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Islamic Finance and its Effect on Financial Performance of Commercial Banks in Kenya: A Case Study of First Community Bank Limited

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ABSTRACT

In this study, First Community Bank Limited was used as a case study to examine the goals of islamic finance as they relate to the financial performance of commercial banks. Determine the effect of riba, gharar, and maysir bans on the monetary execution of commercial banks was the explicit aim. The management of First Community Bank Limited and other academics will find the study important. The target population consisted of 106 staff of First Community Bank. The study utilized stratified random sampling, allowing generalizations to be made across a broader population that are statistically valid. Slovin's Formula was used to arrive at a sample of 84 staff out of a target of 106 staff of First Community Bank. Questionnaires were used as the data gathering tools. The study concluded that the restriction of riba (interest) has an impact on the financial health of commercial banks based on its findings. The majority of respondents concurred that gharar restriction had an impact on the financial performance of commercial banks. According to the research’s conclusions, commercial banks’ financial performance is impacted by the prohibition of gharar. Majority of respondents stated that the ban on maysir (gambling) affects how well commercial banks function financially. The study concluded that the restriction of maysir (gambling), based on its findings, had an impact on the financial health of commercial banks. Majority of the respondents agreed that sharing of business risks influence financial performance of commercial banks. Based on the findings, the study came to a conclusion that sharing of business risks affects financial performance of commercial banks. The response of prohibition of riba (interests) and financial performance of commercial banks. On property rights affect financial performance of commercial banks in Kenya, 3% strongly disagreed, 15% disagreed, 20% were neutral, 23% agreed and 40% strongly agreed. On creating wealth affect financial performance of commercial banks in Kenya, 28% agreed and 37% strongly agreed. On reduction of state resources affect financial performance of commercial banks in Kenya, 25% agreed and 36% strongly agreed. banks.

Key words: Riba, Gharar, Maysir and Financial Performance

BACKGROUND OF THE STUDY

The financial services sector, which mobilizes resources and investments and directs them toward business and corporate activities, is essential to the contemporary economy. These fundamental concepts and objectives are applicable to all banking systems, regardless of whether they are conventional or Islamic. However, Islamic finance, from an Islamic standpoint, operates in accordance with the principles of Islamic Shariah, making traditional financial practices unlawful and prohibited. Islamic finance aligns its operations with Islamic ideals in the realm of monetary transactions and other commercial activities (Dar and Presley, 2019).

Islamic banking has changed significantly since it was first introduced in the middle of the 1970s, going from being a specialized commodity to a commonplace source of financial services. Being the first fully functional Islamic bank, the foundation of the Dubai Islamic Bank in 1975 was significant. According to Ziani (2019), Egypt was in the forefront of attempts to establish Islamic Banking Institutions (IBIs). Retail banking customers' desire to match their borrowing and investing with their own values has fueled the expansion of Islamic banking. Initially, Islamic banking products faced challenges in terms of competitiveness compared to conventional banking products, both in terms of cost and service offerings. However, the demand for banking services that align with Islamic principles has driven the expansion and development of more competitive and diverse Islamic banking products over time. The Islamic banking industry has received significant encouragement from governments in various countries.

For instance, Malaysia actively supports the sector by helping Islamic financial services companies and establishing supportive legislative and regulatory frameworks. The need for Shariah-compliant solutions has expanded along with economies and populations in countries that are primarily Muslim. Throughout the 1990s, Islamic banking practices were established globally, particularly in regions with a predominantly Muslim population. However, the growth of Islamic banks dealer desires. Foreign exchange bureaus and local banks such as Kenya Commercial Bank (KCB) and Equity make a living by charging pricing spreads of up to four shillings per dollar above the daily mean exchange rate. The practice, which has picked up steam in recent months, is exacerbating the impact of the shilling's depreciation against major international currencies, with catastrophic ramifications for the economy (Halake 2021).

