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RISK MANAGEMENT PRACTICES AND FINANCIAL PERFORMANCE OF SELECTED ISLAMIC BANKS IN KENYA

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ABSTRACT
This study investigates the effect of risk management practices on the financial performance of Islamic banks in Kenya, with a focus on credit, operational, liquidity, and compliance risk management. A descriptive research design was employed to collect data from Gulf African Bank, Dubai Islamic Bank, and Premier Bank. Using both primary and secondary data analyzed through descriptive and inferential statistics, the study found that all four risk dimensions positively and significantly influence financial performance. Credit and liquidity risk management had the strongest impact. The study concludes that an integrated and Shariah-compliant risk management framework enhances profitability and stability in Islamic banks. It recommends that policymakers and practitioners strengthen credit evaluation, liquidity planning, and compliance governance to promote sustainable Islamic banking growth in Kenya.
Keywords: *Risk Management, Financial Performance, Islamic Banks, Credit Risk, Liquidity Risk, Kenya*

INTRODUCTION
The stability, profitability, and sustainability of the global financial system depend largely on the performance of banks, which play a pivotal role in mobilizing savings and allocating credit for economic growth. Effective risk management is central to this performance, as it shields institutions from insolvency, enhances investor confidence, and ensures operational continuity. Globally, banks are evaluated through financial indicators such as Return on Assets (ROA) and Return on Equity (ROE), which reflect their efficiency in utilizing resources and creating value. However, the global financial crisis of the past two decades has underscored the need for robust risk management frameworks to ensure resilience. International standards such as the Basel Accords and recommendations from global financial consultants emphasize that strong risk cultures, stress testing, and effective internal control systems are essential to profitability and stability.

Within this global context, Islamic banking has emerged as an alternative financial system founded on ethical and Shari'ah-compliant principles that prohibit interest (riba),

uncertainty (gharar), and speculative trading (maysir). Despite its growth and increasing acceptance, Islamic banking faces unique challenges because it relies on profit-and-loss sharing and asset-backed financing rather than conventional interest-based models. As a result, Islamic banks are more exposed to credit, operational, liquidity, and compliance risks. These risks must be carefully managed to sustain profitability while upholding religious and ethical values. Across Africa, Islamic banking remains nascent but growing, with institutions in Nigeria, Sudan, and South Africa demonstrating its potential. Yet, weak regulatory frameworks, limited product diversification, and insufficient Shari'ah-compliant instruments continue to hinder performance. Studies across African economies reveal that while effective risk management positively influences profitability, Islamic banks still face high exposure to credit and liquidity risks due to structural and governance limitations.

In Kenya, Islamic banking has grown significantly, supported by three fully Shari'ah-compliant institutions—Gulf African Bank, Dubai Islamic Bank, and Premier Bank. These institutions cater to both Muslim and non-Muslim clients seeking ethical and transparent financial services. Nonetheless, their financial performance lags behind that of conventional banks. Reported ROAs remain low or negative, non-performing loans continue to rise, and liquidity constraints persist. The collapse of First Community Bank in 2023 further highlighted vulnerabilities in credit and liquidity management. Although Islamic banks are founded on principles of fairness and shared risk, their operational frameworks have not yet produced sustainable profitability. Most existing studies in Kenya have focused on conventional banks, leaving a gap in empirical research linking risk management practices to the financial performance of Islamic banks.

Financial performance in Islamic banking is multifaceted, combining profitability with adherence to Shari'ah principles. Conventional measures such as ROA and ROE remain relevant but must be interpreted within the context of ethical investment and non-interest financing. Because Islamic banks operate through trade- and partnership-based contracts, such as Murabaha and Mudarabah, their income streams depend on project performance and market conditions. Consequently, effective risk management becomes the key determinant of profitability and sustainability. Poor credit evaluation, weak internal processes, or inadequate liquidity reserves can erode performance, while strong governance and compliance frameworks enhance stakeholder confidence.

Credit risk management remains central to Islamic banking because lending and borrowing occur through profit-sharing arrangements. The inability of clients to meet obligations directly affects both the bank's financial health and its ethical credibility. Effective credit risk management requires rigorous client assessment, continuous monitoring, and diversification of portfolios while respecting Shari'ah principles. Similarly, operational risks from process failures, system weaknesses, or human errors—poses a major threat to efficiency. In Islamic banks, operational failures can also translate into Shari'ah non-compliance, making risk mitigation doubly important. Building an

ethical and vigilant organizational culture supported by technology, internal controls, and continuous training is thus vital for performance.

