

FACTORS AFFECTING ADOPTION OF ISLAMIC BANKING SERVICES AMONG BANKING CONSUMERS IN KENYA

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Abstract

Banking industry is becoming more competitive these days. As a result of this Commercial Banks in Kenya have to develop relevant products to meet the needs of the clients who are still not served by the Commercial Banks that offer Islamic banking products and other Commercial Banks that do not offer Shariah Compliant products. Therefore they have to provide the best avenues through which the untapped market may be reached. The fact that most Commercial Banks in Kenya survive in the market with very few products and almost with the same features may suggest a problem in product development. The project entailed the concept of new product development hence adoption of Islamic banking the objectives of the study were to determine the consumers' level of awareness on Islamic banking services. To determine customer attitude and behavior affecting adoption of Islamic banking service. To determine customer values and beliefs influencing the adoption of Islamic banking services. To determine the level of complexity in Islamic banking services. The results show values and beliefs were the biggest impediments towards adoptions of Islamic banking hence the study recommended for extensive user awareness of the products.

Keywords: conventional banking, islamic banking services, banking consumers

INTRODUCTION

The Commercial Banks and Mortgage Finance Institutions are licensed and regulated in pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued there under. They are the dominant players in the Kenyan

Banking system and closer attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with the laws and regulations (CBK, 2010).

As at 31st December 2010, the banking sector comprised of the Central Bank of Kenya, as the

regulatory authority, 44 banking institutions (43 commercial banks and 1 mortgage finance company), 2 representative offices of foreign banks, 5 Deposit-Taking Microfinance Institutions (DTMs) and 126 Forex Bureaus. 31 of the banking institutions are locally owned while 13 are foreign owned as shown in chart 1. The locally owned financial institutions comprise of 3 banks with public shareholding, 27 privately owned commercial banks, 1 mortgage finance company (MFC) while 5 DTMs and 126 forex bureaus are privately owned. The foreign owned financial institutions comprise of 9 locally incorporated foreign banks and 4 branches of foreign incorporated banks (CBK, 2010).

Overview of Islamic Banking

The emergence of Islamic banking system has created a new dimension to the current economic models (Fazlan et al., 2007). Widely known as Islamic banks, these interest-free institutions are organized financial intermediaries, which operate in accordance with Islamic law (Shariah Law) (Iqbal & Mirakhor, 2007; Khabir & Lewis, 2007). The term “Islamic Banking” is defined as the conduct of banking operations in consonance with Islamic teachings (Mirakhor, 2000; Haque et al., 2007). The main principles of Islamic banking activities comprise of prohibition of interest (riba) in all forms of transactions undertaking business and trade activities, based on, fair and legitimate profit (Mirakhor, 2000; Haque *et al.*, 2007). It is one of the most rapidly growing segments of the global finance industry, at an estimated growth of 15-20 percent per annum (Haque et al., 2007). Starting with Dubai Islamic Bank in 1975, the number of Islamic financial institutions worldwide now exceeds 300 located in 75 countries (El-Qorchi, 2005). Islamic banking services provide indirect competition to the services offered by conventional banks.

The Islamic banking system is gaining recognition worldwide. Many international conventional banks have started to open branches which operate in

accordance with Shariah principles. The Islamic banking system is expected to face strong competition not only from the Islamic banks but also from well established conventional banks that offer Islamic services (Naser and Moutinho, 1997). Although the Islamic banking system is different from the conventional banking system, there are some similarities between the two. For instance, an Islamic bank conducts its activities in accordance to Shariah principles that strictly prohibit any payment or receipt of interest. However, the Islamic banks can also offer services which are similar to those offered by conventional banks. When competition intensifies and banks start to offer similar services, customer’s satisfaction can influence the performance of an Islamic bank and determine its competitiveness and success (Naser, *et al.*, 1999).

The most important difference of Islamic banking from conventional banking is the prohibition of interest or usury (riba) in all forms of transaction, and promoting profit and loss sharing (PLS) as an alternative to Riba. Riba originally Meant “‘increase and growth’ as defined in the Quran. Increase means the increase over capital or nominal amount, the increase being either large or small. According to Islamic law, Riba technically refers to the premium that must be paid by the borrower to the lender along with principal amount as a condition for an extension in its maturity (Zaheed, *et al.*, 1994). The main sources of Shariah are the Holy Quran, Hadith, Sunna, Ijma, Qiyas and Ijtihad.

