Addis Ababa University

College of Business and Economics

Department of Business Administration

Performance Assessment of Interest Free Banking of the Commercial Bank of Ethiopia

A Research Project Submitted to the Department of Management for the Partial Fulfillment of the Requirements of the Degree of Master of Business Administration- Financial Services

By: Gizachew Abebe

December, 2019

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Approved By Board of Examiners

Dr. Alem Hagos (PhD)	________________	________________
Advisor	Signature	Date
Dr. Zinegnaw A.	________________	________________
External Examiner	Signature	Date
Dr. Sewale Abate	________________	________________
Internal Examiner	Signature	Date

Statement of Declaration

I, Gizachew Abebe Zerihun, declare that this research titled "**Performance Assessment of Interest Free Banking of the Commercial Bank of Ethiopia**" is the result of my own effort and study. I also declare that all sources of materials used for the study have been duly acknowledged. I have produced it independently except for the guidance and suggestion of the Research Advisor.

This study has not been submitted for award of any Program in this or any other institution.

Declared by: Gizachew Abebe

Signature___________________

Date________________________

Certification

This is to certify that Gizachew Abebe Zerihun has done a study on the topic "**Performance Assessment of Interest Free Banking of the Commercial Bank of Ethiopia**".

This study is of his original work and all the sources of materials used for the research project paper had been duly acknowledged.

Advisor's Name: Dr. Alem Hagos (PhD)

Signature: ___________________________

Date: _______________________________

Place: Addis Ababa University

ACKNOWLEDGEMENT

All praise and thanks be to GOD who gives me the power and health to do this study. I also would like to express my deepest indebtedness to my families, as always they were there, in all my efforts and sacrifices their time to help me.

Secondly, a heartfelt gratitude and appreciation goes to my advisor, Dr. Alem Hagos (PhD) for his valuable guidance and in depth understanding that he extended to me during the entire work of this paper and enabled me to complete this research paper.

Finally, I wish to acknowledge the efforts and support of those individuals that led to the success of this study such as employees of the Commercial Bank of Ethiopia and the Public Financial Enterprises Agency who sponsored this research project.

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List of Acronyms

ATM- Automated Teller Machine

CAR- Capital Adequacy Ratio

CBE- Commercial Bank of Ethiopia

COSR- Cost to Income Ratio

CSA- Central Statistics Agency

GDP- Gross Domestic Product

IFB- Interest Free Banking

IFBR- Interest Free Banking Ratio

IMF- International Monetary Fund

LATD- Liquid asset to Total Deposit ratio

LDR- Loan to Deposit Ratio

NBE- National Bank of Ethiopia

OE- Operational Efficiency

PLS-Profit and Loss Sharing

ROA- Return on Asset

ROE- Return on Equity

SME- Small and Medium Enterprises

SPSS- Statistical Package for Social Sciences

TLTA- Total Loan to Total Asset ratio

UAE- United Arab Emirates

Abstract

Interest free banking is one of the emerging trends in the global economy and the fastest growing industry across the globe. It is a banking service that abides by Shariah principles in all of its activities and Commercial Bank of Ethiopia has started the service since 2013. This research project was designed to assess Interest free banking performance of the Commercial Bank of Ethiopia. To achieve the stated objective, purposive sampling technique was used. The study employed descriptive research design approach and collected both primary and secondary data and the data was analyzed using statistical descriptions of mean, maximum minimum values and growth rates of number of branches, population to branch ratio, amount of deposit and investment, and other financial ratios like ROA of IFB, IFB ratio, liquidity ratio, efficiency ratio, and bank size. Accordingly, the study find out that the service accessibility of the IFB of the CBE highly increased. In addition, study found out that though the deposit and financing of the IFB has shown continuous improvement, it is still low as compared to the size of the Bank and its accessibility. The low performance was due to lack of trust of the Muslim society, less effort of the bank in promoting its IFB products/services, lack of awareness of customers and employees and gaps in regulatory frameworks. Coming to the financial ratios, the study concluded that the ROA, IFB ratio, Efficiency and bank size of the IFB has shown continuous improvement over the study period. However, though the liquidity ratio of the IFB has shown a declining trend, the bank is still very liquid since the investment of the IFB is very low and majority of the deposits are safe keeping. Based on the findings and conclusions of the study, the researcher has recommended that the management of the Bank should exert their marketing effort to promote the IFB products so that the public awareness can be enhanced. The bank should also exert its effort to enhance the awareness of its employees so that they can properly promote the service. In addition, the study recommends that the government should revise its regulatory frameworks so as to enhance the IFB financing services. Moreover, the management of the Bank should insist the government to amend its regulatory frameworks. Finally, the researcher suggested further industry level study of the area by other professionals.

Key words: Interest free banking, accessibility, deposit, IFB financing, ROA, IFB ratio, liquidity ratio, efficiency ratio, Bank size.

CHAPTER ONE

1. INTRODUCTION

This research project was designed to assess the performance of interest free banking of the Commercial Bank of Ethiopia. This chapter specifically provides background information about the title under investigation and it is organized in to nine sections. The first section deals with background of the study and the second and third sections deal with background of the Commercial Bank of Ethiopia which is under study and the statement of the problem respectively. Coming to the four and fifth sections, research questions and objectives of the study are presented respectively. The sixth part describes the significance of the study. Moreover, scope of the study and limitation of the study are discussed in the two sections seven and eight respectively. Finally, organization of the paper is presented in the last section of the chapter.

1.1. Background of the Study

Interest free banking also known as Islamic banking can be defined as a banking service that abides by Shariah principles in all of its activities through its role as a financial intermediary between savers and investors and achieves a balance between economic and social return (Alharbi; 2015, Al-Sultan; 1999**).**Islamic banks provide commercial services to customers that comply with the religious injunctions of Islam that is free from interest (Ahmad; 1994), Kettell; 2011), as sited by kerima (2016). In addition, according to IMF (2014, page 3), Islamic banking is defined as a "form of financial intermediation based on profit and loss sharing (PLS) and the avoidance of interest rate-based commitments and contracts that entail excessive risks and finance activities prohibited under Islamic principles (e.g. gambling and alcoholic beverages)."

Interest free banking service is one of the emerging trends in the global economy and the fastest growing industry across the globe. This form of banking service has developed over a long period of time since its inception in Egypt in 1963 with the introduction of new products in the banking industry. This emergence of the banking service in the industry is not only limited to Muslim countries but also expanded in non-Muslim countries. More specifically, according to IMF (2015) Islamic finance is projected to continue to expand in response to economic growth in countries with large and relatively unbanked Muslim populations. As a result, “Islamic banking assets with commercial banks globally crossed $1.7 trillion in 2013, suggesting an annual growth of 17.6% over the last four years.” (Shaikh, S.A. (2014)).Nowadays, many countries are experiencing “Dual banking” system where interest-free banks operate along with conventional banks by opening a separate window for the specified service (Kerima 2016). Similarly, the interest free banking service has been expanded to Ethiopia like other African countries.

According to the www.countrymeter.infoaccessed on 09/03/2019, out of the total population of 109 million, 34.6% are Muslims that provide substantial potential for interest free banking services in the country. The National Bank of Ethiopia (NBE) has identified this huge demand for Interest free banking service and authorized banks to conduct IFB business in year 2011. The NBE directive SBB/51/2011 authorizes conventional banks to provide their IFB services by introducing ‘a dedicated window’ alongside of conventional banking operation “in a manner consistent with Islamic finance principles and mode of operation”. On the basis of this authorization, Commercial Bank of Ethiopia (CBE) was the second bank next to Oromia International Bank S.C to be granted the IFB service license from the NBE on September 17, 2013.Accordingly, CBE had launched its IFB operation by using 23 branches as a pilot on December 16, 2013 and at the end of June 2018, 952 branches are providing the IFB service by opening a dedicated window of at least one in each branch.

Hence, this research project is prepared to empirically assess the performance of Interest free banking of the Commercial Bank of Ethiopia.

1.2. Background of the Commercial Bank of Ethiopia

Commercial Bank of Ethiopia was founded in 1942 G.C with the name of State Bank of Ethiopia. The State Bank of Ethiopia was performing the duties of both commercial and central banking. In 1963, the Commercial Bank of Ethiopia was legally established as Share Company and take over the commercial banking activities of the former state bank of Ethiopia and the central banking activity is then separated. It started operation on January 1, 964 with a capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.In the 1974 revolution, Commercial Bank of

Ethiopia got its strength by merging with privately owned Addis Ababa Bank. Since then, it has been playing significant role in the development endeavor of the country.

The Commercial Bank of Ethiopia has served the public for more than 75 years not only by providing banking service activities but also by providing public education about saving and playing pivotal role contributing its part in the corporate social responsibility and creating job opportunity for the society as a citizen. Its strong capital base enables the bank to become more competent and pioneer in technological adaptations in the banking industry of Ethiopia. For example, it is the first bank who introduces ATM service in Ethiopian banking industry. In addition, it is the first bank that use T24 Core Banking system to make all its branches networked throughout the country. As of June 30, 2019, CBE has 1,444 branches and more than 20 million account holders throughout the country and also it has opened subsidiary banks in South Sudan and Djibouti.[1]

In order to realize its vision, the Bank has designed different strategies. In the strategy, business growth, operational excellence and digitalization are the core pillars of the strategy. In its strategy, the bank has exerted its effort to expand its service using different channels like mobile banking, internet banking, ATM services, CBE Birr, and special services for some segments of the society like women, youth, students and Muslims.

In line with the authorization of the bank by the NBE to give the Interest free banking service, the bank has started providing the service in 2013 using a dedicated IFB window in its branches. Interest free banking is available to all customers who want to make use of the alternative banking service. CBE has a separate and dedicated system that does not mix the movement of accounts in those windows with the conventional ones.

As a result, the bank is now providing the interest free banking service to customers in a manner consistent with the Sheria'h principles by avoiding interest in its services. As of June 2019, the bank provides the IFB service in more than 1,000 branches by dedicating a separate window. Interest free banking (IFB) refers to a banking business in which mobilizing or advancing of funds taken in a manner consistent with Islamic finance principles and mode of operation that

[1] www.combanketh.com

mainly avoids receiving or paying interests through units or windows within the conventional bank that exclusively offers interest free banking services.

1.3. Statement of the Problem

Interest free banking service is one of the emerging trends in the global economy and the fastest growing industry across the globe; IMF (2014). According to IMF (2015) interest free banking as a financial institution, has potential contribution to the public like financial inclusion especially of large underserved Muslim population, provide support to small and medium sized enterprises (SMEs) through its asset-backed financing scheme, and it is less risky as compared to the conventional banking system as a result of the risk sharing principle of the interest free banking system that prohibits speculation.

According to IMF (2014), the Islamic financial assets market has grown at an annual average rate of 16% since 2006 and the number of Islamic financial institutions reached about 350 with a total asset of USD1.7 trillion in 2013. More specifically, as indicated by Aden (2014), the deposits in Islamic banks particularly in Arabian Gulf countries are rising steeply. The study shows that the conventional banks are at risk of losing 30 to 40 percent of their Muslim customers in the coming decade as a result of the introduction of Sharia complaint banking products and services. This indicates that the interest free banking service has a great potential market to serve and prosper. Coming to Ethiopian financial industry, this potential could not be unique. According to Tsion (2017), there is huge untapped opportunity of the IFB market to be exploited by financial service providers in Ethiopia to utilize the niche in offering IFB services.

However, though it has untapped opportunity for the IFB services to prosper there are also many challenges that hinder the IFB service to compete with the existing conventional banking system. In general, the challenges of IFB emanates from its unique nature and guiding principles. As a result the Interest free banks operate under dual constraints. According to Samad (2004), interest free banks are expected to obey not only to the Islamic laws but also to the conventional business laws of the land and it is natural to note that it faces stiff competition with the long existed conventional banks.

