



**Analyzing the Challenges of Interest Free Banking Service: The
Case of Selected Commercial Banks in Addis Ababa**

By: Senait Tadele

**A Thesis Submitted to the School of Graduate Studies of Addis Ababa
University School of Commerce in Partial Fulfillment for the Award of the
Degree of Master of Arts in Marketing Management.**

**Addis Ababa University, School of Commerce
Department of Marketing Management, Post Graduate Program**

August, 2016

Addis Ababa, Ethiopia

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Approved by Board of Examiner

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Chair of Department or Graduate Program Coordinator

Statement of Certification

This is to certify that Senait Tadele has carried out her research work on the topic entailed **“Analyzing the Challenges of Interest Free Banking Service: The Case of Selected Commercial Banks in Addis Ababa”** is her original work and comply with the regulation of the school for the award of Master’s Degree in marketing Management.

Declaration

I, **Senait Tadele**, declare that the thesis entitled “**Analyzing the Challenges of Interest Free Banking Service: The Case of Selected Commercial Banks in Addis Ababa**” is my original work. I have carried out the present study independently with the guidance and support of the research advisor, **Temesgen Belayneh (PhD)**. Any other contributors or sources used for the study have been duly acknowledged. Moreover, this study has not been submitted for the award of any Degree or Diploma Program in this or any other Institution.

Senait Tadele: _____

Signature **Date**

Place and date of submission: Addis Ababa University, August, 2016

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Abstract

The main objective of this study is to analyze the operational challenges of Interest-Free Banking in Ethiopian Banking Industry. It is also aimed at providing solutions to these challenges. To achieve this objective, a cross sectional data is generated from a sample of respondents, consisting of staff and Managers were sourced via structured questionnaires and Interview. Both primary and secondary data collection instruments is used to collect data, closed ended and open ended questionnaires along with interviews is used for the purpose of data collection. The data is analyzed using percentage, graphs and tables. The selection of the respondents is carried out by using systematic sampling method.

The result of the study indicates that interest free banking is in its early stage in the industry and most of the staffs and managers have no ample knowledge about the product and services of IFB. Moreover, it indicates there is absence of proper legal frame work, sufficient and skilled man power, absence of Auditing and Accounting standards as well as Insurance firms.

The researcher recommended giving adequate and proper training as well as benchmarking and sharia advisory in policy and legal issues rather than depending on undependable sources.

Keywords: Islamic Banking, Interest- Free Banking, Interest-Free Window, Operational Challenges

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Senait Tadele

List of Abbreviation and Acronyms

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

ARCIFI: International Arbitration and Reconciliation Centre for Islamic Financial Institutions

CBE: Commercial Bank of Ethiopia

GCC: Gulf Co-operation Council

GCIBAFI: General Council for Islamic Banks and Financial Institutions

IDB: Islamic Development Bank

IFB: Interest Free Banks

IFI: Islamic financial institutions

IFSB: Islamic Financial Services Board

IIFM: International Islamic Financial Market

IIRA: Islamic International Rating Agency

IMFI: Islamic micro finance institutions

LMC: Liquidity Management Centre

NBE: National Bank of Ethiopia

NBFI: Non-bank financial institutions

NGOs: Non-Governmental organizations

OIB: Oromia International Bank

PLS: Profit-and-Loss Sharing

SEC: Securities and Exchange Commission

SMEs: Small- and Medium-Sized Enterprises

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Chapter One

1 – Introduction

1.1 Background of the Study

The most recent and significant development in the banking industry is the emergence of Islamic Banking System and Interest-Free Banks (IFBs) in both developing countries and developed countries of the world.(Ahmed, 2000)

Within a span of five decades; Islamic Banking has been successfully developing into a viable alternative banking framework all over the world. Of recent, it has been reported that there are approximately 500 Islamic Banks World Wide controlling about one trillion worth of assets and the figure is estimated to reach four trillion dollars by the year 2020 (Aliyu, 2010). Also, Mamman (2005) states that there are over 75 countries operating Interest Free Banks (IFBs) with an annual growth rate of 12-15 percent per annum. However, despite the global upsurge in the development of Islamic Banking and interest free Banking, its practical operation in Ethiopia has been limited due to a number of challenges.

Despite this consistent growth, many supervisory authorities and finance practitioners remain unfamiliar with the process by which Islamic banks are introduced into a conventional system. This paper attempts to shed some light in this area by describing the main phase's in the process, and by flagging some of the main challenges that countries will face as Islamic banking develops alongside conventional institutions.

The concept of Islamic Banking and Interest-Free Banking are synonymously used in Islamic economics literature as an alternative banking framework to the interest-based conventional banking practice. Although in technical terms, there is a difference between an interest-free bank and an Islamic bank but they are sometimes used interchangeably. Ahsan (1988) defined an Islamic bank as “a financial and social institution whose objectives and operations as well as principles and practices must conform to the principles of *Shariah* and which avoid the use of

interest in any of its operations. It stands for an alternative financial system based on Islamic ideals. It is not only a financier but also a partner in productive economic development”. Mannan (1976) states that Islamic banking is an interest-free financing system essentially based on profit and loss sharing. And its operations are in conformity with *Shariah*. It is therefore, the cornerstone of the Islamic Economic System which is by definition Interest-Free. Siddiqi (1983) conceived an Islamic bank as a financial intermediary mobilizing savings from the public on the basis of *Mudaraba* (profit and loss sharing contract) and advancing capital to entrepreneurs on the same basis. The bank shares the profits of the enterprise according to a mutually agreed percentage and shares these profits with depositors according to a percentage announced by the bank in advance.

While stating the difference between Islamic Banking and Interest-Free Banking, Gusau (2000) argues that “Islamic banking system is supposed to operate completely within the *Shariah* in all its activities both in sourcing of funds and disbursement of the funds. It not only avoids interest in all its ramifications but also it avoids all other Islamically prohibited activities. Interest-free banking system on the other hand, does not engage in interest but there is no reason to suppose that all its other activities will be done strictly according to *Shariah*”.

From the above, three things have become clear, namely: Islamic Bank must;

- 1) Charge no interest
- 2) Conform to *Shariah* principles in all its operation and
- 3) Promote Islamic ideals

Thus, it can be seen that interest-free operation is a necessary but not a sufficient condition for a bank to qualify as an Islamic Bank. In addition to non-interest charges, the bank must promote Islamic ideals.

Therefore, Interest-Free Banking Window can be described as the provision of Interest-Free Banking services by conventional banks on the basis of profit and loss sharing (PLS) principles. It is an operational strategy adopted by conventional banks in which interest-based banking services are operated alongside Islamic banking services within the same banking hall, for the

purpose of meeting increasing demand from customers, improve mobilizations of savings as well as benefit from the new vista of opportunity offered by Islamic banking system. It should be seen as an integral aspect of financial globalization which entails the integration of Islamic financial system with the Western Financial System to produce global financial system.

1.1.1 Historical Development of IFB

The first modern IFBs emerged in the 1960s and 1970s. Since then, Islamic banking and finance has spread to a large number of Muslim countries, including the Gulf Co-operation Council (GCC) states, Malaysia and the Arab world at large. Islamic finance grew through the 1980s with traditional retail and commercial banking activity (including trade finance) gradually being re-cast in Shariah-compliant forms. This took place particularly in the GCC states and in Malaysia. Since then, Islamic financial products have grown in range and sophistication to include capital market, insurance and funds management products. By the 1980s, Iran, Sudan and Pakistan had mandated Islamic banking and finance systems, although mandatory implementation in Pakistan has been postponed. The GCC and Malaysia have been most active in developing dual systems where Islamic and non-Islamic financial institutions operate alongside each other. In the GCC, Bahrain took the lead in developing an Islamic banking system. Since the end of the 20th century, European banks have grown their Islamic finance operations across the Gulf and Asia. In 2002, the UK Government adopted a policy to facilitate the growth of Islamic finance and the growth of the UK as an international Islamic finance center. An increasing number of countries in Europe and Asia have followed suit. (Iqbal, 2005)

1.1.2. Banks Providing IFB Services in Ethiopia

The issue of establishing Interest Free Banking service in Ethiopian banking industry is a new concept. Various efforts have been made to see it come through by some concerned parties but faced all sorts of challenges due to lack of legal and regulatory framework, and as a result of lack of awareness about the system. With all these challenges and oppositions, a careful consideration of the National Bank of Ethiopia's (NBE) directive No. SBB/51/2011 that allows banks to offer

Interest Free banking service alongside their conventional operation came into play in October 2011, but IFB in Ethiopia only started in 2013, when the Oromia International Bank (OIB) launched the service. The CBE joined the market at the end of October, followed by United, which began providing the service on May 1, 2014.

There are six banks who provides IFB service in Ethiopia, namely Commercial Bank of Ethiopia, Oromia International Bank S.C., United Bank S.C., Nib International Bank S.C., Wegagen Bank S.C. and Cooperative Bank of Oromia S.C.

CBE is one of the three banks currently providing IFB, along with the United Bank and Oromia International Bank. Interest-free banking mainly targets individual and institutional customers that do not want interest on their deposits, for religious or other reasons. The directive defines the service as the mobilization or advancing of funds undertaken in a manner consistent with Islamic finance, avoiding the receiving and paying of interest.

The service, which will be offered at separate windows, can be used by individuals, government institutions and non-governmental organizations (NGOs). Services offered under interest-free banking include – deposits, foreign exchange and money transferring services, and are commonly available for customers who engage in trade partnerships, agricultural forwards contracts, construction, manufacturing and import-export trade.

Around three and a half years ago, ZemZem, a prospective new bank, asked to join the banking industry as a full-fledged interest-free bank, but was unable to start operations as the NBE's directive requires that interest-free banking be given alongside conventional banking services. ZemZem Bank was floating shares with the sole intention of operating interest-free banking, since December 2010. It was able to raise 137 million Br in paid-up capital and 337 million Br in subscribed capital from 6,800 shareholders.

The licensing and supervision of banking business directives to authorize interest free banking also orders banks not to go past the maximum share of interest-free banking business in their consolidated balance sheet without prior approval from the Central Bank. A violation of this could lead to the closure of an interest-free banking window. Establishing a Sharia advisory board and separate financial reports, keeping all data and ensuring the segregation of activities

from conventional banking are also some of the requirements set by the directive to launch the program.

The three banks that started giving IFB services are offering savings (Wadia) and current (Amanah) account services, as well as equity financing (Mudrabah), based on principles drawn from Islam. These principles include avoiding interest, gambling and uncertainty. All business should also be conducted in writing, and profits will be shared as agreed, but loss according to capital. (Mikias Merhatsidk, Fortune Writer; Published on May 18, 2014 [Vol14, No733])

1.2 Statement of the problem

Banking system is one of the most important economic sectors and strongest financial intermediaries in the economy that plays a key role in economic development in societies through receiving the deposits of depositors and instead pay loans and facilities to applicants and give interest (Iravani et al, 2012). So it is difficult to conceptualize how an economy would operate and survive without the crucial services offered by banks. Business organizations and especially the banking sector are operating in an environment characterized by a complex and competitive climate (Agbolade, 2011).

Over the past four decades, Interest free banking has emerged as one of the fastest growing industries. It has spread to all corners of the globe and received wide acceptance by both Muslims and non-Muslims (Iqbal and Molyneux, 2005). Interest free banking performs the same essential functions as banks do in the conventional system, except that the need for them to carry out their transactions in accordance with the rules and principles of Islam (Henry and Wilson, 2004; Iqbal and Mirakhor, 2007). From a theoretical perspective, interest free banking is different from conventional banking because interest (riba) is prohibited in Islam i.e., banks are not allowed to offer a fixed rate of return on deposits and not allowed to charge interest on loans. A unique feature of interest free banking is its profit and loss sharing (PLS) paradigm, which is predominantly based on the Mudrabah (Profit and loss sharing) and Musharakah (joint venture) concepts of Islamic contracting (Khan, Mirakhor, 1989; Iqbal, 1997). Interest free banking financial services are currently very popular among the non-Muslims in different parts of the

world (Knight, 2007). Observing this increasing demand, different giant multinational conventional banks are opening interest free banking windows providing interest free services to widely scattered population (Hassan and Ahmed, 2001, Huda *et al*, 2007).

Changes in the Ethiopian financial landscape and the introduction of IFB has generated new dimension and phenomenal in banking sector. Such scenario had also led to the changes in the customer's taste and demand for better and high quality banking services. Since the emergence of more financial institutions in recent years, both conventional and IFB, customers, Muslims and non-Muslims alike have been presented with enormous choices to choose from in term of banking products and services. Due to lack of legal and regulatory framework and lack of awareness about the system in Ethiopia that facilitate the establishment of Islamic financial institutions there was no alternative banking systems to serve the Muslim community until the National Bank of Ethiopia directive allowed Ethiopian banks to engaged in interest free banking which come in to play in October 2011, but started in September 2013. The introduction of Islamic banking Window alongside with conventional system has generated new dimension and phenomenal in banking sector in Ethiopia. Moreover, the interest free banking is a new system in Ethiopia which needs a lot of effort and resources to increase the knowledge of employees for proper awareness about interest free banking products.

The central premise of this paper is to identify the challenges of IFB service in Ethiopia, out in-depth diagnosis shows that despite efforts to develop the IFB offering, the lack of an adequate legal framework, the scarcity of skilled Islamic banking professionals and the limited awareness of Islamic finance products hindering progress in this field. This study will provide an analysis of the current IFB service challenges that banks face. The analysis will also examine other factors that need to be taken into consideration for the effective development of IFB activities in Ethiopia.

