

**ROLE OF ISLAMIC BANKS IN WELFARE IMPROVEMENT: CASE STUDY  
FIRST COMMUNITY BANK, NORTHERN KENYA WAJIR BRANCH**

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## DECLARATION

I HUSSEIN ADEN MOHAMUD, declare that to the best of my knowledge and wisdom, this dissertation is original and has never been presented before to the Kampala international University or any other higher institution of learning for any academic award.

Signed: NAH:-

Date: 16<sup>th</sup> Dec 2011

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## **APPROVAL**

The following research by HUSSEIN ADAN MOHAMUD which has been carried out under the title: ROLE OF ISLAMIC BANKS IN WELFARE IMPROVEMENT, CASE STUDY: FIRST COMMUNITY BANK LTD- NOTRHERN KENYA WAJIR BRANCH, has been under my supervision and is now ready for submission to the School of Economics and Applied statistics of Kampala International University for award of the Bachelor of Arts In Economics with my approval.

Signed: .....

Date: 17.12.2011.....

MUTUMBA. S. GEOFFREY

**SUPERVISOR**

## **DEDICATION**

This piece of work is dedicated to my parent, Aden Mohamud and my mother Rukia Abdille who first hatched the idea of education and introduced me to this wonderful formal education during my childhood.

I also wish to dedicate this important academic document to the entire family most especially my brother Hassan and sister Zainab because I strongly hold the view that my success is their pride.

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## ABBREVIATIONS

K.C.B	-	Kenya Commercial Bank
C.B.K	-	Central Bank of Kenya
F.C.B	-	First Community Bank
F.I.S	-	Financial Institution Statute
F.Is	-	Financial Intermediaries
B.O.D	-	Board of Directors
G.D.P	-	Growth Domestic Product
I.M.F	-	International Monetary Fund
W.B	-	World Bank

## **ABSTRACT**

The people of Wajir have a long time and still earning their living from livestock keeping like camels, cattle, goats, sheep and very few from peasantry agriculture where bananas, maize, mangoes, tomatoes are grown majorly for subsistence purpose. The minority of people in Wajir district are dealing in motor vehicles mechanics, taxi drivers. The majority women inclusive are petty traders with retail and wholesale business in Wajir district.

The research focused on the role played by First Community Bank Ltd as an Islamic commercial Bank to the society in Wajir District. During the study period oral interviews, observation, questionnaire, journals and review of library materials were used to collect the necessary data.

It was recommended that the feasible way to foster welfare improvement in Wajir district is by extending/offering credit services to the society by Islamic banking institutions and also to mobilize their saving culture and target them to profitable microeconomic ventures. In this way, many will get access to funds which can be invested and in time they may raise enough so as to fend for themselves. It is hoped that when the number of people who get access to those credit services increase in Wajir district, welfare improvement will be as well be checked.

# **CHAPTER ONE: INTRODUCTION**

## **1.1 Introduction**

This chapter presents the background, statement of the problem, research question, research objective, scope of the study.

## **1.2 Background**

First Community Bank is the first licensed commercial bank approved by the Central Bank of Kenya (C.B.K) within the meaning of the Banking Act Cap 488 to operate as a fully -fledged sharia compliant institution.

The bank received its formal approval from the Central Bank of Kenya on 29th May, 2007 as the first sharia compliant banking institution in the entire East and Central Africa region. The bank commenced its official operation on 1st June, 2008 with an initial branch and head office in Nairobi.

By the first two months of operation the bank expanded its branch networks to three branches in Nairobi, one in Mombasa and one in Wajir. Two years later the bank opened branches in Kisumu, Wajir, Moyale, Habaswein, Nakuru and Isiolo. Nevertheless, its branch network was planned to open more branches in various unbanked regions of the country. Regionally, the bank had mid-term plans to establish operation in other East African financial centre where there is sufficient demand for Sharia compliant financial services.

As a pioneer sharia compliant banking institution First Community Bank, in addition to its core banking business also plans to be an agent for bringing into Kenya a number of other innovative sharia compliant products such as Islamic Insurance (Takaful), Islamic bonds (sukuk) and sharia compliant mutual fund and shares trading. All products are offered on fully

sharia compliant basis approved by Sharia Advisory Board composed of prominent Islamic scholars both from inside and outside the country.

### **Ownership and Shareholding**

The ownership of First Community Bank Ltd is currently Kenyan professionals and investors who had envisioned having a specialized institution of this nature in the country. 95% of the shareholding are made up largely of Kenyan investors and 5% of the shareholding are foreigners. All share the passion for bringing this Islamic Banking to the Kenyan market driven by the highest echelons of Ethics in business.

### **1.3 Statement Of The Problem**

Despite the many financial institutions in Kenya springing up, a good number have failed as a result of economic liberalization and financial reforms. However, there is concern over the low presence or representation of Islamic Banks in the country which has hampered welfare improvement.

Kenya being a predominantly agricultural country and also having a good percentage of Muslims needs to extend loans and Financial Advice based on Islamic System to support the economy. Most of the Financial Institutions have concentrated their operations using the interest-based concepts of banking. Therefore I set myself the task of testing the credibility of the above Islamic bank on welfare improvement with a view to measure its Islamic role in the above District.

## **1.4 Objectives Of The Study**

### **1-4.1 General Objectives**

Generally the objective of the research is to find the roles of the Islamic Banks on welfare improvement. This is to identify and describe the nature of Islamic Banks in economic development in order to have an Islamic Based Economy immune from Modern interventions and dominations. Hence control the monetary and the fiscal situations of the economy by use of the Islamic System of Banking.

### **1.4.2 Specific Objectives**

- I. To find out how the bank contributes to employment opportunities in the District.
- II. To find out whether First Community Bank Ltd has effectively participated in development in Wajir District.
- III. To find out various problems that First Community Bank faces in welfare improvement.

## **1.5 Research Questions**

- I. How does the bank contribute to the employment opportunities in the District?
- II. To what extent is the bank participating in development in this District?
- III. What are the problems that First Community Bank faces in welfare improvement?

## **1.6 Significance Of The Study**

The study contributes to the understanding of the importance of establishment of the First Community Bank in the field of welfare improvement of Wajir District.

The study will give suggestions and recommendations as to what solutions can be availed for various challenges met by the bank as the survey on the bank's customers will suggest.

Also highlights the important areas that can play a key role in improving the commercial banking in Kenya.

In addition, this is going to help the Ministry of Finance as well as other Ministries in formulation of economic development programmes.

