

**THE EFFECT OF OPERATIONAL RISK MANAGEMENT  
PRACTICES ON THE FINANCIAL PERFORMANCE IN  
ISLAMIC BANKS IN KENYA**

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## DECLARATION

This research project proposal is my original work and to the best of my knowledge has not been presented in any institution or university for academic purpose(s).

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This research project proposal has been submitted with my approval as the University Supervisor.

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## **DEDICATION**

This project is dedicated to my parents for their continued support through our education journey.

## **ACKNOWLEDGEMENT**

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## **LIST OF ABBREVIATIONS**

**AMA** – Advanced Measurement Approach

**BIA** – Basic Indicator Approach

**BIS** – Bank of International Settlement

**NBC** – National Bank of Commerce

**NMB** - National Microfinance Bank

**NPLs** – Non –Performing Loans

**ROA** - Return on Assets

## ABSTRACT

The Islamic banking system has gained momentum worldwide. The Islam banks risks are normally viewed from the perspective of the uncertainty. The Islamic laws are very clear on any element of providing information asymmetry or speculative behavior which leads to dishonest profits which is haram according to Islam doctrines. The Islamic religion provides that any financial activity which may lead to an investment earning interests on the invested amount is unlawful. The study aimed at evaluating the effects of Islamic banking profitability covering 5 years. SPSSv21 was used in the study to aid in data analysis in order to establish the association linking the variables under study. The ANOVA shows an F value of 3.776 and a P value  $< 0.05$  indicating that the overall regression model for the control variables is significant hence it has some explanatory value. Hence, an existence of strong association linking ROA to different financing modes. At 95 percent confidence interval P-value ( $p < 0.05$ ) implying that the variables combined do influence Islamic banks performance. In the full model constituting of predictors and the control variables, Ijarahad the most statistically significant coefficient as indicated by the t-ratio of 2.353 ( $\beta = 7.58E-10$ ,  $t = 2.353$ ,  $p \text{ value} = 0.04$ ). thus, the available Islamic products available in Kenyan commercial banks had a strong direct association to ROA implying that the diversification and introduction of more financing modes will enhance commercial banks performance offering Islamic financial services. instruments such as Sukuk since Islamic banks are locked out of treasury bills and bonds which are

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

ORM has gained momentum in past years from the stakeholders to the academicians. This is mainly due to large losses suffered by the financial institutions over the last decade even leading to collapse of many institutions (Hoffman, 2002). Increased number of collapsed financial institutions has forced the stakeholders to rethink the issue of ORM. There are numerous definitions of OR with the BCBS which defined the term by embarking on various consultative meeting with the banking stakeholders across the globe. (BCBS, 2001).

Banks like other corporations are established so as to maximize their shareholder wealth. Wealth is the function of risk and return. In every market, if an institution or organization intends to attain high returns, it has to invest in investment portfolios which high are deemed to be riskier. Commercial banks operate in the industry which is associated with high risks which usually emanate from various sources. They differ in their natures and occurrences pertaining to different business activities. That is to say that certain risk is particular in their natures that specifically affect the operations of banking industry (Young, 2012).

The Islam banks risks are normally viewed from the perspective of the uncertainty. The Islamic laws are very clear on any element of providing information asymmetry or speculative behavior which leads to dishonest profits which is haram according to Islam

doctrines. The Islamic religion provides that any financial activity which may lead to an investment earning interests on the invested amount is unlawful. This does not imply that the investors have to suffer all the losses associated with the businesses as it recognizes the risks associated with banks especially the commercial banks which are associated with default risk from some of its clients. The regular commercial banks, the clients are guaranteed of a fixed rate of interest return on the deposited amount with their capital as well.

The regular banks must therefore, meet the financial obligation with the depositors even if it doesn't realize the projected returns. The losses suffered or profits generated solely affect the shareholders who suffer losses when the bank post losses and gain dividends in times when firms report profits. On the hand, Islamic banks spread the risk amongst its clients. The group associated with the firms profit share is the shareholders. The profits in the banking sector are not guaranteed. This puts the investors in a situation whereby they stand a chance to lose part or all of their invested funds.

The Islamic banks were established with the sole purpose of being a perfect substitute to the regular commercial banks. Islamic Banking has grown substantially and has become one of the best service providers in the banking industry especially among the developing nations leading to the witnessed increased growth of GDPs especially in the countries where the institutions are well established. The sector operates normally as the regular banking institutions with the exception of charging interest rates and it is based on the underlying fundamental concept of justice as well as sharing of risk (Benhayoun et al., 2014). Islamic banking emanated from Islam which highly encourages for the wealth to be shared equally among all thus making it a cornerstone

in championing for the bridging of the gap that exists between the haves and have nots in the society (Ismail, 2010).