Though the banking industry in Ethiopia has been operating over a century, the interest free banking had not been practiced for a long time. So, one third of the Ethiopian population were excluded from the interest free banking services and forced to use the conventional banking services regardless of the Islamic principles; Debebe (2015). As accessed on the respective commercial banks' web sites on June 11, 2019, many commercial banks like Awash bank S.C, Abay Bank S.C, Wogagen Bank S.C, Dashen Bank S.C, and Cooperative Bank of Oromia have started providing Interest free banking services in their banking operations using a separate window.

Numerous researches have been conducted in developed and emerging market countries on various aspects of Interest free banking. However, due to the novelty of the concept to Ethiopia the IFB service is not yet well researched and there are still few literatures available. Among these few studies Mohammed (2012), Tsion (2017), Akmel (2015), and Kerima (2016) had studied the Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia. As a result, the above mentioned studies found out that lack of awareness, regulatory, supervisory and institutional challenges, lack of support, gap in research and development in Islamic studies, lack of qualified human resource as well as wrongful association of the service with specific religion and the global terrorism are the major challenges that the interest free banking services faced. Accordingly, Tsion (2017) mentioned that there is huge untapped opportunity of the IFB market to be exploited by financial service providers in Ethiopia to utilize the niche in offering IFB services. In addition, Mohammed (2012) found out that there is a bright prospect and huge opportunity of the interest free banking in Ethiopia.

On the other hand a research by Debebe (2015) who studied the factors affecting customers' use of IFB in Ethiopia and found out that 100% of IFB account holders were all Muslims, there is lack of customers' awareness and misconception regarding the benefit the IFB service and the bank is not going as planned since it is new for the industry. Teferi (2015) has also confirmed this finding stating the overall awareness level of respondents towards IFB in our country-Ethiopian context is inadequate. In addition, the findings of Tsion (2017) revealed that lack of awareness by customers about IFB services is one of the main challenges.

Abraham (2017) has also studied on determinants of customers' intention to use interest free banking products and factors affecting employees' product knowledge and provided various recommendations to the concerned organs.

Moreover, Teferi (2015) had studied about 'Contribution of IFB to economic development and its prospect in Ethiopia'. According to Teferi (2015), introduction of IFB does not only create inclusive financial system for the Muslim population but also has a potential to influence and enhance the economic development of the country through resource mobilization and employment creation by encouraging people to use the banking system.

However, none of the above studies had tried to assess the performance status of the interest free banking providing banks. Thus, this study, therefore, attempts to fill this research gap by assessing the performance of interest free banking of the Commercial Bank of Ethiopia.

1.4. Research Questions

The study attempts to answer the following research questions:

- What is the performance status of the interest free banking of the CBE?
- How is the trend of the interest free banking performance of the CBE?

1.5. Objective of the Study

The general objective of this study was to assess the performance of IFB of the Commercial Bank of Ethiopia so that it can provide a clear picture of interest free banking of the Commercial Bank of Ethiopia. Moreover, this study attempted to address the following specific objectives:

- To analyze the performance trend of the interest-free banking of CBE with respect to branch accessibility, amount of deposit and loan;
- To evaluate the profitability of the IFB of the CBE;
- To assess the liquidity performance of IFB of the CBE;
- To analyze the efficiency of IFB the CBE;
- To evaluate with the Bank size of IFB of the Bank.

1.6. Significance and Implications of the Study

This study has significant contribution both to the practical and theoretical body of knowledge on the interest free banking principles and practices. Theoretically, the study is expected to contribute to the existing pool of knowledge on interest free banking particularly in the Ethiopian context and can serve as a basis for further research in the field of interest free banking. Practically, the findings of this research enable the Commercial Bank of Ethiopia to design appropriate strategies that may enhance its IFB performance.

1.7. Scope of the study

The study was limited to assessing the performance of IFB of the Commercial Bank of Ethiopia. Thus, it could not cover other commercial banks that started providing the IFB service in the country. The reason behind this case study is that the title was given by the sponsoring organization that is the Public Enterprises Agency. In addition, the study did not cover other non-financial internal and external performance measurement parameters of the bank. This study was also limited to the period of four years from 2015 to 2018. As a result, the researcher could not use research models and adopted exploratory research design to assess the performance of the IFB of the commercial Bank of Ethiopia. Coming to the set performance parameters, this study was limited to those parameters like branch accessibility, amount of deposit and financing, ROA of the IFB, IFB ratio, liquidity ratio, efficiency ratio, and bank size.

1.8. Limitation of the Study

Since the Interest free banking in Ethiopia is a new phenomenon (not more than five years of service experience); it was difficult to find well organized adequate data to make the study. Thus, only four years IFB performance data could be found from the financial statement of CBE and hence availability of long ranged data was the major limitation to use appropriate models for the study. In addition, since the IFB service of CBE has been given using a dedicated window of the conventional banking service, the IFB service shares resources of the conventional banking. The financial report of the IFB could not separately identify its fixed assets and other common costs. So, the data obtained from the financial statements of the Bank were used with its limitation.

1.9. Organization of the Paper

This research project is organized in to five chapters. The first chapter is the introduction part of the paper. Chapter two presents review of the theoretical and empirical literatures of the study. The research methodology, design and methods used during data collection and analysis for the study are presented in Chapter three. Chapter four presents data analysis, interpretation and presentation of the study. Chapter five finalizes the research project with summary of findings, conclusion and recommendations of the study.

CHAPTER TWO

2. LITERATURE REVIEW

2.1. Introduction

The review of relevant related literature forms a critical part of any research activity. It helps to establish the theoretical framework and foundation of the field of study. To this end, this chapter attempts to capture the related literature on various themes that underpin the topic under study. The first part of the related literature review discussed with the theoretical review that focussed on Interest free banking concepts and definitions, fundamental principles of interest free banking, Difference between Islamic Banking and Conventional Banking, operating models of IFB and products of IFB. The next part deals with Measurements of Bank Performance and various financial ratios. In addition, local and international empirical studies have been discussed in the third part of the review. The last part of the literature has discussed about the conceptual frame work of the study variables that were tested by the research.

2.2. Theoretical Literature review

2.2.1. Concepts and definition of Interest free Banking

Many scholars use interest free banking and Islamic banking interchangeably even though there is a difference between the two and give various meanings to it. Islamic banking not only avoids interest in all its ramifications but also it avoids all other prohibited activities in Islam. Interest-free banking system on the other hand, does not engage in interest but there is no reason to suppose that all its other activities will be done strictly according to Islamic law “Shariah”(Ibrahim; 2012).

The definition of Islamic/interest free banking revolves around Islamic law. In the definition given by Ahmad (1994), the term "Islamic banking" means conducting banking operations in consonance with Islamic teachings. The definition given by Moin (2013) depicts Islamic banking as the system of banking consistent with principles of Islamic law (Shariah) and guided by Islamic economics.

In other words, Chakraborty, Salam & Rabbany (2015) defined that "An Islamic Bank is a Financial Institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operation."

According to Kettell (2011), Islamic banks provide commercial services that comply with the religious injunctions of Islam. They provide services to their customers free from interest. The giving and taking of interest is prohibited in all transactions under the Islamic financial principles. Bello & Abubakar (2014) define Islamic banking as banking system that operates strictly on the basis of *Shariah*. According to Abdul-Rahman (2010), Interest free banking is defined as conventional banking minus the word interest with a new contract that does not include the word interest and that is structured in a convoluted version of buy/sell, in which the seller changes ownership to the bank and then the bank sells it to the eventual buyer.

Thus, based on the definition given by the above authors, interest free/Islamic banking is banking system or banking activity that operates based on Shariah law, rules and values which prohibit the giving and taking of interest in all transaction and trading activities and in consonant with Islamic finance and economic principles. The reasons behind this prohibition of interest have been explained as money in itself does not have any added value or no intrinsic value and it cannot be utilised in direct fulfillment of human needs rather it can only be used for acquiring some goods or services; (Elgadi; 2016), (Marifas; 2014).Thus, if money is being deposited in a bank or borrowed to someone, no certain return (interest) should be gained or derived from it.

However, opposition to interests does not mean that modern banks do not have a place in Muslim society. What is needed is a new type of banking which avoids the payment and receipt of interest. The core idea is to replace interest by some other principle like profit/ loss sharing. By doing so both the suppliers and borrower of the funds share the risk; both prosper when returns are favorable and suffer together when conditions are poor. This is the basis for what became known as 'Islamic banks' or 'interest free banks' (Al-Sultan; 1999).

2.2.2. Principles of IFB

The operations of interest free banking mainly are based on Islamic principle and teachings of Islam. As a result, an Islamic bank is not allowed to pay or charge interest for the money it received from customers as deposit or lends to customers but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined sharing ratio. There is, thus a partnership between the Islamic bank and its depositors, on one side, and between the bank and its investment clients, on the other side, hereby acting as a manager of depositors' resources in productive uses, that is an interest free/ Islamic bank in relation to its clients plays the role of partner, investor and trader. The complexity of Islamic banking comes from the variety of the instruments employed, and in understanding the underpinnings of Islamic law (Kettell; 2011). Islamic banking is a unique type of banking system that devoid all forms of transactions that are prohibited in Islam. So for any bank to be classified as Islamic bank, the following fundamental principles must be adopted for its operations (Al-Sultan; 1999), (Samad; 2004), (Bello & Abubakar; 2014), (Kettell; 2011) (Ismayil; 2012), and (Abdul-Rahman; 2010):

a. Prohibition of interest (Riba): Interest means a fixed predetermined amount in addition to the principal. It is prohibited in Islam. So for any bank to be called Islamic bank, it must not engage in any interest related transactions, but rather, profit and loss sharing transactions.
b. Prohibition of speculation (gharar): The term gharar literally means hazard. More so, it means transactions that have too much risk and are therefore linked to gambling. Since Islam prohibits speculation, a potential Islamic bank will avoid all transactions with excessive risk.
c. Profit, loss, and risk sharing: Since interest is prohibited in Islam, the providers of funds and the entrepreneur in an Islamic banking settings share the business risk and profits based on mutual agreement. This act will equitably distribute income, enhance social justice, and alleviate poverty etc.
d. Shari'ah approved activities: Islamic banking is a banking system that is based on Shari'ah. So any transactions that are prohibited by Shari'ah in the likes of alcohol, gambling etc. are avoided in Islamic banking. Islamic banks can only partake in transactions or activities that are approved by the Shari'ah advisors.

e. Social Justice: Islam prohibits Muslims from any transactions leading to injustice and exploitation of any kind. So Islamic banks can not engage in any transactions that will lead to exploitation of any party.
f. Compulsory payment of zakat: It is mandatory for an Islamic bank to pay zakat. Zakat is one of the five pillars of Islam.
g. Overseen by Shari'ah advisors: Every Islamic bank must be regulated by experts in Islamic law who will have to audit the operations of Islamic banks and its products to make sure that they comply with Shari'ah guidelines.

