitability changes as the interest rate changes. Majok (2015) aver that return on assets-based measures of bank profitability and exchange rates have a favorable correlation (ROA). Also, it was found out that as domestic currency changed in value, performance outcomes of commercial banks in South Sudan also changed. The study was to determine whether a positive or negative impact on performance as a result of changes on net profit margin (NPM). It was established that performance changed proportionately to changes in exchange rate.

### **1.1.2 Financial Performance of Islamic Banks in Kenya**

This measures the efficiency which individuals involved in the running of business operations have utilized resources to generate wealth for shareholders as they meet the expectations of other stakeholders. Many firms measure performance in financial terms by looking into the revenue generated from utilization of land labour, capital and management at their disposal. It also evaluates the returns generated from assets (ROA), returns generated from equity (ROE), and operating profit margin (OPM) (Miller et al, 2000). The

profitability of the firm was weighed by ROA in accordance to total assets employed. The more the ROA, the more the performance of an organization is considered to be better. Other measures adopted in measurement of performance include cash flow which looks into liquidity as businesses strive to fulfill their financial commitments as they become due within the short term without affecting normal operations (Dobbins *et al.*, 2000).

According to Dobbins et al (2000), liquidity (cash flow) was the capability of a business to pay debts when they become due in the short term, while the normal activities of the business. According to Mongeri et al (2011) solvency looked a company's capacity to fulfill its debt responsibilities in circumstances when all its assets are liquidated and continue operating normally following occurrence of a financial adversity. Some of the commonly applied measures of performance is the ratio of debt to assets; debt to equity and equity to assets. The absolute measure of profit (or loss) was net profit, which was irrelative to initial investments made to ensure that a given performance target is obtained in profitability. Cash flow was the amount of money easily accessible to acquire the financial obligations of the company. The table below show the financial performance of first community bank as just a representative of the Islamic banks. The data was obtained from the website of the bank by focusing only on profits after tax. It shows a decrease in the profits earned as from 2012 to 2016.

**Table 1.1: First Community Bank Net Profit**

<b>Year</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
<b>Net Profit /Loss (kshs)</b>	241,305,000	132,202,000	50,437,000	(12,114,000)	(55,734,000)
<b>Total Revenue</b>	940,305,000	1,002,513,000	1,003,005,000	1,312,739,000	1,271,299,000
<b>Net Profit Margin</b>	25.66%	13.18%	5.02%	0.92%	4.38%

**(Source: First Community Bank Financial Reports)**

This second table shows the financial performance of Gulf African Bank from 2012 to 2016. This shows a variation that is yet to be known as to why in this study.

**Table 1.2: Gulf African Bank net profit**

<b>Year</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
<b>Net profit/Loss(kshs)</b>	242,221,000	285,477,000	401,372,000	730,703,000	498,321,000
<b>Total Revenue</b>	1,448,570,000	1,595,023,000	1,912,911,000	2,855,321,000	2,454,334,000
<b>Net Profit Margin</b>	16.72%	17.89%	20.98%	25.59%	20.30%

(Source: Gulf African Bank financial reports)

The data was obtained from both banks website. The financial reporting for these banks was in accordance with Accounting and Auditing Organization for Islamic Financial Institutions (AAOIF) and Islamic Financial Services Board (IFSB)

### **1.1.3 Macroeconomic variables and financial performance**

The general business environment in an economy is defined by macroeconomic variables because of their effects on money supply, supply of good and demand (Pervan and Pavic, 2010). However, these variables may affect business operations at the firm, industry and country or macro level. Therefore, as different variables change at each of these levels, performance results of insurance companies in Croatia changed respectively in the same direction (Curak et al., 2011). An inverse though significant relationship resulted from changes in ownership, inflation, profitability and overall expenses ratio. According to Curak et al. (2011), the level of risk underwritten, firm size as measured by assets, general increase in price of commodities and ROE resulted in composite insurance firm performance. In a nother study, Ugur and Ramazan (2005) noted that expectations in inflation affected stock returns among firms quoted on Turkey exchange. Inflation and



stock returns were negatively related as a result of inflation in the economy. According to Li (2006), high inflation conditions result in low financial performance because of the loss in purchasing power of the currency. The resultant effect is stressed aggregate performance of an economy. The channels through which inflation is passed to affect economic growth are also affected by exchange rates especially where an economy is involved in international business.

According to Muchiri (2012), macroeconomic variables affect performance outcomes registered by firms at the NSE. The variables like money supply and inflation affect the general demand and supply of goods and services produced by companies thus affecting the prices of their equity (Shares). The effect of interest rate was negative and minimal on share prices. However, currency exchange rates bore the highest impact on share prices.

According to Gikungu (2012), macroeconomic variable changes resulted in an increase in share prices at NSE. However at the period under study, money supply increased tremendously as well as inflation and interest rates. Money supply together with inflation bore little though positive effects on share prices. The cost of borrowing bore negative effects on the performance of share prices for firms whose traded at the stock exchange. Money supply regressed against share prices posted a positive but little effect similar to that posted when regressing inflation against share prices. Cost of borrowing on its own bore a negative though small effect which was difficult to ignore.

Muya (2013), on his study on the factors which affect performance outcomes among insurance firms operating in Kenya concluded that changes in cost of borrowing manifested itself in financial performance outcomes among insurance firms. It affected the returns earned by companies as measured by return on investments. The study shows that

through profitability, insurance firms were able to put their resources into profitable ventures as they kept away from those posing high risks. A further study by Grace and Hotchkiss (1995) found out that GDP was inversely related to premiums paid by customers taking up policies together with interest rates had an inverse effect on profits. Kipngetich (2011) supported this relationship through examination of commercial banks' performance.

#### **1.1.4 Islamic Banks in Kenya**

According to Moin (2008), Islamic banking follows the provisions of Shariah. They are building around the tenets of Islamic faith and governance. As per Shariah, such banks are not required to charge interest on loans while at the same time, they are not allowed to offer customers interest on their deposits. Shariah bars money being used as a commodity for the purposes of earning profit. It believes that profits should be achieved from transacting in goods and services only as opposed to earning it on the control of money by itself. Islamic banking principles have been developed along ethical principles so that no one individual is treated unfairly.