### **1.1.1 Operational Risk Management**

The principal organization of central bank (based in Basel Switzerland) in the major economies of the world defines this term as the risk of losses which is caused by weak internal control systems ranging those emanating internally as well as the ones emanating externally. These risks can be subdivided into the predictable and unpredictable. This kind of risk has become wide spread over the last couple of decades as every financial institution has experienced it in one way or another Bloom & Galloway (199).

Globalization and technological advancement has opened doors for the financial institutions to report high returns but at the same time making them susceptible to various risks, (Bloom & Galloway, 1999). The internal control systems of the financial institutions has lagged behind in terms of providing strong systems to be able to cope with the advanced technological advancements in order to avoid the vices it comes with it; Barings incidence, 1995. This incidence opened eyes of many financial institutions to strengthen their ORM.

The BCBS report in 2003 any risk apart from the credit and interest have significant influence on commercial banks performance. The report identified the following examples of the technological progression; technology in the industry has resulted to new risks example; increased use of technology in the banking industry has resulted to frequent system failures which are catastrophic and lead to massive losses especially in

the institutions where every activity is computerized. Globalization has led to increased cases of frauds and complication of the processing processes in cases where the adopted system is complicated. The witnessed growth of banks has resulted to the need for continuous maintenance of the control systems. According to the Credit-Suisse Group (2001), many financial institutions have established committees whose sole purpose is to mitigate risks which have resulted to exposure of new kind **risk** like operational risks which the group categorized as organizational risks, process risks, technology risks, human risks and external risks.

### **1.1.2 Financial performance**

Dayson et al., (2006), defined financial performance as the efficiency with which a firm uses its resources in generating revenues. Quach, (2005) define performance as a proxy for revealing the health of a firm as well as its going concern, and also used for comparing firms in the same industry. There are various ratios which are used for measuring the performance of firms.

Firms are mostly concerned with their profitability, as profitability serves as the main driver for firms engaging in businesses as firms constantly making losses will in the end be insolvent. The notable measures of financial performance in companies include ROA, ROE and net margin on sales. It also serves as the measure of how well a firm is performing in the corporate world. The use of equity and debt impact the common performance measures in different ways. A given firm with relatively high use of debt will have higher interest expense and therefore lower net margin. On the other hand, a relatively lower use of equity would result in a proportionately higher return on equity. Therefore, if a corporate entity were to use relatively less debt and more equity, the opposite would be true ((Quach, 2005).

Many firms use past and present financial performance as the only measures of how well the firm is performing but they focus on the performance of other firms in that industry (Carton, 2004). The main ratios used as proxies for financial performance include: growth of sales, ROI and ROS, ROE as well as the dividends earned by the shareholders (Zenios et al., 1999).

### **1.1.3 Operational Risk Management and Financial performance**

Good financial risk management system is highly relevant in enhancing financial performance of banking institutions. Effective risk management enables organizations to gain on new openings and to mitigate threats to their financial sustainability (Rasid et al., (2011). Firms experiencing good financial performances achieve this through effective risk management strategies, which minimize the effects of financial risk (Williamson, 2004).

According to Zaki et al., (2011) credit risks, especially weakness in credit risk management is one of the key reasons behind the failure of majority financial institutions. This occurs if the banking institutions fail to institute proper credit risk management strategies. Nuxoll (2003) states that poor internal control strategies increase the risks which lead to decline in the firm returns due to huge financial losses to an organization. The study concludes that operational risks affects banking institutions negatively especially if it happens unexpectedly.

According to Mwaipopo (2012), effective operational risk management strategies ensure that banking institutions report high returns hence they are able to advance loans to its clients in timely manner. In his study, Bongomin (2009) examined the link between operational risks management to banks financial performance in Uganda. The

findings showed that operational risks management predicts 53% of the variance in the financial performance of banks in Uganda.

#### **1.1.4 Islamic Banks in Kenya**

Islamic banks are operated *shariahs* which prohibit engaging in business activities which are set with the intention of gaining interests. Require that the financial institutions must provide all information needed by the clients and discern from all the hidden charges or cost associated with their services. The third factors is that the banking institutions should not engage in the gambling activities in their attempt to maximum on their revenues by gaining “easy” cash. Other factor is that the institutions should not engage in illegal financial activities like engaging themselves in drug related businesses. All the parties engaging in financial activities must share profit and losses equally. All Islamic banking institutions must adhere to the above factors which distinguish them from the normal banking institutions. The operational risks faced by these institutions are the same as those faced by the normal banking institutions (Archer & Haron, 2007).