Liquidity risk poses another major challenge since Islamic banks cannot access interest-based interbank markets or central bank instruments. They must therefore rely on Shari'ah-compliant liquidity management tools such as commodity Murabaha and profit-sharing investment accounts. While these ensure compliance, they often yield lower returns, thereby constraining profitability. Balancing liquidity and profitability thus require innovation and diversification of funding sources, supported by regulatory facilitation of Islamic financial instruments. Compliance risk, on the other hand, arises when banks fail to meet legal, regulatory, or Shari'ah standards. For Islamic banks, compliance extends beyond conventional regulation to include religious oversight by Shari'ah boards. Any breach can lead to reputational damage, loss of investor confidence, and diminished legitimacy. Strengthening compliance frameworks, enhancing staff training, and adopting regulatory technology (RegTech) can reduce these risks and reinforce ethical integrity.

The relationship between risk management and financial performance in Islamic banking has been widely acknowledged in global and regional studies, which show that institutions with strong risk frameworks achieve higher profitability and greater resilience. However, this relationship remains underexplored in Kenya. The persistent underperformance of Islamic banks despite their ethical foundations underscores a need to examine how credit, operational, liquidity, and compliance risk management practices affect their financial outcomes. Addressing this gap will provide empirical evidence to strengthen institutional frameworks, promote competitiveness, and contribute to the sustainable growth of Islamic banking in Kenya.

OBJECTIVE

General Objective

The purpose of this study is to evaluate the effect of risk management practices on the financial performance of Islamic banks in Kenya.

Specific Objectives

The specific objectives of the study are:

a) To determine the effect of credit risk management on the financial performance of Islamic banks in Kenya.
b) To assess the effect of operational risk management on the financial performance of Islamic banks in Kenya.
c) To investigate the effect of liquidity risk management on the financial performance of Islamic banks in Kenya.
d) To examine the effect of compliance risk management on the financial performance of Islamic banks in Kenya.

SIGNIFICANCE OF THE STUDY

This research is significant for several reasons. Practically, it offers managers of Islamic banks evidence-based insights to enhance risk frameworks, strengthen liquidity positions, and improve asset quality and profitability. Policymakers, including the Central Bank of Kenya, may use the findings to refine regulatory guidelines and develop Shari'ah-compliant instruments that promote financial inclusion and resilience. Academically, the study contributes to the growing body of literature on Islamic finance by empirically linking risk management practices to performance within the Kenyan context. The findings will also provide a foundation for comparative research across emerging Islamic banking markets. The study focuses on Kenya's three fully Shari'ah-compliant banks—Gulf African Bank, Dubai Islamic Bank, and Premier Bank—and covers the key departments directly involved in credit, operations, finance, and compliance. Both primary and secondary data are utilized, with financial reports spanning 2017–2024 to capture performance trends and primary data collected from relevant bank personnel. Through this scope, the study provides a comprehensive view of how risk management practices shape the financial outcomes of Islamic banks in Kenya. In conclusion, effective risk management is integral to the financial stability and sustainability of Islamic banks. Credit, operational, liquidity, and compliance risks directly influence their profitability, governance, and ethical standing. Understanding and addressing these risks within the Kenyan context is essential for strengthening Islamic banking as a viable and competitive component of the national financial system.

LITERATURE REVIEW

Theoretical Framework

The theoretical framework links the existing body of knowledge with the problem under investigation and explains why the study variables should be related. Following Orodho (2003), an appropriate framework guides variable selection and the logic of the hypotheses. The present study on the effect of risk-management practices on the financial performance of Islamic banks in Kenya is anchored on Modern Portfolio Theory (MPT), Stakeholder Theory, and Merton's Default-Risk Model. Together, these theories explain how diversified risk exposure, stakeholder legitimacy, and default probabilities shape performance in faith-based financial institutions.

Modern Portfolio Theory

Markowitz (1952) demonstrated that investors should evaluate portfolios as a whole because covariance among asset returns determines total risk. MPT proposes that diversification reduces unsystematic risk without proportionally reducing expected return, creating an efficient frontier of optimal portfolios (Elton & Gruber, 1997). Although the model assumes rational investors and access to all asset classes, its diversification logic applies to banks' loan, deposit, and investment portfolios. In Islamic banking, Shariah restrictions on interest-bearing or speculative assets narrow the universe of permissible instruments, but the theory still guides asset allocation among trade finance, equity participation, and profit-sharing products. Empirical work using

MPT concepts (Abuzayed et al., 2020; Zhang & Zhang, 2022) confirms that balanced diversification enhances stability. Hence, MPT supports the study's expectation that effective risk-management practices—particularly credit and liquidity risk diversification—improve Islamic banks' financial performance.