### **1.7 Scope of the study**

It should be noted that it is generally an acceptable phenomenon that all economies in the contemporary world and the Kenyan economy in particular intend to attain and maintain high rates of economic growth and development. It is also a fact, however, that the economy of Kenya is dwindling and on recession aggravated by inflation, high public debt and low foreign exchange, increased population growth, low productivity e.t.c.

Thus, it is against this background that the study is intended to find out whether successful economic development is a direct outcome of a national operation of the Islamic Financial Institutions. This outcome of this research shall be useful to persons, institutions, structural organizations as well as policy makers who are interested in and concerned with the economic development of Kenya.

The study focused on the economic importance of the bank to this District in improving the standard of living of the people. This is due to the limited time and resources which could not permit a bigger sample and geographical coverage by the researcher coupled with tight schedule for other academic obligations. Hence, this limited the exploration of the topic.

## 1.8 Operational Definitions

**Financial Intermediation:** Refers to the flow off of money from savers to deficit spenders by way of financial institutions.

**Financial Institutions:** Refers to the channels through which monetary and credit policies are implemented.

**Commercial Banks:** These are profit making institutions which operate on people's deposits to lend and invest.

**Ijara:** Leasing.

**Mudarabah:** Partnership (company) between two parties one contributing capital and the other contributing services

**Murabahah:** Management and share profit per agreed ratio.

**Musharakah:** Partnership (company) between two or more parties contributing capital to trade with and share profit and loss per their capital contributing.

**Qur'an:** Holy book for the Muslims.

**Qard:** Loan.

**Qard-Al-Hasan:** Loan on an interest-free basis and the debtor pays when he or she is able

**Riba:** Translated as usury and considered as interest.

**Shariah:** Islamic law as laid down in the Holy Qur'an, sunnah he or she is able and other sources.

**Sunnah:** Sayings and practices of the prophet Muhammad (P.B.U.H).

## **CHAPTER TWO: LITERATURE REVIEW.**

### **2.0 Introduction**

This chapter presents theoretical, conceptual framework and related literature on the nature and ways through which Islamic banks have contributed to welfare improvement in Kenya. The materials have been extracted from textbooks, journals, financial reports and other documents related to the study. The materials show how the Islamic banks have been effective in fostering improvement of welfare development in the Kenya.

### **2.1 Theoretical framework**

Dr. Anwar Iqbal Qureish, "Islam and the theory of Interest", sh. Mohammad, Lahore, (1946) presents his ideas on "place of banking in an Islamic system" and suggests that like public health and education, the government should sponsor banking as a social service in which the bank should never pay any interest to account holders nor charge any interest on loans advanced. The author also suggested that the banks should become partners with businessmen, sharing any loss that might be incurred.

Banking has done for man's modern economy what the advent of money did for his primitive economy when barter was the rule. It has greatly facilitated exchange and helped capital formation and production on a vast scale unprecedented in human history. But the way it has done so has been largely responsible for some of the greatest evils of modern economics: inequalities in income distribution and wealth, concentration of economic power, an endemic tendency towards inflation and fast accumulation of debts in several sectors of the economy with serious political, economic and social consequences.

The system therefore, call for a close scrutiny in a study which advocates a basic reform in banking that would eliminate these ills and gear the system to the universally acclaimed ends of justice, equity and progress.

Sheikh Mahmud Ahmed, "Economics of Islam," Sh, Mohammad Ashraf, Lahore (1952), suggested that the bank should be established by raising capital on a partnership basis from shareholders. No dividend or interest should be paid on the current account, but there should be another account in which people may deposit capital on basis of partnership, the banks' profit being divided in such a way that shareholders also receive more profits than account holders.

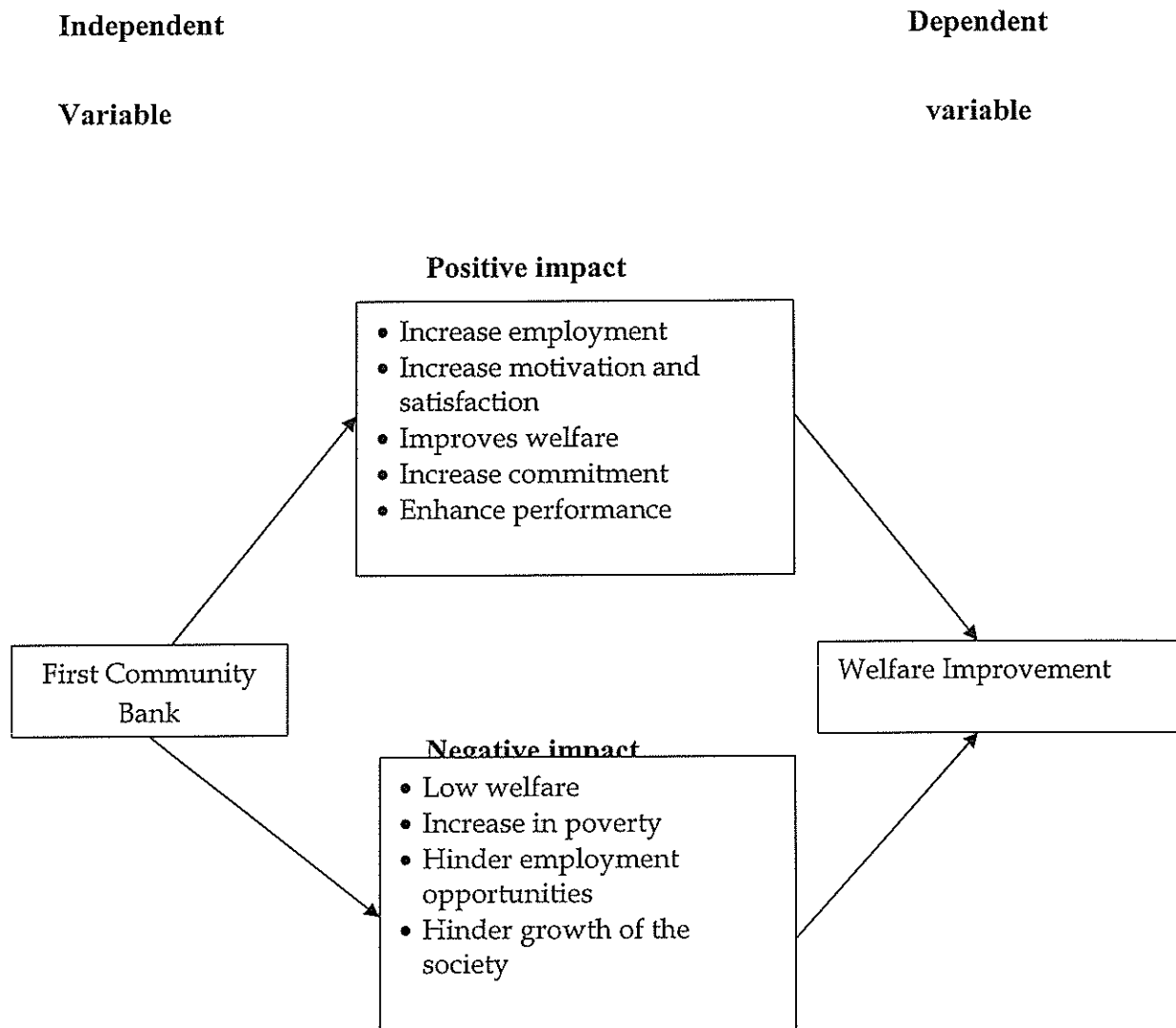
Mohammad Uzair (1955), "An outline of Interest free banking" Raihan publications, Karachi. The framework of interest-free banking based on the principle of mudharaba presented here is in keeping with shariah. The issue of central banking is not touched upon. The writer argues that no capital investment should be made with the bank's own deposits or with credits.