The challenges confronting every Islamic banking system the world over could be categorized into institutional challenges and operational challenges. Institutional challenges are those challenges that are unique to Islamic banking institutions while the operational challenges are those challenges confronting the operations of Islamic banking.

This study attempted to investigate the problems associated with the operation of IFB Service in Ethiopian Banks. Specifically the study is designed to address the following basic questions.

- ✚ What are the factors that influence operation of interest free banking in line with conventional banking system?
- ✚ What is the overall awareness of employees and managers towards interest free banking product and services?
- ✚ What are the factors that have most impact on the operation of interest free banking?

1.3 Objectives of the study

The general objective of the study is analyzing the challenges of interest free banking service some selected commercial banks in Addis Ababa and to examine and suggest a framework that will redress the challenges.

The specific objectives are:

- ✚ To analyze the factors that influence operation of interest free banking in line with conventional banking system?
- ✚ To assess the overall awareness of employees and managers towards interest free banking product and services?
- ✚ To investigate the factors those have most impact on the operation of interest free banking.

1.4 Significance of the study

It is very recently that Ethiopian Banks begins providing IFB product and service in a dedicated window in some branches in Addis Ababa and branches in outline branches. Therefore, analyzing the challenges and recommending the redress absolutely be useful first to Planners and policy makers of banks to formulate additional strategies and tactics in relation to IFB. Secondly, understanding the level of awareness and knowledge of Managers and Employees towards IFB product and services has much importance in analyzing the gaps for the stakeholders. In addition,

the study is important because banks can draw lesson to understand the environment and major challenges of IFB. Moreover, it is significant because of the fact that the study will become reference for further research.

1.5 Scope of the study

The study focuses on the practice of Interest Free Banking (IFB) or Islamic banking in Ethiopian Banks that are authorized and registered to provide the service by NBE. The study was delimited to Managers, staffs and Employees who delivers IFB service in stated banks. The focus of the study was also delimited to the data obtained from the rates using questionnaires and interviews of the staffs and didn't include customers' opinion that would have a significant effect on the comprehensiveness of the study.

1.6 Limitation of the study

The study is not conducted widely by including more other branches but limited to some selected branches only due to limitation of time and budget in conducting the study. Moreover, it is has been done on time of pregnancy and labor of the researcher. This may have some effect on the research work.

1.7 Operational Definitions of Terminologies

A. Bank: - Bank is an institution responsible for receiving, collecting, transferring, paying, lending, investing, dealing, exchange and Serving money and claim to money to both locally and internationally.

B. Interest Free Banking: - is non-interest based financial or banking service which complies fully with Islamic laws.

1.8 Organization of the study

This paper specifically investigates the operational challenges of Islamic and interest free banking in Ethiopia using interest free banking scheme of Commercial Banks of Ethiopia State as a case study. To achieve this objective, the paper is divided into five sections. The first chapter deals with background of the study, statement of the problem, objectives of the study, significant, scope and limitation of the study and organization of the paper. The second chapter focuses on pertinent literatures and conceptual frame work of the study and operational definition of terminologies. Chapter three describes the research methodology employed in the study and operational definition of variables. Chapter four focus on result and discussion of the study. The last chapter of the paper presents major findings, conclusions and recommendations of the study.

Chapter Two

Review of Related Literature

2. Introduction

This chapter deals with operational definition of terminologies, literature that reviewed in relation to overview of interest free banking, Basic principles and Modes of Operation in Islamic banking, Islamic banking market overview and Challenges of Interest Free Banking System in Ethiopia.

2.1 An Overview of Interest-Free Banking Window

The remarkable success in the operation of Islamic banking system in both Muslim and non-Muslim countries within the short period of its existence proved beyond reasonable doubts, the viability and prospects of the scheme in the contemporary global economy. Ziyad (2010) outlined four reasons why Islamic banking is the fastest growing sector in global finance.

- i. Increasing demand for *Shariah*-compliant product.
- ii. Demand for diversification from conventional clients.
- iii. Regulatory amendments and increasing flexibility towards Islamic finance and
- iv. Seeking an alternative to volatile interest-driven markets.

As part of the steps towards meeting the new challenge to the global financial system paused by the Islamic banking revolution, conventional banks began to open Islamic windows popularly known as interest free windows, particularly in the early 2000. (Muhammad 2002)

The impressive program of the Islamic banks paved the way for the introduction of Islamic windows by the conventional banks in many African countries. In Ethiopia, the National Bank of Ethiopia's (NBE) directive that allows banks to offer interest-free banking services alongside

their conventional operations came into play in October 2011, but IFB in Ethiopia only started in September 2013, when the Oromia International Bank (OIB) launched the service. The CBE joined the market at the end of October, followed by United, which began providing the service on May 1, 2014.

2.2 Philosophy of Interest Free Banking

The definitions of Islamic banking or IFB revolved around one thing - Islamic law (*Shari'ah*). This can be understood in the following definitions from different authors. For instance, Sanusi (2011) views Islamic banking as an alternative form of financial intermediation that is based on profit motive. That is, IFB is market driven but with a moral dimension based on the Islamic value system. Akram et al. (2011) see Islamic banking or IFB as that banking system which is run in accordance with the Islamic laws and the *Shari'ah* board; that guides the institutions. Furthermore, Lawal (2010) defined Islamic banking as a system of banking that is consistent with the principles of Islamic law (*Shari'ah*) and its application through the development of Islamic economies. In addition, Marimuthu (2010) define it as the conduct of banking based on *Shari'ah* principles. In the same line, Ghayad (2008) sees Islamic banking as a banking system that operates in accordance with the rules of *Shari'ah* i.e. *Fiqh al-Muamalat* (Islamic rules on transactions). In conclusion, Islamic banking is a kind of banking system that operates strictly on the basis of *Shari'ah* (Islamic law).

Many Interest free banking literature assert that although interest free banks perform mostly similar functions to that of conventional banks, their approach is distinctly different (Ahmed, 2000; Chapra, 2000; Warde, 2000; Henry and Wilson, 2004; Iqbal and Molyneux, 2005; Iqbal and Mirakhor, 2007). To illustrate, some of the salient features of interest free banking and finance which making it distinctive and unique from its conventional counterparts include: first, Islamic banking strives for a just, fair and balanced society as envisioned by the Islamic economics (Mirakhor, 2000; Warde, 2000). Accordingly, the many prohibitions (e.g interest, gambling, excessive risks, etc.) are to provide a level playing field to protect the interest and benefits of all parties involved in market transactions and to promote social harmony (Ahmed, 2000; Chapra, 2000). For example, the prevailing practice of interest in the conventional banking

system involves injustice to the borrowers since the interest on their loans have to be paid irrespective of the outcomes of their business. Similarly, interest-bearing contracts can be unjust to the lenders especially when their returns on deposits, which have been channeled by the banks to the entrepreneurs, do not commensurate with the actual performance of the investment (Lewis and Algaud, 2001; Iqbal and Molyneux, 2005).

Second, Interest free banking is constructed upon the principle of brotherhood and Cooperation, which stands for a system of equity sharing, risk sharing and stake taking. It promotes such sharing and cooperation between the provider of funds (investors) and the user of funds (entrepreneur) (Ahmed, 2000; Iqbal and Molyneux, 2005). Third, as a system grounded on ethical and moral framework of the Islamic law of Sharia, Interest free banking is also characterized by ethical norms and social commitments (Ahmed, 2000; Mirakhor, 2000; Warde, 2000). There is a moral filter based on the definitions of halal (permissible) and haram (prohibited and undesirable) operating at different levels, carving the conscience of entrepreneur and firm, promoting a positive social climate for society, and providing an expedient legal framework (Chapra, 1992). Accordingly, Interest free banks cannot finance any project which conflict with the moral value system of Islam such as financing a brewery factory, a casino, a night club or any other activity.

2.3 Basic principles and Modes of Operation in Islamic banking

2.3.1. Basic Principles (Features) of Islamic Bank

Islamic banking is a unique type of banking system that devoid all forms of transactions that are prohibited in Islam. So for any bank to be classified as Islamic bank, the following basic principles must be adopted for its operations (Greuning and Iqbal, 2008; Abraham, 2008; Islamic Financial Stability Forum, 2010; and Sanusi, 2011):

- a) Prohibition of interest (Riba).** Interest means a fixed predetermined amount in addition to the principal. It is prohibited in Islam. So for any bank to be called Islamic

bank, it must not engage in any interest related transactions, but rather, profit and loss sharing transactions.

b) Prohibition of speculation (gharar). The term gharar literally means hazard. More so, it means transactions that have too much risk and are therefore linked to gambling. Since Islam prohibits speculation, a potential Islamic bank will avoid all transactions with excessive risk.

c) Profit, loss, and risk sharing. Since interest is prohibited in Islam, the providers of funds and the entrepreneur in an Islamic banking settings share the business risk and profits based on mutual agreement. This act will equitably distribute income, enhance social justice, and alleviate poverty etc.

d) Shari'ah approved activities. Islamic banking is a banking system that is based on Shari'ah. So any transactions that are prohibited by Shari'ah in the likes of alcohol, gambling etc. are avoided in Islamic banking. Islamic banks can only partake in transactions or activities that are approved by the Shari'ah advisors.

e) Social Justice. Islam prohibits Muslims from any transactions leading to injustice and exploitation of any kind. So Islamic banks can't engage in any transactions that will lead to exploitation of any party.

f) Compulsory payment of zakat. It is mandatory for an Islamic bank to pay zakat. Zakat is one of the five pillars of Islam.

g) Overseen by Shari'ah advisors. Every Islamic bank must be regulated by experts in Islamic law who will have to audit the operations of Islamic banks and its products to make sure that they comply with Shari'ah guidelines.

2.3.2. Modes of Operation in Islamic Banking

The modes of operation of Islamic banking are numerous and there is room for further innovation in the modes of operation provided they are in line with shari'ah principles. Below however, we restrict ourselves to the popular ones:

a) Qard Hasan loans: It is a benevolent loan given to deserving customers by Islamic banks to alleviate poverty. The beneficiary is required by Shari'ah to pay back only the principal to the Islamic bank. However, the client may pay an addition to show appreciation to the Islamic bank but this intention should not be disclosed to the bank by the customer at the beginning of the transaction.

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

c) Murabahah (Cost-Plus Sale Contract): This type of contract is mostly use in the procurement of equipment. It is a sale contract between Islamic bank and its client at a fixed profit called mark-up. In this contract, the client will provide all the specifications of the commodity and the Islamic bank will take the risk of purchasing it for the client at a cost plus mark-up which the client can either pay in installment or sum at a spot or at a stated period.

d) Ijarah (Lease): Ijarah is synonymous to leasing contract in conventional banking. It is a contract whereby an Islamic bank purchases an asset and leases it out to its client on the

agreement that the client will be paying a fixed amount at regular interval usually monthly for a specified period of time to the Islamic bank. It may also include the option of the client purchasing the asset at the end of the contract from the bank.

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

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

2.4 Differences Between Islamic Banking and Conventional Banks

The following are the main differential points between conventional banking and Islamic banking.

S.No	CONVENTIONAL BANKING	ISLAMIC BANKING
1	Money is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.
2	Time value is the basis for charging interest on capital.	Profit on trade of goods or charging on providing service is the basis for earning profit.
3	Interest is charged even in case the organization suffers losses by using bank's funds. Therefore, it is not based on profit and loss sharing.	Islamic bank operates on the basis of profit and loss sharing. In case, the businessman has suffered losses, the bank will share these losses based on the mode of finance used (Mudarabah, Musharakah).
4	While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is a must, while disbursing funds under Murabaha, Salam & Istisna contracts.
5	Conventional banks use money as a commodity which leads to inflation.	Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.

Source: adapted from Hassen MK and Ahmed M (2001)

2.5 Challenges of Interest Free Banking System in Ethiopia: Theoretical Discussion.

An inspiring performance so far and the huge potential ahead, combined with the resolution of issues which could boost the growth momentum of the Islamic finance industry, gives rise to a number of challenges. The future relies on the policymakers and the practitioners and how they face the challenges. The major challenges are briefly discussed below.

Studies on challenges of Islamic banking have been conducted all over the world in order to enhance the establishment of Islamic banking as well as its operation. However, some of these studies are based on a single country experience (CBE IFB Service Performance report, June 2015; Zaineb, 2014) while others are based on the general system ((Iqbal et al, 1998; Ariss et al, 2007; Shaukat et al, 2011; Iqbal, 2001; Dusuki and Aboizaid, 2007; and Ahmad et al, 2011)). Single country studies are studies based on a particular country experience, while general system studies are studies based on the general system of Islamic finance.

2.5.1 Review of Country – Specific Studies

In this section we review country specific studies beginning with the study by Zaineb Sefiani (2014) which uses descriptive analysis to examine the gaps and challenges of the current IFB directive. The study finds that the directive is relatively simple thus leaving a lot of flexibility to the banks offering IFB products. Given the high level of flexibility, there is no effective control, from a regulatory perspective, as to what the banks are licensed to offer for an IFB window. In addition due to the in-existence of relevant legislation, each bank has adopted their own methodology, models and benchmarks for launching IFB products with little coherence or commonality in the market.

