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ADDIS ABABA UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

Challenges and opportunities of interest free banking in Ethiopia

A Thesis submitted to the Department of Accounting and Finance for the fulfillment of the requirements of the Degree of Master of Science in Accounting and Finance

Tsion Sisay

Addis Ababa, December 2017

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By: Tsion Sisay

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Declaration

I, the undersigned, declare that this study entitled: **Challenges and opportunities of interest free banking in Ethiopia**, is my original work and has not been presented for a degree in any other university and that all sources of materials used for the study have been duly acknowledged.

Candidate's Name: **Tsion Sisay**

Signature/Date _____

Statement of Certification

This is to certify that the thesis prepared by Tsion Sisay, entitled: **Challenges and opportunities of interest free banking in Ethiopia** and submitted in partial fulfillment of the requirements for the Degree of Master of Accounting and Finance complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

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List of Acronyms/Abbreviations **CBE** Commercial Bank of Ethiopia **IFB** Interest Free Banking
IFBW Interest Free Banking Window **MIS** Management Information System **NBE** National Bank of
Ethiopia **PLS** Profit and Loss Sharing **SDD** Special Demand Deposit

ABSTRACT

In order to examine opportunities and challenges adjacent to the growth and development of

interest free banking in the case of Commercial Banks, operating in Addis Ababa, Ethiopia. A descriptive study was conducted on five commercial banks namely Commercial bank of Ethiopia, Oromia International bank s.c, united bank s.c, Wegagen bank s.c and Nib international bank s.c. The population of this study consisted of branches of those commercial banks located in different parts of Addis Ababa city based on their IFB deposit mobilization and number of IFB accounts depending on the information obtained from the IFB divisions on the above banks. Data were collected from a total of 123 respondents by means of structured questionnaires which were distributed to branches and were filled by bank staffs who had the knowledge about interest free banking system. The results revealed that the main challenges in implementing IFB system included lack of awareness by customers about IFB services, institutional, need for special regulations and lack of specialized human resource. In addition, the difficulty in segregation of funds for effective implementation of IFB was another problem expressed by respondents. On the other side, IFB in Ethiopia was believed to still have a huge untapped opportunity to be exploited by other financial services providers which would use customer satisfaction as a niche in offering IFB services. Other potential opportunities mentioned included global trends, economic growth in Ethiopia and within Muslim communities. The findings suggest that the opportunities of interest free banking are more significant than its challenges in Ethiopia. A number of recommendations related with the study findings were forwarded.

Key word: *Interest free banking, banks of Ethiopia, opportunities, challenges, Shariah.*

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Islamic finance also known as interest free banking has grown rapidly over the past decade, and its banking segment has become systemically important in a dozen countries in a wide range of regions. 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. It is also fueled by the large savings accumulated by many oil-exporting countries that are seeking to invest in Shari'ah-compliant financial products.

The growing reach of Islamic finance promises a number of possible benefits. For example, it is often argued that Islamic finance is inherently less prone to crisis because its risk-sharing feature reduces leverage and encourages better risk management on the part of both financial institutions and their customers. It is also argued that Islamic finance is more stable than conventional finance, because: (i) Islamic finance involves prohibitions against speculation; (ii) financing is asset-based and thus fully collateralized; and (iii) it is founded on strong ethical precepts. Moreover, Islamic financial institutions (IFIs) are considered to be a good platform for increasing access to financial inclusion, including access to finance for SMEs, thereby supporting growth and economic development (IMF, 2015).

Nonetheless, Islamic finance faces a number of challenges. For example, despite the efforts of Islamic finance standard setters, in many countries the industry is governed by a regulatory and supervisory framework developed for conventional finance. Therefore, it does not fully take account of the special nature of Islamic finance (Al-Maraj, 2014). The industry is still largely a nascent one, lacking economies of scale, and operating in an environment where legal and tax rules, financial infrastructure, and access to financial safety nets and central bank liquidity are either absent or, if available, do not appropriately take into account the special characteristics of Islamic finance (Askari et al 2010; Ernst and Young, 2014; IFSB, IsDB, and IRTI, 2010).

National Bank of Ethiopia (NBE) has authorized banks to undertake IFB business in year 2011 following this authorization banks have started IFB services in year 2013. According to Sefiani (2014), for the sizable Muslim population in Ethiopia, there is a need for adequate banking services to serve this segment of the population. Currently, 18 private and government owned banks are operating in Ethiopia more than seven banks have adopted the IFB system. These include Commercial bank of Ethiopia (CBE), Nib international bank S.C, Oromia international bank S.C, United bank S.C and Wegagen bank S.C. They are the first banks to have started Interest free banking service as per the requirements (www.nbe.gov.et).“Interest free banking” refers to a system of banking or financial activity that is compliant with Shariah principles and guided by Islamic economics which prohibits the collection and or payment of interest as well as engaging in activities forbidden by Shariah (www.orointbank.net). In fact, Interest free banking provides profit-sharing investment accounts to the depositors. These depositors are not assumed to share the profits/losses of the bank but neither fall in to the category of the capital of the bank nor can be regarded as liabilities of the bank, in the accounting sense of the term (Elgar, 2009).

One of the services offered by Ethiopian banks includes profits/losses sharing banking service. This service needs careful screening because of the danger of adverse selection, and careful monitoring as this may lead to the problem of asymmetric information and moral hazard. One factor contributing to adverse selection is that in a mixed financial system with both Interest free and conventional banks, entrepreneurs may not like the idea of profit sharing if they have rosy expectations of the success of their ventures whereas they may prefer profit-sharing finance from Interest free banks if they are less sure of a positive outcome. This might burden Islamic banks with a disproportional share of bad debts (Khan, 2010). This research attempts to understand the opportunities and challenges attached to interest free banking in Ethiopia by using the case of 5 commercial banks operating in Addis Ababa.

1.2 Statement of the problem

According to IMF (2015) interest free banking has the potential to contribute in at least three dimensions. First, it promises to foster greater financial inclusion, especially of large underserved Muslim populations. Second, its emphasis on asset-backed financing and risk-

sharing feature implies that it could provide support for small and medium sized enterprises (SME), as well as investment in public infrastructure. Finally, its risk-sharing features and prohibition of speculation suggest that Islamic finance may, in principle, pose less systemic risk than conventional finance. However, for this potential to be realized, and to allow this industry to develop in a safe and sound manner, a number of challenges need to be addressed (IMF, 2015).

The Central Statistics Agency (CSA, 2007) of Ethiopia reported that the Muslim population consisted nearly twenty one million of the total population of the country which is nearly 34% of the total population, but until 2011 there was no specific service for Muslims who wanted to perform their business according to their faith. These factors have consequently inhibited a good number of potential customers from doing business with the banks available in the country because those people considered the services offered by the banks as against their religious faith.

Numerous researches on the prospects, challenges, operational and risk aspects of Interest free banking in developed and emerging market countries are available. However, due to its novelty to Ethiopia the concept is not yet well researched and the literature is still few. Among these studies Mohammed in 2012 has studied the Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia" in his work discusses the potential challenges as: 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 with specific religion and the global terrorism but This study was conducted before the practical introduction of the IFB in Ethiopia . Therefore, it was not based on actual observation of facts. And also Akmel Hailu's (2015) study is about "challenges and prospects of Islamic banking for resource mobilization in Ethiopian commercial banks. "The study focuses on challenges and opportunities of IFB only on resource mobilization other challenges and opportunities are not well addressed. On the other hand a research by Debebe Alemu (2015) who studied the factors affecting customers' use of IFB in Ethiopia and found out that 100% of IFB account holders were all Muslims. Evidently, the failure of banks to meritoriously serve the Ethiopian Muslim population hinders the development of the Muslim inhabited areas in particular and the economy of the nation as a whole. This study is about impact assessment on the attitude towards IFB usage which does not address the current problem at hand. And also Teferi's (2015), study is about "Contribution of IFB to economic development and its prospect in Ethiopia". The contribution

of the study includes assessing the Muslim population in to the banking (financial system) to the economic development and GDP growth. This study has a gap of taking the realities of other countries and in Kerima Ali Mohammed's (2016) study which is about "Challenges on Interest Free Banking Services" The study discusses the challenge faced by service providers and users of IFB products and scope of service provided by Ethiopian banking through IFB including whether there is unmet demand of users, awareness of customers and capacity of bank .the study doesn't addressed the opportunities of interest free banking as a new business strategy in Ethiopia. This, study, therefore, attempts to fill the above research gap by investigating the challenge and opportunity of interest free banking from the service provider's view.

Therefore, as the idea of interest free banking is still new for the economy, new for the society, and new even for business practitioners it is necessary look at the opinions regarding services and products offered under Interest free banking by Ethiopian commercial banks and their regularity with the original Interest free banking law.

It is equally important to ascertain the challenges and opportunities surrounding the practice of IFB so as to formulate alternative solutions for its effectiveness. This study tried to analyze the above mentioned points by considering the case of five commercial banks operating in Addis Ababa, namely Commercial Bank of Ethiopia, Oromia International Bank, Wegagen Bank, NIB international Bank and United Bank which are one of the first banks to start interest free banking in Ethiopia and who starts working as a division level.

1.3 Objectives of the study

1.3.1 General objectives

To assess opportunities and challenges adjacent to the growth and development of interest free banking in the case of Commercial Banks, operating in Addis Ababa, Ethiopia.

