CHAPTER ONE: INTRODUCTION

1.1. BACKGROUND OF THE STUDY

The most noteworthy and recent development in the banking industry is the emergence of Islamic Banking system and Interest-Free Banks (IFBs) in both developing and developed countries of the world.

With the span of five decades, Islamic banking has been successfully developing into a viable alternative banking framework all over the world. In recent time, it has been reported that there are approximately 500 Islamic Banks Worldwide mobilizing about one trillion worth of assets and the figure is estimated to reach four trillion dollars by 2020 (Aliyu 2010). Mamman (2005) also states that there are over 75 countries providing Interest-Free Banking service with an annual growth rate of 12 to 15 % per annum.

The concept of Islamic Banking and Interest-Free banking are synonymously. In the Islamic economics literature, they are discussed as alternative banking framework to the interest-based conventional banking practice. Although interest-free bank and Islamic bank are used interchangeably, Ashan (1988) defined Islamic Bank as “a financial and social institution whose objectives and operation 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. Mannan (1982) also defined Islamic Banking as an interest-free financing system especially based on profit and loss sharing and its operations are in conformity with Shariah. It is therefore, the cornerstone of Islamic Economic system (IES) which is by definition Interest-Free. According to Siddiqi (1983) an Islamic bank is a financial intermediary mobilizing savings from the public on the bases of Mudaraba (Profit and Loss Contract) and advancing capital to entrepreneurs on the same bases. The bank shares the profits of the enterprise according to the mutual agreed percentage and shares these profits with depositors according to a percentage announced by the bank in advance. Gusau (2000) argues that interest-free banking system and Islamic banking system is supposed to operate completely following the Shariah rules in terms of both sourcing and disbursement of funds. From the above two things have become clear, namely: interest-free bank charge no interest, and it conform to the Shariah principles in all its operation.

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 saving as well as benefit from the new vista of opportunity offered by Islamic Banking system. It should be seen an integral aspect of financial globalization which entails the integration of Islamic financial system with the Western Financial System (WFS) to produce global financial system.

1.1.1. HISTORICAL DEVELOPMENT OF IFB

The guideline principle of interest free banking have existed throughout Islamic history, yet modern Interest free banking has been around for relative short time. During the time of Ottoman Empire, which dominated the Muslim world from 1299 to 1922, an interest-based banking style was introduced to the Islamic world in order to finance the expenditure of the large expansion of the empire. Most Islamic jurists at this time thought of it as a contradiction to the Islamic principles the prohibit usury (riba in Arabic). The Hebrew word for usury is neshek, meaning literally "a bite" to indicate the pain inflected up to the debtor. Usury is interpreted in the Quran and the Bible as any interest charged on loans, as opposed to the modern definition of usury as the charging of unreasonable or relatively high rate of interest (O'Sullivan 1996).

The mid-twentieth century writing on Islamic finance has given rise to practical discussions on the subject, which has in turn raised the issue of replacing conventional financial practices with alternatives that are in compliance with Islamic law. Shari'ah denotes the Islamic law that governs all aspects of Muslims' lives. It is derived from the Quran and the Sunnah, which is the sayings and examples set by the Prophet Mohammed. The development of modern Western banking goes back to the mid-seventeenth century, when development in mathematics and statistics provided powerful tools for financial mathematical science. These tools were developed over 300 years, and as consequence, we have a robust interest-based financial system in place. At the same time, the legal and regulatory framework for the western banking model has come a long way (Dowd 1999).

Like other conventional banks, financial intermediation is the substratum, on which Islamic banks base their existence; and financial intermediation organizes the savings-investment process, making it a crucial institution of economic growth (Gorton & Winton 2002). Additionally, Commercial Bank Deposits (CBD) is the stock in trade and it is the main exogenous variable that gives a definition to the supply side of financial intermediation in a Banking institution; Islamic Banks inclusive; i.e. the level of mobilized CBD determines the extent to which a banking institution can meet the demand for loan able funds.

As stated in Rammal and Zurbruegg (2007), Islamic banking has the same purposes as conventional banking i.e. to make money for the banking institution by lending out capital. The term "Islamic banking" refers to a system of banking or banking activity that is consistent with Islamic law (Shariah) and guided by Islamic economics. In particular, Islamic law prohibits usury i.e. the collection and payment of interest, also commonly called *Riba.* In addition, Islamic law prohibits investing in businesses that are considered unlawful, or *haraam* (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, all of which are contrary to Islamic values). This is the distinguishing feature of Islamic Banks as distinct financial institutions from other conventional banks; and Muslim scholars have stated that the criticism of usury, which is the basic difference between conventional and Islamic banks, was well established during the lifetime of the Prophet Muhammad and reinforced by several of verses in the Qur'an dating back to around 600 AD. The original word used for usury in the text is *Riba*, which means "excess or addition". This is accepted to refer directly to interest on loans so that, as exemplified by Islamic economists. According to Gorton & Winton (2002), the prohibition of interest is a well-established working principle, integrated into the Islamic economic system on or before the time of Caliph Umar. However, this interpretation of usury has not been universally accepted or applied in the Islamic world. A school of Islamic thought which emerged in the 19th Century, led by Sir Sayyed, argues for an interpretative differentiation between usury, or consumption lending, and interest, or lending for commercial investment (Iqbal 1997). Nevertheless, Gorton & Winton (2002) provide evidence for "a gradual evolution of the institutions of interest-free financial enterprises across the world" They cite, for instance, the existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North America

Omar (1995) has attempted to trace the origin of Islamic Banking and states that an early market economy and mercantilism was developed between the 8th-12th centuries, which some refer to as "Islamic capitalism. The monetary economy of the period was based on the widely circulated currency, known as the dinar, which welded regions that were previously economically independent. Early Muslims recognized the need for commercial banks in what they perceived and described as "necessary evil," Hence for the purpose of satisfying the precepts of the Sharia, they proposed the banking system that is based on the concept of *Mudarabha* i.e. profit and loss sharing. The first modern experiment was undertaken in Egypt under cover without projecting an Islamic image—for fear of being seen as manifestation of Islamic fundamentalism that was anathema to the political regime. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967, by which time there were nine such banks in the country.

Chong and Lin (2007) conducted a study of Islamic banking in Malaysia, and have provided an insight into the operating system of the model. Their report indicates that in theory, Islamic banking is different from conventional banking because interest is prohibited in Islam. Also, another unique feature is its profit-and-loss sharing (PLS) paradigm, which is predominantly based on the *mudarabah* (profit-sharing) and *musharakah* (joint venture) concepts of Islamic contracting. Under the PLS paradigm, the borrowers share profits and losses with the banks, which in turn, share profits and losses with depositors. Siddiqi (1998) pointed out that in PLS financing, the bank and the capital demanding entrepreneur agree upon a ratio of profit-sharing. Hence, advocates of Islamic banking argue that Islamic banks are theoretically better poised than conventional banks to absorb external shocks because; the banks' financing losses are partially absorbed by the depositors (Khan and Mirakhor 1989; Iqbal 1997). Similarly, the risk-sharing feature of the PLS paradigm, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and thus, promote economic growth (Chapra 1992; Mills and Presley 1999). Additionally, the PLS paradigm subjects Islamic banks to greater market discipline because they, are required to put in more effort to distinguish good customers from bad ones since they have more to lose than conventional banks. The banks also need to monitor their investments and borrowers more closely to ensure truthful reporting of profits and losses. Furthermore, their depositors are required to choose their banks more carefully and to monitor the banks more actively to ensure that their funds are invested prudently. Thus, the advocates have argued further, that a primary advantage of PLS banking is that it leads to a more efficient allocation of capital because the return on capital and its allocation depend on the productivity and viability of the project (Khan 1986).

The modern IFBs emerged in the 1960s and 1970s. 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 bank activity (including trade finance) gradually being re-cast in Shariah-compliant forms. This took place particularly in the GCC states and in Malaysia. Islamic financial products have grown in range and sophistication to include capital market, insurance and funs management products. By the 1980s, Iran, Sudan, and Pakistan have 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 20^{th} 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 canter. An increasing number of countries in Europe and Asia have followed suit. IFIs have taken the form of commercial banks, investment banks, insurance companies, funds management companies and other financial service companies.

1.1.2. BANKS PROVIDING IFB SERVICES IN ETHIOPIA

The issue of establishing IFB service in the Ethiopian banking industry is a new approach. Various efforts have been made to launch IFB services by some concerned parties, but faced all sorts of challenges due to differences in culture and religion. With all the challenges National Bank of Ethiopia (NBE) issued a directive (Directive No. SBB/51/2011) in October 2011 that allows commercial banks to offer IFB service alongside their conventional operation (NBE business proclamation no 592/2008; Article 22(2)). 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 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 shariah advisory board and separate financial reports, keeping all data and ensuring the segregation and permissibility activities from conventional banking are also some of the requirements set by the directive to launch the program. But, IFB in Ethiopia only started in 2013, when the Oromia International Bank (OIB) launched its services. Commercial Bank of Ethiopia (CBE) joined the market in October 2013, followed by united bank, which began providing the service in May 2014.

There are six banks that provide IFB services in Ethiopia, namely Commercial Bank of Ethiopia (CBE), Oromia International Bank (OIB), United Bank (UB), Nib International Bank (NIB), Wegagen Bank (WB) and Cooperative Bank of Oromia (CBO). Among the six banks, three of them successfully operated IFB. Service offered under interest-free banking – deposits, foreign exchange, and money transfer services – are commonly available for customers who engage in trade partnership, agricultural forward contract, construction, manufacturing and import-export trade. The three banks that started giving IFB services are offering savings (Wadia Amana) and current (Kard) account services, as well as equity financing (Mudarabah), based on principles drawn from Islam. These principles include avoiding interest, gambling and uncertainty. All business should be conducted in writing and profits will be shared as agreed, but loss according to capital (NBE Annual IFB performance report, June 2015). CBE is one of the three banks currently providing IFB, along with the United and Oromia International Bank. Interest-free banking mainly targets individual and institutional customers that do not want interest to their deposits, for religious or other reasons.

Around five and 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 give 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 a paid-up capital and 337 million Br in subscribed capital from 6,800 shareholders (Zeyeneb 2014).

Despite this consistent growth, many supervisory authorities and finance practitioners remains unfamiliar with the process by which Islamic banks are introduced into 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.

1.2. STATEMENT OF THE PROBLEM

Over the past four decades, IFB 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 (Archer and Haron 2007). 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 is in accordance with the rules and principles of Islam (Hallock and Heintz 2001; iqbal and Mirakhor 2007). From 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. Unique feature of interest free banking is its profit and loss sharing (PLS) paradigm, which is predominately based on Muderabah (Profit and loss sharing) and Musharakah (joint venture) concepts of Islamic contracting (Mirakhar 1990; Iqbal 1997). Interest free banking financial services are currently very popular among the non-Muslims in different parts of the world (Mustafa 2003). However, it is not limited to Islamic countries. In August 2004, the Islamic Bank of Britain becomes the first bank licensed by a non-Muslim country to engage in Interest free banking (Chong and Lin 2007). Observing this increasing demand, different giant multinational conventional banks are opening interest free banking windows providing interest free services to widely scattered population (Zaher and Hassan 2001). Studies by Zyeneb (2014) pointed out that religion is the main reason for choosing interest free products and services, which has been grounded under the principles of Quran and the Hadith. But the present study tries addresses operational challenges of interest free banking pointed out not only religious factor but also non-religious factors like inadequate legal and regulatory environment, banks provide conventional banking service on IFB window, problem of providing dedicated window and banks use IFB related services for conventional banking all this things are included in this research in conjunction with a religious as the influential factors behind. According to Zeyneb (2014) the research was designed only secondary source of data. Further, the present study tries to add value to the previous study by collecting fresh data from different primary sources and secondary data employees who are directly responsible in operational challenges and prospects of interest free banking.

Finally the motive in doing this research is interest free banking is new emerging and changes in the Ethiopian financial landscape and the introduction of IFB has generated new dimension and phenomena in the banking sector. Such scenario had also lead 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, Muslims and non-Muslims alike have been presented with enormous choices to choose from term of banking products and services.

Institutional challenges are Islamic financial institutions face a unique mix of risk and risk-sharing agreements resulting from the contractual design of financing instruments, which is based on the principle of shariah, the nature of liability base and the unique relationship between the bank and the Investment Account Holder (IAH), the liquidity infrastructure and constraints, and the overall legal frame work and environment. Institutions offering Islamic financial services (IIFS) are set on different foundations from the conventional financial institutions. The first priority of IIFS is to adhere to shariah rules and principles, which take priority over profit. While operational challenges are challenges confronting the operation of Islamic banking. 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. This study attempted to assess the problems and prospects associated with the operation of IFB service in selected banks in Addis Ababa.