In Islamic history banking have made major contribution to GDP growth in past couple of years. The banks started as exchange bureaus commonly known as *Sayarifah* which also engaged in advancing loans and deposit taking for short periods (Chapra and Khan, 2000). These institutions were later replaced by others known as the *Jahabidhah*, whose service provision is similar to the modern day financial institutions (Chachi, 2005). These institutions initially started as the trading merchant before transforming to

deposit taking institutions especially after experiencing immense popularity and growth (Heck, 2006).

The Islamic banking in the country over the past decades have experienced immense growth commanding a market share of 1% pertaining to market assets. The Islamic banks in the country are few with only two of them operating in the country with a total of Kshs 8 billion from the deposits and over 1 million clients. This is an indication of untapped potential in the industry (Muriri, 2009). The FCB in the country began its operations in the year 2008 which was later followed by the establishment of Gulf African Bank, the first ever full Islamic bank.

## **1.2 Research Problem**

Recent financial crises have proven that risk management practices are essential for organization, large and small and therefore, risk awareness should be made a key component of strategy development in any organizations. However, according to Khan et al. (2008), most of these risks are beyond the control of a given organization although he observed that an organization can prepare and protect themselves in time-honored ways. The businesses need to balance between risks managing as well as revenues generation in order to remain competitive. The external factors pose major threats to the existence of firms as compared to the internal factor to the organization and this clearly shows the ever changing risk factor. Banks generally operate in environments where risk changes often, hence the need for an efficient risk management process, categorized by risk type to be able to address the specific risk factors.

Risk management is integral to banking sector profitability. It involves managing the risk factors of an organization in such a way that it conforms to the institution culture. Financial institutions in the recent time have come under immense pressure particularly from stakeholders to effectively manage their operational risk (BCBS, 2014). By linking operational risks, banks are able to appreciate the purpose of risk-based management frame-work? Such appreciation is critical for the institution to fund the processes of ever changing operational risk management in order to achieve its organizational objectives (Payle, 1997). Some of the global studies on risk management financial performance include BNM (2008) who established that the readiness of the banking institutions to mitigate risks is important as witnessed in the global financial crisis in 2008. This led to the emergence of Basel III which was aimed at mitigating those risks (BCBS, 2009).

The review of the local studies shows that several researches pertaining to the study topic exist in Kenya. Kabiru (2002) carried out a research to establish the correlation linking credit risk practices to NPLs among Kenyan banks. Ongechi (2009) analyzed the risk management strategies used by Fina Bank Limited in lending to SMEs. Kithinji (2010) carried out a study on the correlation linking credit risk management to ROA of banking institutions in Kenya. Muasya (2009) on the effect of NPLs on Kenyan banks ROE covering the period of financial crises while Wanjira (2010) analysed the association linking NPLs to ROA among Kenyan banks.

These researches primarily focused on commercial banks in dealing with credit risk management aspects with no reference to Islamic Banks. Yet there are unique risks associated with Islamic Banks such as shariah non-compliance risk, equity investment

risk and rate of return risk. None of the studies have dealt with the comprehensive risk management practices that address all the aspects of business risks including operational, financial, compliance and governance risks impact on the financial performance of the Islamic banks in Kenya. The researcher aimed at filling the study gap by finding out the effect of operational risk management on the financial performance of Islamic banks in Kenya. The study therefore sought to answer this research question: What is the effect of operational risk management on the financial performance of Islamic banks in Kenya?

### **1.3 Research Objective**

To determine the effect of operational risk management practices on the financial performance of Islamic banks in Kenya.

### **1.4 Value of the Study**

The study may offer vital contributions which will improve the understanding of risk management and its effect on the profitability of Islamic banks and by extension other banking institutions in Kenya.

The goal of operational risks management is to make sure daily running of the banks are going as planned. The findings of this research will be important to the following: Senior managers of banks as it will provide guidance on the framework of management and identification of operational risks by decision makers within the banking industry. Commercial banks staff members who face operational risk management will be able to draw inference to the study in picking up areas of improvements.