1.3.2 Specific objectives

Specifically this study endeavors to fulfill the following specific objectives:

1. To describe the situation surrounding Interest free banking services and products in selected Ethiopian commercial banks and their orderliness with the original Interest free banking law.

2. To assess opportunities of Interest free banking system and whether its services.
3. To identify the challenges encountered by commercial banks when implementing Interest free banking service.

1.4 Research questions

1. What is the situation surrounding provision of Interest free banking services and products in selected Ethiopian commercial banks and whether they are in conformity with the original Interest free banking law?
2. What are the opportunities of Interest free banking system in Ethiopia?
3. Will the introduction of Interest free banking have positive impact?
4. What are the challenges faced by commercial banks when implementing Interest free banking service?

1.5 Significance of the study

This study tackled the challenges and opportunities of IFB system from the service providers point of views. Hence the present study is expected to fill that gap by giving first hand information on such as an important topic. It is expected to contribute both theoretically and practically. Theoretically, the findings of this study contributes by filling an important gap to serve as a reference material to the existing body of the literature and initiate other interested researchers. On the practical side, this study provides an opportunity to acquire knowledge and practical experience for the researcher, but also to bank managers (both governmental and private banks), bank policy and decision makers to identify and understand the challenges and prospects of Interest free banking services. Moreover, the result of the study would contribute by providing case specific evidences on the probable situation faced by Ethiopian Banks that are offering interest free banking services.

1.6 Scope of the study

In order to conduct the study in depth given the time and resources available, this study focused only on purposively selected sample respondents who were working in five commercial banks namely Oromia international bank S.C, Commercial Bank of Ethiopia, NIB international bank

S.C, United bank S.C and Wegagen bank S.C. These five banks were chosen because they are the leader to start the IFB delivering service in Ethiopia. The data were collected from employees, managers, supervisors of the five banks from their selected branches based on high number of IFB users and deposit mobilization.

1.7 Limitation of the study

This study focuses on finding the existing situation of five commercial banks operating in Addis Ababa, Ethiopia which offer IFB services to their customers. Information was collected from 123 branches in Addis Ababa. The study was conducted from the service provider's point of views its analysis is limited to describing the existing situation related with IFB services and products.

1.8 Organization of the paper

This paper is organized into five chapters. The first chapter deals with presenting the background and the statement of the problem under investigation, followed by the objectives and questions to be answered in the course of the study. The second chapter presents extensively the reviewed literature related with interest free bank banking system and also includes the conceptual framework followed throughout this study. Chapter three presents the description of studied banks and the methods used to meet the objectives of the study. Chapter four presents the results of the analysis and discussion. The last chapter provides the conclusion and recommendations drawn from the findings.

CHAPTER TWO: LITERATURE REVIEW

2.0 Introduction

This part of the study attempts to present a brief theoretical framework, views of different scholars which are one way or the other pertinent to the study as well as ends with presentation of the knowledge gap in Ethiopia banking industry and conceptual framework are presented in this section.

2.1 Theoretical and conceptual review

2.1.1 Concepts and definition of Interest free Banking

Many scholars gives various meaning to this term Interest free banking. It refers to a system of banking or banking activity that is consistent with the principles of the Shari'ah (Islamic rulings) and its practical application through the development of Interest free banking economics. The principles which emphasize moral and ethical values in all dealings have wide universal appeal. Shari'ah prohibits the payment or acceptance of interest charges for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles.

While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Interest free banking was formed to provide an alternative basis to Muslims although Interest free banking is not restricted to Muslims. (www.islamic-banking.com). According to Yahiya Abdul-Rahman, (2010), Interest free banking 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. Many participants in Interest free banking business thought with good intentions that these guidelines made the contract Interest free.

Interest free banking according to Sandrararajan, (2011) consists of mobilizing funds through noninterest bearing deposits and through investment deposits based on “profit-sharing and loss-bearing” contracts and channeling these funds to finance permissible (under the Shari’ah law) investments activities, using various forms of Interest free finance contracts. Interest free banking as described according to Yahiya Abdul-Rahman, (2010) as a system of banking that mobilizes saving on the basis of profit and loss sharing that is considered to be fairer and more conducive to measurement and development. Owing to the growing demand by the Muslim population in Western countries and also to the increasing interest of Islamic investors to diversify geographically their portfolios, conventional banks are increasingly becoming interested in entering the market of interest free financial products (HassenandLewis, 2007)

Interest (Riba)

Interest is the component in the banking concept. According to Mohammed and Mahdi, (2010) interest is one of the most effective factors for deciding to deposit in banking system. Herald and Heiko, (2009) also mentioned interest as one of the determining factor for commercial bank deposit and it is important element of Interest free economic society. All covers the meaning to load additional money on funds lent to borrower. In addition to this Iqbal and Mirkahor, (2011) interest simply refers to the “premium” that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in the duration of loan. Interest is a contractual instrument by which the lender collects a predetermined interest added to the principal amount it has lent out. The principal amount can be money, gold, silver, or tangibles including wheat, barley, etc. (Qasaymeh, 2011)

Prohibition of interest

Prohibition of interest is any unjustifiable increase of capital, whether in loans or sales, it is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal that is, guaranteed regardless of the performance of the investment is considered interest and is prohibited (Iqbal and Mirkahor, 2011).

2.1.2 Interest free banking models

Interest free window service

According to Juan Sole, (2007) an interest free banking window is simply a window with a conventional bank via which customer can conduct business utilizing only sharia compatible instruments. Sanusi (2011) defines interest free banking window as a business model in which conventional banks offer interest free banking products and services from their existing branch network. In short, interest free banking window refers to a situation whereby a conventional banking system provides some of the interest free banking products or services. In other words, it can be seen as a banking system that meets up only the profit, loss, and risk sharing principle of interest free banking for some of its products. (Audu and Mikailu, 2014)

Subsidiary/branch Interest free banking service

The commercial banking unit, which offers shari'ah compliant products and services only in the specific branch. It is a semi-independent office of a bank engaging in banking activities such as accepting deposits or making loans at facilities away from a bank's home office. This branch banking established when the main bank feels there is a potential of concentrated customers are found in the area want to serve these customers.

Full-fledged Interest free banking service

Once a conventional bank has operated an Interest free window for some time and has gathered a sizeable customer base for its Interest free banking service activities, it may decide to establish an Interest free subsidiary, or even fully convert into a full-fledged Interest free bank. By following either of these two routes, the bank may benefit from economies of scope and concentration of knowledge and expertise. The bank will be able to offer a wider range of Shariah-compliant banking products than through the Islamic window alone. For example, it may be better equipped to fully engage in Islamic investment banking activities, such as underwriting

sukuk (bond) issuances or managing Shariah-compliant investment and hedge funds, or to manage its own treasury and money market operations (Sole, 2007).

2.1.3 Sources of Funds for Interest free banks

Interest free banking institutions utilize various mechanisms for mobilizing funds from the general public, depending on the institution's organization, geographic location, market strategy, capital resources and charter. (Delwin A. Roy, 1991:438) Interest free banks are deposit-taking institutions but do not pay interest on deposits. Their sources of funds classified as either include shareholder investments, savings accounts, current accounts, and investment accounts. The source of funds in Interest free banks can be used for borrowing by corporate investors to fund specific project (Bala et.al (2009: 24)

Shareholder Funds

An Interest free bank may raise an initial equity funds by following the principles of musharaka (equity participation) under this principle, the capital owners enter in to a partnership with the bank by contributing equity in return for a share of banks profit or loss on the basis of predetermined ratio (Bala et.al (2009: 23).

Wadiah saving accounts

Interest free banks offer saving account with an aim of drawing in and persuading depositors to enjoy this safe keeping facility. Bank customers normally choose saving accounts because of fulfilling precautionary motives (Haron& Wan-Azmi, 2008).Interest free banks practice the principle of wadia in operating customer saving account. The bank may request permission to use customer funds deposited in these accounts as long as these funds remain within the banks discretion. The bank does not share with the customer profit earned from the use of customer funds deposited in these accounts funds but does guarantee the customer deposits. The bank however reward customer with gift as a token of its appreciation for being allowed to use the funds (Bala et. al (2009: 25).The situation is very different in the Interest free banks. Here too the

depositor's first aim is to keep his savings in safe custody. Interest free banks divide the conventional savings account into two categories. Savings account and investment account.

The investment accounts operate fully under the PLS scheme capital is not guaranteed, neither is there any pre-fixed return. Under the savings account the nominal value of the deposit is guaranteed, but they receive no further guaranteed returns. Banks may consider funds under the savings accounts too as part of their resources and use it to create assets (Abdul-Gafoor, 1995:14). This is theory in practice; however, the banks prefer, encourage and emphasize the investment accounts. This is because since their assets operate under the PLS scheme they might incur losses on these assets which losses they cannot pass onto the savings accounts depositors on account of the capital guarantee on these accounts. In the process the first aim of the depositor is pushed aside and the basic rule of commercial banking capital guarantee is broken (Abdul-Gafoor, 1995:14).