Principles of Islamic finance

The prohibition of Riba (interest or usury) and the removal of debt-based financing; second is Gharar which is a type of trading that is also prohibited in Islam which according to El Gamal (2001), means “trading in risk”. Gharar occurs when the purchaser does not know what has been bought and the seller does not know what has been sold. In other words, trading should be clear by stating in a contract the existing actual object(s) to be sold, with a price and

time to eliminate confusion and uncertainty between the buyers and the sellers.

Thirdly, Maysir, which is speculation, betting, gambling or taking heavy chances. Maysir is forbidden in Islam because it contains ambiguity and does not guarantee returns for beaters. Risk sharing where the provider of financial funds and the entrepreneur share business risk in return for a pre-determined share of profit and losses; desirability of materiality, a financial transaction that is a direct or indirect link to a real economic transaction; and the Consideration of justice, where a financial transaction should not lead to the exploitation of any party to the transaction. The above prohibitions and recommendations manifest themselves as the following commercial products and services offered by Islamic financial institutions:

Mudharabah (Capital financing): A lending contract and has two forms: one tier and two-tier. Both forms involve two parties: one providing labour (borrower) and the other providing capital (bank) at a predetermined share of risk and return (Hassan & Zaher, 2001). The two-tier Mudarabah works as a joint stock company, whereby the bank, with shareholders, invests in the fund for the purpose of lending it out to entrepreneurs. The rate of return is agreed on after expenses have been deducted. On the other hand, the one-tier Mudarabah is a contract between the bank and the money borrower, to provide capital for a specific project. The difference between the two-tier and one-tier system, is that the one-tier Mudarabah only includes the bank and an investor. However, in a two-tier system, there is the bank, an investor and a money borrower and this works as a stock company.

Musharakah (Partnerships): Musharakah, similar to Mudarabah, is a financial contract between two or many parties to establish a commercial enterprise based on capital and labour contribute. The profit and loss is shared at an agreed proportion according to amount of contribution (Hassan and Zaher,

2001). For example, if an entrepreneur had fifty percent of the capital for an investment in project X but needs more capital to continue, the bank then may fund the other fifty percent with the agreement of sharing profit and loss at a predetermined rate of return.

Murabaha (Cost plus profit): refers to a sale of a good or property with an agreed profit against a deferred or a lump sum payment. There are two contracts in Murabahah: the first contract is between the client and the bank, whereas the second contract is between the bank and supplier. The client (purchaser) orders a certain commodity through the bank, the bank then buys the commodity from the supplier and sells it to the client with specified profit whereby the client can make a lump sum or a deferred payment to the bank.

Ijara (leasing) or a lease ending in a purchase. The leasing purchase is another technique adopted by Islamic banks in financing equipments and instruments for customers. This system is almost similar to the leasing activity provided by the conventional banking. Leasing is a contract between the bank and the customer to use particular assets. In this case the bank becomes the lessor and the customer the lessee who wants to use the assets and pays rent (Zineldin, 1990). The leasing agreement is based on profit sharing in which the bank buy the movable or immovable property and lease it to one of its client for an agreed sum by installments and for a limited period of time into a savings account held with the same bank. The contract is called 'ijara-wa-iqtina' (leasing purchase), when the ownership of the assets is transferred to the clients after the completion of the leasing contract.

Quard E Hassan (Interest free loans): Quard E Hassan means an interest-free loan given by the Islamic bank to the needy people in the society. The practice of dealing with this sort of investment differs from bank to bank. It is normally given to

needy students, small producers, farmers, entrepreneurs and economically deprived segments of the society who are not in a position to obtain loan. The main aim of the loan is to help needy people to be self-sufficient and to raise their income and standards of living (Ahmad, 1993; Kazarian, 1991; Zineldin, 1990).

Aitab (Hire Purchase): According to Al-Zuhayli (2002), Aitab refers to the owning the benefit of certain assets for a specific period of time, by paying an agreed sums of rental, with an agreement that the owner will transfer the rented asset to the hirer at the end of the agreed period or during the period, provided all rental payments or installments have been made in entirety. The transfer of ownership is affected by a new and independent contract, either by giving the asset as a gift, or selling it at an agreed price.