In their current state, IFB windows do not fully and effectively adhere to Islamic principles. ***Article 2.2 of the Ethiopian IFB directive states that IFB business “refers to banking business in which mobilizing or advancing funds is undertaken in a manner consistent with Islamic***

finance principles". Hence, in order to achieve Sharia compliance, IFB windows need to have an extra layer of governance to ensure that the principles outlined in the latter article are met.

On the institutional level, only OIB has opted for a Sharia Supervisory Board (SSB) model. So far CBE and United Bank have not sought any Islamic expert advice to develop their Interest Free product offerings; instead they have relied on Internet desk research. These banks do not currently have any Sharia board or Sharia advisors ((Zaineb Sefiani (2014))

CBE IFB Service Performance Report, (2015) explores the problems and challenges that the introduction of Islamic banking in Ethiopia may likely face. The study finds that the major problems and challenges in introducing Islamic banking in Ethiopia are:

➤ ***Lack of Sharia Supervisory board:***

Having an adequate Sharia Advisory board guarantees a product is compliant with Sharia principles. In Ethiopia, no directive, guidelines or authority supervises and authenticates the Sharia validity of an IFB product. The lack of authority leaves the consumer at risk of not being offered genuine Islamic financial products. Therefore there is a need to address how IFB products can be controlled at the product development stage but also monitored on a regular basis to ensure that they continuously comply with Sharia principles.

➤ ***Awareness:***

In the past years of the service the report identified that there is a lack of awareness of IFB product among Muslim and non-Muslim communities in Ethiopia. It is essential to reach out and educate the community about IFB product and service as a whole. From a balance sheet perspective an increase of IFB customer base on the deposit side means that the bank will have more funds available for financing IFB loans.

➤ ***Manpower Problem:***

There is problem of shortage of professionally qualified personnel to operate interest free banks in Ethiopia. In fact it has been widely acknowledged that there is a global shortage of

experienced professionals in Islamic finance sector to feed the industry and the regulators. Still the challenge of having qualified and competent Shariah scholars with good ground in Islamic finance and jurisprudence is holding back the service. This would be a critical issue since most of the instruments and services would have to be cleared by each firm's Shariah board. There is the need for staff development in Shariah, economics and accounting based on Islamic principle in order to overcome such challenge.

➤ ***Poor Financial Literacy in Ethiopia,***

A large proportion of cash is being held by the non-bank public, particularly the informal sector due to low level of financial literacy. Thus, Interest-Free Banks are faced with the task of simultaneously contributing in raising the level of financial literacy as well as showing the viability of interest free services to attract customers.

The followings are significant constraints on the operation of Interest-Free Banking services and take due consideration. These factors constitute the challenges that continue to make it difficult for the bank to operate Interest-Free Window or expand and developed the service.

- ❖ Delay in recruiting sharia consultant/Advisor
- ❖ Unsatisfactory progress interims of expanding the service to new Branches (for some District)
- ❖ In some branches, IFB-Windows aren't well-branded and windows aren't dedicated at all
- ❖ A very significant portion of financing demand and requests are from non-priority sector Inadequate Legal and regulatory Framework (e.g. Inability to trade on ECX Floor, Tax related issues etc)
- ❖ Low Level of awareness or familiarity of IFB Services on part of Customers
- ❖ Gaps noted in the existing financing procedure particularly in terms of providing defined directions
- ❖ Inadequate marketing and promotion of the IFB services (at branch level and corporate level)

2.5.2 Review of General System Studies

A review of general system studies is rendered in this section. The study by Dusuki and Aboizaid (2007) assessed the challenges in realizing the *maqaeid al-Shari'ah* in contemporary economics transactions. They conclude that the major challenges are inadequate understanding of *maqaeid al-Shari'ah* and various tools in Islamic law, inability to understand the very aims of *Shari'ah* and its application to modern transactions, and finally circumventing the prohibition of *riba*.

Iqbal (2001) opines that the challenges facing Islamic financial industry are limited set of short terms financial instrument and inadequate medium – to long – term financial instruments, limited coverage of Islamic finance, concentration of Islamic banking, poor risk management and governance framework, and difference between Islamic finance in theory and in practice. The author recommends adequate risk management and diversification of the institution, provision of non – banking financial services, and development of capital markets that are islamically inclined to improve its activities and functions, and be able to compete favorably. Iqbal (1998) opine that the challenges hindering Islamic banking are institutional as well as operational challenges. The institutional challenges are poor institutional framework, inadequate legal framework and supervisory policies, poor supervisory framework, disparity in accounting standards, lack of equity institutions, absent of organized secondary financial market, and lack of short term market placement of funds. While the operational challenges are improper financial engineering, lack of teaching, training, research and development in this institution, lack of profit sharing finance, inability to adequately mobilize deposits, competition, and finally globalization.

Finally, Shaukat (2011) are of the opinion that the lack of ultimate authority that governs Islamic financial industry, inadequate qualified human resource in both conventional banking and Islamic laws, illiquidity of Islamic long – term assets with short - term liabilities, lack of *Shari'ah* auditing standard personnel, and shortage of short – term investment products are the challenges of Islamic banking system. They further state that the other challenges facing Islamic banking system are lack of innovation, lack of adherence to local regulatory reporting and operational requirements, lack of transparency and accountability, operating manually, and lack of high quality services.

In short, from both single country as well as general studies on Islamic finance, one can deduce that the importance of adequate human resources qualified in Islamic and conventional settings, financial innovations, awareness, adequate provision of both short- and long-term financial instruments, proper *Shari'ah* regulating body, adequate legal framework, proper institutional framework etc. cannot be over looked in order to improve this institution.

2.6 Employees Attitude towards IFB Service

According to Fishbein and Ajzen (1991) attitude is defined as evaluative effect of individual's "negative or positive feelings in a specific behavior performing. Actually, attitude is related to behavioral intention of individuals considering the fact that they shape their intentions to do a specific behavior in the direction of which they have positive outcome (Tan & Teo, 2000). Likewise, Attitude toward behavior is the degree to which an individual has unfavorable or favorable appraisal or evaluation of behavior in the question (Ajzen & Fishbein, 1991). There is a tendency to think that Interest free banking is reserved for people of Islamic religion. But, Islamic institutions and instruments have developed in countries where Muslims are minority like United States. Countries with a significant proportion of Muslims have largely adopted Islamic Banking, Malaysia and Pakistan is common example. Attitude of employees regarding a specific service is able to influence to adopt the service or idea.

2.7 Levels of Awareness of Employees towards IFB

A new idea does not go beyond the knowledge function, if sufficient knowledge is not obtained to become adequately informed so that, persuasion can take place (Kotler & Armstrong, 2001; Rogers, 2003). On the other hand, in an age of information and "innovation overload" (Herbig & Kramer, 2004) in which bank new products are continuously being introduced, many new products providers are extremely conscious of the need to provide employees with as much information as possible about the product/services to make them aware because new products require effective communication. Creating an awareness have been tested as one of the key variable and positively influence employees attitude in numerous studies specifically in the area of on-line banking, internet-banking and self- services technology adoption (Gerad et al., 2003;

Gholami et al., 2010; Daud et al., 2011; Hanafizadeh & Khedmatgozar, 2012; Agarwal et al., 2009). However, limited studies have investigated on awareness in the area of Islamic banking adoption. Most of these studies, include Metawa & Almosawi (1998); Okumus (2005); Bley & Kuehn (2004); Hamid & Nordin (2001); Naser, et al., (1999); Haron, et al., (1994); Khattak & Rehman (2010); Saini et al. (2011); Ahmad & Haron (2002) indicates that employees are aware of existence of Islamic banks. However, they are unaware regarding the use of specific Islamic method of finance or low usage rate and could not differentiate between Islamic and conventional banks financial products and services because of Islamic banks have not done enough in educating their customers and promoting products and services appropriately.

2.8 Conceptual Framework of the Study

The study would be focused on the challenges of interest free banking products and services. Based on the study by Zeineb (2014) there is no effective control, from a regulatory perspective, as to what the banks are licensed to offer for an IFB window. In addition due to the in-existence of relevant legislation, each bank has adopted their own methodology, models and benchmarks for launching IFB products with little coherence or commonality in the market. Studies by commercial bank of Ethiopia IFB performance report (2015) some of the challenges are Lack of Sharia Supervisory board, low level of Awareness, and delay in recruiting sharia consultant/advisor, unsatisfactory progress interims of expanding the service to new Branches. The study by Aliyu (2010) assessed the major challenges are inadequate understanding of Shari'ah and various tools in Islamic law, inability to understand the very aims of Shari'ah and its application to modern transactions. Shaukat (2011) opines that the lack of ultimate authority that governs Islamic financial industry, inadequate qualified human resource in both conventional banking and Islamic laws, illiquidity of Islamic long – term assets with short - term liabilities, lack of Shari'ah auditing standard personnel, and shortage of short – term investment products are the challenges of Islamic banking system. Hence, based on the above literature reviewed entire study are going to analyze.

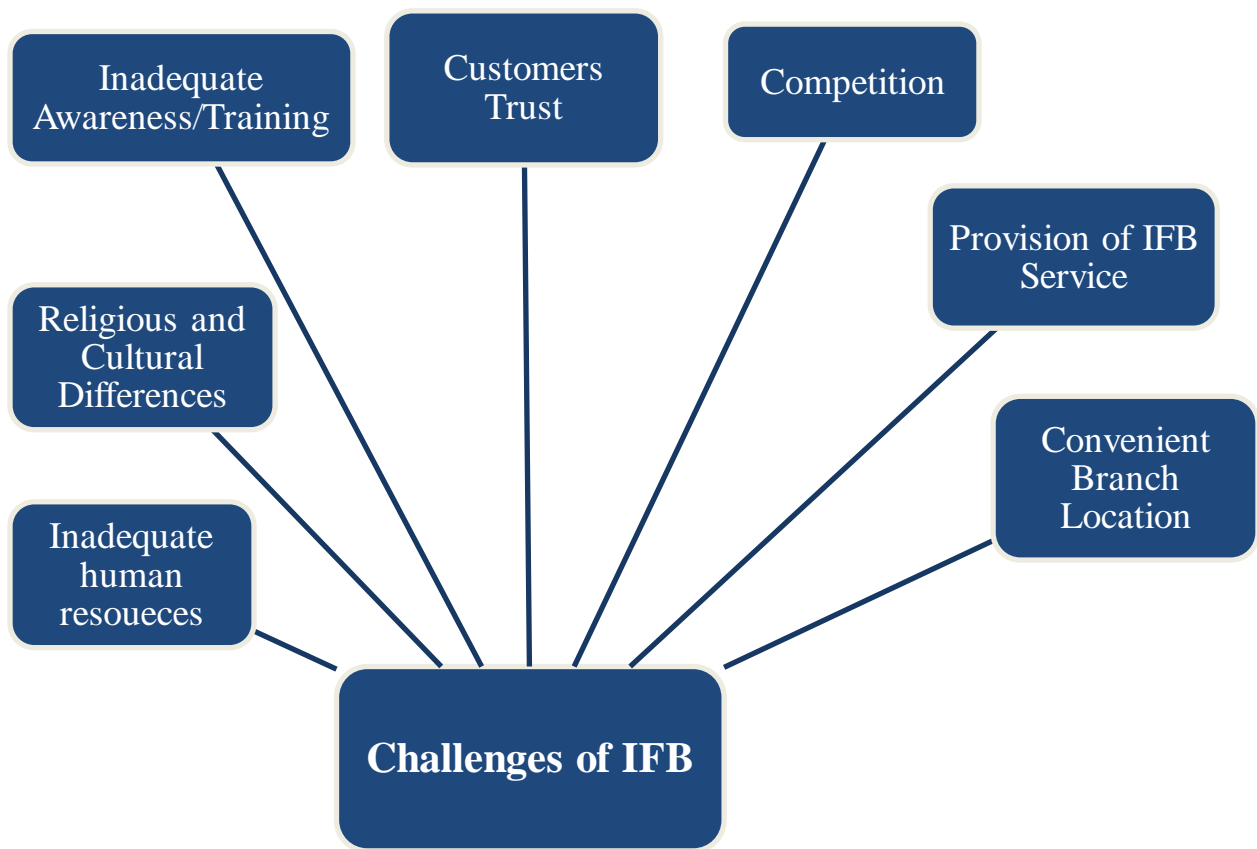


Figure 2.1 Conceptual framework

Source: Aliyu (2010), CBE IFB Service Performance Report, (2015) and Zaineb Sefiani (2014)

2.9 Operational Definition of Variables

2.9.1. Dependent Variable

It is operationally defined Challenges of interest free banking. This is to determine if those challenges influence the performance of banks and if it does not influence their operation in interest free banking. It is dummy variable takes a value of “0” if those challenges influences banks performance on interest free banking and “1” otherwise.

2.9.2. Independent Variables

Review of related literature on challenges of interest free banking, past research finding and the author’s knowledge related to interest free banking are used to establish working hypotheses of this study. In other way of saying, among a number of factors, which are related to operational challenges towards interest free banking, in this study, the following, Operational and institutional performance factors were hypothesized to explain the dependent variable.

