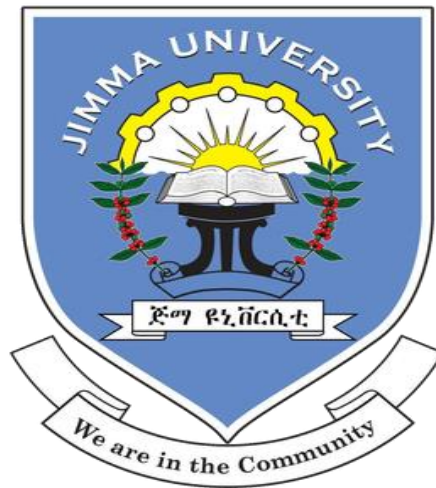


**Prospect and Challenge of Interest Free Banking: The Case of  
Selected Commercial Banks Jimma City**

*A Research Paper Submitted To the Graduate Studies of Jimma University for the  
Partial Fulfilment of Masters Business Administration Program*

*By: Alemnesh Asefa*



**JIMMA UNIVERISTY**

**COLLEGE OF BUSINESS AND ECONOMICS**

**DEPARTMENT OF MANAGEMENT**

**JUNE 17, 2021**

**JIMMA, ETHIOPIA**

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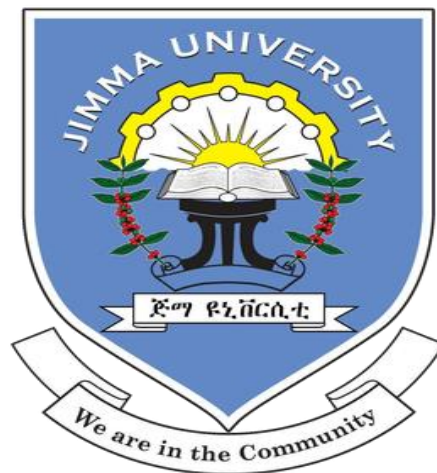
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**COLLEGE OF BUSINESS AND ECONOMICS**

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### **Certificate**

This is to certify that Alemnesh Asefa has carried out her proposal work on the topic entitled *prospect and challenge of IFB practice in some selected commercial bank in Jimma city*. The work is suitable for submission for the reward of the MBA degree in masters of business administration.

<b>Major Advisor</b>	<b>Signature</b>	<b>Date</b>
<b>Co- Advisor</b>	<b>Signature</b>	<b>Date</b>

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## **Acronym and Abbreviation**

<b>AB</b>	Abay bank
<b>BOA</b>	Bank of Abyssinia
<b>CBE</b>	Commercial bank of Ethiopia
<b>CBO</b>	Cooperative bank oromia
<b>ECX</b>	Ethiopian commodity exchange
<b>GDP</b>	Gross domestic product
<b>IFB</b>	Interest free banking
<b>MFI</b>	Micro finance institution
<b>OIB</b>	Oromia international bank
<b>OIC</b>	Organization of Islamic conference
<b>SSB</b>	Shariah supervisory board
<b>UK</b>	United Kingdom

## **Abstract**

*The main purpose of this study was to identify prospect and challenge of interest free banking: the case of selected commercial banks Jimma city. The study mainly focused on the existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB banking practice, lack of awareness and understanding about IFB banking, regulatory challenge and absence of liquidity instrument on interest free banking. The study employed both explanatory and descriptive research design approach. The study was based on sample size of 359 respondents. The study selected the respondents using simple random sampling technique and judgmental sampling technique. Primary data was obtained using interview and self-administered questionnaires. The questionnaire was made up of both open ended and closed ended questions. The drop and pick method was preferred for questionnaire administration so as to give respondents enough time to give well thought responses. Data was analyzed using Statistical Package for Social Sciences (SPSS Version 20.0). All the questionnaires received were referenced and items in the questionnaire were coded to facilitate data entry. After data cleaning which entailed checking for errors in entry, descriptive statistics such as frequencies, percentages, mean score and standard deviation were estimated for all the quantitative variables. Inferential data analysis was done using multiple regression analysis. Based on the finding the study conclude that there is a strong and a positive correlation with existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice and regulatory challenge on interest free banking. And also Lack of awareness and understanding about IFB banking and absence of liquidity instrument are negative correlation on interest free banking. The study recommended that the national bank of Ethiopia and the Shariah Supervisory Board in Ethiopia has to provide more training and create awareness to the staff and public in order to get more opportunities and minimize the equipped challenges by providing the training centre.*

**Keywords:** Interest free banking, Prospect, Challenge

# CHAPTER ONE

## 1. Introduction

The aim of this chapter is to provide background information on the study. The remaining parts of the chapter are organized as follows. The first section of the research presents background for the study, section two presents statement of problems and then research question comes in the third section. The fourth, fifth and sixth section sets out, objectives of the study, research hypothesis and significance of the study respectively. Finally section seven and eight presents were scope, and organization of the study respectively.

