

Credit Risk and Financial Performance of Fully Fledged Islamic Bankss in Kenya

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Abstract: Islamic banks must carefully analyze the loans granted in order for them to get back the loans as per the agreements. The aim of this study was to assess how credit risk affects financial performance of Islamic Banks in Kenya. The agency theory and the modern portfolio theory guided the inquiry. Descriptive research design was embraced targeting 3 commercial banks offering Islamic products in Kenya and census was used. Secondary cross sectional quarterly data on particularly loan loss provisions and total loans was collected although other associated data on total liquid assets, total deposits, loan loss provisions, total loans, exchange rates fluctuation, total employee expenses, number of employees and net income was collected for the period 2017 all through to 2021 to help augment the results. Three regression models were used to estimate the link between Islamic banking risk, bank size and financial performance. It emerged that credit risk ($r=0.463$, $\beta= -0.249$, $p<0.05$), significantly affect financial performance of Islamic banks in Kenya. It was recommend that the credit managers of the Islamic banks in Kenya should review the existing credit risk management framework and mechanisms to manage the increasing trend in NPLs.

Keywords: Credit risk, loans, Islamic banks, Financial performance

1. INTRODUCTION

Financial performance (FP) is one of the objectives that guide existence of the firm and it helps in maximization of the wealth of the shareholders. FP of the firms is determined by the day to day operations that are carried out (Obeng&Mkhize, 2017). However, risks are inevitable and unforeseen as the firm (including Islamic banks) carries out the daily activities to enhance their financial performance. Unlike the conventional banks, Islamic banks are expected to be Shariah compliant, which require adherence to prohibition of *riba* and this may create differences in their risks which are of greater concern when considering their financial performance. It is the profit sharing principle that informs how the operations of Islamic banks are conducted and this exposes these institutions to an array of risks (Vatimetou, Zouari& Anwar, 2017).

Studies done globally, like in Jordan post certain results like the one by Shair et al. (2019) who observed that majority of the commercial banks in Pakistan have placed more weight on liquidity and credit risks as they seek to enhance their financial performance. Similarly, Mohammed, Mohammed and Ahmed (2021) shared that credit risk and liquidity risk as well as operational and transactional risks has widely been recognized among commercial banks in Baghdad. Surprisingly, within the context of Bangladesh, Majumder and Li (2018) shared that credit risk has an inverse relationship with financial performance. In Kuwait, Al-Yatama, Al Ali, Al Awadhi and Al Shamali (2020) showed that operational and credit risks are the key issues that affected financial performance of the insurance entities in Kuwait. In Bangladesh, Khalid, Rashed and Hossain (2019) noted that no significant link exists between liquidity risk and financial performance.

Borrowing evidence from West African Countries like in Tunisia, Hakimi (2020) showed that operational and credit risk is directly and significantly connected with financial performance. In Nigeria, Oye (2020) showed that operational risk is positively connected with financial performance. However, Gadzo, Kportorgbi and Gatsi (2019) leveraged the context of Ghana arguing that an inverse link exists between credit risk and financial performance. The empirical evidence from Africa thus

show a lack of consensus as to the effect of credit risk on financial performance of financial institutions and this study thus helps to fill the gap.

In Kenya, Omondi (2019) argued that credit, operational, transactional and liquidity risks are important factors that banks need to consider in order enhancing their financial performance. Muriithi and Waweru (2017) failed to provide evidence of existence of significant link between leverage coverage ratio and the ability to financially perform. Studies within the Islamic banking context have largely been unexplored. Much of the existing literature on risk largely focuses on conventional banks which create gap for this current study. Kagunda (2018) noted existence of a significant interconnection between liquidity risk and the ability to financially perform. Although risk has attracted a lot of attention, its analysis.

It should be noted that risk is the eventuality that stem due to variability in profits as well as losses (Ko, Lee &Anandarajan, 2019). Islamic banks face an array of risks including credit, liquidity, operational, market, interest and foreign exchange risks (Bessis, 2002). Risks pertaining to this study include credit risks (CR), liquidity risks (LR), transactional risks (TR) and operational risks (OR). It is a challenge to diversify these risks but can only be transferred. The attributes of Islamic banking aim at reduction of inherent risks especially the religiously established principles. However, the loan contracts in Islamic institutions can contribute towards an increase in risks.

