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AN ASSESMENT ON INTEREST FREE BANKING PRACTICE IN ETHIOPIA

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GSE/7790/12

**A THESIS SUBMITTED TO ADDIS ABABA UNIVERSITY
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BUSINESS ADMINISTRATION**

ADVISOR: ABEBE YITAYEW (PHD)

A.A, ETHIOPIA

May, 2022

Statement of Declaration

I, Muhammad Musema, hereby declare that this thesis paper is my original work other than where I have clearly indicated that it is the work of others. All sources of material used for this thesis have been duly acknowledged and this thesis is not presented before, by me or any other party for any purpose.

May, 2022

Certification

The thesis entitled “An Assessment on *Interest free Banking Practice in Ethiopia*” submitted to the Addis Ababa University College of Business and Economics for the award of degree of Masters of Business Administration is a record of independent research work carried out by Mr. Muhammad Musema, under my supervision and guidance. This study is of his original work and all the sources of materials used for the thesis paper had been duly acknowledged.

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COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF MBA

The thesis entitled “An Assessment on *Interest free Banking Practice in Ethiopia*”, prepared by Mr. Muhammad Musema, submitted in partial fulfillment of the requirements for the degree of Master of Business Administration in Finance complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

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Table of Contents

Contents

Statement of Declaration.....	i
Acknowledgement	iv
Table of Contents	v
List of Tables	vii
List of Figures.....	viii
Abstract.....	x
CHAPTER ONE	1
1. Introduction.....	1
1.1 Background of the Study	2
1.2 Statement of the problem	3
1.3 Research Questions	5
1.4 Objectives of the study.....	5
1.4.1 General objective of the Study.....	5
1.4.2 Specific objectives of the Study.....	5
1.5 Significance of the Study	6
1.6 Scope of the Study	6
1.7 Limitations of the study	6
1.8 Organization of the study	7
CHAPTER TWO	8
Review of Related Literature	8
2.1 Introduction	8
2.2 Theoretical Literature Review	8
2.2 The Need for Interest Free Banks	9
2.3 Objectives of Interest Free Banks	9
2.5 The Development of Interest Free Banks	10
2.6. Islamic Banking	12
2.6.1 Basic principles and characteristics of Interest Free Banks	12
2.6.2 Interest Free Banks Dealing: Goods not Money	17

2.6.3 Islamic Banking: Sources and Uses of Funds.....	19
2.6.4. Islamic Banking modes of financing	22
2.7. Interest Free Banking system Vs conventional banks	23
2.8 Shariah Audit and Compliance	27
2.9. Islamic Corporate Finance.....	29
2.10. Success Factors of Islamic Banks	31
2.11. Challenges facing Interest Free Banks	32
2.11.1. Shari’ah arbitrage.....	32
2.11.2. Shari’ah compliance throughout the Islamic product’s life cycle (PLS)	32
2.11.3. Shortage of experts in Islamic banking.....	32
2.12. Empirical Literature Review	33
CHAPTER THREE	37
3. Research Methodology	37
3.1 Research Design and Approach.....	37
3.2 Source of data and collection methodology	37
3.3 Target population and sampling Design	38
3.4 Data analysis method	39
CHAPTER FOUR	40
Data Presentation, Analysis and Interpretation.....	40
4.1 Introduction.....	40
4.2 Background of the Respondents	40
4.3 Reliability Test.....	43
4.4 Analysis and Presentation on Interest Free Banking Practice.....	44
4.4.1 IFB Service Compliance with Principles	44
4.4.2 Opportunities of Implementing IFB Service for Conventional Banks.....	50
4.4.3 Challenges of Interest Free Banking	53
4.5 Analysis on the performance of IFB windows.....	57
CHAPTER FIVE	61
Summary, Conclusion and Recommendation	61
5.1 Summary	61
5.2 Conclusions.....	62
5.2 Recommendations.....	64
Bibliography:	66

List of Tables

Table 2.1: A Brief Definition of the Main Islamic Modes of Financing	26
Table 4.1: Gender of Respondent	41
Table 4.2: Age group of Respondent	41
Table 4.3: Educational Level of Respondent	41
Table 4.4: Work Experience of Respondent	42
Table 4.5: Job Position of Respondent	43
Table 4.6: Reliability Statistics	44
Table 4.7: IFB Service Compliance with Principles	46
Table 4.8: Opportunities of IFB	51
Table 4.9: Challenges of IFB	54
Table 4.12: Analysis on the financial growth of IFB windows	59

List of Figures

Figure 2.1: Sources and Uses of Funds in Islamic Banks	20
Figure 4.1: The Growth Performance of IFB	58
Figure 4.2: Risk Management framework in Islamic Banking	26

Acronyms

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

BBP: Banking Business Proclamation

CBE: Commercial Bank of Ethiopia

CBs: Conventional Banks

FDI: Foreign Direct Investment

FDRE: Federal Democratic Republic Of Ethiopia

IB: Islamic Bank

IFB: Interest-Free Banking

IFI: Islamic Financial Institution

NBE: National Bank of Ethiopia

GDP: Gross Domestic Product

NIB: Nib International Bank

OIB: Oromia International Bank S.C.

PLS: Profit and Loss Sharing

R&D: Research and Development

SPSS: Statistical Package for the Social Sciences

SSB: Shariah Supervisory Board

Abstract

The main purpose this thesis paper is assess practical implementation of IFB in Ethiopia with specific reference nine commercial banks currently providing IFB service. The study has used both primary and secondary data sources. Structured questionnaire were the primary source of data. A total of 45 sample respondents were taken through purposive sampling. As the orientation of this paper is chiefly descriptive in nature, the data was analyzed using descriptive statistics of percentage, frequency and mean. The finding of the study depicts, most of banks are doing in accordance with IFB principles. However, there were also some gaps on Sharia advisors related to properly performing their role, duty and responsibilities in a regular manner, again doubt on their academic knowledge and experience on IFB. In addition, there was a gap related to applying one of the major IFB principles known as risk and return sharing principle, and lack of financing, which resulted inability to meet financial needs of IFB customers and made total financing below an average. Moreover, result from study revealed that providing IFB through dedicated window facilitated for the banks to take many opportunities. Furthermore the result indicates that banks have been facing many challenges to provide IFB successfully, such as; lack of well trained and experienced human resource on IFB, lack of qualified Sharia advisory scholar, lack of educational and training curriculums on IFB, limitation of capital and resource, lack of knowledge and proper understanding of IFB among the society on IFB products and services, and lack of suitable banking polices for IFB. Accordingly, the study recommends for the banks, government and all other responsible body, that, to take consideration for the above discussed and other features of IFB industry and to take proactive measures from all perspectives.

Key Words: Interest fee banking, compliance, opportunities, challenges, growth.

CHAPTER ONE

1. Introduction

According to Ahmad (2012), Interest Free Banking has emerged as one of the most rapidly expanding sectors in the global financial system, that emerged as an alternative financial system which is in line with values and ethos of Islam, and governed by the principles of Sharia Law that requires avoiding any unethical practices in achieving its goals and objectives.

Yet, the western principles and laws have dominated all parts of the world. IFB is part of the Islamic revival of Islamic principle. The development process of the IFB system has passed a lot of hurdles before reaching to present status, mainly owing to the dominance of the conventional financial industry that holds totally opposing values to the Islamic economic system (Alyu 2016).

In Islamic financial law there are some methods of financing such as Musharaka, Murabaha, Mudaraba and Ijarah which provide all the contractual details of the business and some contracts are based on profit and loss sharing schemes. Islamic financial system is based on risk sharing between parties and there is not wholly burden on one contracted parties. Interest free banking is not only for Muslim community because it provides moral and more ethical concept of financing and investment (Wondosen 2018).

Theoretical basis of Islamic banking and the structure of Islamic banks in practice render certain issues from the perspective of conventional banking theory. The interest-free nature of Islamic banking requires distinguished products that can be employed both on the asset and the liability sides of an Islamic bank (IB). The profit and loss sharing saving and investment accounts entail more transparency and prudential regulations. In addition, to comply with the directives of regulatory authorities and central banks, Islamic Banks also accord to the tenets of *shariah* (Islamic jurisprudence), and thus are exposed *shariah* compliance risk (Zaheer 2013).

1.1 Background of the Study

The conventional banking system has dominated the world economy for hundreds of years. By and large, it has contributed to the growth of the world economy. Needless to say, the commercial banks, with the support of the modern insurance practices, have acted as the catalyst in the transformation of the agrarian economies into modern economies. Conventional Banks (CBs) that have been in operation for more than four centuries are nothing but the right hand and major instrument of enforcing the *capitalist* economic worldview of market-led economy. Hence Conventional Banks have exacerbated the weakness of capitalism which in general terms include widening of the gap between the rich and poor members of the community, unemployment, monopoly and inflation and economic inefficiency (Alyu 2016).

The history of modern Islamic Bank (Interest Free Banking) has been traced back to the saving house established in Egypt in 1963 with the introduction of new products in the banking industry. An interest free banking system under the paradigm of Islamic Finance has been presented by the Sharia jurists as alternative. Basically, IFB has been developed using two different models. The first model consists in setting up fully fledged IFBs while the second model consists in setting up Subsidiary and windows dedicated to Islamic finance within conventional banks (Jemal 2018).

Coming to Ethiopia, developing a more inclusive financial system in any given country is a primary determinant of the soundness of a financial system and public trust in its institutions and markets. This could best be achieved through the financial inclusion of the large segment of the unbanked segments of the society into the organized and formal financial system. Art. 22 (2) of the Banking Business Proclamation No. 592/2008 has given power to the National Bank of Ethiopia to regulate regarding interest-free banking business. Based on this enabling provision of the proclamation, the NBE has enacted a directive for the authorization the conventional banks to undertake an interest free banking business *alongside* of their operations, which is titled as “Directives to Authorize the Business of Interest Free Banking No. SBB/51/2011” (Alyu 2016). After that in 2013, Oromia International Bank S.C has been a pioneer to launch interest free banking service and the Commercial Bank of Ethiopia and united bank followed the business (Debebe 2015).

In Ethiopian, in the near past, there were major issues such as lack of supportive regulatory and policy regimes that facilitate the establishment of Interest Free Banks, which was the most important worth of mentioning. Responding to a strong public demand, now the government was amended a new proclamation No: 1159/2019 (article 59) that allowed the establishment of full-fledged interest-free banking in Ethiopia on May 2019. Then NBE, issued a directive number SBB/72/2019 on June 18, 2019 to allow banks in Ethiopia to conduct interest free Banking operation using the fully fledged banking system, which is a replacement of the directive number SBB/51/2011. After the issuance of the new directive private Banks like Hijira bank and Zamzam bank banks currently are joined the industry (Suadiq 2020).

Currently, in order to attract and retain the specific needs of the IFB service of the market, a significant number of conventional banks in Ethiopia are providing interest free banking service in one segregate window as per the requirement of the NBE directive (Akmel 2015).

1.2 Statement of the problem

The banking industry is one of the most important financial sectors that play the role of financial intermediation in the economy which ultimately will bring about economic development. In today's competitive world, banks are struggling to get a resource (deposit) and then advancing same to generate profit out of it. IFB became an emerging opportunity for the business community with peculiar operating philosophy, principles and practices that require due awareness and knowledge to make use of full-cycle IFB services including deposit, financing, international trade service and other various non-cash facilities (Teferi 2015).

In Ethiopian, the IFB is in operation for about 10 year period in the form of dedicated window after series of acceptance challenges as to its importance to the Economy. Starting from 2011 there is an improvement and development in IFB system. Currently twelve conventional banks and two new interest-free banks have the license from NBE and start IFB service. The rapid diffusion of interest free banking adoption by conventional banks reflects their understanding of the importance and untapped demand. Even if deposits are increasing over the years, some bank are only providing deposit service and not yet financing.

Interest free banking faces significant operational challenges as a result of having its own sharia experts, require well trained man power, and operating in regulatory environment that was originally designed for conventional banks (Karbhari et al. 2004, cited in Wondosen 2018).

The formation and implementation of interest free banking within conventional banks has raised and created eminent challenges'. They are facing some criticism with a sense of suspicion among the Islamic scholars and the Islamic banking clients on the authenticity, clearance of monetary system, etc. Some scholars argue that conventional banks should not be permissible to open Islamic windows, as their sources for fund is unlawful. Hence they are not complying with Sharia at first place exploiting the Muslim investors and unfairly competing with Islamic financial institutions. On the other hand, there is a group of contemporary scholars who permit this type of banking service as long as the sharia conditions laid down for them are satisfied and fulfill certain required conditions such as: complete segregation of funds; the existence of a Sharia supervisory board; management committed to Islamic financial concepts; safeguarding Muslim investors' funds from negligence, trespass, and fraud; and compliance with the standards of the Accounting and Auditing (Yaquby 2000, cited in Jemal 2018).

Although, many Islamic banking clients also believe that conventional banks are involved in immoral activities from an Islamic Sharia point of view. Hence, there is still a sense of suspicion and mistrust amongst the majority of interest free banking clients with regards to these “Islamic windows” and their Interest free banking products. This explains the reluctance from numerous Interest free banking clients to deal with Islamic windows and their financial products (Al-Awsat 2010, cited in Jemal 2018).

A significant amount of theoretical and empirical research on Islamic banks has been undertaken throughout the world and most of them are concentrated in Middle East countries. However, coming to Ethiopia, IFB industry was on early stage compared to other countries, which did not have more than 10 years age. Also studies conducted in Ethiopia on IFB have limited scope and methodology. These and the above paragraphs imply that IFB industry needs to be more explored. Therefore this study tried to assess and examine Interest Free Banking Practice in Ethiopian context and in different perspective.

1.3 Research Questions

In order to address the research problem properly, and to achieve the intended objectives of the study, certain research questions are designed that the study tries to answer:

1. Do interest free banking windows operate in accordance with IFB Principles and Sharia requirements?
2. What are the opportunities of providing IFB service for the conventional banks?
3. What are the challenges that IFB windows face in providing of IFB services successfully?
4. How is the growth trend of IFB windows in the financial industry of the country?

1.4 Objective of the study

1.4.1 General objective of the Study

The general objective of the study is to assess and examine practical implementation of interest free banking windows with particular reference to Commercial banks currently offering interest free banking service in Ethiopia.

1.4.2 Specific objective of the Study

Based on the general objective the study strives to achieve the following specific objectives:

- To examine whether IFB windows are operating in accordance with IFB Principles and Sharia requirements or not.
- To assess the opportunities of providing IFB service for the conventional banks.
- To determine the challenges that IFB windows face in providing of IFB services successfully.
- To assess the growth trend of IFB windows in the financial industry of the country.

1.5 Significance of the Study

The findings of this study are useful in many ways and for many parties. It provides a clear picture of how the IFB does works, valuable information and better approach to deal IFB. Also help those concerned policy makers to formulate necessary and solution-oriented policies that will in fact have a benefit to all citizens, provide suggestion as a solution in order to tackle challenges related with IFB. Furthermore, the study help through improving the way to those who are interested to undertake further research on the same stream in the future.

1.6 Scope of the Study

The concept of Interest Free Banking cover a wide scope and it is very essential issue. In accordance with the title comprehensiveness, various investigations can be carried from different perspectives. However, in order to make the study more manageable in terms of the researcher's aim and interest, available time, finance and facilities, the scope of the study was delimited only to examine theory and practical implementation of IFB in Ethiopia with particular reference to selected Commercial banks currently offering interest free banking service. There are two fully-fledged IFB and nineteen conventional banks operating in Ethiopia banking industry and twelve of them had got license to offer IFB. The scope of the study comprised of all banks those had got license to offer IFB on dedicated window basis. Furthermore, the study conducted in Addis Ababa city at the head offices of selected banks for ease of reach and convenience to the researcher. With regard to the research participants, the study tried to cover IFB department Directors and managers. The study includes data collected from the participants of the study through questionnaires and from secondary sources. Lastly, In order to describe the current status of IFB service the researcher have used the most recent six years data from the fiscal year 2016 GC up to 2021 GC.

1.7 Limitation of the study

In conducting the study the researcher faced lack of relevant and exhausted related research works done on the subject in our county. Also, the study limited mainly in to bankers and could not customers. Correspondingly, the presence of work overload during the study may have an impact. The other important limiting factor may be is the participants understanding about the

Sharia law. And participants may not be reflective of the entire population. However, none of these factors will affect the quality of the research.

