# FACTORS AFFECTING CREDIT RISK IN FIRST COMMUNITY BANK

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**A RESEARCH PROJECT REPORT SUBMITTED TO UMMA UNIVERSITY IN PARTIAL FULFILLMENT FOR THE AWARD OF DEGREE IN ISLAMIC BANKING AND FINANCE.**

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## DECLARATION

This Research Project is my original work and has not been presented for any award or a diploma in any other university.

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**DATE : ….14th June 2021…..**

## DEDICATION

First I would like to thank the Almighty for keeping me fit and healthy to see this through. This project is dedicated to my beloved mentors and lectures, who gave me guidance and confidence throughout my work. I would also like to thank my supervisor Mr. Tego for the assistance and guidance he has given me. Finally, I thank my parents for the support when needed.

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## OPERATIONAL DEFINITION OF TERMS

**Riba** – it is used in Islam to refer to interest charged on money advanced to a person or interest paid on deposit

**Sharia** – it is the Islamic law.

**Fish al mamma** (rules of transaction) – these are the Sharia laws that govern all financial transactions

**Quran** – Islamic holy book.

## ABSTRACT

The main purpose of the study was to investigate factors affecting credit risk in Islamic banks. A case study in First community bank was conducted to enhance fulfillment of this research question. The objectives of this research were to determine how loans characteristic, borrower characteristic, Islamic banks characteristics and ownership structures affect credit risks. The study adopted a descriptive research design whereby the respondents were expected to fill questionnaires strategized on the bases of the research question at hand. The target population for the study included 350 individuals, which comprised of 200 staff and 150 customers from the First community bank. Data collected was presented for sorting, analysis and presentation using various modes. Qualitative and quantitative data analysis was used. Final presentations included graphs, charts and explanations as obtained from the data collected. The researcher sort to validate and ascertain and authenticate the data that prepared a complete report based purely on the information emanation from the research. Based on the outcome of this study the research was concluded and termed as a success since it helped answer the research questions established.Recommendations were made and suggestions for further studies also were given.

# CHAPTER ONE

# INTRODUCTION

## 1.0 Introduction

This chapter gives a background to the factors affecting credit risk faced by Islamic banks in Kenya. The chapter also covers the company profile, statement of the problem, the research objectives, and the corresponding research question, significance of the study, scope and limitations of the study.

## 1.1 Background of the study

The introduction of a fully-fledged Islamic banking in Kenya in the year 2007 has been welcomed positively by both Muslims and non-Muslims due to its transparency, caring partnership and free from the uncertainty of interest rate fluctuations. This led to the launch of Islamic banking window by a number of conventional or commercial banks. Furthermore, Barclays bank, National bank and Kenya commercial bank operate Islamic windows with the former branding its services “LARIBA” banking.

This was followed by the licensing of First Community Bank by central bank of Kenya in 2007 as fully fledged Sharia’h compliant bank and a year later Sharia’h compliant bank of Gulf African bank was also licensed.

According to Kettell (2011), Islamic banking is defined as banking in consonance with the ethics and value system of Islam and governance, in addition to the conventional good governance and risk management rules, by the principle laid down by the Islamic Sharia’h.

It is based on the Islamic law Sharia’h which came from the Quran and Sunnah, as well as opinions collected and agreed by Sharia’h scholars.

Islamic law pr-ohibits the payment and collection of Riba (interest). The argument against interest is that money is not used as a commodity which will make profit but that it should be earned on goods and services only.

Islamic Sharia’h allows safeguarding of all economic activities for the protection of public interest, when any activity runs against Islamic ethics and morality, it is outlawed.

In addition, for an investment to be legitimate, one of the most important requirement is the its outcome must fulfill the reality of investment transactions and that it enables Islamic financial institution to state what it expects to make profits.

The main conditions governing Islamic investment include, money does not generate money in itself, but it becomes productive if it is involving an activity or work; investment is subject to the rule of profit and loss sharing; investment in business in lawful and contracts must be free of uncertainty and conditions which lead to disputes.

## 1.2 Statement of the Problem

The essence of credit risk in Islamic banking is of such importance since the nature of risk faced is unique as compared to conventional banks.

Islamic banks operate side by side with conventional banks and they are equally exposed to same or more credit risks.

The uniqueness of the credit risk emanated from the composition of its assets and liabilities.

According to Khan and Ahmed, 2011 the difference in the nature of its assets and liabilities composition and their profit and loss sharing basis change the nature of risk that Islamic banks face.

As an institution entrusted with public funds it has a responsibility to utilize this funds I n ways in ways that protect the rights of the owners of the funds.

On the asset side, investments whose funds are Sharia based can be undertaken in form profit sharing, mode of financing, fixed income modes financing (costs plus make-up sale), installment sale (medium/long-term), differed or prepaid sale leasing.

On liabilities, deposits can either be kept in form of current accounts where depositors get their deposit on demand or investment accounts where depositors in Islam banks are rewarded with the opportunity to share with the banks the profit and business risks or losses of the activity. The forms of loan advanced are unique as they don’t involve interests. Bearing in mind credit risks is mostly faced by affecting risks.

## 1.3 Objective of the Study

### 1.3.1 General Objective

The purpose of the research project was to evaluate the factors that affect risks in Islamic banks in Kenya through a case study of the First Community Bank Ltd.

### 1.3.2 Specific Objectives

The specific objectives of the case study were:

i. To find out how loans characteristic affect credit risk.
ii. To find out how borrower characteristic affects credit risks
iii. To assess how Islamic banks characteristics, affect credit risks
iv. To find out how ownership structures affect credit risks

## 1.4 Research Questions

The research project answers the following questions:

i. How does the loan characteristic affect credit risks?
ii. How does a borrower's characteristic affect credit risks?
iii. How is an Islamic bank characteristic a factor of credit risk?
iv. How does owner ownership structure contribute to credit risks?

## 1.5 Significance of the Study

The study is of paramount importance to the banks that offer Islamic products whether fully fledged or through Islamic windows as it highlights the unique factors that affect credit risks in Islamic banks and all banks. The study evaluated the types and nature of credit risks and mitigation availed to reduce its exposure.

The study is also of great importance to the regulatory and supervisory authorities of Kenya as it highlights the unique risks, mitigation and challenges presented by this concept of banking.

It also points out regulatory challenges faced by Islamic banks.

## 1.6 Scope of the Study

The research focused on evaluating the factors that affect credit risk in Islamic banks in Kenya through a study of first community bank. The study targeted employees' and customers of the bankssimple random sampling and purpose sampling was used to identify respondents and questionnaires will be administered to the respondents. The technique of simple random sampling was chosen since it allowed every respondent to have an equal chance of selection. It is efficient and save time purpose. Purpose sampling was used on bank staff with knowledge on credit department of the bank.

## 1.7 Limitation of the Study

The researcher expects some degree of lack of co-operation from some employees to give the required information but the researcher aims to sensitize the respondents on the aim of the study in addition to assuring them of their confidentiality. Additionally, absenteeism of the key informants, some key management officials may have tight schedules, as they may not avail themselves to participate in the research. However, the researcher will liaise with the management and the supervisors and make the necessary arrangements in addition to adopting the necessary data collection procedure, which will be comfortable to the participants.