Stakeholder Theory

Freeman (1984) redefined the purpose of the firm as creating value for all stakeholders—shareholders, employees, customers, regulators, and society. Later scholars (Harrison et al., 2007; Freeman et al., 2010) emphasized that legitimacy and trust are as vital as profitability. For Islamic banks, stakeholders include Shariah boards and religious communities whose expectations extend beyond financial returns. Studies show that stakeholder-oriented governance correlates with higher performance and reputational stability (Al-Amri & Hossain, 2020; Elamer et al., 2023). The theory underpins the study's compliance-risk construct: institutions that uphold both regulatory and Shariah obligations earn legitimacy that sustains profitability.

Merton's Default-Risk Model

Merton (1974) viewed a firm's equity as a call option on its assets; default occurs when asset value falls below debt obligations. Asset value and volatility thus determine default probability (Bharath & Shumway, 2008). Despite assumptions of frictionless markets, the model remains foundational for credit-risk analysis (Hue, 2024; Zhang & Zhu, 2021). In Islamic banks the same logic applies qualitatively: deterioration in asset quality or borrower performance increases default risk even without interest-based debt. The model therefore justifies monitoring non-performing financing and loan-loss provisions as predictors of profitability.

Empirical Literature Review

Credit Risk Management and Financial Performance

Across countries, effective credit screening and diversification reduce defaults and enhance profitability (Catherine, 2019; Yeasin, 2022; Kaaya & Pastory, 2013). Islamic-bank evidence from Malaysia and Nigeria (Abdullah & Muneeza, 2022; Olawale & Adekunle, 2023) confirms that Shariah-compliant credit frameworks improve ROA and ROE. In Kenya, limited research (Aden & Mohamed, 2023) shows persistent weaknesses in credit appraisal and collateral systems. The contextual gap justifies testing H_1 within Kenyan Islamic banks.

Operational-Risk Management and Financial Performance

Operational efficiency and strong internal controls consistently predict profitability (Lyambiko, 2015; Falih et al., 2022). Ghanaian evidence (Gadzo et al., 2019) links Basel-based operational-risk adoption to stability, while recent studies highlight fintech and cybersecurity risks in Islamic finance (Al-Hassan & Karim, 2022; Kassim & Owusu, 2023). Research comparing Islamic and conventional banks (Ibrahim & Nor, 2022; Salim &

Hassan, 2023) reveals higher compliance costs but stronger reputational capital. Few studies, however, examine these trade-offs in East Africa, motivating H_2.

Liquidity-Risk Management and Financial Performance

Empirical results from Iraq and Bahrain (Al-Husainy & Jadah, 2021; Oudat & Ali, 2021) confirm that liquidity buffers raise profitability. Recent analyses (Hermuningsih & Rahmawati, 2023) find liquidity and profitability mutually reinforcing. African studies (Ngugi & Hussein, 2022; Aman & Yusuf, 2023) show that the absence of Shariah-compliant interbank markets constrains liquidity in Islamic banks. Thus, examining liquidity-performance dynamics under Kenya's dual system addresses an important gap and tests H_3.

Compliance-Risk Management and Financial Performance

Evidence from Rwanda and Kenya (Jerome, 2016; Tung'a, 2013) links strong compliance to better financial outcomes. Recent Islamic-bank research (Hassan & Haron, 2023; Ayele, 2023) shows that Shariah-governance frameworks improve profitability through reduced penalties and higher trust, while excessive regulation can hinder innovation (Khalifa & Samir, 2022). No Kenyan study has empirically assessed dual compliance, warranting H_4.

CONCEPTUAL FRAMEWORK

A conceptual framework is a logical organization of key notions and principles gained through the relevant areas of study, which are then applied to organize a later presentation (Kombo & Tromp, 2009). An applied conceptual framework refers to a carefully designed set of interrelated factors that is considered to be important in the development of the subject being studied. According to Mugenda and Mugenda (2003), a conceptual framework is a theoretical construct that aims to explain and describe the relationship that exists between the variables of interest (dependent and independent variables).