1.8 Organization of the study

The study has five chapters, the first chapter deal with the problem & its approach which include introduction, background of the study, statement of the problem, objective of study, significance of the study, scope study, limitation of the study, and organization of the research. Then, chapter two provides theoretical and empirical literatures about interest free Banking. The next chapter three presents the methodological concerns used in conducting the research, including the research designs, sampling technique, method of data collection, data collection instruments, method of data analysis and so forth. Chapter four gives details on data presentation, analysis & interpretation of the study. The last chapter deals about conclusion and recommendations based on the findings of the study.

CHAPTER TWO

The Review of Related Literature

2.1 Introduction

This chapter aims at presenting theoretical and empirical literatures review related with Interest free banking system. The theoretical section attempts to give the reader a better understanding of the fundamental principles and features of Interest Free Banking. This chapter also discusses the Islamic financial contracts (modes of operation) in addition to the most used Interest Free financial products in the areas of banking. It eventually highlights the most significant challenges associate with Interest Free Banking. Next, in the empirical review section, previous studies related with interest free banking at the national level will be discussed.

2.2 Theoretical Literature Review

Islamic finance refers to a system which identifies and promotes financial orders that are consistent with the principles of Islamic law, *the Sharia*. Set of principles substantially differentiate Islamic finance from the conventional (capitalist) finance, as it goes beyond the pure financial issues. Specifically, Islamic law prohibits the collection and payment of interest. Muslims earnings must come from permissible means, and must also be spent on religiously acceptable categories of expenditure. Consequently, Islam prohibits investing in businesses that are considered unlawful or contrary to the Islamic teachings and values (Dusuki 2006, cited in Ahmad 2012).

Islamic finance is as old as the religion itself. Its practices have been really used throughout the last 1500 years across the world. Islamic finance has, moved from a mere old theoretical concept to a practical reality. A natural consequence of this progress is the opening up of new avenues for its advancement. Islamic finance is, indeed, a growing sector with its diversity in different segments in various parts of the world. Islamic finance has not taken root solely in Muslim-majority countries but has also spread to non-Muslim countries (Alkheil 2012).

Muslims need financing services as much as anyone in order to finance their business ventures, to facilitate capital investment, and/or to undertake trading activities, etc. Muslims attempt to

restructure their financial lives on the basis of Islamic law, and consequently to find out the means to fulfill their financial requirements in view of prohibition of interest in a world where the entire financial system is based on interest-usury. Their intent is to create a just, ethical and socially inclusive financial and business system across the broad spectrum of society. It is, therefore, the biggest challenge and the formidable task for them to reform their financial institutions, products and services, instruments and contracts on an interest-free basis in order to bring them in harmony with the dictates of Islamic law and within the constraints of Islamic regulations (Ahmad 2012).

2.3 The Need for Interest Free Banks

Interest is the cornerstone of the modern financial system. Keeping in mind the strict prohibition of interest in the Islamic framework, Islamic finance system cannot be developed without intermediaries like banks and financial institutions. Banks and financial institutions will remain a part and parcel of economics and finance in the Islamic framework as well. Modern businesses need huge amounts of funds, while people at large have mostly small savings. This necessitates the presence of such intermediary institutions through which business needs can be directly and indirectly fulfilled with savers' pooled money in such a way that savers/investors can also get a just return on their investments and business and industry can get the funds required for ensuring a sufficient supply of goods and services for the welfare of mankind (Ayoub 2007)

The prohibition of *riba* is the core for the creation of the Islamic financial system, the system's prevailing practices also reflect other principles and doctrines of Islam, such as the admonition to share profits, the promotion of entrepreneurship, the discouragement of speculative behavior, the preservation of property rights, transparency, and the sanctity of contractual obligations. The Islamic financial system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the expected responsibilities of the individual, society, the state, and all stakeholders. (Bala, S. and Zaha, R. 2009)

2.4 Objectives of Islamic financial institutions

The objectives of Islamic financial institutions and the objectives of *Shari'a* may differ. If, however, industry practices are in line with the substance of *Shari'a*, they should lead to fulfillment of the objectives of *Shari'a* (Bala, S. and Zaha, R. 2009).

The objective of Islamic financial institutions is the pursuit of profits without violating *Shari'a*. The shareholders of and investors in Islamic financial institutions may have purely economic considerations and not be concerned with the objectives of *Shari'a*. Among the most important policies or goals pursued by the Islamic financial system are providing *Shari'a*-compliant financial products and services, creating stability in money value, promoting economic and social development, resource optimization and equitable distribution of resources (Bala, S. and Zaha, R. 2009).

The principal objective of *Shari'a* as explained in literature on Islamic finance is economic justice through equitable distribution of resources. The rationale offered is quite simple. Lending money for interest directs the flow of money to those who are considered low credit risks (a government, for instance) or those who can provide collateral (say, a rich individual or a big company), even if they may not have the businesses and ideas with the greatest economic potential. Such behavior, it is argued, leads to such economic ills as the concentration of wealth in a few hands, which, in turn, have wide social implications (Bala, S. and Zaha, R. 2009).

2.5 The Development of Interest Free Banking

Partnerships and profit-sharing ventures consistent with the beliefs of Islam were commonly used to finance productive activities even prior to the teachings of the Prophet Muhammad. Over time, however, as the center of economic gravity moved to the Western world, the profit sharing approach to structuring financial transactions fell out of favor and Western financial institutions came to dominate the capital markets. Islamic financial institutions gradually succumbed to the ways of the West and adopted interest based financial transactions (Bala, S. and Zaha, R. 2009).

It is generally accepted that the modern Islamic finance came in the first part of 1960s with the establishment of the “*Myt –Ghamr*” local savings bank in Egypt and the *Pilgrims'* Management and Funds in Malaysia. In 1975, Dubai Islamic Bank (DIB), the world's first Islamic commercial bank was established in UAE followed by the establishment of Islamic Development Bank (IDB) in Jeddah, Saudi Arabia. During the 1980s, 1990s and beyond, the industry of Islamic finance expanded steadily and spreading around the globe. The demand for Islamic investments began to grow rapidly within and outside Muslim-majority countries (Ahmad 2012).

Nowadays, the ideas and concepts of Islamic finance are attracting Muslim and non-Muslim investors -seeking to invest into new business opportunities in many parts of the world. The Islamic banking and finance industry is set to grow 15-20% annually. This growth has become particularly visible since 2001 mainly due to the increased oil wealth across GCC-states (Ayoub 2007).

The coverage and extent of Islamic banking and finance vary considerably from countries where the sector is totally Islamic such as Pakistan and Iran, to others where conventional and Islamic systems coexist with each other such as Malaysia and GCC-States. Many countries also allowed conventional banks to set up Islamic windows, opening the way for some of the prominent international banks to get involved. The growth in Islamic finance, however, has been driven mostly by Muslim countries from GCC-States and Asia, and is designed to meet the needs of Muslims around the world. In most countries, financial institutions that involved in Islamic finance are growing faster than counterparties-conventional banks due to the strong demand for products and services complied with the ethical and moral Islamic investment guidelines (Ahmad 2012).

Islamic financial sector is increasingly going global, where large group of European countries opening their arms to welcome Islamic finance. They even outweigh some Muslim countries in adopting and implementing Islamic banking structures and operations. The UK, for example, is said to be the eighth-largest global center for Islamic finance in 2007, behind countries such as Saudi Arabia and the majority of the GCC-countries. Moreover, the UK's first stand-alone Islamic commercial bank, the Islamic Bank of Britain (IBB), reported an increase in the number of non-Muslim customers. This was primarily because High Street banks in the UK offer fewer opportunities for house mortgages, particularly during the economic crunch of 2007. Such trends have prompted many to conclude that the Islamic banking provides a viable alternative to conventional banking and is now being treated seriously by regulators (Ahmad 2012).

In practice, the most well-established Islamic finance forms are: Sukuk, funds, banking and Takaful. Products that may be the subject of innovation include private equity, private wealth management, hedge funds and derivatives. By and large, commercial banks account for the bulk of the global Islamic assets with investment banks, Sukuk issues, Funds and Takaful making up the balance (IFSL 2010, cited in Ahmad 2012).

Banking penetration is relatively low in Africa. According to the Moody's special report in 2008, Africa has witnessed a modest growth in Islamic finance practices. Recently, around 37 IFIs operate in Africa to serve the Muslim population of "412" m inhabitants, the second largest Muslim population in the world. Assuming that banking entrenchment in Africa represents an average 50% of its total GDP-per capita, the Islamic finance market on the continent is potentially worth relatively US-\$ 235 bn. As of year-end 2007, the actual depth of Shari'ah-compliant financial intermediation in Africa was US-\$ 18 bn, equating to a market share of less than 8%. The industry however, is now highly concentrated of its development in some African countries. Specifically, more than 50% of African's assets are located in Sudan, with Egypt ranking second with a much lower share of around 20%. Taking into consideration that the continent continues to economically grow at its current pace incremental wealth creation will make it easier for the Islamic financial services sector, including Islamic commercial banking, Takaful, investment and microfinance, to develop. In practice, Islamic banks in the North African countries were less affected by the global crisis of 2007 partly due to their limited reliance on international funding and thus, have a significant room for growth in penetration in the coming years (IFSL 2010, cited in Ahmad 2012).

Recently, the investments through Islamic finance systems are acceptable in a significant number of Muslim and non-Muslim countries around the world. Recognizing the importance of Islamic finance, Islamic banks are expanding their network globally. Conventional banks in Muslim countries along with global conventional banking majors are also now offering Islamic products and services, either through Islamic windows or through newly established Islamic entities. This led, however, to a tremendous growth of Islamic capital market products and services, institutions and banking clients (Ahmad 2012).

2.6 Islamic banking

Islamic banks are banking institution whose activities include all currently known banking activities. They have the same purpose as conventional banks except that they make money by lending out capital in accordance with the rules of the Islamic law. Islamic banks have to set up Shari'ah Committees (SC) to ensure that they conduct their affairs in accordance with the Shari'ah principles. Islamic banks advance funds on a profit-loss-sharing (PLS) principle or on a debt-creating basis. They provide finance to enterprises through either sharing directly in the net

results of their activities or financing their purchases of assets, goods and services. In an Islamic mortgage transaction, instead of loaning the buyer with money to purchase an item, a bank might buy the item itself and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, because the bank's profit cannot be made "explicit", there are therefore no additional penalties for late payment. Consequently, Islamic banks ask for strict collateral in order to protect themselves against default and thus, the purchased item is registered to the name of the buyer from the start of the transaction in form of Murabaha financing. Moreover, Islamic banks lend money to companies by issuing floating rate interest loans which is pegged to the company's individual rate of return. This practice is called Musharaka, where the bank's profit on the loan is equal to a certain percentage of the company's individual profits (Ahmad 2012).

Additionally, Islamic banks mobilize funds on the basis of a Mudaraba or Wakalah contracts. They can also accept demand deposits which are treated as interest-free loans from the clients to the bank and are certainly guaranteed. In theory, Islamic banking is often synonymous with full-reserve banking, with banks achieving a 100% reserve ratio. This is, however, not always the case in practice. Islamic banks further play the role of an investment manager for the owners of time deposits (usually called investment deposits: restricted or unrestricted). They provide the owners of funds the opportunities to place their financial resources profitably, as they become implicit partners of those institutions that share in their net profit, while carrying a proportional share in their risk. In a way that depends on the size and date to maturity of each deposit, an Islamic bank shares its net earnings with its depositors who must be informed in advance of "the formula used for sharing the net earnings with the bank" (Ahmad 2012).

2.6.1 Basic principles of Interest Free Banking

Islamic 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. Sharia's principles are widely utilized in Islamic finance. As Islamic financial institutions seek to structure more innovative products for customers, it is, therefore, important to understand the principles of Islamic finance and the specific features of each principle. Conventional investors also need to understand these standards in order to be able to provide the services demanded by consumers who want to comply with Islamic guidelines, as well as to know the potential

implications of the interaction between Islamic and conventional financial institutions. (Bala, S. and Zaha, R. 2009)

Most of authors on Islamic finance commonly stated the following as a governing principles for Interest Free Banking:

A. Freedom from interest (Riba)

Riba is Arabic for “growth” or “increase” and denotes the payment or receipt of interest for the use of money. The Quran, the Muslim holy book, expressly forbids *riba*, which includes any payment of interest (not only excessive interest) on monetary loans. The Quran states, “O You who believe! Fear Allah and give up what remains of your demand for usury, if you are indeed believers.” Muslim scholars have interpreted *riba* to mean any fixed or guaranteed interest payment on cash advances or on deposits (Vadillo 2006).

In prohibiting *riba*, Islam seeks to foster an environment based on fairness and justice. A loan with a fixed return to the lender regardless of the outcome of the borrower’s course of action is viewed as unfair. *Riba* 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, S. and Zaha, R. 2009)

The Muslim jurists have generally classified interest "Riba" into two broad types, namely: I) "*Riba al-Fadl*", which is described as the "unlawful" excess in the exchange of two "counter-values" (i.e., inequality of quantity or weight and dissimilarity of quality). In order to be lawful, the exchange of identical commodities must occur immediately (on spot) and there must be no disparity in amount. II) "*Riba al-nasi'ah* ", which is related to the artificial extension of the repayment period of a loan for additional payment of money. This implies that fixing beforehand a positive return (interest) on a loan, as a reward for waiting, is not allowed in Islam. "In this sense, *riba* has the same meaning as interest. It makes no difference whether the loan is for consumption, or business purposes, or whether the return is a fixed or a variable percentage of the principal. It also makes no difference whether an absolute amount to be paid in advance or on maturity, or received in the form of a gift or a service if stipulated as a condition in the loan contract or an extension in its maturity" (Ahmad 2012)

B. Risk-and-Return Sharing

Shari'a prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards (*mudharabah*) 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, S. and Zaha, R. 2009).

Profit-Loss Sharing (PLS) suggests an equitable sharing of risks and profits between the parties involved in a financial transaction. Under PLS, "the lender and the borrower assume the investment's risk based on a pre-agreed formula". PLS acquires several forms depending upon the type of contract e.g. Mudaraba (Joint venture) and Musharaka (partnership and collaboration). In both of these forms, the financier makes the funds available, not as a lender, but rather as an investor. The financier shares the profit (loss) and is not assured, in advance, of a positive rate of return. Losses must be shared by the financier in proportion to his share in the total financing while profits may be shared in any mutually agreed ratio. However, the financier liability remains limited to the extent of financing provided by him and no more (Ahmad 2012).

C. Shari'a-Approved Activities

Islamic banks may engage in or finance only activities that do not violate the rules of *Shari'a* and are permitted by Islam. To ensure all products and services offered are *Shari'a* compliant, each of banks should have an independent *Shari'a* supervisory board (Bala, S. and Zaha, R. 2009).

Investment is forbidden in socially and ethically detrimental activities. These include, for example, gambling, pornography, alcohol...etc. It is also not permissible to acquire the shares of the companies providing financial services on interest like conventional banks and insurance companies whose business are not acceptable by Islam (Ahmad 2012).

D. Sanctity of Contract

Islam 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 will be deemed illegal and unenforceable (Bala, S. and Zaha, R. 2009).

E. Avoidance of Gharar

Gharar is defined as the uncertainty, hazard and game of chance (gambling). It technically refers to the sale of probable items whose existence or characteristics are not certain, or a sale involving *excessive* risk or moral hazard. This, to some extent, makes this way of trade similar to gambling. The reason of prohibition is that speculators generate their private gains at the expense of society at large (Ahmad 2012).

Shari'a prohibits financial transactions that involve *gharar*, which is often translated as “deception,” “excessive risk,” or “excessive uncertainty.” Examples of *gharar* are the sale of fish in the sea, of birds in the sky, and of unripe fruits on the tree, which cause excessive and avoidable uncertainty (Bala, S. and Zaha, R. 2009).

Unlike *riba*, which involves the question of the presence or absence of interest, *gharar* raises the question of degree. And it does not apply to noncommutative contracts (i.e., those, such as gifts, that do not involve an exchange). It is not as well defined as *riba*, and a ruling of permissibility based on *gharar* could take into account a cost–benefit analysis. For instance, *gharar* is present in contracts where the object of the sale is not in the possession of the seller or does not exist at the time the parties enter into the contract but such contracts are permissible (Bala, S. and Zaha, R. 2009).