### 1.7.1 Fear of victimization

The respondents had a tendency to be suspicious to the researcher and this affected the extent of information they provided. This concern was addressed upfront using the school identification card from the University and providing necessary assurance to the respondents.

### 1.7.2 Confidentiality

Confidentiality is a very sensitive matter and therefore was anticipated to be an impediment. However, the researcher assured the respondents that none of the information was to be used for anyother purpose other than which had been declared.

### 1.7.3 Co-operation

The research was also limited by the reluctance of some respondents to complete questionnaires promptly and those who failed completely. This limited the level of response rate. However, the researcher made efforts to assure the respondents by explaining the potential benefits of the study to them.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.0 Introduction

This chapter is developed to reviewing literature relevant to the current study. It provides critical look of relevant literature which are related to this study. According to Saucer, Lewis and thorn hill,(2000) literature review forms the framework on which the research is based as it helps to develop agood understandingc of an insight into relevant previous research and emerging trends.

The information found on the literature is related to the select area of study. It includes previous research findings, books, journals and newspapers. This project concerns itself with evaluating the factors that affect credit risks in Islamic banks.

## 2.1 Theoretical Review

Several theories related to credit risks have attempted to evaluate the underlying factors that affect credit risks like the uniqueness of Islamic banking and risks it faces as it operates side by side with conventional banks. First section discloses the theory of credit scoring and competitive pricing of default risks. The second deals with the stages of human conviction theory that explains how customers choose to adopt unique banking services offered by Islamic banks and lastly, modern portfolio theory which attempts to highlight the means of maximizing returns while minimizing risks.

### 2.1.1 Theory of Credit Scoring and Competitive Pricing of Default Risks

Jose Victor Rios and Dean Corban (2001) of University of Texas at Austin proposed this theory of unsecured consumer credit. Where borrowers have frame work to mitigate an adverse credit risks. Borrower has the legal option to default by way of filing for bankruptcy which will permanently discharge them of all the debts.

They further argued that defaulters should not be excluded from further borrowing. Where previous borrowing was default on factors beyond the borrowers control and there should be free entry of leaders to buy out debts from other lenders. Lastly they poised that leaders should not collude to punish defaulters by way of increasing rates of payment, and introduction of conditions that are unfavorable to borrowers.

In their framework, they argue that limited credit or credit at higher rates of interests following default comes as a result of lenders optimal response to limited information about the agent’s type and earnings realization. The lender learns from an individual borrower and repayment behavior though a credit score which forms creditworthiness for not defaulting. A credit files to represent credit worthiness of that person. It gives details on financial: employer, monthly gross and net salary, whether permanent or on contract, position in employment. Demographic characteristics likeage and marital status.

They found out that credit score affects unsecured customers credit market behavior. It is through scoring that banks use it to regulate extension of credit where people having high score being offered credit on more favorable terms. Whereas people who default on their loans experience a decline in their score thereby losing access to credit on favorable terms.

### 2.1.2 Stages of Human Conviction Theory

Several theories related to customer satisfaction affect the rate of adoption and acceptance of any innovative product or service like the introduction of Islamic banking in the Kenya market where clients had been accustomed to conventional banking concept.

Rogers and Shoemaker (1971) state that a customer goes through several stages in knowledge conviction and decision confirmation before they finally adopt a new product. They constructed a typology depicting the characteristics by which a potential adopter evaluates an innovation;

Relative advantage which is the degree to which the innovation is perceived to be superior to that which it is made to replace, compatibility as the degree to which innovation is perceived to be consistent with the innovators existing values, past experience and needs, complexity which is the degree to which the innovation is perceived difficult to understand compared with the existing concepts, trial able where the innovation is available for trial on a limited basis without large commitment. Lastly, observable as the degree to which results will be apparent.

## 2.2 Empirical review

The study reviewed previous studies that had been done on credit risk in Islamic banks. Banks rank credit risk as one of the most important risk affecting the operations. The research critically reviewed the literature and analyzed the factors affecting credit risk. It distinguished factors affecting credit risk in Islamic banks, and mitigation of such credit risk.

Khan and Ahmed (2001) argued that credit risk in Islamic banks is in the form of settlement or payment risks arising when one party to a business transaction pays money on a contract or bank deliver assets before receiving its own cash, thereby exposing it to potential risk. A research they carried for Islamic institutions in 28 countries they found that credit is highest in Musharakah followed by Mudarabah financing.

There finding highlighted that banks perceive profit and loss sharing modes to have higher credit risk. Mark up is found highest in the product of deferred contracts. Sudarajan and Errico (2002) argued that while profit and loss sharing modes may shift the direct credit risk of Islamic banks to the investment depositors, they may also increase the overall degree o of the asset of asset side of the banks' balance sheet since the assets under the mode does not have security. The rationale to this principle is that the ratio of the riskier assets to total assets should typically be higher in an Islamic bank than in conventional bank. Samad and Hassan (1999) in their study of Malaysian Islamic banking reveals that the performance of risk from 1984-1997 in risky business measured by debt-equity ratio increased over the years. This ratio is significantly related to profitability. In comparison with two conventional banks, Bank Pertanian and Perwira Affin bank, Islamic banksrisk indicators are lower. The reason for low risk of the Islamic bank is that investment in government securities is much larger than conventional banks.

Berger and De young (1997) found the risk weight assets are significantly and positively related to credit risk measure by non-performing loans to total loans. They rationalize that a banks a relatively risky loan portfolio will result in higher Nonperforming loans. For less capitalized banks they found that risks weighted assets are significant but negatively related to risks. This finding supports the hazard hypothesis that, on average, thinly, capitalized banks take riskier loans which potentially could lead to higher NPLs.

As for conventional banks, brewer, Jackson and Mondschean (1996) found that loan sectors are associated with risks. Fixed –rate mortgage loans, investments in service corporations and real estate loans are found to be significant but negatively related to risk. However, non-fixed rate mortgage loan is significant and positively related to risk.

Henie Van Greunig and Zarwich, 2011 in their book, Risk analysis in Islamic banks analyzed credit risks specific to Islamic banks. They found that the unique characteristics of the financial instruments offered by Islamic banks results in specified credit risks. In Mudarabah transactions, Islamic banks are exposed to credit risks when the banks deliver the assets to the clients but does not receive payment form the clients on time. In case of non-building Murabahah where clients havethe right to refuse delivery of the product purchased by the bank is further exposed to price and market risk.

They pointed that credit risk management in Islamic banks is complicated by additional externalities. Especially in the case of default by the counter party, Islamic banks are prohibited from changing any accrued interest or imposing any penalty, except in the case of deliberate procrastination. Clients may take advantage by delaying payment, knowing that the bank will not charge a penalty, the bank's capital is stuck in unproductive activity and the banks investors are not earning interest.

In mitigation of credit risk, they argued that, the techniques used are similar with those of conventional banks except where there are no credit rating agencies banks rely on the client's track record and client's worthiness through informal sources and local community networks. They laid down policies for managing credit risk in Islamic banks.

Formal policies laid down by supervisory authority which is done by a dedicated board of directors and administered by management, a lending policy should outline the outline the scope and allocation of banks credits faculties and how credit portfolio is management and that is how investment how investment and financing assets are originated, appraised, supervised and collected is not overly restrictive and allow the presentation of proposals to the board that officers believe are worthy of consideration and do not fall within guidelines.