RESEARCH METHODOLOGY

Research Design

The study adopted a descriptive research design due to the comparative analysis needed to meet the study's unique objectives. The research design adopted for the study was descriptive since it was able to present the findings and results of the study using means, standard deviations and modes (Saunders, Lewis & Thornhill, 2019; Kothari, 2021). This approach was ideal for the study since it was appropriate for analysis of the likert scale questionnaire design used (Creswell, 2018). The management staff of First Community Bank Limited. made up the population in this research. These individuals were considered essential for the study as they possess the crucial information regarding employee entrances and exits within the organization.

Table 1.Target Population

Category	Frequency	Percentage
Top Level Management	2	2
Middle Level Management	12	11
Support Staff	92	87
Total	**106**	**100**

Sample and Sampling Technique

Kothari (2021) characterized sampling as the most common way of choosing and evaluating a somewhat modest number of people, items, or occasions to make inferences about the entire populace from which the sample was drawn. A sample is a purposefully chosen, constrained, and accurate representation of a certain population. The survey utilized stratified random sampling, allowing generalizations to be made across a broader population that are statistically valid. Slovin's Formula, a formula for estimating an acceptable sample size, was used to estimate the sample size of 84 respondents.

Data Collection Instruments

Primary data was collected for this study. Primary data, according to Kale and Jayanth (2019), is brand-new information created by the researcher who is in charge of planning the study, gathering the data, evaluating it, and summarizing the results. The researcher provided a structured questionnaire to the participants in order to gather the primary data. A questionnaire, as per Saunders et al. (2019), is a strategy for getting information in which every member should answer a bunch of inquiries in a particular request. There were only closed-ended items on the survey used for this investigation.

Data Collection Methods and Procedures

Data was gathered through administration of questionnaire to a cross section respondents drawn from various categories. The respondents were to fill the questionnaire and then the questionnaires were collected by the researcher. That helped in reducing instances of non-respondent. Follow ups were done through telephones emails and interviews to ensure a viable response rate for the study. The questionnaires were scrutinized for errors omissions ambiguity legibility and relevance.

Data Analysis

Qualitative data was grouped into categories and analyzed thematically. The frequency of the data obtained in relation to each objective of the study were recorded and percentage worked out. Before processing the response, the completed questionnaires were edited for completeness and consistency.

Ethical Considerations

The study was guided by the following ethical dimensions for the period of the study: a research authorization permit was obtained from the participating institutions; the respondents were respected and the researcher ensured questions were answered as per expectations of the research, interjecting questions, intelligibly. The researcher picked respondents without any discrimination

LITERATURE REVIEW

According to Varpio, Paradis, Uijtdehaage and Young (2020), a theoretical framework is a set of guidelines for conducting research. A theoretical framework is related to, reflects the research questions, and is based on current theories in the subject of study.

Theoretical Literature Review

Islam and Theory of Interest

Early Islamic economists, such as Uzair, Maududi, Ahmad, Hameedullah, and others, suggested that many problems associated with capitalism were rooted in interest-based lending. These issues included unemployment, inflation, persistent poverty despite overall abundance, growing inequality, and cyclical business cycles (Mirakhor & Mohamed 2020). They proposed that replacing interest with profit sharing could help resolve these problems. However, in the following decade, Islamic economists were unable to provide rigorous economic research, particularly at the macroeconomic level, to substantiate these claims. (Khan, Rizvi, Ali & Haroon 2021). During this period, the primary focus was on exposing the shortcomings of capitalism and establishing a connection between these flaws and the institution of interest. Scholars such as Maududi, Qureshi, and Siddiqi argued that interest-free banking was not only possible but also wouldn't have adverse effects on savings and investment. Some proponents even contended that the elimination of interest would stimulate investments and enhance productivity. Mannan, among others, supported this view (Khan et al, 2021).

Profit and Loss Sharing Theory

Irshad (1964) emphasized the value of mudaraba as the cornerstone of Islamic banking in his study. He did, however, perceive mudaraba differently than most people would. Irshad argued that both labor and capital, including entrepreneurship, contributed equally to output, and therefore, they should share in both the losses and gains. This differs from the traditional Shariah principle where the capital owner and the business owner have distinct roles and do not share profits and losses equally. Additionally, Irshad proposed two types of deposit accounts. The first resembled a current deposit, repayable upon demand, but with no interest offered. Instead, the funds deposited would be utilized for social welfare programs.

