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Credit Risk Management Impact on Islamic and Conventional Banks in Kenya

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Abstract

The aim of this study was to analyse the relationship between credit risk management practices and financial performance of both Islamic and conventional banks in Kenya.

In order to achieve this objective, the study assessed the current credit risk management practices of these banks and linked them with various banks' financial performance. The study used both the primary (survey questionnaires) and secondary data (annual reports). Results were analysed descriptively and statistically and the study revealed the importance of coordinating the entire risk management policies strategically to avoid duplication and enhance efficiency.

Anotable outcome from this research was that Islamic banks adopt some extra measures to manage their specific risks due to the innovative and unique banking nature. The study hopes to contribute to the enhancement of credit risk management practices of both the Islamic and conventional banks to increase the overall competitiveness in the banking industry in Kenya.

Keywords: Islamic banking, Risk management for Islamic banks, Islamic banking in Africa.

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1. Introduction:

Banks generally face many inherent risks including credit risk, interest rate risk, liquidity risk, market risk, foreign exchange risk and solvency risk (Toumi, 2011). However, loans are believed to be the largest source of credit risk for commercial banks (Wheelen, 2000). It is also worth noting that credit risk is the most expensive risk for financial institutions as it may directly threaten the solvency of any financial institution (Chijoriga 1997).

Credit risk has been defined as the possibility that a bank borrower or counterparty may fail to meet their obligations in accordance with the terms of the agreed contract (Saunders, 2008). Hence, it is apparent from the above definition that credit risk arises whenever a lender is exposed to a loss from a borrower or a counterparty, who fails to honour his/debt obligation as they fall due (Luy, 2010). According to Njanike (2009), bad credit risk management related issues such as speculative loans and the concentration of credit facilities in certain sectors were among the major factors that caused the last financial crisis in many parts of the world. A large number of conventional banks in certain European and African countries including Kenya suffered severe financial problems due to lack of robust credit risk management practices(King, 2009). Countries that have suffered similar fate due to poor credit risk management strategies during the last financial crisis include Mexico, Venezuela, and Zimbabwe (BGL, 2010).

Credit risk management is even more serious for Islamic banks due to the unique nature of their banking services and the additional risks they assume in the process of drawing their financing contracts resulting from the specific features of their liquidity infrastructure, legal requirements and the Sharia governance guidelines with which they should comply in their day-to-day operations (Cihak and Hesse, 2008).Therefore credit risk management should be at the centre of both Islamic and conventional banks due to its great importance to the successful operation of the entire banking industry.

1.1. Significance of the study:

There are a large number of studies published about credit risk management in general. However, the number of empirical studies on credit risk management practices of financial institutions was found to be scarce especially in the Kenyan context.

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Why Kenya?

Kenya was selected as it is the first African country that introduced Islamic financial services where Islamic banks are competing with conventional banks on a level-playing field (Ndungu, N:2010).

In Kenya, the credit management practices adopted by both conventional and Islamic banks have not been yet studied and data on how credit risk management practices affect the performance of both conventional and Islamic banks. Furthermore, the existence or otherwise of significant differences between the two types of entities as far as credit risk management is concerned has not been documented. This study therefore aims to shed light on these facts. Hence, the main objective of this research is to analyse the relationship between credit risk management practices and financial performance for both Islamic and Conventional banks in Kenya. To achieve the main research objective of this study, the research tasks have been broken down into more specific research sub-objectives as stated below:

- To assess the credit risk management practices of both Islamic and Conventional banks in Kenya
- To evaluate the financial performance of both Islamic and Conventional banks in Kenya by using selected financial ratios
- To analyse the relationship between credit risk management practices and financial performance for both Islamic and conventional banks in Kenya
- To compare the above results for Islamic and conventional banks in Kenya.

The researcher believes that the study is significant as it will inform industry players on the importance of proper credit risk management and its on the financial performance of both Islamic and conventional banking institutions. It will also influence policy formulation in matters affecting the wider economy.