1.3. RESEARCH QUESTIONS

This study is designed to address the following basic research questions:

1) What are the major challenges that face Interest Free Banking Operation in Ethiopian Banking industry and the problems encountered in practicing IFB?

2) How banks do fit their conventional banking system in line with Islamic/interest free Banking.

1.4. OBJECTIVE OF THE STUDY

1.4.1. GENERAL OBJECTIVE

The general objective of the study is to assess the operational challenges and prospects of Islamic banking systems in selected banks in Addis Ababa and to suggest solutions that can overcome these challenges.

1.4.2. SPECIFIC OBJECTIVE

The specific objectives of the study are:

1) To assess religious and cultural difference in Ethiopia that influence IFB products and services.
2) To assess the operational challenges of IFB in Ethiopian Banking Industry.
3) To investigate overall awareness of employees towards IFB products and services.

1.5. SIGNIFICANCE OF THE STUDY

The significance of this study occurs in two ways. Firstly this study assesses operational challenges and prospects of Interest Free Banking. Secondly, the findings of this study add to the wealth of knowledge in other Interest free banking studies. It will also be helpful for individuals who want to conduct further studies in related topics and other organizations that face similar problems. Inevitably, this study contribute to the growing body of research on antecedents to operational challenges of IFB by examining over all challenges of towards IFB products and services to provide factor that influence the performance of IFB products and services the study become necessary. It is believed that this study add value to the literatures because the study become reference for the future research.

1.6. DELIMITATION/SCOPE OF THE STUDY

The main focus of this study is to identify the operational challenges and prospects of interest free banking in six commercial banks of Addis Ababa that is highly engage delivering IFB Services since April, 2016. Furthermore, while conceptually challenges can be broadly categorized as operational and institutional, this study only focuses on the operational challenges that are hampering the implementations of IFB in the study cases.

1.7. LIMITATION OF THE STUDY

Some constraints such as time and lack of sufficient fund hinder the need to include a large sample size that can nearly represent the total population of the study. In order to get a clear picture of the issue involving larger number of respondents in the different organizations is required. But due to time constraint and lack of access to sufficient research fund hindered to include more cases. The shortage of up-to-date reference materials and research works that are relevant to the topic, specifically relevant to the Ethiopian context.

1.8. OPERATIONAL DEFINIATION OF KEY TERMS

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

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

1.9. ORGANIZATION OF THE STUDY

This paper is organized into five chapters. Chapter one comprises the introduction parts of the paper, which includes background of the study, statement of the problem, research question, objective of the study, significance of results, delimitation/scope of the study, limitation of the study, operational definitions of key terms and organization of the study. Chapter two presents literatures that can help to frame the study. It included theoretical framework and country specific studies. Chapter three discusses the methodology adopted by the study that is important to address the objectives of the study. It discusses the research design and approach, study population and sample size, sampling technique, data source and collection method, data validity and reliability, method of data analysis and ethical consideration. Chapter four incorporates the data analysis and discussion part. Finally, chapter five presents the summary, conclusion and recommendation part of the thesis.

CHAPTER TWO: LITERATURE REVIEW

2.1. INTRODUCTION

This chapter reviews literature that is relevant to the study. It includes theories and conceptual issues on operational challenges of Interest Free Banking, literature that overviews interest free banking, basic principles and models of operation in Islamic banking, Islamic banking market overview and challenges of interest free banking system in Ethiopia. It further highlights findings from empirical studies conducted on operational challenges of Interest Free Banking by other researchers as a point of reference for the understanding and interpretation of the results.

2.2. AN OVERVIEW OF IFB 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.

1) Increasing demand for Shariah-compliant product.
2) Demand for diversification from conventional clients.
3) Regulatory amendments and increasing flexibility towards Islamic finance and
4) 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. Mustafa (2003) observed that it is difficult to know with certainty how many conventional banks round the globe use Islamic instruments of banking and finance.

The list includes among others some of the world's giant conventional banks such as Kleinwort Benson, Chemical Ban, Citi Bank (USA), ANZ (Australia Grindlays), J. Pmorgan, Goldam Sachs (USA), Bankers Trust, Chase, Manhattan, Hongkong and Shanghai Banking Corporation, Union Bank of Switzerland, Girozentale of Australia, The ABS International, ABN (Amro Netherlands), HSBC (UK), Deutch Bank (Germany) and Societe Generale (France). In addition, many conventional commercial banks in many Muslim countries, are offering Islamic banking services. These include among others, Bank Misr in Egypt, National Commercial Bank in Saudi Arabia, Saudi American Bank, and British Saudi Bank. In Malaysia, almost all commercial banks are offering Islamic banking services through their windows after the interest free banking scheme was launched in 1993, in order to allow conventional banks to offer Islamic banking services. More importantly effective from December, 1998 the interest free banking was replaced by Islamic banking and effective from January 1999 (Ziyad 2010).

2.3. BASIC PRINCIPLES AND MODES OF OPERATION OF ISLAMIC 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. 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, Mustafa (2003) 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, Aziz (2007) defined it as the conduct of banking based on Shari'ah principles. In the same line, Yunis (2007) saw 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 literatures assert that although interest free banks perform mostly similar functions to that of conventional banks, their approach is distinctly different (Mirakhor 1988; Chapra 1992; Aziz 2007; Hallock and Heintz 2001; Archer and Harron 2007; Iqbal and Mirakhor 2007). To illustrate, some of the salient features of interest free banking and finance which makes 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 1988; Aziz 2007). Accordingly, the many prohibitions (e.g. interest, gambling, excessive risks, etc.) are to provide a level playing field to protest the interest and benefits of all parties involved in market transactions and to promote social harmony (Mirakhor 1988; Chapra 1992). 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; Archer and Harron 2007).

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) (Mirakhor 1988; Archer and Harron 2007). 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 (Mirakhor 1988; Aziz 2007). 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.

2.3.1. BASIC PRINCIPLES (FEATURES) OF ISLAMIC BANKING

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 Islamic Financial Stability Forum (IFSF) 2010; and Sanusi 2011):

1) 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.
2) 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.

3) 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.
4) 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.
5) 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.
6) Compulsory payment of zakat. It is mandatory for an Islamic bank to pay zakat. Zakat is one of the five pillars of Islam.
7) 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

According to El Tiby (2011) 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's principles. However, some of the popular ones:

1) 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.
2) 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.

3) 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.
4) 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.
5) Musharaqa (Equity Partnership):Musharaqa 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.
6) 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. ISLAMIC BANKING MARKET OVERVIEW AND PROMISING POTENTIAL OF ISLAMIC FINANCE

2.4.1. ISLAMIC BANKING MARKET OVERVIEW

Increasing universal acceptance and popularity of Islamic financial products and services as well as continuous innovation to develop globally accepted and recognized Islamic financial products and services, to 1.6 billion Muslims worldwide and Islamic assets are set to hit more than USD1.03 trillion by 2012 (The Banker 2009).

1) Islamic finance has expanded at annual rate of 15-20% with a presence spanning more than 75 countries with more than 300 Islamic financial institutions.
2) Many of the world's largest financial institutions have engaged in Islamic banking and structured financial products.
3) Outstanding global and domestic Islamic sovereign & corporate Sukuk exceeded US$50 billion in 2006, US$82 billion in 2007 and expected to surpass US$150 billion by 2010.
4) Islamic private capital investments especially among the Middle Eastern high net-worth individuals (HNWIs) estimated to be worth US$1.5 trillion in 2006, to reach US$2 trillion by 2010.

Islamic finance has rapidly grown from a highly specialized niche market into a multi-billion dollar global industry, expected to continue double-digit growth in the coming decades. Islamic retail banks and non-bank financial institutions operating across the world already number in the hundreds, in both Muslim majority and Muslim minority countries. The IFIs' product portfolio has significantly grown on account of innovative products, both for retail and corporate operations. Financial institutions of the West and America, including Citigroup, Deutsche Bank (DB), ABN AMRO, HSBC and UBS, are increasingly offering products based on the Shari´ah principles.

The experiences of Islamic banks in Kuwait, Bahrain, Saudi Arabia, Sudan, Britain and in other parts of the world point towards tangible success in the areas of product innovation, venture capital, equity finance, finance for trade, housing and other consumer needs and international syndication for trade and project finance deals. Owing to the growing amount of funds available with Islamic banks, refining of Islamic financing techniques and the huge requirement of infrastructure development in Muslim countries, there has been a large number of project finance agreements in the recent past, particularly in the Middle East region. Islamic banks now participate in a wide range of financing, stretching from simple Shari´ah – compliant retail products to highly complex structured finance and large-scale project implementation. These projects include the construction of power stations, water plants, roads, bridges and other infrastructure projects (Al Omar 1996).

Electronic money has also been introduced by a number of IFIs. A number of institutions, including Kuwait Finance House, Dubai Islamic Bank, etc., are offering credit cards, while debit cards have been issued by a large number of IFIs. National Commercial Bank of Saudi Arabia has introduced an "advance card", which does not have a credit line and instead has a prepaid line. Added benefits are purchase protection, travel accident insurance without the involvement of interest and extra fees. This prepaid card facility is especially attractive to women, the young, the self-employed and small establishment employees who sometimes do not meet the strict requirements of a conventional credit card facility (Grais 2004).

Some efficient and Shari´ah – compliant vehicles have been developed lately. Besides a large number of general Islamic funds, a number of multimanager funds have been established to ensure best practice and results without compromising on the Shari´ah compliance matters.
A number of Islamic financial market indices have been developed that are observing screening and purification criteria for investment in equity markets. Some examples are the Dow Jones Islamic Index, Al-Meezan Islamic Investment Index and the Malaysian Islamic Index. A large number of corporate bodies and sovereigns have been using Sukuk in place of interest-based securities for more than five years. The vehicle of Shari´ah-compliant Sukuk has been successfully introduced even in Japan and China (El-Hawary 2004).

International infrastructure institutions like the Islamic Development Bank, Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), the General Council for Islamic Banks and Financial Institutions (GCIBAFI) and the International Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI), Shari´ah support institutions like the AAOIFI and Shari´ah councils of various groups, as well as other commercial support institutions such as the International Islamic Rating Agency (IIRA) and the Liquidity Management Centre (LMC) are playing a crucial role in promotion and standardization of financial operations of IFIs. Bahrain is the main center for Islamic finance in the Middle East region, playing a vital role in fostering Islamic banking operations and regulation. The ARCIFI is working in Dubai as a support institution to resolve disputes that may occur between industry participants and their counterparties (AAOIFI 2008).

From this perspective, Islamic finance must take into account the factors that provide impetus and the driving force needed for the fast promotion of the emerging Islamic finance industry. These factors include:

1) An increasing demand for Riba-free investment instruments for religious reasons, which has been a catalyst for the emergence of financial institutions working on Shari´ah –compliant bases. Riba has been prohibited in the severest terms and a conscientious Muslim cannot harbor any idea about involvement in interest-based transactions. Islamic banking has thus enabled such people to fulfill their aspirations for doing business or investing their money without pricking their consciences.
2) The resurgence of Muslim cultural values, resulting in the desire to conduct financial business in accordance with the Shari´ah principles.
3) The active involvement of the Shari´ah scholars and experts in Islamic jurisprudence in coordination with bankers and the practitioners, which has been instrumental in improving the availability of innovative products and increasing awareness about the concepts and philosophy of Islamic banking.
4) The development of Shari´ah-compliant products and instruments of investment, which has facilitated gainful deployment of excess liquidity that IFIs had in the early years of their establishment and broadened the base of the Islamic capital market.
5) The standardization of modes and products on a Shari´ah basis and accounting and auditing procedures, particularly the AAOIFI's Shari´ah Standards, which have played a crucial role in enhancing credibility, and hence demand, for Islamic banks' products. Risk management, capital adequacy and corporate governance standards introduced/being developed by the IFSB has also played a significant role in providing recognition for Islamic finance.
6) The growth of surplus money in the Gulf region due to increasing petroleum prices and the growth of economies in Muslim countries.
7) Flexibility in the regulatory framework in a number of regions, and deregulation and privatization of financial institutions, which has also facilitated the growth of banking

and non-banking financial institutions in Islamic as well as Muslim minority countries.For example, in the USA, more than two dozen Islamic investment institutions are providing needed facilities to communities who avoid Riba. This began when the Glass–Steagall Act of 1933 was repealed in 1999. Flexibility provided by the FSA in the UK in respect of the treatment of IFIs' deposits, stamp duty on mortgages (which needs only be paid once in a retail transaction) and accommodating Islamic banking practices has given a big impetus to the Islamic finance industry in the UK and ultimately in the whole of Europe.