Islamic Banking Theory

Chapra (1982) used the mudaraba principle as the basis for his model of Islamic banking. However, one of his primary concerns was the impact of credit creation on the creation of artificial purchasing power. In the interest of promoting equality and justice, Chapra proposed transferring the resulting "seigniorage" to the public coffers. Additionally, Al-Jarhi (1983) advocated for commercial banks to be subjected to a 100% reserve requirement.

Mohsin (1982) provided a thorough and detailed framework for Islamic banking, which is still applicable today. His strategy successfully combines the traits of development, merchant, and commercial banks. Mohsin's system consolidates an extensive variety of non-banking administrations such trust business, figuring, land, and meeting since it perceives that premium free banks can't depend on conventional financial tasks. This innovative approach aims to enhance the scope and sustainability of Islamic banking by diversifying the range of services offered. Several of the mentioned operations extend beyond the traditional scope of commercial banking and may be deemed advanced and specialized, making them potentially impractical for many Muslim nations at their current stage of development. Mohsin's model, as explicitly mentioned, acknowledges the coexistence of riba-free banks with interest-based banks, indicating its compatibility within a capitalist framework. It is evident that his framework was designed to align with and operate within a capitalist environment.

Empirical Literature Review

Prohibition of riba (interest) and financial performance of commercial banks

The concentrate by Metwally (2014) on the elements influencing the monetary exhibition of commercial banks found that Riba, also known as interest or usury, refers to any fee imposed on a loan contract or when obligations are rescheduled. In conventional finance, interest serves as the cost of debt. Atahirru (2022) further explains that usury, closely associated with riba, refers to an excess or addition over the principal amount lent. Regardless of its small value, interest represents an additional surplus over the money initially provided. Within the framework of Islam, riba is strictly prohibited.

Money is viewed as a medium of trade rather than having intrinsic worth, according to a research done by Bashir (2001) to assess the functioning of Islamic banks. Due to this perspective, charging interest on loans is considered unjust. The prohibition of interest and the lack of a comprehensive theoretical explanation for it have faced criticism from scholars. Scholars have debunked claims that interest serves as a foundational principle supporting the existence of traditional financial markets.

In a research on the global financial crisis by Chapra (2021), it was emphasized that lending money creates a debt for which there is no justification for the lender to earn a return. Similar to this, there is no justifiable reason for the market to enforce an absolute guarantee of interest when money is used to purchase an asset. Islam is not the only major religion that forbids interest; Judaism, Christianity, and Hinduism are all examples. The Bible expressly forbids interest, making no distinction between it and usury.

Some scholars contend that even though the Qur'an and the Sunnah do not state why riba is forbidden, it is possible to draw these justifications. One reason is that Arabic scholars refer to riba as Fasad, which refers to a form of societal corruption beyond legal boundaries. Another reason is that riba represents the unjust and unlawful appropriation of someone else's property. To put it differently, interest or usury involves the assertion of property rights that exist outside the legal framework of recognized property rights, which undermines the fair distribution of wealth between the wealthy and the poor (Fasa, Aviva, Firmansah & Suharto 2019).

A study conducted by Iqbal (2017) on Islamic financial systems, finance, and development, it was found that the Holy Qur'an emphasizes the eradication of usury and the promotion of charity. Allah does not hold affection for sinners and wrongdoers. Moreover, riba diminishes the dignity of human beings and promotes the practice of generating wealth out of nothing, which contradicts the principles of Islamic banking. Money is viewed in Islamic beliefs as only a means of transaction with no intrinsic worth. It is thought that those who store their money in banks or lend it out to earn interest are gaining without exerting much effort or incurring any risks. Shariah encourages people to spend their money in successful trade and commercial endeavors in order to be productive and benefit society.