2. Literature review:

It is well documented that banks face various risks such as interest, market, technological, foreign exchange, country, liquidity insolvency and credit risks (Tandelilin, Kaaro, Mahadwartha, and Supriyatna, 2007). However, credit risk arises whenever a lender is exposed to a loss from a borrower or a counterparty who fails to honour his/her debt obligations (Luy, 2010). According to Colquitt

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(2007), this loss may be derived from deterioration in the counterparty's credit quality which may consequently lead to a loss of the total value of the debt.

Greuning and Bratanovic(2009) maintain that credit risk failure is a major threat to any bank's performance and it is one of the principal causes of bank failures. According to Owojori et al., (2011), the available statistics from many liquidated banks clearly shows that the inability to collect loans and advances extended to customers and creditors or companies related to directors or managers was a major contributor to the financial distress faced by many of the liquidated banks in Kenya which led to the revocation of banking licenses from these banks by the Central Bank of Kenya (CBK). Hence, looking at the credit risk management practices of all commercial banks in Kenya, Islamic or conventional is important to gauge how their respective credit risk management policies impact on their financial performances.

Markowilz, (2008) pointed out that the negative impact of credit risk on banks can be reduced through portfolio diversification. However, the biggest challenge facing these banks is how to maximize returns while minimizing risks and the most critical factor in credit risk management is striking a balance between the two. Financial institutions seek to achieve this objective through efficient diversification of risks and most studies on the relationship between credit risk management and financial performance of banks have been conceptual in nature, often drawing the theoretical link between good risk management practices and improved bank performance. Schroeck (2002) and Nocco and Stulz (2006) stress the importance of coordinated risk management practices to maximize the firms' value which suggests that companies should manage risks strategically by reviewing all the risks together in a coordinated manner. Stulz (1996) associates good risk management practices with the elimination of costly lower-tail outcomes by proposing "full-cover" risk management as compared to "selective" risk management practices.

Some studies have been conducted on the topic of credit risk management in Kenya. For instance, Muridi(2003), looked at the credit risk management practices applied by financial institutions in Kenya and Miwirigi(2006) carried a survey on credit risk techniques employed by Kenyan commercial banks. Although these studies have somehow enlightened us on credit management practices in Kenya, they have not established a clear relationship between credit risk management practices adopted by these banks and their financial performances. However, Greuning and Bratanovic(2003), found that failure to pay the principal and the interest as specified in the credit agreement threatens the bank's liquidity and suggested that

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credit risk management is the most important area in risk management as 80% of all banks' balance sheet relate to credit and poor credit risk management is the most common reason for bank failure. However, in Kenya, studies conducted on this topic, suggested that poor management precedes bad credit risk management in causing bank failure, but Idarus(2005), found that credit risk management is the most critical aspect of risk management in Kenya.

2.1. Procedures for credit risk management for banks:

Al-Tamimi (2002) Al-Tamimi (2002) studied the degree to which banks utilized risks management techniques to deal with various types of risks and the result of the study was that most of the banks studied faced credit risks. However. The main methods used in identifying these credit risks were the follow-up and inspections by branch managers as well as robust financial statement analysis. Dan (2011) aimed to outline strategies to identify, prioritize, and mitigate credit risks to achieve the organization's performance and profitability objectives. The study concluded that there is unanimous agreement among financial experts that good credit risk management practices help organizations enhance their financial performance and at the same time prevent the waste of the organisation's resources.

Monitoring is an important procedure to ensure that credit risk management is effectively practiced by banks (Javid, 2009). Effective credit risk management involves the execution of a reporting and review structure to ensure that risks are properly identified and assessed as well as that appropriate control and responses are consequently put in place (IRM, AIRMIC and ALARM, 2002). Proper credit risk monitoring practices can be used to ensure that credit risk management practices which help the banks' management to uncover mistakes at an early stage are in place (Al-Tamimi and Al-Mazrooei, 2007). Moreover, it was discovered by the same study that there are significant differences between the conventional and Shariah compliant banks as far as risk monitoring and control is concerned. Pausenberger and Nassauer, (2002) are of the view that various controls have to be established at different levels since the control by the management board alone is insufficient to ensure the effective functioning of the risk monitoring system. This is because the management board members do not have sufficient time to exercise extensive controls on the organisation. Hence, the management board should appoint an independent unit which is responsible for internal supervision (Scholtens, 2003). The internal audit is normally responsible for this task, but the supervisory board is also expected to oversee the credit risk management process as they are supported by the internal auditors. Any defects identified by the internal