Gharar does not create additional wealth. "It only transfers wealth from its (losing) owners to new (winning) ones". Transactions containing risk are supposed to enhance uncertainty and deceptive behaviors. However, in practice, as it is involved in every economic activity, minor

uncertainties and certain degree of risk are religiously permitted. Overall, the ban of Gharar and Maysir has particular relevance for financial markets, notably the derivatives market and the insurance business. Therefore, the trade of all conventional derivative instruments is unacceptable in Islamic finance (Ahmad 2012).

To minimize *gharar*, contracts must carefully state the terms of the agreement, particularly by giving a thorough description of the asset that is the subject of the contract and the asset's transaction price. In a sale, if the asset being sold and its price are not clearly defined or specified, the sale contract would be considered to have excessive *gharar* (Bala, S. and Zaha, R. 2009).

F. Money as a Potential capital

Based on Islamic principles, money is considered as “potential” capital. That is, it becomes actual capital only when it is invested in a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital. Taking into consideration that the modern finance are based on the concept of money's time value, Islamic finance does not revoke the time's monetary valuation. "Shari'ah does not prohibit increment in loan in the price of a commodity in any sale contract to be paid at a future date. It does prohibit making money's time value an element of a lending relationship where it is claimed as a predetermined value. In this case, Shari'ah requires that a loan be paid back in the same currency by which it was given" (Ahmad 2012).

2.6.2 Islamic Banks Dealing: Goods not Money

Conventional banks deal in money: they get money from the public as loans and pay the interest; they give advances to needy people or firms in the form of money and charge them interest. In domestic or foreign trade financing activities or even in the case of finance lease, goods are also involved, but they have no concern with the goods or assets themselves; their main concern is with financing the purchase of goods and for that purpose they also deal in documents to facilitate the trading of goods. As such, there is a famous quote in conventional banking: “Banks deal in documents not in goods”. They undertake no responsibility or risk in respect of the subject of the contracts and their counter payments or price (Ayoub 2007).

In contrast, Islamic banks deal in goods and documents and not in money. They use money only as a medium of exchange for purchasing the goods for the purpose of leasing or selling onward, thereby earning income or profit. In this process they also use documents for executing sale and lease contracts, keeping in mind the Shari'ah principles and facilitating the operations (Ayoub 2007).

Islamic banks intermediate between savers/investors and fund users by involving certain goods and assets or papers representing ownership of real assets. In Salam or Murabaha, for example, the banks deal in certain commodities, not money. They purchase the goods directly or through their agent (under a Wakalah arrangement), at their own discretion for maintaining inventory, or upon an order by their client. The banks take on ownership and the related risks and then sell them at cost plus a profit margin, just like traders. After the execution of a sale, the risk transfers to the clients who will be bound to pay the price at the settled time. In Istisna'a, the manufacturers manufacture the asset and deliver it to the bank along with all related assets and market risks (Ayoub 2007).

In Salam, they receive goods against which they have made prepayments; after that, the asset risk and the price risk is theirs and not the Salam seller's. Contemporary scholars have suggested a parallel contract of Salam whereby a bank may sell a commodity purchased through Salam for the same date of delivery or even the quantity. Scholars are of the view that as long as the original and the parallel Salam contracts are not linked together or made conditional on each other in any way, there is no restriction on the terms of the parallel Salam contract, which is a new and independent contract that should be honored regardless of whether the first Salam contract is honored or not (Ayoub 2007).

Involvement in forward trading of goods on the basis of Salam and Istisna'a not only has great potential for developing the agricultural and rural micro-finance market, but also for making the future of the majority of people living in rural areas secure. However, forward foreign exchange operations with delayed payment of any of the currency of exchange and most types of financial futures are not available in the Shari'ah-compliant system, because these instruments are hedging strategies of the interest-based system. The spot foreign exchange market can function without any problem (Ayoub 2007).

In Ijarah, Islamic banks have to deal in physical assets; they purchase the assets for lease to the clients. So long as the asset remains on lease, its ownership and related risks/expenses remain with the bank; if the asset is damaged without any fault on the part of the lessee and it is not able to deliver the normally intended benefit, the bank's right to receive rental will cease. For transfer of the asset's ownership to the lessee, there must be a separate sale or gift agreement with all related conditions (Ayoub 2007).

In Musharakah- and Mudarabah-based investments, Islamic banks' earnings depend on the result of economic activity undertaken by the client, and they will share the profit as per agreed ratios and bear the loss as per their share in the capital of Shirkah business (Ayoub 2007).

In addition to the above business activities, Islamic banks may provide services against service charges or management fees. However, they cannot receive any fee on lending operations as cost of funds, as that would amount to Riba. Similarly, any penalty in case of default by the clients in paying their debts will not be credited to their Profit & Loss Sharing Statements (Ayoub 2007).

Islamic banks also earn non-fund-based income. Besides the charges for transfer of funds or making payments on behalf of clients, they may engage in fund management against fixed fees under the contract of Wakalatul Istismar as a part of their non-fund-based activities. Under this arrangement, all profit/loss will be that of the client(s) and the banks will be entitled to a fixed management fee against their service for managing the clients' investment (Ayoub 2007).

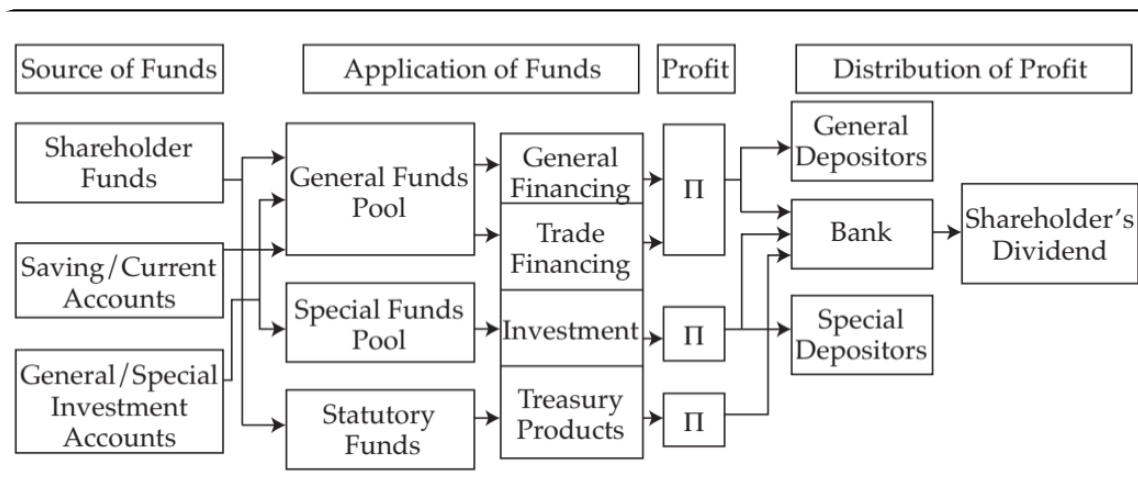
2.6.3 Islamic Banking: Sources and Uses of Funds

Once regarded as a specialized backwater of global banking, Islamic banking has gained substantial strength in the world of international finance. It is developing into a full-fledged financial system offering a broad range of *Shari'a*-compliant products and services to meet the needs of individuals and institutions. Since its inception in the early 1960s, modern Islamic banking has been widely adopted throughout the Muslim world. In this period, Islamic finance has expanded in complexity through the creation of new *Shari'a*-compliant products in response to the increasing global demand for such products. Viewed by many as a financing system that encourages entrepreneurship, Islamic banking and finance are making inroads into the areas of commercial and investment banking (Bala, S. and Zaha, R. 2009).

Sources of Funds

Islamic banks are deposit-taking institutions but do not pay interest on deposits. Their sources of funds include shareholder investments, savings accounts, current accounts, and investment accounts, classified as either general or special. Similar to conventional bank depositors, Islamic banking depositors are seeking safe custody of their funds and convenience in using their funds. Islamic banking depositors may also expect to earn some profit on deposit balances, but this profit is not guaranteed. Account holders may use automated teller machine (ATM) facilities, internet and mobile banking, and international debit cards (Bala, S. and Zaha, R. 2009).

Figure 2.1: Sources and Uses of Funds in Islamic Banks



a. *Shareholder funds*. An Islamic bank may raise initial equity by following the principle of *musyarakah* (equity participation). Under this principle, the capital owner enters into a partnership with the bank by contributing equity in return for a share of the bank's profit or loss on the basis of a predetermined ratio (for example, 70 percent/ 30 percent or 60 percent/40 percent), with the larger fraction due the investor (Bala, S. and Zaha, R. 2009).

b. *Wadiah savings accounts*. Islamic banks practice the principle of *wadiah* in operating customer savings accounts. The bank may request permission to use customer funds deposited in these accounts as long as these funds will remain within the bank's discretion. The bank does not share with the customer profits earned from the use of the customer's funds but does guarantee the customer's deposits. The bank may, however, reward customers with a *hibah* (gift) as a token

of its appreciation for being allowed to use the funds. *Hibah* could be a portion of the profit generated from the use of the funds. *Hibah* may be paid at any time, but in practice, most Islamic banks pay *hibah* at a regular periodic interval, such as quarterly or semiannually (Bala, S. and Zaha, R. 2009).

c. *Current accounts*. The current account is a deposit account that can be used for business or personal purposes and, like a savings account, is based on the Islamic principle of *wadiah*. Account holders are not guaranteed any return for keeping their funds with the bank, but they may be rewarded with *hibah*. Customer current account balances are guaranteed. The primary distinction between savings and current accounts is that minimum balance limits and withdrawals are more flexible for current accounts (Bala, S. and Zaha, R. 2009).

d. *Investment accounts*. Investment accounts operate on the principle of *mudharabah* (profit sharing), with banks accepting deposits from investors for either a fixed or unlimited period of time. Investment accounts are also known as “profit-and-loss-sharing” deposits. The ratio for sharing profits and losses identifies the only return guarantee the account holder receives from the bank. For this kind of arrangement, the customer is referred to as an “investor” (*rabbul-mal*) with the characteristics of a silent partner. The bank acts as an agent (*mudarib*) for the investor in the management of the funds and invests them in *Shari'a*-compliant stocks, economic projects, and so forth. Although these accounts are known as profit-and-loss-sharing accounts, all investment losses are borne solely by the investor, except when the loss results from the bank’s misconduct or negligence (Bala, S. and Zaha, R. 2009).

In general, Islamic banks do not charge any investment management fee; the returns are mainly from shared profits. Investment accounts are an important source of funds for Islamic banks and are used for investment and financing activities. Islamic banks seek to earn a profit on investment accounts, in contrast to their expectations for savings or current account deposits, which are more likely to be held for precautionary or transaction purposes to serve the needs of customers (Bala, S. and Zaha, R. 2009).

2.6.4. Islamic modes financing

There are many contracts and institutional forms used within the Islamic finance industry. Financing tools that have been widely exercised by Islamic banks are primarily based on two general principles: the PLS principle and the mark-up (MUP) principle. The first principle states that the bank (financer) is allowed to profit from a given loan under the condition that the bank is willing to share the investment risk. Contracts that are based on this principle (e.g. Mudaraba and Musharaka financing) can possibly be seen as equity investments. Under the MUP principle, the bank may purchase a good/service or lease an asset in barter for a margin. Contracts that are based on this principle include debt-based financing modes such as: Murabaha, Salam, Istisnaa and Leasing (i.e, pure Ijarah and Ijarah & Iqtina) and referred to as “fixed return financing based on the “mark-up” or “cost-plus” concept (Ahmad 2012).

a. Equity financing and profit sharing: In both equity financing and profit-sharing activities, the bank provides funds to an enterprise in return for a share of the profits generated by the borrowed funds. The distinction between the two structures is that equity financing allows the bank to participate in the enterprise’s decision making. Profit-sharing arrangements preclude bank participation in the borrower’s management decisions (Bala, S. and Zaha, R. 2009).

b. Credit purchases: For credit purchase transactions, the bank provides immediate delivery of the goods or services sought by the customer in exchange for the customer promising to make a series of deferred payments to the bank equal to the cost of the goods or services plus a markup.

c. Leasing: In leasing arrangements, the bank purchases a durable asset and leases it to the customer in return for regular payments that reflect the cost of holding and maintaining the asset (Bala, S. and Zaha, R. 2009).

In general, penalties imposed by Islamic banks for late payment or default are not collected for the bank’s own benefit but are donated to charity. Some Muslim countries allow banks to charge a penalty to recoup the costs of collecting the missed payment (Bala, S. and Zaha, R. 2009).

The permissibility of risky capital investment without explicit interest earning generates 3 forms of Islamic financing for both investment and trade: **I)** synthetic loans (debt-based) through a sale-repurchase agreement or back-to-back sale of borrower or third party-held assets. **II)** Lease

contracts (asset-based) through a sale-leaseback agreement (operating lease) or the lease of third-party acquired assets with purchase obligation components (financing lease). **III**) Profit-sharing contracts (equity-based) of future assets. As opposed to equity-based contracts, both debt- and asset-based contracts are initiated by a temporary (permanent) transfer of existing (future) assets from the borrower to the lender, or the acquisition of third-party assets by the lender on behalf of the borrower (Jobst 2005, cited in Ahmad 2012).

In reality, Islamic finance industry relies on debt-based structures instead of equity-based ones. This might be due to the fact that the capital adequacy requirements for equity-based products, in order to maintain high capital ratios and prevent dilution of banks ownership rights, are higher than debt-based ones. Also, the taxation treatment of debt makes it more attractive than equity. However, if Islamic banks use equity-based structures, their operations will be riskier. Specifically, while the larger payouts to depositors in the short term may increase deposits and thus, could provide some comfort in the present economic scenario, the rate of return to depositors at Islamic banks will be low in the long term which could, in turn, encourage deposit withdrawals leading to a potential liquidity and solvency problems, particularly due to the compliance with regulatory and taxation rules (Abedifar and et al. 2012, cited in Ahmad 2012).

2.7 Islamic banking system Vs conventional banks

Conventional Banking System

Conventional banks mostly act as intermediaries between lenders & borrowers enjoying almost a risk-free spread. Specifically, banks do not usually indulge in equity financing. They carry much less risk, major part of such risks being transferred to the borrowers. The purpose of investments is to maximize private profit & wealth without any restriction. The emphasis then is primarily on credit-worthiness of clients (Ahmad 2012).

Conventional banks guarantee the capital (value of the deposits) and rate of return (interest rate). In case of debtors default, the bank can charge additional money (compound penal rate of interest). In case of banks bankrupts, depositors are paid before the shareholders. However, for commercial banks, borrowing from the money market is the main source of liquidity (Ahmad 2012).

Transactions are financial asset based money. Debt burden arising out of excessive use of credit leads to bankruptcies and waste of financial resources. Due to absence of goods & services behind the money while distributing funds, the expansion of money takes place, which creates inflation. Bridge financing and long term loans are not made on the basis of existence of capital goods; rather they are distributed on the basis of window dressed project feasibility of the entrepreneur (Ahmad 2012).

Debt financing gets advantage of leverage for an enterprise due to interest expense as deductible item from taxable profits. This causes huge burden of taxes on salaried persons. Thus, the saving and disposable income of the people is affected badly. This results decrease in the real GDP. Trading and dealing in derivatives are widely considered as the main source of liquidity in the conventional financial, commodity and capital markets (Ahmad 2012).

Islamic Banking System

Opposite to conventional banking, the theory of Islamic banking distributes risks and rewards equally between the borrower and the lender. On mudarabah based model of Islamic banking (silent partnership), Mudarabah which refers to a contract between two parties for a commercial venture wherein one party (rabb-ul-maal), invests capital in the business, and the other party (mudarib) exerts skills and efforts in the business. It is the exclusive responsibility of mudarib to manage the business without any involvement of the investor. The two parties share the profit according to a pre-agreed ratio. In case of loss, all the financial loss is borne by the investor. The loss of mudarib is in terms of sacrifice of the time and effort that he exerts (Zaheer 2013).