8) The conversion of a few financially sound institutions in the Middle East to Islamic modes of business in recent years on account of increasing demand, which has also provided a self-enforcing impetus to the movement of Islamic finance.
9) The fact that, as investors are gaining awareness, high net worth individuals are shifting their investments to Shari´ah-compliant institutions. This is leading to the development of Islamic finance markets and the availability of a wider range of services.
10) The real-asset-based and ethical nature of Islamic financial products based on the avoidance of gambling and interest, which has increased demand for such investments and widened the IFIs' customer base.

In the light of the above, the way forward for the Islamic banking industry is to take advantage of all the above factors and explore other such factors in order to provide even more powerful impetus for its sustainable development, enabling it to contribute to the welfare of human beings on a wider scale (Mustafa 2003).

2.4.2. PROMISING POTENTIAL OF ISLAMIC FINANCE

The amazing development of Islamic finance in the last decade and analysis of the factors that served as driving forces for the fast growth is indicative of the huge potential for the industry in the future, because the factors will hopefully continue to provide impetus. An important observation to be made in this regard is that while firm foundations of the system have been laid down, the focus should now be on realization of the basic objectives of the theory of Islamic finance. In other words, potential should be related to the expectations of the pioneers of the concept of Islamic finance and the apprehensions of a large number of contemporary scholars, who are minutely watching the procedures, direction and trends of its growth in terms of the impact of the system in benefiting societies and removing the anomalies created by the conventional system. Having said that, the Islamic banking and finance industry has a large potential ahead in retail, corporate and investment banking and fund management (Gomaa 2006)

Potential in Fund Management

IFIs may engage in fund and portfolio management through asset management companies regulated by the central banks, as the case may be in various jurisdictions.

Broadly, the following may be the categories of funds:

1) Funds yielding return with minimum possible variation: these funds can be based on short-term Murabaha and leasing operations of banks in both local as well as foreign currencies and hence can be made to offer minimal risk to the investors in such funds. Such low-risk funds, which would be earmarked for purchase of goods and their resale on mark-up and short- to medium-term, leasing operations giving fixed earnings to the banks, would be best suited for risk-averse savers who cannot afford possible losses in PLS-based investments.
2) Funds yielding high returns based on Musharakah or long-term leasing operations for those who are willing to take some risk for higher returns (Divanna 2007).

Potential Relating to Sukuk

Sukuk, a by-product of the fast-growing Islamic finance industry, have confirmed their viability in mobilization of resources and their effective use for the benefit of both investors and fund users. Their growth is attributable to a number of factors, including their potential for liquidity and fund management. They could also be used as a tool for monetary policy and open market operations and for liquidity management. Sukuk create a framework for participation of a large number of people in financing projects in the public and private sectors, including those of infrastructure such as roads, bridges, ports, airports, etc., on the basis of various modes. A variety of target-specific Sukuk can be issued, keeping in mind the relevant Shari´ah rules. This requires appropriate enabling laws to protect the interests of investors and issuers, appropriate accounting standards, study of the targeted market, monitoring of standardized contracts, appropriate flow of financial data to investors and the provision of a standard quality service to the customers at large (Yunis 2007).

Potential in Specific Sectors

Asset-based modes of Islamic finance are more suitable for enhancing business and for capital formation in priority sectors of small business, cottage industry and agriculture. If Islamic banks and NBFIs adopt structures and procedures to suit such sectors, it could be highly profitable for them, and beneficial for business and industrial communities and the related economies. This is because the financing of small-and medium-sized enterprises and micro finance have proved to be effective approaches for broad-based economic growth and alleviating poverty in the developing and emerging economies. Islamic micro finance institutions (IMFIs) would have fewer default, moral hazard and asymmetric information problems (Aziz 2007).

2.4.3. ISSUES IN ISLAMIC FINANCE

Commensurate with the prospects of growth in the Islamic finance industry are some of the issues and challenges. Some major issues are discussed below.

Shari´ah Interpretation: An Issue?

A large number of experts and policymakers consider that different Shari´ah interpretation of some modes and concepts is a major issue hindering the development of Islamic finance. Is it really an issue or merely a buzz word? This, in itself, is a question. It seems that it is not as big an issue as some people consider; it is no longer a real problem. No doubt, in the wake of emerging issues in the fast-moving world of finance, some aspects will remain to be decided in the light of the Shari´ah principles, and the same may be resolved as and when confronted, but the major Shari´ah-related issues that the Islamic finance movement faced in the early years of its foundation have been resolved or cleared by dint of ample work by the jurists.

The Islamic Fiqh Council of the OIC, the AAOIFI and the Shari´ah scholars in general have discussed at length almost all major areas and provided a number of alternatives to most of the conventional products, except derivatives based on interest or short-selling and speculative transactions in the Forex markets. Now the practitioners have to proceed on the basis of the achieved consensus.

1) Product innovation from the Shari´ah perspective does not mean that alternatives must be provided for each and every instrument or product used by conventional institutions. This is not possible; a discipline based on ethics and just hypotheses cannot afford to follow any unethical system step by step. Islamic finance will have to observe certain

restraints so that it does not become exploitative and unjust, as is the case with its counterpart, interest-based system.

2) There are some unresolved issues as well, but these are not purely of Shari´ah interpretation; the practical difficulties and the ground realities have given rise to these issues. Therefore, such problems and issues can be resolved once and for all by a body of Shari´ah scholars like the OIC Islamic Fiqh Council or that of the AAOIFI. And if this is not possible, the Shari´ah boards/Shari´ah advisors of the respective banks may decide cases on merit by resorting to Ijtihad, subject to the widely accepted principles of the Shari´ah.
3) Another practice-related issue could be that of the liability of the banks' shareholders towards investment account holders of Islamic banks. This is a complicated issue because it also involves conflict of interests; its solution lies in a firm regulatory framework with special emphasis on safeguarding the interests of the depositors. Losses to banks could be due to overexposure, lack of diversification, imprudent banking practices and/or actual business losses. The Shari´ah boards of the banks may decide the cases on merit, keeping in mind all such factors (AAOIFI 2008).

Integrity and Credibility

The integrity of IFIs has unfortunately become an issue; a large number of people, intentionally or inadvertently, express doubts, not only about the credibility of the system but also about the intention and integrity of the scholars and the practitioners involved in the process of evolution. This has to be tackled with joint efforts by the Islamic banks, the central banks/regulators and the Shari´ah scholars if rapid growth of the emerging discipline of finance is the objective. Many academicians, policymakers, regulators, religious leaders and even those who are working with Islamic banks are not confident about the Shari´ah position of Islamic banks' products (Aziz 2007). The integrity of Islamic financial institutions depends on:

1) The status of Shari´ah compliance of their products.
2) The impact of the products on the clients and the society or economy.
3) Professional competence and care for the interests of the stakeholders.
4) Behavior towards and observance of Shari´ah norms by IFIs' incumbents.

As regards the first factor, Shari´ah scholars may play a crucial role in enhancing the credibility of IFIs. People with Shari´ah considerations normally approach the Shari´ah scholars to get advice for investment in Shari´ah-compliant avenues. But the problem is that many religious leaders do not fully understand the operations of IFIs. Hence, they give edicts prohibiting people to invest in any institution called a “bank”. To them, a bank cannot work on Islamic principles and any amount received or paid over and above the amounts deposited or taken from the banks is Riba, irrespective of the nature of banks’ operations.

It is pertinent, therefore, that an association of IFIs in different countries or the central banks should launch programs for awareness and education of such religious leaders, not only about the functions of banking and other intermediary institutions but also about the principles and philosophy underlying Islamic banking operations.

Factor two above is very important in enhancing the credibility of Islamic banking. People generally question the impact of present Islamic banking practices vis-à-vis the impact of the conventional banks’ operations. Normally, Islamic bankers fail to defend themselves on this point because they do not have in mind such ideas; like conventional bankers, they are simply told how to earn profit. They must be given sound and intensive training about the philosophy and functioning of IFIs and the differences between the services of Islamic banks and those of their counterparts, and about how and to what extent Islamic banking practices could be useful for society.

Further, Islamic bankers and the public in general must be apprised of the role various modes of financing can play in socio-economic development. The stakeholders should also have knowledge of the limitations and challenges facing Islamic banking, due to which it might not be able to achieve the results proclaimed in Islamic finance theory, at least in the short or medium terms.

As regards points three and four above, the moral dimension is the main ingredient of Islamic banking and finance. IFIs may implement a code of conduct reflecting Islamic values and principles, strictly ensuring that it is demonstrated in the management procedures, operations and overall behavior of their incumbents. This is particularly relevant in Muslim majority areas, where Islamic culture has a deep bearing on the approaches and ideas of the masses. Islamic banking is one aspect of an Islamic way of life and if an Islamic banker is involved in any unethical or prohibited practices, it could undermine the integrity and credibility of the system. Therefore, ensuring good governance by IFIs on the basis of Islamic behavioral principles and moral and business ethics is a big challenge for the integrity and long-term health of IFIs.

The ultimate objective in this regard should be to provide the best services at competitive rates and to strike a balance between the interests of the shareholders and those of the depositors. It has been observed that to compete with conventional financial institutions, some IFIs have been giving fixed rates of return, either by paying from the shareholders' part or by allocating more to the shareholders in the case of higher profits. Although profit equalization reserves can be maintained with sufficient disclosure and transparency, apportioning profits just to compete in the market and without taking the partners into confidence is against the spirit of the Shari´ah. An effective enforcement of the code of conduct would enhance the integrity of the system (Haron and Shanmugam 1997).

Structure of Financial Institutions

What the structure of Islamic banks should be is another issue. Should they become traders or business entities? In most countries, they have to operate analogously to the conventional banks, within the national banking systems in general and in respect of international financial and business transactions in particular. Although the philosophy, process and the procedures of Islamic banks differ, they do serve as financial intermediaries and as a link in the chain of the banking system. Like conventional banks, they mobilize savings and undertake the financing of economic and social development activities for the benefit of the economies where they operate. While fulfilling this objective, which is indisputably accepted by all Islamic scholars, they have to undertake real sector business instead of dealing in money on the basis of interest. This implies that Islamic banks' procedures should be different from those of the conventional banks, in the sense that the latter deal in money while Islamic banks have to deal in goods. Islamic banks' modus operandi is also different from that of the business community in general, because they do not normally hold inventories of the goods for selling or leasing. They rather purchase the goods/assets on requisition of their clients for letting or onward sale, and there is no Shari´ah objection in this regard (Aziz 2007).

Regulatory and Tax Issues

Another pertinent issue is the regulatory framework for Islamic financial institutions. Like the conventional institutions, IFIs, too, require regulation for the following reasons:

1) Making the needed information available to the investors.
2) Protecting the interests of savers.
3) Ensuring Shari´ah compliance and soundness of the financial system.
4) Making the legal framework conducive to the smooth functioning of the system in which "cost of funds" cannot be recovered in the case of default.
5) Making the monetary policy and management effective (IFSB 2005).

The policy, nature and the level of regulation and supervision and the legal frameworks have important bearing on the size, growth, Shari´ah compliance and integrity of the Shari´ah based finance discipline. As the nature of their operations is different, IFIs have to face different problems in respect of legal, regulatory and taxation rules. In order to foster stability in Islamic banking, there is a need to develop uniform regulatory and transparency standards that are tailored to the specific characteristics of Islamic financial products and institutions (El-Hawary 2004).

Other regulators are also required to amend rules and regulations to facilitate Islamic banking transactions with proper risk management and Shari´ah compliance. For a comprehensive framework, the following steps would be needed:

1) Saving the IFIs and their customers from dual taxation, particularly in respect of mortgage financing and Murabaha and leasing operations.
2) Facilitating the IFIs to fulfill all Shari´ah – related requirements on the deposits and assets sides.
3) Providing an effective Shari´ah compliance framework.
4) Ensuring that banks adopt justifiable procedures for distribution of profits between the shareholders and the depositors, and then among various categories of depositors.
5) Enforcing prudential rules and regulations, keeping in mind proper risk management and the needs and nature of the new system.

6) Ensuring that the risks relating to current accounts, which are a liability for the IFIs, are borne by the banks themselves and not transmitted to investment accounts, particularly when the bank is in distress.
7) Vigorous training of concerned central bank staff, enabling them to effectively supervise and guide the IFIs.
8) Establishment of a research and training center for banking regulations, supervision and education.
9) Rating institutions and feasibility study institutions with specially trained incumbents are the infrastructure of the new system that should be provided (El Tiby 2011).