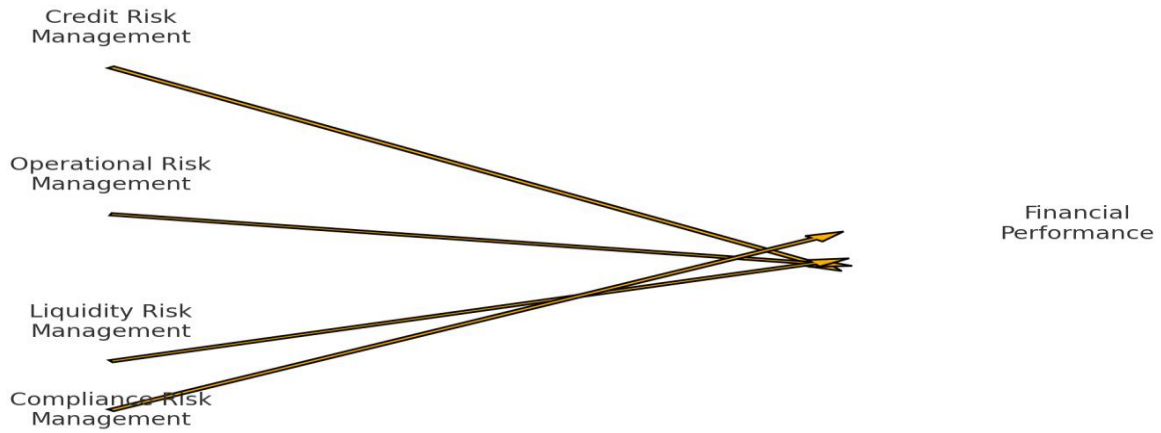

Figure 1: Conceptual Framework

Operationalization of Study Variables

It details the process of converting the variables of the study into quantifiable indicators to enable the organized collection and analysis of data. Operationalization is a procedure that makes abstract concepts like risk management practices and financial performance real. The study facilitates a close relationship between theoretical constructions and the measurement through the disaggregation of each variable in terms of the relevant indicators. The process improves reliability and validity because it ensures coherence between the goals of the study and the acquired data. Independent variables of interest are credit risk management, operational risk management, liquidity risk management, and compliance risk management. All of these variables are measured by well-developed financial indicators based on theoretical and empirical sources. In an example, credit risk management will be functionalized by the measures of loan to value ratio, non-performing loans, and capital adequacy ratio, whereas operational risk management will be functionalized by measures of operational losses, operations efficiency as well as solvency risk. Likewise, liquidity risk management can be quantified in terms of liquidity ratios, loan-to-deposits ratios and cash reserves, whilst compliance risk management can be quantified in terms of compliance cost ratio, regulatory compliance and non-compliance penalties. These indicators were chosen due to their applicability to the performance of Islamic banks and due to the frequent use of these indicators in the corresponding studies.

METHODOLOGY

The overall objective of this study is to examine the influence of risk management practices—specifically credit, operational, liquidity, and compliance risks—on the financial performance of Islamic banks in Kenya, using indicators such as Return on Assets (ROA) and Return on Equity (ROE) to assess outcomes and provide insights for enhanced governance and sustainability in the sector. This study adopted a descriptive research design, which is most suitable for exploring the relationships between risk management practices and financial performance without manipulating variables. This approach allows for the collection, description, and analysis of both quantitative and qualitative data, providing an accurate depiction of existing conditions in Islamic banks. It facilitates the observation of natural phenomena, identification of patterns, and integration of numerical data for measurable insights with contextual evidence for deeper interpretation. The design supports mixed methods, enabling comparative analysis across institutions and minimizing bias through systematic, replicable procedures. By capturing cross-sectional and indicative longitudinal trends, it offers a holistic view of risk dynamics and their impact on financial outcomes, while ensuring ethical feasibility in a real-world banking context.

The target population consisted of all personnel in the key departments—credit, operations, finance and accounting, and compliance and risk—across the three fully Shariah-compliant Islamic banks operating in Kenya as of December 31, 2024: Gulf African Bank, Premier Bank, and Dubai Islamic Bank. These banks represent the entire

Islamic banking sector in Kenya, which operates under strict adherence to Shariah principles, avoiding interest-based transactions and emphasizing ethical, asset-backed financing. The context of the study is the Kenyan financial landscape, where Islamic banks face unique challenges such as regulatory compliance with both conventional and Shariah standards, limited market penetration, and risks amplified by economic volatility. The accessible population totals 108 employees across these departments, serving as the units of observation, while the banks themselves are the units of analysis. This population allows for generalization of findings to the broader Islamic banking practices in Kenya, focusing on how risk management influences performance amid growth in Islamic finance.

Given the small and heterogeneous population of 108 respondents, the study employed a census sampling design, involving the entire target population to eliminate sampling bias and ensure comprehensive data collection. This method is appropriate for in-depth analysis, as it captures all relevant perspectives from the diverse departments, enhancing the reliability and accuracy of results. No sampling technique is required beyond the census, as the full population size is manageable and aligns with recommendations for populations under 200, where a 10-30% sample might otherwise suffice but would risk omitting key insights.

