International Journal of Research Publication and Reviews, Vol 4, no 10, pp 2156-2162 October 2023

International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

The Impact of Leadership Style on the Financial Performance of Commercial Banks in Kenya: A Case of Islamic Banks

Marjan Usama Ismael

The School of Business Administration and Management Of Mount Kenya University

1.1 Background to the Study

Financial performance is used as a general measure of an organization's overall financial health over a given period and improving on financial performance is the ultimate goal of any organization and measures (Nuber, Velte & Hörisch, 2020). Financial performance of a bank is considered very important and necessary mechanism for the survival of the financial sector of any economy of the world. The soundness of a banking system is the most important pillar for economic development (Ongore & Kusa, 2013). Hence, banks are the most involved financial institutions in the financing of the economy. Banks mainly due to their intermediation function, play a significant role in the financial sector of any country in the world (Azolibe, 2022). In the past two decades, the banking sector world over has undergone significant changes in its operating environment, especially in terms of its structure and financial performance (World Bank, 2022).

Evaluating the financial performance of a commercial bank is important in measuring its financial health, earnings capacity, and potential for expansion, all of which are vital for investors, regulators, and depositors alike (Baselga-Pascual & Vähämaa, 2021). Through financial analysis, it is possible to identify potential vulnerabilities in the operations of the bank. In determining financial performance of a bank, several ratios are used such as Return on Equity, Return on Asset, and net interest margin, among others (Sari & Endri, 2019; Sunaryo, 2020). Return on Equity is an important ratio that is used to determine the financial performance of a bank (Choiriyah, Fatimah, Agustina & Ulfa, 2020). These measures can be classified as investment performance measures and profit performance measures where profit performance includes the profits measured in monetary terms that come from the difference between the revenues and expense (Meher & Zewudu, 2020). In view of this background, this study will measure financial performance using return on assets (ROA).

The study of leadership styles has gained significant attention in recent years, reflecting the evolving complexities of the business environment, social changes, and technological advancements. Researchers are increasingly focusing on identifying which leadership styles and approaches are most effective in various contexts, such as diverse workplaces, remote work settings, and rapidly changing industries (Khan, Ismail, Hussain & Alghazali, 2020; Elkhwesky, Salem, Ramkissoon & Castañeda-García, 2022).

Studies have shown that the style of leadership adopted can have profound implications for the success of an organization or team (Fischer & Sitkin, 2023; Mulyana, Ridaryanthi, Faridah, Umarella & Endri, 2022). Knowing when to apply different styles enhances communication, productivity, and employee satisfaction. Thus, understanding leadership styles and approaches is crucial for anyone in a leadership role or aspiring to become a leader (Asbari, Santoso & Prasetya, 2020).

Purwanto, Bernarto, Asbari, Wijayanti and Hyun (2020) explains that leadership styles and approaches vary widely, and the effectiveness of each depends on the situation and the team being led. The importance of understanding leadership styles cannot be overstated because the effectiveness of a team often hinges on the approach taken by its leader. For instance, autocratic leadership is likely to be effective in crisis situations where quick decisions are needed, but it is also has the potential to stifle creativity and morale in a more stable, collaborative environment (Tedla, 2022). In addition, democratic leadership fosters innovation and employee satisfaction but may be too time-consuming in emergency situations (Goleman, 2020). Leaders often need to adapt their style to the maturity and capabilities of their team members. It is possible that a new team with less experience can benefit from a more directive approach, whereas a highly experienced team might excel with a more delegative or laissez-faire style.

Leadership is considered important for the success of an organization, as it helps navigate global business challenges. Hosseini, Hajipour, Kaffashpoor and Darikandeh (2020) argue that the presence or absence of effective leadership has the ability to make or break an organization. According to Mills (2023), without leadership, organizations risk stagnation and internal conflict due to divergent views and solutions among team members. Successful leadership inspires enthusiasm and commitment, enhancing organization performance. The style of leadership affects performance since performance cannot be achieved in the absence of a leadership that can adapt to the changes and challenges of the environment. Therefore if an organization wants to improve its performance, it is the leadership style that should be analyzed and adapted to new requirements (Popa, 2012).