Prohibition of Gharar (Excessive risk and Uncertainty) and financial performance of commercial banks

In a survey conducted by Chapra (2021) on the global financial crisis, it was found that Gharar refers to a situation where there is uncertainty or lack of clarity about the existence or characteristics of the item being sold. There are different perspectives on Gharar, with some considering it to be applicable only to unknown elements, excluding those that are simply risky. Gharar is present in transactions where both the buyer and seller are uncertain about what they are exchanging. It is particularly relevant when the effects or outcomes of the transaction are hidden or uncertain. The practice of Gharar involves selling potential goods or assets whose existence or features are uncertain, making the transaction akin to gambling.

In a study conducted by Saeed (2016) on Islamic banking and interest, it was observed that uncertainty in financial and commercial transactions leads to a concept called gharar. The challenge lies in adopting economic efforts that are free from gharar in a society where uncertainty prevails. It is important to distinguish between "gambles" and "decisions made in the face of ambiguity." Instead of gambling, decisions taken in the face of uncertainty entail evaluating the market worth of probable causes such that their value overcomes any prospective losses. In its broadest definition, the term "gharar" can apply to any contract for sale or purchase when there is a degree of doubt about the kind, amount, price, timing of payments, existence, or identity of the object. Despite the absence of explicit statements in the Qur'an, gharar is widely recognized as prohibited.

Prohibition of Maysir (gambling and games of chance) and financial performance of commercial banks

As indicated by Iqbal and Molyneux's exploration on Islamic monetary frameworks (2022), Islamic researchers characterize maysir as betting or any shots in the dark, including lotteries, gambling club style games, and wagering on the consequences of creature races. These activities involve deliberate risk-taking as a means of making a profit. According to Sharia, both gambling and chance games are prohibited. The Holy Qur'an (5:90) supports the prohibition of maysir by stating that it is among the abominations created by Satan and advises believers to stay away from such practices to ensure success.

In a study conducted by Iqbal (2022) on Islamic financial systems, it was found that the Holy Qur'an addresses the issue of alcoholic beverages and games of chance in Chapter 2, Verse 219. The verse acknowledges that these activities have some benefits for mankind but emphasizes that their negative consequences outweigh the benefits. Muslims who follow Sharia principles do not question the prohibition of maysir (gambling) and accept it as a fundamental aspect of their faith. While the exact justifications for the prohibition may vary, there are several interpretations that suggest reasons why gambling and chance games are forbidden. Because of the high level of uncertainty and risk associated with gambling and chance games, certain individuals may benefit greatly while others may lose all their money and even face financial ruin. This often leads to broader societal and economic problems. From an economic perspective, gambling and chance games do not contribute to the overall wealth of society.

Organizational performance

Sorenson (2014) research on the impact of Islamic finance on financial performance found that various boundaries, including credits and advances, stores, all out revenue income, all out revenue costs, and different elements, influence a commercial bank's execution. Additionally, analysts or investors may delve deeper into the bank's financial records to assess factors such as decreasing debt levels and margin growth rates.

In a study conducted by Wheelen and Hunger (2018) on strategic management and business policy, it was determined that the criteria for measuring performance vary depending on the companies and their specific goals, which may include objectives such as profit generation, market share expansion, and cost reduction. Additionally, businesses frequently use a variety of financial metrics, including return on investment (ROI), earnings per share (EPS), and return on equity (ROE), to assess their profitability and expansion. Analyzing operational cash flows and return on investment capital, with return on investment acting as a measure of profitability, are additional methods for evaluating a company's success.

DISCUSSION OF RESULTS AND FINDINGS

This section summarizes the findings of the study, which were based on many statements that looked at the effect of Islamic Finance on the Financial Performance of Commercial Banks with a focus on First Community Bank Limited. The study used a 5-point Likert scale, with 1= strongly disagree (SD), 2 = disagree (D), 3 = moderate (M), 4 = agree (A), and 5 =strongly agree (S) (SA). The mean and standard deviation of these comments based on this scale are also presented in this section.