Data collection involved a mix of primary and secondary tools and methods. Primary data was gathered through a structured questionnaire administered to all 108 managers and staff in the specified departments via a drop-and-pick-later approach, facilitated by two trained research assistants for accuracy and high response rates. The questionnaire included closed-ended questions for quantitative data on risk practices and performance metrics, supplemented by open-ended sections for qualitative insights. Secondary data was sourced from publicly available annual financial reports of the three banks from 2020 to 2024, using a customized data collection template (Appendix III) to extract key financial indicators like ROA and ROE. Prior to full implementation, a pilot study was conducted on 11 respondents (10% of the population, excluded from the final sample) to test the questionnaire's clarity, validity, and reliability. Validity was assessed through content review by experts, construct checks via Kaiser-Meyer-Olkin (KMO > 0.5), Bartlett's Sphericity ($p < 0.05$), and Exploratory Factor Analysis. Reliability was measured using Cronbach's alpha, targeting a coefficient of ≥ 0.7 for internal consistency. Ethical procedures include obtaining university approval, a NACOSTI research permit, informed consent from participants, and assurances of anonymity and confidentiality. Data storage is secure, with access limited to the researcher, and any additional non-public data requires bank permission.

Data analysis employed descriptive and inferential statistics using the Statistical Package for Social Sciences (SPSS). Descriptive analysis summarized data through means, standard deviations, frequencies, and percentages to identify patterns in risk management and performance. Inferential analysis included Pearson correlation to

examine relationships between variables and multiple linear regression to model the influence of independent variables (X1: Credit Risk Management, X2: Operational Risk Management, X3: Liquidity Risk Management, X4: Compliance Risk Management) on the dependent variable (Y: Financial Performance), expressed as $Y = \beta0 + \beta1X1 + \beta2X2 + \beta3X3 + \beta4X4 + \varepsilon$. Diagnostic tests precede regression: Kolmogorov-Smirnov for normality ($p > 0.05$ to assume normal distribution), Variance Inflation Factor (VIF < 10) for multicollinearity, and Breusch-Pagan/Godfrey for heteroscedasticity (to ensure constant error variance). Findings are presented in tables, graphs, and narratives for clarity and replicability, linking results to theoretical frameworks and practical implications.

Hypotheses are tested through inferential statistics at a 5% significance level. The null hypotheses posit no significant influence of each risk management practice on financial performance (e.g., H0: Credit risk management has no significant effect on financial performance), while alternatives suggest a positive influence. Pearson correlation assesses association strength, and regression coefficients (β) determine the direction and magnitude of effects, with t-tests evaluating significance ($p < 0.05$ rejects H0). This rigorous testing ensures evidence-based conclusions on how risk practices contribute to ROA and ROE, informing policy recommendations for Islamic banks.In summary, this methodology aligned with the study's objectives by providing a structured, ethical framework for data collection and analysis, ensuring valid and reliable insights into risk management in enhancing financial performance within Kenya's Islamic banking sector.

SUMMARY OF FINDINGS

This study sought to assess the effect of risk management practices on the financial performance of the Islamic banks in Kenya in relation to the four predominant variables, which include credit risk management, operational risk management, liquidity risk management, and compliance risk management. In the analysis, both primary and secondary data were used in three banks that are fully Shariah-compliant. The sample of respondents used in primary data collection comprised 80 individuals in credit, operations, finance, and compliance departments, and secondary data were obtained in the annual financial reports of the banks from 2020-2024. Descriptive and inferential analyses have been done and supported by a theoretical interpretation.

The findings of the descriptive results indicated that the credit and liquidity risk practices are quite structured, but operational and compliance controls are fragmented and reactive. Combined with an inferential analysis, these patterns can be seen as a risk culture in the transitional phase, where there is an awareness of the relevance of financial prudence but where such practices were not found to be system-wide coherent. This interpretation was further supported by the secondary data based on annual financial statements as the results indicated that the change in returns on assets and equity was sometimes reflected by a change in liquidity and credit risk exposure. This kind of evidence would indicate that the financial performance of Islamic banking is not

accidental, rather it is actively related to the degree to which the risk policies are adhered to and controlled.

Theoretically, the findings support the timelessness of the Modern Portfolio Theory (MPT) and the Stakeholder Theory. The correlation between diversified risk management and financial performance is positive, which explains that diversified asset structures and profit-sharing system can be used to obtain portfolio optimization even in a Shariah-limited environment. On the same note, the focus of the Stakeholder Theory on ethical governance and inclusiveness find agreement with the compliance-related results showing that Islamic banks are more effective when they reconcile the financial prudence with stakeholder trust and social responsibility. These observations confirm the fact that strong risk management is not just a financial need but also a moral requirement that is inherent in the Islamic finance model.