Protecting the rights of the depositors is said to be the foremost important objective of regulators all over the world, as per their vision and mission statements. However, practically, the situation is the reverse. Working in the "capitalist" structure, the regulators/central banks in almost all economies where the financial sector has been "liberalized" do not intervene in the rate structures of financial services, while actually they need more intensive supervision in order to protect the depositors and entrepreneurs from possible exploitation by financial institutions working with the motto of "self-interest" and maximization of their net profits (Lewis and Algaoud 2001).

Shari´ah Compliance Framework

The need for Shari´ah compliance of IFIs' operations is accepted by all, but what the framework should be in different situations is an issue that needs to be resolved. One option is to have Shari´ah boards in all Islamic financial institutions that could guide in product development and application and also enforce internal Shari´ah controls at a micro-level. The other option is that the central banks or monetary authorities may facilitate the establishment of independent Shari´ah boards/committees in the private sector, with members having Shari´ah as well as banking knowledge, that could provide advisory and consultancy services in respect of all aspects relating to development and implementation of products and periodical Shari´ah-related inspection of IFIs. Another option is that there should be a central Shari´ah board in a country or jurisdiction to advise the regulators on Shari´ah issues and facilitate the IFIs in ensuring Shari´ah compliance in coordination with Shari´ah advisors/boards of the individual banks (Yunis 2007).

2.4.4. THE EXPERIENCE OF INTREST FREE ISLAMIC BANKS

The concept of Islamic Banking and Interest-Free banking are synonymously. In the Islamic economics literature, they are discussed as alternative banking framework to the interest-based conventional banking practice. Although interest-free bank and Islamic bank are used interchangeably, Ashan (1988) defined Islamic Bank as "a financial and social institution whose objectives and operation 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. Mannan (1982) also defined Islamic Banking as an interest-free financing system especially based on profit and loss sharing and its operations are in conformity with Shariah. It is therefore, the cornerstone of Islamic Economic system (IES) which is by definition Interest-Free. According to Siddiqi (1983) an Islamic bank is a financial intermediary mobilizing savings from the public on the bases of Mudaraba (Profit and Loss Contract) and advancing capital to entrepreneurs on the same bases. The bank shares the profits of the enterprise according to the mutual agreed percentage and shares these profits with depositors according to a percentage announced by the bank in advance. Gusau (2000) argues that interest-free banking system and Islamic banking system is supposed to operate completely following the Shariah rules in terms of both sourcing and disbursement of funds. From the above two things have become clear, namely: interest-free bank charge no interest, and it conform to the Shariah principles in all its operation.

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 saving as well as benefit from the new vista of opportunity offered by Islamic Banking system. It should be seen an integral aspect of financial globalization which entails the integration of Islamic financial system with the Western Financial System (WFS) to produce global financial system.

The guideline principle of interest free banking have existed throughout Islamic history, yet modern Interest free banking has been around for relative short time. During the time of Ottoman Empire, which dominated the Muslim world from 1299 to 1922, an interest-based banking style was introduced to the Islamic world in order to finance the expenditure of the large expansion of the empire. Most Islamic jurists at this time thought of it as a contradiction to the Islamic principles the prohibit usury (riba in Arabic). The Hebrew word for usury is neshek, meaning literally “a bite” to indicate the pain inflected up to the debtor. Usury is interpreted in the Quran and the Bible as any interest charged on loans, as opposed to the modern definition of usury as the charging of unreasonable or relatively high rate of interest (O’Sullivan 1996).

The mid-twentieth century writing on Islamic finance has given rise to practical discussions on the subject, which has in turn raised the issue of replacing conventional financial practices with alternatives that are in compliance with Islamic law. Shari’ah denotes the Islamic law that governs all aspects of Muslims’ lives. It is derived from the Quran and the Sunnah, which is the sayings and examples set by the Prophet Mohammed. The development of modern Western banking goes back to the mid-seventeenth century, when development in mathematics and statistics provided powerful tools for financial mathematical science. These tools were developed over 300 years, and as consequence, we have a robust interest-based financial system in place. At the same time, the legal and regulatory framework for the western banking model has come a long way (Dowd 1999).

Like other conventional banks, financial intermediation is the substratum, on which Islamic banks base their existence; and financial intermediation organizes the savings-investment process, making it a crucial institution of economic growth (Gorton & Winton 2002). Additionally, Commercial Bank Deposits (CBD) is the stock in trade and it is the main exogenous variable that gives a definition to the supply side of financial intermediation in a Banking institution; Islamic Banks inclusive; i.e. the level of mobilized CBD determines the extent to which a banking institution can meet the demand for loan able funds.

As stated in Rammal and Zurbruegg (2007), Islamic banking has the same purposes as conventional banking i.e. to make money for the banking institution by lending out capital. The term “Islamic banking” refers to a system of banking or banking activity that is consistent with Islamic law (Shariah) and guided by Islamic economics. In particular, Islamic law prohibits usury i.e. the collection and payment of interest, also commonly called *Riba.* In addition, Islamic law prohibits investing in businesses that are considered unlawful, or *haraam* (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, all of which are contrary to Islamic values). This is the distinguishing feature of Islamic Banks as distinct financial institutions from other conventional banks; and Muslim scholars have stated that the criticism of usury, which is the basic difference between conventional and Islamic banks, was well established during the lifetime of the Prophet Muhammad and reinforced by several of verses in the Qur'an dating back to around 600 AD. The original word used for usury in the text is *Riba*, which means “excess or addition”. This is accepted to refer directly to interest on loans so that, as exemplified by Islamic economists. According to Gorton & Winton (2002), the prohibition of interest is a well-established working principle, integrated into the Islamic economic system on or before the time of Caliph Umar. However, this interpretation of usury has not been universally accepted or applied in the Islamic world. A school of Islamic thought which emerged in the 19th Century, led by Sir Sayyed, argues for an interpretative differentiation between usury, or consumption lending, and interest, or lending for commercial investment (Iqbal 1997). Nevertheless, Gorton & Winton (2002) provide evidence for “a gradual evolution of the institutions of interest-free financial enterprises across the world” They cite, for instance, the existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North America Omar (1995) has attempted to trace the origin of Islamic Banking and states that an early market economy and mercantilism was developed between the 8th-12th centuries, which some refer to as "Islamic capitalism. The monetary economy of the period was based on the widely circulated currency, known as the dinar, which welded regions that were previously economically independent. Early Muslims recognized the need for commercial banks in what they perceived and described as "necessary evil," Hence for the purpose of satisfying the precepts of the Sharia, they proposed the banking system that is based on the concept of *Mudarabha* i.e. profit and loss sharing. The first modern experiment was undertaken in Egypt under cover without projecting an Islamic image—for fear of being seen as manifestation of Islamic fundamentalism that was anathema to the political regime. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967, by which time there were nine such banks in the country.

Chong and Lin (2007) conducted a study of Islamic banking in Malaysia, and have provided an insight into the operating system of the model. Their report indicates that in theory, Islamic banking is different from conventional banking because interest is prohibited in Islam. Also, another unique feature is its profit-and-loss sharing (PLS) paradigm, which is predominantly based on the *mudarabah* (profit-sharing) and *musharakah* (joint venture) concepts of Islamic contracting. Under the PLS paradigm, the borrowers share profits and losses with the banks, which in turn, share profits and losses with depositors. Siddiqi (1998) pointed out that in PLS financing, the bank and the capital demanding entrepreneur agree upon a ratio of profit-sharing. Hence, advocates of Islamic banking argue that Islamic banks are theoretically better poised than conventional banks to absorb external shocks because; the banks' financing losses are partially absorbed by the depositors (Khan and Mirakhor 1989; Iqbal 1997). Similarly, the risk-sharing feature of the PLS paradigm, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and thus, promote economic growth (Chapra 1992; Mills and Presley 1999). Additionally, the PLS paradigm subjects Islamic banks to greater market discipline because they, are required to put in more effort to distinguish good customers from bad ones since they have more to lose than conventional banks. The banks also need to monitor their investments and borrowers more closely to ensure truthful reporting of profits and losses. Furthermore, their depositors are required to choose their banks more carefully and to monitor the banks more actively to ensure that their funds are invested prudently. Thus, the advocates have argued further, that a primary advantage of PLS banking is that it leads to a more efficient allocation of capital because the return on capital and its allocation depend on the productivity and viability of the project (Khan 1986).

The modern IFBs emerged in the 1960s and 1970s. 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 bank activity (including trade finance) gradually being re-cast in Shariah-compliant forms. This took place particularly in the GCC states and in Malaysia. Islamic financial products have grown in range and sophistication to include capital market, insurance and funs management products. By the 1980s, Iran, Sudan, and Pakistan have 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 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 canter. An increasing number of countries in Europe and Asia have followed suit. IFIs have taken the form of commercial banks, investment banks, insurance companies, funds management companies and other financial service companies.

The issue of establishing IFB service in the Ethiopian banking industry is a new approach. Various efforts have been made to launch IFB services by some concerned parties, but faced all sorts of challenges due to differences in culture and religion. With all the challenges National Bank of Ethiopia (NBE) issued a directive (Directive No. SBB/51/2011) in October 2011 that allows commercial banks to offer IFB service alongside their conventional operation (NBE business proclamation no 592/2008; Article 22(2)). 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 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 shariah advisory board and separate financial reports, keeping all data and ensuring the segregation and permissibility activities from conventional banking are also some of the requirements set by the directive to launch the program. But, IFB in Ethiopia only started in 2013, when the Oromia International Bank (OIB) launched its services. Commercial Bank of Ethiopia (CBE) joined the market in October 2013, followed by united bank, which began providing the service in May 2014.

There are six banks that provide IFB services in Ethiopia, namely Commercial Bank of Ethiopia (CBE), Oromia International Bank (OIB), United Bank (UB), Nib International Bank (NIB), Wegagen Bank (WB) and Cooperative Bank of Oromia (CBO). Among the six banks, three of them successfully operated IFB. Service offered under interest-free banking – deposits, foreign exchange, and money transfer services – are commonly available for customers who engage in trade partnership, agricultural forward contract, construction, manufacturing and import-export trade. The three banks that started giving IFB services are offering savings (Wadia Amana) and current (Kard) account services, as well as equity financing (Mudarabah), based on principles drawn from Islam. These principles include avoiding interest, gambling and uncertainty. All business should be conducted in writing and profits will be shared as agreed, but loss according to capital (NBE Annual IFB performance report, June 2015). CBE is one of the three banks currently providing IFB, along with the United and Oromia International Bank. Interest-free banking mainly targets individual and institutional customers that do not want interest to their deposits, for religious or other reasons.

2.5. REVIEW OF COUNTRY-SPECIFIC STUDIES ON THE CHALLENGES OF INTEREST FREE BANKING SYSTEM

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 other 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; Zyeneb 2014).

Zyeneb (2014) used a descriptive analysis to examine the gaps and challenges of the current IFB directive in Ethiopia. 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 its 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.

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: Skill and knowledge gap particularly in the area of finance and inadequate marketing and promotion of the IFB services.

Iqbal (1997) argued 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 recommended 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.

Chapra (1992) explained 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.

Aziz (2007) discussed 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.

According to Lewis and Algaoud (2001), the nature and character of Interest free Banking model, is summed-up in the report on the unique feature of Islamic and interest free banking in theory, is its profit and loss sharing (PLS) paradigm. In practice however, we find that Interest free banking is not very different from conventional banking.

These implication suggest that the rapid growth in Interest free banking is largely driven by the Islamic resurgence worldwide rather than by the advantages of the PLS paradigm and that Islamic banks should be subject to regulations similar to those of their system counterparts (Chong and Lin 2007).

Islamic banking sector is growing consistently and it is expected that it will grow in future also. The Islamic banking is different from conventional banking.

Now the most of the conventional banks are willing to Islamic banking network. The commercial banks are also opening the new separate branches of Islamic banking under separate head. Due to globalization the Islamic banking network has moved to the Muslim and non-Muslim communities. This also proves that Islamic banking system will be flourished. The expansion of this is the only reason that it is interest free banking network.

Islamic banking is the banking which is Shari a` compliant. Islamic bank will perform better than conventional banking. In functioning the Islamic bank performing well, its main function is to promote trade.

As the growth increase the banking sectors have to faces some challenges and these must be overcome. Islamic banking is playing vital role in the growth of economy with special reference to corporate social responsibility (Ullah and Jamali 2010).