Current Accounts

The current account is a deposit account that can be used for business or personal purpose and like a saving account. Account holders are not guaranteed and return for keeping their funds with the bank, but they may be rewarded a gift. The primary distinction between current account and saving account is that the minimum balance limits and withdrawals are more flexible for current accounts (Bala et.al (2009: 25). In addition to this according to Haron& Wan-Azmi, (2008) current accounts also known as checking accounts, meaning cheque is used to make several type of payments. Current accounts are demand deposit accounts kept with the bank on custodial arrangements and are repayable in full on demand. Current accounts are based on the principle of wadia (trust or safe keeping) or amanah (trust), creating an agency contract for the purpose of protecting and safekeeping the depositor's assets (Iqbal and Mirkahor, 2011:154).

Investment account deposits

According to Tabir, (2007:81) Investment deposits represent the case when owners of the fund seek a return on their funds and are willing to spare these funds for an agreed period. These accounts also operate on the principle of mudarabah, but the modes of investment of the funds

and distribution of the profits are customized to suit the needs of the clients. In general, these accounts are linked to special investment opportunities identified by the bank. These opportunities have a specific size and maturity and result from the bank's participation in a pool of investment, private equity, joint venture or a fund (Iqbal and Mirkahor, 2011:154).

Investment deposits can have various deposit arrangement options:

(a) Investment deposit under Mudarabah Option

A mudarabah transaction requires that the contract be explicit on the following matters: goal or purpose of the mudarabah, its tenure, role function of the concerned parties, profit-sharing ratio, principle for sharing losses, the extent to which indebtedness can be created in the name of the mudarabah and the principle for final settlement There can be more than one line of mudarabah deposits in order to address diverse goals and concerns of the depositors. Each such line of deposits can be for a distinct purpose, and has separate starting and maturity dates. (Sayeed, 2007:87)

(b) Investment deposit under Musharakah deposit option

Investment accounts operate on the principles of (profit sharing). With this option the banks accepting deposits from investors for either a fixed or unlimited period of time. The accounts are also known as profit and loss sharing accounts. Musharakah option can be construed as sharing in both capital and effort (Bala et.al, 2009).

(c) Investment deposit under Ijara Option

According to this option, ownership of funds always remains with the depositors, and is at no stage shared with the banks (as opposed to the case of mudarabah or musharakah) or transferred to them (as in the case of a loan). The banks come in the picture as manager of depositors to administer the funds. Under these circumstances, owner of the funds and, hence, all profits belong to the depositors. The banks would be entitled to a fee.

2.1.4 Uses of financial resources in Interest free Banking

Financial intermediation is the major function of modern banking system. Financial intermediation means taking funds from people who have more than they need at this juncture in time and providing those funds to persons who need them for their economic transactions and activities. (Hassen and Lewis, 2007:279)

According to Yahiya Abdurahman, (2010) Interest free banking pays close attention as to whom and what to finance. Interest free banks (IFB) do not finance for example alcohol and gambling related businesses, such as liquor stores or gambling casinos. It also does not finance environmentally irresponsible companies and businesses that are not fair to their employees. IFB does not finance speculative activities that are focused on making money out of money, based on speculations in the different financial, commodities, and real estate markets. It is community banking at heart. It believes in community development. It considers its role to be a qualified professional entity that is sound, safe, responsible, and trustworthy to attract the deposits and savings of the community. (Abdulahman, 2010:198). Offer a broad spectrum of financial structures ranging from simple sharia complaint retail products such as saving and current accounts to leasing trust finances and large scale infrastructure financing. (Bala et. al, (2009: 26)

Murabah Financing

Murabah financing is a popular method used by interest free banks to meet short term trade financing needs for its customers. It is often referred to us cost Plus-financing or mark up financing. In this type of financing the bank agrees to fund the purchase of specific asset or goods from a supplier at the request of customers up on acquiring the asset, the bank sells it to the customer at the predetermined mark up. Murabah financing is the back bone of contemporary interest free banking (Balaet.al, (2009: 30). An advantage of murabah is that an interest free bank is usually rigorous financially than its customers, so it can obtain discounts on purchases for its clients. When goods are purchased for several clients at one time, the discount may be larger, this controls costs for clients and contributes to the overall success of murabah(Roy, 1991:434).

Musharakah Financing

Musharakah is a type of partnership financing in which one of the partners is an interest free bank. Profits and losses are shared on predetermined formula. Profit sharing need not be based on the proportion of the shares owned, but liability of loss is limited to the contributions of the shareholders. In other words, investors cannot be liable for more than the amount of capital they invest in the partnership. (Shanmugan and Gupta, 2007) Musharakah is an Arabic word which means sharing, and relates to the sharing of profits or losses resulting from joint ventures or partnerships. In the business environment musharakah is a partnership contract based upon equity participation, by which partners provide capital under joint venture. The sharing of profits and losses resulting from such partnerships is pre-determined and partners may co-manage the enterprise. The bank may act as a passive partner while the customer manages the venture (South Africa art; 281:35)

Mudarabah Financing

It is a commercial activity in which an Islamic bank entrusts funds to an entrepreneur. Which is also known as trust financing? The arrangement enables the entrepreneur to carry out business projects. Profits are distrusted between the bank and entrepreneur on predetermined ratio. All losses are born by the supplier of the fund (bank) as long as there has been negligence on the part of the entrepreneur (Bala et.al (2009: 34).

Ijarah

Ijara means to give something on a lent. Under the ijara arrangement the bank purchases a tangible asset based on the clients' specification and leases it to the client. The bank gives the right to use the asset to lessee as well as physical position of the asset. In return the lessee makes rental payments based on the agreed schedule. Up on the expiration of the lease the lessee returns the asset to the bank (lessor). Ijara is typically used for high cost assets with long life span (Bala et.al (2009: 32).

According to Delwin A. Roy, (1991:434) Ijara is a source of short or medium-term finance that is used by businesses in fields such as construction, for the financing of heavy machinery or other equipment. The bank purchases goods such as construction equipment and then leases them to the client on a specified sum, fixed-period basis. Monthly payments by the client are fixed at rates which cover all or most of the original purchase price of the item over the period of the contract. A contract can incorporate both Murabaha and Ijara if the eventual sale to the client is agreed upon at the time the original contract is made.

Bai' bithman Ajil (BBA)

Bala et.al (2009: 28) defines bai' bithmanajil is the sale of goods by the bank to a customer on a deferred payment basis over a specified period at a price that included a markup or profit margin agreed to by both parties. Bai' bitmanajil plan is commonly used for financing the purchase of real property, vehicle or consumer goods.

Al-Ijarathumna al bai (AITAB)

Financing on this modality essentially an ijara (leasing) contract combined with bai-purchase contract. Under the first contract, the purchaser (customer) leases the goods from the owner (the Bank) at an agreed rental price for specified period. Upon expiration of the leasing, the purchaser enters into a second contract to purchase the goods from the owner at an agreed price (Bala et al (2009: 34).

Istisna

In istisna financing, a commodity is purchased or sold before it comes in to existence, which is an exception to the sharia principle requiring that an underlying asset be present in order for a financial transaction to be taken (Bala et al (2009: 34),

Tawaruk

In this structure the bank directly or indirectly buys an asset and immediately sells it to a customer on a differed payment basis. The customer then sales the same asset to a third party for immediate delivery of and payment (Bala et al (2009: 34).

Bai Salam

Financing is a forward financing transaction frequently used in the agriculture industry. In this structure, the bank purchases specified asset in advance of a predetermined delivery date. Typically the bank receives a discount for the advance payment plus a profit margin (Bala et al (2009: 34).

Qard Hassen

This refers a gratuitous, or charitable, contract in which the borrower is required to repay only the amount borrowed with no profit (mark up) to the lender. It is a form of benevolent financing extended on a good will basis. Quad hassen literally mean good loan (Bala et al (2009: 34).

2.1.5 Principles of interest free Banking Service

According to Bala et.al, (2009) interest free finance is based on the themes of community banking, ethical banking, and socially responsible investing. Its goal is to be an ethical, indigenous, and equitable mode of finance. The six key principles that govern interest free are as follows.

Freedom from interest /segregation of funds

The Quran, the Muslim holy book, expressly forbids Interest, which includes any payment of interest (not only excessive interest) on monetary loans. A loan with a fixed return to the lender regardless of the outcome of the borrower's course of action is viewed as unfair. Interest is also believed to be exploitative and unproductive because it is considered to represent sure gain to the lender without any possibility of loss as well as a reward in return for no work. These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation. (Bala et.al, (2009)

Risk-and-Return Sharing

The profit and loss sharing is related to the principle that profits are distributed according to contractually agreed shares but liability to losses should be proportionate to the capital contribution (Monzerkahf and khan, (1992). Risk sharing principle applied because interest is prohibited, pure debt security is eliminated from the system and therefore suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses (Iqbal&Mirkahor, 2011).

An interest free banking service provider shares in the profit and loss of each borrower's business transaction. In turn, the bank divides its share of profits and losses with its general and special investors who have deposited funds in the bank. (Bala et.al, 2009) Shari'a prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards between the parties to a transaction. This profit-sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a creditor-debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is that such increases in successful projects also provide stimulus to the economy. (Bala et.al, (2009)

Shari'a-Approved Activities

Interest free banking service providers may engage in or finance only activities that do not violate the rules of Shari'a. To ensure that all products and services offered are Shari'a compliant, each interest free banking service has an independent Shari'a supervisory board.

Sanctity of Contract

Yahiya Abdul-Rahman, (2010:200) explains that Interest free banking service providers cannot finance alcohol-related businesses, gaming, gambling, polluting businesses, or other unethical activities. They finance businesses in a fair and just way and serve all customers of all background.