Leaders bring clarity and direction, aligning staff towards common organizational goals. Leadership involves a high level of commitment to the vision and the team, as well as the assumption of significant responsibility and risk.

Etemesi (2021) adds that good leadership requires active listening and preparedness for unexpected challenges. Charles Keating (2021) emphasizes that effective leadership varies in approach sometimes being directive, other times encouraging, or even reorienting the group based on needs. Therefore, leadership serves as the linchpin in meeting a bank's goals, reducing ambiguity, and effectively responding to both expected and unexpected challenges to enhance financial performance.

Research has demonstrated that leadership style in banks such as Islamic banks serves as a cornerstone for achieving strong financial performance while adhering to the unique ethical and operational challenges posed by Shariah law. Just like risk management practices, leadership styles need to be meticulously designed and executed for the smooth operation and financial health of Islamic banks. A strong leadership style aids in achieving financial stability, solvency, and compliance with regulatory standards, particularly given the unique challenges that Islamic banks face due to their adherence to Shariah principles (Mobarak, 2020; Al-Amri & Hossain, 2020). An effective leader is vital for guiding the bank in ways that align with its principles, prohibition against interest, and investment in ethically permissible businesses. These unique operational frameworks of Islamic banks require a leadership style that is not only adaptable but also deeply understanding of Islamic finance principles.

In the United Kingdom, the impact of leadership styles on the performance of commercial banks has been a topic of interest, especially in the wake of financial regulations and uncertainties like Brexit (Jallow, Masazing & Basit, 2017). UK banks such as Barclays and HSBC have been increasingly focusing on transformational and adaptive leadership styles to navigate through complex regulatory landscapes and market volatility. The emphasis is often on long-term vision, ethical banking practices, and innovation to stay competitive, reflecting an integrated approach to leadership that aligns with the complexities of modern banking in the UK (Jallow, Masazing & Basit, 2017). Malaysia, banks such as Maybank and CIMB Group have been adopting a more participative and transformational leadership approach, by engaging employees in decision-making processes and fostering a culture of continuous learning and improvement (Saleh, Mehmood, Khan & Jan, 2022). This style is particularly effective in nurturing innovation, which is crucial for banks in emerging markets like Malaysia where competition is fierce, and there is a constant need to differentiate services.

In South Africa, a study by Smit et al. (2021) found that transformational leadership styles, when combined with effective talent management practices, had a positive influence on talent engagement and organizational performance. The study indicated that a transformational leadership style had varying impacts depending on other influencing factors like organizational practices. Interestingly, the study also revealed that transformational leadership by itself did not significantly impact work engagement. A few more studies in Tanzania affirm the position that leadership style affects organizational performance. For instance, Mgeni and Nayak (2016) found a major and moderate positive correlation between transactional leadership style and small business enterprises' performance. On the other hand, Machumu and Kaitila (2014) found that leadership style is an important variable in motivating teachers in Tanzania in their careers. The authors noted that democratic leadership style enhances great satisfaction of teachers in primary schools, while *laissez-faire* and autocratic leadership styles were undesirable.

In Kenya, the poor financial performance of some commercial Islamic banks have prompted a focus on the role of leadership styles as a lever for improving financial outcomes (Ongongo & Mang'ana, 2022). Faced with a competitive landscape intensified by new market entrants and technological innovations, banks are under pressure to revisit their leadership strategies (Ichsan, Nasution, Sinaga & Marwan, 2021). Further complexity arises from the Central Bank of Kenya's new regulations, such as increased capital requirements, compelling banks to adapt their leadership approaches for compliance and optimized performance (Wanyoike, Mugambi & Joshua, 2022). In this challenging economic environment, effective leadership styles that foster innovation and employee engagement are seen as key to streamlining operations and improving financial standing. Despite the importance of this topic, there is a notable gap in research specifically exploring the link between leadership styles and the financial performance of commercial Islamic banks in Kenya, highlighting the need for this study.