Descriptive Statistics for Prohibition of riba (interests) and financial performance of commercial banks

The answers to questions regarding the prohibition of riba (interests) and how it impacts the financial stability of commercial banks are listed in Table 2. 3% of participants strongly disagreed with the statement that "Property rights affect the monetary execution of commercial banks in Kenya," 15% disagreed, 20% disagreed, 23% agreed, and 40% strongly agreed. 1% strongly disagreed with the statement that "creating wealth affects the monetary execution of commercial banks in Kenya," 13% disagreed, 20% were indifferent, 28% agreed, and 37% strongly agreed. A total of 8% strongly disagreed with the statement "Reduction of state resources affects monetary execution of commercial banks in Kenya," 16% disagreed, 19% disagreed, 25% agreed, and 36% strongly agreed.

Table 2: Prohibition of riba (interests) and financial performance of commercial banks

Statement	Strongly Disagreed		Disagree		Neutral		Agreed		Strongly Agreed		Mean
	F	%	F	%	F	%	F	%	F	%	
Property rights affect financial performance of commercial banks in Kenya	2	3	11	15	15	20	17	23	30	40	3.6
Creating wealth affect financial performance of commercial banks in Kenya	1	1	10	13	15	20	21	28	28	37	3.6
Reduction of state resources affect financial performance of commercial banks in Kenya	6	8	12	16	14	19	19	25	27	36	3.6

Descriptive Statistics for Prohibition of gharar (excessive risk) and financial performance of commercial banks

Table 3 displays the participants' perspectives on gharar (high risk) and its impact on the monetary execution of commercial banks. According to the statement "Economic growth affects the monetary execution of commercial banks in Kenya," 1% strongly disagreed, 9% disagreed, 18% were neutral, 29% agreed, and 41% strongly agreed. "Market value affects monetary execution of commercial banks in Kenya," had a 4% strong negative response. 15%, 16%, 29%, and 36% strongly disagreed with the statement. "Financial growth affects the monetary execution of commercial banks in Kenya," was a statement that 4% strongly disagreed with, 12% disagreed with, 17% were neutral on, 26% agreed with, and 34% strongly agreed with. The statement "Transaction cost directly depends on the quality of the loan portfolio" was strongly disagreed with by 4% of participants. 47% highly agreed, 37% agreed, 12% disagreed, 17% disagreed, and 37% disagreed. The average score across all assertions was 3.6.

Table 3: Gharar (excessive risk) and financial performance of commercial banks

Statement	Strongly Disagreed		Disagreed		Neutral		Agreed		Strongly Agreed		Mean
	F	%	F	%	F	%	F	%	F	%	
Economic growth affects financial performance of commercial banks in Kenya	1	1	7	9	14	18	22	29	31	41	3.8
Market value affects financial performance of commercial banks in Kenya	3	4	11	15	12	16	22	29	27	36	3.6
Financial growth affects financial performance of commercial banks in Kenya	3	4	9	12	13	17	28	26	29	34	3.6
Transaction cost directly depends on the quality of the loan portfolio	3	4	9	12	13	17	28	37	35	47	3.6

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Descriptive Statistics for Prohibition of Maysir (Gambling) and financial performance of commercial banks

Table 4: Sharing of Prohibition of Maysir (Gambling) and financial performance of commercial banks

Statement	Strongly Disagreed		Disagreed		Neutral		Agreed		Strongly Agreed		Mean
	F	%	F	%	F	%	F	%	F	%	
Games of chance affects financial performance of commercial banks in Kenya	1	1	7	9	13	17	22	29	42	56	4.0
Alcoholic beverages affects financial performance of commercial banks in Kenya	2	3	11	15	14	19	22	29	26	35	3.6
Economic growth affects financial performance of commercial banks in Kenya	3	4	10	13	13	17	21	28	28	37	3.6

Statement	Strongly Disagreed		Disagreed		Neutral		Agreed		Strongly Agreed		Mean
	F	%	F	%	F	%	F	%	F	%	
Increase of society wealth affects financial performance of commercial banks in Kenya	2	3	11	15	14	19	22	29	26	35	3.6