The regulator (Central Bank of Kenya) may use this study to design and improve on the current risk management framework for all commercial banks in Kenya. The study may improve the risk management knowledge under the study topic. This may improve on the future researchers by providing materials that form the basis for further study in the banking sector.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

Theories and work that has been carried out by other scholars in the past concerning the phenomenon under study were highlighted. It will bring forth the gap that exists in the topic under study despite the previous researches that have been carried out by other scholars.

#### **2.2 Theoretical Review**

Various theories including: risk management theory, modern portfolio theory, PLS theory and theory of Islamic banking were discussed.

##### **2.2.1 Risk Management Theory**

According to Wenk (2005), risk management model consists identifying risk, resource distribution and regulation of the unfortunate events occurring to take advantage of the emerging prospects. Risks emanate from various sources ranging from the environmental factors, poor projections, financial factors and natural factors among other factors. Methods of managing risks varies in accordance with the cause or origin of the risk factor (Simkins & Fraser, 2010). The commonly used strategies in managing risks comprise forward shifting which entails transfer it to another individual, reducing the effects of the risk, as well as acceptance of the negative effects associated with it.

Effectively managing risks has huge benefits to all institutions whether it's huge or small (Ranong & Phuenngam, 2009). They include; high turnover, firm efficiency, gives it an edge over its competitors, decreased pressure from the shareholders, ensure

the going concern concept is still held, efficiency in firms utilization of resources, less supervision costs, decreased embezzlement of firm resources by the top management, leads to improvement in firms innovative culture (Wenk, 2005).

### **2.2.2 Modern Portfolio Theory**

The modern private equity practice Markowitz (1952) is considered the pioneer authority behind the portfolio theory and posits that investors can reduce variance in their investment by investing in various securities. The model presupposes that diversification is vital to investors as they provide the balance as an investor is going to experience losses in some securities and gains in others. Therefore, the main argument behind this theory is for the investors to be rational when choosing the mix of their investments and focus on the investments which yield higher returns. Mignola & Ugoccioni, (2006) on their study on the impact of diversification on investment returns found a strong and positive correlation between the two phenomena. This theory is considered to be a strong basis in financial sector and the cornerstone to finance (Linbo 2004).

The modern portfolio theory presents an investment rule that is considered to be reasonable as investors want to maximize their wealth and generate a high utility as possible. The rule states that an investor should diversify his investment portfolio among those investments that are expected to generate the highest return (Chopra & Sodhi, 2004). Accordingly, investor's choice of the assets forming part of their portfolio is dependent on their risk tolerance on the efficient frontier whether risk averse, risk taker or risk neutral

This theory advocates that the investors aim at reducing their risks while increasing their returns and thus they should diversify to avoid risking everything on one endeavor.

Through investing, investors stand a chance of increasing their returns since they investment in various investment opportunities. The risk and return from any investment can be duplicated in many ways through various combinations of other investments (Ogada, 2014). This theory assumes that returns are unpredictable and no one can end up making windfall returns (Mignola & Ugocioni, 2006).

### **2.2.3 Profit and Loss Sharing Theory**

The PLS concept among the financier and intended fund user is applied. This is a vital concept as it's based on the Islamic law which advocates for equality among human kind whether rich or poor. These laws advocate for the clients to bear some of the risks associated to investing activities (Jedidia & Hamza, 2014). The PLS applied in these institutions which is in accordance with the Shariah laws. The concept emerged due to the prohibited interest earning which is haram in Holy Quran (Ashraf, 2013). The only option of minimizing the risks particularly during the loss making period is through PLS in order to achieve the objective of bridging the gap between the have and have nots in the society (Zamil, 2014).

The PLS notion plays a vital role in GDP growth through ensuring wealth is equally distributed among all the members of the society hence restoring peace and stability in the society. This system further leads to a more improved capital allocation system whereby efficient capital allocation leads to better project performance (Nedal, 2011). This system is associated with better performance as compared to the interest earning systems (Siddiqui 2001). Many past scholars have associated this system to a more stable market by reducing the inequalities which are witnessed in the regular

commercial banks whereby the poor face many constraints before accessing any finances (Zamil, 2014).

#### **2.2.4 Theory of Islamic banking**

The Islamic banks are founded on the Islamic shariah which prohibits the institutions from charging interests to its clients as this goes against the Holy Quran (Hassan & Lewis, 2007). The theory is founded against the common notion that financial institutions have to charge interest rates for their survival by asserting that interest rates the teaching provide for by the Islam provide all the necessary guidelines necessary for the institutions to continue working profitably (Ahmad, 2006). The shariah also prohibits use of contracts intended to exploit the other party (Hassan & Lewis, 2007).

