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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 achieving this objective, the study assessed the current credit risk management practices of these banks and linked them with the 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 several facts regarding the current credit risk management practices at the selected Islamic and Conventional banks in Kenya.

One of the most important findings was the importance of coordinating the entire risk management policies strategically to avoid duplication and enhance efficiency. Another notable outcome from this research was 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.

The study hopes to contribute in terms of recommending strategies to strengthen the credit risk management practices of both the Islamic and Conventional banks so as to increase the overall competitiveness in the banking industry in Kenya.

1.0 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.

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.

2.0 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 (2007), this loss maybe 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).

Markowitz, (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.

2.1 Procedures for credit risk management

According to Al-Tamimi and Al-Mazrooei (2007), credit risk identification is the initial stage in the credit risk management process. However, for the implementation of good credit risk management in an organization, the first step is to study risks and their impact on the organisation. Tchankova (2002) concluded that credit risk identification is a very important step in credit risk management and the objective is to identify important credit risk areas inside and outside the corporation (Kromschroder and Luck, 1997). Consequently, the
organization will be able to highlight the intensity of the various risk areas via risk mapping which could steer the organization away from high and low intensity risks.

Al-Tamimi (2002) studied the degree to which banks utilized risk 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 organization’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 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.

Salas (2002) investigated the existence of credit risk in Spanish commercial and savings banks and the schedule of data collected was supposed to compare the determinants of problematic loans of these banks during the period between 1985-1997. Both the macroeconomic and individual bank-level variables were taken into account. GDP growth rate, firms, family indebtedness, rapid past credit or branch expansion, inefficiency, portfolio composition, size, net interest margin, capital ratio and market power were the list of variables that were tested to explain the impact of credit risk further. The results of the study discovered that the role of competition in the banking sector and ownership structure determined the credit risk appetite of these banks to a large extent.
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.

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.
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). 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 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 some commentators, 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).
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 & Wiersema 1996). 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’s 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 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 risk 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.

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.

3.0 Methodology

The purpose of this study is to assess 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 was 1000 (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.

### 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.

4.0 Discussion of the results

The main aim of this study was to analyze 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.

**Figure 4.1 Age category of respondents studied**

<table>
<thead>
<tr>
<th>age of respondent</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>20-25</td>
<td>8</td>
<td>6.7</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td>26-30</td>
<td>13</td>
<td>13.3</td>
<td>13.3</td>
<td>13.3</td>
</tr>
<tr>
<td>31-35</td>
<td>33</td>
<td>33.3</td>
<td>33.3</td>
<td>33.3</td>
</tr>
<tr>
<td>36-40</td>
<td>20</td>
<td>20.0</td>
<td>20.0</td>
<td>20.3</td>
</tr>
<tr>
<td>&gt;40</td>
<td>26</td>
<td>26.7</td>
<td>26.7</td>
<td>26.4</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

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 26% of the respondents who were above 40 years of age. Only 6% of the respondents were between 20-25 years old.
**Figure 4.2: Gender of the respondents studied**

<table>
<thead>
<tr>
<th>gender of respondents</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>male</td>
<td>73</td>
<td>73.3</td>
<td>73.3a</td>
<td>73.3</td>
</tr>
<tr>
<td>Valid female</td>
<td>27</td>
<td>26.7</td>
<td>26.7</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100.0</td>
<td></td>
<td>100.0</td>
</tr>
<tr>
<td>Missing System</td>
<td>0</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The table presents gender of the respondents studied. The gender was either male or female. The table also shows frequency, percent and cumulative percent of the subjects. As the table above shows, majority of the respondents (73%) were male while the remaining 27% were female.

**Figure 4.3: The type of bank that respondents worked for**

<table>
<thead>
<tr>
<th>classification of banks</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic</td>
<td>33</td>
<td>33.3</td>
<td>33.3</td>
<td>33.3</td>
</tr>
<tr>
<td>Valid Conventional</td>
<td>67</td>
<td>67.7</td>
<td>67.7</td>
<td>100.0a</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Missing System</td>
<td>0</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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.
**Figure 4.4: Subject’s response on credit risk management environment, policies and procedures**