2.2.3. Difference between Islamic Banking and Conventional Banking

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shari'ah in all its transactions. Hence, Islamic bank like conventional bank is an intermediary and trustee of money of other people and play a pivotal role in the economic development of societies. However, as the basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba (interest), there exists difference in that the interest free banks do not charge or receive interest and share profit and loss with their depositors. According to Aden (2014), the fundamental differences between Islamic banking and conventional banking, is not only in the way it practices its businesses, but above all the values which guide Islamic banking whole operation and outlook. These values prevailed within the ambit of *Shari'ah* (Islamic law) are expressed not only in its transactions, but in the breadth of its role in society as a whole. Some of the specific differences between conventional and interest free banking are as follows:

Table 2.1: Difference between Conventional Banking and Interest Free Banking

Criteria	Conventional banking	Interest free banking
Interest	Allowed	Prohibited
Stakeholder	Shareholders are principal stakeholders	God is the principal stakeholder and the society at large is the concern of the IFB
Function of the bank	The basic and most important function of conventional banks is to lend money and get it back with compound in g interest.	The basic and most important function of Islamic banks is to participate in the partnership business.
Money	Used as a commodity that is bought and	It has no intrinsic value s that

Criteria	Conventional banking	Interest free banking
	sold through the interest	it could not be bought or sold
Decision	Based on the interest of the shareholders	Based on the interest of the society
Restriction of business	No restriction	Restricted based on Islamic law: alcohol, tobacco, pork, pornography, gambling, defence and weapon production are not allowed
Loan granted	Given to whoever has guarantor/collateral is the main determinant	The projects profitability is the main determinant of financing
Emphasis	The conventional banks grant greater emphasis on the credit worthiness of the customers	The Islamic banks grant greater emphasis to the viability and the benefit of the financed projects
Investment of deposit	Customers have no opportunity to choose where their money is invested	Both the bank and the customer have a stake on the financial activities and investments based on the Islamic law
Reward	Reward companies regardless of where they invest	Share profits/losses between the bank and the depositor
Governing law	Governed by business law of the land	Governed by both business law of the land and the Sharia’h law
Relationship	Debtor- creditor	Partnership

Source*: Adapted from Abdul-Rahman (2010), Duran & Garcia-Lopez (2012), Moin (2013), Mohammed (2012),Elgadi(2016),Debebe (2015), Ismayil (2012), Kerima (2016)*

2.2.4. Operating Models/Forms of Interest Free Banking

According to Alharbi (2015), the development of the Islamic banking industry is moving at a fast pace, and almost every country now has some form of Islamic banking system. However, the operating form of the banking system differs from country to country depending on the specific regulatory framework of the countries. In some countries like the central bank has established an Islamic Bank division to regulate the Islamic banking operations and others like Sudan and Iran tried to Islamize all banking services; (Sole, 2007). In general, recent literatures summarized that there are three forms of interest free banking system (Alharbi; 2015), (Jemal; 2018), (Kerima; 2015), (Aden; 2014):

a. Full-Fledged Interest Free Banks

These are independently established banks that generally are not under any conventional banking influence. Theoretically, such forms of Islamic Banks have the capacity to offer new-to-market products, based on the approvals obtained from Shariah Committees. Such banking forms are common in Middle East where standalone Islamic banks are established.

b. The Islamic Subsidiary Model

Islamic banking subsidiary is a form of Interest free banking system where Islamic banking products and services offered by subsidiaries of the existing conventional banks, but the operation and management of the two are clearly separated (Sole, 2007). Islamic Subsidiary pursues its business on the strength of the Parent Bank, which is the conventional bank. Most of the conventional banks offer Islamic products via Islamic banking subsidiary.

The main advantage is that decisions are autonomous in a Subsidiary, there is more control of marketing and sales and branches, and the Bank (as an independent entity) can chart its own course. However, there will still be influence from the parent conventional bank and the products and services offered are generally aligned to the products and services offered by the parents. The Subsidiaries are also dependent on the strategy of the parent conventional Bank, where it can choose to invest heavily or adequately for the operations of its subsidiary.

c. The Interest Free Banking Window Operating Model

Sole (2007) defines Islamic banking window as a business model in which a window within a conventional bank is established via which the bank offers Islamic banking products and services from their existing network. This model relies on the existing conventional infrastructure where all the processes, operations, and all other functions are provided by the conventional bank using a separate window.

This is model is believed to be appropriate when the interest free banking system is at early stage since it has low set-up cost and Ethiopia is one example of this model. Opening of such window will require the bank to establish the appropriate firewall to avoid the commingling of Islamic and conventional funds. According to Sole (2007), it is a common practice that Islamic windows are used as a take-off platform for moving into the Islamic financial industry in South East Asia and Western countries.

2.2.5. Major IFB Products

According to Elgadi (2016), Islamic finance has become one of the fastest growing sectors in the worldwide financial industries that offer new opportunities for the financial industry to address previously unexplored consumer and business segments. The introduction of Islamic financial products across the world has been in response to the growing need of a significant segment of the marketplace that refused to deal with interest-based instruments. It provides several products through different modes. Such products are briefly described below being categorized in to two as deposit and financing products (Elgadi; 2016), (Al-Sultan; 1999), (Muatuz; 2017) and (Akmel; 2015).

2.2.5.1. Interest Free Banking Deposit Products

These IFB products are also called sources of funds for the IFB service system. There are four main sources that include shareholders' funds, current accounts, investment accounts and savings accounts. These sources of deposit of IFB products are shown as follows:

a. Unrestricted Investment Deposits (Unrestricted Mudaraba)

This type of deposit is an earning deposit which is mobilized with the knowledge that bank acts as the Mudarib (manager) and invests the fund without restriction and intervention of the capital provider in any Shariah compliant manner. The profit on the investment will be shared as per agreement and loss will be shared by the depositor (capital provider). The bank has discretion to participate in the investment. The bank can pool the money for its daily IFB business activities.

b. Restricted Investment Deposit (Restricted Mudaraba)

Such type of IFB deposit is an earning deposit which is mobilized with the knowledge that bank acts as the Mudarib (manager) and invests the fund in restricted investment based on active intervention of the capital provider complemented with professional advice from the bank side. The profit on the investment will be shared as per agreement and loss will be shared by the depositor (capital provider).

c. Wadiah (Safekeeping) Deposit

It is a peculiar non-earning type of IFB deposit that operates under the contract of Wadiah Yad Dhamanah (guaranteed custody). The bank accepts deposits from its customers looking for safe custody and convenience and requests permission to make use of the customer funds for investment purposes promoting transparency. The customers may withdraw their balances at any time. Profit generated from the use of the customers' funds belongs to the bank and the losses, if any, will be borne by the bank as well. However, the bank may at its absolute discretion rewards the customers by declaring profits to them. Under the contract of Wadiah, the custodian i.e. the Bank is not allowed to mention or to promise any reward on the deposit received. The owner/depositors too cannot demand any rewards or return from their Bank on their savings.

d. Demand Deposit (Amana Current Accounts)

Amana Current accounts are non-earning deposits that operate based on the principle of al-wadiah, whereby the depositors are guaranteed repayment or withdrawal of their funds on demand. At the same time, the depositor does not receive return for depositing funds in a current account, because the guaranteed funds will not be used for profit and loss ventures.

2.2.5.2. Islamic Banking Financing Products

As a general rule, IFB financing involves carrying out of investment and /or the purchase of goods, services and assets. Islamic banks provide financing using two basic methods. The first depends on profit and loss sharing and the second involves the sale of goods and services on credit and leads to the indebtedness of the party purchasing those goods and services (Al- Jarhi and Iqbal; 2001). Al-Sultan (1999) and Elgadi (2016) have discussed about seven common Islamic financing products. On the other hand, Bello & Abubakar (2014) mentioned six popular Islamic financing products commonly provided by most Islamic banks. In general based on the above stated writers some of popular Islamic financing products being marketed worldwide by Islamic banks are described below.

a. Mudaraba (Silent Partnership)

A mudarabah contract is a financial transaction in which there are two partners in the contract. One of the partners will provide the needed capital (Rabb-ul-Maal) and the other partner will go into the business as entrepreneur (Mudarib). That is, the Islamic bank will act as the capital Provider (Rabb-ul-Maal). In this type of financial contract, profits are shared between Islamic bank and the entrepreneur (client) based on predetermined ratio. However, in the event of loss the Islamic bank (or depositors) bears the loss while the entrepreneur loses his or her effort provided that it was not as a result of his or her negligence.

b. Murabaha (Cost-Plus Sales Contract)

This type of contract is mostly used in the procurement of equipment. It is a sales contract between Islamic bank and its client at a fixed profit called mark-up. In this contract, the client will provide all the specifications of the commodity and the Islamic bank will take the risk of purchasing it for the client at a cost plus mark-up which the client can either pay in installment or sum at a spot or at a stated period.

c. Ijara (Lease)

Ijarah is synonymous to leasing contract in conventional banking. It is a contract whereby an Islamic bank purchases an asset and leases it out to its client on the agreement that the client will be paying a fixed amount at regular interval usually monthly for a specified period of time to the Islamic bank. It may also include the option of the client purchasing the asset at the end of the contract from the bank.

d. Musharaka (Equity Partnership)

Musharaka is a contract in which two or more persons contribute capital for the establishment of a particular business venture in such a way that each partner has right to either involve in the administration of the business or not. However, partners may decide to be active or sleeping partner at their own will. In this kind of transaction in Islamic banking, profits are shared based on agreed ratio which need not be equal to their individual capital contribution, but loss is shared strictly based on individual capital contribution. So, Islamic bank will act as a partner in this case in order to contribute to the capital formation as well as in sharing profits and loss.

e. Salam (Forward Trade Contract)

This is a sale contract whereby Islamic bank agrees to supply some specific commodities to the buyer (its client) at a future date that is specified in exchange of an advanced full spot payment to the bank. That is, the client pays the full amount and delivery of the commodity to the client is done in specific future date by the Islamic bank.

f. Istisna (contract of manufacture)

It is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. It is used by Islamic banks, and consists of two separate Istisna contract.

2.2.6. Determinants of Bank Performance

According to Ongore and Kusa (2013), the main determining factors of bank performance can be categorized into two categories as bank specific (Internal factors) and macroeconomic (external factors). In other words, these factors are commonly used that bank performance is a function of internal and external factors. Internal factors generally refer to the individual bank specific characteristics which influences how the bank performs. These factors are mostly managed and influenced by the bank management and policy decisions that can vary from bank to bank. These internal factors mostly employed are capital adequacy, asset quality, expenses, bank size, management quality, liquidity management, loan portfolio, and income diversification.

On the other hand, External determinants of bank performance are concerned with those factors which are not influenced by specific bank's management decisions and policies, rather by events outside the influence of bank. These external factors are industry wide or country wide factors that are outside the control of the management of the bank like market concentration, inflation, tax rate, GDP and interest rate. External variables consist of premium rate, business sector structure, gross domestic product, inflation, regulation, and business sector development growth;(Khan M.M., Ijaz F.& Aslam E.; 2014), (Ongore and Kusa; 2013), (Nuhiu A., Hoti A. & Bektashi M.; 2017), (Nouaili M., Abaoub E. & Ochi A.; 2015).

However, according to Antoun R., Coskun A. & Georgievski B. (2018): The determining factors of the financial performance of commercial banks are classified into three categories: bank-specific factors, industry-specific factors, and macroeconomic factors. According to the writer, bank-specific factors are variables that determine the performance of bank like bank size, deposits, business mix, diversification, and operating efficiency. On the other hand, industry-specific factors are factors that can measure the market structure in the banking sector by using the concentration ratio, which measures the proportion of an industry's total assets controlled by its three largest firms. The last category of factors is macroeconomic factors. These factors are factors related with the business cycle of the banking industry such as recession expansions of the business. In addition the effect of inflation is categorized in these macroeconomic factors.

In general, based on the above discussed literatures, the performance of the bank can be determined by two basic categories of factors. These are internal and external factors. The internal factors are under the control of the Bank Management whereas the external factors are beyond the control of the bank.

2.2.7. Measurements of Bank Performance

According to Hassan (2012), evaluating bank performance is a complex process that involves assessing interaction between the environment, internal operations and external activities. Demez, Ustaoğlu and İncekara (2018) had also mentioned that due to the complexity of the process and the need for considering a wide range of elements and variables, performance measurement particularly in the banking sector is not an easy task.

Regulators usually used a popular measurement called CAMEL framework to evaluate financial health and performance of financial institutions and uses financial ratios. This CAMEL framework uses five factors as Capital Adequacy, Asset Quality, Management Quality, Earnings and Liquidity. When one of the above factors proved to be inadequate, this shows the increased likelihood of the institution to fail.

When we come to the measurement of the Interest free banks, the failure of the bank could not only due to inadequacy of the above mentioned CAMEL factors but also as a result of the non-compliance of the Shari'ah principles (Al-Jarhi and Iqbal, 2001).