Credit Risk arises when the borrowers in the financial entity are not in position of fulfilling their obligations as established in the contract of the loan facilities. Of great important is the financial entity to engage in detailed analysis and appraisal of the borrowers before disbursal of loan facility to them (Mohammad & Mohamed, 2017). Careful analysis of the loans advanced to customers ought to be evident in financial institutions so as to ensure they are being repaid as per the agreed terms of the contract. This can go a long way in reducing exposure of the financial entity to credit risk (Fouad, 2014).

It was in 2007 when Islamic banking was initiated in Kenya and 3 fully fledged IBs are in place: First Community Bank (FCB), Dubai (DIB) and Gulf African Bank (GAB) (Osman, 2009). The FCB was the first of these entities to start operations in Kenya in 2007. There are also some conventional banking entities like Absa and National Bank of Kenya that also provide Islamic banking products to customers (Osman, 2009). Within the East African region, Kenya has the most developed Islamic banking segment covering an array of products including the insurance (Takaful). There has been increasing growth and expansion of Islamic banking in Kenya due to an influx of most Somalia people in the country (Dahir, 2017).

The Islamic banks claim that they provide same contribution towards the growth of economies just as the conventional banking entities. Such contribution is seen in terms of driving financial inclusion in the economy. The profitsharing practice of these entities allows them an opportunity to efficiently allocate their resources for productive purpose (Zarrouk, Chak&Haija, 2017).The Islamic banks have limited operations in the country with branches highly concentrated in cities like Nairobi and Mombasa. Geographically, these institutions have limited operations across the country. The justification of focusing on these institutions is because of they are relatively new in the country with greater potential to grow and realize better financial positions.

2. STATEMENT OF THE PROBLEM

Islamic banks have faced a decline in their financial performance within the last five years in Kenya. Majority of these institutions have recorded negative ROA, which signify losses as opposed to profits being generated (CBK, 2019). For instance, the average ROA of the three Islamic banks combined stood at -0.1, -0.058, -0.024, -0.009 and -0.001 for the years 2017, 2018, 2019, 2020 and 2021 respectively (CBK, 2021). This declining trend in FP of the IBs is coupled by the banking market environment that has undergone extensive changes. In the perspective of demand, there has been an increase in sophistication of customers who are always seeking to get value for their money. From the supply point of view, the globalization forces have led to deregulation practices among governments (Mohammad & Mohamed, 2017). The two forces have contributed towards intensified level of competition occasioned by reduction of both costs and profits.

The existing studies include Omondi (2019) who appraised the nexus between financial risk and FP of Kenyan commercial banks where interest rate risk was found to have a positive effect while foreign exchange and credit risk had a negative effect. Al-Afeef and Al-Ta'ani (2017) conducted a study among commercial banks in Jordan focusing on risks and how they impact on banking safety and significant effect was registered. Shair, Sun, Shaorong, Atta and Hussain (2019) did a study on risk and competition and their influence on profitability using evidence from banks in Pakistan. It was shown that liquidity risk had positive effect while credit risk had negative effect. Mohammed, Mohammed and Ahmed (2021) were keen to bring out the banking risks and their impact on electronic banking services taking a comparative approach and a significant link was registered. The reviewed inquiries present gaps that are suggested to be bridged by the present inquiry.

3. RESEARCH HYPOTHESES

H₀₁: Credit risk has no significant effect on financial performance of fully fledged IBs in Kenya.

4. THEORETICAL REVIEW

4.1. Agency Theory

Ross (1973) and Mitnick (1975) as well as Jensen and Meckling (1976) are believed to be the proponents of this theory. The theory provides a discussion of the issues that come about when ownership and management is separated. It argues that the key goal that informs existence of the entity is cost minimization and maximization of the level of efficiency. At firm level, the shareholders are regarded as principals while managers are the agents. Thus, the managers are charged with the goal of making decisions that optimize the wealth shareholders acquire (Tosi, Brownlee & Silva, 2003).

Perrow (1986) offered criticism of this theory arguing that it places much emphasis on conflict between the agents and the principals. The other constraint of the theory is that contractual agreement between agents and principals occur within constrained time frame. The theory will be applied in looking at ways and means of reducing costs that might increase possibility of operational risks.

4.2. Modern Portfolio Theory

It was Markowitz (1952) who developed this theory and it lays the foundation of diversification for reduction of risks and thus maximization of returns. Markowitz (1952) held that portfolios that are diversified are more stable and can create more returns. The theory provides an opportunity for investors to make an assessment of the desired returns within the portfolios they hold. During the management of their portfolios, the key task played by investors is how best to maximize the returns realized (Elton, Gruber, Brown Goetzmann, 2009).