### 1.1 Background of the Study

Now a day Islamic banking business is growing at a faster rate because of the interest free system and money developed countries have started to look at it as the alternative from their conventional banking system (Abduljelil and Khalilur 2014). Islamic bank is an institution that mobilizes financial resources and invests them in an attempt to achieve predetermined Islamic ally-acceptable social and financial objectives. In addition to this Islamic banking is a system that mobilizes savings on the basis of profit /loss sharing that is considered to be fairer and more conducive to investment and development (Hassen& Lewis, 2007). Each bank competes to attract the customers by providing various types of services to retain those potential customers and attract the new ones to work with them. These competitions lead the existing banks as well as new entrants innovative to provide new type of services to the public. The main reason to do this is attract and meet the resource they lack liquid funds to their basic requirements. Interest free banking is a banking system which operated based on the teaching of the Islamic faith.

It is unique feature is that it is free of interest beside this characteristics, the IFB system has other objectives, such as equitable distribution of income and wealth and increased equity participation in the economy (Clifford, 2010).it is not allowed investing in a business that provide goods and service considered contradict to its principle, Haraam, such as business that sell alcohol or pork, or business that produce median such as gossip column or pornography, which are contrary to Islamic value (Mohammed, 2014).

According to the information obtained from the national census Agency, the Islamic population comprises around 33.9% of the total population, this offer the opportunity for substantial customer that would patronize Islamic banking product. The national census shown in Ethiopia there is a huge

potential for interest free banking service .The study made by Abdulkadir (2014) has found out that there is a significant need for Islamic banking product and service in our country Ethiopia. Beyond satisfying the need of Ethiopian customer Islamic banking will also create for Ethiopian government to gain diplomatic advantage financial dealing with Muslim dominated nation (Usmani, 2002).

Islamic banking are significantly different from that of conventional bank in many aspect: in Islamic bank the compensation is always a price(Thaman) but in the conventional bank the compensation is always interest, in the Islamic bank the relation of the bank-customer is as seller-buyer and partner but under conventional the relation is creditor-debtor. Also Islamic bank can be different from that of the conventional bank, it do not permitted to finance things that harm the society like alcohol ,tobacco but there is no such restriction in conventional bank.

The Islamic banking are face with serious problem to practice Islamic law, proper interbank money market is not available and poor regulation framework for IFB system (Erfan, 2014). To fulfil the demand of the Ethiopian Muslim customers ,national bank of Ethiopia in 2008 amended Ethiopian banking business proclamation (592/2008) to include provision of IFB and pave the way for the establishment of Islamic banking in Ethiopia .However the declaration was amended by other declaration (51/2011)which prohibited the establishment of full-fledged Islamic financial institution ,but give the right to open the door for existing commercial bank to create on interest free banking as (Yobdar 2018)explanation. Currently different Islamic bank are expected to join the banking industry as a full –fledged interest free banking ,such as zemzem,Hijira,Nejashi and zad bank, but currently zemzem bank are already started its operation and the left other are on the way to start their operation this create an opportunity for the development of the counters economy.

After the issuance of working directive s, SBB/51/2011 different commercial bank granted the license in order to deliver IFB service to their customers. Some of the bank which are started to provide IFB service such as CBE, OIB, OCB, AB, NIB and so on have joined IFB business by giving depositary product for the time being. However the purpose of this study was to assess the prospect of interest free bank and the challenge that bank face in implementing interest free banking service in case of CBE, OIB, OCB and Awash bank Jimma city.

## **1.2 Statement of the problem**

The banking industry in Ethiopia has been operating in the country for over a period. But interest free banking had never been practiced even though around one third of Ethiopian identify as Muslim according to the 2014 national census. They had been precluded themselves from dealing with commercial banking activity considering its dependability on interest .Recently many commercial bank started using interest free banking transaction ,tools and technique in their operation. This is really encouraging and motivating for the banking industry as a whole particularly interest free banking since significant amount of adult population does not access to formal banking because of their unavailability of formal banking frame work or paying or receiving interest prohibited in the religion. There is a fact that there are sufficient Muslim investor and borrower in both Islamic and non- Islamic country to warrant the concentration of traditional bank who seek to serve such clients are still relatively untapped market (Mohammed,2012).

Development of Islamic financial institution is advantageous to every economy because it enhance equitable distribution of income, operate interest free transaction and invest in only lawful investment and in real sector of the economy (Habib2001).