- 1. Inadequate human resources:-**This particular variable is a dummy variable that assumes a value of “1” if the respondent believes the survival of Islamic banking depends on adequately qualified human resources in teaching, training and research in Islamic Finance with knowledge in both Islamic and conventional finance as well as economics and “0” otherwise.
- 2. Religious and Cultural Differences:-**One of the major challenges of Islamic banking, this issue is a serious one that needs to be effectively and efficiently resolved this is because of the fact that others with different cultural and religious belief will have a misperception of the institutions that may lead to not accepting the institution by the general public. Religious and cultural difference is dummy variable that assumes a value of “1” if the operation of the banks influenced by religion and “0” otherwise. It was hypothesized to have positive relationship with dependent variable.
- 3. Inadequate awareness:-**this variable is a dummy variable which assumes a value of “1” if respondents believe IFB service is challenged by lack of information about the objectives, principles, and advantages of Islamic banking in the country and “0” otherwise.

4. **Customer's trust of the service:** - this particular variable is a dummy variable that assumes a value of "1" if the respondent believes that IFB services are influenced by consumers' trust of service and "0" otherwise. It refers the fact that customers' believe the banks may not work in line with shariah law. It was expected to have negative relationship with dependent variable.
5. **Competition with conventional banking service:** - this refers to pioneer banks efficiency and performance on the banking sector. Competition is dummy variable that assumes a value of "1" if the respondents' believe that the operation of IFB is influenced by competition and "0" otherwise. It was hypothesized to have positive relationship with dependent variable.
6. **Provision of IFB service:** - this variable is a dummy variable that assumes a value of "1" if the operation of interest free banking influenced by provision of interest free banking service and "0" otherwise. It is defined as availability of IFB service at banks windows. It was expected to have direct relation with the dependent variable.
7. **Convenient branch location:** - it is a dummy variable that assumes a value of "1" if the branch location has positive outcome regarding the operational success and "0" otherwise. It was hypothesized that it has direct relation with the operational challenges.

2.10 Literature gap identified

From the above literature review most of studies were emphasized on countries with large number of Muslim culture and community than those are Christian dominated country like Ethiopia. Even if some study conducted regarding interest free banking in Ethiopia by Zeineb Sefiani, which only emphasizes on the current interest free banking directive and the study by Commercial Bank of Ethiopia which stresses more on the institutional challenges. Until August, 2016 there is no research undertaken in Ethiopia regarding "Challenges of Interest Free Banking Service". This study emphasized on interest free banking products/services to analyze their effect on the banks performance. The purpose of the study was to analyze the Challenges of Interest Free Banking Service (inadequate human resource, inadequate training, customers trust, competition, service availability, branch location) as well as mainly to find out which variables mainly influence the introduction of interest-free product and services in the context of Ethiopia.

Chapter Three

Research Methodology

3.1 Introduction

The underlying factor in most studies on research methodology is that the selection of methodology is based on the research problem and stated research questions. Methodologies cannot be true or false, only more or less useful (SilverMan, 2001). Conducting any type of research should be governed by a well-defined research methodology. This chapter deals with methodology which includes research approach, research design, target population, source and types of data, sampling design, data collection method, methods of data analysis, validity, reliability and ethical considerations employed in this study.

3.2 Research Approach

In order to show the existing phenomenon as it exists this research used more of qualitative study method to answer the research questions and used some quantitative information to know the challenges of interest free banking some selected banks. Qualitative information was gathered from the organization by using questionnaire and interview. The related data with questionnaire and interview were collected and analyzed.

3.3 Research Design

According to R. Kothari, (2004), a research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. In fact, research design is the conceptual structure within which research is conducted; it constitutes the blueprint for the collection, measurement and analysis of data. This study is institutional based descriptive analysis study because it attempts to describe challenges of IFB and its related challenges, which are used to answer the research questions as it is considered appropriate that is designed to assess how those challenges of IFB affects banks performance. The study employs mainly qualitative approaches to describe and assess the research.

3.4 Target Population

Target population is defined as the entire group a researcher is interested in. According to Zikmund (2003), the definition of population was identifiable total set of elements of interest being investigated by a researcher.

The population of this study includes various branches of commercial banks which are located in Addis Ababa. Addis Ababa is the capital city of the country where the majority of business transactions and economic activities are undergoing with many marketing dynamics. Hence, taking branches of banks in Addis is found to be ideal for the study. The study is only confined to those branches of Commercial bank of Ethiopia, Oromia international bank S.Co., United bank S.Co., Wegagen bank S.Co., Cooperative bank of Oromia and Nib international bank S.Co. which are found in Addis Ababa, and those branches are clustered geographically as south, north, east and west Addis Ababa districts by the banks. Therefore, selecting branches on the basis of the fact that IFB service user located for the analysis reasonably provides similar result. Hence, five branches from each CBE district and four branches from districts of private banks are selected randomly from the four regions for the study.

3.5 Sources and Types of Data

The study uses qualitative and quantitative types of data from both primary and secondary data sources. The primary data is collected from Employees of the Banks that gives IFB purposely selected branches located in Addis Ababa. The primary data sought to obtain both qualitative and quantitative data. Secondary data is obtained from selected branches, districts and various Bank organs and published as well as unpublished materials. The secondary source of data sought to obtain from qualitative type of data.

3.6 Sampling Design

There are commercial banks that offer interest free banking service and the additional banks which begin to offer IFB operation were taken as population, and purposely draw a sample from the total to get rich evidence. The total number of commercial banks which had been offering IFB service in the year 2015 is six banks. Moreover, there are three banks that joined the market and the total numbers of commercial banks who offer IFB are nine. However, to undertake this research paper, the

researcher purposely sampled six banks. Those banks are Commercial bank of Ethiopia, Oromia international bank S.Co., United bank S.Co., Wegagen bank, Nib international bank and Cooperative bank of Oromia.

Thus, the study used purposive sampling method to draw the sample from the population. The banks who offer IFB in Ethiopia were one state owned bank, and eight private owned commercial banks, from each category six banks was used as a sample units that can be based on the managers and employees who are working on IFB windows. From these branches twenty branch from the four districts commercial bank of Ethiopia and twenty branches from other banks are selected for the research understudy. The selection of the respondents is carried out by using purposive sampling method because they are very much concerned about interest free banking services offered by their branches. The total of 132 bank staff, were sampled to see their intention on the challenges of interest free banking system in Ethiopia. Hence samples are chosen to represent the relevant attributes of the whole population.

3.7 Data Collection Method

The primary data is obtained through Interview and semi-structured questionnaire. Interview with the banks manager and the questionnaire is obtained from the Banks Employees of selected branches locate in Addis Ababa. The questionnaire is used to obtain information on usage IFB products and over all awareness of Employees towards IFB products and services. Five point Likert Scales was used to know perception of Employees towards IFB products and services and also to investigate the problems encountered in practicing IFB.

The secondary source of data is obtained by reviewing various published and unpublished books and articles. The secondary data seek to obtain information on overall awareness of the respondents towards IFB products and services.

3.8 Method of Data Analysis

Both qualitative and quantitative techniques are used to analyze the data. Qualitative data that are collected by using semi-structured questionnaire are organized. Quantitative data also analyzed using descriptive statistics such as percentage, mean, frequency. In addition to, a similar

methodology is used effectively to analyze the opinion of respondents on various issues on Interest free banking operations. As result, Statistical Packing for Social Science (SPSS), Version 20.0 is used to process the raw data.

3.9 Validity and Reliability

Validity

The validity of the questionnaire refers to the degree to which it measures or able to catch all the necessary ideas it is supposed to measure. Unfortunately there is no single clear-cut indicator of questionnaire validity measure. A number of different steps were taken to ensure the validity of the study. First data was collected from the reliable sources, from the respondents who have a good exposure in IFB service; survey questions were made based on literature review and frame of reference to ensure the validity of the result; the questionnaire has been pre-tested by pilot test before starting the survey. The response has been collected in two weeks' time and in this short period of time there is no major event that could alter respondents' response.

Reliability

Numbers of different steps are taken to ensure the reliability of the study; questionnaire was divided into four parts in order that respondents could concentrate more on each question; the theories that have been selected for the study was clearly described and research question has been formulated based on the previous theory.

3.10 Ethical Considerations

The researcher treated all the information given by respondents kept confidentially without disclosing the respondents' identity and would not be used for any personal interest. Furthermore the questionnaires were distributed only to voluntary participants. Lastly, all secondary sources were quoted to keep the rights of ownership of all materials.

Chapter Four

Data Presentation, Analysis and Interpretation

4.1 Introduction

In this chapter, based on data that were collected by questionnaires, in-depth interview and from secondary sources (from Banks profile, written materials such as; books, journals, research results, and from scholars articles) that have impact on the operational challenges of IFB service analyzed broadly. The data were presented in tables, graphs and description forms. The responses of the closed ended questionnaires were organized in tables and graphs whereas open ended and in-depth interviews were summarized by the researcher in a thematic approach in a way convenient to analyze Ethiopian banks operational challenges on IFB.

As indicated in table 4.1 a total of 132 questionnaires were distributed for bank customer service managers, customer service officers and other bank staffs who are working on IFB windows as well as ordinary bank staffs as designed in the methodology part. However, among the total distributed 108 or 81.81% were returned to the researcher with successful responses. The remaining 19 or 18.18% of the respondents were not able to return the questionnaires in a given time.

Table 4.1: Questionnaire Distribution and Response Rate

<i>S/No.</i>	<i>Questionnaires</i>	<i>Number</i>	<i>Percentage</i>
<i>1</i>	<i>Distributed</i>	<i>132</i>	<i>100%</i>
<i>2</i>	<i>Returned</i>	<i>108</i>	<i>81.81%</i>
<i>3</i>	<i>Unreturned</i>	<i>19</i>	<i>18.18%</i>

Source: Survey result, 2016

This response was considered large enough and sufficient for statistical reliability and generality (Tabachnick and Fidell, 1996; Stevens, 2002). The high response rate undoubtedly improved the validity and reliability of the survey since the grater the response rate, the more accurate are the estimated parameters in the population sampled (Pallant, 2002).

4.2. Results of Descriptive Statistics

4.2.1. Demographic Profile of the Respondents

Sex of respondents

Based on table 4.2, from 108 persons who returned the questionnaires with successful response, the dominant number of respondent are male with 70.3%, where as 29.7% are female. Though it fact that most of the employees of the industry are male, the figure is occurred due to chance of occurrence while distributing the questionnaire.

Age of the respondents

The survey result in Table 4.2 shows that the largest group of sample respondents` age fall below 40 years age; 57(52.7%) were < 25 years and 25 (23.14%) were 26-40 years which indicated that the banks staff position is dominated by young and early adult age personnel. More than 82of the respondents were in these age groups that account a total of about 76%. The other 6 (5.5%) were 41-60 years. The remaining two persons are serving in their old age i.e. above 60 year.

Level of education of the respondents

The survey result about level of education of respondents in Table 4.2 shows that, majority of the respondents found above degree level. Only7 or 6.4% attends diploma, 75 or 69.44% gone to Universities for their first (bachelor) degree which is a little bit higher than two third. The remaining 26 (24.07%) or around 1/3 were second (masters) degree holders. This implies that majority of the bank staffs are becoming educated in order to fulfill educational requirement of most of the banks.

In comparing the sex and education composition, female respondents who got diploma are 4 out of seven i.e. about 57.13%, those ladies who hold their first degree accounts 28 i.e. 37.33% of the whole bachelor degree holders and no female master`s degree holder are found in the survey. The figure clearly indicated that males were dominants in higher educational backgrounds of the respondents. The higher we go into the educational as well as hierarchical level of organization; we got more men than women. This is the effect of lower awareness level in educating girls than boys in the community in the past.

Religion of respondents

As it is indicated in Table 4.2.1, the majority of the respondents are non-Muslim that is nearly 58.44%. On the other hand, the remaining 41.66% of respondents found to be followers of Islam. The implication of the result is dominant employee of banks as well as who are related to IFB are followers of religion other than Islam.

Table 4.2.1: Background Characteristics of the Respondents

S.No.	Demographic Variables	Sub Group	Number	Percentages
1	Gender	Male	76	70.3%
		Female	32	29.7%
2	Age	18 – 25	57	52.7%
		26 – 30	25	23.14%
		31 – 35	12	11.11%
		36 – 40	6	5.5%
		Above 41 Years	2	1.85%
3	Educational Level	Diploma	7	6.4%
		BA/BSc Degree	75	69.44%
		MA/MSc	26	24.07%
		Other	-	
4	Current Position	Customer Service Manager	12	11.11%
		IFB Window Officer/Clerk	23	21.30%
		Customer Service Officer/Clerk	67	62.04%
		Other	6	5.56%
5	Year of Employment	Less than 1 year	22	20.37%
		1 – 5 years	69	63.89%
		6 – 10 years	10	9.26%
		11 – 15 years	6	5.56%
		Above 16 Years	1	0.93%
6	Religion	Muslim	45	41.66%
		Non – Muslim	63	58.44%

Source: Survey result, 2016

Experience/Year of Service

Majority of the employee affiliated to IFB service worked less than five year in the industry that accounts 101 of the respondents i.e. nearly the entire respondents except the seven who remain serving the industry 6 to above 16 years in the sector. This is directly related with the age distribution of the respondents that comprises mostly fresh population.