Credit Risk Management and Financial Performance

Descriptive findings showed that most respondents moderately agreed that their banks had effective credit risk controls in place. Specifically, 35% agreed that non-performing loans remain a challenge, while 43.8% strongly disagreed that loan-to-value ratios were well managed, indicating gaps in credit oversight. The overall mean score for credit risk management was 3.02, signifying a moderate level of effectiveness. Respondents also agreed (mean = 3.19) that loan recovery mechanisms were somewhat functional but could be strengthened. The study found that credit risk management had the strongest positive correlation with financial performance ($r = 0.541$, $p < 0.05$) and emerged as the most influential predictor in regression analysis ($\beta = 0.276$, $p = 0.001$). This indicates that efficient credit appraisal, monitoring, and recovery directly enhance profitability and asset quality. Secondary data further supported these results. Gulf African Bank and First Community Bank demonstrated modest improvements in Return on Assets (ROA), averaging 1.2% and 0.8% respectively, between 2021 and 2023, partly attributed to tightened credit policies. Conversely, Dubai Islamic Bank's negative ROA during the same period (-2.5% to -0.8%) reflected the consequences of weak credit risk frameworks. These findings reinforce Merton's Default Risk Model, which emphasizes the relationship between a firm's asset base and its likelihood of default. Islamic banks that effectively manage credit exposures are better able to maintain solvency and enhance financial performance within Shariah-compliant frameworks.

The findings on credit risk management confirm that credit discipline remains the most decisive driver of financial outcomes in Kenya's Islamic banking sector. The strength of the relationship ($r = 0.541$) suggests that even minor lapses in borrower assessment or loan monitoring can substantially erode profitability. This reinforces global literature by Khan and Ahmed (2021), who observed that robust credit governance frameworks directly improve capital adequacy and earnings stability in Islamic financial institutions. However, the Kenyan context adds a unique layer — most Islamic banks operate in a relatively shallow credit market where clients have limited collateral options and rely

heavily on trust-based instruments such as Murabaha or Musharakah. This duality increases exposure to moral hazard, making the quality of pre-lending appraisal and ongoing portfolio review more critical than in conventional banks.

From a theoretical perspective, the results extend Merton's Default Risk Model, which postulates that the probability of default is inversely related to the strength of a firm's asset base and risk controls. In the Shariah-compliant framework, this relationship manifests through profit-sharing and asset-backed contracts that redistribute credit risk between lender and borrower. Therefore, sound credit risk management not only protects capital but also upholds Stakeholder Theory's premise of fairness and accountability. When Islamic banks enforce disciplined lending consistent with ethical norms, they sustain solvency while fulfilling their fiduciary responsibility to depositors and investors alike.

Operational Risk Management and Financial Performance

Descriptive statistics showed that 56.3 percent of respondents had agreed and strongly agreed that their banks had increased their efficiency of operations, and 62.5 percent of respondents had a belief that internal fraud and human errors were under control. The total average in the area of operational risk management was 3.42, which indicates an overall positive view of the internal control systems and operational protection. The results of the correlation were a moderate positive correlation between financial performance and operational risk management ($r = 0.476$, $p < 0.05$), and the regression analysis showed a significant impact ($b = 0.191$, $p = 0.014$). These results indicate that better internal controls, competency of the staff, and usage of technology directly contribute to financial stability and performance. The trends in the secondary data support this correlation: years of higher operational efficiency (2022-2023) were the periods of lower operational costs and consistent and increasing Profit After Tax (PAT) in all three Islamic banks, with an average yearly improvement of 12%.

The findings highlight that operational efficiency and strong internal controls play a strategic role in shaping the sustainability of Islamic banks in Kenya. The observed correlation ($r = 0.476$) reinforces that minimizing operational disruptions, whether caused by human error, system inefficiency, or governance lapses, translates directly into measurable financial gains. This outcome aligns with Basel Committee principles (BIS, 2020), which stress that operational resilience is a determinant of both stability and investor confidence. However, Islamic banks face an added dimension: their processes must conform not only to regulatory requirements but also to Shariah governance frameworks, making operational oversight more intricate and multi-layered.

From a theoretical standpoint, these results lend weight to the Stakeholder Theory, which underscores organizational transparency and trust-building as pathways to superior performance. In Islamic banking, where the moral obligation to protect depositor funds is deeply rooted in religious ethics, operational risk management becomes both a

fiduciary and spiritual imperative. Continuous staff training, investment in digital control systems, and independent Shariah audits can therefore transform operational risk frameworks from reactive safeguards into proactive drivers of competitive advantage.