### **2.3 Determinants of the Financial Performance**

Important measure of financial performance is profitability (Wild, Shaw & Chiappetta, 2009). Muthini (2005) conducted study on determinants of bank profitability in Kenya by empirically evaluating the link between internal and external determinants over profitability over a period of ten years (2002 to 2012).

#### **2.3.1 Capital Adequacy**

This is extra funds for bank to provide a buffer particularly when the firm is facing liquidity problem (Athanasoglou et al. 2005). The banking institutions faces the problem of hoarding cash which leaves the bank fragile while huge capital decreases the probability of the bank collapse (Diamond, 2000). CAR is used as an indicator of how the institution will be able to overcome the hard-economic conditions (Sangmi & Nazir, 2010).

### **2.3.2 Asset Quality**

This is directly proportional to the age of the banking institution (Athanasoglou et al.2005). Many banking institutions depend on the loans advanced to its clients to generate future cash flows. The banks have to get it right when it comes to the loans as the quality of the loan is directly proportional to their profitability. Major losses suffered by banks emanate from the loans advanced to its clients due to the default rate (Dang, 2011). This implies that the measurement of asset quality is number of NPLs. This reveals an inverse correlation which exists between the number of NPLs and bank profitability; as NPLs increase bank performance decline, as NPLs reduce bank performance improve (Sangmi and Nazir, 2010).

### **2.3.3 Management Efficiency**

Efficiency refers to way of producing the best output out of the limited resources, which in this case, is reaching out to as many clients as possible given the small sizes of the institutions. Efficiency is the best proxy for banks performance as it shows the best way of providing services given the limited resources of the institutions and minimizing wastage of the available resources (Olasupo, Afolami&Shittu, 2014). The efficiency of banking institutions could be measured by its productivity (for instance, Borrowers per Staff Member) (Rahman et al. in Ilhomovich, 2009; Sangmi & Nazir, 2010).

Efficiency involves cost minimization and income maximization at a given level of operation. Thus, efficiency can be measured by its productivity (for instance, number of borrowers per staff) and cost management (for instance, cost per borrower) dimensions. The proxy for productivity is the ratio of the funds required to lend to the

actual borrowers, is used and it is estimated to be positively associated with financial sustainability (Athanasoglou et al.2005).

#### **2.3.4 Liquidity Management**

This is a term used to refer to the ease of converting an asset into one which can yield cash easily (Dang, 2011). Many investors prefer liquid markets especially the speculators. Firms with many liquid assets are more preferred by the investors and can easily raise capital from the public without much struggle. The banks are able to advance loans easily as well as pay the creditors without struggling (Ilhomovich, 2009). Banks are more likely to be affected by the fluctuations in liquidity as there are continues activities of cash deposits and withdrawal (Said and Tumin, 2011).

#### **2.3.5 Macroeconomic Factors**

Diverse macro factors are; inflation costs, interest rates, and taxes. These factors influence the bank loan repayment amounts that in turn influence affordability of the bank loans and therefore the banking institutions loan uptake levels (Athanasoglou et al., 2005).

Major macro-economic factors in the context of commercial banks include central bank rate, growth in gross domestic product, lending interest rates, inflation rate, interest rate spread, and money supply. Other factors include GDP growth and government policies (Vong & Chan, 2009).

### **2.4 Empirical Literature Review**

Tafri, Rahman, and Omar (2011) carried out a study on correlation linking risk management to ROA among the Islamic banks in Middle East. The study results revealed a strong direct correlation linking risk management to ROA. The study also compared the performance of Islamic banks to other forms of banks and concluded that

their performance was relatively lower as compared to the Islamic banks which do not charge interests. Since this study was carried out in Middle East, this created a contextual gap.

Abdullah, Shahimi, and Ismail (2011) assessed the severity of the operational risks on financial performance of Islamic banks in Malaysia. They employed primary data collected through questionnaires. The study findings revealed that the Islamic banks in the country face operational risks coming from both internal and external sources, which range from management to interest rates. Credit risk was the major concern to the profitability of the financial institutions as the non-performing loans were the major challenge financial institutions were facing which emanated mainly from the firm's inability to screen out the bad debtors. Competitiveness among the banking institutions in the country were also another major challenge due to high number of such institutions in the country. The study recommended that for the bank to overcome the challenge it has to put in place risk management strategy or department.