Prohibition of speculative behavior

An interest free financial system discourages hoarding and prohibits transactions featuring extreme uncertainty, gambling, and risk. (Iqbal and Mirkahor, 2011:10) interest free views contractual obligations and the related full disclosure of information as a sacred duty. Full disclosure is intended to reduce financial speculation (gharar), which is strictly prohibited by

Islam, by providing as much information as possible for investors to make accurate assessments about the risks and rewards of an investment. The conditions that are necessary for a contract to be valid include a competent understanding of the underlying asset(s) and the profit-sharing ratio, as well as the presence of a willing buyer and seller. Contracts must also not offend Islamic religious and moral principles; if they do, they are considered as illegal and unenforceable. (Bala et.al, (2009: 7-8)

Segregation of Funds

An important principle behind interest free finance is the desire to maintain the moral purity of all transactions. The funds intended for Shariah-compatible investments should therefore not be mixed with those of non-Islamic investments. This requirement is not based on the assumption that the activities of non-Muslims are intrinsically impure. The rationale behind this principle is rather one of prudence, in the sense of taking all the necessary precautions to ensure that interest free funds do not become mixed with other funds that may be involved with Riba, Gharar, or haram activities.

Therefore, in order to ensure compliance with Islamic principles, conventional banks wishing to offer IB products must guarantee and publicize that the funds devoted to conventional activities will not be mixed with those destined for Islamic activities. In operational terms, this requires that banks establish different capital funds, accounts, and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, to a large degree, it is in fact establishing a separate entity from the rest of the bank (Sole, 2007: 5).

2.1.6 Opportunities to interest free banking

Interest free banking operation now exists in about 100 countries worldwide and is said to be growing at 10-15% a year. In Africa, with a well over 40% of the population constituting Muslim society, the interest free banking business has spread out quiet quickly as the target community eagerly awaited its introduction into the markets (NIB, 2015).

The current trend seems to be toward separation between interest free and conventional banks. Some countries have opted for a clear separation between these banks, while others have allowed conventional banks to set up Islamic windows, opening the way for some of the largest multinational banks to participate. Even large conventional banks in United States and Europe have opened Islamic financing windows (IMF, 2005).

According to Nuri Hussein, the acting director of the OIB, interest free banking department the newly-introduced Islamic banking is booming in Christian-majority Ethiopia. OIB managed to mobilize 300 million Birr within two months, have more than 4,000 customers, who have deposited in the Islamic banking program and Customers are now depositing on average 2-2.5 million Birr on daily basis (DireTube.com).

2.1.7 Challenges faced by Interest free banking

In interest free banking system there is a serious shortage of scholars and qualified managers. Unfortunately the managers are not well trained in the use of interest free financial practices. Interest free banking in western countries especially in UK is facing the problem of legal system because Interest free banking not yet proper regulated due to this there is possibility to create tension between Interest free banking and regulators. It is fact that interest free banking is not well regulated at the moment because they have not a strong branch network. Islamic bank of Britain has only eight branches around the UK (www.islamic-bank.com).

In conventional system, long-term finance is provided through long-term bonds and equities. Apart from the general public, the most important source of these long-term investments is investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, their need for equity markets is much higher. On the top of it, the most of the products in Islamic banks are based on goods and commodities while prices and currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of Salam and Istisna'a. To hedge the risk, they are in need of derivative products and consequently of Future Exchanges (Abdul Jabbar P. 3).

As to Ephrem Mekuria, communications manager of CBE & Taye Dibekulu, president of UB, He explained to Addis fortune Magazine, that the customers are increasing in number; however lack of awareness from potential customers and the absence of a highly qualified workforce in the area are the major challenge in interest free banking. Also according to Andualem Hailu, planning and research manager at Awash International Bank, there are some contentious issues, like double-taxation and calculations of taxes on the investments and the bank which needs to be clear in the process (www.Addis Fortune.net may 18 2014).

2.2 Empirical Evidences

2.2.1 Empirical Evidences General review

Abdulmajid et.al (2015) wrote about the efficiency in interest free banking and conventional banking an international comparison investigates the efficiency of interest free banks and conventional banks using an output distance approach. They obtained measures of efficiency after allowing the environmental influences such as country microeconomic conditions accessibility of banking services and the bank type. The parameter estimates highlighted that interest free banking appears to be associated with higher input usage.

Furthermore, by allowing for bank size and international differences in the underling inefficiency distributions, it demonstrated statically significant differences in inefficiency related to these factors even after controlling for specific environmental characteristics and interest free banking. Due to this interest free banks are found to have high returns to scale than conventional banks. While this suggests that interest free banks may benefit from increased scale, they emphasis and the results suggest that identifying and overcoming the factors that cause interest free banks to have relatively low potential output for a given input usage levels will be the key challenges for Islamic banking in the coming decades (Abdulmajid et.al,2015).

Ismaeil, et al. (2015) showed the recent development of insolvency of many conventional banks made by the Central Banks to initiate the acquisition of some banks while others were ordered to merge. This was a strong signal to seek for alternative banking system. However, the advocacy for the Islamic banking system as alternative to conventional banking system has been received

with mixed feelings. He also posited that awareness, manpower, legal framework, societal belief, cash requirements were some of the challenges while economic growth, attraction of investors, and fostering of egalitarian society are the likely prospects for the establishment of the interest free banking. He concluded that interest free banking system hold a potential to transform all sectors of the economy with eradication of poverty, equitable distribution of income and employment opportunities in the country through effective mobilization and allocation of capital.

Roddney Wilson, (2010) indicated that interest free banking finance has become increasingly significant in financial centers in the West, notably London, despite the regulatory hurdles presented by operating in a non-Muslim financial environment. At the same time interest free financing methods are viewed as a challenge and opportunity by Western bankers, many of whom have sought to get involved in this growing industry. In client driven societies there is willingness by those in financial services to listen and learn from the experiences of interest free banks, which in the longer run may bring a major breakthrough for interest free banking at the retail level in the West.

Hanudin Amin, (2013) in his article of some view points of interest free banking retail deposit products in Malaysia indicated that those products were centered on the current accounts, saving accounts and investment accounts. These deposit products are examined in terms of their definitions, features and calculations. On the same note, some discrepancies between deposit facilities offered by interest free and conventional banks are exposed. The purpose of such exposition was to provide to novice readers a basic but profound explanation concerning the difference between the two categories of deposit facilities.

2.2.2 Empirical Evidences in Ethiopian Context

In Ethiopia, IFB is a recent phenomenon. As a result, there is little empirical literature on the area. The studies conducted so far include the following: Among these studies Mohammed in 2012 has studied the Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia“ in his work discusses the potential challenges as: 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 with specific religion and the global terrorism but This study was conducted before the practical introduction of the IFB in Ethiopia .

Therefore, it was not based on actual observation of facts. And also Akmel Hailu's (2015) study is about "challenges and prospects of Islamic banking for resource mobilization in Ethiopian commercial banks. "The study focuses on challenges and opportunities of IFB only on resource mobilization other challenges and opportunities are not well addressed. On the other hand a research by Debebe Alemu (2015) who studied the factors affecting customers' use of IFB in Ethiopia and found out that 100% of IFB account holders were all Muslims. Evidently, the failure of banks to meritoriously serve the Ethiopian Muslim population hinders the development of the Muslim inhabited areas in particular and the economy of the nation as a whole. This study is about impact assessment on the attitude towards IFB usage which does not address the current problem at hand. And also Teferi's (2015), study is about "Contribution of IFB to economic development and its prospect in Ethiopia". The contribution of the study includes assessing the Muslim population in to the banking (financial system) to the economic development and GDP growth. This study has a gap of taking the realities of other countries and in Kerima Ali Mohammed's (2016) study which is about "Challenges on Interest Free Banking Services" The study discusses the challenge faced by service providers and users of IFB products and scope of service provided by Ethiopian banking through IFB including whether there is unmet demand of users, awareness of customers and capacity of bank .the study doesn't addressed the opportunities of interest free banking as a new business strategy in Ethiopia. This, study, therefore, attempts to fill the above research gap by investigating the challenge and opportunity of interest free banking from the service provider's view.

2.3 Summary

The reviewed literature was on different aspect of Interest free banking mainly about concept and practice of interest free banking. It was highlighted that the Ethiopian population is one of the fastest growing populations in the world and the Muslim community was a great proportion of that growing population. Though the introduction of interest free banking in the county was found to be a very great achievement for the development of the country's economy however, few researches had given attention to understanding this concept in the Ethiopian context. It was found out that the few researches dealt with factors affecting consumers to use IFB, this study provides information relevant to the understanding of the customers' side. However, no study

had considered the challenges and opportunities of IFB system from the service providers' point of views. Hence the present study is expected to fill that gap by giving first hand information on such as an important topic.