Despite the complexities, various financial ratios are usually used to assess the performance of financial institutions by analyzing accounting data on the financial statement of the institution. The uses of financial ratios, calculated through the bank's accounting statements, are found quite common in the many literatures. For instance, Samad (2004) has adopted three major categories of financial ratio (profitability, liquidity and credit risk management) in his performance assessment of interest free and interest based banking in Bahrain. In addition, Talam (2014), Elgadi (2016) and Mabonga (2016) have also used these ratios to measure the performance of the interest free banking. On the basis of the BASEL factors of performance measurement, Hassan; 2005), (Kablan & Yousfi; 2011), (Akhter, Raza, Orangzab and Akram; 2011), (Salami and Adeyemi; 2015), (Alghfais; 2017), (Awan; 2009), (khan; 2013), and (Khan, Ahmad, Rahman And Haleem; 2018) had mentioned various financial ratios as a measure of financial performance of companies.

Based on above reviewed literatures, these ratios are grouped under five broad categories namely Profitability, Liquidity, Risk and Solvency, Capital Adequacy and Operational (efficiency).

- **Profitability Ratio:** One of the most frequently used tools of financial ratio analysis that measures the managerial efficiency that shows bank's overall efficiency and performance. The profitability ratio can be measured using:
  - Return on Assets (ROA): It measures the amount of profit earned relative to the firm's level of investment in total assets i.e. ROA = Net Profit/Total Assets. According to Rusydiana A. S. & Al Parisi S. (2016), ROA can also be measured by the ratio of profit before tax to total asset.
  - Return on Equity (ROE) = net profits/equity. It shows a rate return on base capital, i.e., equity capital. The higher the ROE, the more efficient is the performance.
  - Cost to Income Ratio (COSR) = total cost/total income. Cost incurred per dollar generation of income or in other words, income generated per dollar cost which is considered to be one of the best indices for measuring economic efficiency or profit

performance. The lower the COSR ratio, the better is the profitability performance of a bank.

- **Liquidity Ratio:** Liquidity ratios are used to determine the ability and capacity of a financial institution to meet its short-term debt obligations. Liquidity ratios attempt to measure a company's ability to pay off its short-term debt obligations. The higher liquidity ratios mean bank has larger margin of safety and ability to cover its short-term obligations. In other words, according to Samad (2004), liquidity is the life of a commercial bank. So, the higher the amount of liquid asset for a bank, the greater is the liquidity of the bank. So, commercial banks must hold sufficient liquidity. Liquidity ratio can be measured by total loans to total asset ratio (TLTA), liquid assets to total deposit ratio (LATD) and loans to deposit ratio (LDR). According to Moin (2013), bank with low LDR is considered to have excessive liquidity, potentially lower profits, and hence less risk as compared to the bank with high LDR. However, high LDR indicates that a bank has taken more financial stress by making excessive loans and also shows risk that to meet depositors' claims bank may have to sell some loans at loss.

- **Capital Adequacy Ratio:** Capital adequacy ratios are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. It indicates the healthiness of financial institution to shock withstanding losses. It can be calculated as: Capital Adequacy Ratio (CAR) = Capital / Risk-weighted Asset.

- **Risk and Solvency Ratio:** The solvency ratio indicates whether a company's cash flow is sufficient to meet its short-term and long-term liabilities. A bank is solvent when the total value of its asset is greater than its liability.

- **Operational (Efficiency) Ratio:** Operational ratios typically used to analyze how efficiently and effectively a company is using its resources to generate sales and increase shareholder value (Moin; 2013). It measures managerial efficiency in generating operating revenues and controlling its operating expenses. There are several ways of measuring operational efficiency of a bank. According to Iqbal (2001) and Moin (2013), the ratio of cost to income or Total Operating Expenses / Total Operating Revenue is used to evaluate the operational efficiency of banks. Lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues.

2.3. Empirical Review

Many empirical studies on challenges, opportunities and other related issues of interest free banking have been conducted by different scholars all over the world based on the specific context of countries that have adopted the system. Even though these studies discussed the theoretical and practical aspects of interest free banking, some of these studies are based on a single country specific experience and some of them based on the general system of Islamic banking.

In this section the researcher has reviewed country specific empirical evidences conducted by different researchers on performance of interest free banks in different countries and in Ethiopia in particular.

2.3.1. International Empirical Review

According to Sole (2007), interest free banking has experienced the fastest growth rates of 10-15 percent per annum, and has been moving into an increasing number of conventional financial systems. Despite this consistent growth and still the industry has high untapped potential in comparison to the conventional banking industry; it is operating in so many operational and institutional challenges.

According to Irfan, Majeed & Zaman (2014), Sole (2007), Bello & Abubakar (2014), interest free banking is an emerging industry not only in Muslim countries but also in non-Muslim countries. Nowadays, many countries are experiencing “Dual banking” system where interest-free banks operate along with conventional banks. For instance it is successful in countries like United State of America, United Kingdom and Europe. In addition, Irfan, Majeed and Zaman (2014) conducted their study on ‘The Performance and Efficiency of Islamic Banking in South Asian Countries ‘and results demonstrate that Islamic banking is more efficient on the financial performance of the bank than conventional banking. In addition, the researchers added that since Islamic banks practice Islamic principles that eliminate uncertainty and exploitation, its growth and performance is better than conventional banking system.

Diana Kirigo Thomi (2014) has made his research in Kenya on 'The Effect of Islamic Banking Products on Financial Performance of Commercial Banks in Kenya' and come up with the finding of all available Islamic products in Kenyan commercial banks have a positive significant relationship with the performance of the bank. Similarly, Wycliffe Mabonga has conducted his research in 2016 on 'Adoption of Islamic Banking on Financial Performance of Commercial Banks in Kenya' using six determinants of Islamic bank performance (Islamic bank ratio, capital ratio, liquidity ratio, efficiency ratio, expense management ratio and asset size) and found that Islamic banking ratio contributed most to the financial performance of commercial banks as measured by ratio. According to the study adoption of Islamic banking by commercial banks has a positive contribution on the financial performance of commercial banks in Kenya. Similarly, the study conducted by Norbert Kimutai Talamin 2014 on 'the effect of Islamic banking on financial performance of commercial banks in Kenya' using the six determinants of Islamic bank performance found out that the banks' capital ratio, liquidity ratio, bank size and Islamic banking ratio had a positive influence on the commercial banks' financial performance while efficiency ratio and expenses management ratio have a negative effect on the financial performance of commercial banks in Kenya. Thus, the study concludes that Islamic banking positively influenced the financial performance of the commercial banks in Kenya.

On the other hand, Samad (2004) has made his research on 'Performance of Interest-Free Islamic Banks Vis-À-Vis Interest-Based Conventional Banks of Bahrain' for a period of 1991-2001 in terms of profitability, liquidity risk and credit risk by using the Student t-test. The result of the study shows that there is no major difference between Islamic banks and conventional banks in the profitability and liquidity of performance measured in terms of various financial ratios. The findings also indicate that Islamic banks as newcomers to the financial market are doing as well as conventional banks. In addition, Islamic banks are exposed to less credit risk compared to conventional banks so that their credit performance is superior to that of conventional banks.

A research was conducted by Akhter, Raza, Orangzab and Akram in 2011 on Efficiency and Performance of Islamic Banking: The Case of Pakistan and the result shows there is no significant difference between Islamic and conventional banks with regard to profitability. On the other hand, the study found out that there is a difference in the liquidity and credit performance of the two banking systems. Another study conducted by Jaffar and Manarviin 2011 on ‘Performance comparison of Islamic and Conventional banks in Pakistan’ found that Islamic banks perform better in possessing adequate capital and better liquidity position while conventional banks pioneered in management quality and earning ability. On the other hand, another investigation made by Khan, Ahmad, Rahman & Haleem (2018) on the Performance of Islamic and Interest Based Banking in Pakistan indicates that Islamic banks are more liquid and less risky but they are less profitable and less efficient.

A study in the Arabian Gulf by Aden (2014) has shown that deposits in Islamic banks are rising steeply so that conventional banks are at risk of losing 30-40 percent of their Muslim clients to Islamic banks. Moreover, as per the assessment made by Elgadi in 2016 using the topic of ‘assessing the Financial Performance of Islamic Banking: The case of Sudanese banks’, the finding proves that the Islamic banking has a positive impact on the profitability of the bank since the central Bank of Sudan encourages to use such mode of financing in all economic activities. On the other hand, the study found out that there is a managerial gap in the interest free banking system.

According to the study of Blasig (2017) in Middle East on the topic of ‘Does the banking system affect banks’ performance?: Islamic Vs. conventional banking’, conventional banks outperform Islamic banks in respect of most performance measurement dimensions though Islamic banks are more liquid and perform better in efficiency ratio and the researcher had adopted five major financial ratios like profitability, efficiency, liquidity, solvency and credit risk. In the same manner, another study was conducted in UAE by Massah and Al-Sayed in 2015 on ‘Banking Sector Performance: Islamic and Conventional Banks in the UAE’. The finding of the study indicated that there is superiority of the conventional banks over Islamic banks in UAE with regard to profitability, credit risk management and solvency of the financial performance.

In general, most of the above reviewed empirical literatures use various financial ratios to evaluate and compare the financial performance of the interest free and conventional banking systems. Most of the studies show that Islamic banking has a positive contribution to the performance of the banking industry. In particular, most of the researchers concluded that the Islamic banks registered better profitability and liquidity performance as compared to that of the conventional banks. However, some studies had concluded in a different way that the performances of conventional banks outweigh the performance of the Islamic banks in some countries. On the other hand most of the studies found out that there is a gap in managerial quality in the interest free banking system.

2.3.2. Empirical Review in Ethiopian Context

Interest free banking (IFB) service started in 2013 and it is a recent phenomenon to the banking industry in Ethiopia and to the researchers in particular. Due to this fact, the empirical studies conducted in the area are very limited. The studies conducted so far include the following:

A study was conducted by Mohammed in 2012 on ‘Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia’. Even though it is conducted before the practical implementation of the IFB service in Ethiopia, the researcher has identified potential challenges of the service like lack of awareness, regulatory and institutional challenges, lack of support, gap in research and development in Islamic studies, lack of qualified human resource as well as wrongful association of the service with specific religion and the global terrorism. Similarly, Kerima in 2016 about ‘Challenges on Interest Free Banking Services’ and Tsion in 2017 about ‘Challenges and opportunities of interest free banking in Ethiopia’ respectively, had conducted their research and come up with various operational and institutional challenges that could be solved by different stakeholders.

Another study was conducted by Akmel in 2015 about “challenges and prospects of Islamic banking for resource mobilization in Ethiopian commercial banks’. The study concludes that Islamic banking service will bring additional capacity in the economy in connection with additional resource for banks, investment opportunity, reaching unbanked customers and employment opportunities in the country through effective mobilization and allocation of capital.

In addition, a research by Debebe (2015) on factors affecting customers’ use of IFB in Ethiopia found out that 100% of IFB account holders were all Muslims, there is lack of customers’ awareness and misconception regarding the benefit the IFB service and the bank is not going as planned since it is new for the industry.

Teferi (2015) has also studied about “Contribution of IFB to economic development and its prospect in Ethiopia’ and concluded that IFB is deemed to play an integral role in Ethiopia in catalyzing the economic development subject to many efforts required by various stakeholders.

In 2017, Abraham had also conducted his study on ‘Determinants of Customers’ Intention to Use Interest Free Banking Products and Factors Affecting Employees’ Product Knowledge: The case of Commercial Bank of Ethiopia’. The study concluded that customers’ intention, attitude, religious belief, social influence and perceived financial cost (pricing) are found to be influential factors with respect to the customers point of view while employees’ product knowledge, Underlying Sharia’ principle and Training are significant factors that can affect employees’ product knowledge.

Generally, based on the above reviewed empirical literatures many studies have been conducted in different countries and evaluated the performance of Islamic banks as compared to the conventional banks. In addition, the effect of Islamic banks on the performance of the commercial banks has been evaluated in some African countries like Kenya and come up with the positive effect of Islamic banks to the financial performance of commercial banks.

Coming to Ethiopian context very few studies were conducted focusing on challenges and opportunities of the interest free banking services and come up with almost similar findings. However, none of the above studies could evaluate the existing performance of the IFB service of banks. As a result this study was designed to assess the performance of the IFB of the Commercial Bank of Ethiopia.