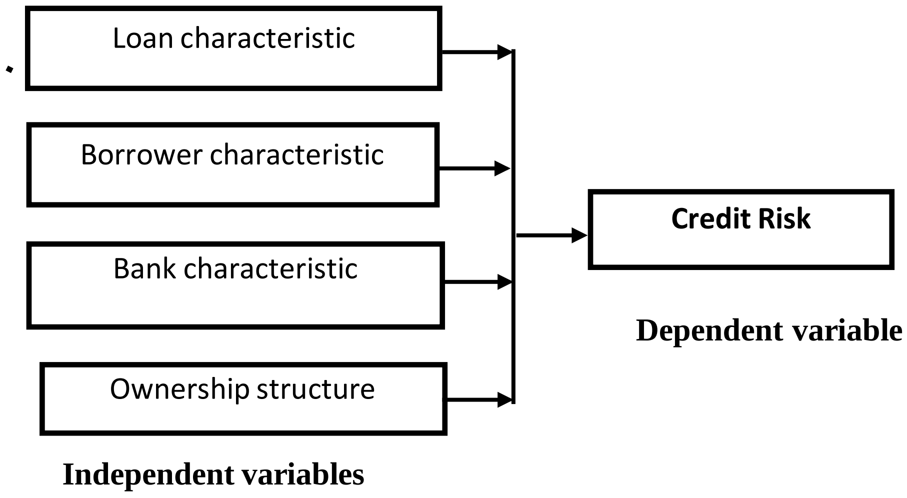
Specific measures typically include three policies set to reduce credit risk which include avoiding concentration and large exposure, diversification, lending to connected parties and overexposure to a sector or regions. The other aims to classify assets which mandate periodic evaluation of the collectability of the portfolio of credit instrument. Lastly, aims at provision of loss and making allowances at a level adequate to absorb anticipated loss.

Mohamed khan (2002) in his study of Tunisians Islamic banks looked at the impact of alternative ownership structures on banks performance and managerial behavior with special emphasis on institutional and managerial ownership. His results suggested a positive relationship between institutions and managerial ownership. His results suggested a positive relationship between institutional ownership and the value of the firm explained by internal mechanism of control. He also found out that the value of the firm explained internal mechanism off control. We also found out that the higher the managerial ownership the lower is the institutional ownership

### 2.3 Conceptualization

The model identified credit risk as the dependent variable which was triggered by the independent variables. The research identified that the dependent variable was as a result of loan characteristic, borrower characteristic, banks characteristics and ownership structure. The independent variable is a variable that the researcher manipulated in determining its effects.

**Figure 2.1: Conceptual framework**




### 2.3.1 Loan Characteristics

The loan advanced by the bank was influenced by several characteristics; the amount of the loan which was arrived at after carrying out a credit appraisal of the borrower taking into consideration among other things the conduct of the borrower's account and prove of repayment ability. Where the loan amount was security which was charged by bank on either movable or fixed assets to cover the loan advanced in case of default, it was realized to cover for the loan amount. The duration of payment was another characteristic that affect credit risk where the duration extends from months to several years. In a case of long duration of years, and a borrower's financial position changes adversely the bank bore default risk. The purpose of the loan was an important characteristic such that where a loan advanced was diverted for other purposes other than that sought it resulted in defaults as other financial requirements may arise which was not anticipated.

### 2.3.2 Borrower Characteristics

Willingness and ability of the borrower to repay the loan were the primary factors considered in the appraisal of credit risk. The criteria for testing the ability to repay were the personal characteristics such as age, sex, and family status, borrower's occupational or economic position. The borrower was asked to provide credit references, banking connections and information concerning his charge accounts, since these gave some evidence of his probity. Age, sex, marital status, number of dependents and permanence of residence were important in assessing personal characteristics. Ability to repay was judged by nature of occupation, tenure of employment and industry employment, while the financial capacity was indicated by income and assets owned.

Of significance was a balanced income –expenditure relationship, or a substantial net worth which reflect not only the borrower's financial capacity but also prudence and foresight in managing financial affairs.

### 2.3.3 Bank Characteristics

There were two variables that influenced bank credit risk, one was internal and the other external variable. (Nabila Zribi and Younes, 2011the factors influencing bank credit risk). The internal variable concerns the ownership structure, efficiency and bank governance. These internal factors as they suggest are the potential determinants of credit risk. On the other hand, to the external factors resulted from three views, social view where the state interferes in banks to correct market failures caused by private banks, the political view where they postulate that state-owned banks are mechanisms for pursuing politician's private interests such as political favors, and lastly the agency view where they showed state-owned banks are basically benevolent maximizers of social welfare but are plagued by corruption and misallocation.

### 2.3.4 Ownership Structure

Ownership structure plays an important role in influencing credit risk and a particular focus is put on the relationship between public and state-owned banks. This showed that generally, it is assumedthat state owned banks take more risks but their findings have shown that private owned banks take more risk than other banks since they are exposed to more risk as they play an important role in the facilitation of the credit policies and their loans are less sensitive to macroeconomic shocks.

## 2.4 Summary

The researcher looked at different statistics that formed the premise upon which research was expected to be done on the research parameters as follows;

It assessed the loan characteristics and found it differed from one individual to the other; the loan amount was also found affecting credit risk. This was measured by examining the total amount loaned, the purpose and security taken for loan.

It found out that borrower characteristics affected credit risk of the bank after examination of the age, financial capacity and sex of borrowers.

It determined how the banks characteristics affected credit risk. This was measured by looking at the performance, efficiency and governance practice of the bank.

Ownership structure was a key factor in influencing how the bank was managed in regard to corporate governance. The research measured this  by looking at internal and external variables effect of management. This being shareholders’ interests and external as outside stakeholders.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter discusses the research design and methodology of the study; it provides a full description of the research design, the research variables as well as a broad description of the population and its selection. The chapter further discusses research instruments, data collection techniques and data analysis procedures.

## 3.2 Research Design

Design of research is the science and art of planning for conducting studies so as to get the most valid findings. This was a case study on the factors affecting credit risk in Islamic banks. A descriptive design was used to study the relationship between loan characteristics, borrower characteristics, banks characteristics and ownership structure of credit risk in Islamic banking in Kenya.

Descriptive design was used to gather data that identified standards against which conditions were compared to determine the relationship that exist between specific events. The study was conducted on bank staff and customers, thus this method of collecting data included use of questionnaires and interviews.

The study was carried out within a period of two weeks since the population involved was small and involved the collection and analysis of considerable amount of data that achieved the requisite accuracy.

### 3.3 Research Location

In this study, the target population comprised customers and staff of the First Community Bank. The targeted population included 350 individuals, which comprised of 200 staff and 150 customers in the bank drawn from 7 out of 17 branches situated in Nairobi due to ease in carrying out researchwithin the time limit. The target population is described in Table 3.1 below.