The premises of this theory include adherence to concerns about normality by the returns from the securities, ability of to make decisions that are rational and investors seeking to ensure their returns are maximized (Ulrich & Marzban, 2008). The theory considers past performance which fails to offer results that can guide future decision making processes (Bakar & Rosbi, 2018). The assumption that returns are distributed normally is also misleading, especially for some specific equities. This theory will be used to underpin the main independent variable bank risk.

5. RESEARCH METHODOLOGY

5.1. Research Design

The study adopted a descriptive research design. This is the type of design whose focus is on providing a description of the degree which a given event has occurred (Bryman & Bell, 2007). Through this design, it was possible to have a description of Islamic banking risks and financial performance. This was critical in providing answers to the developed hypotheses.

5.2. Target Population and Sampling Design

Targeted population covers the elements that the researcher has interest to uncover in an inquiry (Mugenda & Mugenda, 2008). Three fully fledged Islamic banks were targeted. To sample is to identify representative elements that should be included in the inquiry. The main reason for carrying out sampling is to reduce on costs of gathering data since it is not possible to cover all the population. This study used census and thus all the 3 banks were covered.

5.3. Data Collection and Procedure

The study used a sheet to gather auxiliary information. The data was collected on a quarterly basis to generate adequate data point for supporting quantitative analysis. Information from auxiliary sources on a quarterly basis was gathered in this inquiry over a period 2017-2021. This information was gathered on total liquid assets, total deposits, loan loss provisions, total loans, exchange rates fluctuation, total employee expenses, number of employees and net income. Further Information from auxiliary sources was obtainable within the time frame 2016-2020 and it was obtained from monetary reports of the banking entities. The data was collected from CBK reports and the respective entities. The researcher used a data capture form prepared in an excel worksheet. All the data was collected and organized based on trading years. The data was used to calculate the proxies for the key variables in the study.

5.4. Data Analysis and Presentation

Descriptive statistics covering means and standard deviations were utilized to summarize the data and present distributions of the data collected. Inferential analysis was utilized to understand the effect of the variables. A multiple regression models shown below was used to inform the basis for analyzing the hypothesized link between study variables.

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \epsilon_{it}(i)$$

Where:

Y_{it} - Financial performance (Return on Asset) of bank I and time t

X_{1it} - Transaction risks of bank I and time t

X_{2it} - Credit risks of bank I and time t

X_{3it} - Operational risks of bank I and time t

X_{4it} - Liquidity risks of bank I and time t

S_{it} - The error term

i: 1-3 Islamic banks

t: time period 2017....2021

Model I was used to estimate the effect of the independent variable (IB risk) on the dependent variable (FP).

6. RESEARCH FINDINGS

6.1. Trend Analysis of Islamic Banking Risks

Four Islamic Banking risks: operational, transactional, credit and liquidity risk were identified and their trend across the period of consideration was explored and summed up as demonstrated in Figure.

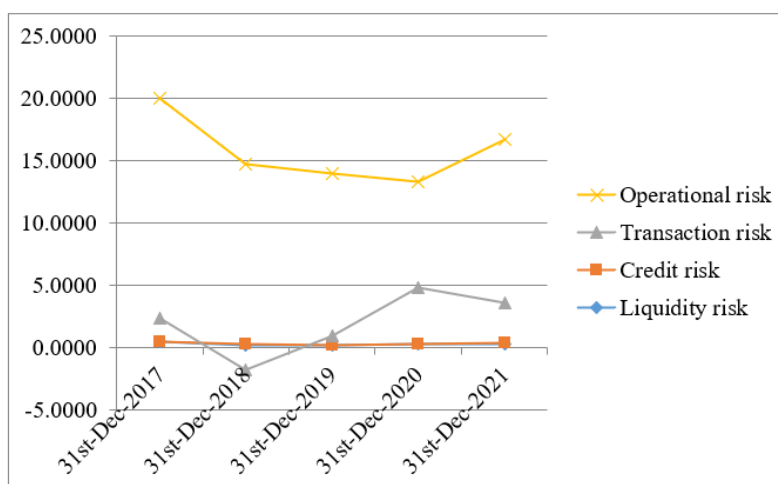


Figure 1. Trend Analysis on Islamic Bank Risk

Source: Research Data (2022)

Figure 1 demonstrate that operational risk is above all other the risks that the institutions face followed by transactional risk and credit risk as well as liquidity risk. Liquidity risk and credit risk are also same across the Islamic banks in Kenya. Hence, operational risk is the most outstanding risks those Islamic banks in Kenya do encounter. At some point like for the case of 2018, transactional risk among Islamic banks was negative. This can be attributed to significant fluctuations in exchange rate against dollar that increased the exposure of these institutions to transaction risks. This means that the foreign transactions of the Islamic banks in 2018 were characterized by significant degree of volatility as compared to the executed across the remaining periods.