1.2 Statement of the Problem

The fully fledged Islamic banks in Kenya have suffered poor financial performance over the last decade as they adhere to Sharia Law that does not allow them to charge interests instead, they charge profits (Kamotho, 2022; Njoka, 2022). Since their registration, three fully fledged Islamic Banks in Kenya have posted below average financial performance compared to conventional banks in terms of Return on Assets (ROA).

For instance, Dubai Islamic Bank recorded Return on Assets (ROA) of -32.15%, - 16.6%, -8.8% and -5.22% for the periods 2017, 2018, 2019 and 2020 respectively (CBK, 2021). For Gulf African Bank, ROA of 0.6% and 0.9% were recorded in 2019 and 2018 respectively (CBK, 2022).

On the other hand, data on Non-Performing loans indicate that as at July 2019, the total non-performing loans (NPLs) increased to Ksh. 336.4 billion from Kshs. 308.8 billion in the same period in 2018. This trend if not reversed reduce the little interest income generated by banks.

As Islamic banking continues to grow in Kenya, it is crucial to understand the effectiveness of risk management strategies employed by these institutions. According to a study by Abbas *et al.* (2019), leadership style play a vital role in ensuring the stability and sustainability of Islamic banks. However, the specific impact of these leadership styles on the financial performance of Islamic banks in Kenya remains largely unexplored. Islamic banks are faced with challenges of managing risk (Shabbir & Rehman, 2019). These challenges include the lack of appropriate Islamic liquidity management instruments and the limited availability of Shari'ah-compliant short-term investment opportunities which hinders the ability of Islamic banks to effectively manage risk and potentially impacting their financial performance negatively.

Existing studies on the impact of leadership styles on the financial performance of commercial banks has yielded mixed results, with some studies indicating significant effects while others show insignificant or even negative impacts (Maina & Waithaka, 2018; Kasuni, Mandere & Njeru, 2022; Walela & Okwemba, 2023). For example, studies such as those by Frei (2023) have reported improved financial performance in banks in the USA and Hong

Kong due to leadership styles. However, studies like the one by Mwangi, Awuor and Kithae (2022) have found the impact of leadership style to be positive but insignificant. These findings have also presented methodological or contextual gaps, as they focus on either non-bank financial institutions or are limited to small regions within Kenya.

There is also evidence suggesting that leadership style can have a negative impact on financial performance in both banking and other sectors (Bătae, Dragomir & Feleagă, 2021; Cindiyasari, Junarsin, Nani & Septiani, 2022; Tian, 2017). However, these studies were not conducted in a Kenyan context much less in the context of Islamic banks, leaving questions about their applicability to Kenyan Islamic commercial banks.

These inconsistencies in the findings, along with the conceptual, methodological and contextual gaps in the existing research, highlight the need for further research into the relationship between leadership style and financial performance of Islamic commercial banks in Kenya.

This study therefore seeks to address the identified gaps by analyzing the impact of leadership styles on the financial performance of commercial banks in Kenya with focus on Islamic banks.

1.3 Objectives of the Study

The study is guided by a general objective and specific objectives captured hereunder.

1.3.1 General Objective

The general objective of the study is to determine the impact of leadership styles on the financial performance of commercial banks in Kenya with focus on Islamic banks.

1.3.2 Specific Objectives

The specific objectives of the study are:

i. To examine the impact of transactional leadership style on the financial performance of Islamic commercial banks in Kenya.

ii. To determine the impact of transformational leadership style on the financial performance of Islamic commercial banks in Kenya.

iii. To analyze the impact of servant leadership style on the financial performance of Islamic commercial banks in Kenya.

iv. To assess the impact of autocratic leadership style on the financial performance of Islamic commercial banks in Kenya.

v. To determine the moderating role of operating environment on the relationship between leadership styles and financial performance of Islamic commercial banks in Kenya.

1.4 Research Hypotheses

The study seeks to test the following null hypotheses:

H_{01}: Transactional leadership style does not significantly impact the financial performance of Islamic commercial banks in Kenya.