Al-Wadiah (Savings Account): Al- Wadiah means 'Trusteeship', in this case banks act as trustee for its customers. The bank is given the authority by depositors to use the funds at the banks own risk. This type of deposit is almost similar to a current Account" or demand deposit' except that the bank guarantees its customers the full return of the deposited fund with any profit. The profit or loss from the use of such deposit is shared between the banks and the depositors at an agreed ratio between both parties (Ahmed, Rahman, & Ahmed, 2006).

Al-Wadiah (current Accounts): Islamic banks accept deposits from customers on current accounts as conventional banks do. Banks use such funds with the permission of thr customers and at the sole risk of the banks, and hence, the depositors of this type of account are not entitled to any share in the profit earned by the bank (Ahmed, *et al.*, 2006; Ali & Sarker, 1996).

All the contracts presented are interest-free and represent the Islamic bank as an investment manager or as an investment deposit. Moreover, if borrowers default for serious reasons, they are not obligated to repay borrowed money based on profit

and risk sharing. In addition, these lending contracts are detailed, with the timing of payments and the responsibilities of both parties clearly stated, to prevent confusion and misunderstanding. These contracts lead to a more stable financial system that has a favorable impact on both Islamic banks and overall economic growth according (Iqbal and Molyneux, 2005).

On the other hand, every Islamic bank has a Shariah board that regulates internal operations to maintain consistency with Islamic rules and principles. The board has scholars that approve or disapprove banking issues (Dar and Presley, 2000). For example, issues regarding lending contracts and their details need to be followed closely to ensure that both parties are treated fairly.

STATEMENT OF THE PROBLEM

It is nearly half a decade now, ever since Islamic banking was launched in Kenya, back in 2007, when Gulf African Bank (GAB) and First Community Bank first commenced its operations (CBK, 2009). And as at December, 2010 the two banks collectively only commanded a market share of 0.9% of the banking sector with gross assets of Ksh.16.54bn, net loans and advances of Ksh.9.23bn and deposits of Ksh.13.76bn. The two banks had 58,101 deposit accounts and 2,609 loan accounts as at the end of December 2010 (CBK, 2010).

This implies that although the number of Kenyan banking consumers using Islamic banking services is growing; a majority still have not adopted the system. This paper will therefore review some of the factor that affects the adoption of Islamic Banking services in Kenya.

SPECIFIC OBJECTIVE

- i. To determine the consumers' level of awareness on Islamic banking services.
- ii. To determine customer attitude and behavior affecting adoption of Islamic banking service.

- iii. To determine customer values and beliefs influencing the adoption of Islamic banking services.
- iv. To determine the level of complexity in Islamic banking services.

RESEARCH METHODOLOGY

The study adopted a descriptive survey research design. The study was carried out in Nairobi East district, specifically Pumwani division. The division is subdivided into five locations: Bahati, Eastleigh North, Eastleigh South, Kamukunji and Pumwani. Within Eastleigh, there are three sections and these are Section I from Juja Road, Section II, where most of the activities of Eastleigh takes place, and finally, Section III towards Moi Air base. This study was done in section II because of the fact that the two banks are situated in this area.

The target population was all the account holders of the two banks which is approximately 65,000 and since the population is large, the researcher used an equivalent proportion to yield a representative sample. A sample size of 196 will be used to carry out the study. For this study, a self-administered questionnaire was designed for the banking consumers. Open ended and Closed-ended questions was used to provide a list of possible answers which also include perceptual measures that was be rated on five & three-point’s likert scale. Data collected will be analyzed using statistical package for social sciences (SPSS).

RESEARCH FINDINGS AND DISCUSSION

Analysis on the Awareness of Islamic Banking

Various factors including awareness affect adoption of Islamic banking and the researcher sought to find out the level of awareness, sources of information on Islamic Banking, the number of respondents using Islamic Banking services, the various services used and also the duration of use.