A number of studies have been conducted worldwide in the Islamic banking sector and many studs exist in challenge and prospect of IFB. From the few studies iqbal,et.al (2000)show that the challenge hindering Islamic banking are institutional as well as operational challenge in Arab country. The institutional challenge are poor institutional framework, inadequate legal framework and supervising policy ,absence of organized secondary market and lack of short term market placement fund .While the operational challenge are improper financial engineering ,lack of teaching, training, research development in this institution ,lack of profit sharing finance, inability to adequate mobilize deposit competition and globalization.

Saleh et al (2005) show the Lebanese experience with Islamic banking since the foundation of the first Islamic bank. They find that lack of public awareness and acceptance, lack of research and development institution, inadequate manpower and high competition from conventional bank offering Islamic activity are the major challenge of Islamic banking in Lebanon.

In Ethiopia, however, few studies were conducted on the attributes of IFB. Among these studies Mohammed in (2012) has studied the “Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia” and his work has identified the potential challenges as: lack of awareness, regulatory and supervisory challenges, institutional challenges, lack of support and link institutions, gap in

research. This study was undertaken before the practical introduction of the IFB in the country. Therefore, it was not based on actual observation of facts on the ground. Therefore, it was not based on actual observation of facts on the ground. Debebe (2015) has conducted a study on „Factors Affecting Customers to Use Interest Free Banking in Ethiopia“. The study is centered on „customers“ intention and willingness to use interest free banking“. The result showed that perceived relative advantage, perceived compatibility, customers“ level of awareness and subjective norm have a significant positive impact on the attitude towards interest free banking in commercial bank of Ethiopia. This study is about impact assessment on the attitude towards IFB usage which does not address the current problem at hand. On the other hand Teferi“s (2015) study is about „Contribution of IFB to economic development and its prospect in Ethiopia“. The study has assessed the contribution of including the Muslim population in to the banking (financial system) to the economic development and GDP growth.

Thus, none of the above studies have addressed the prospect and challenge of IFB banking service in case some selected commercial bank in jimma city. But the researcher focused on this case area due to large number of Muslim society are live on it, knowing the prospect and challenge of IFB banking are very important for the development of the country’s economy as a whole .In order to achieve the objective of the study in to effect the researcher limit its study are to some selected commercial bank of Ethiopia in jimma city (CBE, Awash Bank, OIB and cooperative Bank of oromia).

### **Research questions**

1. What are the prospects in delivering interest free banking system in some selected commercial banks in Jimma city?
2. What is the level of demand for interest free banking product other than those currently provided by the banks?
3. What are the challenge which the bank and its customer face in using and delivering interest free banking system?
4. What are the types of service offered by Islamic banking and their consistency with Islamic law (sharia)?
5. How Islamic banking service will have an effect on deposit mobilization effort of the bank?

### **1.3 Objective of the study**

#### **1.3.1 General objective of the study**

The general objective of the study was to examine the prospects and challenge of IFB activity especially in some selected commercial bank in jimma city (CBE, Awash Bank, OIB and cooperative Bank of oromia).

#### **1.3.2 Specific objective of the study**

- ✓ To investigate the prospect of interest free banking system in some selected commercial banks jimma city.
- ✓ To evaluate the level of demand for interest free banking product other than currently provided by the banks
- ✓ To identify the challenges the bank and its customer will face in delivering and using interest free banking system.
- ✓ To identify the types of service offered by Islamic banking and their consistency with Islamic law (sharia)
- ✓ To reveal out how Islamic banking service will have an effect on deposit mobilization effort of the bank?

### **1.4 Research hypothesis**

Based on the empirical review the following hypothesis were formulated

H<sub>1</sub>: Huge Amount of Potential Customer has a significant positive effect on IFB practice.

H<sub>2</sub>: Deposit Mobilization and Profitability of IFB service has a significant positive effect on IFB practice.

H<sub>3</sub>: Directive of NBE related to IFB banking service has a significant positive effect on IFB practice.

H<sub>4</sub>: Lack of Awareness and understanding has insignificant negative effect on IFB practice.

H<sub>5</sub>: Regulatory challenge has a significant negative effect on IFB practice.

H<sub>6</sub>: Absence of liquidity instrument has insignificant negative effect on IFB practice.

### **1.5 Significance of the study**

The finding of this research was contributed primarily to interest free banking services. The study will contribute to the existing pool of knowledge concerning interest free banking particularly in Ethiopian context.



This study finding was add on to the body of knowledge already existing and was also be a basis for further research.

It also helps as a basis for further research in the felid of interest free banking. Again it provides the understanding of the challenge facing interest free banking system. The study also was assisted the bankers in formulation different strategies and policy to eliminate challenge related to interest free bank.