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auditors must be reported to the supervisory board as well as to the management board. Also, the shareholders of the corporation should exercise their right to insist on getting relevant information in order to judge the efficiency of the credit risk management function. Hence, the director's report should be comprehensive enough to enable the shareholders to assess and review the status of the corporation with regard to the credit risk management function thoroughly (Saunders et al., 2008). Khan and Ahmad (2001) carried out studies on credit risk management practices employed by various banks and discovered that on average, the lowest effort was placed on measuring, mitigating and monitoring risks and more was devoted to credit risk management policies and procedures for internal control. Hickson, (1996), explained that banks differ in their credit management practices due to their differences in debt / equity ratio.

Rajagopal (1996) attempted to analyse credit risk management practices employed by various banks and suggested a model for pricing their financial products based on credit risk assessment of the borrowers. It was concluded that good credit risk management results in good banking which ultimately leads to the profitable operation and the long-term survival of the institution. This means that proper approach to credit risk identification, measurement and control will safeguard the interests of the banking institution in the long run.

To address certain issues in the banking industry, comprehensive credit risk management plan must be put in place (Basel Committee 1999). These practices should also be aligned to sound practices that are related to the assessment of asset quality, the adequacy of provisions and reserves as well as the disclosure of credit risk.

Richard et al (2008) conducted a study in Tanzania to understand credit risk management systems of commercial banks established in less developed countries. The result obtained indicated that there were noticeable differences between the credit risk management practices employed by commercial banks that operated in a lesser developed economy compared to those operating in developed economies. Therefore it can be concluded that the environment in which the bank operates is an important factor for the selection and the success of the relevant credit risk management practices. This proves the importance of studies looking at the credit risk management practises of banks in the third world countries such as Kenya since it was found that they are clearly different from banks operating in Western environment which indicates the significance of this study and we hope this study will shed light on how credit risk management practices impact on the studied banks' profitability.

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2.2. Credit risk management for Islamic banks:

Islamic finance has been gaining momentum in the global financial industry since 1975 when Dubai Islamic bank which was the first Islamic commercial bank in the world was established in the United Arab Emirates and according to Zaher and Hassan (2001), Islamic finance would control 40-50% of Muslim savings by 2015.

Islamic act as financial intermediaries like conventional banks, but the main distinction is the application of Sharia principles in their banking operations and the application of certain profit and loss sharing products such as Mudaraba and Musharka(Dar & Priesley:2000).However, some observers are of the view that Islamic banks have similarities to developmental financial institutions such as credit unions and cooperative financial institutions as far as community service is concerned(Iqbal, Z. and Mirakhor, A. :2007). In fact, the Islamic finance industry has been growing at impressive rate of 15-20% in the last ten years and assets managed by Sharia compliant financial institutions are estimated to be more than USD750 billion(Asian Bankers, 2008). In Kenyan context, it is interesting to know that despite being very new to Kenya and having limited outreach, Islamic banks have shown impressive results in their short period of presence in this country and have attracted customers from whole spectrum by appealing to Muslims and non-Muslims equally as religion is not necessarily the main motivation for some bank customers (Erol, C., & El-Bdour, R.:1989).

Apparently, the Islamic finance industry is expected to grow further due to the intense debate on the ethical aspects of the currently dominant conventional finance as well as its large potential customers of over one billion Muslim population worldwide which has further intensified the need for more research into the various aspects of this industry (Beck, 2013). The fact that Islamic finance is relatively new compared to conventional finance means many aspects of this industry has not yet been investigated and credit risk management practices of Islamic banks is one of the key areas that needs further research (Hasan, 2010). Since Islamic banks are heavily involved in the intermediation process as conventional banks do, credit risk management strategies are equally important to them too (Nawi, 2013).As banking in general is considered to be a risky business, it is extremely important for all banks regardless of their banking orientation to manage their most imminent risk factors such as credit, liquidity, operational and market risks as how well these risks are managed by the concerned bank determines the survival and success of such bank(Khan and Ahmed, 2001).Moreover, the credit risk management practices adopted by Islamic banks should not conflict