2.4. Analytical conceptual framework

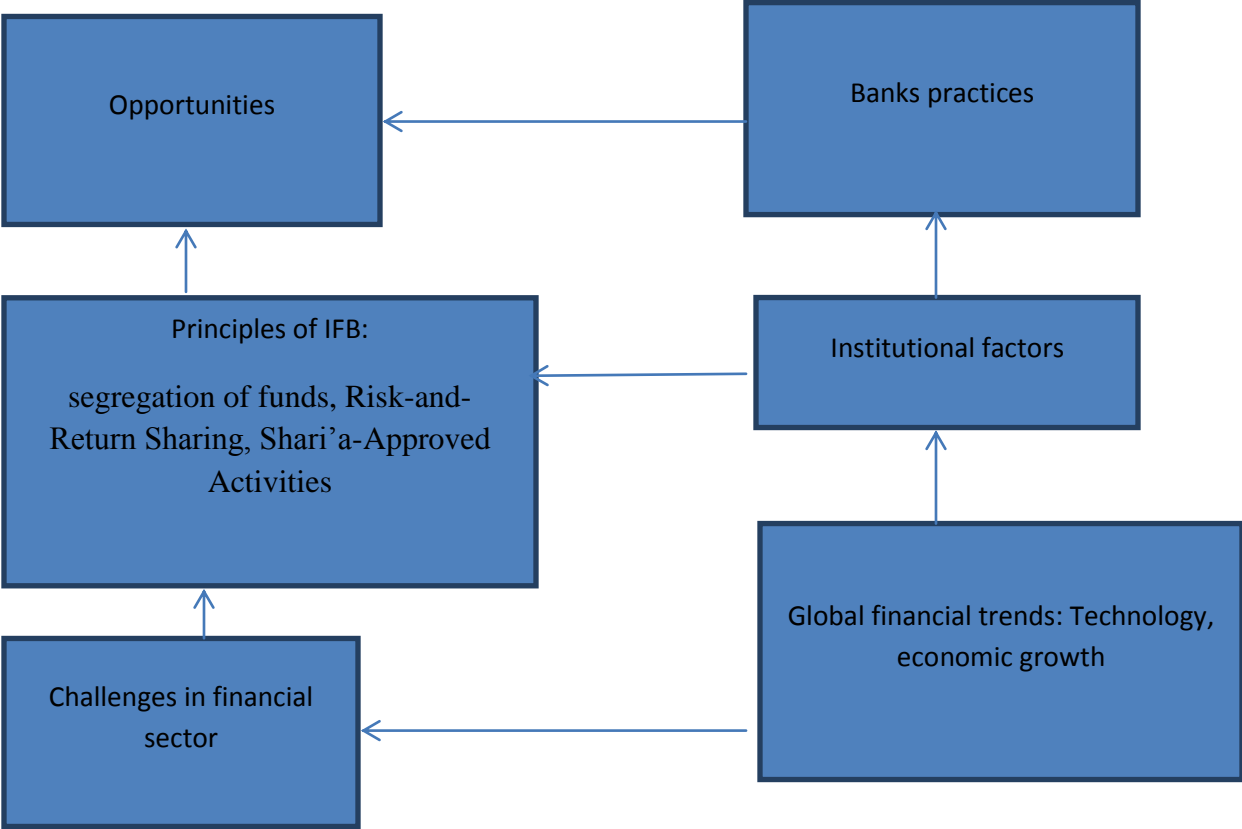


Figure 2.1 Analytical framework of the study

Source: Author, 2017

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This part of the study attempts to explain the research methods and tools that were applied to collect and analyze information gathered from a sample of five commercial banks found in Addis Ababa.

3.2 Description of area under study

This study involved 5 banks that are involved in provision of services related with IFB system. Those are Commercial Bank of Ethiopia (CBE), Oromia International Bank, NIB international bank, Wegagen Bank and United Bank. The number of customers using IFB from these banks are 32,000 people; 25,000 people; 10,000 people; and 11,000 people from CBE, OIB, NIB, Wegagen and United bank respectively.

The financial services by these banks are almost the same and range from: 1. Wadiah amanah (saving with guarantee) 2). Amanah (qard) current account, 3) Mudharabah (profit sharing saving account), 4) Mudharabah (profit sharing fixed time deposit account)

Trade partnership financing include: 1) Murabah, 2) salam, 3) Istisana, and 4) Ijara

3.3 The Research Design

In order to achieve the main objective of the study a descriptive and explanatory research design was used to gather as much information as possible to show the challenges and opportunities of Interest free banking service of Ethiopian commercial banks. According to Ghauri and Gironhaug, (2005) the basic difference between the three main classes of research designs are exploratory, descriptive and explanatory. The research can be exploratory when it deals with unknown problem, Descriptive when there is an awareness of the problem and explanatory when the problem is clearly defined.

3.4 Population and Sampling techniques

The present study considered a sample of five Ethiopian commercial banks based on the fact that they offer IFB services. The sample representative from each bank and category was computed by due to strong relationship with the subject under the study.

As Kothari (2004) if the total area of interest happens to be a big one, convenient way in which a sample can be taken is to divide the area into a number of smaller non overlapping areas and when the cluster sampling unites do not have the same number or approximately the same number of elements, it is considered appropriate to use a random selection process where the probability of each cluster being included in the sample is proportional to the size of cluster.

Table 3.1 Sample Size Determination method

Number of branches in Addis Ababa	51-90	91-150	151-280	281-500	501-1200	1201-3200	3201- 10000	10001- 35000	35001- 150000
Small	5	8	13	20	32	50	80	125	200
Medium	13	20	32	50	80	125	200	315	500
Large	20	32	50	80	125	200	315	500	800

Source: Adapted from Carvalho, 1984

The researcher used cluster sampling by dividing the five banks based on their duration in the interest free banking sector. The researcher divided the five banks in to three cluster which are long duration, medium duration and short duration .bank durations are taken as clusters so there were three clusters the long duration cluster included commercial bank of Ethiopia and Oromia International bank S.C the medium duration cluster included united bank S.C and the short duration cluster included Wegagen bank S.C and Nib international bank S.C Malhorta and Peterson (2006) stated that, larger the sample size of the research the more accurate the data.

The study used a large sample size based on determination method developed by Carvalho (1984). In Addis Ababa, 735 branches have been identified .So, based on based on determination method developed by Carvalho (1984), the number of branches which was equal to 735 was situated between 501-1200, hence the researcher selected the large sample size which is 125.This implies that to collect information for the study, one questionnaire was supposed to be distributed to a total of 125 branches in Addis Ababa.

Table 3.2 Sample size calculation

Name of the Bank	Number of Branches in Addis	Proportion	Sampled branches
CBE	420	57.1	71
OIB	65	8.8	11
NIB	75	10.2	13
United Bank	92	12.5	16
Wegagen Bank	87	11.8	14
Total	735	100	125

Source: Author, 2017

3.4 Types and sources of data

In conducting this study both primary and secondary data were used. The sources of primary data were employees, managers and personnel of the five banks affiliated with IFB services. These data were collected by using a structured questionnaire which comprised

information related with the respondents demographic characteristics, the information on the IFB services, on the challenges and on the opportunities of IFB systems.

Secondary data were also collected and used to describe and elaborate the conceptual aspects of the interest free banking and financing services and their applicability. Information was obtained from different websites, books written by various authors, bulletins released by foreign banks and by both the National bank commercial banks of Ethiopia, thesis and papers were also consulted.

3.5 Data analysis techniques

The collected data were checked, sorted and screened for any errors. The researcher used quantitative data analysis techniques. To analyze the data descriptive statistics methods were used. Numerical data collected by close ended questions on the questionnaire were categorized and organized into tables and analyzed using frequency counts, percentages, mean scores and standard deviation. The results were then interpreted by writing descriptions about the quantitative data. The information collected from open-ended questions was analyzed using narrative technique.

CHAPTER FOUR RESULTS AND DISCUSSION

4.0 Introduction

To gain an understanding on the opportunities and challenges related with the use IFB system in Ethiopia a survey was conducted on 123 banks operating in Addis Ababa. This chapter presents the findings from the survey. A survey was conducted from different branches of five commercial banks which offer the IFB related services to their customers. These banks are located in different parts of Addis Ababa city. A total of 125 questionnaires designed to collect information on the situation surrounding the implementation of IFB system were supposed to be filled but only 123 questionnaires were filled completely and returned back. The following results are results from the survey. This part is divided into two main sections: The first section summarizes the characteristics of the respondents, the second presents the information related with the opportunities and challenges of IFB system for the surveyed banks.

Section I: Demographic Characteristics of respondents

4.1 Sex of respondents

The results showed that the majority of respondents were male (62.6%, N=123) while the rest were female. Given the fact that the people who filled the questionnaires were expected to be the banks' employees who are affiliated with the IFB system, this implies that the majority of people with knowledge about IFB in the banks are males.

Table 4.1 Sex of sample respondents

Sex	Frequency	Percent
Female	46	37.4
Male	77	62.6
Total	123	100.0

Source: Author, 2017

4.2 Religion of Sample respondents

Religion of sample respondents was also among the characteristics examined to understand if there was a person who had an understanding of the Shariah principles and hence would provide a boost to the bank's IFB services. The results (See figure 4.1) revealed that among the respondents who were all bank employees only 20%(N=123) were Muslims, whereas the biggest proportion 55% were Orthodox Christian. This may imply that this service is

being implemented by people who may not even have a clear understanding of what it stands for, unless special trainings have been delivered this could have effects on the implementation of this banking system.