Mohammad Abdullahi Al-Arabi (1966 and 1967), "contemporary banking transactions and Islam's views Thereon, paper in Islamic preview, and in Islamic thought." The major part of the describes the evil of interest and the banking systems based on the interest. The system of banking would be run on the capital procured from the people on the basis of mudharaba. The bank can advance capital procured in this way as well as the capital of its own shareholders to businessmen also on mudharaba. As regards the profit distribution and responsibility of loss the position adopted is strictly in accordance with the sharia.

Hassannuzzaman (1964), "Interest-free consumption loans and consumer behavior, in some Economic aspects of Islam." Ummu publishing house, Bahadurabad, Karachi. In this paper the effects of interest rate fluctuations on the demand for consumer loans was discussed and the author pointed out the ideas that in an interest-free banking system, the demand for interest-free loans would be unlimited, this is not based on any sound economic theory because in the determination of this demand other social and economic factors are much more critical than interest rates.

## 2.2 Conceptual framework

This illustrates the conception framework of dependent and independent variable



Source : Jones & George, (2003)

## **2.3 Related Literature**

### **Islamic Finance And Global Crisis**

An Islamic finance gains prominence globally many famous people including the Vatican's has joined in endorsing Muslims way of doing business.

The Vatican's official newspaper, L'Osservatore Romano, recently published an article titled "Islamic finance proposals and ideas for the west in crisis," prepared by an Italian Economist Loretta Napoleon and Claudia Segre, which said the basic rules of Islamic finance could relieve suffering markets particularly International Finance System.

Since Islam prohibits Riba (usury)the article argued "Sukuk bonds," securities that comply with Islamic law may be an alternative to interest. Sukuku Bonds are real investment and never speculative. The article said in this current global crisis, banks should take Muslims as an example, adding the Islamic finance system which may help in creating new rules in the western world.

The Chief Executive Officer (C.E.O)of Gulf African Bank, Najmal Hassan said, "The Kenyan market is resonating with the whole world as we have witness a tremendous growth rate since January 2008,with nine branches already in operation. "It is Ethics, fairness, transparency and partnership values that draws in the crowd and it is these values that transcend religion".

During the recent World Islamic Economic Forum (WIEF) in Indonesia, one of the speakers, Malaysia Prime minister Abdullahi Ahmed Badari said, "The Islamic financial system ability to remain largely unscathed by the difficulties affecting the conventional financial system is tantamount to its integrity and validity and expects to see Islamic finance play a more prominent role in the international financial system."

Rosie Kmeid, Head of corporate communications and marketing at path solutions, an information technology firm that supplies software to Islamic banks said, "Long considered by westerners as odd, Islamic finance is going mainstream. Islamic finance appeals to some of the largely international financial institutions seeking to tap into emerging markets. Although sharia-compliant products have been around for many years, faith based dealings of all appellations are nowadays enjoying a period of truly remarkable growth and developments."

Rose Detho, Central Bank of Kenya's director in charge of bank supervisor said, "Disclosures on interest income and interest expenses have been suitably modified to accumulate Islamic products within the existing CBK prudential regulatory disclosure framework without necessarily amending the Banking Act."

Mr.Nadith Adam, Chief Executive Officer, First Community Bank said, "Globally, Islamic banking is going at an average rate of between 15%and 20% annually."

### **2.3-1 Consequences Of Interest**

The ultimate investor faces an uncertain world in which the results of his enterprise cannot be foreseen with certainty. Investors are nevertheless obliged to commit himself to the bank for payment of a fixed percentage return over and above the principal. In doing so his only guide are his expectations regarding the profits of his enterprise. Should the expected rate of the profits be lower than the market rate of interest or to be more realistic not sufficiently higher than to leave some profits for himself, he is constrained to drop the project. These often include profits rated high in the social order of priorities but the individual is entirely helpless in this regards.

Therefore, the society is obliged to adopt other methods to take care of such projects. Historically, it had to admit them into the public sector or finance them through special agencies relying on public funds raised through borrowing or taxation. The institution of fixed

interest charges on advances is therefore inimical to the growth of a free society and it introduces a tendency towards socialization.

Secondly, interest due to or bank advances has to be treated as an item of cost raising the cost curves and influencing the firms policy regarding pricing of its products and the wages offered to labour, assuming that the imperfectly competitive world affords some maneuverability to many firms in these respects. Higher cost curves imply higher equilibrium prices and smaller scales of productions. Furthermore, the profit-sharing entrepreneur is free from the constraint of realizing interest costs as his sole commitment to the supplier of capital is that of sharing the expose profit with him. Though still a profit-seeker he can nevertheless take care of social objectives in his price policy and wages policy should he so desire. He can serve other ends at the cost of some short-term profits. No such freedom is available to an interest paying entrepreneur.

### **2.3-2 Types of usury(riba)**

- i. **Riba al-nasiah:** This is defined as any excess compensation over and above the principal which is without due consideration. The prophet (s.a.w)said, "Every loan that draws interest is riba." Riba al –nasiah or deferred usury is related to extension of the repayment period for additional payment of money. It is also called Riba Jahilliyah which was a pre-Islamic form of usury and the worst of its kind.
- ii. **Riba al-fadl:** Riba al –fadl means the excess which is taken in exchange of specific homogeneous commodities such as selling gold with another gold whereby one has more weight than the other.