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with Sharia principles which are the guiding principles for their entire operation (Khan and Ahmed, 2001). However, Islamic banks need to have very effective and efficient credit risk management strategies in the face of the increasing pressure of globalisation as they have to deal with the challenges of cross border financial flows. According to Sharia principles, Islamic banks should not invest in high risk projects leading to Gharar which means excessive and unnecessary risk as doing this violates Islamic finance principles (Honohan.P:2001). From risk management perspective, Islamic banks share both risk and return with their customers while conventional banks bear the entire risk as risk is totally transferred to the bank upon signing the contract (Imam, P. and Kpodar, K: 2010). Some researchers found that Islamic banks' performance is particularly affected by the robustness of their credit risk management strategy as well as their Sharia governance guidelines and auditing standards (Sundararajan and Errico, 2002).

Anam et al(2012), studied liquidity risk management practices of Islamic banks in Brunei Darussalam by looking at various aspects of Islamic banks' risk issues including risk assessment and analysis, risk identification, risk monitoring and risk management practices. Also, they studied risks particularly faced by Islamic banks and the research revealed that foreign exchange, credit risk and operational risks are biggest risks faced by Islamic banks.

2.3. Credit Risk Management and financial Performance:

"Financial performance is the ability of the organization to use their financial and human resources efficiently for the purpose of achieving its goals" (Robins &Wiersema1996).Hence,. "The organization's ability to achieve its long-term goals depends on its financial performance" Wheelen and Hanger 2000.

Financial performance is the measurement of the result achieved or expected in light of predetermined criteria that can be measured (Al-Hannawi 2005). Furthermore, Normani (2010) found positive relationship between credit risk management practices and financial performance of conventional banks in Malaysia and this result was in the same line with Eric' thesis (2002) which found positive relationship between credit risk management practices and financial performance in insurance companies in Uganda.

Ernst and Young (2012) found that while most organizations perform the basic elements of credit risk management, the top performers do more and the study also found specific risk management practices that were consistently present in

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the risk management strategies of the top performers. Several other studies draw the link between good credit risk management practices with improved financial performances. For instance, Smith (1995) and Schroeck, (2002). These studies in particular propose that prudent credit risk management practices reduce the volatility in the banks' financial performance, namely operating income, earnings, firm's market value, share return and return on equity. Schroeck (2002) proposed that ensuring best practices through prudent credit risk management results in increased earnings.

Eccles (1991) suggests that it is essential for all organisations to maintain a balance between financial performance and acceptable risks to achieve their financial goals. Increasing shareholders' return is the man objective of all bank management strategies and this objective often comes at the cost of an increased risk. The banker's motivation for adopting good credit risk management strategies comes from the mitigation of those risks which can lead to a poor financial performance of the bank and that is why the issues of credit risk management practices in the banking sector have greater impact not only on the banking industry but on the entire economy (Tandelilin et al, 2007).

Tai (2004) concluded that empirical evidence indicates that financial shocks emanating from the banking sector have significant impact on the volatilities of foreign exchange and the aggregate stock market prices, suggesting that banks can be a major source of contagion during financial crisis. Similarly, (Njanike :2009) found that the main cause of the latest financial crisis was the absence of effective credit risk management which shows the importance attached to this topic as far as the financial performance of banks is concerned.

Cebenoyan and Strahan (2004) found evidence that banks which have advanced credit risk management practices have greater credit availability and reduced risks in the banking system. Also, the greater the credit availability, the greater it leads to the optimum utilization of the bank's productive assets and profits. Also, Kithinji (2010) found that inadequate credit systems had the largest influence on any bank's performance. Likewise, (Aruwa and Musa :2012) found that there was strong relationship between credit risk management and bank performance. As this study aims to establish the link between the credit risk management practices adopted by commercial banks in Kenya and their financial performance, we expect to gain better insight into this matter by the end of this crucial study.

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3. Methodology:

The purpose of this study is to asses credit risk management techniques employed by Islamic and conventional banks and how they affect the financial performance of both Islamic and Conventional banks in Kenya. Also comparing the impact of poor credit risk management practices in conventional banks as opposed to Islamic banks in Kenya will be looked at.