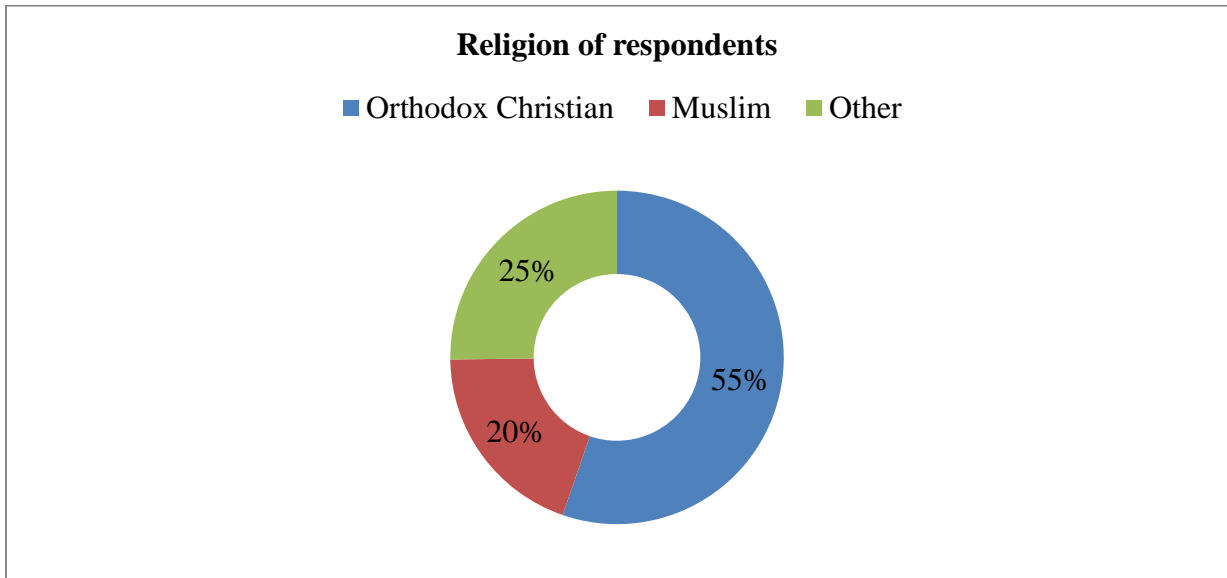


Figure 4.1 Religion of sample respondents

Source: Author, 2017

4.3 Work experience of sample respondents

The results revealed that the majority of respondents i.e. at least 60% (N=123) of the surveyed banks' employees belonged to two groups that had less or equal to 10 years work experience, with 33.3% (N=123) in the group of 0-5 years of experience and 30.1% (N=123) having between 6-10 years of experience. This implies that the surveyed employees had enough knowledge on the subject under study.

Table 4.2 Work experience of respondents

Work Experience(in years) (N=123	Frequency	Percent
0-5	41	33.3
6-10	37	30.1
11-15	16	13.0
16-20	18	14.6
21&above	11	8.9

Source: Author, 2017

4.4 Education level of respondents

Education level of respondent is another variable that was investigated in the course of this study. The results showed that only 4.9% (N=123) had a certificate level. On the other hand 51.2% had a bachelor level whereas 25.2% had achieved post graduate education level. This reveals that the people who were assigned to fill the questionnaires of this research had a great knowledge about their profession and therefore could contribute by providing insights necessary for this study. The respondents were expected to be people with knowledge about IFB system.

Table 4.3 Level of education of respondents

Level of education of respondents	Frequency	Percent
Certificate	6	4.9
Diploma	23	18.7
Bachelor	63	51.2
Masters	31	25.2
Total	123	100.0

Source: Author, 2017

4.5 Position of respondents in the bank

Regarding the positions of respondents in the Banks, it was found out that the majority were Customers service officers who were the main respondents for this study with 35% (N=123), managers also participated at 12.2% and accountants held 7.3%.The group of others included a variety of position such as Auditor, Risk Analysts, Chairperson, and non-filled with a proportion of 45.5% (See table 4.4). Habitually the customer relation officer and the managers both hold most of the time important information related with the Bank's activities and therefore, the information collected in this paper is good.

Table 4.4 Position of respondents in the bank

Current position in the bank	Frequency	Percent
Manager	15	12.2
Accountant	9	7.3
CSO	43	35.0
Others	56	45.5
Total	123	100.0

Source: Author, 2017

Section II: Challenges of interest free banking system in Ethiopia

4.6 Wrong association of IFB with Religion

Wrong association between IFB and Religion was a variable investigated to understand whether the respondents perceived that IFB services were well implemented in line with the Shariah's principles. It was indicated that more than 50% (N=123) of the respondents disagreed that IFB was wrongly associated with Religion. Among them 36.6% strongly disagree with the statement that IFB was wrongly associated with Religion and 26.8% disagreed. The whole group average stood at 2.38(SD=1.406). This implies that the group of respondents had a positive opinion towards the ways by which IFB is associated with Religion.

Table 4.5 Banks' customers views about IFB and religion is wrong

There is a wrong association of IFB with religion(N=123)	Frequency	Percent
Strongly disagree	45	36.6
Disagree	33	26.8
Neutral	12	9.8
Agree	19	15.4
Strongly agree	14	11.4
Mean	2.38	
Standard deviation	1.406	

Source: Author, 2017

4.7 Customers have awareness on IFB services

This variable was investigated to understand from the banks side what they thought about the level of awareness among their customers. The results showed that more than 65% (N=123) disagreed with the statement that customers had awareness about IFB services. The average of the whole sample is 2.32 (SD=1.111) which implies a tendency of the sample to disagreeing with the statement that the customers had awareness about IFB services.

Table 4.6 Do customers have awareness about IFB services in Ethiopia?

Bank Customers have Awareness about IFB(N=123)	Frequency	Percent
Strongly disagree	30	24.4
Disagree	52	42.3
Neutral	17	13.8
Agree	20	16.3
Strongly agree	4	3.3
Mean	2.32	
SD	1.111	

Source: Author, 2017

4.8 Views of respondents about segregation of funds in commercial banks of Ethiopia

This variable was collected by asking to the respondents if they found the segregation of found necessary. The results revealed that more than 35%(N=123) did not agree with the idea of separating the IFB funds from that of conventional banking system. However, a more important proportion of respondents belonged to the other side which believed that it was important to separate IFB funds from conventional banking system with more than 55% of respondents belonging to this group. The average of the sample stood at 3.29 (SD=1.453) implies that there is a tendency of the respondents towards agreeing with the statement that segregation of funds was required for effective implementation of IFB. One respondent mentioned the following remark on the questionnaire: “*Segregation of fund is not easy to implement both at branch and headquarter level; I think it is better to practice in Muslim populated area*”.

Table 4.7 Position of respondents about segregation of funds

Segregation of fund is mandatory(N=123)	Frequency	Percent
Strongly disagree	19	15.4
Disagree	26	21.1
Neutral	11	8.9
Agree	34	27.6
Strongly agree	33	26.8
Mean	3.29	
SD	1.453	

Source: Author, 2017

4.9 Need for research on IFB by sample respondents

It was indicated by the respondents that there is a need for research on issues related with interest free banking. The results indicated that 30.9%(N=123) and 22% manifested the need for research on issues of IFB. On the other hand 16.3% and 22.8% expressed their negative opinion with respect to research need on IFB issues. However the average of the sample which is 3.20(SD=1.43) revealed an increased tendency towards agreeing with the statement.

For example one of respondent indicated his concern in the following words “*For me, the current contribution of IFB is still minimal. It is better to study the challenges of implementing IFB system’s services instead...*”

Table 4.8 Desire for research on IFB by respondents

There is Research gap on IFB(N=123)	Frequency	Percent
Strongly disagree	20	16.3
Disagree	28	22.8
Neutral	10	8.1
Agree	38	30.9
Strongly agree	27	22.0
Mean	3.20	
SD	1.430	

Source: Author, 2017

4.10. IFB facing institutional challenges in Ethiopia

The study also tried to assess whether the respondents perceived any institutional threats for IFB system. The results revealed that the majority of respondents, in fact more than 50% (N=123) agreed with the fact that IFB system was facing institutional challenges. This tendency is further indicated by the average of the group that stood at 3.24 (SD=1.327). These results (See table 4.8) are further supported by a remark that was mentioned on the questionnaire by a respondent who stated the following: “*Legal and regulatory challenges in the Ethiopian financial sector make IFB hard to implement for banks...*”

Table 4.9 Institutional challenges of IFB in Ethiopia

Institutional challenges (legal, supervisory,regulatory) in IFB(N=123)	Frequency	Percent
Strongly disagree	16	13.0
Disagree	25	20.3
Neutral	18	14.6
Agree	41	33.3
Strongly agree	23	18.7
Mean	3.24	
SD	1.327	

Source: Author, 2017

4.11 Interest free banking system needs special regulations in Ethiopia

This statement was raised to try to get the attention of respondents towards the uniqueness of IFB system in the Ethiopian context and their views on the subject. The results of the survey indicated that only 9.8%(N=123) and 18.7% strongly disagree and disagreed respectively with the statement. It was further found out that more than 50% agree with the statement. The average of the sample respondent was 3.33(SD=1.246) which is a strong indication that the respondents recognized the importance of the statement in capturing their perceptions of the distinctive reality surrounding the IFB system and hence that there was a need for special regulations for IFB.