CHAPTER THREE

3. RESEARCH METHODOLOGY, DESIGN AND METHOD

3.1. Introduction

This research was designed to assess the performance of interest free banking of the Commercial Bank of Ethiopia. This part of the study attempted to describe the research methods, designs and tools that were applied to collect and analyze the data so that the intended research objectives could be addressed. This chapter outlines the study methodology, design, and data collection and data analysis methods of the research project.

3.2. Research Methodology

The study adopted a mixed type of research method in order to answer the specified research questions and achieve the intended objective of the study. It allows for both quantitative and qualitative data to be gathered and analyzed using their respective quantitative and qualitative techniques. Specifically, the quantitative and qualitative data were obtained from the primary and secondary sources of data like interviews and financial statements of the Bank.

3.3. Research Design

According to Cooper and Schindler (2014), a research design is defined as a blueprint that enables the researcher to develop solutions to the research problems and guides him in the various stages of the research. In order to assess the performance of interest free banking of the Commercial Bank of Ethiopia, the researcher used descriptive research design. Descriptive research is used to obtain information concerning the current status of the phenomena and to describe "what exists" with respect to variables period or situation. It is often used as a pre-cursor to more quantitative research designs with the general overview giving some valuable pointers as to what variables are worth testing quantitatively.

A descriptive research design is appropriate to assess the performance of the interest free banking of the commercial bank of Ethiopia. As a result, this research design enables to collect more detail quantitative data and conduct detail assessment so that the researcher can made practical recommendations based on the findings of the study. Therefore, this research was conducted in an exploratory research design approach.

3.4. Research Method

3.4.1. Sources of Data

The study was conducted by collecting data from primary and secondary sources. The primary data were collected using semi-structured interviews with purposively selected leaders and performers of the IFB department. The secondary data were collected from annual reports of the Bank and the IFB department. From these sources of data financial statement reports and other reports like accessibility reports were extracted. In addition, bank's web site and different journals, articles, books, postgraduate theses, directives of the NBE were reviewed as background information.

3.4.2. Sampling Technique

This research was designed to assess the performance of interest free banking of the Commercial Bank of Ethiopia and the research is a case study project which was conducted to the specific point of view of the IFB performance of the Commercial Bank of Ethiopia. To address the specified objectives, the study adopted purposive sampling technique from the population of the banking industry in Ethiopia and four years performance data were collected from the annual report of the Bank and its IFB department based on the sample. Moreover, interview has been conducted with the IFB department financing director and operation officers.

3.4.3. Method of Data Collection

For the purposes of this study the data was collected using primary and secondary sources. The primary data has collected using semi-structured interviews with the department leaders and performers. The secondary data has been collected by extracting relevant and supportive data and information from the secondary data sources. These sources were periodic report of the Bank and the IFB department.

3.4.4. Data Analysis Method

So as to address the specified problem statement and answer stated questions, the data collected based on the above techniques was sorted and reorganized using different tables and graphs to make better and efficient analysis. Though the IFB of the CBE has various components, for the purpose of this study, IFB data was analyzed using various measures of IFB performance such as branch accessibility, number of customers, amount of deposit, amount of IFB financing and income, expense and profit/loss of the IFB and financial ratios like ROA, IFB Ratio, liquidity ratio, efficiency ratio, and bank size.

Based on CAMEL rating proxies, the above stated ratio were adopted in various banking performance studies. For instance, Mabonga (2016), Talamin (2014), Thomi (2014) and Elgadi (2016) had adopted these proxies to measure the performance of commercial banks in general and Islamic banks in particular.

Based on the reviewed literatures, the researcher hand adopted the above stated measures of the IFB of the CBE in the following way:

- Branch accessibility: was measured by the number of branches providing the IFB service and the number of windows in those branches;
- ROA: was measured as the ratio of Profit before tax to total asset of the IFB;
- IFB Ratio: was measured by the ratio of Income from IFB to total income of the CBE;
- Liquidity Ratio: was measured by loan to deposit ratio of the IFB;
- Efficiency Ratio: was measured by the ratio of total operating expenses to total asset of the IFB;
- Bank size: was measured by the amount of the total asset of the IFB.

The data obtained based on the above stated measures of the IFB were analyzed using statistical description like mean, maximum and minimum values, growth rates of the variables and trends and the results were depicted using tabular and other forms of presentation in order to convey the intended meaning and be convenient for interpreting the findings of the research.

CHAPTER FOUR

4. DATA ANALYSIS, INTERPRETATION AND PRESENTATION

4.1. Introduction

This chapter deals with data analysis and interpretation of the research project. The objective of the study was to assess the performance of the interest free banking of the Commercial Bank of Ethiopia. Data were collected from interviews, annual reports of the Bank and financial statement of the IFB department for a period of four years from 2015 to 2018. Data was collected based on the identified measures or variables of the study, that is, branch accessibility, number of accounts, amount of deposit, amount of financing and income, expense and profit of the IFB and other financial ratios like ROA of IFB, IFB ratio, liquidity ratio, efficiency ratio, and bank size. The data collected has been analyzed and presented in tabular and graphical forms and interpreted using various statistical descriptions.

4.2. Status of Interest free banking in CBE

In Ethiopia, the Interest free banking service was introduced in 2013 by two commercial banks: commercial bank of Ethiopia and Oromia international bank. The Commercial Bank of Ethiopia is one of the two commercial banks and started the IFB service in December 16, 2013 using 23 pilot branches. This section has discussed the status of interest free banking in terms of number of branches and dedicated windows providing the IFB services, number of account holders, deposit raised and composition of deposits as well as the investment and financing activities of interest free banking of CBE.

4.2.1. Branch Expansion and Number of Accounts

Table 4.2.1: Branch expansion and number of Accounts Summary

Year	2015	2016	2017	2018	Average Growth Rate (%)
Number of Branches offering IFB	340	738	826	952	
Growth Rate	-	117.06	11.92	15.25	**48.08**
Number of Windows	352	750	838	1,045	
Growth Rate	-	113.07	11.73	24.7	**49.83**
Number of Customer	105,453	399,234	573,692	893,661	
Growth Rate	-	278.59	43.7	55.77	**126.02**
Total Number of Muslim Population (33.9% of Eth. Population)	34,183,220	35,121,574	36,069,574	37,027,076	**2.7**
Number of Muslim population per IFB branch	100,539	47,590	43,668	38,894	**44.17**

Source: Own Computation from annual reports and Worldometer estimate[2]

As indicated in the table 4.2.1 above, the number of branches offering the IFB service has shown a continuous increase from 340 in 2015 to 952 in the year 2018 with an average growth rate of 48.08%. Similarly, the number of IFB windows providing the service has also shown an increasing trend over the four years period at an average growth rate of 49.8%. This shows that some of IFB services providing branches have more than one dedicated IFB window based on the potential of the area and number of customers. As a result, the total number of branches reached 952 while the number of IFB windows reached 1,045 at the end of 2018. Moreover, as the number of Muslim population increases at an average growth rate of 2.7%, the population to branch ratio of the IFB continuously improved with an average ratio of 44.17% during the study period. At the beginning of the study period, one branch was serving 100,539 Muslims. In 2018, the ratio show great improvement and reached to 38,894 people for one branch.

Coming to the number of account holders or deposit customers, it shows a continuous raise over the four years study period. The numbers of accounts increase from 105,453 in 2015 to 893,661

[2] www.worldometer.info

in the year 2018 at an average growth rate of 126%. Thus, the accessibility of the IFB service increased over time to address the demand and exploit the potential.

4.2.2. IFB Deposit Products and Performance

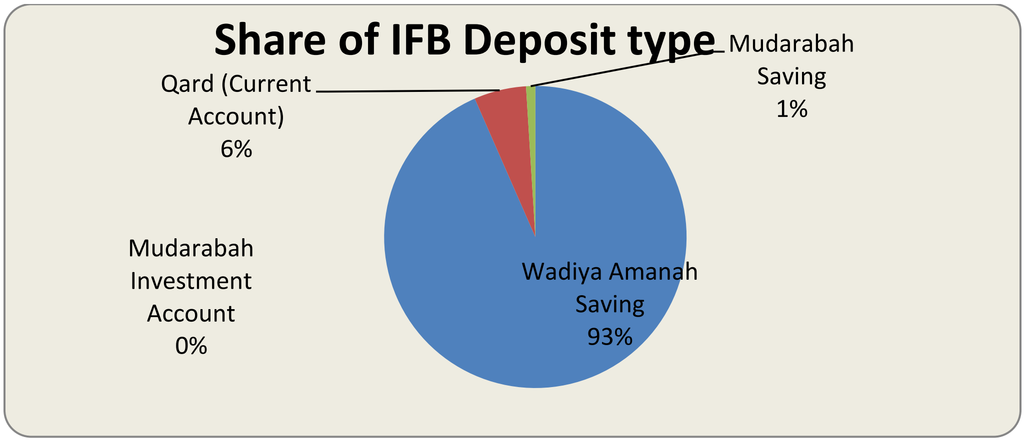
Table 4.2.2: Trend of Deposit by Type

Year	**2015**	**2016**	**2017**	**2018**	**verage**
Wadiya Amanah Saving deposit	1,016.8	3,381.4	5,569.7	9,170.6	
Growth Rate	-	232.5	64.7	64.7	**120.6**
Qard (Current Account Deposit)	181.1	320.8	427.4	547.4	
Growth Rate	-	77.1	33.2	28.1	46.1
Mudarabah Saving Deposit	50.5	63.6	93.6	96.8	
Growth Rate	-	25.9	47.2	3.5	**25.5**
Total IFB Deposit	**1,248.0**	**3,766.0**	**6,091.0**	**9,815.0**	
Growth Rate	**-**	**201.6**	**61.7**	**61.2**	**108.2**

Source: Own Computation from secondary sources

Since customers' deposit is the foundation of banking activity and the major source of finance, banks usually strive to expand their deposits. Table 4.2.2 above outlines the performance and growth rate of Interest free banking deposits of Commercial Bank of Ethiopia. Total deposit of the interest free banking of the Commercial Bank of Ethiopia stood Birr 9.8 Billion at the end of June 2018. Based on the data, the total IFB deposit of the Bank continuously increased over the four years study period at an average growth rate of 108.2% from Birr 1.2 billion in 2015 to Birr 9.8 billion in year 2018.

Graph 4.2.1: Share of IFB Deposit Type



Source: Own Computation from secondary sources

As can be seen from table 4.2.2 and the figure 4.2.1 depicted above, majority of the total IFB deposit comprises Wadiya Amanah saving deposit also called safe keeping deposit which accounts for 93% of the total IFB deposit based on the deposit of the year 208. This type deposit product shows a continuous increase over the study period. As a whole the Wadiyah Amanah saving deposit shows an average growth rate of 120.6% over the four years period. Even though this type of deposit is an investable deposit with the prior agreement of the Bank and the depositor, the customer can withdraw it at any time and could not expect any return. Hence the bank can invest it in a short term IFB investments. As the data obtained from the interview, one of the main reasons that majority of customers use the safe keeping deposits was lack of trust of customers that the bank may invest the money in prohibited areas. Such trust issue was due to absence of IFB advisory board. Another reason was lack of awareness of customers on the nature of the IFB products as well as that of the employees so that they could not create appropriate awareness to customers. Besides, the bank did not aggressively promoted other investable deposits since the investment of the bank was very limited.

Coming to other types of deposit products, Qard (Current Account Deposit) held the share of 6% of the total IFB deposit of the CBE. This type of deposit showed an increasing trend over the four years study period with an average growth rate of 46.1%. The Mudarabah Saving deposit of the IFB which take the share of only 1% of the total IFB deposit shows a continuous increase over the four years study period at an average growth rate of 25.5%. This type of deposit is an earning deposit of the IFB product that can be invested in IFB investment to earn profit and subsequently require the bank to pay for the depositors as profit as per the predetermined rate of profit/loss sharing. However, this deposit type is very low as compared to the other IFB deposits. Hence, this can affect the investment effort of the Bank to enhance its profitability. On the other hand, the Mudarabah investment deposit is also another type of IFB deposit product which is earning deposit to the customer that the Bank can invest on whatever it believes to be profitable and share the profit to the depositor. However, the Bank could not mobilize this type of investment deposit that may enhance its investment and profitability as depicted in the graph above.