CHAPTER THREE: RESEARCH METHODOLOGY

3.1. RESEARCH DESIGN AND APPROACH

A research design is the conceptual framework within which a research was conducted. To achieve the above mentioned research objectives, a descriptive research design was adopted. In addition, the study adopted a quantitative research approach in addressing the research objectives of the study.

3.2. POPULATION, SAMPLE SIZE AND SAMPLING TECHNIQUE

Commercial Bank of Ethiopia has more than 1,000 branches and fifteen Districts across the country. Oromia international bank, cooperative bank of Oromia, united bank, Wogagen bank and Nib international bank have more than 150 branches across the country. The interest free banking structure of the banks start with identifying and recruiting potential IFB customers and end with for those IFB products service availed to them. Based on the information on the commercial banks that deliver IFB Service there were a total of six banks with 442 employees who are directly relating to the subject. The study selected Commercial banks that deliver IFB Service there were a total of six banks; out of them the target populations for this research were Director IFB, Manager IFB and employees (who are working on IFB Window) having more than four years and above experience as the target population. This was done through non-probabilistic expert sampling technique. This non-probability sampling method is suitable to generate relevant data from the employees who are directly responsible for processing the challenges and prospects of IFB request. In addition, this sampling technique enables the researcher to choose the respondents that are most relevant and suitable for the purpose of the study.

Six Directors, six managers and one hundred sixty three officers/professionals that are engaged on interest free banking windows have been taken for the study. Hence, the total respondents of the study were 175.

Table 1 Total number of permanent interest free banking employee

IFB process employee	Commercial Banks	Number of Employee	Employee with above 4 years' experience	Sample Size
Director and Manager IFB	CBE	12	10	2
	OIB	10	9	2
	CBO	9	9	2
	UB	11	8	2
	WB	9	9	2
	NIB	10	10	2
	Sub-total	**61**	**55**	**12**
Officers/professionals that are engaged on IFB windows	CBE	334	226	130
	OIB	11	9	7
	CBO	14	10	8
	UB	9	8	7
	WB	6	5	5
	NIB	7	7	6
	Sub-total	**381**	**265**	**163**
	Total	**442**	**320**	**175**

Source: Own Survey (2016)

All employees may not have information about IFB. The researcher believed that those employees below four years of experiences may not have enough information and understanding on the process of interest free banking. Based on this the researcher used those employees who have at least four years of working experiences as the target population, and determined the sample size based on Krejcie and Morgan (1970), which is presented in Table 2.

Table 2 Table for determining sample size of a known population

N	S	N	S	N	S	N	S	N	S
10	10	100	80	280	162	800	260	2800	338
15	14	110	86	290	165	850	265	3000	341
20	19	120	92	300	169	900	269	3500	346
25	24	130	97	320	175	950	274	4000	351
30	28	140	103	340	181	1000	278	4500	354
35	32	150	108	360	186	1100	285	5000	357
40	36	160	113	380	191	1200	291	6000	361
45	40	170	118	400	196	1300	297	7000	364
50	44	180	123	420	201	1400	302	8000	367
55	48	190	127	440	205	1500	306	9000	368
60	52	200	132	460	210	1600	310	10000	370
65	56	210	136	480	214	1700	313	15000	375
70	59	220	140	500	217	1800	317	20000	377
75	63	230	144	550	226	1900	320	30000	379
80	66	240	148	600	234	2000	322	40000	380
85	70	250	152	650	242	2200	327	50000	381
90	73	260	155	700	248	2400	331	75000	382
95	76	270	159	750	254	2600	335	100000	384

Note: N is Population size, S is recommended sample size

Source: Kerjcie and Morgan (1970)

3.3. SOURCES OF DATA AND METHOD OF DATA COLLECTION

Both primary as well as secondary data have been collected for this study. A set of structured questionnaires have been designed and distributed to the selected respondents who are familiar to interest free banking process. To supplement the primary data, secondary data have been collected from various sources such interest free banking policies and procedures, annual reports and other publications of commercial bank of Ethiopia and national bank of Ethiopia.

3.4. DATA VALIDITY AND RELIABILITY

Sound measurement must meet the tests of validity, reliability and practicality. In fact, these are the three major considerations one should use in evaluating a measurement tool. Validity refers to the extent to which a test measures what we actually wish to measure. Reliability has to do with the accuracy and precision of a measurement procedure. Practicality is concerned with wide range of factors of economy, convenience, and interpretability. Therefore, briefly take up the relevant details concerning these tests of sound measurement. To ascertain the data quality and reliability questionnaire developed using English language as much as possible used easy words in order to make respondents comfortable in understanding the essence of the questionnaire. In the questionnaire to test the reliability of the data some technical method used like asking the same questions in different ways and analyze the answer. In order to test the reliability of data collection instrument, the response obtained were used for calculating the Cronbach alpha. As a result the Cronbach alpha value of 0.88 was obtained after inputting the data into SPSS application. Tavako (2011) indicated that the acceptable values of alpha ranges from 0.70 to 0.95. Thus, the result was show the reliability of the questionnaire. Therefore, the validity, reliability and practicality of this study are ascertained. A 95% confidence level is applied for this research.

3.5. DATA ANALYSIS TECHNIQUES

The data gathered from questionnaire were summarized and analyzed using descriptive statistics method of data analysis. This analysis method helps to transform raw data into forms that makes it easy to understand and interpret. To this end, simple descriptive statistical tools such as frequency and percentages have been used. Then the data were described and presented using tables. The data were coded using scientific statistical data analysis software such as Statistical Packing for Social Science (SPSS), Version 21.

3.6. ETHICIAL CONSIDERATION

The researcher treated all the information given by respondents 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 and reference materials were duly acknowledged for their ownership rights

CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

This chapter presents the results of the data analysis and discusses them based on available literature. Among the distributed questionnaire, 175 have been collected and this makes the response rate to be 100%.

4.1. CHARACTERSTICS OF RESPONSANTS

In this section, the general background the respondents of the study is summarized by focusing their gender, age group, educational status, religion, years of service (Bank experience) and current position in bank classification. This shows that commercial banks has majority of professionals it is easy to transform the knowledge and skill they have to their customers who needs their consultancy and training service.

Table 3 Characteristics of the Respondents

Sex of respondents	Frequency	Percent
Male	115	66.3
Female	60	33.7
Total	175	100
Age group of respondents		
18-25	40	22.9
26-35	103	58.9
36-45	30	17.1
Above 45	2	1.1
Total	175	100
Educational status of respondents		
Diploma	0	0
BA/BSC	147	84
Master Degree	28	16
PHD	0	0
Total	175	100
Religious background		

Muslim	47	28.1
Non-Muslim	128	71.9
Total	175	100
Working experience		
4-10 Years	83	47.4
11-15 Years	64	36.6
Above 15 Years	28	16
Total	175	100

Source; Own Survey (2016)

Among the total respondents i.e. 175, 115 (66.3%) of them were male and the remaining 60 (33.7%) were female. This shows that the number of female staff is less by more than half from the number of male staff which means there is gender imbalance in the organizations. Regarding the age group of the respondents, the larger portion of the respondents that is 103 (58.9%) falls within the age group of 26 to 35. Age group from 18 to 25, 36 to 45 and above 45 hold 40 (22.9%), 30 (17.1) and 2 (1.1%) number of respondents respectively. From this we can say that banks in our study are filled with more younger, energetic and productive manpower that can be able to transform the mission and vision of the organization into reality.

Concerning educational status of the respondents, staffs who are degree graduates have the largest portion which is around 147 (84%), among the total respondents, 28 (16%) of them have master's degrees. From the above table we can see that no one from the selected respondents have diploma and PHD. The fact that almost all of the respondents being educated in different levels it is believed that they can easily understand the questionnaire as desired by the researcher. Concerning religion status of the respondents the large number of respondents that is 128 (71.9%) were non-Muslim religion, among the total respondents 47 (28.1) Muslim. These shows that the number of Muslim staff is less by more than half from the number of non-Muslim staff which means there is religion imbalance in the organizations.

Based on the data collected through questionnaire, the large portion of respondents 83(47.4%) fall within the range of 5 to 10 years of service, the second highest percent 64 (36.6%) of the respondents have between 11 to 15 years of experience, the rest 28 (16%) of respondents have above 15 years and no one from the selected respondents between 1 to 4 years. It is the researcher believe that these combination of the respondents were good enough in finding the accurate information because the majority of respondents have five to ten years of experience in banks , which is more than four years from which the IFB was fully executed and this gives them an opportunity to reflect their opinion on the achievements obtained by banks and clearly understand the current operational challenges and prospects of IFB to identify the weaknesses , strengths and by comparing the previous and the current.

In general the above table which is characteristics of the respondents shows that the study is represented by those who are qualified in understanding the questionnaire as well as the subject matter, most of them are at their younger age and acquired experience which helps them to respond their true feeling without fear of losing their job and those who have an experience of more than four years in banks, again which helps them to understand the practice of IFB which were implemented in various banks . As a result it is the researcher belief that the study is well represented by the respondents which helps to get the opinion of all which assures the accurate data have been secured from the respondents of the sample size.

4.2. EXPECTED OPERATIONAL CHALLENGES OF IFB SERVICES IN ETHIOPIA

In this section, the general capacity of the respondents of the study is summarized by focusing their knowhow and years of service.

Respondents were asked to answer certain items that was scale their assessment regarding expected operational challenges about IFB service. The following tables show the results for respondents‟ frequency score and their understanding about the scales of expected operational challenges of IFB service in Ethiopia. It is to be noted that among the five agreement levels; “Strongly agree”, “Agree’, “Neither agree nor disagree”, ‘Disagree”, and “Strongly disagree”, the agreement level “Neither agree nor disagree” was used on the analysis only as benchmark for respondents’ agreement or disagreement of the item in question.

On the other hand, what the researcher needed as response from the respondents was their agreement or disagreement concerning the case so that the researcher decide either the case is a challenge of IFB or not. Each of the challenges are tabulated and analyzed as shown below on table 4.

Table 4 Expected operational challenges of IFB services in Ethiopia

Items	Responses	Frequency	Percent
There is inadequate legal and regulatory environment for IFB	Strongly Disagree	9	5.1
	Disagree	24	13.7
	Neutral	19	10.9
	Agree	92	52.6
	Strongly Agree	31	17.7
	Total	**175**	**100**
There is a problem of religious misconception on IFB service	Strongly Disagree	16	9.1
	Disagree	34	19.4
	Neutral	18	10.4
	Agree	80	45.7
	Strongly Agree	27	15.4
	Total	**175**	**100**
There is a problem of human resource in IFB	Strongly Disagree	2	1.1
	Disagree	56	32.0
	Neutral	20	11.4
	Agree	54	30.9
	Strongly Agree	43	24.6
	Total	**175**	**100**
Banks provide conventional banking services on IFB windows	Disagree	16	9.1
	Neutral	8	4.6
	Agree	110	62.9
	Strongly Agree	41	23.4
	Total	**175**	**100**
Customers believe banks will use IFB related services for conventional banking service	Strongly Disagree	27	15.4
	Disagree	30	17.1
	Neutral	26	14.9
	Agree	79	45.2
	Strongly Agree	13	7.4
	Total	**175**	**100**
There is a problem of providing dedicated windows for IFB service	Strongly Disagree	24	13.7
	Disagree	24	13.7
	Neutral	16	9.1
	Agree	62	35.5
	Strongly Agree	49	28
	Total	**175**	**100**

Source: Own Survey (2016)

The result presented on table (4) shows that only 33 (18.8%) of the respondents did not agree with the inadequacy of legal and regulatory environment for interest free banking in Ethiopia as operational challenge whereas 123 (70.3%) % of the respondents have believe that there is inadequate legal and regulatory environment for Interest free banking while 19 (10.9%) of the respondents are neutral. According to above findings we can say that most of the respondents did agree with inadequate Legal and regulatory Environment for Interest free banking as operational challenges of IFB service in Ethiopia. This shows that lack of support from the shariah advisory to IFB process of the bank was the greatest challenge that is affecting the smooth running of IFB financing in commercial banks.

Another important item was whether or not respondents think that there is problem of religious misconception on IFB service. About 107(61.1%) of respondents believed that there is a problem of religious misconception on IFB service. On the other hand, 50(28.5%) of the respondents disagreed that religious misconception on IFB service is not a challenge and 18(10.4%) of the respondents was indifferent. The result shows that employees responded the religion difference in Ethiopia makes difficult to introduce interest free banking services due to currently the target customers for interest free banking service are only Muslims. The issue of human resource is one of the components in Expected operational challenges of IFB services in Ethiopia, the scale address whether respondents 'believe that there is a problem of Human resource on IFB service? The result for this question is presented as follows.