### **2.4 Principles Of Islamic Banking**

Islamic banking is based on the principles of trade, partnership, sharing of gains and losses and prohibition of reckless risk. It prohibits:

- i. Interest-based banking
- ii. Gharar-unclear contracts
- iii. Maysir-speculation
- iv. Financing of haram transaction-alcohol, gambling, pork e.t.c

#### **2.4.1 Lending In An Islamic Banking**

Islamic financing involves a buy-sale deal or a rent to sale deal. There is always an underlying asset behind the deal. Allah (s.w) reminds us, “We have permitted trade and forbidden riba.” In Islamic banking the lender must share the risk with the borrower.

#### **2.4.2 Types Of Lending Contracts**

##### **Murabaha/mark-up sale(short-term trade financing)**

The term murabaha comes from the Arabic word “Rabh” which means profit (short-term trade financing). Client identifies goods which he wishes to buy for kshs x and request a bank to finance the transaction. The bank buys the said goods and re-sells them to the client for kshs x margin(e.g 10% agree profit).The client then repays within agreed timeframe. For example, Mannan(1993) is of the view that the cost incurred on the goods or services indispensable to their sale for instance brokerage fee and the like may be include. Personal expenses of the merchant and other expenses not directly involved with the goods are not to be involved into the sale contract on which the murabaha sale is based.

##### **Musharaka**

This is a joint enterprise formed for business where all the partners (the bank and customer) contribute capital and share the profits according to a specific ratio while any possible loss is

in turn shared according to the capital contribution by the two parties. Both the bank and the client contribute capital, client buys know how profit and losses are shared on agreed ratio.(Fahmy and Sarkar 1997)

### **Mudaraba**

This is a partnership where the bank contributes 100% of the capital and the client contributes know-how. Profit is shared on an agreed ratio. If there are any losses, the bank absorbs it fully. This is the equivalent to 100% financing of the bank.

### **Ijara(leasing)**

This is the same as leasing. The bank purchases the asset/house. There is joint ownership between the bank and the client. The client rents it from the bank. Clients enter into an agreement to buy the shares from the bank time to time ending up with a 100% ownership. Repayment is in the form of rental costs which change as the percentage owned by the client increases. The value of the asset can also increase thus the bank has the right to charge a higher price for the sale of its shares. However, this is the transfer of ownership (sale) of a legitimate and well-defined usufruct for a specified period of time against specific returns (Fahmy and Sarkar 1997).

### **Istisna'a**

Istisna'a is a sales transaction where community usually horticultural or agricultural goods is sold before it comes into existence. The price of the commodity must be paid in advance to make the transaction valid.

## **Qard-al-hassan**

Interest-free loans are highly recommended in Islam for the purpose of helping those in hardship. Qard-al-hassan is considered as a contract by virtue of which, “a transfer of ownership of a certain amount of wealth from one person (the creditor) to another (the debtor) is being effected on a promise from the latter to settle the same amount to the former at once whenever he calls for it in future.” (Fahmy and Sarkar 1997:83)

The main feature/condition of qard-al-hassan as a mode of financing is that the loan must be free of any expected return or benefit to the creditor and the debtor has to pay the loan when he/she is able.

## **2.5 Deposits In An Islamic Banking**

Clients deposits fall under the category qard(loan)to the bank and the bank is obliged to pay back. These loans fall under the category of musharaka. The bank is obliged to share in the profits of the bank with its depositors. The bank protects these assets on behalf of its clients as well as gets them the highest halal returns. Since banks don't pay interest, clients must become partners to share in the profits. The only way to become a partner being opening an investment account (time or saving deposit) which allows the bank to invest one's money. Profit sharing is then calculated and distributed which will be very close to prevailing deposits rates.

## **2.6 Types Of Accounts In An Islamic Bank**

### **Current accounts:**

Current accounts are interest-free loan by the account holder to the Islamic bank which maintains these funds and pays them to the customer on demand .These acts are similar to a loan in guarantee and payment of the same. An Islamic bank has the right to invest the funds it

is holding in current accounts without customers bearing any loss. For this reason, the customer doesn't get any profit on this type of account but also doesn't bear any loss.

### **Investment saving account**

Many Islamic banks offer savings accounts to the customers. This account allows the account holder to place funds in a safe environment till such time when they may wish to withdraw them. Profits and losses under investment savings accounts accrue on minimum monthly balance. Profits are paid or loss deducted after the expiry of the financial year and net profits determined.

The balance under the investment saving accounts is invested on the basis of unrestricted mudharaba. An Islamic bank has the right to do everything necessary to realize common interest. An account holder authorizes the Islamic bank to invest the profits made from the moment they are registered in his account with the Islamic bank.

#### **2.6.1 Bank Loans**

The bank advances short-term loans to business parties and not receives remuneration for these services. However, the bank renders this service only to an extent calculated precisely. This is determined as a proportion of the capital deposited in the bank's loan accounts. The borrower will have to guarantee repayment of the loan within the scheduled period.

Although the bank will not be able to receive interest on the loans it issues nor will any remuneration from borrowers, the society benefits from such an important services and the bank be rewarded indirectly. The bank will be allowed to invest the remaining capital in its loan accounts in other profitable economic activities. Now the bank will be clear that it will not be paying any interest on their deposits.

However, the depositors who deposit their capital and savings in the bank will be able to withdraw any amount they want though a sizeable part of the deposits in current accounts is not withdrawn.

### **2.6.2 Islamic Approaches To Money And Monetary Policy**

Muslim society had been using money since its inception and some form of banking was also in existence. But issues relating to money, banking and monetary policy posed themselves in an entirely new perspective in the 21st century.

Emergence of modern banks and other financial institutions in Muslim countries, introduction of paper money, increases in public debt and commercial dealings in securities presented in jurists with new questions to answer. A review of newly introduced western institutions was followed by attempts to devise alternatives free from interest other features repugnant to sharia. Interest in Islamic injunction relevant to management of money and finance increases and the desire to spell out the distinctively Islamic approach in contrast to those of capitalist and socialism led to a number of fresh formalities.

### **2.6.3 Monetary Policy**

Monetary policy is directed at regulating the quantity of money, its availability and its costs. Usually the objectives of monetary policy are price stability, balance of payments, growth of the economy and distributive justice-objectives in whose realization fiscal policy also partakes the Central bank, functioning under supervision of the government (the ministry of finance) pursues these ends using a number of instruments at its disposal.

Policy goals have been discussed by Islamic economists under the general study of economic functions of Islamic state. Not many writers have paid special attention to banking. Some tended to assign the relevant functions of Bait al -mal a view that could hardly stand further scrutiny.

Central banking has yet to be followed up by a more detailed treatment. The absence of bank rates as instruments of policy but changing the reserve ratio and direct controls on supply of credit are two of the conventional weapons still available. In the absence of interest-bearing securities, sale and purchase of certain kinds of shares and loan certificates could provide the means of "open market operations."