The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller. Participation in partnership business based upon the principles of equity financing and real economic activities is the fundamental function. Greater share of potential risks forces Islamic banks to manage it more professionally to ensure better returns than conventional accounts. Depositors & investors have the opportunity to earn higher returns but also could suffer losses. The purpose of investments is to increase beneficial output to the community as whole. Thus, it gives greater emphasis on the viability of the projects. Islamic banks also aim at maximizing profit but subject to Shari'ah restrictions (Ahmad 2012).

Islamic banks, working on the principle of PLS, they cannot, by definition, guarantee any fixed rate of return on deposits. Islamic banks can only guarantee deposits for deposit account, which is based on al-wadiah and thus, the depositors are guaranteed repayment of their funds. However, if the account is based on Mudarabah, for example, clients have to share in a loss position (Ahmad 2012).

Interest-Free Banking has the same purpose as conventional banking except it is based on a comprehensive system of ethics and moral values stemming from the religion of Islam. International Association of Islamic Banks defined the Islamic banking as “the Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic Shariah in the fields of finance and other dealings”. Therefore, the point is obviously clear that Islamic banking differentiates from conventional banking in terms and conditions of its mission and objectives and duties toward society. The Interest-Free Banks takes all these duties and responsibilities greater than conventional banks. Whereas, conventional banking is fundamentally based on the debtor-creditor relationship between the depositors and the bank on the one hand and between the borrowers and the bank on the other, with interest as the price of credit, that reflect the opportunity cost of money (Ramlan and Adnan 2015). Without a clear understanding of these differences, some people, even experts tend to make a common mistake of equating Islamic banks with other conventional banks with the mere change of name (Siddiqui 2013).

Financing is backed by real assets and meant for productive use to reduce the overall debt burden. Due to the existence of goods & services, no expansion of money takes place and thus, no inflation is created. For example, Musharakah & Diminishing Musharakah agreement are made after making sure the existence of capital good before disbursing funds for a capital project (Ahmad 2012).

Sharing profits in Mudaraba and sharing in the business venture in Musharaka provides extra tax to Federal Government. This leads to minimize the tax burden over salaried persons. Due to which savings & disposable income of the people is increased, this leads to an increase in the GDP. The existence of uncertainty in a contract is prohibited. “Full disclosure” by both parties is the norm in contracts. Derivatives trading are considered as having elements of Gharar (Ahmad 2012).

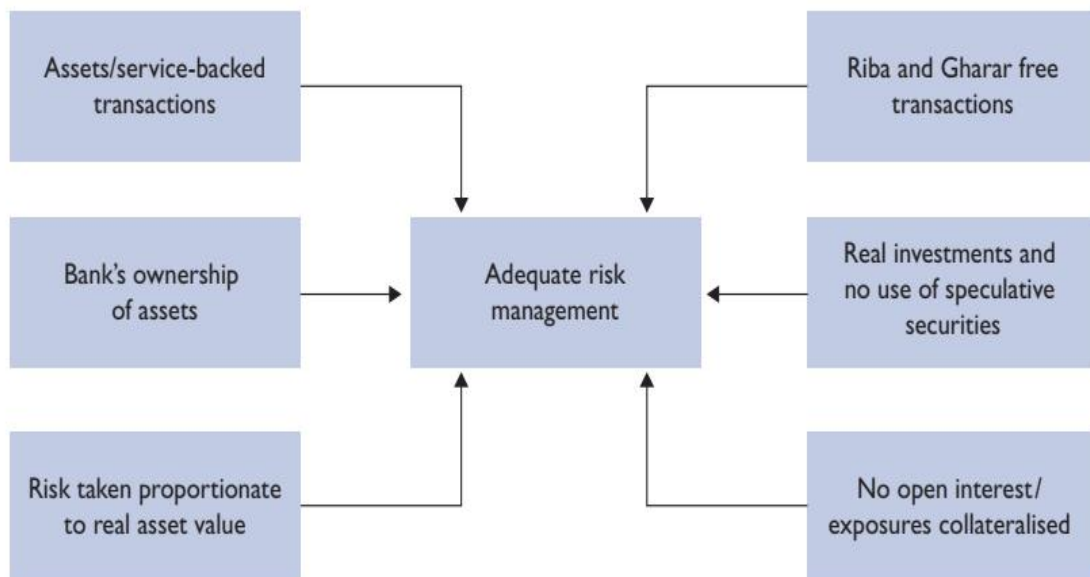
2.7.1 Risks in conventional and Islamic Banking

Risk management is a continuous and vigilant process. It is an activity more than an action. It is designed to manage the risks inherent in the bank's business. The goal of an effective risk management system is not only to avoid financial losses, but also to ensure that the bank achieves its targeted financial results with a high degree of reliability and consistency (Usmani).

A conventional bank is generally exposed to the following types of risks: credit risk, market risk, liquidity risk, operational risk, regulatory risk and reputation risk. A conventional bank lends money and earns interest on the lent money. It lends money for any financial need, be it for the purchase of assets or not. Even, if it provides financing for the purchase of assets, it does not own the assets and is only concerned with the return of its principal amount and interest (Usmani).

Therefore, it avoids facing many risks that Islamic banks have to face due to their Shariah compliant operations. However, the flipside to this is that conventional banks – by way of freedom to lend money only – get themselves involved in excessive leveraging and their money – based financial assets are theoretically exposed to unlimited risks as compared to Islamic banks who by way of asset-backed financing are exposed to risks only to the extent of diminishing value of the real asset (Usmani).

Figure 2.2: Risk Management framework in Islamic Banking



Source: Usmani 2015

An Islamic bank faces a variety of risks in addition to the risks faced by a conventional bank i.e. reputation risk, Shariah non-compliance risk, product/mode of financing risk, process risk, counterparty risk, etc. Apparently, Islamic banking transactions look more risky compared with the conventional banking transactions. But, if we thoroughly consider many prevalent products of conventional banking and finance, we can easily differentiate that Islamic finance has limited risks on its assets as all financing provided by Islamic banks are real asset/service backed. (Usmani).

Shari'ah risk

Shari'ah risk should be managed properly by the IFIs, otherwise the trust of depositors will shatter that may induce them to withdraw their deposits as a result. Shari'ah risk ultimately transforms into the credit risk leading banks toward failure. Violation of Shari'ah results in the reputational risk as depositors and stakeholders lose their trust and in turn IBs lose their market position. To exalt transparency and to control Shari'ah risk IBs are required to submit Shari'ah governance reports to the supervisors regarding SSBs resolutions, as well as Shari'ah audited reports and any refinement to the Shari'ah governance. In this way the supervisory authorities can find out the deficiencies where they lag behind and coerce the IBs to take cardinal measures to overcome the deficiencies within the stipulated timeframe (Zahid and Khan 2019).

2.8 Shariah Audit and Compliance for Islamic Financial Institutions

Shariah Audit is an independent examination of financial as well as operational information of Bank. It is conducted to express an opinion to the stake holders regarding the adherence to Shariah Guidelines, principles by the bank. In case of any non-Compliance noticed, due to any reason, the Shariah Audit will provide suggestions for the remedial / consequential measures (Usmani 2015).

2.8.1 Strategic Importance of Shariah Audit

Shariah Audit is one of the most important functions for any Islamic Financial Institution (IFI), since it gives an independent opinion about the very purpose of existence of any Islamic Financial Institution i.e. its compliance to the Shariah Principles. It is therefore extremely

important that a proper system of Shariah Audit is established in every IFI, which should be regularly updated to reflect the latest practices in the growing field of Islamic Banking and Finance (Usmani 2015).

2.8.2 Responsibility of Shariah Compliance

In principle, it is the responsibility of each and every employee of an Islamic Financial Institution, to ensure adherence to Shariah Guidelines in their scopes of work. The direction towards creating a culture where every member realizes their responsibility for Shariah Compliance must be fostered by the Senior Management and supervised by the respective Departmental Heads. Shariah Audit and Compliance, provides an assessment about the manner in which the responsibility of Shariah Compliance has been exhibited and ensured by the Staff members in implementation, Departmental Heads in Supervision and Senior Management in direction setting to ensure Shariah Compliance (Usmani 2015).

2.8.3 Regulatory models for Shari'ah supervision

SSB serves as an independent body in the IBs without being influenced by the authority of management, board of directors or shareholders. There exist two regulatory models of Shari'ah governance namely national regulatory model and institutional regulatory model. The national regulatory model provides nearly every element of regulation for Shari'ah practices with more participation of regulatory authorities. While, institutional level provides regulatory framework for Shari'ah supervision with little participation of regulatory authorities (Zahid and Khan 2019).

2.8.4 Functions of Shari'ah Supervisory Boards (SSBs)

The functions of SSBs have been described by various regulatory institutions and researchers from time to time according to the needs of SSBs and based upon their activities. Their functions categorized in to five categories: (1) moral function; Shari'ah scholars achieve depositors' confidence in the activities of IFIs by ensuring that they are compliant with Shari'ah laws. (2) Practical function; they provide fatawas on newly developed products/services for strengthening the depositors' confidence. (3) Consulting function; they guide CG bodies based upon Islamic canons and laws. (4) Administrative function; attending meetings of BODs to discuss the issues pertaining to them and intimate their opinions regarding annual reports. (5) Control function; auditing all the transactions performed by the IFIs (Zahid and Khan 2019).

2.8.5 Importance of Shari'ah governance

Shari'ah governance is referred as the system that provides conformity of all commercial transactions and activities of IFIs with Shari'ah. Its significance is procured from religious, social, economic and legal resources. An important pillar on which Islamic banking rests is Shari'ah governance, as all the activities and operations of Islamic banks have to be in compliance with Shari'ah (Zahid and Khan 2019).

2.9 Islamic Corporate Finance

Trade essentially involves two different parties, namely importers and exporters in both domestic and foreign environments. The relationship between these two parties is based on trust, specifically on the terms of payment and delivery. In both international and domestic trade the importers require financing to purchase products from the exporter before selling them in the market (Marifa 2019).

On the other hand, the exporters require financing to manufacture or produce products for the export market before payment is received. To tackle these issues, the Islamic financial institutions have designed a few trade financing products such as Murabaha finance, Istisna finance and Salam finance (Marifa 2019).

Murabaha Financing (Markup Sale)

In corporate Goods Murabaha financing, the customer requests the Islamic bank to purchase goods from specific supplier. The Islamic bank, after purchasing the goods and taking physical / constructive possession, sells the goods to the customer at the cost price plus a profit amount (markup) on deferred payment basis. The customer makes the payment in installments within a predetermined period. Generally, it is used when a customer needs to purchase an asset, equipment, machinery, inventories, raw materials, etc (Marifa 2019).

Manufacturing Financing (Istisna Sale)

Most often, when an Islamic bank gets involved in corporate financing through Istisna, it signs, due to certain reasons, another Istisna contract with the original contractor/manufacturer. This is known in modern custom as Parallel Istisna or “al-Istisna al-Muwazi”. In the first Istisna contract, the Islamic bank acts as contractor / manufacturer (San'e) and concludes the contract

with the original customer who is the purchaser (Mustasne) to sell certain goods to be manufactured as per agreed upon specifications. In the second contract, the Islamic bank acts as the purchaser (Mustasne) and enters into a contract with the ultimate contractor/manufacturer (San'e) to purchase certain goods to be manufactured by the contractor/manufacturer as per agreed upon specifications between the Islamic bank and the contractor/manufacturer (Marifa 2019).

Supplier Financing (Salam Sale)

In the Salam contract, the Islamic bank acts as a purchaser (Al Muslim / Rab-al-Salam) and concludes the contract with the customer (Al Muslim Ilaihe) to purchase certain goods to be produced or procured as per agreed upon specifications. Simultaneously, the Islamic bank receives a binding promise to purchase from an ultimate buyer in order to sell the goods purchased from the customer. Being the purchaser in the Salam Contract the Islamic bank would make an advance payment of the full amount to the customer, which will fulfill the need of the customer of required financing. On the agreed upon delivery date the customer delivers the Salam goods to the Islamic bank which in turn, based on the promise to purchase, sells these goods to the ultimate buyer. In this process also, profit is realized through the difference in price between the two contracts (Marifa 2019).

Islamic Investment Fund

An Islamic investment fund functions in a manner similar to a mutual fund. It executes its functions in the form of a legal entity. The legal form of the fund depends on many factors and can vary as per the requirement. However, an Islamic investment fund can generally be in any of the legal forms. In a company form, the fund manager takes on the role of a board of directors and investors act in the capacity of shareholders. Shareholders would give the mandate of managing the invested fund to the board of directors. In such a scenario, the provision of the company law in the jurisdiction where the fund has been incorporated also governs the fund. This form is particularly preferred in the Middle East region. Secondly, in a trust form, the investors appoint a fund manager as a trustee to manage and invest the funds of the trust. The trust law takes effect and the trustee has a fiduciary responsibility to manage the funds. The third one is partnership form, the fund manager plays the role of a general partner and investors play the role of an ordinary partner. The general partner is responsible for handling the funds. No

matter what form is adopted, the roles and responsibilities of the parties remain more or less the same. The fund manager is responsible for managing the funds and providing returns to the investors (Marifa 2019).

2.10 Success Factors of Islamic Banks

Banking efficiency is the extent to which a bank's management is able to increase its assets and maximize its profits in both the long-run and the short run. There is no doubt that the Islamic bank is fundamentally different from the conventional bank in the nature of its relationship with its depositors – a relationship of partnership. This different nature of bank/depositor relations suggest that the management policy of an Islamic bank should be fundamentally characterized by the maximization of both shareholders profit and depositors' profit (Ali and Ahmed 2007).

Adherence to the Shariah in the banking and finance has become a familiar issue that does not require new juristic reasoning, especially after new standards issued by Accounting and Auditing Organization for Islamic Financial Institutions. What every Islamic bank requires today is effective supervision on the implementation of standards and collective religious rulings in their actual deals and transactions with customers, depositors and shareholders, as well as effective Shariah supervision on innovations by their financial engineering department. This type of supervision cannot be exercised by bringing together senior scholars “who are pre-occupied with a thousand other things” in the Shariah board that presents traditional annual reports at the end of the year. Thus, we consider it very important for every Islamic bank to devise an effective institutional framework of Shari[ah supervision which enables the bank to combine effectiveness with reputation, such that it would be able to get real trust that it can deploy in marketing its services and new innovative financial products (Ali and Ahmed 2007).

Another success factor of the Islamic bank lies in its financial engineering department. This department must always be able to provide a continuous flow of new instruments, windows and investment contracts that assist the bank to attract new customers and offer new services. It is evident that the department of financial engineering has a big role to play in inventing new investment vehicles, especially vehicles that fit off-balance sheet investments. In addition efficiency in investment management, marketing, preservation of shareholders and depositors'

equity, provision of humanitarian and social services are other factors for success (Ali and Ahmed 2007).

2.11 Challenges facing Islamic banking and finance

There are many challenges which are common to conventional banks. But there are several challenges which are particularly specific to Islamic financial institutions. Some of the most important challenges facing Islamic financial industry are identified by previous authors presented as follows:

2.11.1. Shari'ah arbitrage

There is a diversity of opinion as to whether particular practices or services and products are Shari'ah compliant or not. This indicates that some products and services may be approved as being Islamic by some Shari'ah scholars but not by others. The significant differences in the well-known Muslim scholar's interpretation of the Islamic law relating to financial transactions can apply not only to products and services, but also to operations and financial systems (Ahmad 2012).

2.11.2. Shari'ah compliance throughout the Islamic product's life cycle (PLS)

For Islamic finance providers, gaining approval from the Shari'ah Supervisory Board (SSB) on Shari'ah compliance of a product before its launch is not only necessary, but vital. What is also important for Islamic banks is recognizing that the Shari'ah compliance is a continuous process which particularly means that their products (or services) are adequately monitored. This has, however, implications for an Islamic bank's prudential requirements as well as conduct of business. Some products, if they breach Shari'ah compliance rules, "can adversely affect a bank's solvency by converting an asset into a liability on the balance sheet". However, efficient monitoring of Shari'ah compliance may involve reinforcing more effective SSB oversight through the internal auditing process and by developing knowledge and more expertise within an Islamic bank (Ahmad 2012).

2.11.3. Shortage of experts in Islamic banking

One main challenge to expanding the Islamic banking industry is the scarcity of not only the appropriately qualified Shari'ah scholars who must give their approval that an Islamic financial

product does not contradict the religion's principles before it can be marketed, but also the executive specialists who are typically experts and well-versed in international and Islamic banking operations. In practice, the supply of trained and experienced bankers has lagged behind the expansion of Islamic banking. To cater the needs of the Islamic industry, both business and religious schools should offer specialist courses in conjunction with industry experts to prepare the next generation of Shari'ah scholars (Ahmad 2012).