The *Shariah* encourages individuals to engage in economic activities that safeguard and protect the interest of general public's through an established Islamic framework. It holds that Islamic adherence banks need to run their activities in a way that result in them gaining profits. All their operations are supposed to be run in accordance with Islamic ethics and morality which states that indulging in any form of transaction that charges interest is prohibited. They only need to engage in Halal activities which have no elements of interest charges. It therefore encourages its believers to forbid haram activities. A firm serving the Muslims should not engage in any form of business activity that involves speculation (*Gharar*). Financial institutions are not spared either on this because interest is

considered speculations. They are therefore encouraged to observe all accounting standards and principles aligned to *Shariah*. As noted by Ansari and Rehman (2011), Islamic banking became popular in the 1940s in the Middle East as it spread to other Islamic countries.

According to Harris (2012), in Kenya Islamic banking was growing very fast as more and more commercial banks embrace it. It was noted started until the year 2005 when Barclays Bank of Kenya gave it a try by offering differentiated products through Islamic window. The product attracted many customers prophesying Islamic faith to the extent that two fully fledged Islamic banks were regulated by the CBK in 2007: Gulf African Bank and First Community Bank. The growth of these banks has been phenomenal to the extent that they now control a market share of about one percent in Kenya's banking sector. Seeing the potential that this market offered its customers, other conventional banks have also joined the band wagon to offer *Shariah* compliant products by creating Islamic divisions and windows. The market allocated to conventional banks offering Islamic banking accounts for about 0.25% of Kenya's banking market share thus bringing the total market share controlled by Islamic banking to 1.25%.

## **1.2 Statement of the Problem**

Over a period, most countries across the globe had embraced Islamic banking. The existence of fluctuations in profits earned by these banks which were not explained well for scholars, the shareholders and the management to understand the cause of such fluctuations. In Kenya and other countries, Islamic banks have in many occasions experienced economic turbulence which leads to making varying amounts of profits over a period of time. This has made many scholars and researchers to carry out various studies

on both conventional and Islamic banking in determining why the profits were varying. These studies have proved to there being a link between the macro-economic factors and profitability of banks but in specific Islamic banking.

According to Harris (2012), in Kenya, Islamic banking was growing very fast since its first adoption in the year 2007 by Barclays Bank of Kenya. It started by offering bank account products that observed the provisions of Shariah. As the demand for their products grew, more and more independent Islamic banks were licences in the year 2008. The banks have experienced phenomenal growth to controlling about one percent as of December 2021. Other conventional banks have also launched Islamic banking window to tap into those incomes. All these initiatives have yielded a market share of 1.25%.

Syed and Shafique (2011) evaluated five foreign economic parameters, including the GDP, industrialization rate, interest rate, hyperinflation, and joblessness, in their study on the factors that determine the viability of Islamic banks in Pakistan. They studied the 6 traded banks for a period from 2003 to 2009. Profitability was determined through ROA and ROE. They came to the conclusion that, of the 5 financial indicators, the rate of return was the sole one that significantly affected the profitability of Islamic banks. Nienhaus (1983) there was a relationship between the profitability and market structure among banks adhering to Islamic banking provisions. The study identified a model used by Islamic banks in profits between customers and the banks to be positive. However, since the profit was too low, it was recommended that it would be better to benchmark profits to interest rates for better returns for investors. Aligning profit sharing ratio to interest rates charged by conventional banks would have improved bank performance.

Base lending rates set by the CBK normally affects the general level of inflation in an economy negatively (Muhammad, Khizer and Shama, 2011). As inflation goes up,

individuals will be forced to spend more to meet their normal expenses thus eat into their savings. According to Athukorala and Tsai (2003), inflation affected negatively the savings whereas the cost of borrowing expressed as interest positively correlates to savings. If the interest on deposit is increased, more and more individuals will be attracted to save hence increase in savings. The same way fluctuations in exchange rates for different currencies affect the lending patterns adopted by banks in Nigeria (Mbutor, 2010). In another study, Mansur and Elyasiani (1995) noted that changes in currency equivalents have limited effect if any on lending patterns in banks though they affected activities related to financing especially stock prices.

As stated earlier studies have build up possible association between the macro-economic variables considered in this study and financial performance of Islamic banking. However, it had failed to be clear to scholars and the management of Islamic banking in Kenya since there are very few studies that have been carried out in Kenya. In this few studies they did not focus on all the macro-economic variables that featured in this study. Therefore, these studies had failed to give a clear picture on the effects of the macro-economic variables on the profitability of Islamic banking.

### **1.3 Objective of the Study**

This study's primary goal was to investigate the impact of macroeconomic factors on the financial performance of Islamic banking in Kenya..

#### **1.3.1 Specific Objectives**

- (i) To ascertain the effect of interest rate on the financial performance of Islamic banks in Kenya.
- (ii) To assess the effect of inflation on the financial performance of Islamic banks in Kenya.

(iii) To ascertain effect of exchange rates fluctuations on the financial performance of Islamic banks in Kenya.

#### **1.4 Research Hypothesis**

**H<sub>0</sub>1:** Interest rate has no appreciable impact on the monetary success of Islamic banks in Kenya

**H<sub>0</sub>2:** Inflation rate has no appreciable impact on the monetary success of Islamic banks in Kenya

**H<sub>0</sub>3:** Exchange rate fluctuation has no appreciable impact on the monetary success of Islamic banks in Kenya

#### **1.5 Significance of the Study**

This research would help the management of Islamic banking to know where they are doing well or poorly in their operations in relation to the macro-economic variables. This would assist in risk mitigation and also coming up with risk appetite policies. It would help the Islamic banking regulatory body (sharia compliance board) to set appropriate guidelines that assisted in the management of Islamic banks. Finally, it would be useful to the Islamic banking customers especially on the profit determination criterion.

#### **1.6 Scope of the Study**

The study aimed to examine the effect of macroeconomic indicators on the financial performance of Islamic banks in Kenya for period 2009-2021. The research focused on the exchange rate, interest rate and inflation. The research population covered 3 Islamic bank licenses in Kenya with 3 observations on the profit variation for the period starting 2009 to 2021.