### **1.6 Scope of the study**

This study is conducted the prospects and challenge of IFB activity especially in some selected in commercial banks of Ethiopia in Jimma city. In order to conduct the study was focused only on purposively selected sample of the IFB employees and customers of the four banks of Ethiopia namely CBE, Awash Bank, OIB and cooperative Bank of oromia. These four banks were chosen because they are the leader to start the IFB delivering service in Ethiopia in Jimma city. The data was collect from employees, managers, supervisors and customers of the four banks from their selected branches based on high number of IFB users.

### **1.7. Organization of the study**

The research proposal contains five chapters. the first chapter deal with the introduction part such as; background of the institution , background of the study, statement of the problem, objective of the study, research hypothesis, scope of the study, significance of the study, and organization of the paper. The second chapter discusses the theoretical and empirical literature about interest free/Islamic banking. The third chapter is about the methodology of the research that is the research design sampling technique, method of data collection tools, method of data analysis and so on the fourth chapter deal about data analysis and presentation and fifth chapter presents summary of finding, conclusion and recommendation.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

This section reviews the literatures written by different author and researchers conducted by different scholars in relation to the study and present a summary of the prospect and challenge of IFB practice, such as definition, principle and major concept regarding prospect and challenge and review of empirical literature .The study also describe the conceptual framework and research gap.

#### **2.1 THEORETICAL LITIRATURE**

##### **2.1.1 Concepts of Interest Free Banking**

Interest free (Islamic) banking refers to a system of banking or banking activity that is consistent with the principles of the Shari'ah (Islamic rulings) and its practical application through the development of Islamic economics. The principles which emphasize moral and Ethical values in all dealings have wide universal appeal. Shari'ah prohibits the payment or Acceptance of interest charges (Riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its Principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims although Islamic banking is not restricted to Muslims.

Islamic banking appeared on world forum as a prominent player over two decades ago. But actually many principles of Islamic banking system have been generally accepted all over the world for centuries rather than decades Islamic financial system is existed in Muslim community in different shapes according to situation of time. Actually Islamic financial system has a capability to fulfil the society requirements in respectable way. Islamic banking is a growing sector with its diversity in different segments and spectrum. It caters to religious Muslims in Muslim's societies as well as in countries where Muslims are in minority. In addition, it is a broad standard: non-Muslim individuals and communities that seek ethical financial solutions have also been attracted to Islamic banking. It is clear from banking practice that Islamic banking is equally popular in all communities (Iqbal, M., 1998).

It is clear from above statements that Islamic banking is not only Islamic or specific banking But actually it is a system which provides more ethical and moral concept of financial issue as Well as it is really helpful to create a peaceful, economically prosperous and welfare society.

The Organization of Islamic Conference (OIC) defined an Islamic banking as “a financial Institution whose statutes, rules and procedures expressly state its commitment to the Principles Of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations” (Hassan, 1999).

According to this statement it is clear that interest is fully prohibited in Islamic law due to its bad effects on human being and more badly effects on overall society and economy. In an Interest based economy a trend arises that rich people create the methods to increase their wealth through effecting the middle and lower classes. In interest based economy the middle Class cannot contribute positively in economic system then gradually the economy travel toward financial crises such as credit crunch. An Islamic bank is an intermediary and trustee of other people’s money with the difference that it shares profit and loss with its depositors. In practice the most Islamic banks have an Organizational set-up very matched and similar to their conventional counterpart banks (Dar and Presley, 2000). “Islamic banking is phenomenally profitable because, although it’s underlying Funding mechanism is the same as conventional banking, its default experience is better, and its charges higher and less transparent” (Cook, 2006).

It is resulted from above statements that Islamic banking is not totally different from Conventional Banking. They are doing same practice such as saving deposits and consumer Finances but there are some fundamental differences of its practice and objectives. Islamic Banking is Interest free and its main objectives are the equal distribution of wealth, decreasing the poverty and increasing the investment opportunities. It is very beneficiary for Muslim population who want to solve all their financial matter according to their religion, because a number of Islamic and some high street commercial Banks from all over the world offer products and Services that are according to Sha’riah Compliant. “Although the western media frequently Suggest that Islamic banking in its present form is a recent phenomenon, in fact, the basic Practices and principles date back to the early part of the seventh century” (Shaista, W. & Umadevi, N. G., 2013).

### **2.1.2 Evolution of Islamic Banking**

The origin of Islamic banking as a major player in the financial domain was in the early 1970\_s. But the rules and regulations governing Islamic banking system has been present in the world for many centuries.

During the middle ages, Islamic finance was popular and was widely accepted and practiced. It helped in furthering the trade and business in the Muslim world. The Islamic merchants began to

play a very important role in the European region (Mediterranean, Spain and Baltic States). Islamic finance has become a global system spreading as far as Asia, the Middle East, and the western world. Islamic banking is not limited only to the Muslim nations in the Middle East But also exists in the developed economies such as USA, Europe, and the Far East. Today, More than four hundred and fifty (450) Islamic banks are operating from China to USA, having Assets in excess of one trillion US dollars.