2.12. Empirical Literature Review

There are substantial amount empirical studies have been conducted on Islamic banking (IFB) all over the world, especially in the context of countries those have adopted the system and practiced over the years of its evolution to enhance the establishment and operation of Islamic banking. These studies have shown that the principles of Islamic banking (IFB) are common or most similar to all countries and IF banks, however, as the studies were mainly focused on Gulf countries, it cannot be generalized the findings for the rest countries due to their different political, economic, social, cultural, technological, religion, legal and other factors. In these section the researcher reviews country specific studies conducted on interest free banking.

Interest free banking is an infant stage in Ethiopia banking industry is not a well-studied area, through few studies were conducted on the IFB. Here presented the study made before.

Mohammed (2012) has studied the “Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia” and his work has identified that even if there was a huge demand for IFB, there are potential challenges found: lack of awareness, regulatory and supervisory challenges, institutional challenges, lack of support and link institutions, 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. However, the study was undertaken before the practical introduction of the IFB in the country. Therefore, it was not based on actual observation of facts on the ground.

Similarly, Sefiani (2014) in his study, entitled “Policy Analysis on Ethiopia Interest Free Banking (IFB) Directive”, the absence of a suitable legal framework, the lack of skilled IFB experts and inadequate awareness about products are the challenges of Interest-free banking practice in Ethiopia. Sefiani recommended the NBE to revise the directive No. SBB/ 51/2011 in

order to resolve legal problems affecting the interest-free banks such as participation in non-banking business, value-added tax on merchandises and double taxation.

Akmel (2015) the study focused on assessing challenges and prospects of Islamic banking service in resource mobilization efforts in three commercial banks in Ethiopia. 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.

Another study was conducted by Teferi (2015) on “Contribution of IFB to economic development and its prospect in Ethiopia” has identified that IFB plays a vital role in idle monetary resource mobilization, creating employment opportunity, supporting GDP growth and assisting in stabilizing crisis and arresting inflation. Moreover, the introduction of IFB does not only create inclusive financial system, but also has a potential to influence and enhance the economic development of the country subject to adequate awareness creation about its governing principles, compliance with prohibitions, familiarity with operating philosophies, expertise capacity building, experience sharing, and creating supporting regulatory environment. The study was only limited to IFB’s contribution and prospects.

In addition, a research by Debebe (2015) on factors affecting customers’ use of IFB, result showed that perceived relative advantage, perceived compatibility, customers’ level of awareness and subjective norm have a significant positive impact on the attitude towards interest free banking. Although stated that 100% of IFB account holders were all Muslims and the service is not going as planned since it is new for the industry.

On the other hand a study conducted by Kerima (2016) investigated Challenges on Interest Free Banking Services finds out the following challenges: lack of capacity to deliver IFB product at full rage, lack of awareness of customer about IFB products, lack of trust and confidence of customers, inadequate marketing and promotion, double taxation, nature of IFB products, unavailability of IFB products in all of its branches and the IFB being delivered in a Window model. Accordingly, she recommended aggressive promotion and marketing campaign about IFB products, provide sustainable and continuous training to build the capacity of the manpower, the bank shall increase accessibility of its products with the expected services attached to the

products, the bank has to have Shari'ah Advisor, give the required attention and focus for the business and the bank has to be transparent in its IFB business undertaking, in addition to these NBE directives, tax and ECX law shall include exceptions for IFB business.

Aliyu Abate (2016) assessed the Ethiopian interest-free banking regulation in light of global Islamic finance standards and concluded that using as a legal frame work the existing single and sketchy directive No. SBB/ 51/2011 to govern interest-free banking service will be a challenge. He recommended NBE to develop a comprehensive directive for a smooth application of interest-free banking system.

A research conducted by Abraham (2017) has studied “determinants of customers’ intention to use interest free banking products and factors affecting employees’ product knowledge”. The results that of the study on customers’ intention showed that, except for Knowledge, all the other variables: Attitude, Social Effect, Perceived Financial Cost and Religious Belief have significant on IFB use intention.

Aman (2019) descriptively analyzed the expansion and financial performance of IFB windows in Ethiopia. His findings indicate that IFB windows in Ethiopia were able to exponentially expand their deposit accumulation through IFB. Moreover, their financial performance expressed in terms of income and profitability is showing substantial growth.

Ahmed (2019) investigated Ethiopian interest-free banking proclamation after the enactment of Directive No. SBB/72/2019. According to Ahmed (2019), there is no difference between the proclamation No. SBB/ 51/2011 and Directive No. SBB/72/2019. Moreover, the legal framework of Ethiopia is not appropriate for launching full-fledged interest-free banking. Accordingly, there is a need for a conducive legal framework to practice full-fledged interest-free banking in Ethiopia.

Lastly, a research conducted by Nobel (2019) “Factors Affecting Implementation of Interest Free Banking Services in Ethiopia: The Mediating Role of Customer Involvement” to investigate major factors affecting the implementation of Interest Free Banking service. The finding indicates that Awareness, compatibility, complexity, Observability, perceived risk, religious belief and customer involvement were significant factors on implementation of IFB service.

Research Gap

Based on the foregone review of literature at national level, it becomes clear that previous studies mainly focused on the customers' intention, prospects and policy analysis on interest free banking. Although, the studies made are limited to few banks. To this regard this study tried to assess and examine the theoretical principle of IFB with the practical implementation on the ground comprising of all commercial banks providing interest free banking service in dedicated window basis. Accordingly, the study will tries to address the gap in Ethiopian context and will provide periodic study.

CHAPTER THREE

3. Research Methodology

Research methodology forms a critical component of any research activity. It is the part of a study that encapsulates processes, methods and design with which the study is conducted. It is the means by which the research problem is scientifically addressed (Quansah, cited in Kothari 2004). This part of the study attempts to explain the research methodology that was applied on the study to obtain representative data from a sample nine commercial banks found in Addis Ababa. The research design, sampling design, sources of data, method of data collection and data analysis method for the study are presented in this section.

3.1 Research Design and Approach

A research design is the logic that links the *data* to be collected (and the *conclusions* to be drawn) to the initial *questions* of study. It is *a logical plan for getting from here to there*, where *here* may be defined as the initial set of questions to be answered, and *there* is some set of conclusions (answers) about these questions. This study attempts to investigate the theory and practical implementation of interest free banking in Ethiopia with particular reference to Commercial banks currently offering interest free banking service. To conduct the study and to realize the objectives of the study, non-experimental and descriptive research design, which is cross-sectional in its nature was applied due to its appropriateness. Although, mixed research approach being functional, which allows for both quantitative and qualitative data gather and analyze using their respective techniques. Specifically, the study used quantitative analysis and qualitative personal administered questionnaire, with directors, managers and senior staff member of IFB department of commercial banks.

3.2 Source of data and collection methodology

In order to carry out any research activity, information should be gathered from proper sources. The significance of primary data cannot be enlarged and consequently, the study made use of primary data of qualitative nature that was obtained from selected IFB service providing banks. Personal administered questionnaire used to gather primary data from purposively selected IFB window department directors, managers and senior staff members at the Head Offices of banks.

In an effort to make the study more valid, credible and to elaborate the conceptual aspects of the IFB services, secondary data are mandatory. Thus secondary data collected from the annual reports, document review, directives, etc.

3.3 Target population and sampling Design

According to National Bank of Ethiopia, as of June 30 2021, there were total of 21 banks those get license to operate in the banking industry, these are comprise of one development bank (DBE), seventeen conventional commercial banks, one cooperative bank and two fully fledged IFB banks. The fully fledged IF banks are new for the industry and they were not started full operation till June 2021, because of that they are not included for this study.

The population of the study are commercial banks those provide IFB product and services in Ethiopia. Based on the pilot study, there are twelve banks those provide IFB service in window basis, among these, Bank of Abyssinia banned to make research for unknown period and also Debut Global bank is at infant stage for IFB operation, they only give wadiyah saving service and less than one year of experience. Cooperative bank of Oromia have some different operational philosophy in nature with commercial banks so it was excluded to make the rest samples similar. Thus these three banks are not included under the study and the rest nine of them are addressed in the study. Namely, the CBE, OBI, Awash bank, United bank, Wegagen Bank, Nib Bank, Dashen Bank, Abay Bank and Bunna bank.

Applying right sample strategies that is able to reflect desired target of study and selection of true representative from aggregate population is essential. For that, the study used non-probability purposive sampling technique. This was made to collect research sample respondents, by convincing the research purpose. This also help to get respondent who have adequate knowledge, work experience on IFB service and relevant position that can best meet the research objective. Since for every business, plans, policy and strategies are built up, managed, follow-ups are driven by top managers, the study tried to reach mainly those have higher position such as directors and managers of IFB departments found head offices of commercial banks as samples. For the purpose of this study, purposeful sampling was used to obtain five, manageable number, participants from each of nine banks listed above and a total sample size of forty five was taken from all banks to gather data. That help researcher to get the right sample and reliable data.

3.4 Data analysis method

After gathering all required qualitative and quantitative data, it was sorted and screened for any errors and then it checked to prepare tables for making analysis. Also, the study attempts to analyze the various issues that evolve around the research topic. The primary data was analyzed using the applicable statistical tools after all the necessary data are gathered and edited for any errors. The data is presented in a useful and organized manner which was suitable for analysis. The data collected using the structured questionnaire was coded and SPSS (Statistical Package for Social Sciences) version 23, a computer aided programmer and MS-Excel are used as analysis tool. On the other hand secondary data also analyzed mixing with primary data to give further justification. In order to convey the intended meaning and be convenient for interpreting the findings of the research, analysis performed and data presented through table and chart. Although, frequencies, mean and percentages of the data was calculated in order to facilitate the analysis and to make it easily understandable for the readers. In general, the data was presented, organized, analyzed and interpreted by using descriptive analysis method.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter presents the data analysis and results of the study conducted on Interest Free Banking: Theory and Practice in commercial banks. As per the research methodology, data were gathered from primary and secondary sources through questionnaire and document review. The primary data have been collected through distributed questionnaires to the purposively addressed 45 respondents of IFB staff directors, managers, and senior officers of selected commercial banks. As the sample was small, easily manageable, purposely selected and reached, all distributed questionnaires were answered and collected and used for further analysis.

In addition to the questionnaire, secondary data was collected to see the performance of IFB windows from their annual financial statements of the banks. The results are presented in tabular and graph form of representation of, frequencies, percentiles, and means. Although trend analysis done to analyze quantitative data.

The chapter comprises of three sections. Section one discusses the demographic details of the respondents', next the reliability test of the study, and the discussion on Interest free banking practice within commercial banks in Ethiopia based on questionnaire results, finally presents the document review analysis and result.

4.2 Background of the Respondents

Description of the characteristics of the sample target population gives some basic information about the sample and their composition. The demographic characteristics include: gender, age group, work experience, level of education, and occupation. This aspect of the analysis deals with the personal data of respondents. The tables below show the details of background information of the respondents.

Table 4.1: Gender of Respondent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	32	71.1	71.1	71.1
	Female	13	28.9	28.9	100.0
	Total	45	100.0	100.0	

Source: Questionnaire, 2021

As depicted in table 4.1, there were more males as compared to females. Male respondents cover 71.1% (32); on the other hand 13 (28.9%) were females. This shows that the majority of respondents are male. Thus numbers revealing that there was gender imbalance in the IFB departments and insufficient representation of females in leadership positions. However, the for the purpose of these study, diversity of the population regarding the gender was enough.

Table 4.2: Age group of Respondent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	25-35	17	37.8	37.8	37.8
	36-45	21	46.7	46.7	84.4
	Above 45	7	15.6	15.6	100.0
	Total	45	100.0	100.0	

Source: Questionnaire, 2021

The data on age group is essential, as it arrange for researcher with indication of length of experience of participants. From the descriptive result, majority of the respondents fall within the age group 36 – 45 years (46.7%) next is 25 – 35 years representing 37.8%. Also, the respondents that above 45 years are 7 (15.6%). From the result shown, it is expected that respondents will have competent experience that goes with their age group.

Table 4.3: Educational Level

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Degree	39	86.7	86.7	86.7
	Masters	6	13.3	13.3	100.0
	Total	45	100.0	100.0	

Source: Questionnaire, 2021

Table 4.3 indicates among the participants under the study, 39 (86.7%) of them have bachelor degree and the rest of respondents acquired master's degree in a specific field of study and none of participants have above second degree. The result, indicate that educational level of respondents was enough for the purpose of these study.

Table 4.4: Work Experience

1. Work Experience on IFB		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1 to 5yr	19	42.2	42.2	42.2
	6 to 10yr	23	51.1	51.1	93.3
	Above 10yr	3	6.7	6.7	100.0
	Total	45	100.0	100.0	

2. Entire Work Experience Including IFB		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1 to 10yr	21	46.7	46.7	46.7
	11 to 20yr	13	28.9	28.9	75.6
	21 to 30yr	11	24.4	24.4	100.0
	Total	45	100.0	100.0	

Source: Questionnaire, 2021

The fourth question dealt with the respondents working experience. Here, they were asked to state their duration of stay in their respective current IFB position and entire job experience. This data help researcher to assess whether they are relevant to participate under the study or not. As displayed in the table 4.4, work experience on IFB, 19 (42.2 %) of the respondents have up to 5 years' experience, followed by 23(51.1 %) of them range with 6-10 years, and the rest 3(6.7%) of respondents have above 10 years' experience on IFB. Thus respondents have enough work experience on IFB for the purpose of this study.

Since IFB business was started in Ethiopia near past years, excluding experiences other than on IFB may affect result figure. So, the table presents respondents entire job experience including IFB. Participants having up to 10years experience takes 46.7%(21), then 13(28.9%) of them range between 11 to 20 year experience and the remaining 11(24.4%) have 21 to 30 years of experience and none of respondents have above 30 year experience. This tells us the respondents have enough work experience for the purpose of this study.

Table 4.5: Job Position

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Director	10	22.2	22.2	22.2
Manager	18	40.0	40.0	62.2
Senior Officer	17	37.8	37.8	100.0
Total	45	100.0	100.0	

Source: Questionnaire, 2021

Concerning the respondent's current job position, Table 4.5 shows that 10(22.2%) of them are directors, next to this 18(40%) are managers and the rest 17(37.8%) of respondents are senior officers. This tells their position is parallel with their experience and age group and it was enough to get sufficient and appropriate data for this study.

4.3 Reliability Test

The reliability of a scale indicates how free it is from random error. The most frequently used indicator of a scale's reliability is internal consistency. This is the degree to which the items that make up the scale are all measuring the same underlying attribute (i.e. the extent to which the items 'hang together'). Internal consistency can be measured in a number of ways. The most commonly used statistic is Cronbach's coefficient alpha. This statistic provides an indication of the average correlation among all of the items that make up the scale. Values range from 0 to 1, with higher values indicating greater reliability. While different levels of reliability are required, depending on the nature and purpose of the scale, a minimum level of 0.7 is recommended. If α is greater than 0.7, it means that it has high reliability and if α is smaller than 0.3, then it implies that there is low reliability (Julie 2016). The tables below show the reliability statistics as computed by the SPSS software.

Table 4.6: Reliability Statistics

Variables -Scale:	Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
Compliance with IFB Principles (CSR)	.970	.976	12
Opportunities of IFB (OCB)	.968	.973	9
Challenges of IFB (IEF)	.959	.968	11

Source: IBM SPSS Output, merged tables, 2021

To meet consistency reliability of the instrument, the variables are tested by Cronbach's Alpha as indicated in tables above; it was found that greater than 0.7 for the three specific determinants, which indicates it is highly consistent since it is above 0.7.

4.4 Analysis and Presentation on Interest Free Banking Practice

In Ethiopia, the financial sector is dominated by the banking sector. Based on data from National Bank of Ethiopia shows, as of June 30 2021, there are total of 21 banks those get license to operate in the banking industry, these are comprise of one development bank (DBE), seventeen conventional commercial banks, one cooperative bank and two fully fledged IFB banks. As discussed before, in our country, IFB service was introduced in 2013 by two commercial banks, namely: commercial bank of Ethiopia and Oromia international bank. Now as of June 30 2021 data, 14 banks are running IFB business, and among these 12 of banks are offering Interest free banking products and services through a dedicated Islamic window. This section discusses the current practical implementation of interest free banking service in respective of: compliance with IFB principles, opportunities and challenges, based on data obtained from the response collected through the distributed questionnaire.