### **1.7 Limitations of the Study**

Islamic banking was growing in Kenya therefore the study's results were limited to a small population. The secondary data provided did not depict the really picture of the banks in the study.

### **1.8 Organization of the Study**

Comprised of a brief explanation of the study's independent and dependent variables, a problem statement that explains why the study was conducted, goals, a hypothesis, relevance, scope, and restrictions. Chapter two contained the literature review. In this chapter there was an introduction of the chapter, the hypotheses underlying the research that was done, empirical review on the macroeconomic variables and the financial performance, summary literature reviewed and the conceptual framework. Chapter three covers research methodology in terms of design, population, data collection instruments, analysis and model specification. Chapter 4 includes comments and analysis of the results, whilst chapter five offers a summary, a judgment, and suggestions.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter outlines the theories that are applicable to this research, the empirical review on the effects of interest rates, inflation rates and exchange rates on Islamic banking. It also gives the gap left by researchers on this study and the conceptual frame work.

#### **2.2 Theoretical Review**

##### **2.2.1 Demand Pull Theory**

This theory is accredited to John Maynard Keynes in the 1940s. According to this theory it is perceived that inflation occurs in incidences when demand for goods and services exceed existing supply. This means that people compete to get goods and services because the supply is limited. Roland Herrmann (2006) noted that a number of innovative actions brought about by changes in demand and market structures. Other factors have also come into play to influence the rate at which demand pulls production. As a result more new products and services have been invented to meet the changing customer needs. Whenever demand for products and services surpass supply, the immediate reaction of suppliers is to increase prices of such goods. This means that only a few individuals can afford them hence creating a balance between supply and demand. Unlike the conventional banking belief that money has intrinsic value, Islamin banking money possesses no fundamental worth save being a medium of exchange and storing value (Taqi, 1999). As such, it can neither be sold nor rented out to generate value which they term as surplus or profit on its



own. Islam believes that money is only intended to be utilized as a tool for communication exchange and storage of value.

This theory helped in determining the profit sharing ratio between lenders and borrowers in Islamic banks. It was theoretically and practically assumed that the suppliers could raise the consideration paid for goods and services in order to control the demand for them, especially when the government does not control the price of commodities. When this scenario was noticed by the lenders, they increased the profit-sharing ratio. Therefore, in this study, the theory assisted in determining the causes of fluctuations in inflation rates.

### **2.2.2 Purchasing Power Parity Theory**

This line of thinking was discovered by the School of Salamanca in the 16th century, and was revised by Gustav Cassel in 1916, in today's way of foreign trade. According to the information that is currently available, the buying power of the currencies affects the rate at which they are exchanged between two countries. The quantity of goods and services that can be secured by equal amount of currency of each country gives the exchange rate. To ensure that there is equal basket of goods and services that can be gotten with similar value, exchange rates come into play.

This theory elaborates the possible relationship between prices charged on goods and services and exchange rates. According to Shapiro and Rotenberg (1976), the regime of an exchange rate left to forces of demand and supply combined with changes in purchasing power parity between two currencies computed as a price ratio against traded volumes of goods would in most cases be estimated by change in rate at equilibrium. This means that at the long run it affected the profitability of banks particularly to this study the Islamic banks in Kenya. As the value of one currency varies thus purchasing power especially on

imported goods and services. This made it hard for Islamic banks to come up with the exact ratio to use when sharing the profits with the borrower. Therefore, this theory is very useful in determination of the ratio in which a lender and a borrower share profits earned. This the manner in which interest rates is transmitted into financial performance among banking institutions. By describing the assortment of products and services that may be purchased in connection to supply and demand, it assists in determining the value of a particular currency in relation to the currency of another country.

### **2.2.3 Irving Fisher's Theory**

The theory was developed by Irving Fisher in the 20<sup>th</sup> century where, It gives a description on the relationship between general price increase and interest rates. It highlights that the real interest rate is gotten by getting the difference between nominal interest rate and the expected inflation rate (Giddy, 1977). It is argued that the result gotten after subtracting nominal rates of the two countries gives a picture on the likely fluctuations in exchange rate. The Irving Fisher's line of thinking appreciated the role played by interest rates in appreciating currencies which normally tend to be low whereas in depreciating currencies, tend to be high. This is important in explanation of currency gains and losses encountered in international business. It can therefore be concluded that foreign exchange rates factor in expectations of interest changes together with differentials in purchasing power of the currencies involved. This provides some of the explanations advanced in explaining why exchange risk may be absent as per the Capital Asset Pricing Model (CAPM). This theory is very useful because it gives further explanations on the entire macroeconomic variables as used in this study. It shows how they complement each other which are very useful in determining how they influence the performance of Islamic banks.

## **2.3 Empirical Review**

This involves a review of studies as done by other scholars on variables being examined by a study. It examined the methodologies adopted, contexts in which studies were undertaken and concepts covered so as to see the convergence and divergence. The specific areas of coverage in this study include study objectives:

### **2.3.1 Interest Rate and the Financial Performance**

Syed and Shaniqua (2011) analyzed five external economic parameters, including the GDP, factory output rate, interest rate, inflation, and joblessness, that have an effect on the viability of Islamic banks in Pakistan. Between 2003 and 2009, they examined Pakistan's six publicly traded Islamic banks. The measurement of profitability used ROA and ROE. According to the study's findings, just one of the five economic parameters had a discernible impact on the profitability of Islamic banks: mortgage rate.

In a different study, Nienhaus (1983) focuses on the possible nexus between profitability and market structure within Islamic banks. He documented that the ratio adopted in sharing out profits in these banks was informed more by the lending rates used by conventional banks. It was more like Islamic banks adopted interest rate in setting the profit sharing proportions. Interest rates served as a basis in calculating that desired ratio. However in the recommendations, it was noted that it is important to equalize profit-sharing ratio and interest rates as charged by conventional banks. Kipng'etich (2011) extended this knowledge by examining the extent that interest rates affected performance of banks in Kenya through secondary data running from 2006 to 2010. The study discovered that a positive relationship existed within the Kenyan context. This study was undertaken more than ten years ago. The contextual setting and banking practices have significantly changed hence limiting the possibility of applying the findings of this study.