4.2.2 The Current prospect of IFB in Ethiopian Banking Industry

Prior to the launch of IFB in Ethiopia, customers that did not want to receive interest on their savings would sign a waiver to the banks because of their religious beliefs. The fact that monies are deposited in accounts where clients waived their rights to receive interest does not mean that their deposits were now Sharia-compliant. Since there was nothing to state their funds were not used for financing projects on an interest basis and/or projects that contradict with Islamic principles such alcohol business. Such reasons from the demand side and other reasons like introducing new product, from the supply side created IFB in Ethiopia banking arena. The following chart tried to depict the current scenario.

Table 4.2.2 Few Ethiopian banks IFB banking setting as at December 2015

	Oromia International Bank (OIB)	Commercial Bank of Ethiopia (CBE)	United Bank (UB)
Branches	145	965	95
Branches with Interest Free banking Services	100	300	95
Number of Interest Free banking accounts circa	18,000	40,000	1,600
Benchmark	AAOIFI compliant	Relying on AAOIFI and internet	Relying on internet only
Training	Internal by own staff	Internal by own staff	Internal by own staff
Sharia Supervisory Board	Yes (3 scholars)	No	No
Current Product offering	-Current accounts: Amanah - Saving accounts: Wadia - Export financing	-Current accounts: Amanah - Saving accounts: Mudaraba	- Current account: Wadia - Saving account Wadia
Key challenges	- Training and capacity building - Public awareness - Tax/VAT - Land ownership - 20% equity cap - Zakat - Takaful	- Training and capacity building - Public awareness and misconception	- Training - Awareness - Reporting to NBE

Source: Survey result, 2016

According to Interview results, Commercial bank of Ethiopia collected above 600 million deposits from these products and services within few years and the bank serves above 40 thousand customers through bank separate window of branches of the bank which indicates as the bank is on good manner based on one year performance. And also indicated as lack of customers' awareness and misconception regarding the benefit they will get if they use the products and services and for whom it offered, the newness of the products and services for the country, few numbers of bank branches that offer the products and services makes the bank not going as it planned. In addition the request for Interest free banking for long period of time by community and existence of large Potential demand in country reflected as the products and services will be used in future.

Though the current IFB directive does not refer to any benchmarks or frameworks that need to be adopted by financial institutions offering IFB products, banks are adopting some internationally known benchmarks i.e. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) except United bank that merely relies on internet.

Concerning all the three banks have confirmed that the trainings are done internally by staff members that mainly consisted of self-study to develop the material presented to the branch level staff. The transfer of knowledge is currently limited to the individual interpretation by these banks. Moreover there is no certainty that the sources used for developing the internal training material are accurate and complete.

Having an adequate Sharia Advisory board guarantees a product is compliant with Sharia principles. In Ethiopia, no directive, guidelines or authority supervises and authenticates the Sharia validity of an IFB product. The lack of authority leaves the consumer at risk of not being offered genuine Islamic financial products.

4.3. Assessment of Employees Awareness and Training about IFB Product/Service

According to article 6.4 of the Ethiopian Licensing and Supervision of banking/insurance/micro financing business directive: A bank should “give training to directors at least once in a year on areas of financial analysis, corporate governance, applicable laws, regulations and directives, risk management and internal control.” And the bank “shall file certificate of training of directors with National Bank.” At the moment, there is no mention of IFB training for those banks with an IFB window or any reference to who should be allowed to deliver these courses (such as internationally accredited institutes or locally recognized training companies). That is why they are enforced to mainly do on an individual institution basis and mentioned as a point of failure.

a. Knowing the demarcation

About 58.29% of the respondents rated their overall awareness towards IFB as high and very high while, 22.7% & 11.1% rated as moderate and limited awareness towards IFB products and services respectively. On the other hand, as the descriptive statistics result depicts in the Table 4.3 shows that, 2.77% of the respondents weak with the mean score is 2.58. The implication of the result is that, the respondents are familiar with IFB. This is because of most respondents hear points of differences by training, media as well as peer to peer discussion.

Table 4.3.1 Awareness in difference of IFB and conventional banking

		Frequency	Percent	Mean
Understanding the difference in IFB and conventional banking	Strongly Agree	17	15.7	2.58
	Agree	46	42.59	
	Moderate	30	27.77	
	Disagree	12	11.11	
	Strongly Disagree	3	2.77	
Total		108	100.00	

Source: Survey result, 2016

This result confirms the finding of Ahmad & Haron (2002) which indicates that employees are aware of existence of Islamic banks. However, they are unaware regarding the use of specific Islamic method of finance or low usage rate and could not differentiate between Islamic and conventional banks financial products and services.

b. Proper knowledge of services offered

Table 4.3.2 Knowledge of the product and services of IFB

		Frequency	Percent	Mean
I know properly the Interest free banking services currently offered by my bank	Strongly Agree	5	4.6	3.05
	Agree	13	12.03	
	Moderate	67	62.03	
	Disagree	15	13.88	
	Strongly Disagree	8	7.4	
Total		108	100.00	

Source: Survey result, 2016

Though most of the respondents know where the demarcation between IFB and conventional banking lies on, they don't have a proper knowledge of the products and services being given by their bank. As per table 4.4, the mean value of the respondents on the issues converges to moderate that implies they do have moderate knowledge on the product. The number is Even less than from the respondent who works on IFB windows which mean the employee are giving the service without proper knowhow of the product and services.

c. Knowing the basic principles of IFB

Interest Free banking service in any scenario works on preserving the principles that are provided by sharia law. Therefore, knowing these basic principles is the first thing to know before providing the service. However, according to the survey result, most of the respondents don't know all the ideologies in a proper way. Table 4.5 indicated that only about 13% highly recognize the founding principles IFB.

Table 4.3.3 Knowledge of the founding principles of IFB

		Frequency	Percent	Mean
I know the basic principles of IFB like prohibition of interest (Riba), etc.	Strongly Agree	3	2.77	3.56
	Agree	11	10.18	
	Moderate	55	50.92	
	Disagree	32	29.62	
	Strongly Disagree	7	6.48	
Total		108	100.00	

Source: Survey result, 2016

This result also confirms the finding of Ahmad & Haron (2002) which indicates that employees are aware of existence of Islamic banks and they are unaware regarding the use of specific Islamic method of finance.

d. Understanding philosophy of IFB

Islamic banking is a kind of banking system that operates strictly on the basis of *Shari'ah* (Islamic law) and prohibits any activities that don't ally with the law. Many prohibitions (e.g interest, gambling, excessive risks, etc.) are to provide a level playing field to protect the interest and benefits of all parties involved in market transactions and to promote social harmony (Ahmed, 2000; Chapra, 2000). Therefore, understanding these philosophies is the major thing to discern before providing the service. However, again in this case as per the survey result, most of the respondents don't appropriately understanding these stepping stones. Table 4.6 indicated that only about 21% highly distinguish the philosophy of interest free banking system.

Table 4.3.4 Knowledge of the philosophy of IFB

		Frequency	Percent	Mean
I know the basic principles of IFB like prohibition of interest (Riba), etc.	Strongly Agree	5	4.63	3.77
	Agree	18	16.67	
	Moderate	44	40.74	
	Disagree	34	31.48	
	Strongly Disagree	7	6.48	
Total		108	100.00	

Source: Survey result, 2016

e. Awareness on the benefit of IFB

Islamic banking as any other banking products comes with an advantage. Knowing these advantages will help Ethiopian banks to gain customers who miss this chance for so long. Therefore, they have to equip their personnel with a proper knowhow about the benefits it is going to provide. Operating in line with sharia law, profit sharing, cooperation and brotherhood are few of the advantages for the customers.

Table 4.3.5 Awareness on the benefit of IFB

		Frequency	Percent	Mean
<i>I am aware of the benefits of products/services of Islamic banks</i>	Strongly Agree	8	7.41	3.02
	Agree	21	19.44	
	Moderate	51	47.22	
	Disagree	20	18.52	
	Strongly Disagree	8	7.41	
Total		108	100.00	

Source: Survey result, 2016

Even though the survey shows a better result in awareness than the above few attributes of IFB, there is still a more to be done to increase the awareness level. As it is depicted above, only about 74% of the respondents are aware of the benefits and the remaining 26% are not.

f. Other awareness measures on IFB Product/Services

Table 4.3.6 awareness measures on IFB

Items	Alternatives									
	SD		D		N		A		SA	
	N	%	N	%	N	%	N	%	N	%
<i>I know Interest free banking are offered to Muslim and non-Muslim customers</i>	23	21.30	38	35.19	20	18.52	15	13.89	13	12.04
<i>I know the basic modes of operation of Interest free banking i.e Qard Hasan, Mudarabah, Ijarah, etc which are in line with sharia principles</i>	34	31.48	36	33.33	22	20.37	9	8.33	7	6.48

Source: Survey result, 2016

There are about 61 respondents who don't know a fact of non-Muslim customers could use IFB services and products. Though it is guided by the sharia law and pillared Islamic principles, other religion followers could use the product. However, there are respondents who are working on IFB window and even their supervisors assume it is merely for Muslim customers. This is a very huge factor not to attain the intended customer base on the sector. Even the marketers of these banks focus on Masjids and Muslim community only.

Research findings of Zeineb (2014) confirms in the past years of the service the report identified that there is a lack of awareness of IFB product among Muslim and non-Muslim communities in Ethiopia.

On the other hand, very amazingly more than a significant number of respondents i.e 70 (64.8%) either doesn't have information or know very little about the mode of operation in IFB services of their own bank. Even those who work on IFB related areas know about Qard Hasan, Mudarabah, Ijarah, etc which are products given by every bank that do have IFB window. This shows there is significant knowledge gap on the performers and supervisors of Interest Free Banking in the Ethiopian banking arena.

g. Training and Capacity building

Skilled professionals are in short supply in the Islamic finance industry especially in Ethiopia. Those banks that begin Islamic banking services are obligated to provide own personnel training mechanism basing the internet as a source of information for them. Table 4.3.7 below, depicts that there are even employee of these banks who don't get adequate and regular training that can equip them to provide the service.

Table 4.3.7 Training and Knowledge of respondents on IFB

Items	Alternatives									
	SD		D		N		A		SA	
	N	%	N	%	N	%	N	%	N	%
<i>My bank gives me training on IFB on a regular basis.</i>	31	28.70	45	41.67	21	19.44	11	10.19	-	-
<i>The training that is given by my bank is good enough to make me aware of IFB products and service.</i>	48	44.44	43	39.81	18	16.67	1	0.93	-	-
<i>I usually tell a customer in-need about the product/services of IFB</i>	27	25.00	15	13.89	19	17.59	38	35.19	9	8.33

Source: Survey result, 2016

From the total of 108 respondents there are only 11 who agreed on persistent training provision. From these eleven respondents ten of them are from CBE who works on IFB window and management level. This indicates that other banks are even worse in giving regular training. The remaining 90% consider there is no enough training or believe it is not consistent to be updated.

Concerning adequacy, only one person (believed to be by chance) agreed. As per the interview, many believe it is not enough to answer the question of the customers and not helpful enough to run IFB window operation smoothly as well as to be an expert on the field. It is a very dangerous sign for the bank management to be considered. Even things goes this way Interest free Banking will loss its existence on the market and banks will cost for it.

This were in line with the study of Iqbal (1998) , which identifies lack of teaching, training, research and development in this institution as a major challenges of interest free banking system.

Since they are placed there to serve their customer and given a goal to achieve, many tell about the product and services their bank is giving regarding IFB. From the total respondents 35% and 8% agree or strongly agree about telling their customers or prospective customers about type, usage and advantage of IFB products and services. Without knowing well what Islamic banking is, they are providing the service. In the future, this may cost banks or IFB products may not be given in a proper or right way.

4.4 Analysis on Religion and Cultural Differences

In 2013, the World Bank estimated Ethiopia's total population at 94.1 million of which 35% to 40% are Muslims. And there are about 86 ethnic groups and more languages in Ethiopia. These facts make the country land of diversity. (World Bank)

The basic question here is diversity is suitable for IFB or not? Because many of the benchmark countries residents are similar in culture and common in religion i.e. Islam, the researcher questioned the practicability in a secular nation.

i) Cultural diversity

Our culture differs in every corner of the country. It sometimes shaped by many factors including religion. Respondents are asked if this difference in culture does matter in introduction of IFB services. However, majority of them (62% strongly disagree and 13.8% disagree) about the difficulty it makes for introducing IFB service in to our banking arena.

Table 4.4.1 Cultural difference in IFB introduction

		Frequency	Percent	Mean
<i>Our (Ethiopians) diversity in Culture makes the IFB services introduction difficult</i>	Strongly Agree	5	4.6	4.14
	Agree	8	7.4	
	Moderate	13	12.03	
	Disagree	15	13.88	
	Strongly Disagree	67	62.03	
Total		108	100.00	

Source: Survey result, 2016

ii) Religious diversity

As that of the culture, our religious combination is very diverse. From the total of 94 million Ethiopian (World Bank) Muslims comprise average of 40%, orthodox Christian estimated to be 44% and the remaining 16% are other religion followers. Ethiopia is one of few countries that introduce Islamic banking with such religious diversity. Does this diversity could affect the introduction of IFB in Ethiopia? Many of the respondents disagree like that of cultural diversity.