4.4.1 IFB Service Compliance with Principles

Nowadays, more than two third of banks operating in our country are providing IFB services. There is also aggressive marketing and competition between them. On the other hand, unlike conventional banking, as IFB business is directly linked to religious rule, first and foremost, always the requirements should be fulfilled and obeyed. However, as orally acquired information

from NBE staff, there is no controlling and supervision by NBE, who is legally responsible body. The main IFB requirements are: complete segregation of funds in all kinds of activities from the conventional operation, including ICT, deposit, loan, investment, transactions recording and reporting; existence of a sharia supervisory board and they have responsibility of controlling whether particular practices or services and products are Sharia compliant or not; Interest and related operations should be avoided and should operate based on profit and loss sharing principles and so on. Moreover, the bank's management, which is leading and controlling all operation, should give commitment to the implementation of IFB.

The table below presents respondents responses on compliance issues related to IFB service, to rate the below items Likert-scale applied, where one represent strongly disagree and five represent influence to a great strongly agree.

Note: SD=strongly disagree (1), D=disagree (2), N=neutral (3), A=agree (4), SA=strongly agree (5)

Table 4.7: IFB Service Compliance with Principles

Item No	Statements	Response	Response Categories					Total	Mean
			SD	D	N	A	SA		
CSR1	Do you agree that there is complete segregation of IFB deposits and loans from the conventional operation?	Frequency	-	-	-	25	20	45	4.44
		Percent	-	-	-	55.6	44.4	100	
		Cumulative	-	-	-	55.6	100		
CSR2	Do you agree that IFB deposits are only used for Sharia approved activities (investments)?	Frequency	-	-	3	10	12	45	4.20
		Percent	-	-	6.7	66.7	26.7	100	
		Cumulative	-	-	6.7	73.3	100		
CSR3	Do you agree that the bank always maintains firewall between Interest free banking and conventional liabilities?	Frequency			4	31	10	45	4.13
		Percent	-	-	8.9	68.9	22.2	100	
		Cumulative	-	-	8.9	77.8	100		
CSR4	The bank have an effective technological infrastructure in place to separate Interest free banking operation from conventional ones	Frequency	-	1	3	27	14	45	4.20
		Percent	-	2.2	6.7	60	31.1	100	
		Cumulative	-	2.2	8.9	68.9	100		
CSR5	The Shariah scholars' play their roles while the bank developing and launching different products?	Frequency	-	2	4	29	10	45	4.04
		Percent	-	4.4	8.9	64.4	22.2	100	
		Cumulative	-	4.4	13.3	77.8	100		
CSR6	Do you agree that without prior approval from the Shariah board, the bank didn't announce new product?	Frequency	1	2	2	30	10	45	4.02
		Percent	2.2	4.4	4.4	66.7	22.2	100	
		Cumulative	2.2	6.7	11.1	77.8	100		
CSR7	The Shariah Board regularly monitors the functions and operations of the IFB windows	Frequency	2	3	5	20	15	45	3.96
		Percent	4.4	6.7	11.1	44.4	33.3	100	
		Cumulative	4.4	11.1	22.2	66.7	100		
CSR8	Do you believe that the operations of IFB windows in strict compliance with sharia requirements?	Frequency	-	1	2	33	9	45	4.11
		Percent	-	2.2	4.4	73.3	20	100	
		Cumulative	-	2.2	6.7	80	100		
CSR9	The Sharia Board practically engaged in, visiting, reviewing and controlling Interest free banking operations.	Frequency	1	3	3	23	15	45	4.07
		Percent	2.2	6.7	6.7	51.1	33.3	100	
		Cumulative	2.2	8.9	15.6	66.7	100		
CSR10	Do you believe that the boards' have enough religious and academic knowledge and experience on IFB?	Frequency	-	5	5	30	5	45	3.78
		Percent	-	11.1	11.1	66.7	11.1	100	
		Cumulative	-	11.1	22.2	88.9	100		
CSR11	Do you agree that all the operation of IFB window is far apart from interest and uncertainty?	Frequency	3	6	2	22	12	45	3.76
		Percent	6.7	13.3	4.4	48.9	26.7	100	
		Cumulative	6.7	20	24.4	73.3	100		
CSR12	Do you agree that the bank is working risk and return sharing principle?	Frequency	5	18	3	13	6	45	2.93
		Percent	11.1	40	6.7	28.9	13.3	100	
		Cumulative	11.1	51.1	57.8	86.7	100		
		Mean Value of All CSR Items							3.9704

Source: Questionnaire results through IBM SPSS Output, merged tables, 2021

As the table 4.7 shows, the questions tried to assess compliance issues through different perspectives, coming to the first question, "Do you agree that there is complete segregation of

IFB deposits and loans from the conventional operation?” all of respondents agreed on the statement and the mean value is above 4 points. This tells there was no gap on segregations of funds.

Secondly, on the statement *“Do you agree that IFB deposits are only used for Sharia approved activities (investments)?”* majority (94.3%) of participants agreed but 6.7% of the rest have doubt view and totally it have 4.2 score of mean value. This implies banks invest IFB deposits only under Sharia approved areas but it should have to be assured 100% through external body.

Next, responses regarding the question *“Do you agree that the bank always maintains firewall between Interest free banking and conventional liabilities?”* shows, 10(22.2%) of respondents strongly, then 31(68.9%) agree and few (8.9%) respondents have impartial view on the statement. Still the mean value is above 4 points. This tells there is higher assurance on the subject matter.

Succeeding, CSR4 assess on ICT requirements, asking: *“Does the bank have an effective technological infrastructure in place to separate Interest free banking operation from conventional ones?”* One respondent disagreed, 3(6.7%) respondents chosen neutral opinion, 27(60%) of them agreed and the remaining 14(31.1%) are highly agreed. Thoroughly, majority of respondents agreed that there is effective technological infrastructure for IFB service.

Again on the above table 4.7, the study assessed on Sharia advisory board issues, coming back to questions, participants were asked: *“Does the Shariah advisors/scholars’ play their roles while the bank developing and launching different products?”* Here, 4.4%(2) of respondents disagreed, next 8.9%(4) of them have doubt , then 64.4%(29) of participants agreed and the rest 22.2%(10) strongly agree. The result shows majority of participants agreed and it also have above 4 points value of mean. These indicates that the Shariah advisors participate while the bank developing and launching IFB products, but it is expected to have more participation.

The next question examines boards’ level of authority, these enquired as: *“Do you agree that without prior approval from the Shariah advisory board, the bank didn’t announce new IFB product?”* Here respondents marked different answers, thus; 1(2.2%) strongly disagree, 2(4.4%) disagree, 2(4.4%) neutral, 30(66.7%) agree and 10(22.2%) strongly agree. These indicate that

banks have co-work with Shariah advisory board and this is considerable and should have to upsurge the level of cooperation and verification.

Although, regarding the statement: *“Does the Sharia Board regularly monitors the functions and operations of the IFB windows?”* participants reaction shows as: 77.7% of respondents agree whereas, 11.1% disagree and again 11.1% of respondents have impartial view on the statement. Also a mean value of response less than four was recorded. In addition to questionnaire results, the researcher faced challenge to get sharia advisors in person, because of they did not came to office regularly, since all of them work with additional responsibility on different Islamic Institution. These indicate that, even if majority of respondents agree, there is some gap identified and these should be filled with hiring fulltime sharia advisors.

Afterward, respondents were asked; *“Do you believe that the operations of IFB windows in strict compliance with sharia requirements?”*, and most (93.3%) of participants agreed, 4.4% shown impartial response and the remaining 2.2% disagreed on the statement. The result denotes that there is higher level of compliance with sharia requirements, but as respondents may measure from their practical experience and different perspective the operations of IFB windows should be stretched to 100% level of compliance.

In addition, the above table 4.7 presents the question forwarded to participants, that; *“Does the Sharia Board practically engaged in visiting, reviewing and controlling Interest free banking operations?”*, and 84.4% of respondents agreed, 6.7% of them have some doubt, 8.9% of participants disagree and the statement have a mean value of 4 points. This question came to supplement CSR7 above and the responses provided have almost close ratios. These entails that the boards should have to follow up IFB operation and give assurance to the service.

Continuing to the next question, respondents were asked their opinion; *“Do you believe that the boards’ have enough religious and academic knowledge and experience on IFB?”* responses show 11.1 % (5) disagree, 11.1% (5) neutral, 66.7% (30) agree, and 11.1% (5) strongly disagree. The result tells most of, but not all, advisors working on banks have religious and academic knowledge and experience on IFB, still there is some gap on their competency.

As the table 4.7 shows on CSR11, around 75% of respondents agree with the statement that; *“all the operation of IFB window are far apart from interest and uncertainty”*, whereas

20% of participants disagree and the remaining 4.4% have impartial view. Also the mean value scored 3.76 points. Regarding the result, the researcher believes that compliance issues on IFB should not be simply analyzed based on higher frequency or percentage, it is essential that 95% and above confidence, so in order to address these question effectively, additional data was important that why not the remaining 25% of respondents didn't agree with the statement. As informally collected data on these issues; foreign currency exchange rate fluctuation, some doubt between sharia scholars on murabaha product, the effect of currency devaluation and market inflation are some of their possible reasons for disagreement on the statement. However, these reasons don't seem that it can be controlled by the banks and these are general economic issues. But on the murabaha, sharia scholars have a responsibility to create general and agreed framework. Now back to the results, it implies that the operations of IFB windows are far apart from interest and uncertainty.

The last question on the above table 4.7 presents responses concerning the enquiry; "*Do you agree that the bank is working on risk and return sharing principle?*" And yet, the numeric results show that half (51.1%) of the respondents disagreed with the statement, whereas 42.2% of respondents agreed and on the middle around 6.7% of respondents were have impartial view. Also the mean value is below 3. As per further investigation on the result, these significant differences between the opinions of respondents may come from the reasons that conventional banks mostly do on risk free or less risk business, whereas IFB products mainly like 'musharka' are conducted based on return and risk sharing principle, most of banks didn't started working on that way. Since that was one of the major IFB principles, without working on this principle, IFB can't be said it was fully operational. So this indicates that there is less implementation of profit and loss sharing principle.

From the above discussion of the descriptive statistics results shown, the mean score for each of the statements on compliance of IFB with sharia principles reported to be closer to and above 4 points, except the last item. Although, as SPSS output shows, the mean value of all CSR items is 3.9704, which is closer to the scale measure of agreement which is 4, and these indicate that, respondents largely agreed to the statements forwarded and these denotes that banks mostly do IFB in accordance with Sharia requirements and IFB principles. However, there was also some gaps identified such as on Sharia advisors related to properly performing their

role, duty and responsibilities in a regular manner, again doubt on their academic knowledge and experience on IFB, and there was gap on Banks side related to working with risk and return sharing principle.

4.4.2 Opportunities of Implementing IFB Service for Conventional Banks

As many studies shows, in most countries including Ethiopia, Sharia compliant or IFB business are growing and expanding and these was recorded as one of the important developments displayed in the financial industry. Since the last ten years, the growing and particular financial needs of Muslim community motivated and pushed the managements of conventional banks to start Interest free banking service. In Ethiopia there is higher potential market for interest free banking those are looking for IFB product and services to save borrow and invest. Recalling, the primary goal of business companies' is to maximize shareholders wealth, there was also substantial cost to set up and operate interest free banking business. These include opportunity cost using existing infrastructure, purchasing and installing a separate ICT infrastructure with the conventional system, hiring experts, sharia advisors and new employees, other training, advertising and operational costs. So that the additional benefits those banks started IFB have been got should be determine. To assess the opportunities that conventional banks experienced through providing IFB service, certain specific questions were addressed to the participants of this study. The responses of respondents on the assessment are shown on table 4.8 below.

Table 4.8: Opportunities of IFB

Item No	Statements	Response	Response Categories					Total	Mean
			SD	D	N	A	SA		
OCB1	Do you agree that providing IFB service as alternative service to the customers increases the performance of the bank?	Frequency				22	23	45	4.51
		Percent				48.9	51.1	100	
		Cumulative				48.9	100		
OCB2	Does providing IFB Service help Banks to keep their existing customers who are opting to switch to other banks?	Frequency				21	24	45	4.53
		Percent				46.7	53.3	100	
		Cumulative				46.7	100		
OCB3	Does Interest free banking help banks to attract new unbanked society (customers)?	Frequency				22	23	45	4.51
		Percent				48.9	51.1	100	
		Cumulative				48.9	100		
OCB4	Does providing Interest free banking service increase competitiveness of banks than others?	Frequency			1	23	21	45	4.44
		Percent			2.2	51.1	46.7	100	
		Cumulative			2.2	53.3	100		
OCB5	Does Interest free banking enhance the bank's brand image?	Frequency		1	1	18	25	45	4.49
		Percent		2.2	2.2	40	55.6	100	
		Cumulative		2.2	4.4	44.4	100		
OCB6	Interest free banking enable banks to offer varieties of financial products and services	Frequency				15	30	45	4.67
		Percent				33.3	66.7	100	
		Cumulative				33.3	100		
OCB7	IFB help banks to resist the effect of inflation and maintain their financial liquidity through decreasing interest expenses on savings accounts to customers.	Frequency		2	2	26	15	45	4.20
		Percent		4.4	4.4	57.8	33.3	100	
		Cumulative		4.4	8.8	77.7	100		
OCB8	IFB serve to attract foreign investors who seek the service and in turn to get foreign currency	Frequency				21	24	45	4.53
		Percent				46.7	53.3	100	
		Cumulative				46.7	100		
OCB9	Does IFB have positive effect on mobilization of financial resources?	Frequency		1	3	21	20	45	4.33
		Percent		2.2	6.7	46.7	44.4	100	
		Cumulative		2.2	8.9	55.6	100		
		Mean Value of All CSR Items							4.469

Source: Questionnaire results from IBM SPSS Output, merged tables, 2021

As on the table 4.7 depicts, nine questions were forwarded to participants to assess the opportunities of implementing IFB service for conventional Banks. It begins with the statement; “Do you agree that providing IFB service as alternative service to the customers increases the performance of the bank?” and the figure shows, all respondents agreed and it has mean value 4.51. This tells they believe that providing IFB service increases the performance of the bank.

Respondents view on the next statement; *“Providing IFB Service help Banks to keep their existing customers who are opting to switch to other banks”* shown a score of agree (46.7%), strongly agree (53.3%) and a mean value above 4.5, which demonstrates IFB brought an advantage for banks to keep their customers.

Succeeding to inquire provided, participants asked; *“Does Interest free banking helps banks to attract new unbanked society (customers)?”* and as response on table 4.8 above shows, 22(48.9) agreed and 23(51.1%) of participants highly agreed on the statement. This shows positive result on IFB.

Again on table 4.8 above, respondents enquired that; *“Does providing Interest free banking service increase competitiveness of banks than others?”* and the numerical outcome show as majority (98.8%) of respondents agreed and only 2.2% have impartial view. The result indicates that there is no doubt that providing IFB service increase competitiveness of banks.

Continuing to the next question; *“Does Interest free banking enhances the bank’s brand image”* responses given as 2.2% disagree, 2.2% neutral, 40% agree, 55.6 strongly agree and mean score of above 4 points. This indicates that the view of respondents with regard to the statement is high and higher than average, which tells importance of practicing IFB for banks.

Although, regarding the statement: *“Interest free banking enables banks to offer varieties of financial products and services”*, all of respondents agreed and highly agreed to the statement and it shows mean value of 4.67. This question was a supplement for the above OCB4 and the results is closer to the previous one. It emphasizes on that, IFB has opened a new opportunity window for banks.

As the table 4.8 shows on OCB7, some of participants reacted differently with the statement; *“IFB help banks to resist the effect of inflation and maintain their financial liquidity through decreasing interest expenses on savings accounts payee to customers”* respondents that of 4.4% (2) checked on disagree, again 4.4% (2) of have impartial view, then 57.8% (26) agreed, the remaining 33.3% (15) strongly agreed and mean value of above 4 was recorded. In addition to that, it’s known that banks pay a minimum of 7% interest on normal saving accounts and the higher expense that Banks’ incur on their operation is interest expense. However, when customers use IFB accounts, the bank will not incur such expense. Altogether implies that, banks

those are providing IFB service become advantageous in respect of minimizing the effect of inflation and maintaining their financial liquidity.