Jalaluddin (1999) carried out a study on the attitudes of Australian Banking institutions specifically on the profit and loss sharing methods. It was observed that many banking institutions in the country were prepared to lend under the PLS concept as it puts off the pressure from the banking institutions and at the same time increasing the demand for the banking loan services. They also revealed that they will experience decrease on the number of the defaulters as its common on other forms of banking institutions in the country.

Chong and Liu (2009) researched on whether Islamic banks are indeed interest-free, using Malaysian experiences as a case study. Their findings suggest that PLS schemes is indeed the distinguishing feature of Islamic banking although they tend not to be as important as a mode of financing on the assets side of the balance sheet. While the financing structure on the deposit-side is theoretically a profit- and loss-sharing contract, pay-outs tend to be closely pegged to rates on conventional deposits. Unlike conventional banks, Islamic banks do earn fees and commissions relating to services beyond traditional deposit and loan financing activities.

Kadubo, (2010) studied factors behind the wide spread development of Islamic banking institutions in East African region. The study results indicated customer needs which suit the individual clients as the main factor behind their development. It recommended that the banks should diversify their products to attract many clients from different religious settings.

Kamau (2010) in a study of adaptation of risk management by commercial banks in Kenya, indicated that operational risk was very critical and it was 44% out of the other risks that occurred in commercial banks, and this is due to the high increase in the use of automated technology, lack of qualified staffs and lack of management supports in the organizations, and also the internal and external frauds.

Macha (2010), in his research on operational risk management and profitability of banking institutions in East African Region revealed that out of 60 banking institutions, only 20 of them have insurance against operational risk. According to Bank of Tanzania it is very risk and possibility of the bank failure is very high if the bank will not secure

its cash or properties by insuring them. The study showed that although there are a number of cash operation risks facing commercial banks, corrupt employees in the banking organizations deal with are the major cash operation risks that face the commercial banks. The study further established that cash operation risk management practices are very critical business process, due to the nature of business that banks engage in. that explain why there has been a huge investment to put in place adequate risk management practices across the industry in an effort to secure the banks business activities. To a very great extent each bank has engaged in the use of regulators guidelines which provide the minimum threshold of practices that must be used by all banks in managing the cash operations risks.

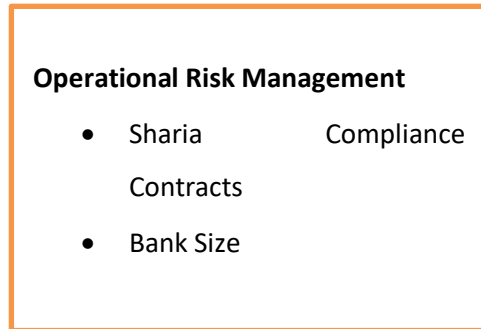
Yusuf, (2005) in a survey approach examined the operational risk management by commercial banks in Kenya. The study indicates that quantification of risks into various categories was widely practiced by Kenyan commercial banks, the research indicate that only sixteen (16) out of twenty two (22) banks surveyed had segregated risks into various categories and thus only few of these banks used various models to quantify risks. In additional the study notes that a Central Bank of Kenya survey of July 2005, indicated 20 banks out of the total banks registered in the county had capital reserves to deal with operational risk management. In conclusion the study undertakes that in Kenya banks do not necessarily make an attempt to predict the degree of occurrence of risks.

Wako et al. (2014) conducted a study that was aimed at analyzing performance of Islamic banks in Kenya. This study adopted random sampling method. It found out that global economy changes, advancement in information technology, the difficulties of

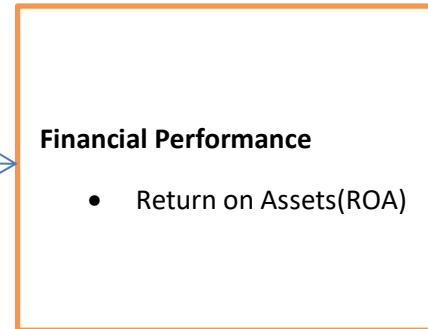
legal and institutional framework, weak risk assessment and corporate governance standards were major factors affecting Islamic commercial banks performance in Kenya.

## 2.5 Conceptual Framework

### Independent Variable



### Dependent Variable



## 2.6 Summary of the Literature Review

Several studies were reviewed to establish the effect of operational risk management on profitability of Islamic banks in Kenya. A good number of the reviewed studies for instance Yusuf (2005); Macha (2010) & Kinde (2012) focused on the factors affecting sustainability of Islamic banks while studies by Kadubo (2010) assessed the relationship between operational risk management. Similarly, Chong and Liu (2009) who explored the severity of operational risk among the financial institutions, Kamau (2010) who explored the association linking financial risk management systems to financial performance of banking institutions in Kenya. Most studies explore the determinants but operational risks have not been explored widely. The scarcity of literature on the topic calls for an examination of effect of operational risk management on Islamic banks in Kenya.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter discusses an overview of different methods and tools used to gather data to meet the objective of the study. It describes the research design, it state the target population, sample design, highlight data collection procedure and data analysis.