Kibe (2003) discovered a beneficial connection in his investigation of the link between interest rate spread and the success of Kenyan commercial banks. The cost of debt to a borrower was quantified through interest rates. The higher the interest rate the higher the profits made by banks. According to Tariq and Mash (2016), their research into how interest rates affect bank deposits revealed that they have no discernible effect on the degree of risk depending on interest rates. Deposits in Islamic banks

Mushtag and Siddiqui (2016) on their study looking at ways that interest rate related to savings pattern together with investment capabilities in Islamic and non Islamic countries. The study did a comparative analysis where it was established that cost of borrowing loans bore little though significant effect on savings among countries prophesying Islamic faith. Non Muslim countries exhibited positive and significant impact. The study noted the need to develop diverse policies among Islamic countries as religious issues and beliefs influenced cost of borrowing and amount set aside as savings among countries that prophesy Islamic religion. Islamic religion forbids dealing interest rates whenever money is involved. This concept is supported by Siaw and Lawer (2015) within the Ghanaian context by examining how interest rate offered on deposits together with inflation affected overall deposits. The study further noted that growth in money supply positively impacted profitability.

### **2.3.2 Inflation Rate and the Financial Performance**

General increases in prices of commodities in an economy affects interest income among commercial banks because of its influence on returns for the depositors. According to Revell (1980), increase in price of commodities could affect profitability of banks through variations. Bourke (1989) and Molyneux and Thornton (1992) set out to test the hypotheses through consumer price index (CPI) where it was established that profitability

varied great at various levels of CPI. Anticipation of high inflation has been found to bring about higher nominal interest rate as they seek to maintain existing real interest rate.

According to Muhammad, Khizer and Shama (2011), the cost incurred on borrowing money from financial institutions affects deposits because they move in a similar direction. According to Athukorala and Tsai (2003) in their study on savings determinants in Moroccan banks, found out that general increase in prices bore negative impact on amounts set aside by people in banks and interest rate bore positive effect.

### **2.3.3 Exchange Rates and the Financial Performance**

In a study, Mbutor (2010) examined the nexus between lending rates in banks, exchange rates and volatility in stocks prices using the context of Nigeria. It started by providing a detailed explanation on how fluctuations in exchange rates affect lending patterns among banks which was found to be negative. Lending patterns were established to depend largely on demand for loans and money supply. In another study, Mansur and Elyasiani (1995) established that changes in exchange rate bore no effect directly on lending patterns adopted by commercial banks. However, it played a role in financing activities as it affected real output and stock prices. This is further confirmed by Adebola et al. (2011) among Islamic bank financing in long run.

Wong, Wong and Leung (2008) examined the extent to which foreign exchange exposure affected profitability reporting among commercial banks in China. The study applied the capital market approach together with equity price on listed banks. Secondary data was obtained from financial statements together with other publications. According to study results, the size of the bank as expressed by assets and its reliance on foreign currency were strongly correlated. The banks in change engaged in huge volumes of international trade where foreign exchange exposure was massive. A review of empirical literature

posted that average foreign exchange exposures among state owned banks was higher than in Hong Kong.

### **2.3.4 Financial Performance of Islamic Banks**

Several studies have been undertaken on financial performance of Islamic Banks. For instance, Hawaldar, Rahman, Tm and Kumar (2017) noted that measuring financial performance of Islamic banks using profitability and liquidity posted no different results from those posted by conventional banking institutions in Bahrain. Islamic banks posted impressive ratios despite them being new comers in the industry. Additionally, Islamic banks seemed to be exposed to reduced credit risk in general compared to that of conventional banks. This showed that the policies implemented by Islamic banks boosted their financial performance besides reducing their risk exposure. In addition, the researcher used metrics like net operating income, earnings before interest and taxes, profit after taxes, and net asset value.

In another study, Milhem and Istaiteyeh (2015) examined the difference between financial performance of conventional and Islamic banks using data drawn from Jordan for the period ranging from 2009-2013. The study specifically looked at the following financial ratios: valuations, flexibility, risk and solvency, and effectiveness. From the findings, differences were noted between the performance of Islamic and Conventional banks. However, results on the analysis of Islamic banks in the Middle Eastern and Asian countries indicated that they operating inefficiently resulting in a decreasing returns to scale. Further analysis indicated that they were well capitalized, possessed higher asset quality and could withstand shocks related to banking crisis. In comparison to their traditional counterparts, Islamic banks were generally judged to be more lucrative, more liquid, and more capitalized.

In Kenya, Qamar (2018) examined the extent to which Islamic products affected financial performance of banks operating on Islamic policies in Kenya. The analysis comprised of data collected from two banks: Gulf African Bank and the First Community Bank. From the analysis of secondary data, it was established that Islamic banking g products positively influenced financial performance. They improved financial performance of banks.

## 2.4 Summary of the Literature Review and Research Gaps

This chapter focused on the findings on the impact of general increases in price of commodities (inflation), cost of borrowing money from banks (interest rate) and exchange rate on the financial performance of Islamic Banks. From the literature reviewed, the impact varied from one country to another though the direction was in uniform direction. The findings had focused on both international and local (Kenyan) scholars who had carried out studies on the interest rate, inflation rate and exchange rate as independent variables and financial performance among Islamic banks being the dependent variable.