**Table 3.1: Target population**

| Category | Target population | Percentage |
|---|---|---|
| **Customers** | 150 | 60 |
| **Staff** | 100 | 40 |
| **Total** | 250 | 100 |

### 3.4 Sample Designs and Procedures

The sample was selected using stratified sampling method. This method allows selecting of a group of respondents having similar characteristics. Random selection meant choosing a sample in such a way that each member of the population had an equal chance of being selected. High reliability is easy to obtain by presenting all subjects with a standardized stimulus which ensures that observer subjectivity is greatly eliminated (Mugenda and Mugenda, 2003)

The sample size was 100 respondents (40 staff and 60 customers). Simple random sampling was used to select the customers whereas purposive sampling was used to select the staff from different departments. Out of the 100 respondents 52 were male while 48 were female. The quality of any research is influenced by the appropriateness of methodology, instrumentation and suitability of the sampling strategy that has been adopted (Manion, 2001. Researchers such as Babbie (2005) and Gaya (2003) states that sample size for descriptive studies should be between 10%-20% of the population as described in Table 3.4.1 below.

**Table 3.2: Sample design**

| Category | Target population | Sample | Percentage |
|---|---|---|---|
| Staff | 100 | 40 | 40 |
| Customer | 150 | 60 | 40 |
| Total | 250 | 100 | 40 |

### 3.5 Data Collection Instruments

The study used a self-administered questionnaires designed using open ended and closed ended questions. A questionnaire is a research tool composed of set questions for the purpose of gathering information from respondents (Mugenda and Mugenda, 2003). The reason for using questionnaires was because they are quick to analyze and were easily understood by respondents. Additionally, interviews were conducted for more precise information. This was collected from different categories of the respondents. Interviews are cost effective and interactive.

### 3.6 Data Analysis

The objective of data analysis was to synthesize the raw data and make it understandable to users of the research findings. It included a reduction of the accumulated data to reasonably manageable size by summarizing the information gathered.

Data collected from the primary source was compiled, sorted, edited for accuracy and clarity and classified accordingly. During data analysis, cross tabulations and frequency tabulations was used to present the results of the study. The analysis is in descriptive and tabulation format. The data was presented in the form of prose, statistics and tables. Graphs and charts were used for better illustrations of the findings where applicable.

### 3.7 Research ethics

Ethical concerns that was of great importance in this study included:

#### 3.7.1 Confidentiality

During the study the researcher was required to be bound by ethics and to treat information that was availed as confidential and was to be purposely for research only. This was done by seeking authority from the administration department of the bank before issuing the questionnaires and giving them a letter from the school of business of Zetech University that confirmed carrying out research.

### 3.7.2 Honesty

Honesty was observed in all communication by candidly collecting, analyzing results and compiling report before drawing conclusion and making recommendations based on the findings ofthe study. This means there was non-fabrication, non-falsification, and right presentations of this report that meets the purpose of the research as well as to make this document a useful reference material for future research.

### 3.7.3 Objectivity

Effort was made to avoid bias when recording responses to the questions given in interviews and questionnaires as well as in data analysis, data interpretations and other areas where objectivity was expected.

# CHAPTER FOUR

# DATA ANALYSIS AND PRESENTATION OF FINDINGS

## 4.0 Introduction

This study presents the data analysis and interpretation of the results. The main objective of the study was to evaluate the factors affecting credit risk in Islamic banks. The results are presented in figures and tables to highlight the major findings, this was explained by the procedures and techniques applied to analyze and present the data obtained from the questionnaires. The analyzed data reflected various respondent views on factors affecting credit risk in Islamic bank in Kenya. Data was collected from both customers and staff of the bank.

The researcher collected responses from a total of 100 respondents out of the targeted 250 respondents sampled. This accounted for 40%. The data collected was discussed with the help of distribution tables and figures.

## 4.1 General Information of Respondents

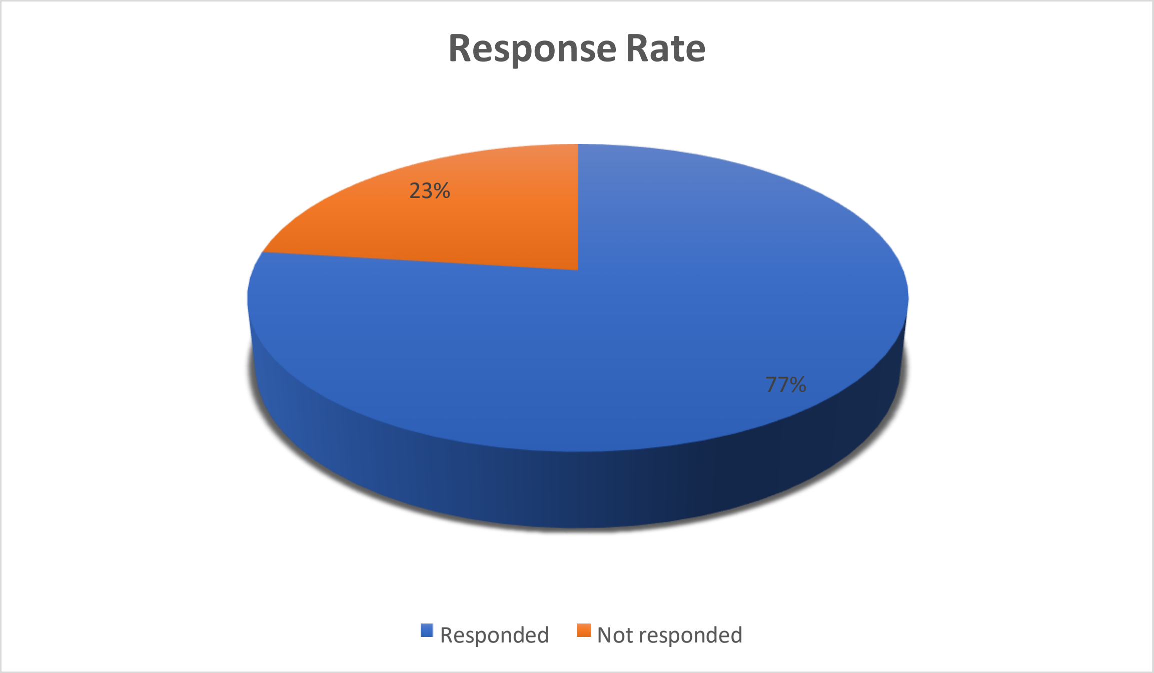
### 4.2.1 Response rate analysis

In determining the actual number of the respondents who answered and submitted back the questionnaires, the analysis of the response rate was conducted as follows.

**Table 4.1: Response rate**

| | | |
|---|---|---|
| Responded | 77 | 77% |
| Not responded | 23 | 23% |
| **Total** | **100** | **100%** |

**Figure 4.1: Response rate**




The figure shows that out of 100 respondents who were issued with the questionnaire, 77 (77%) respondents actively participated in the study by answering and submitting back the questionnaires. The figure indicates that only 23 (23%) respondents were not able to fill and submit the questionnaires for data analysis. The finding of the study was therefore obtained from 77% of the respondents.