6.2. Trend Analysis on Financial Performance

Financial performance was the dependent variable that was covered in this study. This variable was represented by ROA, a measure that was adopted because it has been commonly adopted in literature when it comes to measuring of FP. Figure 2 is the breakdown of the trend analysis on this variable.

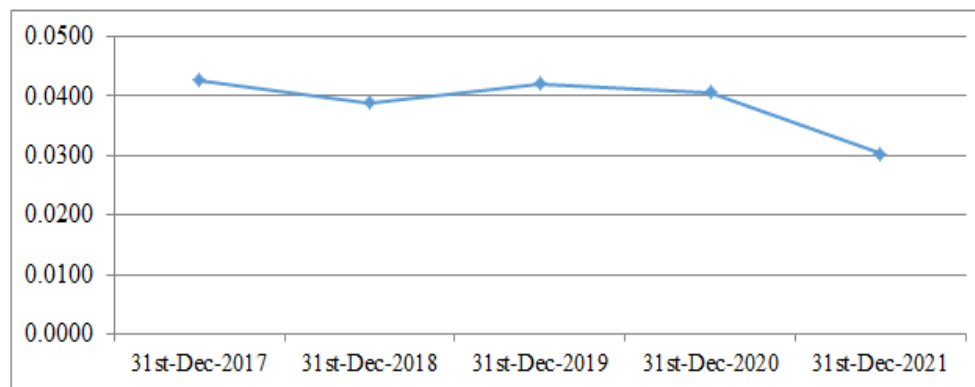


Figure2. Trend Analysis on Financial Performance

Source: Research Data (2022)

From the results, there was generally a fluctuation in financial performance of this institution which can be attributed to the afore-stated risks that they had exposure to especially the operational and transactional risks. The period 2018-2020 was characterized by stability and a consistent rise in financial performance before the trend worsened in 2021 probably occasioned by the COVID-19 pandemic that reduced the profits generated by this institutions. This trend in financial performance of the Islamic banks in Kenya is empirically supported by Dubai Islamic Bank whose value of ROA reported for 2017, 2018 and 2019 were -32.15%, -16.6% and -8.8% respectively (CBK, 2019). For First Community Bank, the value of ROA reported in 2016 and 2018 were -0.28% and -1.6% respectively (CBK, 2018). Gulf African Bank has also been experiencing a decline in its financial performance in terms of ROA as shown by 4.42%, 2.78%, 0.81%, 0.9% and 0.6% for the year 2015, 2016, 2017, 2018 and 2019 respectively (CBK, 2019).

6.3. Pearson’s Correlation Analysis

Correlation analysis was conducted to provide a description of the relationship existing between Islamic banking risk and FP. Table 1 is a breakdown of the findings.

Table1. Correlation Matrix

		Financial performance	Liquidit y risk	Credi t risk	Transact ion risk	Operati onal risk	Firm size
Financial performance	Pearson Correlation	1					
Liquidity risk	Pearson Correlation	.199	1				
Credit risk	Pearson Correlation	.463	.428	1			
Transaction risk	Pearson Correlation	.580	.099	.576	1		
Operational risk	Pearson Correlation	.517	.432	.461	.421	1	
Firm size	Pearson Correlation	.238	.101	.257	.079	.314	1

Source: Research Data (2022)

LRis a weak but positive correlate of FP ($r=0.199$). Thus, liquidity risk is a correlate of FP. The finding concur with Golubeva, Duljic and Keminen (2019) who used a case of European markets to link liquidity risk and profitability and the identified measures of liquidity were seen to have a direct link with profitability. Musembi (2018) showed that the level of liquidity and ability of financially planning were linked in significant terms.

The findings on credit risk show that it has a moderate and positive interplay with FP of Islamic banks in Kenya ($r=0.463$). This means that credit risk is positively related with FP. This finding contradicts with Ekinici and Poyraz (2019) who noted an inverse link between CR and ROA as well as ROE as proxies of FP. Gadzo, Kportorgbi and Gatsi (2019) showed that an inverse link exists between the study variables covered. Munangi and Bongani (2020) showed existence of an inverse link between credit risk and financial performance. Onang’o (2017) showed that only NPLs had an inverse and significant link with FP.