### **2.1.3 The Principles of Interest free banking**

#### ***2.1.3.1 Principles of IFB***

As Iqbal and Molyneux (2005), Banks which participate in the Islamic banking system should follow the shariah (Islamic law) principle. This principle deals with the moral and ethical values which should be considered in dealing with business transaction. The main principles are riba (usury), Gharar (risk and uncertainty), profit or loss sharing and prohibited transaction.

#### ***1. Riba (USURY)***

Based on the doctrine of Holy Quran which is pointed out in (2:275-280, 3: 130-132, 4:161-etc) and Hadith as riba (interest) is prohibited. Ali and Sarkar (1995), Islam prohibits its followers to receive or provide usury even for the purpose of getting a loan or the charged interest rate is low. In Islam, only a number of loans are allowed, such as *Qard al-Hasan* (benevolent loan), where the borrower is not charged any interest or additional

#### ***2. Risk and uncertainty (GHARAR)***

“*Gharar* means risk, uncertainty, and legal ambiguity or uncertainty that any one of the parties to a contract can exploit at the expense of the others as Khalifa M. (2016). Activities or transactions like (sale of unborn-she-camel or sheep, conditional sale, sale with loan, selling of agricultural produce before mature, selling the fish in the water etc.) are not permissible/permissive Ajagbe T. S. et al (2013). Though business transactions are generally plagued by a certain level of uncertainty, the excessive one is not welcome under Islamic finance. Hence, contracts forming the basis of business transactions and Islamic banking services should be known to a large extent about their consequence, Latifa and Mervyn (2007).

#### ***3. Profit and loss sharing (PLS)***

Based on Dusky and Abdullah (2007) study, 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. Chong and Liu (2009) also identify that a unique feature of Islamic banking is its profit-and-loss sharing (PLS) paradigm, which is predominantly based on the *mudaraba* (profit-sharing) and *musharaka* (joint venture) concepts of Islamic contracting in which the assets and liabilities of Islamic banks are integrated in the sense that borrowers share profit and losses with the banks.

#### **4. Prohibited transactions**

Islamic banking system is known as a system free of business activities that violate Sharia regulations such as investment in business related to liquor and gambling. Therefore Islamic banks in Malaysia in particular have established their own Shariah Advisory Council, which comprises Sharia experts who act as auditors and advisors to the bank. They are wholly responsible in ensuring that operations and activities of the bank do not breach the values of Islamic ethics as Mohammad Taqiuddin et al. (2013).

#### **2.1.4 Types of Financing in Islamic Banking**

IFB banking does not finance speculative activity that are focused on making money out of money, based on speculation in the difference financial, commodity and real estate market. Islamic bank offer broad spectrum of financial structure ranging from simple sharia compliant retail product such as saving and current account to large scale infrastructure financing (bala et.2009).

##### **2.1.4.1 Murabah Financing**

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

Limited to the contributions of the shareholders. In other words, investors cannot be liable for more than the amount of capital they invest in the partnership. (Shanmugan and Gupta, 2007) Musharakah is an Arabic word which means sharing, and relates to the sharing of profits or losses resulting from joint ventures or partnerships. In the business environment musharakah is a

partnership contract based upon equity participation, by which partners provide capital under joint venture. The sharing of profits and losses resulting from such partnerships is pre-determined and partners may co-manage the enterprise. The bank may act as a passive partner while the customer manages the venture (South Africa art; 281:35)

#### **2.1.4.2 Musharakah Financing**

Musharakah is a type of partnership financing in which one of the partners is an Islamic bank. Profits and losses are shared on predetermined formula. Profit sharing need not be based on the proportion of the shares owned, but liability of loss is

#### **2.1.4.3 Mudarabah Financing**

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

#### **2.1.4.4 Ijarah**

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

According to Delwin A. Roy, (1991:434) Ijara is a source of short or medium-term finance that is used by businesses in fields such as construction, for the financing of heavy machinery or other equipment. The bank purchases goods such as construction equipment and then leases them to the client on a specified sum, fixed-period basis. Monthly payments by the client are fixed at rates which cover all or most of the original purchase price of the item over the period of the contract. A contract can 17 Incorporate both murabaha and ijara if the eventual sale to the client is agreed upon at the time the original contract is made.

#### **2.1.4.5 Bai'bithmanAjil (BBA)**

Bala et.al (2009: 28) defines bai'bithmanajil is the sale of goods by the bank to a customer on a deferred payment basis over a specified period at a price that included a mark-up or profit margin

agreed to by both parties. Bai'bitmanajil plan is commonly used for financing the purchase of real property, vehicle or consumer goods.