Liquidity Risk Management and Financial Performance

Experience in Descriptive analysis showed that there was moderate consensus among respondents that their banks had sufficient liquidity buffers. Approximately 42.5 percent answered that the loan-to-deposit ratio was being well managed, with only 26.3 percent answering that there were effective liquidity policies. The total of the liquidity risk management score was 3.03, indicating that the liquidity strategies were working but not in their best form. The results of the inferential statistics showed a positive correlation between liquidity risk management and financial performance ($r = 0.512$, $p < 0.05$) and a substantial regression coefficient ($b = 0.238$, $p = 0.009$). It means that careful liquidity planning, tracking, and restructuring of sources of funds increases profitability and financial strength. These results were supported by secondary data analysis, which indicated that banks that had higher liquidity ratios (greater than 25 percent) showed positive profitability even in the case of economic fluctuations. As an example, the liquidity ratio of Gulf African Bank was 29% in 2021-2023, which is in line with the constant PAT growth, whereas the companies with lower liquidity ratios, like Dubai Islamic Bank, reported negative ROA rates.

The findings on liquidity risk reinforce a fundamental insight in Islamic finance, that liquidity stability is both a financial and moral obligation. Unlike conventional banks, Islamic banks must preserve liquidity without recourse to interest-based interbank borrowing, forcing them to rely on asset-backed mechanisms such as Sukuk, profit-sharing investment accounts, or commodity Murabaha. The moderate liquidity performance score (mean = 3.03) suggests that Kenyan Islamic banks are in a transitional phase, experimenting with limited Shariah-compliant instruments while managing short-term obligations largely through conservative asset retention.

From a theoretical lens, these results further validate Modern Portfolio Theory (MPT), which argues for balancing return and risk through optimal diversification. Islamic banks that maintain a balanced mix between liquid reserves and profit-generating investments can cushion against systemic shocks while sustaining growth. The secondary data trends, where banks with stronger liquidity ratios achieved consistent profitability, indicate that prudent liquidity buffers act as a stabilizer, allowing banks to respond effectively to withdrawal pressures or funding shocks. Furthermore, the growing role of digital liquidity management tools and cross-border Sukuk markets presents new opportunities for Islamic banks in Kenya. Integrating these instruments within local regulatory frameworks could enhance flexibility, reduce idle cash holdings, and align liquidity practices with both Shariah tenets and global prudential standards.

Compliance Risk Management and Financial Performance

Descriptive findings revealed that respondents moderately agreed that compliance procedures were in place, with a mean score of 2.86. About 43.8% disagreed that compliance cost ratios were well-managed, though 41.3% agreed or strongly agreed that regular internal audits and staff training supported adherence to regulatory and Shariah guidelines. Correlation analysis indicated a positive and significant association between compliance risk management and financial performance ($r = 0.428$, $p < 0.05$), and regression results confirmed their significance ($\beta = 0.158$, $p = 0.029$). This suggests that adherence to Shariah and regulatory frameworks, combined with effective compliance audits, contributes to institutional stability, although the short-term profitability effect may be modest.

Secondary financial data echoed this conclusion: years marked by stricter compliance enforcement (e.g., 2022–2023, following the CBK directive on risk-based supervision) saw a gradual improvement in net profit margins across the Islamic banking sector. These findings support the Stakeholder Theory, which emphasizes regulatory integrity and ethical conduct as key drivers of institutional reputation and stakeholder trust, both critical to long-term financial success in Islamic banking.

The findings underscore the dual nature of compliance in Islamic banking; it functions both as a regulatory safeguard and a spiritual contract that anchors public trust. While the quantitative analysis shows a moderate influence on financial performance, its strategic impact extends far beyond profit margins. Compliance mechanisms that align with both Central Bank of Kenya (CBK) prudential regulations and Shariah Supervisory Board (SSB) standards provide the institutional discipline necessary for sustainable operations. This balance ensures that Islamic banks not only meet legal obligations but also uphold religious and ethical expectations, reinforcing legitimacy in a competitive financial environment.