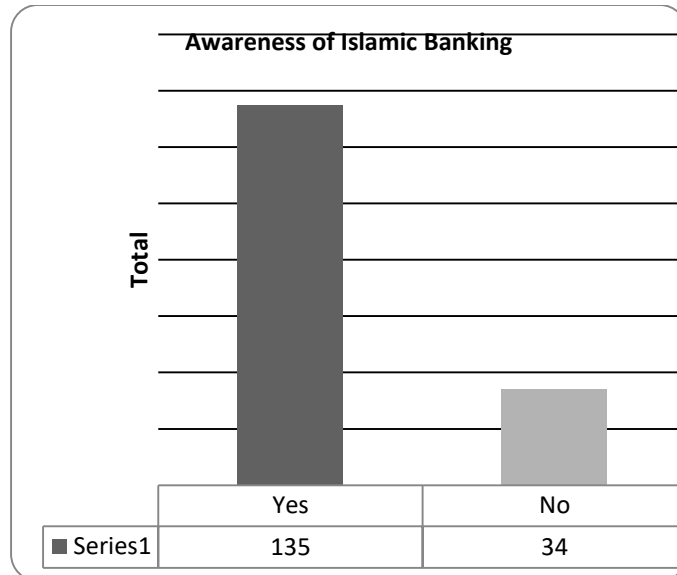


Fig 1: Awareness of Islamic Banking

Most of the respondents, 135 indicated that they were aware of Islamic Banking, while 34 indicated not being aware. This indicates that even though adoption rate was low, most of the respondents were still aware of the existence of Islamic Banking.

Analysis of the respondent’s awareness on the availability of Islamic banking services

Table 1

Islamic Banking Services	Frequency	Percentage
Al-WADIAH (Savings a/c)	54	64.3%
Al-WADIAH (Current a/c)	74	88%
MUDHARABAH (Capital financing)	10	11.9%
MUSHARAKAH (Partnership)	0.0	0.0
MURABAHA (Cost Plus Profit)	12	14.3%
IJARA (Leasing)	8	9.5%
QUARD HASAN (Interest free Loan)	34.0	40.5%
AITAB (Hire Purchase)	0.0	0.0
Others	0.0	0.0

On the aspect of awareness of Islamic banking services, 64.3 percent of the respondents are aware

of Al-Wadiah savings account, 88 percent of the respondents are aware of Al-Wadiah current account while 40.5 percent of the respondents are aware of Quard Hasan (Interest free loan). However, the awareness for the other five Islamic banking products is below 20 %. Respondents are least aware of Ijara (Leasing) because only 9.5 percent are aware of this banking product.

This indicate majority of the Islamic banking products are not commonly known to the respondents even though a higher percentage of the respondents were aware of the existence of Islamic banking. This also implies that a majority of the respondents are aware of the fundamental concepts of the Islamic banking systems but are not aware of the specific Islamic financial services like Musharakah, Murabaha, Ijara, Aitab and Quard Hasan.

Analysis on the Sources of Information about Islamic Banking

Table 2 Sources of information about Islamic Banking

Source of information about Islamic Banking	Frequency	Percentage
Friends and Family	70.0	51.9%
Media	35.0	25.9%
Islamic Banking Promotions	30.0	22.2%
Total	135.0	100%

Out of the three sources of information listed, friends and families stood out to be the major source of information at 51.9%, the media had 25.9% while Islamic Banking promotion was least with 22.2%. This indicates that the level of advertisement by the banks is still very low and friends and families being the highest source could be misinterpreting information on the various services or not giving out all the information on the various services.

Analysis of the Respondents with Islamic Banking Services

Table 3 Respondents with Islamic Banking services

Islamic Banking Services	Frequency	Percentage
Yes	84.0	62.2%
No	51.0	37.8%
Total	135	100

Out the 135 respondents who were aware of the Islamic Banking services, only 84 have adopted Islamic banking services while 51 have not adopted yet. This indicates that even though most of the respondents are aware, quite a number have not adopted yet.

Analysis of the number of customers using various Islamic Banking services

Table 4 Number of customers using various Banking services

Islamic Banking Services	Frequency	Percentage
Al-WADIAH (Savings a/c)	44	52.4%
Al-WADIAH (Current a/c)	64	76.2%
MUDHARABAH (Capital financing)	3	3.6%
MUSHARAKAH (Partnership)	0.0	0.0
MURABAHA (Cost Plus Profit)	8	9.5%
IJARA (Leasing)	0.0	0.0
QUARD HASAN (Interest free Loan)	24.0	28.6%
AITAB (Hire Purchase)	0.0	0.0
Others	0.0	0.0

From the findings, the result shows that Al-Wadiah current account (76.2 percent) is the most popular and widely accepted compared to the other products. The second popular account is Al-Wadiah savings account with 52.4 percent. Quard Hasan (Interest free loan) and Murabaha (cost plus profit) is also being adopted and used by the consumers. Only 3.6 percent of respondents have Mudharabah

(capital financing). None of the respondents subscribed to the other services; MUSHARAKAH; IJARA (Leasing) and; AITAB (Hire Purchase). This indicates that Al-Wadiah current and savings account are the most popular services and this could also imply that the services had easy and simple process compared to the other services.