Another measure of deposit performance of the IFB of CBE is deposit per branch. As indicated in the table 4.2.3 below, the deposit per branch of the IFB of the CBE shows a continuous increase over the four years period. Particularly, the deposit per branch of the IFB of the Commercial Bank of Ethiopia was Birr 3.67 Million in 2015 and continuously rose to Birr 10.3 Million in the year 2018 which shows an average growth rate of 41.1%.

Table 4.2.3: Summary of Average deposit per Branch

Year	2015	2016	2017	2018
Total IFB Deposit (Millions Birr)	1,248.45	3,765.73	6,090.62	9,814.80
Number of Branches offering IFB	340	738	826	952
Average Deposit Per Branch (Millions Birr)	3.67	5.10	7.37	10.31
Growth Rate	-	38.96	44.51	39.82

As indicated in the findings of the study, the overall deposit of the IFB shows an increasing trend over the four years study period. However, the table 4.2.4 shown below indicated that the %age Share of IFB Deposit from the total deposit of the CBE is very low though it shows a continuous marginal increase from 0.52% in year 2015 to 2.17% in year 2018 over the study period. Specifically, the share of the IFB deposit over the total deposit of the Bank in year 2018 is only 2.17% of the total deposit of the Bank. As a whole, based on the respondents of the interview, major reasons for limited contribution of deposit of the IFB to CBE deposit were lack of awareness of customers and employees on the nature of the IFB products, lack of trust of customers to the bank on investment, unavailability of the Sheriah Advisory board, and less effort of the bank on properly promoting the IFB service.

Table 4.2.4: Share of the IFB deposit of the CBE

Year	CBE Total Deposit	CBE IFB Deposit	%age Share of IFB Deposit
2015	241,732,234,836.64	1,248,452,045.93	0.52
2016	288,551,118,016.91	3,171,799,839.78	1.10
2017	364,861,625,498.10	6,090,617,940.94	1.67
2018	451,839,696,593.55	9,814,801,726.73	2.17

Source: Own Computation from secondary sources

4.2.3. IFB Financing (Investment)

Basically, the IFB financing is provided in two fundamental methods as in profit or loss sharing in trading activities and in sale of goods and services on credit. These financing activities are given in different forms of investment or financing. Based on the data depicted in the table 4.2.5 below, the total amount of IFB financing of the Commercial Bank of Ethiopia was Birr 38.4 Million in 2015.The data shows that the total IFB investment or financing of the CBE revealed a trend of continuous increase from Birr 38.4 million in 2015 to Birr 295.5 million in 2017 and then declined to Birr 185.5 million in 2018. The IFB financing of the CBE comprise only to the Murabaha which is both domestic trade financing and LC settlement financing and other types of IFB financing were not provided until the end of the study period (2018). The main reason for the dominance of the Murabaha financing it is very simple to implement since it is only purchase and sell of goods to the customer on a specified margin of profit. Moreover, other financing products like Musharaka need partnership of the bank with the customer which is not supported by the legal framework of the country. Istisna which focuses financing of construction is not supported by the legal framework of the country since the lease system considers interest. Besides, the investment of the bank focuses on priority sectors but these sectors are not supported by regulatory frameworks coming to the IFB investment. As indicated in the above discussion in the deposit performance of the IFB of CBE, the Mudarabah saving deposit mobilized is very low. So, the investment extended on interest free financing becomes limited.

As indicated on the Table 4.2.5 below, the domestic Murabaha financing shows a continuous rise over the four years study period. However, the LC Murabaha financing grows over the first three years and declined in 2018. Based on the findings of the interview, the major reason for the decline of LC Murabaha financing was due to shortage of foreign currency in the Bank so that the international trade and LC settlement of the IFB department declined during the budget year.

Table 4.2.5: Summary of IFB Financing Performance of CBE

Year	**2015**	**2016**	**2017**	**2018**
Murabaha Financing	38,445,686	115,106,945	141,801,555	149,262,769
LC murabaha financing	-	53,453,453	153,743,706	36,235,043
Salam Financing	-	-	-	-
Istisna'a financing	-	-	-	-
Ijara (Leasing) financing	-	-	-	-
Total IFB Financing	**38,445,686**	**168,560,399**	**295,545,261**	**185,497,812**
Growth Rate	**-**	**338.44**	**75.33**	**(37.24)**

Source: Own Computation from secondary sources

4.2.4. IFB Income and Expense

Profit maximization is one of the critical objectives of the commercial banks through their intermediary services in the banking industry. Coming to the interest free banking service, profit/loss sharing is one of the principles so that both the bank and the customer will share the profit earned or the losses incurred during the banking activities. Table 4.2.6 highlighted the summary of the income, expense and profit/loss of the IFB of CBE. As indicated in the table, the interest free banking of CBE registered a loss of Birr 2.9 million in 2015. During the fiscal year the total income of the IFB was Birr 2.3 million while the total expense was Birr 5.2 million. On the basis of the findings of the interview, the bank had invested at Birr 38.4 million only at the beginning of the study period. However, the customer defaulted and the investment could not generate any profit to share to the depositors. As a result the Bank had paid Hiba (bonus) to the depositors though it is at loss. This Hiba along with other operational expenses resulted in incurring loss during 2015. In the remaining three study periods, the IFB of CBE has registered a profit before tax of Birr 1.3 million, 15.1 million and 11.3 million respectively. From the data, slight decline was observed during the year 2018 both in income and profit before tax of the IFB of the CBE. On the other hand the expense of the IFB shows a steady increase throughout the four years study period. As obtained from interview results, the decline in the profitability of the IFB in 2018 was due to less investment in the period as a result of shortage of foreign currency for financing international trades.

Table 4.2.6: Summary of Income, Expense and Profit/Loss of IFB of the CBE

Year	**2015**	**2016**	**2017**	**2018**
Total Income/Revenue	2,307,560	7,671,782	23,840,817	21,083,125
Growth Rate	-	232.46	210.76	(11.57)
Total Expenses	5,225,139	6,323,760	8,728,929	9,815,696
Growth Rate	-	21.03	38.03	12.45
Profit/Loss Before Tax	(2,917,579)	1,348,022	15,111,888	11,267,428
Growth Rate	-	(146.20)	1,021.04	(25.44)

Source: Own Computation from secondary sources

4.3. Ratio Analysis of Interest Free Banking of CBE

As indicated in the reviewed literature and methodology of the study, the research had identified various financial ratios to assess the IFB performance of the Commercial Bank of Ethiopia. Accordingly, the data obtained from the secondary sources of the study were analyzed in different statistical values like mean, maximum values and minimum values and growth rates. Hence, table 4.7 indicated below outlines summary of the financial ratios of the IFB of the Commercial Bank of Ethiopia for the four years study period. Based on the summary table, each of the study variables were described hereunder.

Table 4.3.1: Summary of Financial Ratios of IFB of CBE

Year	Return on assets (%)	IFB Ratio (%)	Liquidity Ratio (%)	Efficiency Ratio (%)	Bank size in Millions of Birr
2015	(0.23)	0.01	3.08	226.44	1,248.45
2016	0.04	0.03	4.48	82.43	3,765.82
2017	0.25	0.07	4.85	36.61	6,091.23
2018	0.11	0.05	1.89	46.56	9,815.41
Mean	**0.04**	**0.04**	**3.6**	**98.01**	**5,230.23**
Minimum	(0.23)	0.01	1.89	36.61	1,248.45
Maximum	0.25	0.07	4.85	226.44	9,815.41

Source: Own Computation from secondary sources

4.3.1. Return on Assets (ROA)

Return on Assets is considered to be a financial performance indicator of how effectively a company is using its assets to generate earnings. The higher the Return on Assets the better the company is in its financial performance because it is earning more money on its assets.

The findings depicted in Table 4.3.1 above shows the trend of Return on Assets values over a period of 4 years from 2015 to 2018. The mean value of the ROA of the IFB for the 4 years study period shows 0.04%. The lowest value of the ROA was (0.23%) registered in 2015 while the highest value was 0.25% in the year 2017. As indicated in the table 4.2.6 above, the IFB of the Bank has registered a loss of Birr 2.9 million in 2015. This resulted in negative ROA of the IFB at the beginning of the study period. The result of the study shows that there is a continuous increase in the ROA of IFB of the CBE from (0.23%) in the year 2015 to 0.25% in the year 2017. On the other hand, the ROA of the IFB of CBE declined in the year 2018 to the value of 0.11%. This is due to the decline of the profit of the IFB during the year 2018 from Birr 15.1 million to Birr 11.3 million. Hence, since the overall ROA of the IFB shows an increasing trend over the study period, the study depicted a continuous improvement of the profitability of the IFB of the CBE.

4.3.2. Interest Free Banking Ratio (IFBR)

The findings shown in Table 4.3.1 above outlined the trend of interest free banking performance ratio over the 4 years period. From the findings, the mean value of the IFB ratio as measured by the ratio of the income from the IFB to the total income of the CBE is 0.04. In addition, the lowest value of the IFB ratio was 0.01 registered in 2015 while the highest value was 0.07 in 2017. The result shows that there is continuous increase in the IFB ratio of the CBE over the study period with the exception of slight decline from year 2017 to 2018. The declined in IFBR of CBE observed from 2017 to 2018 was as a result of the decline in the income of the IFB during the 2018 fiscal year due to the decline in IFB investment.

4.3.3. Liquidity Ratio

The findings depicted in Table 4.3.1 above further indicated the trend of liquidity ratio of the Bank over the 4 years study period as measured by the ratio of the IFB financing (loan) to the total deposit of the IFB. Based on the findings, the mean value of the liquidity ratio (loan to deposit ratio) was about 3.6. Based on the result, the minimum value of the liquidity ratio was 1.89 in 2018 while the maximum value was 4.85 in 2017. This shows that there is high variation of the liquidity ratio of the interest free banking over the four years period under study. In particular, the liquidity ratio has shown an increasing trend from 3.08 to 4.85 for the first three years and there was a decline in the year 2018 like ROA and the IFBR discussed above. Since the liquidity ratio is the function of the IFB financing and the total deposit of the IFB, the decline of the liquidity ratio in the year 2018 is resulted from the decline of the IFB financing during the year 2018 as depicted in table 4.2.5 above. In general, the average liquidity ratio of the IFB of CBE shows a declining trend over the four years study period. This shows the IFB is highly liquid since majority of the deposits are safe keeping.

4.3.4. Efficiency Ratio

As indicated in the Table 4.3.1 above, the findings of the study show the trend of efficiency ratio of the interest free banking over the 4 years period. From the findings, the smallest value of efficiency ratio was 36.61%in 2017 while the highest value was 226.44% in 2015 with the mean value of 98.01%. This shows a steady improvement in the efficiency ratio of the IFB of the Bank in the study period under review. This improvement was resulted from the continuous improvement in the profitability of the IFB. Thus, the finding of the study indicated that the efficiency of the IFB of the CBE shows improvement over the four years study period.

4.3.5. Bank Size

Furthermore, the findings as shown in Table 4.3.1 above indicated the trend of bank size as measured by the asset size of the IFB over the study period. Based on the findings, the mean value of bank size of the IFB was Birr 5.2 Billion with the standard deviation of Birr 3.64Billion. Moreover, the findings of the study shows a continuous increase in the asset size of the IFB from the smallest value of Birr 1.2 Billion in 2015 to the highest value of asset size Birr 9.8 Billion in 2018.This implies there is a steady increase in the bank size of the IFB of the Commercial Bank of Ethiopia over the study period. In addition, the table 4.3.2 below shows the asset share of the IFB with respect to the total asset of the Bank. Based on the data, the percentage share of the IFB asset increased from 0.41% in 2015 to 1.73% in the year 2018. However, though the asset size of the IFB increased over time, it is still very low (only 1.73% based on 2018 data) as compared to the total asset size of the Bank. This result show that the total asset of the IFB depends entirely on the customers' deposit and no capital is injected to run the IFB operation of the Bank. Thus, the Bank size of the IFB has increased over the four years study period even though it is very low as compared to the total asset of the Bank.