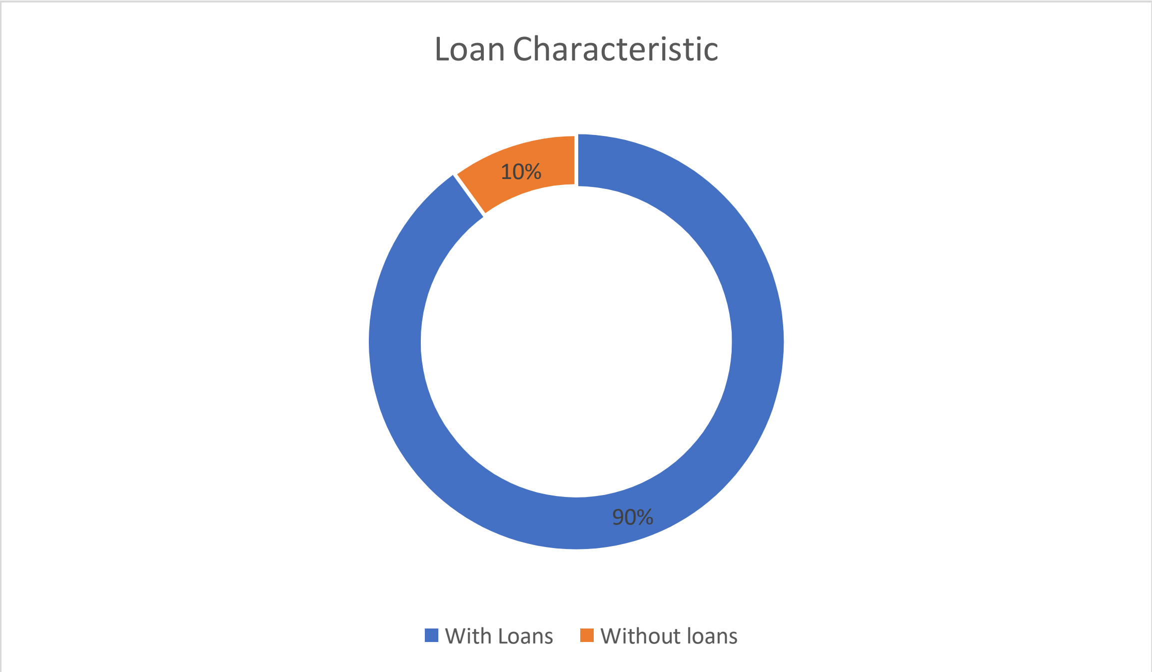
### 4.2.2 Loan Characteristic

The characteristic of loan was an important issue where findings were found as follows:

**Table 4.2: Loan characteristics**

| **Response** | **Frequency** | **Percentage** |
|---|---|---|
| With loans | 70 | 90% |
| Without loans | 7 | 10% |
| **Total** | 77 | **100%** |

**Figure 4.2: Loan characteristics**




90% of the respondents were taken as those with loans while 10% as those who had not taken any loan. This indicated that those who had taken loans were the majority respondents. It showed that loan duration, amount and security charged was the attracting criteria and favorable for taking loans.

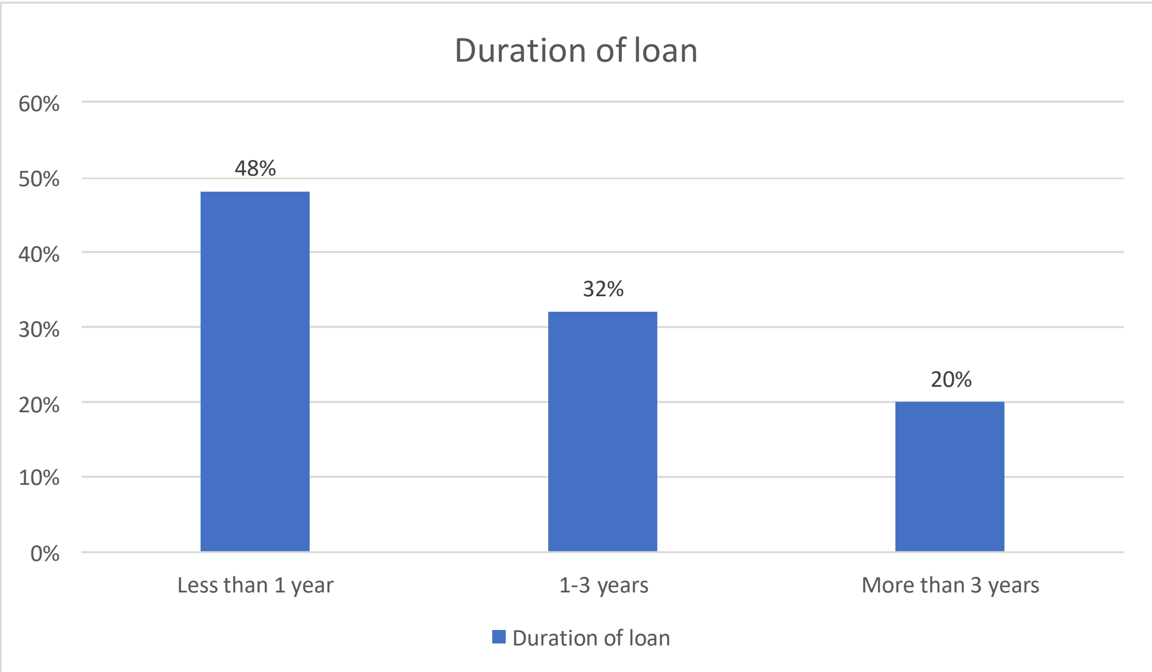
### 4.2.3 Loan Duration Characteristics

This was important in the study in determining the bank's exposure to risk.

**Table 4.3: Duration of loan**

| Response | Frequency | Percentage |
|---|---|---|
| Less than 1 year | 37 | 48 |
| 1 - 3 years | 25 | 32 |
| More than 3 years | 15 | 20 |
| **Total** | **77** | **100** |

**Figure 4.3: Duration of loan**




The table and the figure shows the loan duration the respondents who participated in the research study had. This indicate that 48% took a loan with the bank for less than one year, 32% for more than 1 year but less than 3 years and 20% had taken loan with the bank for more than 3 years.

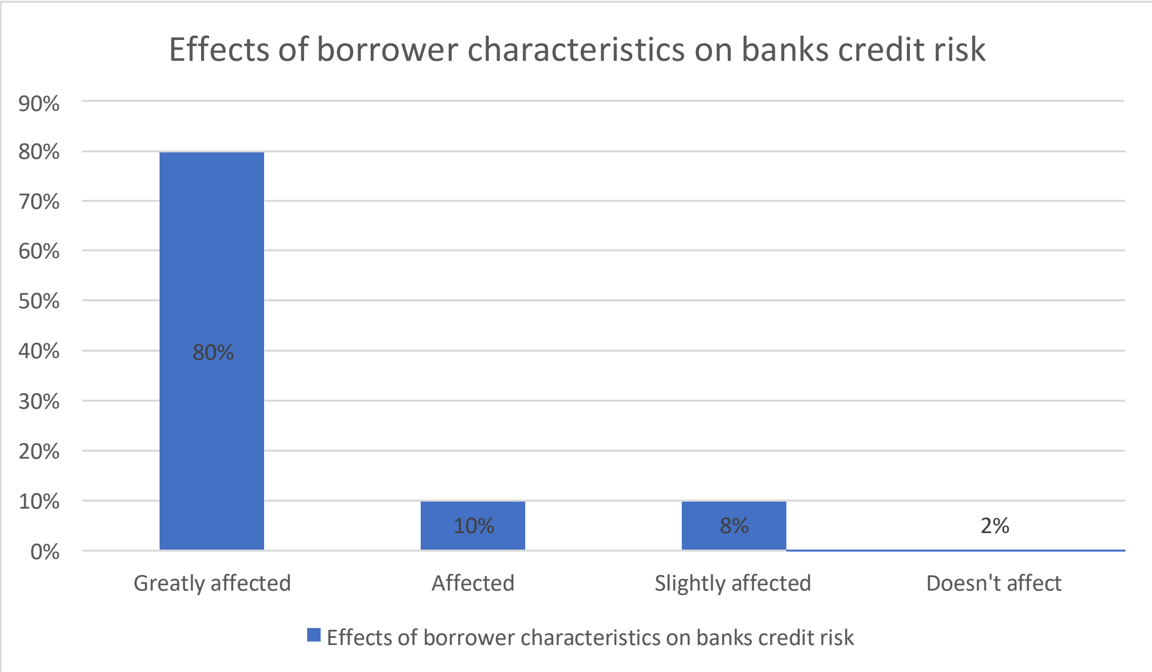
The figure above indicates the category that posed high default risk. Respondents indicated that there is high default for those with loan more than 3 years represented by 48% followed by between1-3 years at 32% and those with less than a year at 20%.