This section presents the research methodology that was applied during the study including the identification of the target population, sampling techniques as well as the overall data collection process.

Polit and Hungler (1999) refer to population as an aggregate or totality of all the objects, subjects or members that conform to a set of specifications. The target population is the entire group a researcher is interested in or the group about which the researcher wishes to draw conclusions (Mugenda & Mugenda, 2009). The target population of this study was the management staff working at the various selected Islamic and conventional banks of the 8 selected banks in Nairobi, Kenya which consisted of 1000 people.

The sample population selected for this study comprised of those staff working at low, middle and high level management positions at the various selected banks.

Purposive sampling method was used where participants who qualify for the inclusion criteria were selected based on their availability. Hence, since on average, the target population was1000 (One thousand) subjects, the researcher used 10% of the target population to arrive at the sample size as suggested by (Mugenda & Mugenda, 2009). The sample size was therefore 100 respondents.

According to Kothari (2009), data can be collected using different tools such as observation, interviews, questionnaires, and focus groups. In this study, questionnaires were used to acquire primary data. Axinn & Pearce (2006) recommend questionnaires because, among other reasons, they provide a high degree of data standardization and adoption of generalized information amongst any population. Therefore, in this study, the researcher used questionnaires and observation as tools for data collection.

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3.1. Validity and Reliability:

Validity and reliability was obtained through pre-testing of the instruments of the Research. Pre-testing was done where the researcher presented the questionnaires to a small group of respondents who were not included in the actual sample.

After being satisfied with the validity and reliability of the data, the obtained data was analysed using various statistical tests including descriptive statistics, correlation analysis and logistic regression. Data was entered on SPSS (Statistical Package for Social Sciences). The data was then presented using tables, graphs and charts.

4. Discussion of the results:

The main aim of this study was to analyse the relationship between credit risk management and financial performance for Islamic and Conventional banks in Kenya. All the eight banks selected responded to the questionnaires, representing a response rate of 100%.Different statistical tests were used to generate meaningful information from the data as the tables below suggest.

Table 4.1.: Age category of respondents studied

age of respondent					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	20-25	8	6.7	6.7	6.7[a]
	26-30	13	13.3	13.3	13.3
	31-35	33	33.3	33.3	33.3
	36-40	20	20.0	20.0	20.3 26.4
	>40	26	26.7	26.7	100.0
	Total	100	100.0	100.0	
The table presents various age categories of study subjects.					

The table shows that majority (33%) of the respondents were between 31-35 years old. This is followed by 27% of the respondents who were above 40 years of age. Only 6% of the respondents were between 20-25 years old. This indicates that most respondents were relatively young professionals at the peak of their career and aware of the topic under study.

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Table 4.2.: Gender of the respondents studied

gender of respondents					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	male	73	73.3	73.3[a]	73.3
	female	27	26.7	26.7	100.0
	Total	100	100.0	100.0	
Missing	System	0	0.0		
Total		100	100.0		
The table presents gender composition of the respondents studied.					

As the table above shows, majority of the respondents (73%) were male while the remaining (27%) were female which indicates the gender composition of bank employees in Kenya.

Table 4.3.: The type of bank that respondents worked for

classification of banks					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Islamic	33	33.3	33.3	33.3
	Conventional	67	67.7	67.7	100.0[a]
	Total	0	0.0	100.0	
Missing	System	0	0.0		
Total		100	100.0		
The table above shows the bank classification of the subjects studied and it shows that respondents belonged to either a Conventional or an Islamic bank.					

The chart indicates that a greater number (67.7%) of the respondents worked for different conventional banks in Kenya. Only (33.3%) of the respondents reported to be working for Islamic banks in Kenya. Again this shows the huge numerical difference between conventional and Islamic banks in Kenya.