The association between the ban on Maysir (gambling) and the monetary execution of commercial banks is seen in Table 11. Following are the participants' opinions on certain statements: In response to the claim that "Games of chance affect monetary execution of commercial banks in Kenya," 1% strongly disagreed, 9% disagreed, 17% were indifferent, 29% agreed, and 56% strongly agreed. In response to the claim that "Alcoholic beverages affect monetary execution of commercial banks in Kenya," 3% strongly disagreed, 15% disagreed, 19% disagreed, 29% agreed, and 35% strongly agreed. 4% strongly disagreed, 13% disagreed, 17% disagreed but were indifferent on the statement "Economic growth affects monetary execution of commercial banks in Kenya," while 37% strongly agreed. In response to the claim that "Increase in society wealth affects monetary execution of commercial banks in Kenya," 3% strongly disagreed, 15% disagreed, 19% disagreed, 29% agreed, and 35% strongly agreed.

Sharing of business risks and financial performance of commercial banks

Table 5: Sharing of business risks and financial performance of commercial banks

Statement	Strongly Disagreed		Disagreed		Neutral		Agreed		Strongly Agreed		Mean
	F	%	F	%	F	%	F	%	F	%	
Profitable investments affect monetary execution of commercial banks in Kenya	2	6	6	11	13	16	21	28	33	44	4.5
Profit sharing affects monetary execution of commercial banks in Kenya	1	1	12	16	14	19	22	29	26	35	3.6
Business risks assets affects monetary execution of commercial banks in Kenya	2	6	11	15	13	16	20	27	29	39	3.6
The gains or losses from the joint investment should be split between the lenders and the borrowers	1	1	11	15	14	19	22	29	26	35	3.6

The replies to the question of how business risks are shared and how it affects the monetary execution of commercial banks are shown in Table 12. Following are the participants' opinions on certain statements: Profit sharing influences the monetary execution of Kenyan commercial banks, according to the following statements: 6% strongly disagree, 11% disagree, 16% disagree, 28% agree, and 44% strongly agree. Profit sharing influences the monetary execution of Kenyan commercial banks, according to the following statements: 1% strongly disagreed, 16% disagreed, 19% disagreed, 29% agreed, and 35% strongly agreed. 6% strongly disagreed, 15% disagreed, 16% disagreed but were indifferent on the statement "Business risks assets affect monetary execution of commercial banks in Kenya," while 39% strongly agreed. The percentages of participants who strongly disagreed, disagreed, were neutral, agreed, and strongly agreed with the statement "The gains or losses from the joint investment should be split between the lenders and the borrowers," respectively, were as follows: 1%, 15%, disagreed, 19%, agreed, and 35%. For all of the assertions, the total composite mean was 3.8.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The vast majority of respondents agreed that commercial banks' financial performance is impacted by the restriction on riba (interest). Based on these data, research has shown that outlawing riba has an effect on the financial stability of commercial banks.

Most participants, according to the outcomes, concurred that commercial banks' financial stability would be harmed by the unlawful prohibition on Gharar (high risk and uncertainty). The review arrived at the resolution that business banks' monetary dependability is affected by the preclusion of gharar. By far most of members agree that the preclusion of maysir (betting) significantly affects the solidness of business banks' funds. The review presumed that the Maysir preclusion affected the monetary progress of business banks in light of these discoveries. The results show that most of perspectives agree that business risk pooling affects the monetary soundness of business banks. The review prompted the end that the gathering of business gambles affects the financial execution of business banks.

Recommendations

A strong legislative framework that strengthens industry regulation must be put in place in order to promote the expansion of Islamic banking in Kenya and maximize the advantages for the nation. To include Islamic banking principles, it is necessary to alter both the Central Bank Act and the Banking Act. It would also be important to create a National Shari'ah Supervisory Board. The body will be in charge of directing the standardization and convergence of Islamic banking products via the application of Ijtihad. Additionally, it will develop Shariah control criteria to guarantee adherence to Islamic principles as well as qualification and certification requirements for Shariah Banking Council members.

It is advised that the Central Bank create a Shari'ah Advisory Board in order to improve the regulatory monitoring of the Islamic banking sector. Better communication between the regulatory agencies and the Islamic banking industry would be made possible by this board. The government is also advised to actively restructure its public debt to include sukkuk components. This approach would enable greater participation and engagement in Islamic banking activities within Kenya's financial landscape.

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