Table 4.4.2 Religious difference in IFB introduction

		Frequency	Percent	Mean
<i>Our (Ethiopians) diversity in Religion makes the IFB services introduction difficult</i>	Strongly Agree	6	5.56	3.94
	Agree	8	7.41	
	Moderate	40	37.04	
	Disagree	18	16.67	
	Strongly Disagree	36	33.33	
Total		108	100.00	

Source: Survey result, 2016

Though a significant number of respondents (33% strongly disagree and 17% disagree) about the effect of religious diversity in the introduction of Islamic banking system, still there is fifty percent respondent who doubt it may moderately or highly affect the operation with a mean value of 3.94.

Knight (2007) noted that interest free banking financial services are currently very popular among the non-Muslims in different parts of the world.

iii) Targeted population selection

Having the fact that employee perceived it is products opt to be given for Muslim community (as depicted on table 4.3.6) than the non-Muslim community, what is the focus of the banks in providing the service is the next question. As per the interview with IFB officials of the banks, they focus much on Muslim merchants, Muslim farmers and housewives. This fact is also seen on the respondent employee.

Table 4.4.3 Target selection in IFB service provision

		Frequency	Percent	Mean
<i>Currently the targeted customers for IFB service are only Muslim customers</i>	Strongly Agree	56	51.85	1.44
	Agree	38	35.19	
	Moderate	10	9.26	
	Disagree	6	5.56	
	Strongly Disagree	-	-	
Total		108	100.00	

Source: Survey result, 2016

As depicted on the above table, most of the respondents believe banks do target Muslim religion followers for marketing their products. More than 51% strongly agree with the fact while 35% and 9% agree and moderately agree on the issue with a mean value of 1.44.

iv) Religion of Service desk personnel

There is also a controversy over who should give the service, a Muslim personnel or non-Muslim one? Respondents are asked by whom the service is given. In most of the banks, by the time of this research has been doing, the service desks are filled by non-Muslim employee. As per the unstructured interview with officials of the banks, these desks are operated by Christian personnel.

v) Whom the customers prefers

It is known that IFB customers are predominantly Muslims. As to the result of the survey, the customers are happy while served by Muslim staffs than other religion followers. More than 44% and 28% agree or strongly agree with this idea and 9.2% moderately agree. These indicate that even the IFB performers do believe they shouldn't give that service because most of them are Christianity followers.

Table 4.4.4 Whom the customer prefers

		Frequency	Percent	Mean
<i>Currently the targeted customers for IFB service are only Muslim customers</i>	Strongly Agree	30	27.78	2.15
	Agree	48	44.44	
	Moderate	10	9.26	
	Disagree	6	5.56	
	Strongly Disagree	14	12.96	
Total		108	100.00	

Source: Survey result, 2016

vi) Religion as a reason

Does their religion cause customers to be IFB products user? As per the survey respondents and interview with officials, Customers' religion does a lot to motivate them to be an IFB service user, because their religious thought has been there in their mind while doing business and using banks. Though there are many non-Muslim IFB banking users and IFB has many things in common with Ethiopian custom like sharing, cooperation, brotherhood and the like.

Table 4.4.5 Religious Reason

		Frequency	Percent	Mean
<i>Customers religion motivated them to be an IFB service user</i>	Strongly Agree	40	37.04	1.67
	Agree	35	32.41	
	Moderate	20	18.52	
	Disagree	7	6.48	
	Strongly Disagree	6	5.56	
Total		108	100.00	

Source: Survey result, 2016

As it is depicted above, only 40 respondents agreed up on religion is a motivational factor to use IFB products and the remaining as well as the majority disagreed and strongly disagreed about the issue. This makes Ethiopian Islamic banking phenomena different than any other country.

vii) Pollution of the money

Using the deposit collected by Islamic banking system should not be mixed with that of conventional banking system as per the principle of IFB. However, since IFB is being provided with the same roof of the conventional banking branch, the customers may think their money will be polluted. Having this assumption, the respondents are asked whether the customers do believe this will be a fact.

Table 4.4.6 Pollution of the money

		Frequency	Percent	Mean
<i>The customers believe the banks use their money for sharia prohibited activities</i>	Strongly Agree	17	15.7	2.58
	Agree	46	42.59	
	Moderate	30	27.77	
	Disagree	12	11.11	
	Strongly Disagree	3	2.77	
Total		108	100.00	

Source: Survey result, 2016

As the above figure depicts, majority (42% agreed and 15% strongly agreed) of the respondents answer their customer do have believe that their money is being polluted. There are significant numbers of respondents (i.e. 27%) who respond their customers believe their money is a little bit polluted.

4.5 Views Regarding Branch Location and Service Availability

The National Bank of Ethiopia's directive came into force in October 2011 about first Islamic Financial Institution in Ethiopia, However, the implementation of this banking system was started only in 2013 by few commercial banks like Oromia international bank S.C, Commercial Bank of Ethiopia and united bank S.C. Customers who are interested in the interest free banking are assured that they will obtain all those services that they would get from a fully-fledged interest free banking. While this research is being done, circa six banks and about 600 of their branches offer IFB products in Ethiopian banking industry.

Respondents are asked about the presence of a branch fully left for IFB service, location selection and full service availability in the selected branches. And the following was the survey summary.

Table 4.5 Branch Location and Service Availability

<i>Items</i>	<i>Alternatives</i>									
	<i>SD</i>		<i>D</i>		<i>N</i>		<i>A</i>		<i>SA</i>	
	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>
<i>There is a branch in my bank that fully left for IFB service only</i>	58	53.70	47	43.52	3	2.78	-	-	-	-
<i>My bank does better on selecting location for serving IFB customers.</i>	2	1.85	14	12.96	25	23.15	59	54.63	18	16.67
<i>The number of branches currently offered IFB service are enough</i>	3	2.78	4	3.70	10	9.26	43	39.81	48	44.44
<i>The full service/products of IFB is offering in every selected branches</i>	67	62.04	34	31.48	7	6.48	-	-	-	-

Source: Survey result, 2016

Though there is an option that IFB service can be offered by fully pledged bank or branch, in Ethiopian banking context the service is being offered at separate windows. As per survey result depicted in the above table, most of the respondent employees recognize this fact and about 97% or 105 of the total 108 respondents denied the presence of fully reserved bank branch for IFB banking operation.

The finding is in line with the current National Bank of Ethiopia's directive No. SBB/51/2011 that allows banks to offer interest free banking service alongside their conventional operation.

Most of the employees of the banks do believe their bank is selecting a better place for giving IFB related products. 59 agree and 18 strongly agree about their bank's selection of a better area of doing business. Even though there are some numbers of respondents who don't agree on this fact, the result implies that their Marketing group is doing well in knowing where their customers are living.

The number of branches being offering IFB related products now reached 600 in Ethiopian banking arena. Employees supports that there is enough number of branches giving the service for the current market potential. 48 or 44% and 43 or 40% of the total respondent of the survey do believe there are adequate numbers of branches giving IFB products and services while there are 9% respondents who neutrally answer the question.

The agreement on the presence of branches that gives IFB services doesn't collaborator the fact of the presence of the full service in these branches. As per the survey result, though there are branches who are assigned to give the service, they are not giving the full service that the bank intended to give. 67 or 62% of the total 108 respondents strongly disagree with the presence of full service/products combination on the IFB service giving branches, following 34 or 31% disagreed respondents.

4.6 Overall Challenges of IFB in Ethiopian banking industry

In this section we shall discuss the issues of potential operational challenges for Islamic/Interest free banking in Ethiopian banking dome.

As it is observed in many countries there are many operational challenges that confront interest free banking (Islamic) banking from its introduction in secular environments and the same is true here in Ethiopia. Some challenges have been identified and respondents reflected on such issues.

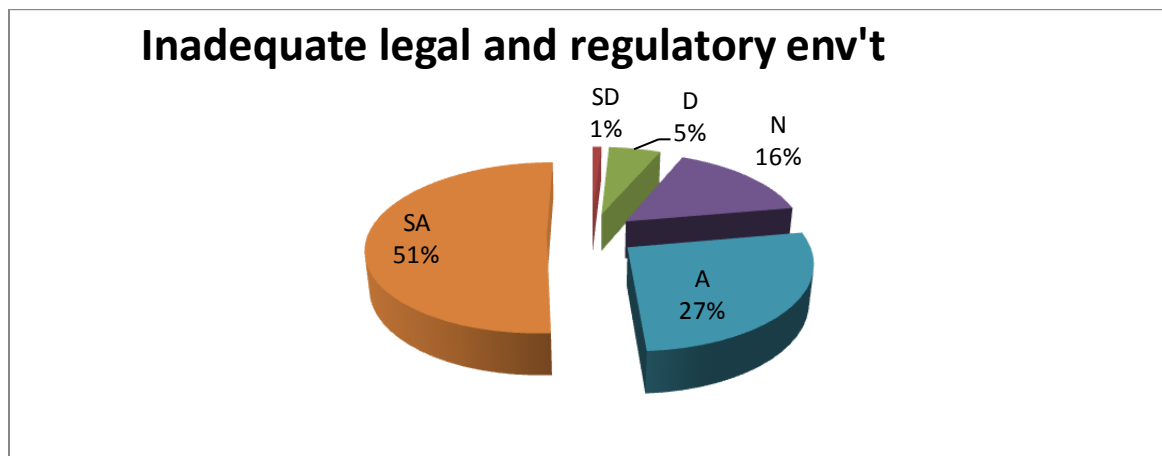
a) Legal and regulatory environment

The introduction of IFB in Ethiopia needs to be supported by adequate legal and regulatory framework and this has been addressed with the current directive for IFB (SSB/51/2011) is a 3-page document and includes the following main points:

1. Only IFB windows are permitted, no fully-fledged interest free banks will be authorized
2. IFB entities need to follow Sharia law
3. IFB windows need to follow the same regulations as the other banks except on the interest rate, which does not apply

The directive is relatively simple thus leaving a lot of flexibility to the banks offering IFB products. Having this fact respondent, employees' area asked whether the current regulatory framework is adequate or not.

Chart 1 Inadequate legal and regulatory environment



Source: Survey result, 2016

As it is stated in the above pie chart, the majority of the survey respondents agreed with the absence of legal and regulatory environment in IFB banking arena. While 41% strongly support, 37% simple agree with little or no policy, practicing and advisory service in the banking industry regarding IFB products. This fact imply that due to the inexistence of relevant legislation banks has adopted their own methodology, models and benchmarks for launching IFB products with little coherence or commonality in the international market.

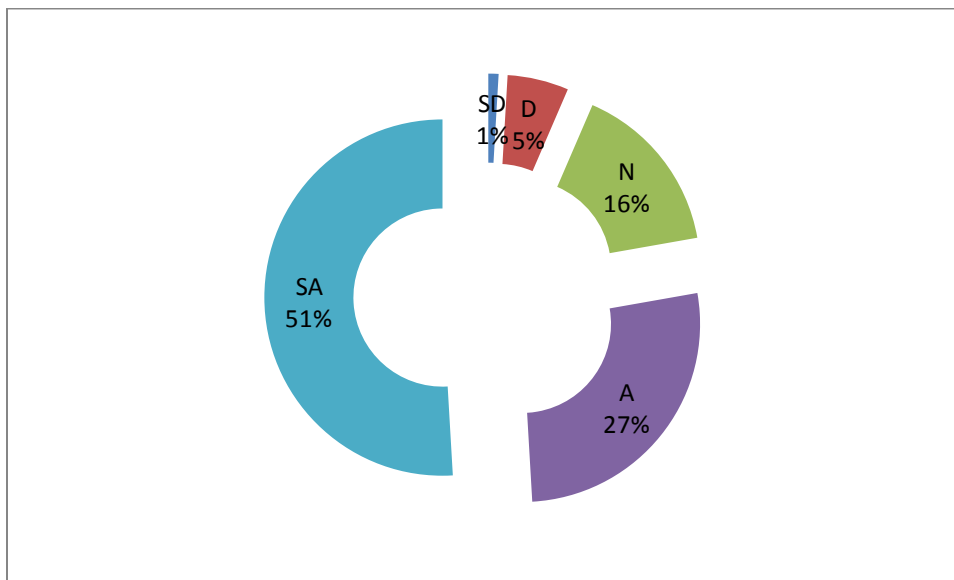
This was in line with the study of Zeineb (2014), which identifies lack of legal framework as major challenges of interest free banking system.

b) Problem of Manpower

There is problem of shortage of professionally qualified personnel to operate interest free banks in world. In fact it has been widely acknowledged that there is a global shortage of experienced professionals in Islamic finance sector to feed the industry and the regulators. This no doubt would be a glaring challenge for Ethiopia. In addition, there is still the challenge of having qualified and competent Shariah scholars with good grounding in Islamic finance and jurisprudence. This would be a critical issue since most of the instruments and services would have to be cleared by each firms Shariah board. (Abubakar, 2001)

The survey respondents are asked to reflect their concern on this issue and it is not far from the internationally recognized fact.

Chart 2 There is a problem of man power in the sector



Source: Survey result, 2016

More than a half strongly agreed with the presence of experts in sector, about 27% give their consent and the other 16% are neutral.

This finding is consistent with the finding of Shaukat (2011) the opinion that the lack of ultimate authority that governs Islamic financial industry, inadequate qualified human resource in both conventional banking and Islamic laws, are the challenges of Islamic banking system.