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Table 4.4.: Subject's response on credit risk management environment, policies and procedures

Item No.	Risk Management Environment, Policies and Procedures	SD (%)	D (%)	N (%)	A (%)	SA (%)	Mean	Std. Dev.
1	formal risk management system is in place	-	-	-	60.0	40.0	4.4	0.548
2	Board of directors outlines the overall objectives	-	-	20.0	60.0	20.0	4.0	0.707
3	Overall objectives are communicated	-	-	-	100.0	-	4.0	0.000
4	Board of directors approves the overall policies	-	-	-	20.0	80.0	4.8	0.447
5	Board of directors ensures that management takes necessary actions	-	-	-	20.0	80.0	4.2	0.447
6	A committee responsible is in place	-	-	-	40.0	60.0	4.6	0.548
7	Internal guidelines are in place	-	-	20.0	80.0	-	3.8	0.447
8	Clear policy promoting asset quality	-	-	-	60.0	40.0	4.4	0.548
9	The bank adopted and utilized guidelines	-	-	-	20.0	80.0	4.8	0.447
10	Mark up on rates on financing are set	-	-	20.0	80.0	-	3.8	0.447
11	The bank has the policy of investment across different countries	-	-	60.0	20.0	20.0	3.6	0.894
12	The bank has the policy of diversifying investment across different sectors	-	-	-	60.0	40.0	4.4	0.548

SD=Strongly disagree D=Disagree

N=Neutral A=Agree SA=Strongly Agree

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From the above results, we have gained some interesting insights into the importance that are attached to a coordinated risk management policies as well as the close involvement of executive directors by all bankers surveyed . For instance, we noted from Table 4.4 that majority of respondents agreed on all the items in the questionnaire tackling this issue. Particularly, it items, 1, 2, 3, 4,5,6,8 and 9 where the mean was 4 or above. What was common on these items is the importance attached to strategic management of all policies and procedures concerning credit risk management and the standardisation of these policies across the concerned organisation. The direct involvement of senior executives ensures goal congruence and serious commitment to the set policies and consistency of the policies in the whole organisation.

Another interesting outcome from this study was that there was no difference between Islamic and conventional banks as far as credit risk management is concerned. The results clearly indicated that both Islamic and conventional banks treat credit risk management as a top priority. However, it is worth noting that the results have made significant contribution to understanding credit risk management practices of Islamic and conventional banks in Kenya by confirming that there are no differences how these two types of banks approach this topic, reversing the results of Tafri et al. (2011) and Wainaina, (2013) which suggested that there were stark differences between the way Islamic and conventional banks approach their credit risk management practices. As far the investment in different countries are concerned, the respondents were not in total agreement which may suggests that the respondents expressed some level of reservation about the similarities of the policies pursued by Islamic and conventional banks when investing in various countries as the local laws and the prevailing environment of each hosting country may differ.

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Table 4.5.: Analysis of credit risk management procedures as adopted by both Conventional and Islamic banks in Kenya

classification of bank and credit risk management style								
Count								
		credit risk management style						Total
		Credit appraisal analysis	Loan Security	Credit approval process	Credit monitoring	Credit guarantee	all	
classification of bank	Islamic	0	0	15	10	5	30	30
	Conventional	20	15	10	15	10	70	70
Total		20	15	25	25	15	100	100

The table above shows the various credit risk management styles adopted by both Islamic and Conventional banks.

This study revealed some interesting results regarding the credit risk management style adopted by both conventional and Islamic banks which reflects the fundamental differences of these two banks of banks and their approach to credit risk management.

As the graph shows that (70%) of conventional banks have adopted all credit risk management styles while only 30% of Islamic banks did the same. Credit guarantee and credit monitoring are being used by both equally. 10% of the study subjects confirmed that conventional banks had an elaborate credit approval process while 15% of Islamic banks had the same. This is to do with the fact that Islamic banks apply more rigorous credit approval process in their Murabaha and Ijara transactions as they are not giving loans as conventional banks do, but are financing an asset in a Sharia-compliant manner which could threat the bank's liquidity unless carefully managed.

Also 15% of the participants confirmed that Conventional banks require security to issue loans while Islamic banks don't require such requirement due to the different nature of their financing schemes. Again this explains, the distinctive financing mechanisms employed by these two different types of financial institutions where conventional banks give loans and Islamic banks finance assets using various Islamic financing modes.