As an alternative to the bank rate a number of other policy instruments are suggested.-The "Re-finance Ratio" refers to the offer of the central bank to provide additional cash to the commercial banks to the extent of a certain percentage of the interest-free loans granted by them. Raising/lowering this ratio will have the effect of expanding or contracting the supply by the commercial banks of short term credit.

Prescribing different ratios in respect of credit extended to different sectors of the economy can be a means of channeling credit into desired directions.

Another instrument is "lending ratio" which refers to the percentage of demand deposits which commercial banks will be obliged to lend out as interest-free loans. Moral suasion in policy decisions arrived at through mutual consultation has played a significant role in recent time. It is hoped it will play a greater role in Islamic banking system.

Thus the central bank in an interest-free system will have a number of instruments which it could use to regulate the credit supply and the terms on which it is available to the entrepreneur. Abolition of interest, absence of interest-bearing securities and hence of the speculation in bonds markets will greatly reduce its problems. The marriage of capital and enterprise affected by the replace of interest by profit-sharing will contribute towards growth and development.

## **2.7 Functions Of Central Banks Under The Islamic System**

1. Printing and circulation of currency notes and metal coins according to the rules and regulative Islam.
2. Foreign currency banking operations and commitments or guarantees of foreign exchange payments of the government in accordance with rules and regulations.
3. Supervision of gold and foreign exchange dealings as a result of import and export goods.
4. Carrying out operations relating to bonds and negotiable documents in accordance with rules and regulations can be maintained by the central bank.
5. Implementation of monetary and credit policies in accordance with rules and regulations.
6. To open various interest-free loan accounts and long term investment deposits and issuance of relevant documents in accordance with rules and regulations.
7. Lender of last resort as well as provision of refinance to the commercial banks and other financial institutions.
8. Acceptance and safekeeping of gold and silver and valuable articles, negotiable bonds and official documents belonging to state and leasing of safe vaults.
9. Signing of agreements and "Payments for implementation of money, commercial and transit agreement" between government and other countries in accordance with rules and regulations.
10. Custody of deposits of international monetary and financial organizations or similar organization in accordance with rules and regulations.
11. Provision of bank's short-term loans and advances to federal and provincial government free of interest.

12. Organizing, control and channeling of money and its circulation according to rules and regulations.

### **2.7.1 Functions Of Commercial Banks Under The Islamic System**

1. To mobilize the savings of the community in the form of various types of deposits (Islamic) and investment accounts and to deploy these resources for financing various types of productive activities permitted in an Islamic society

2. Provides funds to the business enterprise for short, medium and long term and can be entitled to receive a part of the profits earned by the enterprise in accordance with agreed proportion.

3. Accept current account deposits as well as open investment accounts. Current deposits can be payable on demand and no return shall payable on them. As for investment accounts, there can no commitment on the part of the bank to pay a fixed return on them but the account holder can share the profits earned by the banks in agreed proportion. In the event of loss, investment accounts holders can share the loss strictly in proportion to the share to such investment accounts in the total capital funds employed by the bank during a particular accounting period.

4. Monitoring financing arrangement under mudharaba and musharaka about the actual performance of the business finance by commercial banks.

5. Financing new business concerns by subscribing to a part of the share capital of such concerns, e.g taking up a part of the equity at the very conception of a project at a negotiable price below the face value of the shares. This can be a substitute for "bridge financing" arrangements under the interest-based system.

## **2.8 Difficulties Experienced By The Islamic Banks**

Islamic banks face some problems in their areas of operation which are mentioned as below:-

1. In most of their working locations they still perform their duties in economic, administrative, legal, cultural and social situation where there are non-Muslims in one form or another.
2. The position of the Islamic banks in the country is still that of a minority as compared to many other modern banks.
3. Islamic banks follow a system, a philosophy and practices that run parallel to the system, philosophy and practices of non Islamic banks in the country.
4. Islamic banks have a different way or concepts of determining their objectives, system of work and type of functions. They even determine their framework of ethics, transparency and fairness, thus deciding what they may or may not do.
5. Misconceptions such as Islamic banks are conduits of terrorists' funds or these types of banks are exclusively meant for Muslims.
6. A greater challenge to the bank is the unfamiliarity with the Islamic finance regulation and supervision

## **2.9 Duties Owed By A Bank To A Customer**

### **a) Secrecy**

A bank has a duty not to disclose information it has received regarding a customer affairs without the consent of the customer. It doesn't only cover the information concerning the

Account but all the information concerning a particular.

#### **b) Duties to honor a customer's cheques and other orders**

A bank has a duty to this to the extent of the amount standing on a customer's account. It is a defamatory for a bank to dishonor a cheque for an account which has sufficient funds on it.

#### **c) Duties to collect a customer's bills exchange**

A bank has a duty to receive cheques and orders and collect the proceeds due to them and credit customer's account.

#### **d) Customer care services**

Customer services involves all the activities which a business and its employees conduct or perform to satisfy the customers. Customer service also means going out of the way for the, doing everything possible to satisfy the customer and making decisions that benefit both the customer and the business.

Customer service pays, it doesn't cost. It pays the first of which is long-term customer retention. Many businesses understand the cost of losing.

#### **2.9.1 Regulations of Islamic Banks By Central Bank of Kenya(C.B.K)**

The concept of Islamic banking is relatively new in Kenya. There is no clear-cut legislation regulating the issuance of sharia compliant products. The banks are licensed by Central Bank of Kenya and Statutes regulating the banking industry are applicable to them.

Calls have been made for a clear-cut legislation on Islamic banking to support the sector. The reference of "Interest" in some of the statutes has posed a problem to both the regulator and the issuers as one of the core principles of Islamic financing is the absence of Riba(interest)

Globally, the AAOIFI organization (Accounting and Auditing Organization for Islamic Finance Institutions) has provided some sort of guidance for the sector.

## **Shariah Advisory Boards/Committee**

All Islamic Financial Institutions are required to have a sharia supervisory Board/Committee. This board should consist of trustworthy scholars who are highly qualified to issue fatwa (religious rulings) on financial transactions. In addition, shariah Board members ought to have considerable experience in modern business/financial dealings and transactions.

## **Re-Financing of Loans**

However, the concept is picking up in Kenya. Hence, the establishment of main Islamic banks namely; First Community Bank (FCB) and Gulf African Bank. For example, the gulf African bank offers sharia compliant products and services including equipment and vehicle financing, re-financing of loans, musharaka transactions in the real estates and murabaha transactions in the petroleum sector. The banking is expanding and shall soon offer sharia compliant services and products for the construction industry and will soon commence securitization transactions.