#### **3.2 Research Design**

This is the design the researcher intends to adopt in order to connect the study problems to the applicable and achievable manner (Orodho (2003). The research was aimed at determining effects of operational risk management on profitability of Islamic banks in Kenya. Descriptive design was the preferred method for this study. It's defined as an orderly way of presenting data whereby each variable has an equal chance of occurring without any manipulation by the researcher (Borg & Gall, 1989).

#### **3.3 Target Population of the Study**

Population is number of items used in drawing conclusion about the study variables (Oso and Onen, 2009). Secondary data obtained from the individual Islamic banks annual reports and website and CBK banking supervision reports. 7 commercial banks were used for purposes of the study. The study comprised 2 Islamic banks (Gulf African Bank and First Community Bank) and 5 commercial banks that have Islamic windows; Barclays banks, National Bank, Chase Bank, Kenya Commercial Bank and Standard Chartered Bank.

### **3.4 Data Collection**

The study used primary and secondary data. Questionnaire which were send to management of the banking industry. They sought to gain information pertaining to the respondent, financial instruments used, effect on financial performance, investment opportunities. Secondary data from published financial statements will also be used. Secondary data on Islamic banking products for financial years 2011-2015 from Islamic banking products. The information to be used in the study will be the amount of financing made for various instruments, grading of each financial instruments and after tax profits generated by each instruments.

### **3.5 Data Analysis**

Descriptive and inferential statistics were used in the study. Descriptive statistics comprised of the measures of central tendency among them the arithmetic mean, variance and standard deviation. Correlation and pooled regression analysis made up the inferential statistics and they were used to find out the existing correlation linking the research variables. The regression equation was as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where:

Y= Return on Assets (ROA-Dependent variable)

$\alpha$ = Constant Term Y-intercept

$\beta_1, \beta_2, \beta_3$  = Beta coefficients

$\varepsilon$ = Error term.

X1= Shariah Compliance Contracts

X2= Size of the Bank-Natural Logarithm of book value of assets

### **3.5.2 Test of Significance**

ANOVA was used for checking accuracy and to disclose the entire model importance. F-statistic was at 95% confidence level. The *t-test* was used for testing, the significance of the variables.

## CHAPTER FOUR

### DATA ANALYSIS AND DISCUSSION OF FINDINGS

#### 4.1 Introduction

The topic is subdivided into research results and the results discussion. The chapter entails the response rate results, the descriptive, correlation and regression results and finally the results interpretations

#### 4.2 Research Findings

SPSS. V21 was used in coding, entering and computing data. The dependent variable was financial performance of the Islamic commercial banks using ROA while the independent variables were shariah compliance. The regression results are presented below.

**Table 4.1 Model Summary**

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.852 <sup>a</sup>	.606	.477	.16099
a. Predictors: (Constant), Shariah Complainece, bank size.				

*Source: Research data, 2016*

Table 4.1 shows the adjusted  $R^2$  at 0.477 and implying 47.9 percent variation on financial performance of Islamic banks caused by variations in shariah compliance and bank size at 95 percent CI. It implies 60.6 percent variations could be accounted to shariah compliance and bank size. This leaves 39.4 percent to be accounted for by other variables that were not assessed in this study. The (R) reveals the correlation linking variables under study. Study results indicate significant direct association linking the

study financial performance and financial risk management as shown by the R value of 0.852.

**Table 4.2: ANOVA**

ANOVA <sup>b</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	15.764	2	2.252	6.235	.000 <sup>b</sup>
	Residual	12.635	32	.361		
	Total	28.399	34			
a. Predictors: (Constant), Shariah Compliance, bank size.						
b. Dependent Variable: Financial performance						

Source: Research data, 2015

The above table shows ANOVA variance. P-value of 0 implies that the variations in dependent variable is caused by independent variable. The F value at  $6.235 > F_c = 2.021$ , it indicates the model is significant and that shariah compliance and bank size have a strong impact on financial performance of Islamic commercial banks in Kenya.