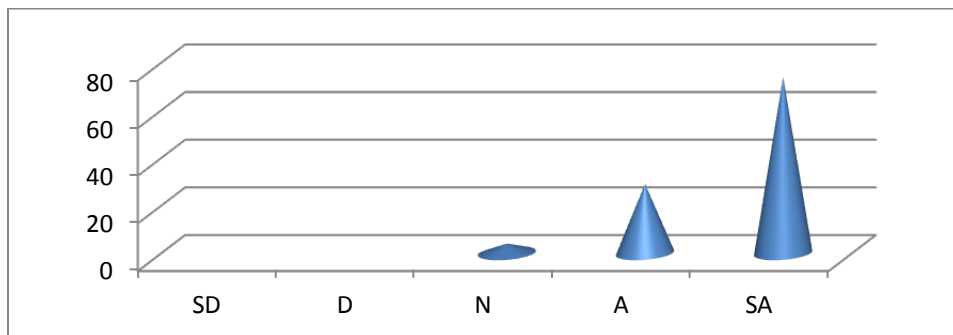
c) Accounting and Auditing standards

Ethiopian banks giving IFB service may be challenged by the disparity in their accounting standard as experienced all over the world. There are two international regulatory bodies in the Islamic finance industry, which have been widely used as standard setting bodies and benchmarks for Islamic and IFB products: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Financial Services Board (IFSB).

However, the existing commercial banking system has similar accounting standard with that of the conventional banking that enable easy supervision and regulation of their operations by the National Bank of Ethiopia. This is different from the standard set by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). In that case, the National Bank of Ethiopia should prescribe and implement this standard to all Commercial Banks providing IFB products in the country in order to comply with the international standard.

Including the official of the banks, majority of the survey respondent employees' is believed there is no or little Accounting and Auditing Standards. More than 35 and 40 respondents agree and strongly agree respectively on the issue.

Chart 3 There is absence of accounting and auditing standards

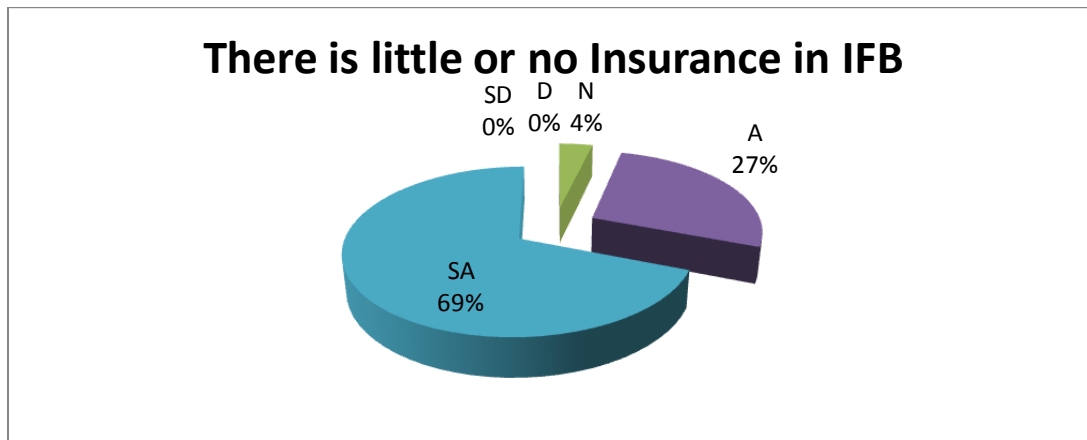


Source: Survey result, 2016

d) Insurance for IFB

As that of the Auditing and Accounting standards, Interest Free Banking is enforced to use the conventional Insurance companies for their protection need. Respondents give agreement for this fact, according to the survey. More than 69% strongly agree and 27% agree about the absence of Insurance service for IFB service.

Chart 4 Insurance in IFB



Source: Survey result, 2016

e) Mixing IFB and Conventional Windows

The current directive for IFB (SSB/51/2011) state that only IFB windows are permitted, no fully-fledged interest free banks. Only dedicated windows in the branch are allowed to give the service. However, while there is no load on that window banks are doing the conventional banking service on it. This makes discomfort for IFB customers. Respondents are asked about the intensity of this mixing and the majority i.e. more than 50% agrees and strongly agree on that. On the other hand, Customers believe banks will use IFB related deposits for conventional banking service, this may confiscate the principal behavior and nature of Islamic banking.

Moreover, from the branch management side, there is a perception problem of dedicated a window for a mere purpose of IFB service due to many reasons. Survey respondents asked to reflect on this window dedication issue and more than 69% of them agree or neutral about the issue. This implies that even though the Head Office IFB department order to leave one or more windows for IFB purpose the branch management is suppressing this service and no or lack of compliance service exist.

All the above results are consistent with the Performance Report done by CBE (2015) as well as Zaineb Sefiani (2014). This consistency indicates the nature of IFB in Ethiopian banking arena is similar in many terms within as well as out of the country.

CHAPTER FIVE

Summary of findings, Conclusion and Recommendation

The study intended to analyze the main problems and challenges in the introduction of interest free banking system in Ethiopia. On the other hand, the purpose of this chapter is to delineate the summary of findings, followed by conclusion and presents some recommendations forwarded.

5.1. Summary of findings

- This study serves as an indicator showing that most respondents are young educated as well as less than five years affiliation in the banking industry and/or IFB.
- The result of the study shows both demand and supply side contributed for the introduction of IFB service in the country and it is in its earliest stage with less than 700 branches giving the service in partial way with less than 100 thousand customers.
- The survey respondents has shown a knowledge gap in many of the basic operational areas like knowing the difference with conventional banking, principles, philosophies, proper know how of the product and its benefits. Most of the time the respondents weight to the disagreement part for positive questions of knowledge based ones.
- Many also believe that they are not getting proper, adequate and regular training that enable them to deliver the service in a better way. Moreover, they doubt the trainers' knowledge base and the ground fact as well as the international standard is different.
- In most cases, respondents believe that our cultural and religious difference is not hindering the introduction of IFB. But they don't deny that the customers will be happy if they are served by Muslim personnel and their religion does motivate them to be an IFB service user.
- The respondent employees also reveal the fact that the current numbers of branches are enough to give the service but they are not working in a full capacity and there are multiple problems for not working with these windows in a proper way. In addition, they praise their marketing in selecting a good location and targeting for the service.

- With great voice most of them agreed in the absence of proper legal frame work, sufficient and skilled man power, absence of Auditing and Accounting standards as well as Insurance firms. They do also reveal there is a problem of mixing with the conventional banking services in many scenarios.

5.2. Conclusions

The main conclusions of the study in relation to challenges of interest free banking system and the associated follow up actions considered are given below. The main challenges of interest free banking include inadequate human resource, lack of benchmarks or frameworks, lack of adequate Sharia Advisory board.

Based on the findings of this research, the following conclusions are forwarded:

- ✓ This study serves as an indicator showing a knowledge gap in many of the basic operational areas like knowing the difference with conventional banking, principles, philosophies, proper know how of the product and its benefits.
- ✓ Many also believe that they are not getting proper, adequate and regular training that enable them to deliver the service in a better way. Moreover, they doubt the trainers' knowledge base and the ground fact as well as the international standard is different.
- ✓ With great voice most of them agreed in the absence of proper legal frame work, sufficient and skilled man power, absence of Auditing and Accounting standards as well as Insurance firms. They do also reveal there is a problem of mixing with the conventional banking services in many scenarios.

5.2 Recommendations

Interest-Free Banking in Ethiopia has some challenges mainly due to the lack of a proper and strong policy along with a shortage of local qualified Islamic finance experts and Scholars. In order for IFB to gain popularity in the Ethiopia, each of these challenges needs to be addressed adequately.

The researcher has identified, in the previous section, a lack of skilled Islamic finance experts on a global basis and this gap is even wider on a local basis in Ethiopia. In order to solve this problem,

- Continuous and better training on a timely basis (monthly, quarterly or semi-annually) to managers and employees about interest free banking services to create and increase awareness.
 - Create awareness programs to all the employees of the bank about interest free banking services practice and challenges by providing *accredited training, In house training, Conferences & seminars, Knowledge portal Working group* on the job and off the job trainings, education programs and by using brochures and fliers.

Recommendation on legal framework and related issues

- ✓ The researcher recommends that the NBE bases the IFB directive on AAOIFI standards and prudential standards on IFSB. It is one of internationally recognized standards that could also be used for developing not only Interest Free Banking products but also micro financing products, which adheres to Islamic principles.
- ✓ Furthermore, it is recommended NBE provide some guidance to IFB windows on the composition of the Interest Free Advisory board. The most suitable board composition would be as follow:
 - a) 1 International renowned scholar or adviser who brings the international expertise and experience
 - b) 1 Scholar from Islamic Affairs Supreme Council in Ethiopia who understands the local factor
 - c) 1 junior Sharia Adviser/scholar in-house who addresses the day-to-day questions in collaboration with a & b

At the NBE, there should be a group of experts that reviews, vets and authorizes IFB windows, as it might be too sensitive to have Sharia scholars sitting at the National Board level.

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APPENDIX: B

Descriptive statistics Result

1. Awareness in difference of IFB and conventional banking

		Frequency	Percent	Mean
Understanding the difference in IFB and conventional banking	Strongly Agree	17	15.7	2.58
	Agree	46	42.59	
	Moderate	30	27.77	
	Disagree	12	11.11	
	Strongly Disagree	3	2.77	
Total		108	100.00	

2. Knowledge of the product and services of IFB

		Frequency	Percent	Mean
I know properly the Interest free banking services currently offered by my bank	Strongly Agree	5	4.6	3.05
	Agree	13	12.03	
	Moderate	67	62.03	
	Disagree	15	13.88	
	Strongly Disagree	8	7.4	
Total		108	100.00	

3. Knowledge of the founding principles of IFB

		Frequency	Percent	Mean
I know the basic principles of IFB like prohibition of interest (Riba), etc.	Strongly Agree	3	2.77	3.56
	Agree	11	10.18	
	Moderate	55	50.92	
	Disagree	32	29.62	
	Strongly Disagree	7	6.48	
Total		108	100.00	

4. Knowledge of the philosophy of IFB

		Frequency	Percent	Mean
I know the basic principles of IFB like prohibition of interest (Riba), etc.	Strongly Agree	5	4.63	3.77
	Agree	18	16.67	
	Moderate	44	40.74	
	Disagree	34	31.48	
	Strongly Disagree	7	6.48	
Total		108	100.00	

5. Awareness on the benefit of IFB

		Frequency	Percent	Mean
<i>I am aware of the benefits of products/services of Islamic banks</i>	Strongly Agree	8	7.41	3.02
	Agree	21	19.44	
	Moderate	51	47.22	
	Disagree	20	18.52	
	Strongly Disagree	8	7.41	
Total		108	100.00	

6. Other awareness measures on IFB

Items	Alternatives									
	SD		D		N		A		SA	
	N	%	N	%	N	%	N	%	N	%
<i>I know Interest free banking are offered to Muslim and non-Muslim customers</i>	23	21.30	38	35.19	20	18.52	15	13.89	13	12.04
<i>I know the basic modes of operation of Interest free banking i.eQardHasan, Mudarabah, Ijarah, etc which are in line with sharia principles</i>	34	31.48	36	33.33	22	20.37	9	8.33	7	6.48

7. Training and Knowledge of respondents on IFB

Items	Alternatives									
	SD		D		N		A		SA	
	N	%	N	%	N	%	N	%	N	%
<i>My bank gives me training on IFB on a regular basis.</i>	31	28.70	45	41.67	21	19.44	11	10.19	-	-
<i>The training that is given by my bank is good enough to make me aware of IFB products and service.</i>	48	44.44	43	39.81	18	16.67	1	0.93	-	-
<i>I usually tell a customer in-need about the product/services of IFB</i>	27	25.00	15	13.89	19	17.59	38	35.19	9	8.33

8. Cultural difference in IFB introduction

		Frequency	Percent	Mean
<i>Our (Ethiopians) diversity in <u>Culture</u> makes the IFB services introduction difficult</i>	Strongly Agree	5	4.6	4.14
	Agree	8	7.4	
	Moderate	13	12.03	
	Disagree	15	13.88	
	Strongly Disagree	67	62.03	
Total		108	100.00	

9. Religious difference in IFB introduction

		Frequency	Percent	Mean
<i>Our (Ethiopians) diversity in <u>Religion</u> makes the IFB services introduction difficult</i>	Strongly Agree	6	5.56	3.94
	Agree	8	7.41	
	Moderate	40	37.04	
	Disagree	18	16.67	
	Strongly Disagree	36	33.33	
Total		108	100.00	

10. Target selection in IFB service provision

		Frequency	Percent	Mean
<i>Currently the targeted customers for IFB service are only Muslim customers</i>	Strongly Agree	56	51.85	1.44
	Agree	38	35.19	
	Moderate	10	9.26	
	Disagree	6	5.56	
	Strongly Disagree	-	-	
Total		108	100.00	

11. Whom the customer prefers

		Frequency	Percent	Mean
<i>Customers are happy while served by Muslim staffs than other religion followers</i>	Strongly Agree	30	27.78	2.15
	Agree	48	44.44	
	Moderate	10	9.26	
	Disagree	6	5.56	
	Strongly Disagree	14	12.96	
Total		108	100.00	

12. Religious Reason

		Frequency	Percent	Mean
<i>Customers religion motivated them to be an IFB service user</i>	Strongly Agree	40	37.04	1.67
	Agree	35	32.41	
	Moderate	20	18.52	
	Disagree	7	6.48	
	Strongly Disagree	6	5.56	
Total		108	100.00	