Issuers in Kenya are however, happy with the support granted by the regulators, in the absence of a clear-cut legislation for the sector. According to one issuer, "the regulators have been supportive so far and are working with us to ensure growth of the industry despite the lack of regulation, which may otherwise cause confusion.

## CHAPTER THREE: METHODOLOGY

### 3.0 Introduction

This chapter presents the research design, sample, population, data collection and data analysis.

### 3.1 Research Design

The final questionnaire as presented in Appendix A consists of questions seeking general data from the respondents as regards their wellbeing now that they have benefited from a loan scheme from First Community Bank Ltd. From such data it was hoped that the wellbeing of the respondents would be varied so as to give the researcher a general view of what the bank loan can do in as far as development is concerned.

### 3.2 Population

**Table 3.3 Questionnaire Distribution in Wajir District**

Location	No.Distributed	No.Returned	%Returned
Jogoo	20	16	80
Waberi	10	5	50
Township	25	22	88
South C	12	8	67
Total	67	51	76

**Source:** Primary data.

A total of twenty (20) questionnaires were distributed in Jogoo location and after two (2) weeks, sixteen (16) were returned. Ten (10) were distributed in Waberi location and five (5) were returned. In Township location, twenty five (25) questionnaires were distributed and twenty two (22) were returned. In South C location, twelve (12) were distributed and eight (8) were returned. Out of the total sixty seven (67) questionnaires distributed in Wajir District only fifty one (51) were returned, being seventy six (76) percent of the total number of questionnaires distributed. This data was collected in a period of four months. Due to limited funds, the researcher couldn't collect more than those that were returned.

### **3.3 Sample Selection**

Wajir District is an extensive area and to effectively study the process of development, there was need to peak on some individuals and study their activities in relation to the borrowed funds. The population in this study comprised of the borrowers from First Community Bank Ltd. They were considered because they were the most resourceful persons who would provide information whether the Islamic banking industry can foster development. The staff of the bank was left out because it would not give the necessary information as all that they would give would indicate positive role of the bank in fostering welfare improvement..

### **3.1 Data Collection**

#### **3.1.1 Questionnaire Technique**

This simple questionnaire was used in the study. It required responses from the respondents to the questions therein. The purpose was to seek opinions and views from those who got loans from the First Community Bank (FCB) so as to participate in development activities

### **3.3-2 Development And Validation Of The Questionnaire**

In developing the questionnaire for the study the researcher contacted the Branch manager who leads the management team of the First Community Bank Ltd-Wajir Branch, with the aim of gathering relevant ideas which would facilitate straightforward data collection on socio-economic development given the bank loan

After consulting various sources, a draft of the questionnaire was forwarded to the Branch manager for verification. The original questionnaire had thirty two (32) items but after modification, it was reduced to twenty seven (27) questions. The rejected questions were considered repetitions.

The final questionnaire as presented in Appendix A consists of questions seeking general data from the respondents as regards their wellbeing now that they have benefited from a loan scheme from First Community Bank Ltd. From such data it was hoped that the wellbeing of the respondents would be varied so as to give the researcher a general view of what the bank loan can do in as far as development is concerned.

### **3.3 Questionnaire Administration**

Because of difficulties in establishing the location of the beneficiaries of the loan the researcher sought the assistance of the staff who introduced the researcher to various beneficiaries of the loan scheme. Also the staff of the bank volunteered in delivering the questionnaire to some of the respondents.

### **3.4 The Interview Research Instrument**

In order to seek the opinions and views of the respondents about development given a bank loans from FCB, guided interviews were conducted.

### 3.5 Actual Interviews

With the introduction of the researcher to various respondents, the researcher was able to conduct interviews with various respondents on the agreed date of appointed.

Summary of successful interviews and percentage returns is presented in table 3.5

**Table 3.5 Interview Returns**

Location	No. Of Interviews		% Returned
	Total	Successful	
Jogoo	3	3	100
Waberi	2	1	50
Township	5	4	80
South C	3	2	67

Source: Primary data.

### 3.6 Observation

In the course of collecting data for the study, the researcher made observations of what was observed. What was observed included; motor vehicles, farm inputs, houses e.t.c. The purpose of this observation was to ensure that really the loan was put to development tasks.

## **CHAPTER FOUR: PRESENTATION, INTERPRETATION AND DISCUSSION OF THE RESEARCH FINDINGS.**

### **4.0 Introduction**

This chapter presents presentation, interpretation and discussion of research findings. First Community Bank Ltd (FCB) is known as the bank for majority of Kenyans because its services are focused mainly towards the low income earners. Furthermore, it is a bank for those who need interest-free banking services in the unbanked regions of the country.

It is expanding gradually with five branches in its first-two months of its operation. The branches are headed by branch managers and deputized by assistant managers who are approved on merits by the Board of Directors.

This chapter will mainly look at the crucial findings on the role played by First Community Bank as an Islamic commercial bank to the society of Wajir district. It has been observed that Islamic banking is one of the solutions needed for societies to develop as well as welfare improvement. The bank has to work in collaboration with the government and the people themselves in order to enhance welfare improvement. This was revealed in research work carried out.

### **4.1 Presentation of research findings**

#### **Objectives Of Setting Up The Business**

During the study, it was found out that First Community Bank; Wajir Branch was established with the following objectives;

a) Serving the needs of the customers especially the low income groups who cannot manage to pay back the high interests paid on loans borrowed. Being a commercial district dominated by pastoralist, the only three existing conventional banks that is Kenya Commercial Bank,

Equity Bank, and Post Bank were not accessible to the individual members who preferred Islamic Banking System. Therefore, First Community Bank was set up to provide such financial services and products to such people.

b) The bank was also established to improve the standards of living, raise the incomes of the people of Wajir district and this would enable them to afford the basic necessities of life.

c) First Community Bank, Wajir branch was established to serve the peasant Muslim segment of the Kenyan society through the provision of cheap and liberal credit under the Islamic principles of banking to help them in their daily commercial activities.

d) First Community Bank was also set up to encourage non-Islamic financial institutions to participate in the Islamic banking sector.

e) The bank was established to supply low cost funds for entrepreneurs who wish to undertake investment projects.

f) First Community Bank was also established to cultivate savings habits among Kenyan Muslims particularly for pilgrimage purposes.

g) Finally, First Community Bank was set up in order to attract savings and investments from other Muslim countries in the world

## **4.2 Interpretation of reserach**

### **The Need For Islamic Banks In Wajir District**

There is need for setting up Islamic banks in the district where most of the peasants engage in agriculture, pastoralist and other commercial activities. The main reason for this is for example extension of credit facilities which are interest-free to these different sectors of economy.