**Table 2.1 Summary of the Literature Review and Research Gaps**

Author(year)	Title	Findings	Gap
<i>Adebola et al. (2011)</i>	The impact of macroeconomic factors on Islamic banking	Exchange rate had no direct impact on Islamic financing activity	It should had direct impact since banks deal with the exchange of currency for a profit
Bourke (1989)	Determinants of European bank profitability	Inflation had significant relationship with profit	The study had not singled out Islamic banks
Tariq and masih(2016)	Effects that interest rates have on deposit in banks	Interest rates didn't have any significant impact on Islamic bank deposits	It focused on deposits instead of profitability
Nienhaus(1983)	Interest Rates effects on Islamic and Conventional Banks	The profit sharing ratio positively related to the lending rate	It failed to separate the study of Islamic banks from conventional banks then give

			distinctive findings by showing how
Syed and Shafique (2011)	factors that affect Islamic banks' earnings in Pakistan	The study's findings led researchers to the conclusion that, of the five economic elements, only one had a substantial impact on the profitability of Islamic banks (interest rate)	It ignored the effects of other macroeconomic factors
Kipng'etich (2011)	Interest rates and Kenyan financial institutions' financial leverage	He observed a link between interest rates and Kenya's commercial banks' financial success.	It failed to separate the study of Islamic banks from conventional banks then give distinctive findings by showing how
Kibe (2003)	The link between Kenyan commercial banks' profits and interest rate spread	He discovered a link between interest rates and Kenyan commercial banks' financial success.	It failed to separate the study of Islamic banks from conventional banks then give distinctive findings by showing how
Mushtaq and Siddiqui (2016)	Interest rate effects on investments and savings in 17 Islamic and 17 non-Islamic nations.	Interest rates had a favorable negligible effects on saving in Islamic nations in contrast to the strong positive link it had with saving in non-Islamic nations.	It had not been specific on the financial performance of Islamic banks
Siaw and Lawer (2015)	research of the factors influencing bank deposits in Ghana	Long-term deposit interest rates and inflation reduced bank deposits, whereas rising reserves had a favorable effect.	The stud had not included the other variable exchange rate in their study
Revell (1980)	The effect of inflation on bank profitability	He believed that inflation could be a factor in the causation of variations in bank's profitability	He did not include information according to the results in his conclusion, although he did hold the view that fluctuations in bank profitability might be caused by inflation.
Bourke (1989)	The effect of inflation on bank profitability	That there was a strong correlation between	The study focused on banks in general but not specific to Islamic



		profit and inflation.	banks in kenya
Molyneux and Thornton (1992)	The effect of inflation on bank profitability	that earnings and inflation were significantly related	The study focused on banks in general but not specific to Islamic banks in kenya
Muhammad, Khizer and Shama (2011)	the effects of interest rates on the bank deposits	It was discovered that bank deposits were negatively impacted by base lending rates and inflation.	It was a finding on deposits and not the financial performance in general
Athukorala and Tsai (2003)	The effect of inflation rate and interest rate on savings	It was discovered that while interest rates had a favourable effect on saving, inflation had a detrimental effect.	The study focused on savings and not the financial performance in general
Mbutor (2010)	The connection between bank loans, exchange rate volatility, and stock price swings.	The study claims that exchange rate variations have a small impact on the lending practices of Nigerian banks.	The study was done in Nigeria and not in Kenya where Muslims are in greater number than in Kenya
Mansur and Elyasiani (1995)	The effect of exchange rates on lending	The exchange rate didn't directly affect bank lending, but it appeared to have an impact on bank cash flows through its impact on actual output and equity markets.	The study focused on lending which was part of the activities that banks do to be performing well financially
Gadanecz et al. (2014)	The effect of exchange rates on emerging markets	exchange rate volatility influence investors decision making and demand higher yield for holding local currency bonds.	The study focused on markets in general and not specific to the Islamic banks in Kenya
Wong, et al (2008)	Chinese banks' vulnerability to foreign exchange	It was discovered that larger Chinese banks had a higher prevalence of unfavorable exposure to foreign currencies.	The study focused on Chinese banks not even Islamic banks