H_{02}: Transformational leadership style does not significantly impact the financial performance of Islamic commercial banks in Kenya.

H_{03}: Servant leadership style does not significantly impact the financial performance of Islamic commercial banks in Kenya.

H_{04}: Autocratic leadership style does not significantly impact the financial performance of Islamic commercial banks in Kenya.

H_{05}: Operating environment does not significantly moderate the relationship between leadership styles and financial performance of Islamic commercial banks in Kenya.

1.5 Significance of the Study

The findings of this study will be invaluable to multiple stakeholders. These stakeholders include the management of Islamic commercial banks in Kenya, policy makers like the Capital Market Authority (CMA) and the Central Bank of Kenya (CBK), as well as owners, shareholders, and future scholars. Management teams at Islamic commercial banks will use the findings of this study to evaluate and possibly reshape their leadership strategies for better financial performance. In addition, policy makers like the CBK and the Capital Market Authority will be able to use the outcome of this study to develop or refine regulations related to leadership styles and approaches in banking sector in Kenya especially those focusing on Islamic banks, which will most likely lead to a more robust and financially stable sector.

To the owners and shareholders of these banks, the findings of this study help them gain insight into how leadership styles impacts the profitability and stability of their investments. This will in turn influence their voting and decision-making in corporate governance. For academia and future researchers, the study will help to fill existing gaps in literature on the role of leadership styles in impacting financial performance within the banking sector, particularly in the Kenyan context. Moreover, this study will add to the broader understanding of how leadership impacts financial performance in competitive industries, equipping future researchers with a localized view from Kenya's banking sector. The study will contribute to both management and finance theories, providing a comprehensive view that could be beneficial for future research and policy formulation.

1.6 Literature Review

The literature of the study will be reviewed per objective. The review will be conducted to identify research gaps in the study. From the review, the study will identify conceptual, contextual and methodological gaps that it will seek to fill. These gaps will form the backbone of the study.

1.7 Theoretical Framework

The study will be guided by Transformational Leadership Theory, Contingency Theory of Leadership, Path-Goal Theory and Leader-Member Exchange Theory (LMX). Transformational Leadership Theory is useful for analyzing how inspirational leadership impacts employee performance and organizational outcomes, including financial performance (Alrowwad, Abualoush & Masa'deh, 2020). The Contingency Theory of Leadership offers a flexible approach to understanding how different situations can dictate the most effective leadership style, particularly useful for examining the moderating role of the operating environment (Shala, Prebreza & Ramosaj, 2021). Moreover, Path-Goal Theory suggests that the leader's job is to help followers in attaining their goals, and to provide the necessary direction and support to ensure that their goals are compatible with the organization's goals (House, 1971). It will be relevant in assessing how leadership styles align team objectives with financial goals. Finally, Leader-Member Exchange Theory (LMX) focuses on the two-way relationship between supervisors and subordinates, and how the quality of this relationship can affect various organizational outcomes, including financial performance (Liden, Sparrowe & Wayne, 1997).

1.8 Conceptual Framework

A conceptual framework is the illustrative presentation of variables, which determine how the independent variables and the dependent variables relate to each other (Mugenda & Mugenda, 2003). Figure 1 shows the conceptual framework that will be used by this study to show the relationship between the variables.