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4.6. Evaluation of financial performance of both Islamic and Conventional banks in Kenya

The study also evaluated the financial performance of the both Islamic and Conventional banks in Kenya by using selected financial ratios. The financial ratios analysis provides a method for assessing the financial strengths and weaknesses of the firm using the information found in its financial statements (Rosly and Abu Bakar, 2003). The financial ratios used in this study include the rate of return on assets (ROA) and the rate of return on equity (ROE). ROA is the most comprehensive accounting measure of a bank's overall performance. Since it is defined as net income over total assets, it shows the profit earned per dollar of assets and

it is an indicator of bank's efficiency as well as being a measure of the bank's ability to generate income from its total operations. The ROE, on the other hand, reflects how effectively a bank's management is using shareholders' investment and it tells the bank's shareholders how much the institution is earning on the book value of their investment (Goudreau, 1992). In fact, ROE is the most important measure of banking returns because it is influenced by how well the bank is performing on all other return categories, and indicates whether a bank can compete for private sources in the economy. For the sake of clarity, in this study, ROE is defined as net income divided by total equity.

Table 4.8.: Financial performance indicators of selected Islamic and Conventional Banks in Kenya based on ROE and ROA ratios

Financial Performance Indicators for Selected Islamic and Conventional Banks in Kenya Name	ROA	ROE
Kenya Commercial Bank (KCB)	0.72	16.03
Diamond Trust Bank	-0.91	-2.36
National Bank	-1.82	199.22
Family Bank	0.40	7.59
First Community Bank	0.56	8.27
Gulf African Bank	0.35	4.58
Equity Bank	0.82	9.35
Standard Chatered Bank	1.17	14.02

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As shown in Table 4.8, in terms of the profitability ratio, the descriptive statistics show that Standard Chatered Bank had the highest ROA of all the banks being considered at 1.2 percent, followed by Equity at 0.8 percent, KCB at 0.7 percent, First Community Bank at 0.6 percent, Family Bank at 0.4 percent, and Gulf African Bank at 0.35 percent. DTB and National Bank had negative average ROA at -1.8 percent and -0.9 percent, respectively. Meanwhile, ROE gives a different perspective compared to ROA. In particular, based on the ROE, National Bank had the highest average ROE at 199.2 percent. Nonetheless, National Bank's ROE was also high compared to the industry average at 56.5 percent in 2007 and 32.9 percent in 2008. The next bank ranked in terms of ROE is KCB with an average ROE for the three-year period at 16 percent, followed by Standard Chatered Bank at 14 percent, Equity Bank at 9.4 percent, First Community Bank at 8.3 percent, Family Bank at 7.6 percent and Gulf African Bank at 4.6 percent. Of the eight banks being reviewed in the period, Diamond Trust Bank is the only bank with negative average ROE of -2.4 percent. Earlier studies done by Kwan et al (2009) and Isik, (2013) had similar findings.

Table 4.9.: Credit risk management practices and financial performance Pearson Correlations

Financial Performance		Risk Management Practices			
Risk Management Environment, Policies and Procedures		Risk Measurement	Risk Mitigation	Risk Monitoring	Internal Control
ROA	-0.349	0.652	-0.089	0.590	-0.427
ROE	0.254	-0.220	0.113	0.007	0.612

In linking the credit risk management practices and financial performance, the mean scores of each risk management practices are correlated with the ROA and ROE. Credit risk management practices are explained by risk management environment, policies and procedures, risk measurement, risk mitigation, risk monitoring and internal control practices. Table 4.9 provides the correlation coefficients for all variables.

In general, the result of correlations analysis between ROA and all credit risk management practices shows an existence of strong positive correlation between ROA and risk measurement practices (+65%). A moderate positive correlation relationship (+59%) exists between ROA and risk monitoring practices. Moreover, there are negative correlations between ROA and internal control practices, risk

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management environment, policies and procedures and risk mitigation practices (-43%, -35% and -9%, respectively). Based on these correlations, it can be concluded that the higher the ROA, the better will be the credit risk measurement practices and also risk monitoring practices in both Islamic and Conventional banks in Kenya. Similar studies done in Uganda and Rwanda by Saunders and Scholten (2006) and Magdarit et al (2011) respectively concluded that there is a significant positive relationship between ROA and credit risk management.