Combined Effect of Risk Management Practices on Financial Performance

The overall regression model demonstrated a strong collective influence of risk management practices on financial performance, with an R value of 0.749 and an R^2 of 0.561, indicating that 56.1% of the variance in financial performance could be explained by credit, operational, liquidity, and compliance risk management collectively. The F-statistics ($F = 18.534$, $p < 0.001$) confirmed that the model was statistically significant. These results highlight that a comprehensive risk management framework, where multiple risk dimensions are managed in a coordinated manner, has a substantial effect on financial performance. The secondary data analysis also supported this conclusion, as banks that demonstrated integrated risk governance frameworks (e.g., Gulf African Bank) recorded superior and more stable financial outcomes compared to those with fragmented risk structures. This integrated outcome validates the combined insights from Modern Portfolio Theory, Stakeholder Theory, and Merton's Default Risk Model, affirming that diversification, prudent risk control, and stakeholder-oriented governance

jointly sustain financial performance within the Shariah-compliant banking context. In summary, both primary and secondary findings confirmed that sound risk management practices, particularly in credit and liquidity domains, significantly enhance financial performance among Islamic banks in Kenya. While operational and compliance risk management also play important roles, their effect is more indirect, improving efficiency, governance, and reputation. Collectively, the study establishes that effective, integrated, and ethically grounded risk management systems are fundamental to the resilience and profitability of Islamic banks.

CONCLUSION

The study establishes that the performance and sustainability of Islamic banks in Kenya are deeply tied to the strength of their risk management culture. It views risk management not merely as a defensive mechanism but as a strategic tool for competitiveness, stakeholder confidence, and ethical integrity. Guided by Modern Portfolio Theory, Stakeholder Theory, and Merton's Default Risk Model, the research examined how credit, operational, liquidity, and compliance risk management affect financial performance within a Shariah-compliant framework. Empirical results show that credit and liquidity risk management exert the strongest influence on financial performance, followed by operational and compliance risks. Correlation and regression analyses reveal that these four risk dimensions collectively explain over half of the variation in banks' performance, underscoring their central role in profitability and stability. Despite some improvements in banks such as Gulf African and First Community, Islamic banks still trail their conventional counterparts, reflecting the need for stronger, more integrated risk frameworks.

Theoretically, the study validates the key propositions of all three guiding theories: diversification enhances stability (MPT), stakeholder trust reinforces performance (Stakeholder Theory), and effective credit controls reduce default risk (Merton's Model). Practically, it concludes that robust credit assessment, internal controls, liquidity management, and regulatory and Shariah compliance are essential for sustainable profitability. Overall, the study fills a major empirical gap by providing Kenya-specific evidence linking risk management and financial performance in Islamic banks. It contributes to both theory and practice, offering actionable insights for policymakers, regulators, and practitioners. Future research should expand across jurisdictions and include qualitative perspectives to better capture how ethics, regulation, and culture interact to shape Islamic banking resilience.

RECOMMENDATIONS

The study concludes that robust risk management practices are essential for the financial performance of Islamic banks in Kenya, with credit and liquidity risks exerting the strongest influence. To strengthen institutional resilience, the study recommends the adoption of an integrated risk governance framework combining quantitative analytics with Shariah oversight. This would involve unified risk dashboards, regular joint reviews

between Risk Management and Shariah Boards, and mandatory integrated risk disclosures by the Central Bank of Kenya (CBK). Such integration aligns with global Islamic finance standards and enhances transparency, accountability, and investor confidence. The CBK, Kenya Bankers Association, and Shariah Councils should develop a comprehensive Islamic banking risk management framework that defines standards for credit, liquidity, and compliance. Policies should introduce Shariah-compliant liquidity instruments (e.g., Sukuk, commodity Murabaha) and promote financial inclusion through risk-sharing and Takaful mechanisms. Implementation should occur between 2025–2027, supported by annual supervisory reviews and Shariah audits. Islamic banks should establish Integrated Risk Management Units (IRMUs) to coordinate all risk functions. Key actions include early warning systems, quarterly stress tests, cybersecurity controls, and staff training. Ongoing professional development in risk modeling, Shariah audit, and fintech should be prioritized. Investing in digital tools like blockchain and AI will improve transparency, decision accuracy, and ethical compliance.

Further studies should use longitudinal data to explore evolving risks such as cyber threats and technological disruption. Collaborative research programs—led by the Management University of Africa, ISRA, and KBA Research Centre—should produce policy papers, host symposia, and facilitate data sharing between 2026–2029. Universities and professional institutions should integrate Islamic risk management into finance curricula, launch certification programs, and hold joint academic–industry workshops. The Commission for University Education and Kenya Institute of Bankers should lead these initiatives from 2025 onward. All recommendations should follow a Results-Based Management approach using indicators such as profitability ratios, non-performing loans, and compliance scores. Independent audits and annual reviews will ensure accountability and continual improvement. Implementing these recommendations will enhance the robustness, competitiveness, and sustainability of Kenya's Islamic banking sector, positioning it as a resilient and ethically governed component of the national financial system.

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