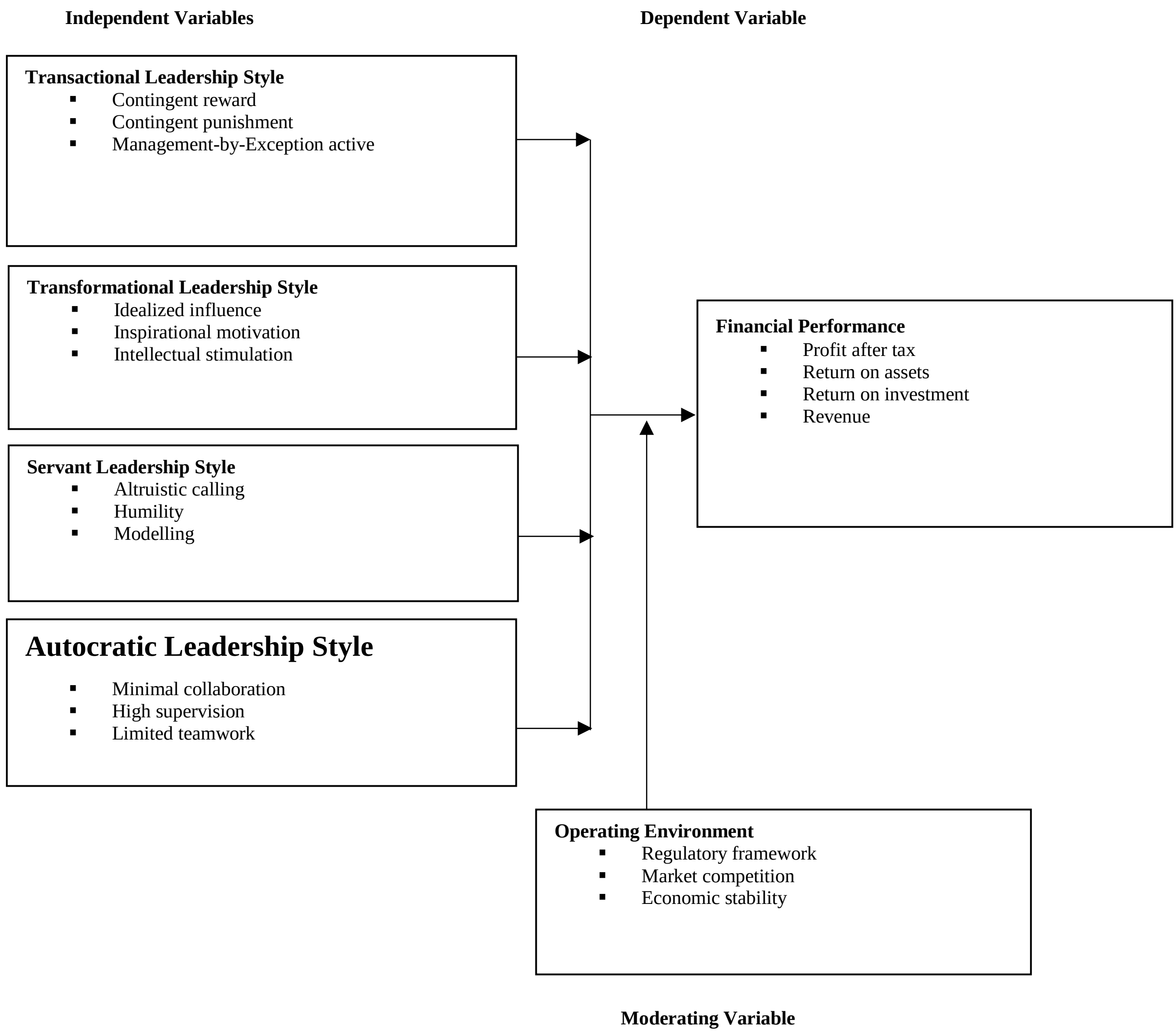

Figure 1: Conceptual Framework

1.9 Proposed Research Methodology

A research design is an approach for a study and the plan by which the strategy is to be carried out (Blumberg, Cooper & Schindler, 2014). It specifies the methods and procedures for the collection, measurement, and analysis of data. Creswell (2017) affirm that a research design is a basic plan that indicates an overview of the activities that are necessary to execute the research project. Kothari (2004) defines research design as a detailed plan on how the research will be conducted. This study will employ a descriptive research design.