### 4.3 Effects of Borrower Characteristic on Banks Credit Risk

**Table 4.4: Effects of borrower characteristics on banks credit risk**

| Response | Frequency | Percentage |
|---|---|---|
| Greatly affected | 61 | 80% |
| Affected | 8 | 10% |
| Slightly affected | 6 | 8% |
| Doesn't affect | 2 | 2% |
| **Total** | **77** | **100%** |

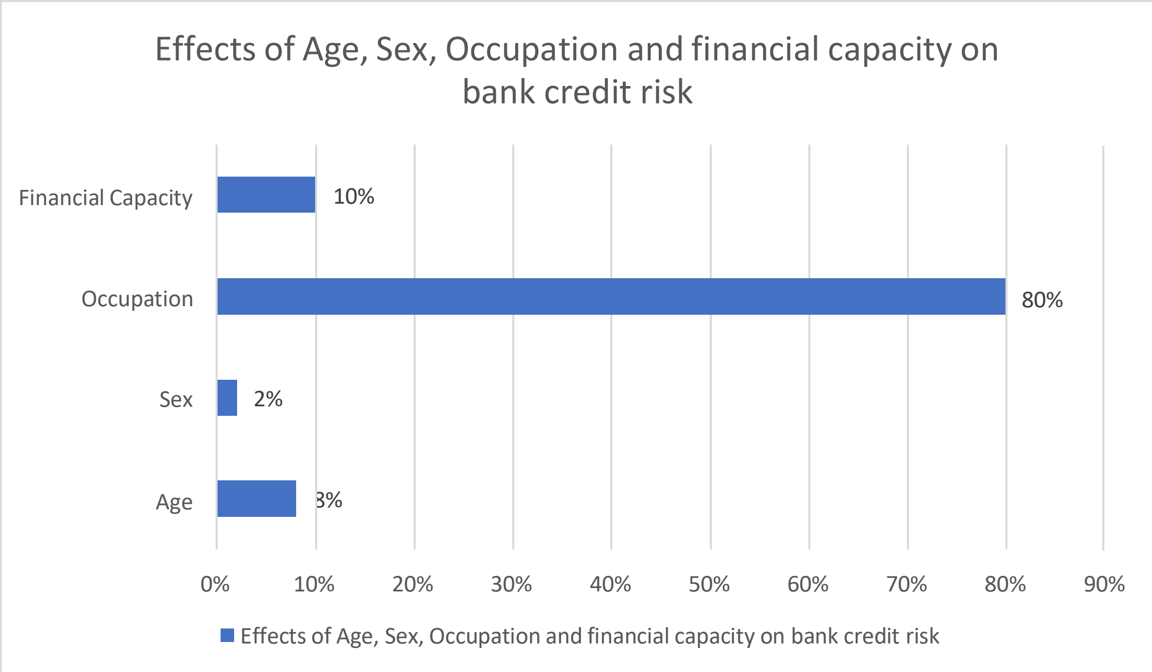
**Figure 4.4: Effects of borrower characteristics on banks credit risk**




The figure above indicates the impact of borrower characteristic on credit risk. The respondents rated the characteristics in terms of impact they had such as whether they had great effect as

Indicated by 80% of those who responded, 10% felt it affected, whereas 8% felt it slightly affected and those who thought it didn't affect were 2%.

**Figure 4.5: Effects of Age, Sex, Occupation and financial capacity on bank credit risk**



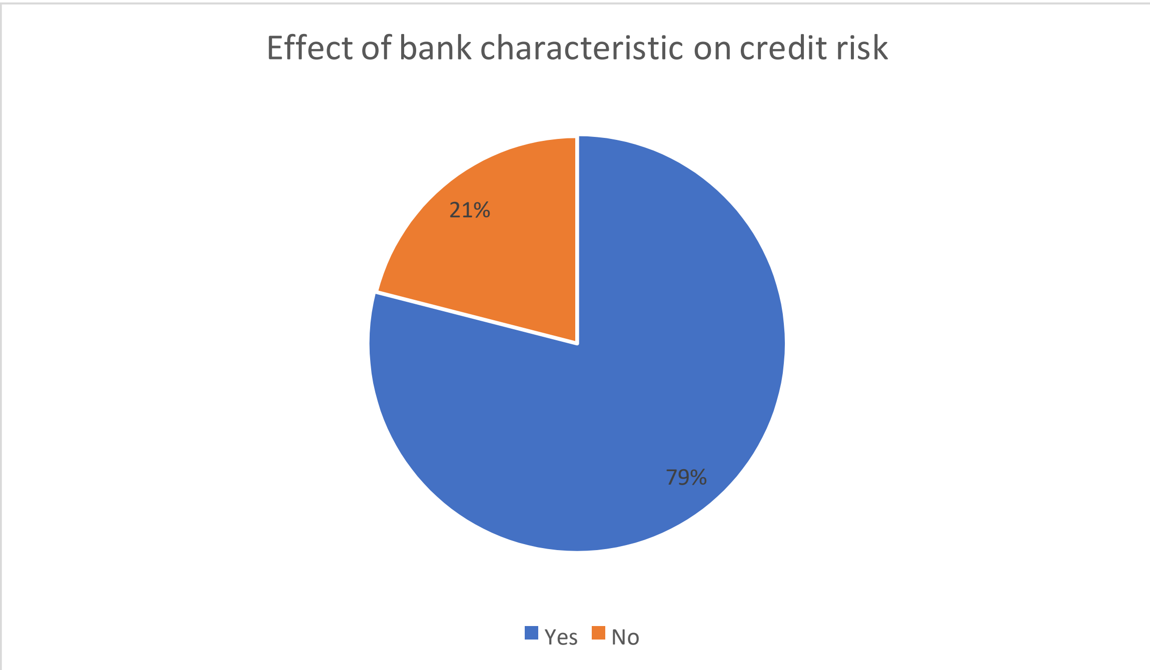

The figure above indicates that the occupation of the borrower carries the highest risk of default as indicated by 80% of respondents while 10% felt that it is financial capacity, 8% felt that age mattered and 2% felt that the sex of the borrower carried the default risk.