Again on the above table 4.8, the study assess opinion of respondents regarding the statement; “*IFB serve to attract foreign investors who seek the service and in turn to get foreign currency*”, responses show that all participants agreed.

The last question, related to the possible opportunities of IFB, forwarded to participants was; “*Does IFB has positive effect on mobilization of financial resources?*” and accumulated responses are 2.2% (1) of disagree, 6.7% (3) of impartial view, 46.7% (21) agree, 44.4% (20) strongly agree and 4.33 of mean value was registered. As majority of respondents were agreed, it implies that IFB has positive effect on mobilization of financial resources.

To summarize the table 4.8 above, almost all of respondents agreed to the statements forwarded and also have an aggregate mean value of above 4points. This implies that, providing IFB through dedicated window facilitated for the banks to take an opportunity of increasing their financial performance, bolding the image of the bank, resisting the effect of inflation, maintaining their financial liquidity, attracting foreign investors, increasing foreign currency source, keeping existing customers, attracting new customers, mobilizing financial resources, and improving their competitiveness than others bank.

4.4.3 Challenges of Interest Free Banking

In every business operation as there was expected opportunity, there was also internal and external factors that create challenges on the success of the business. Like other countries, it was also a normal prediction that interest free banking business in Ethiopia also faces many challenges to provide the service successfully over last ten years. Addressing some of these challenges is important for improving IFB business operation. In order to identify the most critical challenges faced by IFB windows of commercial banks, a detailed questionnaire was distributed among bankers working in the area and the on the table 4.9 below presented the responses.

Table 4.9: Challenges of IFB

Item No	Statements	Response	Response Categories					Total	Mean
			SD	D	N	A	SA		
IEF1	Do you agree that there is lack of well trained and experienced human resource on IFB	Frequency	1	4	2	24	14	45	4.02
		Percent	2.2	8.9	4.4	53.3	31.1	100	
		Cumulative	2.2	11.1	15.6	68.9	100		
IEF2	Lack of qualified Shariah advisory scholar	Frequency	1	9	1	29	5	45	3.62
		Percent	2.2	20	2.2	64.4	11.1	100	
		Cumulative	2.2	22.2	24.4	88.9	100		
IEF3	lack of suitable banking polices for IFB	Frequency		-	1	20	24	45	4.51
		Percent	-	-	2.2	44.4	53.3	100	
		Cumulative	-	-	2.2	46.7	100		
IEF4	Lack of educational and training curriculums on IFB	Frequency	-	4	-	19	22	45	4.31
		Percent	-	8.9	-	42.2	48.9	100	
		Cumulative	-	8.9	8.9	51.1	100		
IEF5	There is limitation of capital and resource to provide IFB financing products	Frequency	-	3	3	25	14	45	4.11
		Percent	-	6.7	6.7	55.6	31.1	100	
		Cumulative	-	6.7	13.3	68.9	100		
EEF6	Higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery	Frequency	5	18	2	20	-	45	2.82
		Percent	11.1	40	4.4	44.4	-	100	
		Cumulative	11.1	51.1	55.6	100			
IEF7	Lack of knowledge and proper understanding of IFB among the society	Frequency	-	-	-	22	23	45	4.51
		Percent	-	-	-	48.9	51.1	100	
		Cumulative	-	-	-	48.9	100		
IEF8	Inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products	Frequency	2	8	3	21	11	45	3.69
		Percent	4.4	17.8	6.7	46.7	24.4	100	
		Cumulative	4.4	22.2	28.9	75.6	100		
IEF9	Lack of commitment from Top management to IFB	Frequency	8	32	1	4	-	45	2.02
		Percent	17.8	71.1	2.2	8.9	-	100	
		Cumulative	17.8	88.9	91.1	100	-		
IEF10	There is Research and development gap on IFB product and service	Frequency	-	-	-	23	22	45	4.49
		Percent	-	-	-	51.1	48.9	100	
		Cumulative	-	-	-	51.1	100		
IEF11	Do you agree lack of supportive link institution, like interest free money market and capital markets that are important to maintain liquidity for IFB, created challenge?"	Frequency	-	-	-	29	16	45	4.36
		Percent	-	-	-	64.4	35.6	100	
		Cumulative	-	-	-	64.4	100		
		Mean Value of All CSR Items							3.86

Source: Questionnaire results from IBM SPSS Output, merged tables, 2021

As the table 4.9 shows, the first question forwarded to participants was; “Do you agree that there is lack of well trained and experienced human resource on IFB?” and responses are 1(2.2%)

strongly disagreed, 4(8.9%) disagree, 2(4.4%) impartial view, 24(53.3%) agree and 14(31.1%) strongly agree to the statement. And mean value of four was reported. This implies that lack of well trained and experienced human resource is a challenge for conventional banks currently offering interest free banking products and services.

On the second, majority of the bankers have agreement with the statement that lack of qualified Sharia advisor scholar is a challenge for the operation of IFB. Among 45 respondents, only 22.2% of the respondents disagreed to the statement and another 2.2 % had an impartial view and the 64.4% of the respondents were agreed to the statement but those who strongly agreed to the statement were counted to be 11.1%. The reported of the above item was 3.65. The results show that almost 75.5% of the respondent agreed that lack of qualified Sharia advisor scholar is a challenge, since existence of competent sharia advisor is the central point for both operation and growth such banking service weather the bank is fully fledged or Islamic window of conventional banks.

The above table also shows that 97.8% of the respondents agreed or strongly agreed that lack of suitable policies for IFB by National Bank of Ethiopia is among challenges of Islamic windows by commercial banks. Only 2.2% of the respondents did not show any response to this statement. The reported mean of the statement also confirmed that there was an agreement among the respondents regarding lack of suitable policies for IFB by National Bank of Ethiopia as a challenge.

Regarding on statement; “*Is their lack of educational and training curriculums on IFB*”, about 8.9% of respondents disagree and the remaining 42.2% and 48.9% of respondents agreed and strongly agreed. Also a mean value of 4.3 was reported. This indicates that lack of educational and training curriculums on IFB was another challenge for banks.

Again on the table 4.9 above, among 45 respondents only 6.7% of them disagreed with the statement that *there is limitation on capital and resource to provide IFB financing products* whereas the other 55.6% agreed, 31.1% strongly agreed and 6.7% of the rest impartial view. Although a mean value of above 4 was registered. This denotes that limitation on capital and resource to provide IFB financing products was additional challenge for banks, since there are substantial costs to set up and operate interest free banking business.

Respondents reacted differently to the statement; “*Do you agree that there is higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery?*” among 45 respondents 40% of them disagreed and 11.1% of them strongly disagreed, on the other hand 44.4% of respondents agreed to the statement and only 4.4% of the respondents did not show any response to this statement. And a mean value below three points was reported. This implies commission fee and additional tax burdens became challenge for some of banks to provide IFB products, since there was no special directive for murabaha products, they are exposed for double taxation, first when the bank buy an asset that will be sold to the customer, second when the bank sell to customer.

Next on the same table 4.9 above, shows the responses of the respondents about the statement that there was lack of knowledge and proper understanding of IFB service among the society. Respondents constitute of 48.9% agreed and the others 51.1% strongly agreed with the statement. This indicate lack of knowledge and proper understanding of interest free banking is also another challenge. Although, 46.7% of participants agreed to the statement that there is inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products, and respondents strongly agreed take 24.4% portion, whereas 17.8% respondents disagreed and 4.4% are strongly disagreed, about 6.7% of respondents have impartial view and mean value of below 4 was reported. This also denotes that banks those providing IFB face another challenge due to lack of adopting different kinds of financing products.

As the table 4.9 shows, only 8.9% of respondents agreed on the statement that lack of commitment from Top management to IFB creates challenge. Whereas, 71.1% of respondents disagreed, 17.8% strongly disagreed, on the statement. The rest 2.2% of participants did not show any response to this statement. The reported mean of the statement also confirmed that there was an agreement among the respondents that there was no lack of commitment from Top management to IFB viewed. Although, all of respondents agreed that there was research and development gap on IFB product and service. Among respondents strongly agreed constitute 48.9 percent and mean value of 4.5 was reported. These indicate that banks faced a challenge raised from research and development gap on IFB.

The last question, related to the possible challenges on IFB, forwarded to participants was; *“Do you agree lack of supportive link institution, like interest free money market and capital markets that are important to maintain liquidity for IFB, created challenge?”* and gathered responses are 64.4% (29) of respondents agreed and 35.6% (16) strongly agreed and 4.36 of mean value was registered. As majority of respondents were agreed on the statement, it implies that lack of supportive link institution created challenges for those providing IFB service.

To summarize the table 4.9 above, most all of respondents agreed to the statements forwarded that there is lack of well trained and experienced human resource, lack of qualified Shariah advisory scholar, lack of suitable banking polices for IFB, lack of educational and training curriculums on IFB, limitation of capital and resource, lack of knowledge and proper understanding of IFB among the society, inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products, lack of supportive link institution and presence of research and development gap on IFB. Besides, it have mean value of above 4points. This implies that, banks those are providing IFB service are facing the above described challenges. Also, even if half of respondents disagree on the statement that there is higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery, it need attention to assure that IFB products are price competitiveness in contrast to conventional banks products.

4.5 Analysis on the performance of IFB windows

IBs are not charity organizations, but profit maximizing firms that are meant to do banking in compliance with shariah. However, some Islamic economists argue that since IBs mobilize transaction accounts from depositors as interest-free loans (*Qard*) that generate revenues, a portion of these deposits (Zaheer 2013).

There are many key performance indicators for banks, among them deposits and loans are the major one. As IFB in conventional banks are established and provided from existing assets and capitals, this section limited to discuss the status of interest free banking in terms of deposit raised by IFB windows and loans settled to IFB customer. Currently, as of June 30 2021, there were 12 conventional banks those are providing IFB service. Banks those are included under the study sample, also assessed their growth on IFB. To do so their annual financial statements and other secondary sources are incorporated to the study. The table 4.10 and Chart 4.1 below

outlines the growth of Interest free banking in terms of deposits accumulated, loan provided and deposits mobilized of nine commercial banks those are providing IFB.

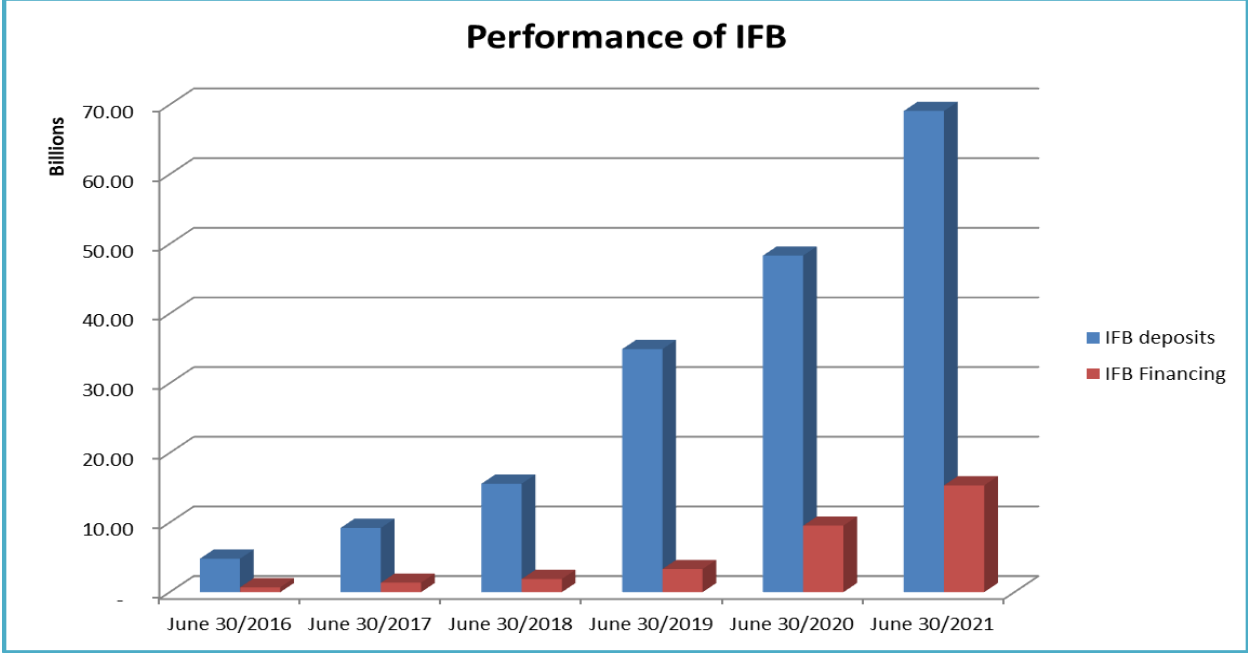


Table 4.10 Analysis on the financial growth of IFB windows

S.No	Banks Providing IFB	Particulars	As of June 30/2021	As of June 30/2020	As of June 30/2019	As of June 30/2018	As of June 30/2017	As of June 30/2016
1	CBE	Deposit	43,897,407,865*	32,516,598,419.00	23,972,301,088.00	9,814,801,727.00	6,090,617,941.00	3,171,799,790.00
		Finance	4,828,714,865*	3,319,502,633.00	253,236,212.00	168,560,399.00	295,545,261.00	185,497,812.00
2	AWASH	Deposit	7,490,279,000.00	3,951,712,000.00	2,155,308,000.00	650,987,000.00	-	-
		Finance	2,120,280,000.00	1,026,507,000.00	260,584,000.00	1,900,000.00	-	-
3	OIB	Deposit	4,878,000,000.00	3,948,000,000.00	4,155,000,000.00	3,013,000,000.00	2,194,910,000.00	1,250,850,000.00
		Finance	3,542,000,000.00	2,903,000,000.00	1,822,000,000.00	1,586,000,000.00	1,054,960,000.00	508,840,000.00
4	Wegagen	Deposit	1,349,650,229.00	1,336,644,165.00	778,400,000.00	409,100,000.00	155,831,017.00	11,520,925.00
		Finance	361,866,000.00	381,481,000.00	236,100,000.00	128,600,000.00	-	-
5	Nib	Deposit	3,100,000,000.00	2,000,000,000.00	1,400,000,000.00	733,166,600.00	322,294,300.00	55,950,300.00
		Finance	823,800,000.00	400,000,000*	280,000,000*	-	-	-
6	United	Deposit	1,649,217,302*	1,230,759,181.00	877,919,154.00	513,374,928*	346,874,952.00	219,817,683.00
		Finance	857,592,997*	671,554,280.00	461,797,264.00	-	-	-
7	Abay	Deposit	1,300,000,000.00	749,000,000.00	462,345,679.00	288,966,049.00	106,769,269.00	89,000,000.00
		Finance	538,000,000.00	299,600,000*	-	-	-	-
8	Dashen	Deposit	4,797,012,000.00	2,366,032,000.00	1,094,113,000.00	136,402,000.00	-	-
		Finance	2,256,056,000.00	542,341,000.00	-	-	-	-
9	Bunna	Deposit	624,139,000.00	223,996,000.00	-	-	-	-
		Finance	-	-	-	-	-	-
Total IFB deposits			69,085,705,396.00	48,322,741,765.00	34,895,386,921.00	15,559,798,304.00	9,217,297,479.00	4,798,938,698.00
Growth Percentage			43%	38%	124%	69%	92%	
Total IFB Financing			15,328,309,862.00	9,543,985,913.00	3,313,717,476.00	1,885,060,399.00	1,350,505,261.00	694,337,812.00
Growth Percentage			61%	188%	76%	40%	95%	
Financing To Deposit Ratio			22%	20%	9%	12%	15%	14%
<i>Source: Own Computation from Secondary Sources, 2021 * indicate projected figures</i>								

As customers' deposits are the grounds of a bank's activity and the source of finance and its profitability, the table 4.10 above shows, the total deposits of the Interest free banking windows of the commercial banks raised from Birr 4.7 billion to Birr 69 Billion over six financial years, which had gone through a minimum of 38% to maximum of 124% growth rate from year to year. Currently, as of June 30 2021 IFB deposits registered that an increment Birr 20.7 billion (48%) over last year same period. Although, among banks, CBE take the largest portion which is 64% and Bunna bank least (1%) deposit share.