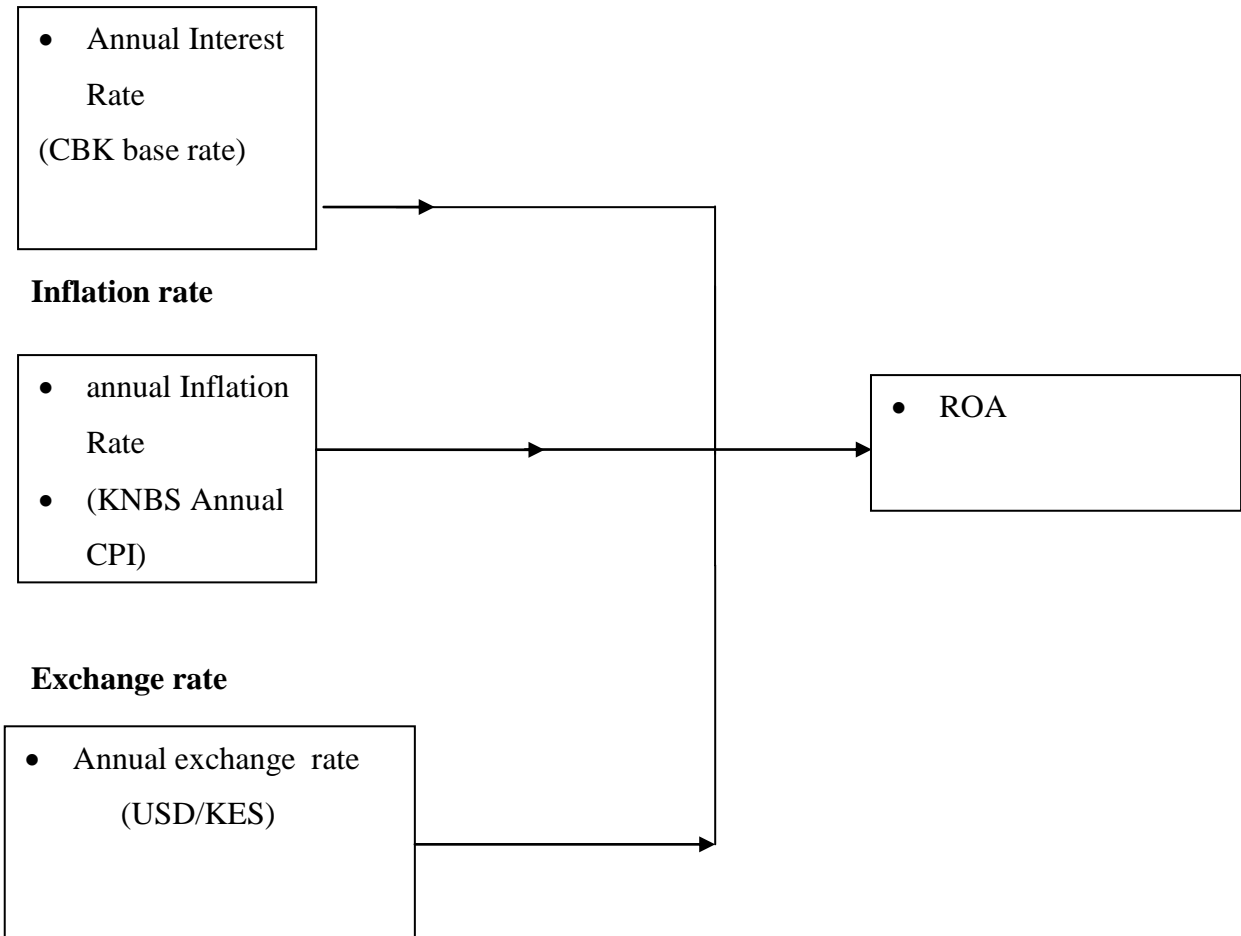
## 2.5 Conceptual Framework

### Independent variables

### Dependent variable

#### Interest rate

#### Financial performance of Islamic banks



Source: (The Researcher, 2022)

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter discusses the different methods that the researcher envisages to apply to ensure that adequate and appropriate data is collected and analyzed in connection with research objectives. It suggests the appropriate design together with the population of interest. It also outlines how the sample was selected and data collection instruments. It checks on elements of validity and reliability to ensure that if a study was to be repeated under similar circumstances, the outcome was the same regardless of the number of times it is repeated.

#### **3.2 Research Design**

This study was done utilizing descriptive study design because the respondents were required to provide descriptive information that helps in building a profile on study elements. As asserted by Mugenda and Mugenda (2003), descriptive design is appropriate whenever a researcher seeks to come up with a profile on the study subjects. This design has successfully been applied by Mushtag and Siddiqui (2016); Muhammad, Khizer and Shama (2011), Mbutor (2010) and Wong et al. 2008) in examining different aspects of macroeconomic variables and firm performance.

#### **3.3 Target Population**

The term "population" describes the full array of components or individuals that a researcher is interested in and that share comparable observable features (Kothari, 2004). They make it easier for a researcher to generalize the findings on it because they have

similar characteristics that a researcher is interested in. The target population of this study comprised three fully fledged Islamic banks licensed and operating in Kenya as at December 2021( CBK;2021).

### **3.4 Sampling and Sample Size**

A census was a method used to methodically gather and collect data about the inhabitants of a specific population. The target population comprised only three institutions whose data could easily be accessed from the website and or head offices situated within Nairobi City County. Therefore, A census was conducted since all three Islamic banks were included in the study.

### **3.5 Data Collections Instruments**

This study used secondary data that was obtained using a data collection schedule. Data on annual inflation rate, annual exchange rate, annual interest rate and annual net profit margin was collected.

### **3.6 Data Collection Procedure**

Secondary data was collected on financial performance of the three banks from published financial reports. The researcher visited the management of the banks that are considered for the study. This assisted in accessing the financial reports for the banks for academic purpose only. Data on inflation was obtained from KNBS, interest rate and exchange rate was obtained from the CBK.

### **3.7 Data Analysis and Presentation**

The study used SPSS Version 24.0 in analyzing data collected. Descriptive statistics including percentages, mean, frequencies and standard deviation were used to carry out the preliminary analysis. The study also used inferential statistics such as correlational analysis and regression analysis. The results were displayed using tables, graphs and charts.

#### **3.7.1 Model specification**

$$Y = \partial + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Whereby:

$Y$  = Financial Performance

$\partial$  = Constant

$\beta_1, \beta_2, \beta_3$  = The coefficients of Independent variable

$X_1$  = Interest Rate

$X_2$  = Inflation Rate

$X_3$  = Exchange Rate

$\varepsilon$  = Error Term

This model helped draw inferences and conclusions that assisted in establishing the relationship between dependent and independent variables. It also helped assess whether the model used was fit for analysis

#### **3.7.2 Operationalisation and Measurement of Study Variables**

The variables of the study were operationalized as exhibited in the Table below:

**Table 3.1 Operationalization of the study Variables**

<b>Variable</b>	<b>Variable type</b>	<b>Operationalization</b>	<b>Measurement</b>
Interest Rate	Independent	CBK Base Rate	Ratio
Inflation Rate	Independent	Annual Inflation (CPI)	Ratio
Exchange Rate	Independent	USD/KES	Ratio
Financial performance of Islamic Banks	Dependent	Return on Assets (ROA)	Ratio (Net Profit /Total assets)

**Source: Author (2023)**

### **3.7.3 Diagnostic tests**

To ascertain and make sure the information were suitable for doing regression analysis, the study performed diagnostic tests.. More specifically, the study conducted autocorrelation test, collinearity test and normality test.

### **3.8 Ethical Consideration**

Information collected in the course of data collection will solely be utilized for scholarly purposes. The results were not published in the social platforms except those that are for academic benefit.

**CHAPTER FOUR**  
**RESEARCH FINDINGS AND DISCUSSION**

**4.1 Introduction**

This chapter presents findings of the study as set out in the objectives. They are arranged according to objectives to ensure that all objectives are handled exhaustively. It starts with diagnostic tests to ascertain the appropriateness of data used in carrying out the analysis. Specifically, the study looked into autocorrelation, collinearity and normality. It then proceeds to examine descriptive statistics of all variables before carrying out inferential statistics.

**4.2 Diagnostic test**

To verify the regression analysis's underlying assumptions, diagnostic tests were carried out. These included autocorrelation, collinearity and normality tests.

**4.2.1 Autocorrelation Test**

The findings of autocorrelation test were determined and summarized as exhibited in Table 4.1.

**Table 4.1 Autocorrelation Test**

<b>Model</b>	<b>Durbin-Watson</b>
1	2.286

The results in Table 4.2 demonstrate the value of Durbin Watson as 2.286. Holgersson (2004) shared that when conducting this test, the statistic values closer or equal to 2 signify absence of serial correlation in the sample data.