#### ***2.1.4.6 Al-Ijarathumna al bai (AITAB)***

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

#### ***2.1.4.7 Istisna***

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

#### ***2.1.4.8 Tawaruk***

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

#### ***2.1.4.9 Bai Salam***

Financing is a forward financing transaction frequently used in the agriculture industry. In this structure, the bank purchases specified asset in advance of a predetermined delivery date. Typically the bank receives a discount for the advance payment plus a profit margin. (Bala et al (2009: 34) 18

#### ***2.1.4.10 Qard Hassen***

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

### **2.1.5. Sources of Islamic legislation**

It is essential to understand the source of Interest free banking before the discussion on fundamentals principles and challenges of Interest free banks. In Islam, the faith and daily activities are linked together unlike any other religion (Alamgir et al, 2017). There is no concept of an economy functioning independently of the religious criteria that inform every single aspect of

human life (Olanipekun, Brimah, and Ajagbe, 2014). According to Novethic (2009), the principles of Islamic finance and motivations behind Islamic finance as laid down by the Shariah, or Islamic law that is based on the writings of the Qur'an and sayings of the Prophet and which also acts as a framework for different aspects of day-to-day life for Muslims. Since banking is part of daily activities, banking practices are guided by Shari'ah, known as Fiqh al-Muamalat (Islamic rules on transactions). The Shariah is the Divine Law that lists moral, ethical and legal principles and promotes a certain code of behaviour described by the Holy Quran and describes or lists both the unwritten and written code of obligations toward every sphere of Human activity. The Shariah includes a set of duties and practices such as prayer, manners, ethics, marriage, conducting business, finance transactions, contracts and other rules of Allah (Szczepanowicz, P.26, 2011). The Shariah also offers several ethical and social criteria for exclusion regarding the investment targets and financial products allowed for Muslims (AAOIFI, cited in Szczepanowicz P.26, 2011).

The rules and practices of Fiqh Muamalat are derived from the Holy Quran, the Sunnah, Ijma, Qiyas, and Ijtihad (Olanipekun et al., 2015; Gait and Worthington, 2009; and Pasha, 2014). Although the classification of these sources as well as their level of acceptance may vary among the Islamic Schools of thought, all schools regard the first two resources as the most important sources of sharia. More specifically, two sources have been identified for Shariah: Qur'an and Sunnah are the primary sources of Shariah. According to Gerrard and Cunningham (1997), the Qur'an (Muslim Holy book), clearly deals with economic- related matters and how they apply in Islam. The Holy Quran also says that commerce and trade includes three basic principles (i) Risk Taking (ghorm); (ii) Work and Effort (kasb) and (iii) Responsibility (Damam) (Pasha, 2014). Furthermore, the Quran contains explicit rules regulating personal status, contracts, property, civil and criminal law, and the economic system. The main prescriptions relating to financial transactions are: the prohibition of riba (i.e. the payment of a fixed or determinable interest on funds); and the prohibition of economic practices that involve the concept of gharar (deceptive uncertainty), maysir (speculation) and harām (prohibited behavior) (Aziz, 2012 cited in Olanipekun et al., 2015). Sunnah generally refers to all that is narrated from the Prophet (PBUH), his acts, his sayings, whatever he tacitly approved, plus all the reports that describes his physical attributes and characters (Kettell, 2011). The Holy Qur'an and the Sunnah of the prophet, which is known as Al-wahyain (the two revelations), are the only primary sources of Islamic law (shafi'i, 1940 cited in Baej, P.9, 2013).



The secondary sources are opinions collectively agreed among Shariah scholars Ijma, Qiyas and Istihad. These secondary sources are Islamic jurisprudence (fiqh), based on the interpretations (Istihad) of experts in particular cases (e.g. ones of implicit or unclear rules), on deductive reasoning (qiyas), (Abedifar, Molyneux, and Tarazi, 2012) and on the expert consensus of various schools of thought (ijma') (Aggarwal and Goodell, 2009).

#### **2.1.6. Retail Islamic Banking Products**

It is division of a bank that deals directly with retail customers. In Islamic banking retail product are the following:-

**Current Account (Alwadiyah):** -The current account is basically safekeeping or Al-wadiyah' account and used for day to day cash management. In 'Al-Wadiyah', a bank is deemed as a keeper and trustee of the funds, Mohammed (2012). Current accounts are demand deposit accounts kept with the bank on custodial arrangements and are repayable in full on demand. Current accounts are based on the principle of wadia (trust or safe keeping) or Amanah (trust), creating an agency contract for the purpose of protecting and safekeeping the depositor's assets. (Iqbal and Mirkahor, 2011:154).