The growth financing or loans obviously rely on the growth in deposits. It was also essential because the overall profitability of the banks depends on that. The total loans provided through IFB shows an increase from Birr 700 million to Birr 15.3 billion in the past six years. For the year 2020/21, the total financing provided to IFB customers grew by Birr 5.7 billion (61%) and stood at Birr 15.3 Billion. However, in terms of deposit mobilization or loan to deposit ratios, only 9% to 22% of total deposits are mobilized, which is very low. As the detail financial statements show, the reason that loan to deposit ratios became low is most of banks are only adopted murabaha and qurd financing products and focus on saving products and also Bunna bank did not started financing. This all implies that there is rapid growth of IFB business, high potential market, stiff competition between banks and increase of new entrants to market, call for new product development, to increase financing, importance of IFB to pull in idle funds to the financial system and needs of much attention from regulatory body.

CHAPTER FIVE

Summary, Conclusion and Recommendation

The study was an attempted to assess Interest free banking practice in the case of nine selected commercial banks in Ethiopia and to evaluate them empirically. From the result of the primary and secondary sources so far attempt been made to present and analyze the data. This chapter presents the final part of the study, provides summary, conclusions and recommendations in line with the findings of the study. It is structured in to three sections. The first section presents summary of major findings, then conclusions drawn from the analysis was stated, finally the third section presents some recommendation suggested for IFB customers, banks, regulatory body and any concerned organs, as a solution to problem that has been identified in the study. Thus also add value to the interest free banking industry as an additional literature.

5.1 Summary of Findings

This section presents major findings, which are summarized from the analysis of the results:

Respondents largely agreed that banks operate and provide IFB service in accordance with Sharia requirements and IFB principles. However, there was also some gaps identified such as on Sharia advisors related to properly performing their role, duty and responsibilities in a regular manner, again doubt on their academic knowledge and experience on IFB, and there was gap on Banks side related to working with risk and return sharing principle.

In relation with opportunities of IFB, almost all of respondents agreed on that, providing IFB through dedicated window facilitated for the banks to take an opportunity of increasing their financial performance, bolding the image of the bank, resisting the effect of inflation, maintaining their financial liquidity, attracting foreign investors, increasing foreign currency source, keeping existing customers, attracting new customers, mobilizing financial resources, and improving their competitiveness than others bank.

Concerned to IFB challenges, respondents agreed that there is lack of well trained and experienced human resource, lack of qualified Sharia advisory scholar, lack of suitable banking polices for IFB, lack of educational and training curriculums on IFB, limitation of capital and resource, lack of knowledge and proper understanding of IFB among the society, inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products, lack of supportive link institution and presence of research and development gap on

IFB. Also, even if half of respondents disagree on the statement that there is higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery, it need attention to assure that IFB products are price competitiveness in contrast to conventional banks products.

Based on the analysis made on financial data, the total deposits of the IFB windows raised from Birr 4.7 billion to Birr 69 Billion over six financial years. Currently, in 2021, IFB deposits registered that an increment Birr 20.7 billion (48%) over last year same period. Regarding financing, total loans provided through IFB shows an increase from Birr 700 million to Birr 15.3 billion in the past six years. For the year 2020/21, the total financing provided to IFB customers grew by Birr 5.7 billion (61%) and stood at Birr 15.3 Billion. However, in terms of deposit mobilization or loan to deposit ratios, only 9% to 22% of total deposits are mobilized, which is very low.

5.2 Conclusions

This section provides concluding statements on compliance of IFB with the governing principles (Sharia), opportunities and challenges of IFB in the Ethiopian context. The main conclusions of this study, which are drawn from the analysis result and critical literature review reflections, are presented as follows:

Conventional banks those are doing IFB businesses are necessarily required to comply with IFB principle and conditions. As the study finding tells, they have complete segregation of funds and mostly they are doing in accordance with Sharia requirements and IFB principles. Also there was good commitment from bank's top management on IFB. On the other hand maintaining fully shariah compliance should be ensured by shariah supervisors, but, there was also some gaps identified such as issues raised on Sharia advisors related to properly performing their role, duty and responsibilities in a regular manner, again doubt on their academic knowledge and experience on IFB, and there was gap on Banks side related to working with risk and return sharing principle.

More than half (12) of conventional commercial banks in Ethiopia are providing interest free banking service and gradually IFB become important within banks since banks started to enjoy the opportunities. The result from study revealed that providing IFB through dedicated window facilitated for the banks to take many opportunities as discussed before. Thus shows importance of paying attention to the industry and customers demand.

During the implementation of interest free banking services, it seems that banks have been facing many challenges to provide IFB successfully which arise from internal and external factors. The major challenges as identified by the respondents are, lack of well trained and experienced human resource on IFB, lack of qualified Sharia advisory scholar, lack of educational and training curriculums on IFB, limitation of capital and resource, lack of knowledge and proper understanding of IFB among the society on IFB products and services that may arise from unfamiliarity of society towards the IFB principle and lack of awareness creation activity. Also, there is lack of suitable banking polices for IFB, which created challenge for banks to adopt different kinds of IFB products. The issue came from the industry was being regulated and supervised by the same legal framework with conventional banks. Thus, taking the unique features and risks associated with the industry, the NBE should develop a new standards and comprehensive regulatory framework for the IFB business.

In addition, there is inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products, lack of supportive IFB link institution such as money market and capital market and presence of research and development gap on IFB. Besides that, there is higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery, it need attention to assure that IFB products are price competitiveness in contrast to conventional banks products. Some of the Challenges listed above are consistent with the study findings of Mohamed (2011). However, still now the challenges are in existence without change except for adjustment made on privilege given to establish fully-fledged IF Bank.

Based on quantitative data reviews, the current status of interest free banking in Ethiopia shows a continuous growth based on past six year performance in terms of deposits and loan. The total deposits of the Interest free banking windows reached Birr 69 Billion and total loans provided through IFB touched Birr 15.3 billion. But volume of deposit to loan ratio is still very low and it accounts only 9% to 22%. In addition, the financing was mainly limited to Murabaha. The main reason for the dominance of the Murabaha financing is that it is very simple to implement and due to the gaps in the legal framework to adopt other types of IFB products such as Musharka and Mudaraba Financing. Although, CBE take the largest portion both on deposits and financing over the private banks.

5.3 Recommendations

This section provides some recommendations based on the results of analysis and conclusions of the study which are believed to help in the future operation of the IFB;

- Shariah advisors should make an effective and regular supervision to manage all the financial operations and they should be competent in both academic and religious knowledge of the banking industry. And they should make report it to the general public at large. Also, NBE should establish a Sharia supervisory board (IFB audit & inspection), which will inspect commercial banks those are providing IFB service.
- Commercial Banks those are providing IFB service should add an effort on awareness creation and proper understanding of IFB product and services among the society through public lectures, conferences, and publications.
- Commercial Banks those are providing IFB service should work towards satisfying the customer needs, provide sufficient information on IFB products, create a public confidence by adhering to the accounting and other operational standards, to be transparent in producing a published report that will be available to the public at large showing the overall operations. Although all banks needs to increase the amount of financing and develop alternative financing products.
- Compared to conventional banking concepts, as IFB is a new discipline and have distinct rules and principles. It need to adopt regular training related to IFB governing Sharia Principle and IFB operating philosophy for employees' capacity building and in order to get more opportunities and minimize the operational challenges.
- NBE should facilitate an experience sharing and training opportunities on Interest Free Banking with pioneers of the industry.
- As IFB aspirate many opportunities through mobilizing idle financial resource, creating employment opportunity, alleviate poverty and bring economic prosperity, the government should support and give more emphasis to IFB industry.
- Due to the gaps in the legal framework on the IFB, banks face many challenges the on the operation. Hence, the study recommends that the government (NBE) should revise its regulatory frameworks and develop compatible regulatory framework so as to

enhance the IFB financing services. Moreover, the management of the Bank should insist the government to amend its regulatory frameworks.

- Furthermore, for successful adoption of IFB, it needs to establish institutions such as: research and development center and training centers.

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ADDIS ABABA UNIVERISTY
FACULTY OF BUSINESS AND ECONOMICS
SCHOOL OF GRADUATE STUDIES
MBA PROGRAM

This questionnaire is prepared to collect primary data from IFB directors, managers and senior staff members of Commercial Banks' who are providing IFB service. The objective is to get an input for the accomplishment of MBA Project Paper on Interest Free Banking in Ethiopia: Theory and Practice in case of Commercial Banks. The information you provide is valuable for the success of the research paper and will be used only for academic purpose. It shall also be kept confidential. For this reason your contribution on honestly filling this questionnaire is helpful to produce quality paper. So, please you are cordially requested to answer the following question. Thank you in advance for your time and honest response.

Muhammad Musema

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Thank you in advance for your cooperation!

Important aspects of the questionnaire

- There is no need to write your name
- Kindly respond to all questions
- Please provide the appropriate information by placing a [√] in the bracket provided to represent your answer

Part One: Basic Information

1. Sex:
 Male Female
2. Age Group:
 25- 35 36- 45 Above 45
3. Educational Level:
 Degree Masters Doctorate
4. Work Experience:
 - i. On IFB:
 1 to 5yr 6-10 11-15 above 15
 - ii. On other areas:
 1 to 10 yr 11-20 21-30 above 30
5. Current Job Position:
 Director Manager Other (specify): _____

Part Two:

A. IFB Compliance Aspects						
Item No	Statements	Response Alternatives				
		Strongly Disagree (1)	Disagree (2)	Neutral (3)	Agree (4)	Strongly Agree (5)
1	Do you agree that there is complete segregation of IFB deposits and loans from the conventional operation?					
2	Do you agree that IFB deposits are only used for Sharia approved activities (investments)?					
3	Do you agree that the bank always maintains firewall between Interest free banking and conventional liabilities?					
4	The bank have an effective technological infrastructure in place to separate Interest free banking operation from conventional ones					
5	The Shariah scholars' play their roles while the bank developing and launching different products?					
6	Do you agree that without prior approval from the Shariah board, the bank didn't announce new product?					
7	The Shariah Board regularly monitors the functions and operations of the IFB windows					
8	Do you believe that the operations of IFB windows in strict compliance with sharia requirements?					
9	The Sharia Board practically engaged in, visiting, reviewing and controlling Interest free banking operations.					
10	Do you believe that the boards' have enough religious and academic knowledge and experience on IFB?					
11	Do you agree that all the operation of IFB window is far apart from interest and uncertainty?					
12	Do you agree that the bank is working risk and return sharing principle?					
B. Opportunities of IFB						
1	Do you agree that providing IFB service as alternative service to the customers increases the performance of the bank?					
2	Does providing IFB Service help Banks to keep their existing customers who are opting to switch to other banks?					
3	Does Interest free banking help banks to attract new unbanked society (customers)?					

4	Does providing Interest free banking service increase competitiveness of banks than others?					
5	Does Interest free banking enhance the bank's brand image?					
6	Interest free banking enable banks to offer varieties of financial products and services					
7	IFB help banks to resist the effect of inflation and maintain their financial liquidity through decreasing interest expenses on savings accounts to customers.					
8	IFB serve to attract foreign investors who seek the service and in turn to get foreign currency					
9	Does IFB have positive effect on mobilization of financial resources?					

C. Challenges of IFB

1	Do you agree that there is lack of well trained and experienced human resource on IFB					
2	Lack of qualified Shariah advisory scholar					
3	lack of suitable banking polices for IFB					
4	Lack of educational and training curriculums on IFB					
5	There is limitation of capital and resource to provide IFB financing products					
6	Higher commission fee and additional tax burdens on the IFB products that affect price competitiveness and service delivery					
7	Lack of knowledge and proper understanding of IFB among the society					
8	Inability to meet financial needs of IFB customers due to lack of adopting different kinds of financing products					
9	Lack of commitment from Top management to IFB					
10	There is Research and development gap on IFB product and service					
11	Do you agree lack of supportive link institution, like interest free money market and capital markets that are important to maintain liquidity for IFB, created challenge?"					

Thank you for your cooperation

Table: IFB Products Description

1. Mudaraba (Passive Partnership-PLS):
It is a special kind of partnership (two tiered transaction for an Islamic bank) where one partner gives money (the capital owner-financer) to another (the investment manager-mudarib) for investing it in an enterprise. The Profit is distributed between the two parties in accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner. The manager will loss the "opportunity cost" of his own labour, which failed to generate any positive income.
2. Murabaha
Murabaha is considered a sale contract between the Islamic bank and his client. The client orders the bank to purchase for him a certain commodity from a third party at a specific price, promising to purchase this commodity, from the bank, once it has been bought, but at deferred price. The deferred price includes an agreed upon profit margin "markup" in the favor of the bank as a return for its services.
3. Musharaka (Active Partnership "joint venture"-PLS):
A contract similar to that of the Mudaraba, with the difference that in the case of Musharaka both partners participate in the management and provision of capital. They also share in the profit and loss of the investments. More specifically, profit is distributed between partners in accordance with agreed ratios, but loss must be distributed in proportion to the share of each partner in the total capital.
4. Diminishing Musharaka (Co-ownership) :
A contract between the bank and beneficiary. The two parties agree to enter into a partnership to own an asset, on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule. As a result, the withdrawing partners share diminishes gradually along with the share of the profits, in line with their declining equity stake

5. Ijarah (Leasing)

The term 'Ijarah' is used particularly in two different situations. On the one hand, it means to employ the services of a person on wages given to him as a reward for his hired services. On the other hand, 'Ijarah' means to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him. In this case, 'Ijarah' is analogous to the term 'leasing', as used in modern business terminology. Here the lessor is called 'Mu'jir', the lessee is called 'musta'jir' and the rent payable to the lessor is called 'ujrah'.

6. Ijarah wa iqtina': A lease ending in the purchase of the leased asset

"Ijarah wa iqtina' is simply a financing contract in which the ownership of the leased asset is to be transferred to the lessee at the end of the lease agreement. This transfer of the ownership is made through a contract, in which the leased asset is either given to the lessee as a gift or is sold to him at a nominal price at the end of the lease agreement".

7. Tawarruq

Tawarruq is a sale of an asset to a purchaser with deferred payment. The purchaser then sells the asset to the third party on cash with a price lesser than the deferred price, for the purpose of getting cash. However, every tawarruq transaction creates a debt. This debt is consistently larger than the cash it transfers to the client. It is considered lawful in fiqh (jurisprudence) to charge a higher price for a good if payments are to be made at a later date (Bai' muajjal). According to fiqh, this does not amount to charging interest, because it is not considered as a lending transaction but rather a trading one. Bai' Mu'ajjal is valid; however, if the due date of payment is fixed in an unambiguous manner. The deferred price may be more than the cash price, but it must be fixed at the time of sale. Once the price is fixed, it cannot be decreased in case of earlier payment, nor can it be increased in case of default.

8. Istisna*

A contract in which a party orders another to manufacture and provide a commodity. The description of, delivery date, price and payment rate are all set in the contract. Hence, it is a kind of sale where a commodity is transacted before it comes into existence. However, it is necessary for the validity of istisna' that the price is fixed with the consent of the parties and the necessary

specification of the commodity is fully settled between them. "The price may be paid in installments, in step with the progress of the work, or partly at the front end and the rest at the time of delivery". However, after the manufacturer starts the work, the contract cannot be cancelled unilaterally.

*all are considered as a debt instruments (Ijara is Quasi-debt instrument)

9. Salam*(or Bay' As-salam: the Islamic alternative to conventional derivatives)

Salam is a sale contract whereby the seller undertakes to supply a specific good to the buyer at a definite future date in exchange of an "advanced price fully paid at spot". The price is cash, but the supply of the purchased goods is deferred. "It is one of the basic conditions for the validity of a sale in Shari'ah that the commodity (intended to be sold) must be in the physical or constructive possession of the seller".

10. Qard hasan (beneficence loans).

This is the zero return type of loan that the Islam urges Muslims to make available to those who need them. The borrower is obliged to repay only the principal amount of the loan, but is permitted to add a margin at his own choice.

(Ahmad 2012, p.12)