Duration of Service use

Table 5 Duration of Service use

Duration of service use	Frequency	Percentage
Less than 1 year	40.0	47.7%
Between 1-2 Years	28.0	33.3%
Between 2-3 Years	16.0	19%
Between 3-5 Years	0.0	0.0
Total	84	100.0

Majority of the respondents (40) indicated that they have been using the services for less than 1 year; 28 respondents between 1-2 Years and 16 respondents between 2-3 years. This indicates that majority of the

Service satisfaction level

Table 6 Service satisfaction level

Level of satisfaction	Frequency	Percentage
Highly Satisfied	30.0	35.7%
Satisfied	54.0	64.3%
Not Satisfied	0.0	0.0
Total	84	100.0

Majority of the respondents, 54 indicated that they were just satisfied with the services while 30 indicated that they were highly satisfied. This indicates that there are improvements need to be done on service delivery so as to fully satisfy all the customers and attract new ones as well.

Analysis of Islamic Values Influencing or likely to influence adoption of Islamic Banking

Some of the Islamic Values such conformity to Islamic doctrines, fairness of service pricing and lack of exploitation may have a positive or a negative impact on adoption of Islamic Banking. This study sought to find out which of the factors had or is likely to have a great influence on adoption.

Table 7 Islamic Values influencing adoption

Islamic Values	Frequency	Percentage
Conformity to Islamic doctrines	81	59.5%
Fairness of service pricing	17.0	12.5%
Lack of exploitation	37.0	27%
Others	0.0	0.0
Total	135.0	100.0

Majority of the respondents, 81 strongly agreed that, conformity to Islamic doctrines influenced or is likely to influence their adoption therefore positively influencing adoption. 17 of the respondents indicated fairness of service pricing and 37 indicated that lack of exploitation. Therefore, conformity to Islamic doctrines was a significant factor influencing adoption because of the believe that Islamic Banking offers services to only customers of Islamic Faith which is not the case according to the banks.

Analysis of Attitude factors influencing or likely to influence adoption

Table 8 Attitude factors influencing or likely to influence adoption

Attitude factors influencing adoption	Frequency Percentage	
	N	%
Reference from friends and family	0.0	0.0
Past banking experience	55	41%
Attitude towards Islam	80	59%
Perceived ease of use	0.0	0.0
Others	0.0	0.0

The majority of the respondent, 59% indicated that, attitude towards Islam influenced or is likely to

influence their adoption of Islamic Banking to a greater extent and 41% of the respondents had past banking experience influencing their adoption. This implies that most respondents still perceive Islamic banking to be for those who ascribe to Islamic faith.

Complexity of the structures

Complexity is the degree to which an innovation is perceived as difficult to understand and use (Rogers, 2003). Any idea could be classified on the complexity-simplicity continuum. Some innovations are clearly understood by potential adopters whereas others are not. Therefore, complexity has been measured in relation to perceptions about the purpose of the respective innovation, its intended use and the ease with which it can be used.

Table 9 Complexity of the structures

Islamic Banking has structures	Frequency	Percentage
Yes	50	37.0%
No	55	40.7%
No idea	30	22.3%
Total	135	100

Majority of the respondents, 65 denied the fact that Islamic Banking services have a complex structure, while 40 agreed that that some of the services indeed do have complex structures and 30 of the respondent had no idea about the complexity. This implies that there is a negative relationship between complexity and adoption rate and complexity is a significant factor influencing adoption.

Analysis of the extent to which complexity has influenced or likely to influence adoption

Table 10 Extent to which complexity has influenced or likely to influence adoption

Extent of complexity	Frequency	Percentage
Great extent	20.0	50%
Moderate extent	10.0	25%
No influence	10.0	25%
Total	40.0	100

Out of the respondents who felt Islamic Banking services to have a complex structure, 20 indicated that complexity has influenced their adoption to a great extent, 10 indicated that complexity had a moderate influence on their adoption while 10 indicated that it had no influence on adoption.

Analysis of the respondents pattern in Islamic Banking services in future

Table 11 Respondents who Intend to Use Islamic Banking services in future

Intention of a/c use in the future	Frequency	Percentage
Yes	30	58.8%
No	21	41.2%
Total	51	100.0

Out of the 51 respondents who were aware of the Islamic Banking services but have not adopted, 30 had intentions to use the service in future while 21 did not show any commitment. The findings imply that still a big percentage of the respondents (41.2%) have no intention to open these accounts in the near future.