#### 4.2.2 Collinearity Test

This test was conducted through computation of the Variance of Inflation factor values and Table 4.2 is a breakdown of findings.

**Table 4.2 Collinearity Test**

	Collinearity Statistics	
	Tolerance	VIF
Interest rate	.897	1.115
Inflation	.891	1.122
Foreign exchange rate fluctuations	.990	1.010
<b>Average</b>	<b>.926</b>	<b>1.082</b>

From Table 4.3, the mean VIF value is given as 1.082. This is in line with the assertion of Midi, Sarkar and Rana (2010) who noted that when testing for colinearity using VIFs, values within range of 1-10 signify absence of this assumption.

#### 4.2.3 Normality Test

The results of the determination of normality are described in Table 4.3.

**Table 4.3 Normality Test**

	n	Skewness		Kurtosis	
		Statistic	Std. Error	Statistic	Std. Error
Interest rate	39	.498	.378	-.394	.741
Inflation	39	1.496	.378	2.120	.741
Exchange rates fluctuations	39	1.724	.378	1.642	.741
Financial performance	39	-1.761	.378	1.432	.741

The findings in Table 4.4 indicate the values of Skewness and Kurtosis as being less than negative or plus 2. This concurs with Akobeng (2007) who shared that such values within range of + or -3 signify the presence of a normal distribution of the data.

#### 4.3 Descriptive Statistical Analysis

The findings of descriptive statistics on the variables of the study were determined and summarized as shown in Table 4.4.



**Table 4.4 Descriptive Statistics**

	<b>n</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>
Interest rate	39	12.00	19.72	14.89	2.238
Inflation	39	3.96	14.02	7.03	2.579
Foreign exchange rate fluctuations	39	-4.30	13.03	1.01	5.057
Financial performance	39	-.32	.04	-.0104	.062

**Source; Field Data, 2023**

Table 4.4 demonstrate that the value of average on interest rate as 14.89% with the minimum, maximum and standard deviation value as 12.00%, 19.72% and 2.238 respectively. This means that on average, the interest rate among Kenyan commercial banks across the studied period hovered around 15% mark. The findings on inflationary pressure indicated an average value of 7.03%, with minimum, maximum and standard deviation values being 3.96%, 14.02% and 2.579. With respect to foreign exchange fluctuation, the study observed that a mean value of 1.01 with maximum, minimum and standard deviation values being -4.30, 13.03 and 5.057. On financial performance determined through ROA, the value of average stood at -0.0104 with minimum, maximum and standard deviation values -0.32, 0.04 and .062 respectively.

**4.4 Inferential Statistical Analysis****4.4.1 Correlation analysis**

Correlation analysis was conducted to predict the relationship between study variables as shown in Table 4.5.

**Table 4.5 Correlation Matrix**

		<b>Financial performance</b>	<b>Interest rate</b>	<b>Inflation</b>	<b>Foreign exchange rate fluctuations</b>
<b>Financial performance</b>	Pearson Correlation	1			

Interest rate	Pearson Correlation	.545	1		
Inflation	Pearson Correlation	-.703	.927	1	
Foreign exchange rate fluctuations	Pearson Correlation	.628	.832	.905	1

The results of Table 4.5 show that interest rates and financial success have a significant and favorable link ( $r=0.545$ ). The finding agrees with Kipng'etich (2011) who extended this knowledge by examining the extent that interest rates affected performance of banks in Kenya through secondary data running from 2006 to 2010 where it was discovered that a positive relationship existed within the Kenyan context. In a similar vein, Kibe (2003) discovered a favorable association between interest rate spread and the profitability of banking institutions in Kenya. The association between inflation and financial performance was demonstrated to be considerable and adverse ( $r=-0.703$ ). The finding agree with Athukorala and Tsai (2003) who found out that general increase in prices bore negative impact on amounts set aside by people in banks and interest rate bore positive effect. It was shown that foreign exchange rate fluctuations had strong and positive correlation with financial performance ( $r=0.628$ ). Wong, et al (2008) examined the extent to which foreign exchange exposure affected profitability reporting among commercial banks in China and foreign exchange exposure related positively with financial performance.

#### 4.4.2 Regression Analysis

Regression analysis was conducted to ascertain the effect of macroeconomic variables on financial performance. Table 4.6 is a breakdown of the model summary.

**Table 4.6: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.759 <sup>a</sup>	.577	.540	.10210

The findings from Table 4.6 indicate that on overall, 57.7% change in financial performance of Islamic banks is explained by macroeconomic variables. This suggests subsequent research should concentrate on factors other than macroeconomic variables that have an effect on economic growth.

#### 4.4.3 Analysis of Variance (ANOVA)

The ANOVA findings were determined and summarized as exhibited in Table 4.7.

**Table 4.7 ANOVA**

	<b>Sum of Squares</b>	<b>df</b>	<b>Mean Square</b>	<b>F</b>	<b>Sig.</b>
Regression	.497	3	.166	15.883	.000 <sup>b</sup>
Residual	.365	35	.010		
<b>Total</b>	<b>.862</b>	<b>38</b>			

The findings in Table 4.7 indicate that on overall, the regression model of the study was significant (F=15.883, p<0.05). The results on magnitude and beta coefficients were calculated and reported as given in Table 4.8.

**Table 4.8 Beta Coefficients and Significance**

	<b>Unstandardized Coefficients</b>		<b>Standardized Coefficients</b>	<b>t</b>	<b>Sig.</b>
	<b>B</b>	<b>Std. Error</b>	<b>Beta</b>		
(Constant)	.215	.209		1.032	.309
Interest rate	.051	.020	.761	2.596	.014
Inflation	-.079	.020	-1.476	-3.860	.000
Foreign exchange rate fluctuations	-.022	.007	-.074	3.143	.016

From Table 4.8, the following regression model is predicted between macroeconomic variables and financial performance:

$$Y=0.215+0.051X_1-0.079X_2-0.022X_3$$

Where:

$Y = \text{Financial Performance}$

$X_1 = \text{Interest Rate}$

$X_2 = \text{Inflation Rate}$

$X_3 = \text{Exchange Rate Fluctuation}$

According to the study's analysis of the beta coefficients, a higher interest rate of one unit would result in a rise in financial performance of 0.051 units. It was observed that a gain in financial performance of 0.079 units would result from a unit drop in inflation. The study found that improving the financial performance of Kenya's Islamic banks by reducing exchange rate fluctuations by one unit.