The above table shows that majority of the respondents 97(55.5%) agree with the statement of there is a problem of Human resource in IFB service, whereas 58(33.1%) of respondents do not agree with the statement. And 20(11.4%) are indifferent. So, we can say that overwhelming number of respondents do not agree with there is a problem of Human Resource in IFB service, while majority of the respondents believe that there is a problem of Human Resource in IFB service. The result show that train and hire skilled human resource is a key to overcome this problem. Another important item in the Expected operational challenges of IFB services in Ethiopia scale was whether respondents 'think that banks provide conventional banking services on IFB windows? The result for this question is presented as follows. The results further shows that majority of the respondents 151(86.3%) agree with the statement of there is banks provide conventional banking services on IFB windows, whereas 16(9.1%) of respondents do not agree with the statement. And 8(4.6%) are neither agree nor disagree. So, we can conclude from this observation that significant number of respondents 151 (86.3%), think that banks provide conventional banking services on IFB windows.

This result provides us to observe that banks provide conventional banking services on IFB windows. So this activity strictly forbidden based on procedure of commercial banks due to permissibility and segregation of funds. The number of respondents that believe customers believe banks use IFB related services for conventional banking service', 92 (52.6%), is customers believe banks use IFB related services for conventional banking service as a challenge high when compared to other respondent categories. In addition, only 57(32.5%) of the respondents believe that there is disagree with customers believe banks use IFB related services for conventional banking service as challenges, while 26 (14.9%) of the respondents neither agree nor disagree with the statement of customers believe banks use IFB related services for conventional banking service'. So, we can argue that the majority of the respondents thought that customers believe banks use IFB related services for conventional banking service.

The majority of the respondents 111(63.5%) agreed with the statement that there is a problem of providing dedicated window for IFB service, whereas 48(27.4%) of respondents do not agree with the statement. And 16(9.1%) are neither agree nor disagree. The results of the above table shows that lack of support from the shariah advisory to IFB process of the bank was the greatest challenge that is affecting the smooth running of IFB financing in commercial banks implies positively correlated with the study done by El Tiby (2011), Chapra (1992) and CBE IFB service performance report (2015).

4.3. BANKS' CAPACITY/KNOW HOW TO PROVIDE IFB PRODUCTS

Respondents were asked to answer certain items regarding banks' capacity/knowhow to provide IFB products. The following table shows the results for respondents frequency score.

Table 5 Banks capacity/knowhow to provide IFB products

Items	Responses	Frequency	Percent
The bank has adequately trained manpower to provide IFB	Strongly Disagree	6	3.4
	Disagree	38	21.7
	Neutral	25	14.3
	Agree	70	40
	Strongly Agree	36	20.6
	Total	**175**	**100**
The bank has experienced manpower to provide IFB	Strongly Disagree	4	2.3
	Disagree	42	24
	Neutral	11	6.3
	Agree	78	44.6
	Strongly Agree	40	22.8
	Total	**175**	**100**
The bank has the necessary IT infrastructure to process , deliver and let use the customer products and services of IFB	Strongly Disagree	24	13.7
	Disagree	27	15.4
	Neutral	24	13.7
	Agree	79	45.2
	Strongly Agree	21	12
	Total	**175**	**100**
The bank has the knowhow to develop IFB products that meets current and future Ethiopian market	Strongly Disagree	24	13.7
	Disagree	18	10.3
	Neutral	36	20.6
	Agree	89	50.8
	Strongly Agree	8	4.6
	Total	**175**	**100**
The bank has the knowhow to promote IFB products	Strongly Disagree	19	10.9
	Disagree	17	9.6
	Neutral	19	10.9
	Agree	64	36.6
	Strongly Agree	56	32
	Total	**175**	**100**
The bank provides its IFB products at convenient branches with the expected service level	Strongly Disagree	29	16.6
	Disagree	34	19.4
	Neutral	27	15.4
	Agree	57	32.6
	Strongly Agree	28	16
	Total	**175**	**100**

Source: Own Survey (2016)

The result shows that only 44 (25.1%) of the respondents did not agree with the bank has adequate trained manpower to provide IFB whereas 106 (60.6%) of the respondents have believe that there is the bank has adequate trained manpower to provide IFB while 25 (14.3%) of the respondents are neutral. According to above findings we can say that most of the respondents did agree with the bank has adequate trained manpower to provide IFB.

Another important item in the Banks capacity to provide IFB products scale was whether respondents ‘think that the bank has experienced man power to provide IFB? The result for this question is presented as follows. As the data in Table (5) shows, the number of respondents that believe the bank has experienced man power to provide IFB’, 118 (67.4%), is the bank has experienced man power to provide IFB high when compared to other respondent categories. In addition, only 46 (26.3%) of the respondents believe that there is disagree with the bank has experienced man power to provide IFB, while 11 (6.3%) of the respondents neither agree nor disagree with the statement of the bank has experienced man power to provide IFB. So, we can argue that the majority of the respondents believed that the bank has experienced man power to provide IFB.

The issue of IT infrastructure to process by the bank is one of the components in Banks capacity to provide IFB products, the scale address whether respondents ‘believe that the bank has the necessary IT infrastructure to process, deliver and let use the customer products/services of IFB? The result for this question is presented as follows. The result shows that majority of the respondents 100(57.2%) agree with the statement of the bank has the necessary IT infrastructure to process, deliver and let use the customer products/services of IFB, whereas 51(29.1%) of respondents do not agree with the statement & 24(13.7%) are indifferent. So, we can say that the overwhelming number of respondents do not agree with the bank has the necessary IT infrastructure to process, deliver and let use the customer products/services of IFB, while majority of the respondents believe that there is the bank has the necessary IT infrastructure to process, deliver and let use the customer products/services of IFB.

Another important item in the Banks capacity/knowhow to provide IFB products scale was whether respondents ‘think that the bank has the knowhow to develop IFB products that meets current and future Ethiopian market? The result shows that majority of the respondents 97(55.4%) agree with the statement of there is the bank has the knowhow to develop IFB products that meets current and future Ethiopian market, whereas 42(24%) of respondents do not agree with the statement. And 36(20.6%) are neither agree nor disagree. So, we can argue that the majority of the respondents believed that the bank has the knowhow to develop IFB products that meet current and future Ethiopian market. This result implies that the banks have the knowhow to develop IFB products that meet current and future Ethiopian market.

The number of respondents that believe that the bank has the knowhow to promote IFB products', 120 (68.6%) is the bank has the knowhow to promote IFB products high when compared to other respondent categories. In addition, only 36(20.5%) of the respondents believe that there is disagree with the bank has the knowhow to promote IFB products, while 19 (10.9%) of the respondents neither agree nor disagree with the statement of the bank has the knowhow to promote IFB products'.

Another important item in the Banks capacity/knowhow to provide IFB products scale was whether respondents 'think that the bank provides its IFB products at convenient branches with the expected service level ? The result shows that majority of the respondents 85(48.6%) agree with the statement of there is the bank provides its IFB products at convenient branches with the expected service level, whereas 63(36%) of respondents do not agree with the statement. And 27(15.4%) are neither agree nor disagree. The results of the above table shows that the bank has the capacity to process and deliver IFB products that meets the current and future Ethiopian market through full filling the necessary IT infrastructure to process and by promoting IFB products. This implies positively associated with the study done by Zeyeneb (2014).

4.4. LEVEL OF DEMAND FOR INTEREST FREE BANKING PRODUCTS

Respondents were asked to answer certain items that assess the level of demand for interest free banking products. The descriptive analysis result is presented below.

Table 6 Level of demand for IFB products

Items	Responses	Frequency	Percent
The bank is providing IFB products such as Quard, Wadiamana, Mudareba and Selam that meets the current demand of its customer	Strongly Disagree	13	7.4
	Disagree	23	13.1
	Neutral	15	8.6
	Agree	75	42.9
	Strongly Agree	49	28
	Total	**175**	**100**
The bank is planning to include other IFB products such as Ijara and Musharakah	Strongly Disagree	14	8
	Disagree	48	27.4
	Neutral	17	9.7
	Agree	68	38.9
	Strongly Agree	28	16
	Total	**175**	**100**
There are demands for other type of products/service such as Ijara and Musharakah but the banks cannot serve due to capacity limit	Strongly Disagree	26	14.9
	Disagree	32	18.3
	Neutral	24	13.7
	Agree	74	42.2
	Strongly Agree	**19**	**10.9**
	Total	**175**	**100**

Source: Own Survey (2016)

The issue of the demand for providing IFB product to process by the bank is one of the components in Level of demand for interest free banking products, the scale address whether respondents 'believe that the bank is providing IFB products like Quard, Wadiamana, Mudareba, Selam e.t.c that meets the current demand of is customer? The result for this question shows that majority of the respondents 124(70.9%) agree with the statement of the bank is providing IFB products like Quard, Wadiamana, Mudareba, Selam e.t.c that meets the current demand of is customer, whereas 36(20.5%) of respondents do not agree with the statement. And 15(8.6%) are indifferent. So, we can say that overwhelming number of respondents do not agree with the bank is providing IFB products like Quard, Wadiamana, Mudareba, Selam e.t.c that meets the current demand of is customer, while majority of the respondents believe that there is the bank is providing IFB products like Quard, Wadiamana, Mudareba, Selam e.t.c that meets the current demand of is customer.

Another important item that assess the level of demand for interest free banking products scale was whether respondents ‘think that the bank is planning to include other interest free banking products like Ijera, Musharakah e.t.c? The result shows that majority of the respondents 96(54.9%) agree with the statement of there is the bank is planning to include other interest free banking products like Ijera, Musharakah e.t.c, whereas 62(35.4%) of respondents do not agree with the statement. And 17(9.7%) are neither agree nor disagree.

As the result on table (6) shows, only 58 (33.2%) of the respondents did not agree with there are demands for other type of product/services like Ijara, Musharakah e.t.c the bank can’t service due to capacity limit whereas 93 (53.1%) of the respondents have believe that there are demands for other type of product/services like Ijara, Musharakah e.t.c the bank can’t service due to capacity limit while 24 (13.7%) of the respondents are neutral. According to above findings we can say that most of the respondents did agree with there are demands for other type of product/services like Ijara, Musharakah e.t.c the bank can’t service due to capacity limit. The result of the above table shows that the level of demand to process and deliver IFB products that meets the current demand to its customer by providing IFB products that are needed by the customers. This implies negative correlation with Iqbal (1997). The deviation comes from limited or low demand for other IFB products and services.

4.5. EMPLOYEE AWARENESS LEVEL FOR INTEREST FREE BANKING PRODUCTS

Respondents were asked to answer certain items that will scale their assessment regarding employee awareness level for interest free banking products. The following tables show the results for respondents‟ frequency score and their understanding about the scales of employee awareness level for IFB products. The result is showed on tables as below.

Table 7 Employees' awareness about the level of IFB products

Items	Responses	Frequency	Percent
I am aware of the types and features of IFB products	Strongly Disagree	1	0.6
	Disagree	14	8
	Neutral	39	22.2
	Agree	88	50.3
	Strongly Agree	33	18.9
	Total	**175**	**100**
I know the difference between IFB products and the conventional banking products	Strongly Disagree	3	1.7
	Disagree	55	31.4
	Neutral	9	5.1
	Agree	75	42.9
	Strongly Agree	33	18.9
	Total	**175**	**100**
I know well the IFB products that are currently provided by the bank	Strongly Disagree	16	9.1
	Disagree	18	10.4
	Neutral	14	8
	Agree	58	33.1
	Strongly Agree	69	39.4
	Total	**175**	**100**
I know that IFB products are offered to Muslims and Non-Muslims	Strongly Disagree	36	20.6
	Disagree	19	10.9
	Neutral	15	8.5
	Agree	79	45.1
	Strongly Agree	26	14.9
	Total	**175**	**100**
The bank gives training to employees on various topics related to IFB on regular basis	Strongly Disagree	25	14.3
	Disagree	54	30.9
	Neutral	20	11.4
	Agree	49	28
	Strongly Agree	27	15.4
	Total	**175**	**100**
The training that is given by the bank is good enough to make aware of IFB products and services	Strongly Disagree	8	4.6
	Disagree	97	55.4
	Neutral	7	4
	Agree	52	29.7
	Strongly Agree	11	6.3
	Total	**175**	**100**

Source: Own Survey (2016)

The result shows that, only 15 (8.6%) of the respondents did not agree with aware of the type and features of interest free banking products whereas 121 (69.2%) % of the respondents have believe that aware of the type and features of interest free banking products while 39 (22.2%) of the respondents are neutral. According to above findings we can say that most of the respondents did agree with aware of the type and features of interest free banking products.