<table>
<thead>
<tr>
<th>Risk Management Environment, Policies and Procedures</th>
<th>SD (%)</th>
<th>D (%)</th>
<th>N (%)</th>
<th>A (%)</th>
<th>SA (%)</th>
<th>Mean</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>formal risk management system is in place</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>60.0</td>
<td>40.0</td>
<td>4.4</td>
<td>0.548</td>
</tr>
<tr>
<td>Board of directors outlines the overall objectives</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>60.0</td>
<td>20.0</td>
<td>4.0</td>
<td>0.707</td>
</tr>
<tr>
<td>Overall objectives are communicated</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100.0</td>
<td>-</td>
<td>4.0</td>
<td>0.000</td>
</tr>
<tr>
<td>Board of directors approves the overall policies</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>80.0</td>
<td>4.8</td>
<td>0.447</td>
</tr>
<tr>
<td>Board of directors ensures that management takes necessary actions</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>80.0</td>
<td>4.2</td>
<td>0.447</td>
</tr>
<tr>
<td>A committee responsible is in place</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>40.0</td>
<td>60.0</td>
<td>4.6</td>
<td>0.548</td>
</tr>
<tr>
<td>Internal guidelines are in place</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>80.0</td>
<td>-</td>
<td>3.8</td>
<td>0.447</td>
</tr>
<tr>
<td>Clear policy promoting asset quality</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>60.0</td>
<td>40.0</td>
<td>4.4</td>
<td>0.548</td>
</tr>
<tr>
<td>The bank adopted and utilized guidelines</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>80.0</td>
<td>4.8</td>
<td>0.447</td>
</tr>
<tr>
<td>Mark up on rates on financing are set</td>
<td>-</td>
<td>-</td>
<td>20.0</td>
<td>80.0</td>
<td>-</td>
<td>3.8</td>
<td>0.447</td>
</tr>
<tr>
<td>The bank has the policy of investment across different countries</td>
<td>-</td>
<td>-</td>
<td>60.0</td>
<td>20.0</td>
<td>20.0</td>
<td>3.6</td>
<td>0.894</td>
</tr>
<tr>
<td>The bank has the policy of diversifying investment across different sectors</td>
<td>-</td>
<td>-</td>
<td>60.0</td>
<td>40.0</td>
<td>-</td>
<td>4.4</td>
<td>0.548</td>
</tr>
</tbody>
</table>

SD=Strongly disagree  D=Disagree  
N=Neutral  A=Agree  SA=Strongly Agree
With regards to “Risk Management Environment, Policies and Procedures”, the results in Figure 4.4 show that all the respondents agree with item 3: Overall objectives are communicated (with a mean of 4.0 and zero standard deviation), indicating the importance of transparency in effective risk management practices. Majority of the respondents (80%) strongly agreed with three items, namely item 4: Board of directors approves the overall policies; item 9: The bank adopted and utilized guidelines; and item 5: Board of directors ensures that management takes necessary actions. This indicates a strong agreement amongst the respondents on the importance of the board of directors in both Islamic and Conventional banks as part of the corporate governance structure. Active participation of the board of directors in the credit risk management practices ensures consistency in achieving the objectives of the banks among the stakeholders.

It also depicts that the lowest mean is for item 11: The bank has the policy of investment across different countries, which means that the respondents do not perceive or are not clear if the Islamic and Conventional banks are abiding to a particular guideline in investing across different countries. This could be attributed to the nature of operations of most of the banks being selected in this study, which are very much relying on the domestic market.

These results are somewhat different from those of Tafri et al. (2011) and Wainaina, (2013) which suggest that credit risk management practices of conventional and Islamic banks have stark differences.
The table above shows the various credit risk management styles adopted by both Islamic and Conventional banks.

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. 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.

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.

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

<table>
<thead>
<tr>
<th>Financial Performance Indicators for Selected Islamic and Conventional Banks in Kenya</th>
<th>ROA</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya Commercial Bank (KCB)</td>
<td>0.72</td>
<td>16.03</td>
</tr>
<tr>
<td>Diamond Trust Bank</td>
<td>-0.91</td>
<td>-2.36</td>
</tr>
<tr>
<td>National Bank</td>
<td>-1.82</td>
<td>199.22</td>
</tr>
<tr>
<td>Family Bank</td>
<td>0.40</td>
<td>7.59</td>
</tr>
<tr>
<td>First Community Bank</td>
<td>0.56</td>
<td>8.27</td>
</tr>
<tr>
<td>Gulf African Bank</td>
<td>0.35</td>
<td>4.58</td>
</tr>
<tr>
<td>Equity Bank</td>
<td>0.82</td>
<td>9.35</td>
</tr>
<tr>
<td>Standard Chartered Bank</td>
<td>1.17</td>
<td>14.02</td>
</tr>
</tbody>
</table>

As shown in figure 4.8, in terms of the profitability ratio, the descriptive statistics show that Standard Chartered 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.

Figure 4.9: Credit risk management practices and financial performance

<table>
<thead>
<tr>
<th>Financial Performance</th>
<th>Risk Management Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control on Environment, Policies and Procedures</td>
<td>Risk Measurement</td>
</tr>
<tr>
<td>ROA</td>
<td>-0.349</td>
</tr>
<tr>
<td>ROE</td>
<td>0.254</td>
</tr>
</tbody>
</table>

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. Figure 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 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 Figure 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.

5.0 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.

Overall, the findings on credit risk management practices show the importance of the board of directors to approve the overall organisational policies in ensuring that the management of the concerned bank takes the necessary steps to mitigate the pertaining credit risks. Similarly,
the findings show the importance that the overall organisational objectives are communicated throughout the bank which indicates that the appropriate governance structure must be in place to cater for this crucial objective. Regarding the risk measurement practices, 80% of the respondents strongly agreed that they should regularly assesses their profit and loss position to minimize the risks as there are varying credit limits for each individual counterparty. The findings of the study further 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. Moving to the internal control policies, the Islamic bankers in the study perceived that their respective banks keep the necessary backups of software and data files.

Furthermore, the study reflected that despite the existence of several differences in the adopted strategies, practices 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. However, the study also 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. Similarly, 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.

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.

References