The study established that transactional risk and FP of Islamic banks in Kenya are strongly and positively linked with each other ($r=0.517$). It then follows that transactional risk is strongly linked to FP. Lelgo and Obwogi (2018) provided an indication that a direct nexus exists between exchange rates and ability of the entity to FP. Pradita and Geraldina (2019) looked at currency risk and the link with performance of the banking entity where a significant nexus was shown between ability of the entity to financially perform and transaction risk. It was shown that operational risk is strongly and positively linked with FP of Islamic banks in Kenya ($r=0.517$). Hence, OR is a strong and positive correlate of FP. The result is supported by Hakimi (2020) who used Tunisia to illustrate the link between operational risk and performance and showed that operational risk is directly and significantly connected with FP. Oye (2020) looked at operational risk management practices and their link with FP. The inquiry showed that operational risk is positively connected with financial performance. Kamau (2018) looked at operational risk management and its connection with FP where it was noted that operational risk is inversely linked with financial performance. On the contrary, Toroitich (2018) focused on exposure to operational risk and its link with FP and the link between credit risk and ROA were inverse. The nexus between bank size and financial performance was weak but positive ($r=0.238$). This means bank size was a positive correlate of FP. The finding contradicts Wayongah and Ochieng (2019) who looked at firm size, leverage and FP and an inverse moderating role of size was noted in this study.

6.4. Regression Results Linking Islamic Banking Risks and Financial Performance

Regression Model Summary

Table 2. Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.893 ^a	.798	.783	.00733

Source: Research Data (2022)

The findings in Table 2 indicate that 79.8% variation in financial performance of Islamic banks in Kenya is jointly explained by Islamic banking risks ($R^2=0.798$).

Analysis of Variance

Table 3. Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.012	4	.003	54.242	.000 ^b
Residual	.003	55	.000		
Total	.015	59			

Source: Research Data (2022)

Table 3 indicate that the overall regression model of the study was significant in statistical terms ($F=54.242$). The resultant $p < 0.05$, this means that Islamic banking risks are significant predictors in the overall regression model.

6.5. Regression Beta Coefficients and Significance

Table 4. Regression Beta Coefficients and Significance

	Unstandardized Coefficients		Standardized	t	Sig.
	B	Std. Error	Coefficients		
(Constant)	.026	.002		15.228	.000
Liquidity risk	-.018	.005	-.101	-3.600	.011
Credit risk	-.249	.080	-.163	-3.113	.015
Transaction risk	.003	.001	.411	3.000	.000
Operational risk	.001	.000	.761	5.500	.002

Source: Research Data (2022)

From Table 4, the following equation is predicted:

$$Y_{it} = .026 - .008X_{1it} - .059X_{2it} + .003X_{3it} + .001X_{4it}$$

Where, Y= is financial performance, X_1 is liquidity risk, X_2 is credit risk, X_3 is transaction risk and X_4 is operational risk

Table 4 provides the findings as follows ($\beta = -0.249$, $p < 0.05$), meaning there is significance and in line Ekinci and Poyraz (2019) who inquiry noted an inverse link between CR and ROA as well as ROE as proxies of financial performance. Catherine (2019) showed that credit appraisal is a significant activity that supports financial performance in a banking entity. Al-Yatama et al. (2020) showed that operational and credit risks are the key issues that affected financial performance of the insurance entities in Kuwait. Gadzo, Kporgbi and Gatsi (2019) largely focused on credit and operational risk and their link with financial performance and showed that an inverse link exists between the studies variables covered. South Africa, Munangi and Bongani (2020) showed existence of an inverse link between credit risk and financial performance. Onang'o (2017) showed that only NPLs had an inverse and significant link with financial performance. Thus the following hypothesis is accepted:

H01: CR has no significant effect on FP of fully fledged IBs in Kenya

7. CONCLUSION

The analysis shows that credit risk did not have a significant effect on financial performance of Islamic Banks.

8. RECOMMENDATIONS

Therefore, it is recommended IBs in Kenya should review the existing CRM framework and mechanisms to manage the increasing trend in NPLs. The loan officers working in the Islamic commercial banks in Kenya should set aside an optimal level of loan loss provisions that minimize the credit risks occasioned by the an increasing in NPLs. Further, IBs in Kenya need to review the existing infrastructures regularly and recommend continuous repair and maintenance to avoid possible non-performance of internal processes and the system. This will contribute towards continuous operations without unforeseen interruptions.

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