First Community Bank has done this mainly to small businesses which borrow money from the bank to expand the operations and the terms of borrowing the money are favourable. However, this improves on the business turnovers.

Because of its flexibility in lending, First Community Bank, Wajir branch accepts household property as security for loans. First Community Bank, Wajir branch has also accepted other options like land title deeds as security for acquiring interest-free loans.

#### **4.2.1 Mobilising Capital**

In Wajir district where there is lack of capital, First Community Bank, Wajir branch has offered an effective means of mobilizing capital e.g. mudharabah where the bank contributes hundred percent (100%) of the capital and the clients contribute technical know-how and profits realized in turn are shared on an agreed ratio. The bank absorbs fully in case of loss occurrence. This has been made possible through lending money to the public to set up productive ventures.

#### **4.2.2 Market For Items**

Items like motor vehicles and houses/assets are usually bought by the bank. Therefore, the local community taps some income from selling such items to the bank. Also the bank rents the houses to the clients. Clients enter into an agreement to buy shares from the bank time to time ending up with a hundred percent (100%) ownership of these rented houses. In turn, building houses for sale or rent has become a lucrative business in Wajir district because of the increased demand.

#### **4.2.3 Job Opportunities**

First Community Bank, Wajir branch has provided job opportunities for some people in Wajir district. The Branch Manager for First Community Bank stressed that out of the employees of

the branch, twelve (12) of them are from the district. This has enabled these people to earn income which has in turn helped increase their standard of living. This is a fair share that is eighty percent (80%) of the branch's employees are from Wajir district as illustrated in the table below;

**Table 4.2.3 Job opportunities in First Community Bank, Wajir Branch**

District	No.of employees	Percentage (%)
Those from Wajir district	12	80
Those from other areas	3	20
Total	15	100

Source: Primary data

#### **4.3 Basis For Advancing Loans In First Community Bank,Wajir Branch**

First Community Bank, Wajir branch advances many loans to its clients basing itself on the following:-

- a) The loan applicant must have an account with the bank which is credited and debited as the circumstances arise
- b) There is need for security/mortgages. These are to help the bank recover its money in case a client defaults on repayment and such mortgages include; motor vehicles, land title deeds, household items e.t.c

c) The client must be a good customer who has proven to carry out all the obligations due to him/her as the Bank- Customer relationship requires irrespective of religion, sex, race, color e.t.c. Customer of undoubted integrity are involved.

d) The loan must have a well set up business which is approved by the bank before disbursing a loan to such a person. This is part of financial advice the bank extends to its clients.

Therefore, the loan applicant who fulfills the above requirements qualifies for a loan from First Community Bank, Wajir branch.

#### **4.4 Problems Encountered While Processing Loans From First Community Bank,Wajir Branch**

a) The preparation of the necessary documents takes a lot of time and this therefore, delays the disbursement of loans.

b) The documentation papers also have too much legal language which is not easy to understand by many bank's customers.

c) There is also problem of poor infrastructure in the villages. This means that the loans officers always have little access to those places where the applicants stay in order to approve their intended projects.

#### **4.5 Problems Faced By First Community Bank,Wajir Branch In Dealing With Its Customers**

a) Firstly, there is a problem of low savings, since the majority of the people in Wajir district are poor. This means that the bank finds it difficult to mobilize these small savings in order to operate normally.

c) There is also a problem of ignorance. Some customers are not well versed with how the bank operates and hence doubt its future profitability in understanding its projects.

#### **4.6 Solutions To Customer Complaints In The Branch**

The management of the bank has increased the number of well-trained employees who are fast enough and can offer efficient services to the customers.

The bank also offers training and the customer service courses to its employees and this has reduced on the number of complaints from the public.

The problem of long queues and waiting time before a customer is served has been reduced by computerization of the branch's operation and the introduction of more tellers in the branch's banking hall. This ensures that many people can now be served at same time.

First Community Bank, Wajir branch has introduced a system of paying and receiving cashiers so as to reduce on the waiting time and queues of customers. This ensures fast and efficient service.

#### **4.7 Debt Recovery Techniques**

The bank takes back possession of real property e.g land. The bank avoids receivable problems in the first place. The bank makes sure that its customers are good credit risks before it does its business with them. However, the bank gets back the loan lent in time as per the agreement with its customers. Therefore, the bank appreciates being made aware of all problems before hand and mostly will be more than willing to work with the borrowers it sees as being proactive and responsible.

#### **4.8 Discussion of The Research Findings**

What was observed in the field of study and from those interviews and the information given on the returned questionnaires indicated that the funds borrowed from First Community Bank were put into development tasks.

All the respondents in this study indicated appreciations to the bank for extending credit facilities based on sharia compliances services and products. They confessed that with access to credit facilities from the bank their income was increased as the savings in the bank had increased.

A part from the bank savings, it was observed that physically and from the daily responded questionnaires, there was increased participation in economic activities. The beneficiaries to the loan confessed that the repayment procedures are favorable and requires one to work hard and because they had maintained this trend of working, they have been in position to repay the loan and expanded their business enterprises.

Just like many Islamic banks in other countries, the future Islamic banking in Kenya is very much dependent on the Muslim individuals and Islamic organizations. Supports from institutions such as Islamic private schools, mosques, Islamic centers, zakat funds and Islamic saving co-operatives are vital especially at the growth stage of these banks.

## **CHAPTER FIVE: CONCLUSION SUMMARY AND RECOMMENDATIONS**

### **5.0 Introduction:**

This chapter presents the conclusion, summary and recommendation of the research findings. The findings in the previous chapter indicated that the banking industry in Kenya has not extended its services to the rural areas in order to facilitate development of those areas. If this is not done, then there will always be an imbalance in growth between the different sectors of the economic. Agriculture which commands almost eighty percent (80%) of the Gross Domestic Product (G.D.P) of Kenya's economy is based in rural areas. Therefore, Islamic commercial banks have been looked at as boosting only the manufacturing and industrial sectors which are mainly based in urban areas or centers. This chapter is therefore, aimed at identifying the possible measures that could be employed in order to improve the banking sector in Kenya through Islamic commercial banks.

### **5.1. Conclusion**

Kenya is trying to improve on the performance of its Islamic financial institutions by implementing both the legal and moral demands of society so as to cope up with the rest of the world which is currently facing financial meltdown. However, this can be achieved if all sectors of the economy move complementary with each other. Although Kenya is trying to emphasize agriculture and livestock in rural areas, the majority poor who live there have no access to funds because these funds can be availed through the extension of banking services preferably Islamic banking services to those areas which will induce their development.