Analysis of the reasons for not using the services in the near future

Table 12

Reasons of not intending to use services in the near future	Frequency	Percentage
Religion	16	35.5%
Satisfied with the conventional banking services	14	31.1%
Service complex to understand	15	33.4%

Out of the respondents who had no intentions of using the services, 16 indicated that its because of religion while 14 indicated that they are satisfied with the conventional banking services while 15 felt that the services were complex to understand. Note that all who use the service use it because they conform to Islamic doctrines.

Analysis from respondents who were not aware of Islamic Banking

Table 13 Conventional Banking services operated

Services operated	Frequency	Percentage
Current Account(s)	35	40.7%
Savings Account(s)	26	30.3%
Loan Accounts(s)	25	29%
Others	0.0	0.0

All of the 35 respondents had current account, 26 had various savings account while 25 of them had loan accounts.

Analysis of the duration of use

Table 14 Duration of operating the account

Time of a/cs operated	Frequency	Percentage
Less than 1 year	-	-
Between 1-2 Years	-	-
Between 2-3 Years	-	-
Between 3-5 Years	10	28.5%
5 and above	25	71.5%

Majority of the respondents 25 indicated that they operated the accounts for 5 years and above while 10 of the respondents indicated that they operated the accounts between 3-5 years.

Analysis of how the respondents knew about the services

Table 15 Knowledge of the existence of those services

Awareness of the service	In agreement	
	Frequency	Percentage
Friends and family	5	14.3%
Media	10	28.6%
Bank promotions & Advertisements	20	57.1%

Out of the 35 respondents, 20 indicated that they knew about the various banking services through Bank promotions & Advertisements; 10 indicated media as the source of the information about the services while only 5 indicated friends and family. This indicates that bank promotions and Advertisements play a major role in creating awareness among customers.

SUMMARY

This This study is aimed at determining the adoption of Islamic banking in Kenya. The responsibility to develop new products is normally housed within the marketing department whenever that department exists in a bank. The researcher sought to establish whether banks have marketing departments. It emerged that most banks had a marketing department.

Use of consultants was found to be rampant in banks indicating some level of incapacity as far as product development is concerned. The giant share being 32% in product development concept and screenings, 32% in prototype / product development, 12% in test marketing and 8% in commercialization, 8% consulted in idea generation and 8% in business analysis.

The most commonly used strategy as evident is the better and marketing strategy which constituted of

32% each, defensive strategy 24% and imitative strategy 12%

The steps that were used in new product development process differed from bank to bank, it includes: market intelligence, product design, approval, launch and test marketing, business generation and drafting within a business unit, consultations and discussions with all the stakeholders, product paper development highlighting the business case for the product, its salient features, target market and marketing strategy, internal capacity to push through the product roll out budget and expected results, signing of the paper by all stakeholders and risk department and finally the approval of the paper by senior management and thereafter the board.

The reasons why banks develop new products is due to the constant change in the environment 36%, drive to develop new products 16%, competition among other commercial banks 28% and attract new clients 20%

Different banks encounter different challenges. These are: limited internal capacities in terms of knowledge, structure and financing, a significant portion of the population is still unbanked and this affects uptake of new products, upstaging competitors who can launch a similar product just before release of a product just before release particularly in view of high staff mobility in the banking industry and ensuring that all products developed are in Shariah compliant.

Limitation of the study

Time constraints did not allow the researcher to give the respondents as much time as they would have wished to enable them complete the questionnaires at their own pace.

Some respondents declined to participate in the study citing confidentiality of the information involved and being too busy to have time to fill the questionnaire due to heavy workloads at their work place.

The study was based on all commercial banks in Kenya located all over the country hence a lot of time and resources was needed to undertake the study.

Recommendations

Based on the findings of the study, the researcher would wish to recommend that banks should minimize their dependency on the use of consultants in new product development because it shows some level of incapacity as far as product development is concerned. The giant share being 32% in product development concept and screenings, 32% in prototype / product development, 12% in test marketing and 8% in commercialization, 8% consulted in idea generation and 8% in business analysis. A legislative framework should be put in place to enhance the regulation of the industry.

This means that both the Central Bank of Kenya as well as Banking Act should be amended to incorporate the Shariah products.

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