Another important item in the Employee awareness level for interest free banking products scale was whether respondents ‘think that there is difference between interest free banking products and the conventional banking products? The result for this question is presented as follows. As the data in Table (7) shows, the number of respondents that believe there is difference between interest free banking products and the conventional banking products’, 108 (61.8%), there is difference between interest free banking products and the conventional banking products high when compared to other respondent categories. In addition, only 58 (33.1%) of the respondents believe that there is disagree with there is difference between interest free banking products and the conventional banking products, while 9 (5.1%) of the respondents neither agree nor disagree with the statement of there is difference between interest free banking products and the conventional banking products’. So, we can say that from this observation that significant number of respondents 108 (61.8%), think that knows difference between interest free banking products and the conventional banking products.

The number of respondents shows, the issue of IFB products currently provided by bank is one of the components in Employee awareness level for IFB products, the scale address whether respondents ‘believe that there is well known the interest free banking products that are currently provided by bank ? The result for this question is presented as follows that majority of the respondents 127(72.5%) agree with the statement of there is well known the interest free banking products that are currently provided by bank, whereas 34(19.5%) of respondents do not agree with the statement of there is well known the interest free banking products that are currently provided by bank. And 14(8%) are indifferent. So, we can say that overwhelming number of respondents do not agree with there is well known the interest free banking products that are currently provided by bank, while majority of the respondents believe that there is well known the interest free banking products that are currently provided by bank. This result provides us to observe that there is well known the interest free banking products that are currently provided by bank.

The issue of Employee awareness level for IFB products scale was whether respondents ‘think well known that interest free banking products are offered to Muslim and Non-Muslim? The result for this question is presented as follows.

The result shows that majority of the respondents 105(60%) agree with the statement of there is well known that interest free banking products are offered to Muslim and Non-Muslim, whereas 55(31.5%) of respondents do not agree with the statement of there is well known that interest free banking products are offered to Muslim and Non-Muslim. And 15(8.5%) are neither agree nor disagree. So, we can say that from this observation significant number of respondents 105 (60%), think that well known that interest free banking products are offered to Muslim and Non-Muslim. This result provides us to observe that employees are well known that interest free banking products are offered to Muslim and Non-Muslim.

The result in Table (7) shows, the number of respondents that believe the bank gives training to employees on various topics related to IFB on regular basis ’, 76 (43.4%), is the bank gives training to employees on various topics related to IFB on regular basis low when compared to other respondent categories. In addition, only 79(45.2%) of the respondents believe that there is disagree with the bank gives training to employees on various topics related to IFB on regular basis, while 20 (11.4%) of the respondents neither agree nor disagree with the statement of the bank gives training to employees on various topics related to IFB on regular basis’. So, we can say that from this observation that high number of respondents 79 (45.2%), think that disagree with the bank gives training to employees on various topics related to IFB on regular basis.

Another important item in the Employee awareness level for IFB products scale was whether respondents ‘think that the training that is given by the bank is good enough to make aware of IFB products and services ? The result for this question is presented as follows.

The above table shows that majority of the respondents 63(36%) agree with the statement of there is the training that is given by the bank is good enough to make aware of IFB products and services, whereas 105(60%) of respondents do not agree with the statement. And 7(4%) are neither agree nor disagree. So, we can argue from this observation that significant number of respondents 105 (60%), think that there is disagree with the training that is given by the bank is good enough to make aware of IFB products and services. The result of the above table shows that the employee awareness level to process and deliver IFB products and services that meets the current demand through the level of awareness in all aspects of IFB services/products that are provided by the bank and training to employees on various issues related to IFB products/services. This implies positive correlation with the study done by Chapra (1992).

4.6. RELIGIOUS AND CULTURAL DIFFERENCE IN ETHIOPIA

Respondents were asked to answer certain items that will scale their assessment regarding religious and cultural difference. The following tables show the results for respondents" frequency score and their understanding about the scales of religious and cultural difference in Ethiopia. The result is showed on tables as below.

Table 8 Religious and cultural difference in Ethiopia

Items	Responses	Frequency	Percent
Our (Ethiopian) diversity in culture makes difficult to introduce IFB services	Strongly Disagree	18	10.3
	Disagree	69	39.4
	Neutral	20	11.4
	Agree	53	30.3
	Strongly Agree	15	8.6
	Total	**175**	**100**
Our (Ethiopian) diversity in religion makes difficult to introduce IFB services	Strongly Disagree	13	7.4
	Disagree	61	34.9
	Neutral	41	23.4
	Agree	55	31.4
	Strongly Agree	5	2.9
	Total	**175**	**100**
Currently targeted customers for IFB services are only Muslims	Strongly Disagree	21	12
	Disagree	35	20
	Neutral	32	18.3
	Agree	59	33.7
	Strongly Agree	28	16
	Total	**175**	**100**
The service that is given by the bank is through Muslim religion follower staffs	Strongly Disagree	37	21.1
	Disagree	75	42.9
	Neutral	12	6.9
	Agree	46	26.3
	Strongly Agree	5	2.8
	Total	**175**	**100**
The customer are happy while served by Muslims staffs than other religion followers	Strongly Disagree	16	9.1
	Disagree	31	17.7
	Neutral	16	9.1
	Agree	85	48.7
	Strongly Agree	27	15.4
	Total	**175**	**100**
The customer believes the bank uses their money for Shariah prohibited activities	Strongly Disagree	1	0.6
	Disagree	35	20
	Neutral	31	17.7
	Agree	90	51.4
	Strongly Agree	18	10.3
	Total	**175**	**100**

Source: Own Survey (2016)

The result shows, only 87 (49.7%) of the respondents did not agree with our (Ethiopians) diversity in culture makes difficult to introduce IFB services whereas 68 (38.9%) % of the respondents have believe that there is our (Ethiopians) diversity in culture makes difficult to introduce IFB services while 20 (11.4%) of the respondents are neutral. According to above findings we can say that most of the respondents did disagree with our (Ethiopians) diversity in culture makes difficult to introduce IFB services.

Another important item in the Religion and culture difference in Ethiopia scale was whether respondents 'think that there is our (Ethiopians) diversity in religion makes difficult to introduce IFB services? The result for this question is presented as follows. The result in Table (8) shows, the number of respondents that believe there is our (Ethiopians) diversity in religion makes difficult to introduce IFB services', 60 (34.3%), is there is our (Ethiopians) diversity in religion makes difficult to introduce IFB services low when compared to other respondent categories. In addition, only 74 (42.3%) of the respondents believe that there is disagree with there is our (Ethiopians) diversity in religion makes difficult to introduce IFB services, while 41 (23.4%) of the respondents neither agree nor disagree with the statement of there is our (Ethiopians) diversity in religion makes difficult to introduce IFB services'. So, we can say that from this observation that significant number of respondents 74 (42.3%), think that disagree with our (Ethiopians) diversity in religion makes difficult to introduce IFB services.

The issue of Targeted customers for IFB service are only Muslims is one of the components in Religion and cultural difference in Ethiopia, the scale address whether respondents 'believe that currently target customers for IFB service are only Muslims? The result for this question is presented as follows.

The above table shows that majority of the respondents 87(49.7%) agree with the statement of currently target customers for IFB service are only Muslims, whereas 56(32%) of respondents do not agree with the statement. And 32(18.3%) are indifferent. So, we can say that overwhelming number of respondents do not agree with currently target customers for IFB service are only Muslims, while majority of the respondents believe that currently target customers for IFB service are only Muslims. This result provides us to observe and infer that currently target customers for IFB service are only Muslims.

Another important item in the Religious and cultural difference in Ethiopia scale was whether respondents ‘think that the service that is given by bank is through Muslim religion follower staffs? The result for this question is presented as follows. The result shows that the respondents 51(29.1%) agree with the statement of there is the service that is given by bank is through Muslim religion follower staffs, whereas 112(64%) majority of respondents do not agree with the statement. And 12(6.9%) are neither agree nor disagree. So, we can say that from this observation that significant number of respondents 112 (64%), think that disagree with service that is given by bank is through Muslim religion follower staffs. This result provides us to observe that disagree with the service that is given by bank is through Muslim religion follower staffs.

The number of respondents shows, the number of respondents that believe the customer are happy while served by Muslim staffs than other religion followers, 112 (64.1%), is the customer are happy while served by Muslim staffs than other religion followers high when compared to other respondent categories. In addition, only 47(26.8%) of the respondents believe that there is disagree with the customer are happy while served by Muslim staffs than other religion followers, while 16 (9.1%) of the respondents neither agree nor disagree with the statement of the customer are happy while served by Muslim staffs than other religion followers’. So, we can say that from this observation that high number of respondents 112 (64.1%), think that the customer are happy while served by Muslim staffs than other religion followers.

Another important item in the Religion and cultural difference in Ethiopia scale was whether respondents ‘think that the customer believes the bank uses their money for sharia prohibited activities? The result for this question is presented as follows. The result shows that majority of the respondents 108(61.7%) agree with the statement of there is the customer believes the bank uses their money for sharia prohibited activities, whereas 36(20.6%) of respondents do not agree with the statement. And 31(17.7%) are neither agree nor disagree. So, we can say that from this observation that high number of respondents 108 (61.7%), think that there is the customer believes the bank uses their money for sharia prohibited activities. The result of the above table shows that the religious and cultural difference in Ethiopian makes difficult to introduce on IFB services positively associated with cultural difference and negatively associated with religion due to the customer are happy while served by Muslim staff rather than other religion followers implies impact on religion difference rather than cultural difference.

CHAPTER FIVE: SUMMERY OF FINDINGS, CONCLUTION AND RECOMMENDATION

This chapter focuses on the summary of the major findings of the research, and provides conclusion, limitation and recommendations.

5.1. SUMMERY OF FINDINGS

The main objective of this study was to assess operational challenges and prospects of interest free banking in Ethiopian banking industry by having the following basic questions and objective to be addressed.

1) What are the major challenges that face Interest Free Banking Operation in Ethiopian Banking industry and the problems encountered in practicing IFB?

2) How banks do fit their conventional banking system in line with Islamic/Interest free Banking and the objective to be addressed assess religious and cultural difference in Ethiopia that influence IFB products and services, to assess the operational challenges of IFB in Ethiopian Banking Industry and to investigate overall awareness of employees towards IFB products and services.

In order to address the above basic questions and objective, descriptive survey research design was employed which comprises quantitative methods of data gathering. Data was gathered through questionnaire that was made to triangulate and increase the validity of the data obtained. To collect representative data, 175 questionnaire copies were distributed by using non probabilistic expert sampling technique. Out of which, 175 of the questionnaires were collected.

The data collected from target respondents through questionnaire was compiled and summarized by using SPSS statistical package for social science software version 21. The variables were analyzed by using frequency counts and percentages. Finally, information obtained through open ended questionnaire, were mathematically analyzed and interpreted.

According to the data analysis presented in previous chapter, there were positive and negative findings concerning the implementation of the interest free banking challenges and prospects by commercial banks in Ethiopia highly engaged on banks process interest free banking services.

On the other hand the adverse findings obtained from respondents that need the attention of banks management are discussed as follows.

1) Employees responded that bank doesn’t gives training to various topics related to interest free banking on a regular basis due to shortage of up-to-date reference materials, specifically relevant to the Ethiopian context.

2) Employees responded the training that is given by the bank is not good enough to make aware of interest free banking products and services due to shortage of up-to-date reference materials, specifically relevant to the Ethiopian context.

3) Employees responded the religion difference in Ethiopia makes difficult to introduce interest free banking services due to currently the target customers for interest free banking service are only Muslims.

4) The customers are happy while served by Muslim staffs than other religion followers. This implies religion difference matters.

. During the study some positive findings are obtained.

1) Most of the employees of the commercial banks filled with educated employees more than 84 % of them degree holder and above degree this indicate the banks have productive employees.

2) More than 93% of employees of commercial banks understand the challenges of IFB and the strategy of the bank is positive for the organization.

3) Most of the respondents have clear understanding the type and feature of IFB, difference between IFB products and conventional banking products, IFB products that meets the current demand of its customer and understand the banks capacity to provide IFB products.

4) Most of the employees of the commercial banks filled with diversity in terms of profession, skill, Gender, and experience and also filled with young employees.