Table 4.3.2: Summary of Asset Size share of IFB

Year	Total Asset of CBE	Total Asset of IFB	Share of IFB Asset (%)
2015	306,636.23	1,248.45	0.41
2016	384,535.50	3,765.73	0.98
2017	485,760.00	6,090.62	1.25
2018	566,799.00	9,814.80	1.73

Source: Own Computation from secondary sources

4.4. Discussion of Findings

The objective of the study was to assess interest free banking performance of the Commercial Bank of Ethiopia. To address the stated main objective, primary and secondary data were used and the data was subsequently analyzed using statistical description methods based on various variables of the study. Accordingly, the findings of the study based on the above analysis were discussed here under.

As indicated in the previous discussion, the Commercial Bank of Ethiopia had started providing its IFB service in December 2013 using 23 pilot branches by dedicating separate IFB windows. Based on the findings of the study, the number of branches reached 952 at the end of 2018 with a total number of windows of 1,045. Furthermore, the total number of account holders of the IFB grows from 105,453 in 2015 to 893,661in 2018 with an average growth rate of 126% per year. Moreover, as the number of Muslim population increases at an average growth rate of 2.7%, the Muslim population to branch ratio of the IFB continuously improved with an average ratio of 44.17% during the study period. The number of Muslim population to branch ratio improved from 100,539 to 38,894 over the four years study period. This shows that the Bank has exerted more effort to expand its branch outreach and customer accessibility.

Based on the study findings, the total IFB deposit of the Bank continuously increased over the four years study period at an average growth rate of 108.17% from Birr 1.2 billion in 2015 to Birr 9.8 billion in year 2018. However, though the deposit grows over time, the deposit per branch of the IFB is still low i.e. Birr 10.3 million per branch according to the 2018 data.

The findings of the study shows that Wadiya Amanah saving (safe keeping) deposit comprises majority of the IFB deposit of the Bank with the percentage share of 93% of the total IFB deposit based on the data of June 2018. This deposit Product has shown a continuous average growth rate of 544.15% over the four years study period. Based on the findings of the study discussed above, the dominance of the Wadiah Amanah deposit was resulted from lack of trust of customers that the bank may invest the money in prohibited areas due to absence of IFB advisory board, lack of awareness of customers on the nature of the IFB products as well as that of the employees so that they could not create appropriate awareness to customers, and the bank did not aggressively promote other investable deposits since the investment of the bank was very limited. Another type of IFB deposit product, Qard (current account deposit) held the share of 6% of the total IFB deposit of the CBE. This type of deposit shows a continuous increase over the study period. The study also revealed that Mudarabah Saving deposit of the IFB take the share of only 1% of the total IFB deposit and this type of deposit shows a continuous increase over the four years study period at an average growth rate of 25.5%. This type of deposit is an investable deposit that allows depositors to earn profit from the investment by the Bank. However, this deposit type is very low as compared to the other IFB deposits so that the investment of the Bank on IFB financing becomes limited. On the other hand, the Mudarabah investment deposit which is unrestricted investment deposit of the IFB is also another type of IFB earning deposit product. But the study shows that the Bank could not mobilize this type of investment deposit during the four years study period. As a result, the investment effort of the Bank on IFB becomes limited.

Moreover, the findings of the study revealed that the %age share of IFB Deposit from the total deposit of the Bank is very low though it shows a continuous marginal increase from 0.52% in 2015 to 2.17% in 2018 over the study period. Though study conducted by Mohammed (2012) and Tsion (2017) concluded that there is huge untapped potential of the IFB to be exploited in Ethiopia, low level of performance of the IFB deposit has been registered compared to the size of the Bank and its high outreach of branches. This low performance of the CBE emanated from lack of trust of the Muslim society that the bank may invest in prohibited areas, less effort of the bank in promoting its IFB products/services to the society, lack of awareness of the employees of the bank to properly describe the products/services. Awareness gap of the society about the nature and benefit of IFB products was also identified by previous studies conducted by Tsion (2017), Teferi (2015) and Debebe (2015).

Coming to the IFB financing, the study indicated that the total IFB investment of the CBE revealed a continuous increase from Birr 38.4 million in 2015 to Birr 295.5 million in 2017. However, the IFB financing of the Bank declined to Birr 185.5 million in 2018. Based on the findings, only to the Murabaha financing was extended and other types of IFB financing were not provided until the end of June 2018. The main reason for the dominance of the Murabaha financing it is very simple to implement since it is only purchase and sell of goods to the customer on a specified margin of profit. Moreover, other financing products like Musharaka need partnership of the bank with the customer which is not supported by the legal framework of the country. Istisna which focuses financing of construction is not supported by the legal framework of the country since the lease system considers interest. Besides, the investment of the bank focuses on priority sectors but these sectors are not supported by regulatory frameworks coming to the IFB investment.

The finding shows that the domestic Murabaha financing shows a continuous rise over the four years study period. However, the LC Murabaha financing grows over the first three years and declined in 2018. The major reason for the decline of LC Murabaha financing was due to shortage of foreign currency in the Bank so that the international trade and LC settlement of the IFB department declined during the budget year. As indicated in the analysis above, the Mudarabah saving deposit, which is investable deposit is very low, comprises only 1% of the total IFB deposit of the Bank. In addition, until the end of June 2018, the Bank could not mobilize the Mudarabah unrestricted investment deposit. Hence, the result revealed that the IFB financing of the CBE was very limited.

From the findings, the profitability performance of the IFB of the Commercial Bank of Ethiopia increased over the four years study period as depicted by the values of the ROA. The continuous increase in the ROA values from (0.23) in year 2015 to 0.11 in year 2018 indicates a steady improvement in the profitability performance the IFB of the Bank during the study period. Based on the findings, this continuous improvement in the profitability performance of IFB of the Bank has been as a result of the growth rate of the profit of the IFB as compared to that of the asset of the IFB of the Bank as indicated above. However, the study shows that even though the bank had invested at the beginning of the study period, it could not generate any profit to share to the depositors due default of the customer. On the other hand, the Bank had paid Hiba (bonus) to the depositors though it is at loss to keep the image of the Bank. This Hiba along with other operational expenses resulted in incurring loss during 2015.

Though there is continuous improvement of the ROA of the IFB, the value of the ROA is still very low, which is below 1%. The ROA value of the year 2018 which is 0.11 shows that Birr 0.11 has been generated from the investment of Birr 100 asset. Thus, the profitability of the IFB service of the CBE improved over time though it is very low. This finding is consistent with the findings of Elgadi (2016) on ‘assessing the Financial Performance of Islamic Banking: The case of Sudanese banks’, the finding proves that the Islamic banking has a positive impact on the profitability of the bank. Moreover, the findings of this study is also in alignment with other research findings made in Kenya by Thomi (2014) and Mabonga (2016) who concluded that Islamic banking contributed most to the financial performance of commercial banks in Kenya. On the other hand this finding is against the investigation made by Khan, Ahmad, Rahman & Haleem (2018) on the Performance of Islamic and Interest Based Banking in Pakistan that conclude as Islamic banks are more liquid and less risky but they are less profitable and less efficient.

The study findings revealed that the interest free banking ratio steadily increased from 0.01 in year 2015 to a value of 0.07 in year 2017 and slightly decline to the value of 0.05 in 2018. The declined in IFBR of CBE observed from 2017 to 2018 was as a result of the decline in the income of the IFB during the 2018 fiscal year due to the decline in IFB investment. Thus, the overall interest free banking ratio of the CBE has shown a continuous improvement over the four years study period. These findings are in line with Talamin (2014) who conducted a research on ‘the effect of Islamic banking on financial performance of commercial banks in Kenya’ and found out that the banks’ Islamic banking ratio had a positive influence on the commercial banks’ financial performance in Kenya. Similarly, Mabonga (2016) has conducted his research in on ‘Adoption of Islamic Banking on Financial Performance of Commercial Banks in Kenya’ and concluded on the positive contribution of the Islamic banking ratio to the financial performance of commercial banks in Kenya.

The study findings revealed that liquidity ratio has shown an increasing trend from 3.08 to 4.85 for the first three years and declined to 1.89 in the year 2018. As a result, liquidity ratio of the IFB has shown a declining trend during the recent years of the study period as a result of the decline of the IFB financing of the Bank that subsequently resulted in the decline of the profitability of the IFB. Liquidity ratio which is the function of the IFB financing and the total deposit of the IFB, the decline of the liquidity ratio in the year 2018 is resulted from the decline of the IFB financing during the year 2018. In general, the average liquidity ratio of the IFB of CBE shows a declining trend over the four years study period. This shows the IFB is highly liquid since majority of the deposits are safe keeping. According to Moin (2013), bank with low loan to deposit ratio (LDR) is considered to have excessive liquidity, potentially lower profits, and hence less risk as compared to the bank with high LDR. The findings are consistent with previous studies done by Mabonga (2016), Talamin (2014) and Thomi (2014) liquidity ratio had a positive influence on the commercial banks' financial performance. Similarly, this finding is also consistent with the investigation made by Khan, Ahmad, Rahman & Haleem (2018) on the Performance of Islamic and Interest Based Banking in Pakistan that conclude as Islamic banks are more liquid and less risky but they are less profitable and less efficient.

The findings of the study further revealed that efficiency ratio of the interest free banking steadily improved from a value of 226.4 in year 2015 to a value of 36.6 in year 2017 and a slight increment to 46.6 in the year 2018. Thus, the overall efficiency of the IFB of the CBE has shown a continuous improvement over the four years study period. According to Moin (2013) and Ika and Widagdo (2008), lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues and increases performance of the bank. This find is consistent with the finding of Talamin (2014) who had made his study on 'the effect of Islamic banking on financial performance of commercial banks in Kenya' using various ratios and found out that the efficiency ratio negatively affected the financial performance of the various commercial banks in Kenya. This finding of the study is consistent with Mabonga (2016) who has conducted his research on 'Adoption of Islamic Banking on Financial Performance of Commercial Banks in Kenya' and concluded on the positive contribution of the efficiency ratio to the financial performance of commercial banks in Kenya. On the other hand, this find is against the findings of another investigation made by Khan, Ahmad, Rahman & Haleem (2018) on the Performance of Islamic and Interest Based Banking in Pakistan that indicates Islamic banks are more liquid and less risky but they are less profitable and less efficient.

The study findings also indicated that bank size of the interest free banking steadily increased from Birr1,248.45 million in year 2015 to Birr 9,815.4million in 2018. However, the percentage share of the IFB bank size as measured by the total asset of the IFB is entirely dependent on the deposit of customers and it is very low as compared to the total asset of the Bank. Hence, the bank size of the IFB of the CBE has shown a continuous rise through time though it is very low as compared to the total asset of the Bank.

CHAPTER FIVE

5. SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1. Introduction

The main objective of this study was to assess IFB performance of the Commercial Bank of Ethiopia. To address the specified objective, primary data collected using interview and four years secondary data on identified measures of performance of the IFB and the Commercial Bank of Ethiopia was collected and subsequently analyzed using various statistical descriptions. Finally, this chapter presents summary of the findings, the conclusions drawn from the analysis and possible recommendations of the researcher. The rest of this chapter is therefore structured into summary of the findings, conclusions and recommendations.

5.2. Summary of the Findings

Based on the findings of the study, the number of branches at the end of June 2018 reached 952 with a total number of 1,045 dedicated windows. The total number of account holders of the IFB grows from 105,453 in 2015 to 893,661 in 2018 with an average growth rate of 126% per year. In addition, the number of Muslim population to branch ratio improved from 100,539 to 38,894 over the four years study period. This shows that the Bank has exerted more effort to expand its branch outreach and customer accessibility.

The findings of the study revealed that the total IFB deposit of the Bank continuously increased over the four years study period at an average growth rate of 108.17% from Birr 1.2 billion in 2015 to Birr 9.8 billion in year 2018. However, based on the data of June 2018, the deposit per branch of the IFB is Birr 10.3 million which is still low.