Islamic banking and finance are a part of Islamic economic system, the basis of which justice and morality. It is a very young concept in modern times yet it is emerging as one of the

fastest growing areas of international finance. It facilitates the uplifting of economic standards of its clients by providing various types of lending contracts.

Above all it is shariah compliant, hence protects a Muslim from dealing with riba, thus avoid Allah's wrath and war. Let us all support Islamic banking venture which is being provided by the establishment of First Community Bank (F.C.B). We pray and believe that the bank will strictly stick to Islamic principles and shariah and uplift the living standards of all those who endeavor to do so in a decent manner.

## **5.2 Summary**

Since majority of the commercial banks in Kenya are always conventional banks which greatly benefit the wealthy suppressing the poor, the government should adopt Islamic banking concept which will be beneficial to the government in terms of development and employment opportunities to everybody hence economic improvements.

For effective Islamic banking to be a reality, the Boards Of Directors (BOD) of First Community Bank should take care while making decisions affecting the bank's operations because inaccurate decisions by poor management always puts the bank at a risk of losing their money to such people. Therefore, only the personnel with high integrity should be employed by the bank if the bank is to achieve its objectives.

## **5.3 Recommendations**

It has been realized that the most commercial banks are conventional banks and usually aim at maximizing their profits. They concentrate themselves in Nairobi city and the nearest towns around it, because they want to deal with the wealthy only. Their interest rates are very high and this means that only a small portion of the Kenyans can afford to borrow from such institutions unlike Islamic banking institutions which are interest-free and cater for everybody.

The minimum balances from their accounts are very high such that a few working class members can deal with them.

Therefore, the government through Central Bank of Kenya should introduce more Islamic Banking Institutions which are aimed at extending banking services to the poor. This would enhance welfare improvement and the standard of living of most Kenyans would improve as a result. Kenya which is a third world country, has a very low per capita income which can only be raised if the government becomes more stringent on Islamic commercial banking within the country.

First Community Bank (F.C.B) should also take time to advise their clients who borrow large sums of money as loans, on how and where to invest it. Since the majority of the people in Wajir district are illiterates of the financial matters in the economy, they sell their properties to acquire loans for the purpose of investing them in ventures which later prove to be unproductive.

The bank should take more accurate measures so that they give loans only to clients after researching and finding out what exactly the clients would wish to invest their money. This will reduce on the non-performing assets which are a result of such unviable ventures. This is because borrowers invest badly and they cannot pay back the loans to the Islamic commercial banks.

The interest-based commercial banks in the country should imitate banking concept of First Community Bank so that the customers will be able to borrow funds from these banks. As earlier noted, First Community Bank banking concept gives the majority of the peasants in the country the opportunity to deposit their savings into these kinds of banks and also to borrow money to expand on their commercial activities or even set up several development projects in the region and the economy as a whole.

The government should also encourage more foreign investors to venture into funding agricultural activities in rural areas through setting up Islamic banks which will provide a variety of and better quality services to the low income earners in the economy at a lower cost. Stiff competition arises through establishment of more Islamic commercial banks, and then these banks will improve on the services they render to their clients in order not to lose them.

The government must establish and aggressively enforce strict short-term targets for bank's problems in key areas such as capital adequacy, insider-lending and replacement of bank management and where necessary close institutions that fail to meet targets.

An effective deposit protection fund should be established to deal with potential bank closure.

At the same time, urgent institutional measures must be taken to address the problem of financial discipline, including establishing a credit information bureau and streamlining the judicial system to expedite legal recourse for debt collection that is fair and transparent.

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## APPENDIX A: QUESTIONNAIRE

Dear Respondent,

I am a student in Kampala International University pursuing a Bachelor of Arts in Economics, currently doing my undergraduate Research on the Topic: ROLE OF THE FISRT COMMUNITY BANK ON WELFARE IMPROVEMENT; CASE STUDY: FIRST COMMUNITY BANK LTD-WAJIR BRANCH.

This programme constitutes a certain percentage to my degree and final examinations, which are scheduled for NOV, 2011. For sure; the information provided by each respondent will be treated as confidential. I therefore, pray that you respond to this questionnaire with maximum sincerity and your positive response to it will enable me achieve my objectives.

Respondent contact:..... village.....

SEX    Male    ☐                      Female    ☐

### TICK WHAT IS APPROPRIATE

1. Do you have an account with First Community BANK?

Yes    ☐                                      No    ☐

2. If yes, what type of account do you have with First Community Bank?

a) Current account    ☐

b) Savings account    ☐

c) Fixed account    ☐

3. Do you operate a bank account elsewhere?

Yes ☐

No ☐

4. If yes, how do you feel First Community Bank services compared with other banks?

.....

.....

.....

5. Do you save with First Community Bank?

Yes ☐

No ☐

6. If yes, has saving with First Community Bank benefitted you?

Yes ☐

No ☐

7. in which way?

.....

.....

.....

8. Do you think First Community Bank concept of banking will help in improving your welfare?

.....

.....

.....

9. Have you ever taken a loan from First Community Bank?

Yes ☐

No ☐

10. If, yes what was the purpose of the loan?

.....

.....

.....

11. Has the money you borrowed helped to achieve your purpose?

Yes ☐

No ☐

12. Have you ever taken a loan from any other bank which is not based on First Community Bank concept of banking?

Yes ☐

No ☐

13. If yes, do you think First Community Bank loan is different from loans of other banks?

Yes ☐

No ☐

14. in which way?

.....

.....  
.....

15. Have you paid back the loan?

Yes ☐ No ☐

16. How do pay back the fund to the bank?

a) Monthly ☐

b) Quarterly ☐

c) Annually ☐

d) Others specify: .....

17. Do you like the way you pay back?

Yes ☐ No ☐

18. Why?

.....  
.....  
.....

19. How do feel financially if you have taken a loan from First Community Bank?

.....

.....

.....

20. Do you think with additional funds from First Community Bank your financial situation will be improved?

Yes ☐ No ☐

21. Do you find any problem in borrowing from First Community Bank?

Yes ☐ No ☐

22. Why?

.....

.....

.....

23. Do these make it impossible for you to come out of some financial problems?

Yes ☐ No ☐

24. Do these problems come as a result of repayment and bank profits?

Yes ☐ No ☐

25. If No, then what other problems?

.....

.....

26. Have you ever reported these problems to any of the Bank officials?

Yes ☐ No ☐

27. Did they consider your problems/complaints?

Yes ☐ No ☐

28. Would you like the Bank to increase on its credit facilities to its customers?

Yes ☐ No ☐

29. Why?

.....

.....

.....

THANK YOU.