## 4.4 Effect of Bank Characteristic on Credit Risk

**Table 4.5: Effect of bank characteristic on credit risk**

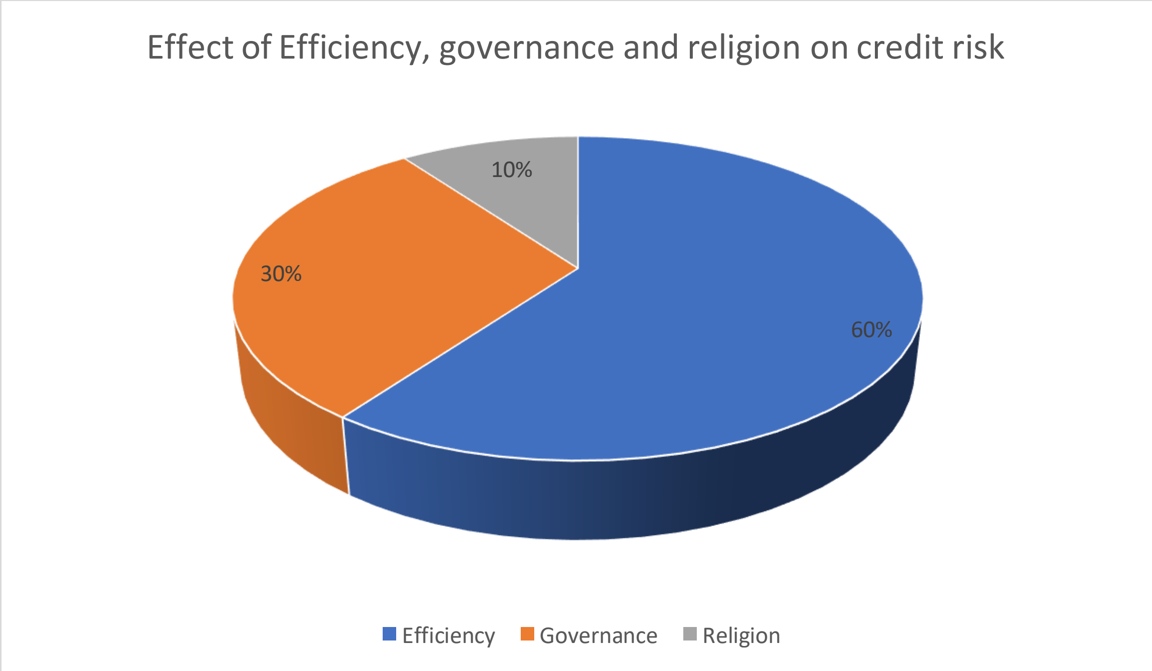
| Response | Frequency | Percentage |
|---|---|---|
| Yes | 61 | 79% |
| No | 16 | 21% |
| **Total** | **77** | **100** |

**Figure 4.6: Effect of bank characteristic on credit risk**




79% of the respondents indicated that banks characteristics such as religion, efficiency and governance affects credit risk while 21% of the respondents indicated that banks characteristics does not affect credit risk.

**Figure 4.7: Effect of Efficiency, governance and religion on credit risk**



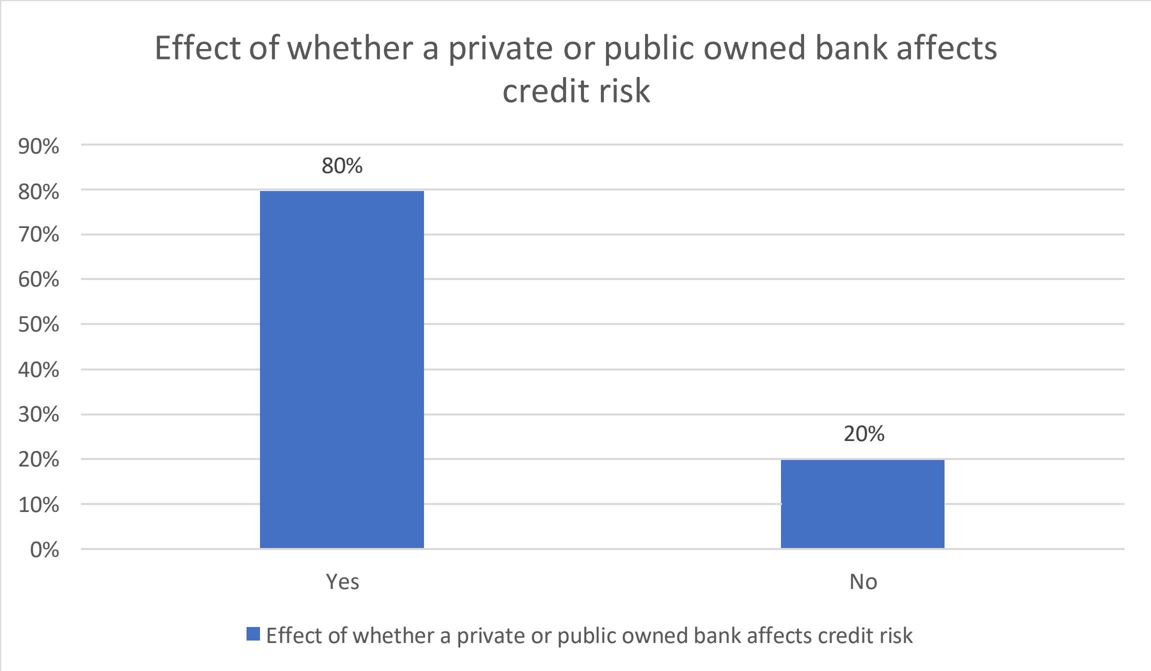

The figure above indicates that efficiency of bank in loan collection is a critical factor in affecting credit risk at 60%, while 30% of respondents felt it was governance principles of the bank, religion affected credit risk in terms of the tailor made products to suit the faith represented by 10% of the respondents.

## 4.5 Effect of Ownership Structure on Credit Risk

**Table 4:6: Effect of whether a private or public owned bank affects credit risk.**

| **Response** | **Frequency** | **Percentage** |
|---|---|---|
| Yes | 62 | 80% |
| No | 15 | 20% |
| **Total** | **77** | **100%** |

**Figure 4.8: Effect of whether a private or public owned bank affects credit risk.**




From the results which were obtained from various respondents, the factor of whether a bank is privately owned or publicly owned affects credit risk.80% felt that it affects while 20% felt it doesn't affect.

This type of analysis was used to analyze the responses given from the unstructured questions. It helped in establishing patterns and relations between the information gathered in the study. It also helped in getting in-depth information on the feeling of the respondents.

### 4.5.1 Loan characteristics

The results of the study showed that majority of the respondents consider loan characteristic as key factor in default risk. The respondents preferred a bigger amount of loan with less security or with longer repayment period. From the findings respondents also felt that the bank would reduce defaults by elongating repayment periods on huge amounts borrowed.

### 4.5.2 Borrowers characteristics

Results of this study showed that majority of the respondents did not find any difference between conventional banking products and Islamic banking and may establish that both offer similar products and the differences are not significant. Therefore, the credit appraisal applies uniformly on matters regarding to sex, age and occupation.

### 4.5.3 Banks characteristics

The results showed that bank management and efficiency affect credit risk. From the responses the findings were found that poorly managed banks increased chances of credit default. This finding therefore requires the banks to set up policies and procedures that adhere to best standards.

### 4.5.4 Ownership characteristics

The result showed that it matters whether the bank is privately or publicly owned as the decisions made affects credit risk. Privately owned as the case in the study are seen to manage well the risks due to interests of those who run with end results to maximize on profit whereas government owned faces influence.