**Savings Account:** -Islamic banks practice the principle of wadia in operating customer saving account. The bank may request permission to use customer funds deposited in these accounts as long as these funds remain within the banks discretion. The bank does not share with the customer profit earned from the use of customer funds deposited in these accounts funds but does guarantee the customer deposits. The bank however reward customer with gift as a token of its appreciation for being allowed to use the funds. (Balla et. al (2009: 25)

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

#### **2.1.7. Islamic and conventional banking**

The main difference between Islamic and conventional banks is the use of money. In conventional banks, money is used as a commodity that is bought and sold through the interest's usage (Pasha 2014).

Table 1: The major difference between Islamic and Conventional banking

<b>Conventional banking system</b>	<b>Islamic banking system</b>
Conventional bank are in the business of lending and borrowing money based on interest	Islamic bank are not money lending institution but they work as trading (investment )house
Under conventional bank almost all the financing and deposit side product are loan based.	Islamic bank work under the socio religious guidelines that prohibit charging and paying interest and avoid all impermissible transaction like gambling, speculative, short selling and sales of debt and receivables
In conventional bank we see no such restriction. interest is the back bone of this system and short selling, sales of debt and speculative transaction are common	Islamic bank do not permit financing the industry that cause harm to the society such as alcohol, tobacco etc
In conventional bank all types of industry are financed on business deemed illegal by the law of the land are not supported	Islamic bank have strong shariah governing frame work in term of shariah board, who approve the transaction and product in the light of the shariah ruling
Generally conventional bank do not involve the selves in trade and business as they act only as money lender	Islamic bank recognize loan as non-commercial and exclude it from the domain of commercial transaction .any loan given by Islamic bank must be free of interest.
In conventional bank almost all financing and deposit side products are loan based	Islamic bank product are usually asset backed and involve trading of asset, renting of asset and participation on profit and loss basis
Conventional ban treat money as commodity and lend it against interest as its compensation	
Under conventional relation of customer and bank is of creditor-debtor relationship	Under Islamic bank the relation of customer and bank is seller-buyer and partner relationship
Here compensation is always interest	Here compensation is always price(thaman)

Adapted from Saidi (2007)

## **CHAPTER THREE**

### **3. Research Design and Methodology**

In this section research approach, research design and research strategy, approaches to research methods, sources of data, data collection method & instruments, sampling methodology and data analysis Techniques was discussed. It also discusses the processes and techniques used in carrying out the study. It also gives a description of the respondents including information on the study population, the number of respondents and how they were selected. It also provides an outline of research design and the instruments for data collection. The methods adopted in the administration of the research instrument, data collection procedure, data analysis and measures used to ensure validity of the instrument used.

#### **3.1 Research Design**

The study was conducted to assess the prospect and challenge of interest free banking system in case of some selected commercial bank in jimma city, there for in order to put the objective of the study in to affect the researcher was used explanatory and descriptive research design approach. The explanatory research design examines the cause and effect relationships between dependent and independent variables. The major purpose of descriptive research is description of the state of affair as it exists at present. This study was used descriptive research design in regarding to the researcher objective which is describing the view of the respondent with regard to the prospect and challenge of interest free banking.

#### **3.2 Research approach**

According to Creswell, (2009) there are three types of research approach, these are quantitative, qualitative and mixed approach. Quantitative approach involve the generation of data in quantitative form ,while qualitative approach to research is concerned with subjective assessment of attitude ,opinion and believes, and it generate result in non-quantitative form. Whereas mixed research approach is an approach to inquiry that combines both quantitative and qualitative form. Keeping in view of the purpose of this study the researcher was adopted mixed research approach consisting both interview and questioners technique for data collection.

### 3.3 Source and type of data

In order to accomplish the objective of the research in to effect the study was used both primary and secondary source of data .The primary data source was staff of IFB department and top supervisors .in an effect to make the research more credible secondary data was used, it is collected from different journals, article, annual report of the bank related to Islamic banking practice.

### 3.4 Target population of the study

The study was conducted on some selected bank CBE, OIB, OCB and Awash bank, to make the research manageable, Jimma city of the banks are considered in this research, since the study was aimed to identify the prospect and challenge of interest free banking in case of CBE, OIB, OCB and awash bank Jimma city, the total target population was IFB employees of CBE, OIB, OCB and Awash bank and IFB customer of the bank.

### 3.5 Sampling technique and sample determination

This study was employed both probability and non-probability sampling technique, such that simple random sampling technique was applied to the potential interest free banking customers of the bank and judgmental sampling technique will be applied for the interest free banking employees and top managemet of CBE, OIB OCB Awash bank at jimma city Based on that the following sample was taken.