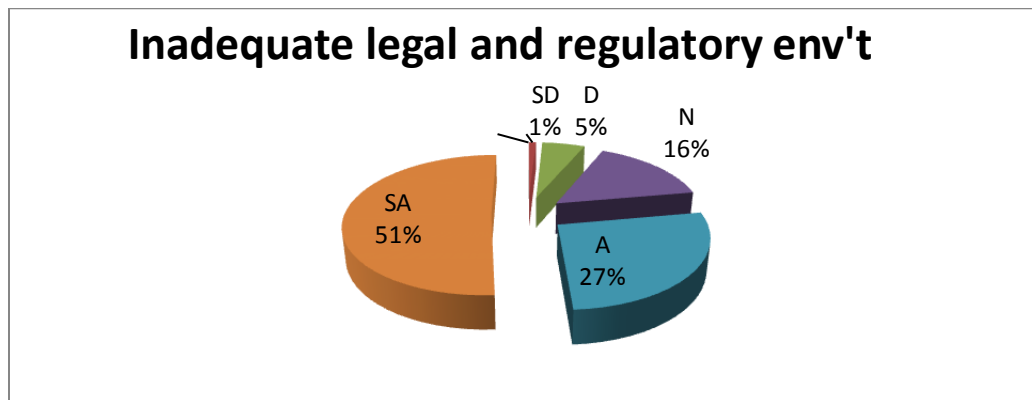
13. Pollution of the money

		Frequency	Percent	Mean
<i>The customers believe the banks use their money for sharia prohibited activities</i>	Strongly Agree	17	15.7	2.58
	Agree	46	42.59	
	Moderate	30	27.77	
	Disagree	12	11.11	
	Strongly Disagree	3	2.77	
Total		108	100.00	

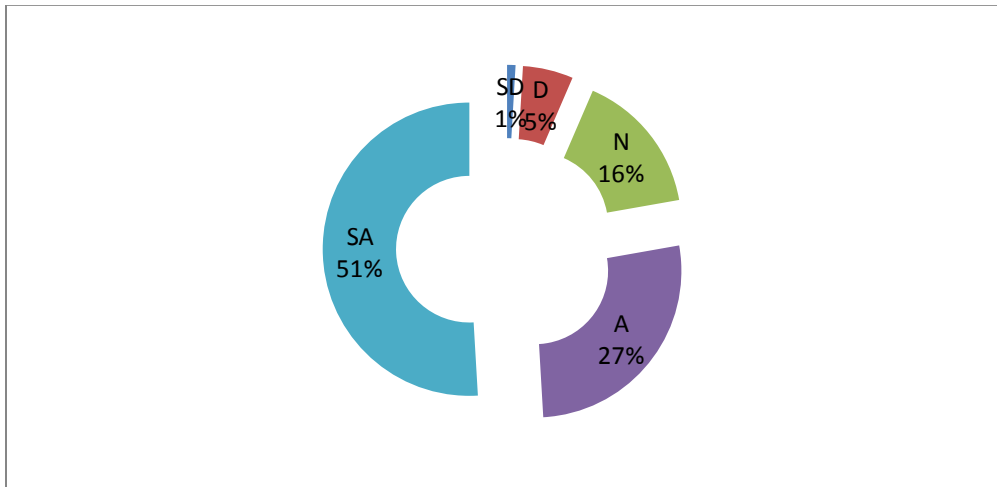
14. Branch Location and Service Availability

<i>Items</i>	<i>Alternatives</i>									
	<i>SD</i>		<i>D</i>		<i>N</i>		<i>A</i>		<i>SA</i>	
	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>	<i>N</i>	<i>%</i>
<i>There is a branch in my bank that fully left for IFB service only</i>	58	53.70	47	43.52	3	2.78	-	-	-	-
<i>My bank does better on selecting location for serving IFB customers.</i>	2	1.85	14	12.96	25	23.15	59	54.63	18	16.67
<i>The number of branches currently offered IFB service are enough</i>	3	2.78	4	3.70	10	9.26	43	39.81	48	44.44
<i>The full service/products of IFB is offering in every selected branches</i>	67	62.04	34	31.48	7	6.48	-	-	-	-

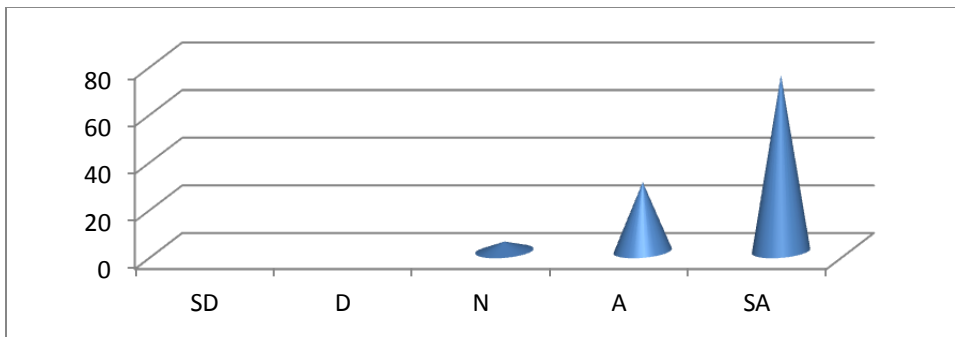
15. Legal and regulatory environment



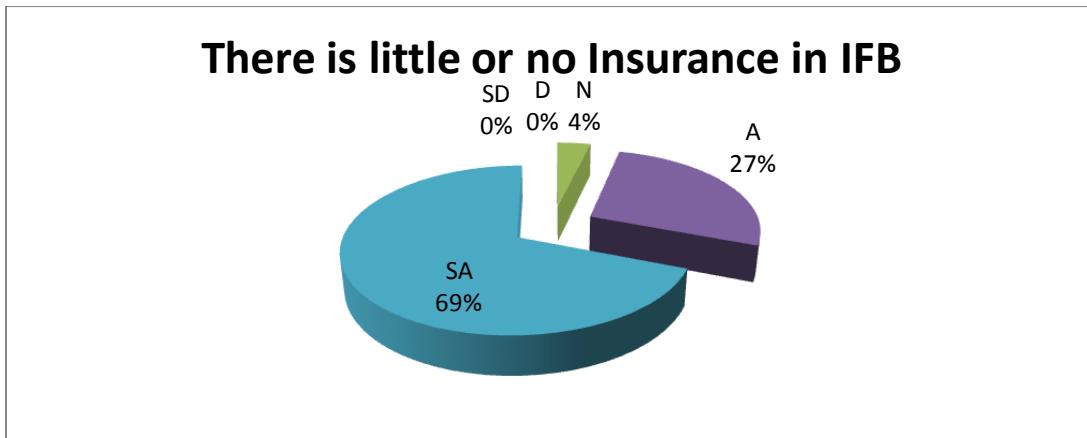
16. Problem of man power



17. Accounting and Auditing Standards



18. Insurance for IFB



ANNEX I

ADDIS ABABA UNIVERSITY

SCHOOL OF COMMERCE

MASTER OF MARKETING MANAGEMENT PROGRAM

INTERVIEW QUESTIONS ON INTEREST FREE BANKING (IFB) SERVICE

1. What do you think about the current status of interest free banking in your bank? Is it going as it planned? What do you think about IFB in future?
2. Do you think employees of your bank are aware of IFB services given by the bank? And does your bank gives training for employees? In what interval?
3. Do you believe the number of branches currently offer IFB services are enough? What is your opinion about the locations of branches that serve the customer?
4. Do you think your bank is going to serve customers in accordance of report that Interest-free banking mainly targets individual and institutional customers that do not want interest on their deposits? Which religious group mostly interested with these services? Does the criteria needed involves non-Muslim properly to use these services?
5. As the IFB is in accordance of sharia law do you believe non-Muslim accept sharia law and adopt these services? Is there non-Muslim customers in your bank those used these services?
6. Do you think as your bank properly undertaking awareness creation activities? What methods mostly used by your bank to aware the customers about IFB?
7. Do you believe as your bank properly customized the existing information technology system to make simple transaction procedures in IFB?
8. What do you think about support from government body on initiation, government regulation, policy and procedures needed on IFB provision and expansion?
9. As your bank keep separate book account and windows in respect of IFB operation, do your bank trusted by customers as there is a proper maintenance of records for all transactions for segregation of funds or activities from conventional one?

ANNEX II

ADDIS ABABA UNIVERSITY
SCHOOL OF COMMERCE
MASTER OF MARKETING MANAGEMENT PROGRAM
QUESTIONNAIRE ON INTEREST FREE BANKING (IFB) SERVICE

Dear respondents, this questionnaire is designed to obtain information about Operational Challenges of Interest Free Banking in Ethiopian banking industry and will only take 20 minute to complete.

The information shall be used as a primary data in conducting a survey, which will help the researcher to fulfill partial requirement for MA in Marketing Management. The study is entirely for academic purpose; and the information you provide will be kept confidential not to be transferred for a third party. Forthcoming result of the study is expected to benefit Ethiopian banks management and the whole stakeholders.

In this regard the researcher kindly request you to provide to the best of your knowledge reliable, genuine, honest and prompt information, which will be a valuable input for the findings to meet the intended purpose.

Please spare some of your precious time and answer the following questions. If the question is not clear and understandable please ask the data collector.

If you have any inquiry, please do not hesitate to contact me and I am available as per your convenience (Tel; 0912194765 or e-mail;senait.tadele@yahoo.com)

- There is no need of writing your name
- In all cases where answer options are available please circle

Thank You, for your cooperation and timely response in advance.

General Information

a. Gender

Male Female

b. Age

18-25 26-30 31-35 36-40 Above 41Years

c. Work position

Management IFB Window Officer/Clerk Customer Service Officer/Clerk Other

d. Educational Level

Diploma BA/BSc Degree MA/MSC PHD

e. Religion

Muslim Non-Muslim

Please CIRCLE one of the choices according to the following 5-point Linkert scale that lies from 1-Strongly Disagree to 5- Strongly Agree that best describe your level of argument with the statements.

“1” for Strongly Disagree “2” for Disagree “3” for Neutral “4” for Agree “5” for strongly Agree

I) Expected Challenges of IFB Service in Ethiopia

S.No.	Questions	Alternatives				
		SD	D	N	A	SA
1	There is inadequate legal and regulatory environment	1	2	3	4	5
2	There a problem of human resource expertise in the sector	1	2	3	4	5
3	There is first entry advantage for the pioneer banks(competition with conventional banking)	1	2	3	4	5
4	There is absence of accounting and auditing standards	1	2	3	4	5
5	There is no/little insurances for Islamic banking finance	1	2	3	4	5
6	Banks provide conventional banking services on IFB windows	1	2	3	4	5
7	Customers believe banks will use IFB related deposits for conventional banking service	1	2	3	4	5
8	There is a problem of providing dedicated windows for IFB service	1	2	3	4	5

II) Questions regarding Employees Awareness and training about product/services of IFB.

S.No.	Questions	Alternatives				
		SD	D	N	A	SA
1	I understand the differences between IFB and conventional banking.	1	2	3	4	5
2	I know properly the Interest free banking services currently offered by my bank.	1	2	3	4	5
3	I know the basic principles of Interest Free Banking like prohibition of interest (Riba), prohibition of speculation, profit/loss sharing, etc.	1	2	3	4	5
4	I understand the philosophy of Islamic banking	1	2	3	4	5
5	I am aware of the uses of products/services of Islamic banks	1	2	3	4	5
6	I know Interest free banking are offered to Muslim and non-Muslim customers	1	2	3	4	5
7	I know the basic modes of operation of Interest free banking i.e.QardHasan, Mudarabah, Ijarah, etc which are in line with sharia principles	1	2	3	4	5
8	I usually tell a customer in-need about the product/services of IFB	1	2	3	4	5
9	My bank gives me training on IFB on a regular basis.	1	2	3	4	5
10	The training that is given by my bank is good enough to make me aware of IFB products and service.	1	2	3	4	5

III) Questions regarding Religious and Cultural difference

S.No.	Questions	Alternatives				
		SD	D	N	A	SA
1	Our (Ethiopians) diversity in <u>Culture</u> makes the IFB services introduction difficult	1	2	3	4	5
2	Our (Ethiopians) diversity in <u>Religion</u> makes the IFB services introduction difficult	1	2	3	4	5
3	Currently the targeted customers for IFB service are only Muslim customers	1	2	3	4	5
4	The service that is given by my bank is through Muslim religion	1	2	3	4	5

	follower staff's					
		SD	D	N	A	SA
5	The customers are happy while served by Muslim staffs than other religion followers	1	2	3	4	5
6	Customers religion motivated them to be an IFB service user	1	2	3	4	5
7	The customers believe the bank uses their money for sharia prohibited activities	1	2	3	4	5

IV) Views regarding branch location and Service availability.

S.No.	Questions	Alternatives				
		SD	D	N	A	SA
1	There is a branch in my bank that fully left for IFB service only	1	2	3	4	5
2	My bank does better on selecting location for serving IFB customers.	1	2	3	4	5
3	My bank offered IFB service for those places that customers are very active	1	2	3	4	5
4	The number of branch's currently offered IFB service are enough	1	2	3	4	5
5	The full service/products of IFB is offering in every selected branches	1	2	3	4	5

Please state your opinion regarding IFB service problems, challenges and solutions

Thank You!