#### **4.5.1 Hypotheses Testing**

The first hypothesis  $H_01$  was that interest rate has statistically significant effect on the financial performance of Islamic banks in Kenya. From the findings, interest rate had p-value ( $p < 0.05$ ), hence it was significant. Thus, the study accepts hypothesis  $H_01$ . This conclusion is in alignment with that of Syed and Shaniqua (2011), who looked at five external economic indicators, comprising GDP, factory output rate, interest rate, inflation, and joblessness, that have an effect on the profitability of Islamic banks in Pakistan. It was demonstrated that only one of the five economic elements had a discernible impact on the profitability of Islamic banks: mortgage rate. The results, however, are at odds with those of Tariq and Mash (2016), who examined how interest rates affect bank deposits and discovered that they have no appreciable effect on the riskiness of Islamic bank deposits.

The second hypothesis of the study was  $H_02$  inflation rate has statistically significant effect the financial performance of Islamic banks in Kenya. The results were that inflation rate ( $p < 0.05$ ) and therefore it was significant. Hence, the study accepts hypothesis  $H_02$ . The finding agrees with Revell (1980)-(this study is too old to be reference to) who observed that an increase in price of commodities could affect profitability of banks through variations.

The last objective was H<sub>03</sub> which stated that exchange rate fluctuation has statistically significant effect the financial performance of Islamic banks in Kenya. The findings were that exchange rate fluctuation had  $p < 0.05$  and thus it was significant. Hence, the study accept hypothesis H<sub>03</sub>. The finding agree with Wong, et al (2008) who explored the extent to which foreign exchange exposure affected profitability reporting among commercial banks in China and foreign exchange exposure related significantly with financial performance.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

The chapter covers a summary of the analyzed results and conclusion. The recommendations and areas that require further research are also mentioned.

#### **5.2 Summary of the Study**

The goal of the study was to determine how interest rate, inflation, and exchange rate fluctuations affected the financial success of Islamic banks in Kenya. According to connection findings, interest rates and financial success showed a significant and favorable association. It was shown that inflation had strong and negative relationship with financial performance. It was demonstrated that changes in foreign exchange rates were strongly and favorably correlated with financial performance.

Regression analysis was used to predict macroeconomic variables on financial performance. From the results, it emerged that the variance in financial performance of nearly half of Islamic banks in Kenya is due to macroeconomic variables. It has been demonstrated that interest rates significantly affect how well Islamic commercial banks function financially. It has been demonstrated that inflation was a highly reliable indicator of the financial success of Islamic commercial banks. The study found that the financial performance of Islamic commercial banks was significantly impacted by exchange rate fluctuations.

### **5.3 Conclusion**

Based on correlation results, the study concludes that there was a high and favorable correlation between interest rate and financial performance. Inflation had a substantial and unfavorable association with financial performance. Foreign exchange rate fluctuations had strong and positive correlation with financial performance. The first hypothesis  $H_{01}$  was that interest rate has statistically significant effect on the financial performance of Islamic banks in Kenya. From the findings, the study accepts hypothesis  $H_{01}$ . The second hypothesis of the study was  $H_{02}$  inflation rate has statistically significant effect the financial performance of Islamic banks in Kenya. From the results, the study accepts hypothesis  $H_{02}$ . The last objective was  $H_{03}$  which stated that exchange rate fluctuation has statistically significant effect the financial performance of Islamic banks in Kenya. Based on regression results, the study accept hypothesis  $H_{03}$ .

### **5.4 Recommendations of the Study**

The policy makers working at the Central Bank of Kenya should leverage the existing monetary policies in order to manage inflationary pressure in the country. There is need for policy makers at CBK to review the existing monetary policies to counter interest rates which have been found to have significant implication on financial performance. It is recommended that CBK ought to formulate relevant policies and regulations that may contribute towards stabilization of exchange rates in the country. The senior managers working among Islamic banks in Kenya should leverage the macroeconomic variables in order to enhance the financial positions of their banks.

### **5.5 Areas for Further Research**

According to the analysis's findings, macroeconomic factors account for 57.7% of the change in Islamic banks' financial results. It implies that in addition to macroeconomic

issues, there are still additional elements that have an impact on the financial performance of these institutions, and these elements should be the main subject of future research. Further research could concentrate on Kenyan institutions other than Islamic banks.



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## APPENDICES

### Appendix I: Introduction Letter

Date: .....

To Executive Office

**NAIROBI.**

Dear Sir/ Madam,

#### **RE: CONSENT FOR PROVISION OF ACADEMIC DATA**

I am MBA student at Kenyatta University. I want to carry out a study titled “**macroeconomic variables and financial performance of Islamic banking in Kenya**”.

I respectfully ask for your help in providing me with specific data from your company so that this study can be completed. A schedule for gathering data is attached. Please include all necessary information. The study findings will be kept in strictest confidence and will solely be used for educational reasons. Just the summary outcomes will be publicly disclosed, and no specific references to your company will be disclosed.

I sincerely appreciate your backing and anticipate it.

Yours Sincerely

**Toel Ombaso Denis**

**Appendix II: Data Collection Schedule**

<b>Year</b>	<b>Annual Exchange rate</b>	<b>Annual interest rate</b>	<b>Annual inflation rate</b>	<b>Net profit after tax</b>	<b>Total revenue</b> <b>Total Assets</b>
2009					
2010					
2011					
2012					
2013					
2014					
2015					
2016					
2017					
2018					
2019					
2020					
2021					

### **Appendix III: List of Banks**

1. First community bank
2. Gulf African bank
3. Dubai Islamic Bank

**INCLUDE THE GRADUATE SCHOOL LETTER AND THE NACOSTI PERMIT  
AS PART OF THE APPENDICES**