5) Most of respondents of commercial banks filled inadequate legal and regulatory environment IFB, problem of religious misconception on IFB and problem of human resource were major operational challenges of IFB.

6) Most of the respondents filled employee awareness level and the bank capacity to provide IFB services was the banks fit conventional banking in line with interest free banking services.

7) Most of respondents of commercial banks filled banks provide conventional banking services on IFB window, banks use IFB related services for conventional banking service and problem of dedicated windows for IFB service were a problem of practicing IFB.

5.2. CONCLUTION

The results and healthy growth of the interest free banking industry compared to the conventional banking industry during recent time are clear evidence that the principles and rules representing the foundation of Interest free banks are solid and valid. Ultimately, it has resulted in the Interest free banking system is a fairly new player in the Ethiopian financial industry, and thus, is faced with many problems and challenges of interest free banking.

The study was conducted to assess operational challenges and prospects of interest free banking in the Ethiopian banking industry.

Interest free banking is mostly large amounts that should be given great concern by the bank in relation to the country's growth and transformation plan. However, interest free banking was different challenges that can be seen from employees and the banks angles.

Based on the findings of this study to conclude that the major challenges of interest free banking services in Ethiopia were inadequate legal and regulatory environment IFB, problem of religious misconception on IFB and problem of human resource on IFB services shows that lack of support from the shariah advisory to IFB process of the bank was the greatest challenge that is affecting the smooth running of IFB financing in commercial banks.

Another findings of this study to conclude that banks fit conventional banking in line with IFB services were the speed and degree of success with which interest free banking was emerge in conventional systems whether the customers and employee are well informed about the opportunity and risks at hand implies the employee awareness level in all aspects to process and deliver IFB products and services that meets the current demand that are provided by the bank and training to employees on various issues related to IFB products/services

In addition to this the banks provide conventional banking services on IFB window, banks use IFB related services for conventional banking service and problem of dedicated windows for IFB service were a problem of practicing IFB services.

An efficient rating system as described in the literature is the one that highlights a positive correlation between challenges of interest free banking and the problem in counter with practicing IFB services. Accordingly, Interest free banking is different from conventional banking, so there are lots of chances of improving the Interest free banking network and there were more chances to grow.

Finally, the growth increase the banking sectors have to faces some challenges and these must be overcome. Interest free banking is playing vital role in the growth of economy with special reference to corporate social responsibility.

5.3. RECOMMENDATIONS

In considering the major findings of the study and the conclusions drawn, some efforts were made to forward possible recommendations for the attainment of a better result out of the operational challenges and prospects of IFB in Ethiopian banking industry for the better achievement of the objectives.

1) It is important to ensure uniformity and harmonization of shariah standards and practices across the board. There, is a need to have one shariah board to support the system. This will also help in enhancing the credibility and confidence in the interest free banking system.

2) To continuously develop upon the Islamic legal infrastructure and framework to cater for the ever developing needs and requirements of interest free finance and to face the challenges of today's and the future's modern world. It is also important to ensure harmony with conventional legal framework. From a human resource perspective, an extreme focus, attention, and generous investment should be given and allocated to develop and train a new generation of experts in interest free banking regulations and laws.

3) The bank should have given training to various topics related to interest free banking on a regular basis to maximize the skill and knowledge of employees.

4) There should be intensive manpower training and development in the area of Interest-Free Banking through the establishment of research centers and capacity building workshops to develop cognate experience.

5) In order to minimize the religion difference in Ethiopia makes difficult to introduce interest free banking services due to currently the target customers for interest free banking service are both Muslims and non-Muslims.

6) Finally, Enhancing and enforcing the standards for effective corporate governance to protect and safeguard customers, as well as for effective market discipline and transparency, to provide timely and reliable information to IAH. The enforcement of these standards will help in enhancing industry credibility and will create confidence among all stakeholders.

In general, it is advisable for commercial banks to sustain all its current strengths, and improve its limitations mentioned above to challenge future uncertainties for the proper implementation of IFB and the success of employees and the bank overall.

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APPENDICES

APPENDICES-A

Questionnaire

St. Mary's University

School of Business

General Introduction

Dear Respondents,

My name is Tesfachin Zegeye. I am a post graduate student St. Mary's University. I am conducting a research on the topic: Assessment of operational challenges and prospects of Interest Free Islamic Banking systems in selected banks in Addis Ababa . This questionnaire is designed to collect information on the topic under caption to fulfill the partial requirements for the Masters of Business Administration in General Management. Since the information acquired is for academic purposes the anonymity of the respondent is guaranteed. Hence, it is not necessary to write your name on the questionnaire. This is therefore, to kindly request you to take few minutes to fill out the questionnaire as genuinely and completely as possible. If you have any inquiry, Please do not hesitate to contact me and I am available as per your convenience through my addresses: Tel-+251923566622 or Email- bakimarakinani@gmail.com

Thank you, for your cooperation in advance for offering your golden time.

July, 2016

Part one: Background Information

Dear respondents, please label a characteristic that correspondent to your background data by using tick "√ "mark.

1.1 **Gender** : 1= Male ☐ 2= Female ☐
1.2 **Age**: 1=18-25☐ 2=26-35 ☐ 3=36-45 ☐ 4=Above 45 ☐
1.3 **Educational qualification**: 1= Diploma☐ 2= BA/BSC☐ 3=Master Degree ☐ 4= PhD ☐
1.4 **Religion**:1= Muslim ☐ 2=Non-Muslim ☐
1.5 **Banking experience in number of years**: 1= 1-4☐ 2= 5-10 ☐ 3= 11-15 ☐ 4= Above 15 ☐
1.6 **Your current position in the bank:**
1= Director ☐ 2= Manager ☐ 3= Professional ☐

Part Two: **Five-point Likert scale questionnaires**

This part is divided in to five sections, in each section there are statements which address issue about Expected challenges of IFB services and products, the bank's capacity/knowhow to deliver interest free banking products, level of demand, employee's awareness, religious and cultural difference about interest free banking products and services. Therefore, Please read each of the statements in each section and rate your level of agreement or disagreement with each statement by using a tick mark '√' on one of the five alternatives.

1. Strongly Disagree; 2. Disagree; 3. Neutral; 4. Agree; 5. Strongly Agree

1. Expected operational challenges of IFB services in Ethiopia

	Items	**Strongly disagree 1**	**Disagree 2**	**Neutral 3**	**Agree 4**	**Strongly Agree 5**
1	There is inadequate legal & regulatory environment for Interest Free Banking.					
2	There is a problem of religious misconception on Interest Free Banking service.					
3	There is a problem of human resource in Interest Free Banking service.					
4	Banks provide conventional banking services on IFB windows.					
5	Customers believe banks will use IFB related services for conventional banking service.					
6	There is a problem of providing dedicated windows for IFB service.					

2. **Bank's capacity/knowhow to provide interest free banking products**

Items		Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	The bank has adequately trained manpower to provide interest free banking					
2	The bank has experienced manpower to provide interest free banking					
3	The bank has the necessary IT infrastructure to process, deliver and let use the customer the products and services of interest free banking					
4	The bank has the knowhow to develop interest free banking products that meets current and future Ethiopian market					
5	The bank has the knowhow to promote interest free banking products					
6	The bank provides its interest free banking products at convenient branches with the expected services level.					

3. **Level of Demand for interest free banking products**

Items		Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	The bank is providing interest free banking products like Quad, Wadiamana, Mudareba, Selam e.t.c that meets the current demand of its customer.					
2	The bank is planning to include other interest free banking products like Ijara, Musharakah e.t.c					
3	There are demands for other types of product/services like Ijara, Musharakah e.t.c but the bank cannot serve due to capacity limit.					

4. Employee awareness level for Interest free banking products

	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	I am aware of the types and features of interest free banking products.					
2	I know the difference between interest free banking products and the conventional banking products.					
3	I know well the Interest free banking products that are currently provided by the bank.					
4	I Know that Interest free banking products are offered to Muslims and non-Muslim.					
5	The bank gives training to employees on various topics related to IFB on regular basis					
6	The training that is given by the bank is good enough to make aware of IFB products and services.					

5. Religious and cultural difference in Ethiopia

	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	Our (Ethiopians) diversity in culture makes difficult to introduce IFB services.					
2	Our (Ethiopians) diversity in religion makes difficult to introduce IFB services.					
3	Currently targeted customers for IFB service are only Muslims.					
4	The service that is given by the bank is through Muslim religion follower staff's.					
5	The customer are happy while served by Muslim staffs than other religion followers					
6	The customer believes the bank uses their money for sharia prohibited activities.					

Thank you

APPENDICES-B

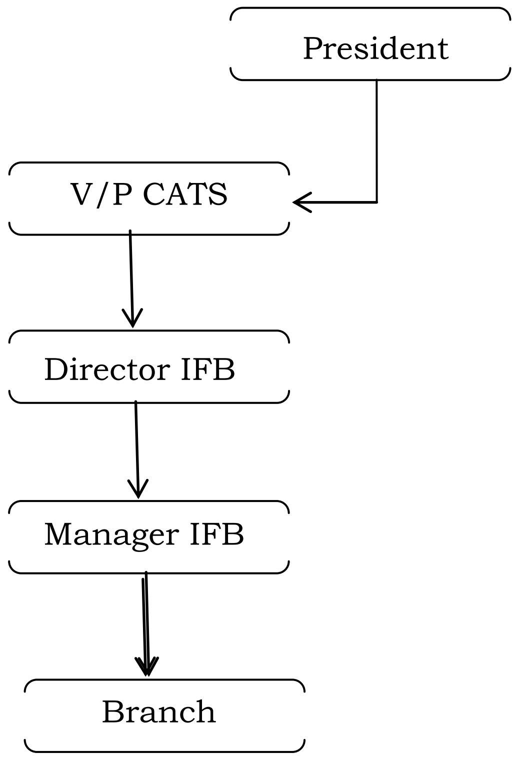
Time schedule

No	**Activities**	**Months**															
		May				**June**				**July**				**August**			
		1	**2**	**3**	**4**	**1**	**2**	**3**	**4**	**1**	**2**	**3**	**4**	**1**	**2**	**3**	**4**
1	Developing first Phase proposal																
2	Second review proposal																
3	Final proposal																
4	Data collection																
5	Data analysis																
6	Approved analyzed data																
7	Report writing and presentation																

Note: 1, 2, 3, 4 in the above table has indicated weeks of the month.

APPENDICES-C

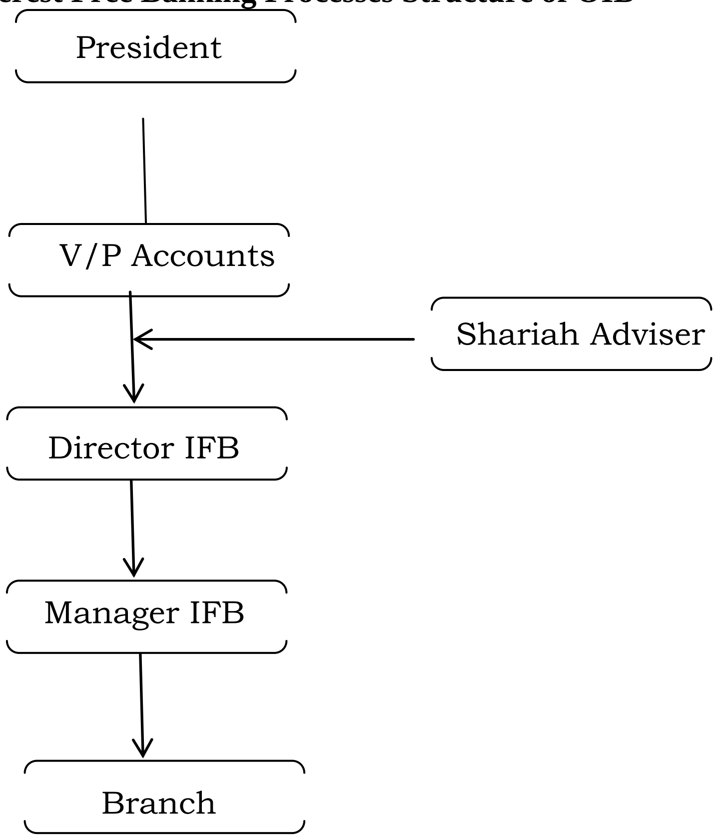
. Interest Free Banking Processes Structure CBE, CBO, UB, NIB and WB



Source: IFB Organizational Structure CBE, CBO, UB, NIB and WB (2016)

APPENDICES-D

Interest Free Banking Processes Structure of OIB



Source: IFB Organizational Structure OIB (2016)