Table 4.10 IFB needs special regulations in Ethiopia

IFB needs special regulations(N=123)	Frequency	Percent
Strongly disagree	12	9.8
Disagree	23	18.7
Neutral	22	17.9
Agree	44	35.8
Strongly agree	22	17.9
Mean	3.33	
SD	1.246	

Source: Author, 2017

4.12 The IFB system is lacking human resources

The results showed that more than 47% (N=123) agreed with the statement that IFB system in Ethiopian is suffering from lack of professionals specialized on the issue. This is further supported by the average of the sample respondents 3.15(SD=1.312) which is higher and manifests a tendency of the sample to agreeing with the statement that IFB lack human resource.

Table 4.11 IFB lacks trained human resources

IFB lack trained human resources(N=123)	Frequency	Percent
Strongly disagree	15	12.2
Disagree	31	25.2
Neutral	18	14.6
Agree	38	30.9
Strongly agree	21	17.1
Mean	3.15	
SD	1.312	

Source: Author, 2017

4.13 Is the IFB facing challenges from the Governmental financial sector authority (FSA)?

In light with the current situations in many Muslim communities around the world with the ideology of radicalization of Islam, evidences have showed that many developed countries do not receive the Muslims in the simplest terms as they receive Christians. This may therefore impede on the development of systems like IFB. It was under the same premise that the researcher assessed whether IFB was also facing trouble from the government. The results of the survey indicated that More than 55% (123) respondents did not agree with the statement that IFB was facing trouble from the Government. However, a large number of respondents(22%) did not give their position on this question.

Table 4.12 IFB is facing challenges from FSA

IFB facing challenge by FSA or Government policies(N=123)	Frequency	Percent
Strongly disagree	33	26.8
Disagree	27	22.0
Neutral	28	22.8
Agree	19	15.4
Strongly agree	16	13.0
Mean	2.66	
SD	1.366	

Source: Author, 2017

4.14 IFB is supported by a strong legal and institutional framework

Another statement was asked to respondents to find out whether IFB was at least supported in terms of legal and institutional framework. The results revealed that 20.3%(N=123) and 30.1% Strongly disagreed and disagreed respectively with the statement, which amount up to more than 50% of the respondents taking into account the neutral responses. Furthermore, the Mean of 2.70(1SD=1.267) the sample indicated that there was a tendency towards the disagreement with the statement. This implies that respondents found that IFB lacked both legal and institutional support. This can be also indicated by the statement of one of the respondents who mentioned on the questionnaire the following: “*Government should provide favorable regulations regarding taxes, title transfer and others...*”

Table 4.13 Is IFB supported by a strong legal and institutional framework

IFB has a strong legal and institutional framework (N=123)	Frequency	Percent
Strongly disagree	25	20.3
Disagree	37	30.1
Neutral	21	17.1
Agree	30	24.4
Strongly agree	10	8.1
Mean	2.70	
SD	1.267	

Source: Author, 2017

Section III: Opportunities surrounding IFB system in Ethiopia

This section comprises of different areas which were considered as the opportunities of IFB:

4.15 Customers are satisfied with IFB services

To assess what the respondents thought about the performance of IFB services among their customers, a statement of whether they thought that the customers of IFB were satisfied or not were asked. The results showed that more than 50% of respondents did not agree with the statement and only 15.4% and 9.8% agree and strongly agreed respectively. The average of the group which is 2.63(SD=1.210) shows a tendency to disagreeing by the sample respondents. This confirms the fact that there is still an untapped opportunity to be exploited by other financial services providers which may use customer satisfaction as a niche in offering IFB services.

Table 4.14 Customers are satisfied by IFB services

Customers satisfied by IFB services(N=123)	Frequency	Percent
Strongly disagree	20	16.3
Disagree	48	39.0
Neutral	24	19.5
Agree	19	15.4
Strongly agree	12	9.8
Mean	2.63	
SD	1.210	

Source: Author, 2017

4.16 There is a high demand in services of IFB

The respondents were also asked if they perceived a high demand in services of IFB by the Ethiopian society. The results revealed that at least 46% (N=123) agree with the statement. Nonetheless, a considerable proportion of 26.8% did not give their opinion on the issue. Taking into consideration the number of respondents' perceptions, there was a potential demand for the IFB services in Ethiopia. This is further reflected in the average of the

sample which is 3.28(SD=1.251) and reflect a strong tendency towards agreeing with the statement.

Table 4.15 There is a high demand in services of IFB

There is a high demand of IFB services in the Ethiopian society(N=123)	Frequency	Percent
Strongly disagree	14	11.4
Disagree	18	14.6
Neutral	33	26.8
Agree	35	28.5
Strongly agree	23	18.7
Mean	3.28	
SD	1.251	

Source: Author, 2017

4.17 Positive Global financial trends on IFB

A statement to understand the position of respondents on the statement whether positive global financial trends would affect IFB in Ethiopia. These Global trends include for example technological advancements, economic growth in Ethiopia and in Muslim communities. The results revealed that 26.8% (N=123) and 16.3% of the respondents strongly disagree and disagreed respectively with the statement. On the other side a considerable number of respondents (19.5%) did not provide their position on the issue. The average of the sample which is 2.77(SD=1.366) also shows that the tendency of the sample is geared towards disagreeing with the statement.

Table 4.16 Positive effects from global financial trends on IFB

Positive effects from global financial trends on IFB	Frequency	Percent
Strongly disagree	33	26.8
Disagree	20	16.3
Neutral	24	19.5
Agree	34	27.6
Strongly agree	12	9.8
Mean	2.77	
SD	1.366	

Source: Author, 2017

4.18 IFB leads to business expansion and investment

Asked whether they thought that IFB favored the expansion of business and investments, the majority of respondents 36.6% and 13.8% agreed and strongly agreed respectively. The average of the sample which stood at 3.20 (SD=1.265) itself shows that there is a tendency to agreeing with the statement by respondents.

Table 4.17 IFB leads to business expansion and investment

IFB lead to business expansion and investment (N=123)	Frequency	Percent
Strongly disagree	16	13.0
Disagree	23	18.7
Neutral	22	17.9
Agree	45	36.6
Strongly agree	17	13.8
Mean	3.20	
SD	1.265	

Source: Author, 2017

4.19 Interest free banking system is flexible and easy to adopt

This statement was also asked to respondents to capture the views of respondents regarding the implementation of IFB system in the commercial banks of Ethiopia. It was indicated that 27.6% (N=123) and 11.4% agreed with the statement that IFB was flexible and easy to adopt, despite 22.8% holding their opinions. The average of 3.04 (SD=1.169) also shows a tendency of the sample towards agreeing with the statement.

Table 4.18 IFB is flexible and easy to adopt

IFB is flexible and easy to adopt (N=123)	Frequency	Percent
Strongly disagree	10	8.1
Disagree	37	30.1
Neutral	28	22.8
Agree	34	27.6
Strongly agree	14	11.4
Mean	3.04	
SD	1.169	

Source: Author, 2017

4.20 Interest free system is not for Muslims only

This statement aimed to capture the views of the respondents on whether they thought that the interest free banking system was for Muslims only. It was indicated that 30.1% (N=123) and 14.6% strongly disagree, and disagreed respectively. This implies that more than 40% of the respondents disagreed with the statement. Furthermore, the mean of the sample also indicated a tendency to not agreeing with the statement that IFB was for Muslims only. As a matter of fact, this adds to the potentials of IFB as this service can benefit both Muslims and non-Muslim customers especially in a country like Ethiopia where Muslims and Christians live together in peace and harmony.

Table 4.19 IFB is not for Muslims only

IFB is not for Muslim only (N=123)	Frequency	Percent
Strongly disagree	37	30.1
Disagree	18	14.6
Neutral	24	19.5
Agree	24	19.5
Strongly agree	20	16.3
Mean	2.77	
SD	1.470	

Source: Author, 2017

DISCUSSION

The main findings of the present study about the situation regarding IFB services revealed that main challenges faced by surveyed banks in implementing IFB system included lack of awareness by potential customers about IFB services, institutional challenges including taxation, desire for special regulations and lack of specialized human resource. In addition, the difficulty in segregation of funds for effective implementation of IFB was another problem expressed by respondents. On the other side, IFB in Ethiopia was believed to still have a huge untapped opportunity to be exploited by other financial services providers which would use customer satisfaction as a niche in offering IFB services. Other potential opportunities mentioned included global trends, economic growth in Ethiopia and within Muslim communities.

The findings of this study are supported by those of previous researches conducted regarding the Interest free banking in Ethiopia. Those studies include Mohamed (2012) Shaik(2014) Sankara muthukumar&Devamohan (2008), and Debebe (2015) which showed that the Islamic banking, had a huge untapped opportunities in Ethiopia to serve more than 30 million Ethiopian Muslims but still needed to address challenges related with lack of awareness and understanding, legal, supervisory, regulatory and/or institutional challenge, and negative attitude of people towards Islamic banking (wrong association with religion), lack of trained human resource, capital resource constraints and lack of suitable banking policies.

Furthermore, as indicated in by the IMF (2005) the current trend seems to be toward separation between interest free and conventional banks.

CHAPTER FIVE: SUMMARY OF MAJOR FINDINGS

5.1 Summary and conclusion

The present study tried to examine opportunities and challenges adjacent to the growth and development of interest free banking in the case of Commercial Banks, operating in Addis Ababa, Ethiopia. A descriptive study was conducted on respondents from five commercial banks operating in Addis Ababa Ethiopia, namely Commercial Bank Of Ethiopia, Oromia International Bank S.C, United Bank S.C, Wegagen Bank S.C and Nib International Bank S.C. The population of this study consisted of branches of those commercial banks located in different parts of Addis Ababa city.