With regard to ROE, as shown in Table 4.9, a highest positive correlation is found for internal control practices (+61%) and followed by risk management, environment, policies and procedure (+25%). In addition, there are negative correlations between ROE and risk measurement practices (-22%). In summary, the banks that have higher ROE tend to practice better internal control practices and risk management, environment, policies and procedures.

5. Conclusion:

This study used both primary and secondary data to examine the credit risk management practices of selected Islamic and Conventional banks in Kenya as well as the financial performance of these banks. In addition, the study aims to test the link between credit risk management practices and financial performance of Islamic and Conventional banks using correlation analysis.

Results were analysed descriptively and statistically and the study revealed several facts regarding credit risk management strategies of conventional and Islamic banks in Kenya.

The study has made certain specific contributions as the following paragraphs explain.

Firstly, the study found that it is extremely important that the board of directors approve the overall organisational policies and ensure that the necessary steps are taken to mitigate credits risks. Secondly, the research found the importance of establishing appropriate governance structures and communicating overall organisational objectives throughout the bank to improve credit risk management. Thirdly, the study revealed that the banks should have good risk monitoring system regarding the compilation of the maturity ladder chart according to the settlement date as well as the monitoring of the cash position gap. Fourthly, the study found that despite the existence of several differences in the adopted strategies, practices

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and concepts of credit risk management for conventional and Islamic banks in Kenya, both types of banks face similar types of risks with minor variations. Fifthly, the study found that Islamic banks adopt some extra measures to manage their specific risks due to the innovative and unique nature of their Sharia-compliant banking products and services. Finally, results showed that for both Islamic and Conventional banks, the overall objectives of credit risk management policies are communicated at the right organisational levels which indicates the importance of transparency in ensuring the adoption of effective risk management practices for all banks regardless of their identity since credit risks are similar across the banking industry(Khandelwal :2008).

5.1. Recommendations:

1. Both Conventional and Islamic banks should develop, assess and adhere to proper, workable and adjustable credit risk management structures since this hugely affects their financial performance.
2. Banks should from time to time assess their financial standing based on properly selected rations to avoid running unwarranted losses.
3. Both Islamic and conventional banks should encourage the involvement of the board of directors in organisational policies.

Research limitations:

- Limited number of banks in Kenya, especially Sharia compliant banks.
- Difficulty in accessing relevant data due to immature financial infrastructure and limited data availability.
- Conducting research in a less developed country with the inherent logistical, technological and data availability challenges.

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تأثير إدارة المخاطر الائتمانية في المصارف الإسلامية والتقليدية في كينيا

محمد حرسي وارسام

كلية إدارة الأعمال - جامعة الشارقة

الشارقة - الإمارات العربية المتحدة

ملخص البحث:

كان الهدف من هذه الدراسة تحليل العلاقة بين ممارسات إدارة المخاطر الائتمانية والأداء المالي لكل من المصارف الإسلامية والتقليدية في كيني.

في تحقيق هذا الهدف، قيمت الدراسة ممارسات إدارة المخاطر الائتمانية الحالية لهذه البنوك وربطتها مع الأداء المالي لمختلف البنوك. استخدمت الدراسة كلا من المرحلة الابتدائية (الاستبانات) والبيانات الثانوية (التقارير السنوية). وقد تم تحليل النتائج إحصاءا وصفيا وكشفت الدراسة أهمية تنسيق سياسات وإستراتيجيات إدارة المخاطربأكمله لتجنب الازدواجية و تعزيز الكفاءة.

وأيضا من النتائج الملحوظة من هذا البحث أن البنوك الإسلامية تعتمد بعض التدابير الإضافية لإدارة المخاطر الخاصة بها نظرا لطبيعة منتجاتها المصرفية المتوافقة مع الشريعة الإسلامية والخدمات.

ونأمل أن تساهم هذه الدراسة من حيث التوصية في تعزيز ممارسات إدارة المخاطر الائتمانية في كل من البنوك الإسلامية والتقليدية وذلك لزيادة القدرة التنافسية الشاملة في القطاع المصرفي في كينيا.

الكلمات الدالة: المصارف الإسلامية، وإدارة المخاطر للبنوك الإسلامية، والخدمات المصرفية الإسلامية في أفريقيا.

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