# CHAPTER FIVE

# SUMMARY, CONCLUSION AND RECOMMENDATIONS

## 5.0 Introduction

This chapter presents a summary of the study findings, draws viable conclusions based on findings and also gives recommendations for policy and practice. It also gives suggestions for further study. The general objective of the study was to evaluate the factors affecting credit risk in Islamic banks using a case study of First Community Bank. The specific objectives were; To find out how loan characteristics affect credit risk, to find out how borrowers characteristics affects credit risk, to find out effect of banks characteristics on credit risk in Islamic banks and to assess the effect of ownership structure on credit risk.

## 5.1 Summary of Findings

This presents the data analysis on the underneath aspects established from the study.

### 5.1.1 Loan Characteristic

Concerning the issue of loan characteristics effect on credit risk, the researcher established that many people see the duration as the most important element affecting default with 48% of respondents concurring on this, also the amount and security matters in determining loan default risk.

### 5.1.2 Borrower Characteristics

The researcher established that Islamic banking offers unique and friendly products which met different customer needs. The findings of the research revealed that 90% of customers have loans with the bank which posed a challenge of high default rates. From the research it was established that occupation is the most important factor in issuing out loans, followed by financial capacity age and sex. Also the respondents indicated that the longer the duration the greater the default it was likely this is confirmed by 80% of respondents

### 5.1.3 Banks Characteristics

The findings of the research revealed that indeed banks characteristics affect credit risk as confirmed from 60% of respondents. This means the way the bank is managed in terms of efficiency and corporate governance which determines adherence of set policies and procedures with aim to reducing credit risk.

### 5.1.4 Ownership structure

The findings of the research on ownership structure whether a private or publicly owned faced a risk stated that public owned banks carry less credit defaults unlike publicly owned where there is outside interference.

## 5.2 Conclusions

Based on the study results the researcher concludes that borrower characteristic affects credit risk in Islamic banks more. The findings of the research revealed that 90% of customers have loans with the bank which posed a challenge of high default rates. From the research it was established that occupation is the most important factor in issuing out loans, followed by financial capacity age and sex. Also the respondents indicated that the longer the duration the greater the default it was likely this is confirmed by 80% of respondents.

With reference to the study results, the researcher revealed that indeed banks characteristics affect credit risk as confirmed from 60% of respondents. The bank management in terms of efficiency and corporate governance which determines adherence of set policies and procedures with aim to reducing credit risk should be carefully taken into account.

Concerning the issue of loan characteristics effect on credit risk, the researcher established that many people see the duration as the most important element affecting default with 48% of respondents concurring on this, hence loan characteristic least affect credit risks.

## 5.2 Recommendations

As part of the research, the research offers the following recommendations which if implemented would help in assessing the impact of credit risk and mitigating its impact.

The bank should have formal policies laid down by supervisory authority and done by a dedicated board of directors and administered by management. A lending policy should outline the scope and allocation of a bank's credit facilities and how credit portfolio is managed that is how investment and financing assets are originated, appraised, supervised and collected is not overly restrictive and allows for the presentation of proposals to the board that officers believe are worthy of consideration and do not fall within guidelines.

Specific measure policies should be set to reduce credit risk which include avoiding concentration and large exposures to single individuals or businesses since any adverse effect on their operations is a great exposure to bank eventually losing the money.

Diversification, lending to connected parties and avoiding overexposure to a sector or regions. The other is to classify assets which mandate periodic evaluation of the collectability of the portfolio of credit instruments.

**5.3 Recommendations for Further Reading**

In the research process, it will be noted that few studies exist that attempt to address the issues of existence of Islamic banking in Kenya. I recommend that more studies should be carried out in Kenya on conventional banks that offer Islamic windows products to understand the credit risk they face. Also more studies should be carried out on credit risks that Islamic banks face in Kenya.

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# APPENDICES

## APPENDIX I: LETTER TO THE RESPONDENTS

**Dear respondents,**

**REQUEST FOR RESEARCH DATA**

My name is HAMDI AHMED and I am currently pursuing a Degree in ISLAMIC BANKING AND FINANCE AT UMMA UNIVERSITY. As part of my course work, I need to conduct a research based on my area of study.

You have been identified as one of the people that could be of assistance with the research and thus request your participation in the research. Essentially, you will be required to complete a questionnaire. You will remain anonymous and your responses will be treated with utmost confidentiality. Information you provide will only be used for academic purposes.

**Thanks in advance,**

**Hamdi ahmed**

**Hamdhyahmed12@gmail.com**

**APPENDIX II: QUESTIONNAIRE**

**QUESTIONNAIRE FORM**

**Instructions.**

a) Please respond to all the questions below.

b) Please tick and fill where appropriate.

.

**SECTION L: PERSONAL/ORGANIZATIONAL DETAILS.**

**1.** Indicate the name of your branch

**2.** Indicate your department

**SECTION 2: LOAN CHARACTERISTICS**

**3.** Have you taken loan with the bank?

Yes ( ) No ( )

**4.** How long have you taken the loan?

Less than 1 year ( ) 1-3 ( )

More than 3 years ( ) other (specify)………………

**5.** What category in your opinion carries high default risk?

Less than 1 year ( ) 1-3 years ( )

More than 3 years ( ) other (specify)…………..

6 Do you think the security of the loan affects credit risk default? Explain briefly

**SECTION 3: BORROWER CHARACTERISTICS**.

Tick appropriately in terms of effect, the factors that affect borrower default rates.

| Factor | Greatly affect | Affect | Slightly affect | Doesn't affect |
|---|---|---|---|---|
| Age | | | | |
| Sex | | | | |
| Occupation | | | | |
| Financial capacity | | | | |

7. What do you consider as responsible for highest default risk.

Age ( ) Sex ( )

Occupation ( ) Financial capacity ( )

What motivates you to take a loan with FCB?..............................................................
………………………………………………………………………………………………

9. What amount of loan are you comfortable taking?

Less than 100,000 ( ) between 100,000 and one million ( )

Between one million and 5 million ( ) other (specify)

## SECTION 4: BANKS CHARACTERISTICS

10. Do you think factors such a religion; efficiency and performance affect credit risk?

Yes ( ) No ( )

11. What do you think affects credit risk the most?

Efficiency ( ) Governance ( ) Religion ( )

**Thank you for your time, participation and cooperation.**

## APPENDIX III: BUDGET

## RESEARCH BUDGET

| No. | Description of the Item | Quantity | Unit Prize | Total Cost |
|---|---|---|---|---|
| 1 | Pens | 1 | 20 | 20 |
| 2 | Foolscaps | 1 rim | 300 | 300 |
| 3 | Transport | | | 1000 |
| 4 | Typing and printing | | | 1200 |
| | Total | | | Ksh 2520 |

## APPENDIX IV: WORK PLAN

| STUDY ACTIVITIES | JUNE | JULY | AUGUST | MID AUGUST | SEPTEMBER |
|---|---|---|---|---|---|
| **Selecting research topic and objectives** | | | | | |
| **Literature review and research methodology** | | | | | |
| **Proposal writing and submission** | | | | | |
| **Data collection and analysis** | | | | | |
| **Final report presentation and correction** | | | | | |
| **Project submission** | | | | | |