Data were collected from a total of 123 respondents by means of structured questionnaires which were distributed to branches and were filled by banks' staffs who had the knowledge about interest free banking system. The results revealed that the main challenges faced by surveyed banks in implementing IFB system included lack of awareness by customers about IFB services, institutional challenges, desire for special regulations and lack of specialized human resource. In addition, the difficulty in segregation of funds for effective implementation of IFB was another problem expressed by respondents. On the other side, IFB in Ethiopia was believed to still have a huge untapped opportunity to be exploited by other financial services providers which would use customer satisfaction as a niche in offering IFB services. Other potential opportunities mentioned included global trends, economic growth in Ethiopia and Muslim communities, etc.

This study suggests therefore that the opportunities of interest free banking are more significant than its challenges in Addis Ababa in particular and in Ethiopia in general. However, there is a number challenges that need to be worked on first for effective implementation of IFB in commercial banks of Ethiopia.

5.2 Recommendations

With respect to the findings of the study the following recommendations are forwarded:

- ✚ The National Bank of Ethiopia should give attention to the IFB system and facilitate regulations that allow effective implementation of IFB system in Ethiopia,

- ✚ The federal revenue authority should check the issues related with taxation of IFB system.
- ✚ Recruitment of more Muslims in banks who would be watching over the IFB system should be considered as it may ensure the conformity of the services and the shariah law.
- ✚ Training of necessary manpower specialized on matters of IFB would add an advantage for the banks,
- ✚ Research focusing on studying the challenges faced by banks in implementing IFB is desirable as it may provide more details on the subject,
- ✚ The difficulty in segregation of funds should be looked into to facilitate for effective implementation of IFB different banks.

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Appendices

ADDIS ABABA UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

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Dear Sir/Dear Madam,

This questionnaire is for evaluating “challenge and prospect of interest free banking in Ethiopia”. Purpose: This research questionnaire is designed to collect data about challenge and prospect of interest free banking in Ethiopia for the partial fulfillment of the requirement for MA program in accounting and finance. The result of this study is intended to serve for academic purpose only. I would like to remind you genuine response is highly valuable and has great contribution for the quality of the research.

NB. Confidentiality of your information is kept and the results will be aggregated and presented only in summary form.

Finally, I would like to Thank in advance for your willingness and cooperation.

INSTRUCTION:

- Writing your name is unnecessary.
- Put “✓” mark as per the questions required in the box or answer in the space provided.

Part One: Respondents Profile

1. Gender Male Female
2. Number of years you have worked with the Bank (in years) 0 0 5-16-2021 ;
above
3. Educational Level Certificate Diploma Degree M PhD
5. Your current position _____

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Part Two: Respondents opinion investigation important aspects of Interest free banking

Next, there are listed of items which deal with respondents view on challenge and prospect off interest free Banking in banking industries. These items will explore respondents'' assessment of challenges facing Interest free banking. So Please tick the number that you feel most appropriate, using the scale from 1 to 5 (Where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree and 5 = Strongly Agree).

A. Challenges Facing Interest free Banking

Items	Strongly Disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1. There is Negative attitude of people regarding Interest free banking (wrong association with religion).					
2. The Community has awareness about Interest free banking system.					
3. Segregation of fund from the conventional banking service activity is mandatory to attract the potential customer of Interest free banking.					
4. There is a gap in research and development in interest free banking services and interest free finance modalities to fill the gap in qualified human resource.					
5. There is Legal, Supervisory, regulatory and institutional challenge.					
6. There is Lack of suitable banking policies for Interest free banking.					
7. Interest free banking should be governed by different set of regulations as they differ from conventional banks in many aspects such as risk					

structure, form of ownership and governance.					
8. There is Lack of Trained Human Resource in Interest free banking.					
9. The current commercial banks customers are fully satisfied with the range of products that the banks provide.					
10. Interest free banking has strong legal and institutional framework.					
11. Interest free banking is facing difficulties by Financial Services Authorities (FSA) or any other Government policies					

B. Prospects and Opportunities of Interest free banking

Instruction: Please tick the number that you feel most appropriate, using the scale from 1 to 5 (Where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree and 5 = Strongly Agree).

Items	Strongly Disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
12. The current global trends in Financial Services will have positive manifestations on the future of Interest free banking in Ethiopia.					
13. There is Interest free banking service need in Ethiopia so that it will alleviate the financial services deprivation of the community those who need interest free service.					
14. The offering of interest free banking products (Saving and Loan Service) will improve the tendency for business expansion and investment.					

15. People would use investmentloan service due to its attractiveness and ease access.					
16. Interest free banking is able to fulfill the society needs and as well helpful to Ethiopiaeconomy					
17. Interest free banking is flexible and easy to adopt in financial system					
18. Interest free banking is up to date and fulfilling the current market requirements					
19. Not only Muslim people are taking the interest free banking service or other communities are also interested in Interest free banking					

20. What do you feel about the contribution of interest free banking both for the customer and the bank in the way of the growth of business?

21. If you have any other opinion regarding to Interest free banking challenges and prospects?

Appendix 2 Glossary of interest free Banking and Finance

Allah: The Creator, an Administrative of the Universe; God

Amanah: Trust, with associated meanings of responsibility, truthfulness and sincerity. As a important secondary meaning, the term also identifies a contract where one party keep another's funds. This is in fact the most widely understood and used application of the term, an has a long history of use in Islamic commercial law. Now a day's HSBC has maintained Amanah bank accounts.

Arbun: Down payment; a non-refundable deposit paid by the buyer to the seller upon finishing a contract of sale, with the condition that the contract will be completed during the prearranged period.

Gharar: (Uncertainty) is a sophisticated concept that covers certain types of insecurity or contingency in an agreement. The prohibition on gharar is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.

Halal: Any activity or transaction that is according to law and also permitted in Islam is known as Halal.

Haram: Any business or contract that is unlawful and also prohibited in Islam is known as Haram.

Islamic banking: Financial services that meet the requirements of the Sha'riah or Islamic law. While designed to meet the specific religious requirements of the Muslim customers, Islamic banking is not restricted to Muslims: both the financial services provider and the customer can be non-Muslim as well as Muslim.

Ijara:Ijara is a kind of lease; it allows the bank to earn profits by charging rentals on the assets leased to the customer. IjarawaIqtinah extends the concept to a hire purchase agreement.

Maysir:(Gambling) one of three fundamental prohibitions in Islamic finance. The prohibition on maysir is often used as the grounds for criticism of conventional financial practices such as assumption, traditional insurance and derivatives.

Mudaraba: is an investment partnership, whereby the investor (the Rub ul Mal) provides capital to another party (the Mudarib) in order to undertake an investment activity. While profits are shared on a pre- agreed ratio, loss of investment is born by the investor only. The

mudarib loses its share of the expected income.

Mudarib: The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investors funds in a project or portfolio in exchange for a share of the profits.

Murabaha: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity from a third party and resells it at a prearranged higher price to the capital user. By paying this higher price over instalments, the capital user has successfully obtained credit without paying interest.

Musharaka: profit and loss sharing. It is a partnership where profits are shared as per as agreed ratio whereas the losses are shared in proportion to the investment of each partner.

Prophet: Hazrat Muhammad Mustafa (PBUH)

Quran: The Holy book of Muslims revealed on Hazrat Muhammad Mustafa (PBUH)

Qard: A Qard is a loan, free of interest. Bank use this arrangement for current accounts holders. In essence, it means that Current Account is a loan to the bank, which is used by the bank for investment and other purposes.

Riba: Interest, Usury. The legal concept extends beyond just interest but in simple terms Riba covers any return of money on money-whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in Islam.

Sha'riah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Sha'riah compliant product meets the requirements of Islamic law. A Sha'riah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of sha'riah compliant products.

Sha'riah advisor: An independent professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the sha'riah, or Islamic law. While some Islamic banks consult individual Sha'riah advisor, most establish a committee of Sha'riah advisors.

Sha'riah Compliant: An act or activity that complies with the requirements of sha'riah c Islamic law.

Sukuk: Sukuk is the Arabic name for a financial certificate but can be seen as an Islami equivalent of bond. However, fixed income, interest bearing bonds are not permitted in Islam, hence **Sukuk** are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Sukuk is a certificate of equal value representing

entire shares in ownership of tangible assets and services or the assets of particular projects or investment activity.

Sunnah: way of life of Prophet Hazrat Muhammad Mustafa (PBUH); They said about anything, they act anything is called as Sunnah.

Surah: Chapters of Quran; there are 540 Sura in Quran.

Takaful: Islamic insurance. Planned as charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of traditional insurance (i.e., interest and gambling) that are challenging for Muslims.

Tawarruq: Reverse Murabaha. As used in personal financing, a customer with an actual need buys something on credit from bank on a deferred payment basis and then instantly resells it for cash to a third party. In this way, the customer can take cash without taking an interest-based loan.

Wakala: Wakala is an agency contract which generally includes in its terms a fee for the skill of the agent.

Zakat: Zakat is one of the five pillars of Islam. It is obligatory for Muslims to pay their wealth to specified categories in society when their annual wealth exceeds a minimum level.

Source : www.islamic-bank.com

www.ubl.com.pk