The target population will comprise all the three Islamic banks in Kenya that are fully Shariah compliant as at 31st December, 2022. These are, Gulf African Bank, First Community Bank (Premier bank) and Dubai Islamic Bank. The units of observation will be top managements of these banks. Since the population is small, the study will adopt census approach to study all the Islamic commercial banks in Kenya. The study rely on primary data which will be collected using structured questionnaire. Data analysis will involve both descriptive statistics and inferential statistics using SPSS software. The study will use both simple and multiple linear regression models to show the relationship between leadership styles and financial performance. The findings will be presented using tables.

REFERENCES

Alrowwad, A. A., Abualoush, S. H., & Masa'deh, R. E. (2020). Innovation and intellectual capital as intermediary variables among transformational leadership, transactional leadership, and organizational performance. *Journal of Management Development*, *39*(2), 196-222.

Asbari, M., Santoso, P. B., & Prasetya, A. B. (2020). Elitical and antidemocratic transformational leadership critics: is it still relevant?(A literature study). *International Journal of Social, Policy and Law*, *1*(1), 12-16.

Baselga-Pascual, L., & Vähämaa, E. (2021). Female leadership and bank performance in Latin America. *Emerging Markets Review*, *48*, 100807.

Bătae, O. M., Dragomir, V. D., & Feleagă, L. (2021). The relationship between environmental, social, and financial performance in the banking sector: A European study. *Journal of Cleaner Production*, *290*, 125791.

Bernard Azolibe, C. (2022). Banking sector intermediation development and economic growth: Evidence from Nigeria. *Journal of African Business*, *23*(3), 757-774.

Choiriyah, C., Fatimah, F., Agustina, S., & Ulfa, U. (2020). The effect of return on assets, return on equity, net profit margin, earning per share, and operating profit margin on stock prices of banking companies in Indonesia Stock Exchange. *International Journal of Finance Research*, *1*(2), 103-123.

Cindiyasari, S. A., Junarsin, E., Nani, D. A., & Septiani, E. (2022). Does Intellectual Capital Affect Financial Performance? An Empirical Evidence from Financial Companies in Indonesia.

Elkhwesky, Z., Salem, I. E., Ramkissoon, H., & Castañeda-García, J. A. (2022). A systematic and critical review of leadership styles in contemporary hospitality: a roadmap and a call for future research. *International Journal of Contemporary Hospitality Management*, *34*(5), 1925-1958.

Fischer, T., & Sitkin, S. B. (2023). Leadership styles: a comprehensive assessment and way forward. *Academy of Management Annals*, *17*(1), 331-372.

Frei, C. (2023). Open Banking: Opportunities and Risks. In *The Fintech Disruption: How Financial Innovation Is Transforming the Banking Industry* (pp. 167-189). Cham: Springer International Publishing.

Hosseini, S. H., Hajipour, E., Kaffashpoor, A., & Darikandeh, A. (2020). The mediating effect of organizational culture in the relationship of leadership style with organizational learning. *Journal of human Behavior in the social environment*, *30*(3), 279-288.

House, R. J. (1971). A path goal theory of leader effectiveness. *Administrative science quarterly*, 321-339.

Ichsan, R. N., Nasution, L., Sinaga, S., & Marwan, D. (2021). The influence of leadership styles, organizational changes on employee performance with an environment work as an intervening variable at pt. Bank sumut binjai branch. *Journal of Contemporary Issues in Business and Government*, *27*(2).

Jallow, M. S., Masazing, M., & Basit, A. (2017). The effects of mergers & acquisitions on financial performance: Case study of UK companies. *International Journal of Accounting & Business Management*, *5*(1), 74-92.

Kamotho, J. (2022). M., Njoka, C.(2022). Credit lending policies and financial performance of Islamic banks in Kenya. *International Academic Journal of Economics and Finance*, *3 (7)*, *488*, *510*, 2.

Kasuni, J., Mandere, E., & Njeru, P. (2022). Investigating influence of strategic leadership on financial performance of commercial banks in Kenya. *International Academic Journal of Human Resource and Business Administration*, *3*(10), 313-328.

Khan, M. A., Ismail, F. B., Hussain, A., & Alghazali, B. (2020). The interplay of leadership styles, innovative work behavior, organizational culture, and organizational citizenship behavior. *Sage Open*, *10*(1), 2158244019898264.