On the basis of the study findings, 93% of the total IFB deposit is the Wadiya Amanah saving deposit while Qard held the share of 6% of the total IFB deposit of the CBE. The study also revealed that Mudarabah Saving deposit of the IFB take the share of only 1% of the total IFB deposit. Wadiya Amanah saving deposit Product has shown a continuous average growth rate of 544.15% over the four years study period. The dominance of the Wadiah Amanah deposit was resulted from lack of trust of customers that the bank may invest the money in prohibited areas due to absence of IFB advisory board, lack of awareness of customers on the nature of the IFB products as well as that of the employees so that they could not create appropriate awareness to customers, and the bank did not aggressively promote other investable deposits since the investment of the bank was very limited.

The study also indicated that the share of IFB Deposit out of the total deposit of the CBE revealed continuous increase from 0.52% in 2015 to 2.17% in 2018. This percentage share shows low performance of deposit of the IFB. This low performance was due to lack of trust of the Muslim society that the bank may invest in prohibited areas, less effort of the bank in promoting its IFB products/services to the society, lack of awareness of the employees of the bank to properly describe the products/services.

Based on the study, the overall IFB financing of the CBE revealed a continuous increase over the study period with the exception of 2018. In addition, it is also found out that the IFB financing was limited and extended only to the Murabaha financing of the IFB during the study period. The main reason for the dominance of the Murabaha financing it is very simple to implement. Other financing products like Musharaka need partnership of the bank with the customer which is not supported by the legal framework of the country. Istisna which focuses financing of construction is not supported by the legal framework of the country since the lease system considers interest. Besides, the investment of the bank focuses on priority sectors but these sectors are not supported by regulatory frameworks coming to the IFB investment. In general, the IFB investment during the study period was limited due the gaps in the legal framework of the IFB in the country and the mobilized investable deposit was very limited.

From the findings, the overall profitability performance of the IFB of the Commercial Bank of Ethiopia shows continuous improvement over the four years study period as depicted by the values of the ROA. Based on the findings, though the ROA of the IFB is still very low, there is continuous improvement in the profitability performance of IFB. The study shows that even though the bank had invested at the beginning of the study period, it could not generate any profit to share to the depositors due default of the customer. On the other hand, the Bank had paid Hiba (bonus) to the depositors though it is at loss to keep the image of the Bank. This Hiba along with other operational expenses resulted in incurring loss during 2015.

The study findings revealed that the interest free banking ratio has shown a progressive increase over the four years study period. However, it showed a slight decline in 2018. The declined in IFBR of CBE observed from 2017 to 2018 was as a result of the decline in the income of the IFB during the 2018 fiscal year due to the decline in IFB investment. Thus, the overall interest free banking ratio of the CBE has shown a continuous improvement over the four years study period. These findings are in line with Talamin (2014) and Mabonga (2016).

Based on the findings, loan to deposit of the IFB has shown an increasing trend from 3.08 to 4.85 for the first three years and declined to 1.89 in the year 2018. As a result, the overall liquidity ratio of the IFB has shown a declining trend during the recent years of the study period as a result of the decline of the IFB financing of the Bank that subsequently resulted in the decline of the profitability of the IFB. Liquidity ratio which is the function of the IFB financing and the total deposit of the IFB, the decline of the liquidity ratio in the year 2018 is resulted from the decline of the IFB financing during the year 2018. In general, the average liquidity ratio of the IFB of CBE shows a declining trend over the four years study period. This shows the IFB is highly liquid since majority of the deposits are safe keeping. The findings are consistent with previous studies done by Mabonga (2016), Talamin (2014), Thomi (2014) Khan, and Ahmad, Rahman & Haleem (2018).

The findings of the study further revealed that efficiency ratio of the interest free banking steadily improved from a value of 226.4 in year 2015 to 46.6 in the year 2018. Thus, the overall efficiency of the IFB of the CBE has shown a continuous improvement over the four years study period. This is due to the continuous improvement of the profitability of the IFB.

The study findings also indicated that bank size of the interest free banking steadily increased over the study period. However, the percentage share of the IFB bank size as measured by the total asset of the IFB is entirely dependent on the deposit of customers and it is very low as compared to the total asset of the Bank. Hence, the bank size of the IFB of the CBE has shown a continuous rise through time though it is very low as compared to the total asset of the Bank.

5.3. Conclusion

Based on the findings of this study the following conclusions have been drawn:

- Over the 4 years study period, since the number of branches increased from 340 to 952, the number of windows rose from 352 to 1,045 and the Muslim population to branch ratio continuously improved, the study concludes that the service accessibility of the IFB of the CBE highly increased.

- During the study period under review, since the total IFB deposit of the Bank continuously increased from Birr 1.2 billion to Birr 9.8 billion the study concludes that there is a continuous growth of the IFB deposit of the Bank. On the other hand, based on the findings, as the deposit per branch of the IFB is Birr 10.3 million and since the share of IFB Deposit out of the total deposit of the CBE is only 2.17% at the end of June 2018, the study concludes that the IFB deposit of the CBE is still low as compared to the size of the Bank and its accessibility. This low performance was due to lack of trust of the Muslim society that the bank may invest in prohibited areas, less effort of the bank in promoting its IFB products/services to the society, lack of awareness of the employees of the bank to properly describe the products/services.

- On the basis of the study findings, 93% of the total IFB deposit is the Wadiya Amanah saving deposit has shown a continuous average growth rate of 544.15% over the four years study period. Like the low performance reasons of the IFB deposit of the Bank, the dominance of the Wadiah Amanah deposit was due lack of trust of customers, lack of awareness of customers and employees on the nature of the IFB products, and the bank did not aggressively promote. From this finding the study can conclude that the safe keeping deposit took the lion share of the IFB deposit and other investable type of deposits are very low. Hence the study concluded that the Wadiyah Amana deposit take the lion share of the IFB deposit.

- Based on the study, as the IFB financing of the CBE revealed a continuous increase over the study period, the study concluded that the IFB financing has shown improvement over time. On the other hand, since the IFB financing is entirely dependent on the IFB customers' deposit and the investable deposit is very low, the study concluded that the IFB investment is very low and limited to Murabaha financing though it shows improvement over time. The main reason for the dominance of the Murabaha financing is that it is very simple to implement and due the gaps in the legal framework of the IFB in the country.

- As the overall ROA of the IFB of the Commercial Bank of Ethiopia shows steady increment over the four years study period, the study concluded that the profitability of the IFB of the CBE has shown continuous improvement though it is still low due to the limited IFB investment.

- Since the interest free banking ratio has shown a progressive increase over the four years study period the study concluded that the income of the IFB has shown a continuous improvement.

- During the study period, the overall loan to deposit ratio of the IFB has shown a declining trend. Hence the study concluded that the IFB of the CBE is more liquid since its investment is very limited and the majority of the deposits are safe keeping.

- As the efficiency ratio of the interest free banking steadily improved from 226.4 in year 2015 to 46.6 in the year 2018, the study concluded that the efficiency of the IFB of CBE has shown a continuous improvement over time.

- During the four years period under review, the study findings indicated that bank size of the interest free banking steadily increased. However, the percentage share of the total asset of the IFB is entirely dependent on the deposit of customers and it is very low as compared to the total asset of the Bank. Hence, the research concluded that even though it shows improvement over time, the total asset of the IFB is very low as compared to the total asset of the Bank.

5.4. Recommendations

On the basis of the findings of the study and the conclusions drawn, the researcher has suggested the following recommendations:

- The study found out that though there is improvement in the deposit of the IFB over time, the deposit share per branch and the IFB deposit share of the CBE are still very low as compared to the size of the Bank and its accessibility. In addition, there is huge gap in overall IFB deposit in general and the investable deposits of the IFB since majority of the deposits mobilized are Wadiyah Amanah (safe keeping) deposits. Since the major reason low performance was due to lack of trust of the Muslim society that the bank may invest in prohibited areas, less effort of the bank in promoting its IFB products/services to the society, lack of awareness of the employees of the bank to properly describe the products/services, therefore, the study recommends that the management of the Commercial Bank of Ethiopia should aggressively promote its interest free banking products and services in order to enhance awareness of the public and increase more customers both in deposit and investment. In addition, the bank should exert its effort to enhance the awareness of its employees so that they can properly promote the service.

- The study found out that though the IFB financing of CBE revealed a continuous increase over the study period, it is very low and entirely limited to Murabaha financing. It is also found out that the main reason for the dominance of the Murabaha financing and low financing performance of IFB is due to the gaps in the legal framework of the IFB financing in the country. Hence, the study recommends that the government should revise its regulatory frameworks so as to enhance the IFB financing services. Moreover, the management of the Bank should insist the government to amend its regulatory frameworks.

- Finally, since this study is limited to the IFB performance of the Commercial Bank of Ethiopia, it could not consider the whole banking industry and respective interest free banking performances. Hence the researcher recommends that detail industry wide study should be made to evaluate the overall performance of the interest free banking of commercial banks in Ethiopia.

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Annex 1: Summary of Interest Free Banking Performance Status from 2015 To 2018

S.No	Particulars	YEAR			
		2015	2016	2017	2018
1	Number of Branches offering IFB	340	738	826	952
2	Number of Windows	352	750	838	1,045
3	Number of Customer	105,453	399,234	573,692	893,661
	Qard (Current Account)	1,216	2,670	3,432	4,550
	Wadiya Amana Saving Account	101,411	393,086	566,466	885,888
	Mudaraba Saving Account	2,826	3,478	3,794	3,223
	Mudarabah Time Deposit	-	-	-	-
4	Trade Financing	38,445,686	168,560,399	295,545,261	185,497,812
	Murabahah Financing	38,445,686	115,106,945	141,801,555	149,262,769
	LC murabaha financing	-	53,453,453	153,743,706	36,235,043
	Salam Financing	-	-	-	-
	Istisna'a financing	-	-	-	-
	Ijara (Leasing) financing	-	-	-	-
5	Total Asset	1,248,452,046	3,765,729,456	6,090,617,941	9,814,801,727
6	Total Deposit	1,248,452,046	3,765,729,456	6,090,617,941	9,814,801,727
	Wadiya Amanah Saving Account	1,016,836,796	3,381,372,622	5,569,703,243	9,170,644,458
	Qard (Current Account)	181,133,953	320,789,472	427,358,128	547,350,444
	Mudarabah Saving Account	50,481,297	63,567,362	93,556,570	96,806,825
	Mudarabah Investment Account	-	-	-	-
7	Income/Revenue	2,307,560	7,671,782	23,840,817	21,083,125
	Income from Trade Financing	1,169,594	3,584,810	13,237,503	15,057,171
	Commission Income	1,131,997	4,063,314	10,566,577	5,997,490
	Other Income	5,968	23,658	36,737	28,464
8	Total Expenses	5,225,139	6,323,760	8,728,929	9,815,696
	Salaries and Benefits	4,764,301	2,673,899	4,449,160	5,714,104
	General Expense	460,838	318,442	529,862	1,005,482
	Profit Paid to IFB depositors	-	3,331,419	3,749,907	3,096,111
9	Profit/Loss Before Tax	(2,917,579)	1,348,022	15,111,888	11,267,428

Source: Compiled from Annual Report of the IFB department of CBE

Annex 2: Interview Questions

1. What do you think about the current performance status of interest free banking in Commercial bank of Ethiopia? Is it going as it planned?

2. How do you see the performance of the IFB as compared to its service accessibility?

3. The overall deposit performance of the IFB is very low (only 2.17%) as compared to the capacity of CBE and its branch accessibility. What are the reasons for the reasons for this performance?

4. Majority of the IFB deposit depends on the Wadiyah Amanah (safe keeping) deposit. What is the reason for this dominance and insignificant performance of other deposits?

5. Based on the financial statement report, the IFB financing is very low and limited to Murabaha financing. In addition the IFB financing of the 2018 declined from the 2017 performance. What are the reasons?

6. In the budget year 2015, the IFB department incurred a loss. Why?

7. What can be the reason for the decline of revenue and profit performance of the IFB in 2018?