**Table 4.3 Regression Coefficients**

Coefficients <sup>a</sup>						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.853	.733		3.890	.000
	Operating efficiency	.218	.101	.202	2.158	.015
	Bank size	.472	.131	.505	3.603	.001
a. Dependent Variable: Financial performance						

Source: Research data, 2016

From Table 4.3 above the regression model can be derived as follows:

$$Y = 2.853 + 0.218X_1 + 0.472X_2 + \epsilon$$

Holding all variables constant, the financial performance of the Islamic commercial banks will be 2.853. The above results imply that sharia compliance and bank size have direct impact on profitability of Islamic commercial banks while capital adequacy, operating efficiency and bank size have a positive effect. A unit increase in sharia compliance leads to improved profitability of Islamic commercial banks in Kenya rising by 0.218, while a unit increase in bank size would lead to increase in financial performance of Islamic commercial banks by a factor of 0.472.

#### **4.3 Discussion of Results**

The study was carried out to assess the effect of operational risk management on the financial performance of Islamic commercial banks in Kenya. The adjusted  $R^2$  shows that 60.6 per cent variations in Islamic commercial banks is attributable to sharia compliance and bank size. The regression model indicates that the independent variables have direct impact on financial performance of Islamic commercial banks.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATION**

#### **5.1 Introduction**

The chapter presents summary, conclusion and recommendations to the study. The study aimed at determining the effect of operational risk on the financial performance of Islamic commercial banks in Kenya.

#### **5.2 Summary**

The study established that 85.2 per cent of the variations in dependent variable are influenced by changes in operational risk management as measured by shariah compliance and bank size. The study further established that the most influential variable is bank size. This was followed by operational risk as measured by shariah compliance. All the independent variables were significant at 5% implying operational risk management influences the financial performance of Islamic commercial banks in Kenya.

#### **5.3 Conclusion**

From the study findings, the operational risk management influences the financial performance of Islamic commercial banks in Kenya. It concludes that sharia compliance and bank size have a positive effect on the performance of Islamic commercial banks in Kenya.

#### **5.4 Recommendations**

The study recommends that there is need for the management of Islamic commercial banks to control their credit risk, through non-performing loan. There is also need for the management of Islamic commercial banks in Kenya to maintain the liquidity level at safe level as it was found that insolvency risk negatively affects the financial performance of Islamic commercial banks in Kenya. Banks management should hedge against interest rate risk as which negatively affects the financial performance of the Islamic commercial bank in Kenya.

The study recommends Islamic banking institutions to expand their operations, capital and also their operational efficiency.

#### **5.5 Limitations of the Study**

The study was limited to determining relationship between operational risk management and financial performance of Islamic commercial banks in Kenya. It was limited to the seven commercial banks in Kenya that offer Islamic banking services.

The study was limited to secondary data, which was collected from central banks and bank financial reports. Therefore, study findings are partly subject to the validity of the secondary data.

The study was also limited to a five year period starting from 2011 to 2015. However, longer period is desirable as it will capture different economic importance.

## **5.6 Suggestions for Further Research**

The study was conducted on Islamic commercial banks in Kenya. The findings can be verified by conducting the same study in other countries as well. This will help to identify if other countries have similar or different results. Future research could focus on challenges facing commercial banks in Kenya in management of financial risk management. It further recommends that a study should be carried out on determinants of operational risk management among commercial banks in Kenya.

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## **APPENDICES**

### **APPENDIX I: LIST OF BANKS PROVIDING ISLAMIC BANKING SERVICES IN KENYA AS AT 2015**

1. Gulf African Bank Limited
2. First Community Bank Limited
3. Barclays Bank of Kenya Limited (La riba)
4. National Bank Limited (National Amanah)
5. Chase Bank Limited (Chase Iman)
6. Standard Chartered Bank Limited (Saadiq)
7. Kenya Commercial Bank Limited

## APPENDIX II-DATA COLLECTION FORM

### BANK PROFILE

Name of the Bank.....

Year of Establishment.....

Mode of Islamic financial services operation at the bank (tick as appropriate)

An Islamic Banking Subsidiary

An Islamic Window within conventional bank

A fully fledged Islamic Bank

### FINANCIAL PERFORMANCE AND MODES OF FINANCING

#### DISTRIBUTION OF THE ISLAMIC BANKING FOR THE LAST FIVE YEARS

Year/Performance	2011	2012	2013	2014	2015
Return on Assets					
Musharaka Financing					
Murabaha Financing					
Ijara Financing					
Salam Financing					
Sukuk Financing					
Composite of Compliance					
Bank Size					