Liden, R. C., Sparrowe, R. T., & Wayne, S. J. (1997). Leader-member exchange theory: The past and potential for the future.

Maina, J., & Waithaka, P. (2018). Organizational Leadership and Performance of Commercial Banks in Nyeri County, Kenya. *Strategic Journal of Business & Change Management. Vol*, *5*, 697-704.

Meher, K. C., & Zewudu, T. (2020). Determinants of firm's internals & macroeconomic factors on financial performance of Ethiopian insurers. *DLSU Business & Economics Review*, *29*(2), 71-80.

Mulyana, A., Ridaryanthi, M., Faridah, S., Umarella, F. H., & Endri, E. (2022). Socio-emotional leadership style as implementation of situational leadership communication in the face of radical change. *management*.

Mwangi, W., Awuor, E., & Kithae, P. (2022). LEADERSHIP STYLE, FINANCIAL INNOVATION AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA. *African Journal of Emerging Issues*, *4*(10), 78-104.

Nuber, C., Velte, P., & Hörisch, J. (2020). The curvilinear and time-lagging impact of sustainability performance on financial performance: Evidence from Germany. *Corporate Social Responsibility and Environmental Management*, *27*(1), 232-243.

Ongongo, L. A., & Mang'ana, R. (2022). Effect of strategic management practices on performance of Commercial Banks In Kenya. *Journal of International Business, Innovation and Strategic Management*, *6*(1), 58-72.

Ongore, V. O., & Kusa, G. B. (2013). Determinants of financial performance of commercial banks in Kenya. *International journal of economics and financial issues*, *3*(1), 237-252.

Purwanto, A., Bernarto, I., Asbari, M., Wijayanti, L. M., & Hyun, C. C. (2020). Effect of transformational and transactional leadership style on public health centre performance. *Journal of Research in Business, Economics, and Education*, *2*(1).

Saleh, T. A., Mehmood, W., Khan, J., & Jan, F. U. (2022). The Impact of Ethical Leadership on Employees Turnover Intention: An Empirical Study of the Banking Sector in Malaysia. *The Journal of Asian Finance, Economics and Business*, *9*(2), 261-272.

Sari, F. N., & Endri, E. (2019). Determinants of Return on Assets (ROA) On Conventional Banks Listed On Indonesian Stock Exchange (IDX) Period 2013–2017. *IOSR Journal of Business and Management (IOSR-JBM)*, *21*(4), 52-62.

Shabbir, M. S., & Rehman, A. (2019). Layers of misconceptions about Islamic banking: are Islamic banks threats, challenges and opportunities for investors?. *Journal of Islamic Marketing*, *10*(3), 874-892.

Shala, B., Prebreza, A., & Ramosaj, B. (2021). The contingency theory of management as a factor of acknowledging the leaders-managers of our time study case: The practice of the contingency theory in the company Avrios. *Open Access Library Journal*, *8*(9), 1-20.

Smit, P. K., Schultz, C. M., & van Hoek, C. E. (2021). The relationship between talent management, transformational leadership and work engagement: An automotive artisan perspective. *SA Journal of Human Resource Management*, *19*, 10.

Sunaryo, D. (2020). The effect of capital adequacy ratio (CAR), net interest margin (NIM), non-performing loan (NPL), and loan to deposit ratio (LDR) against return on Asset (ROA) in general banks in Southeast Asia 2012-2018. *Ilomata International Journal of Management*, *1*(4), 149-158.

Walela, K. B., & Okwemba, E. M. (2023). Effect of leadership behavior on the performance of micro-financial institutions in Kakamega County. *International Journal of Scientific & Technology Research*, *4*(2), 239-252.

Wanyoike, J. E., Mugambi, N. D., & Joshua, P. M. (2022). Mediation Effects Of Firm Characteristics On The Relationship Between Corporate Restructuring And Financial Performance Of Commercial Banks In Kenya. *Webology (ISSN: 1735-188X)*, *19*(3).