**Table 2: IFB customers in banks**

Name of bank	Number of IFB customer	Number of IFB Employee
CBE BANK	2700	18
OIB	1654	9
COOPRETIVE BANK OF OROMIA	1890	7
AWASH BANK	1960	8
<b>Total</b>	8204	42

Source from CBE, OIB, OCB and Awash bank Jimma city, Therefore by using judgmental sampling technique the researcher was taken 42 employee of the bank those worked on IFB.

- For the customer sample it was taken by using the formula which is taken from probability and statics text book.

$$n = \frac{N}{1 + N(e)^2}$$

Where n=sample size

N=total target population

e=error

In the study the researcher was estimated around 95% of confident level of data is going to be reflective of the entire population and the remaining 5% was takes as error.

$$n=8204/1+8204(0.05)^2 =381$$

### **3.6 Method of data collection**

To achieve the objective, the study was used both quantitative and qualitative data that was collected using primary and secondary source of data .The primary data was collected through semi-structured interviews and questioner's .Whereas secondary data was collected by extracting relevant and supportive data and information from secondary data source.

### **3.7 Methods of data analysis and presentation**

All the collected data was organized, summarized, presented and interpreted using tabulation, percentage and SPSS software.

$$Y=\beta_0+\beta_1X_1+\beta_2X_2+\beta_3X_3+ \beta_4X_4 + \beta_5X_5+ \beta_6X_6$$

Where:

Y = Interest free banking

$\beta_1, \beta_2, \dots, \beta_6$  = Coefficients of the independent variables showing how they influence Y

X1= Existence of potential customers

X2= Deposit mobilization and profitability of IFB service

X3= Directives of NBE related to IFB practice

X4 = Lack of awareness and understanding about IFB banking

X5= Regulatory challenge

X6= Absence of liquidity instrument

$\epsilon$ = error term

Data analysis was consists examining, categorizing, tabulating, or otherwise recombining the evidence, to address the initial proposition of a study (Kothari 2004). The data analysis has been conducted by using the Statistical Package for the Social Sciences (SPSS) computer program. Descriptive statistics has to do with calculating frequency, percentages, the mean and standard deviation and also tables were used to summaries the output data. And also, it was used for describing the respondents' demographic characteristics in terms of frequency and percentage. Regression analysis was applied to analyze the empirical date and Pearson Product Moment Correlation was added to conclude the regression analysis. These statistical measures contributed to test the research model validity. Regression analysis tested how the independent variables were regressed on the dependent variable, Use of the system. The Pearson Product Moment Correlation was used to examine the correlation between the variables and the correlation between the variables and system Use. The Pearson r calculates the degree of linear association (correlation) between the variables on a scale from -1 to +1 (Walsh, 2007). Note here that the negative sign is referring to the direction of the relationship and not the strength (Pallant, 2001). Finally, the coefficient of determination (r square) can be calculated by squaring r and multiplying by 100%. This value tells us the amount of variation among the Criterion (interest free banking) by its linear connection to Predictors (Existence of potential customers, Deposit mobilization and profitability of IFB service, Directives of NBE related to IFB practice, Lack of awareness and understanding about IFB, Regulatory challenge and Absence of liquidity instrument).

**Table 3: The Dancey and Reidy's (2004) categorize the value of correlation coefficient**

Value of the Correlation Coefficient	Strength of Correlation
1	Perfect
0.7 - 0.9	Strong
0.4 - 0.6	Moderate
0.1 - 0.3	Weak
0	Zero

Furthermore, Creswell (2003), suggested that qualitative research is fundamentally interpretative i.e. the researcher made an interpretation of the data. Thus, the data that has been collected from the questioner and reviews of documents has been interpreted qualitatively. To sum, the analysis of quantitative data and interpretation of qualitative data combines to seek convergence among the results (Creswell, 2003). Inferential Analysis was used to analyze the relationship between two variables and to assess how the dependent variables explain the independent variable (Creswell, 2003).

### 3.7. Validity and Reliability

#### 3.7.1 Validity

Before empirical analyses are conducted by using the instrument, reliability and validity test were done on items in the questionnaire instrument.

Validity on the other hand refers to whether an instrument actually measures what it is supposed to measure. To assure validity, questionnaires were designed on the basis of previous studies' questionnaires and review of related literatures, the researcher selected multiple sources of evidence namely documentation and personal observation. Finally, the researcher used well- established literature to construct the frame of references.

#### 3.7.2 Reliability analysis

**Table 4: Reliability analysis result**

Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
.812	.814	6

Source: This study: Survey 2021

Before the questionnaires were formally distributed, a pre-trial reliability analysis was performed on 25 completed questionnaires to appropriately adjust the questionnaire design. According to (Nunnally, 1978) Cronbach's alpha should be 0.700 or above. In this study, the value of

Cronbach's alpha is above the base line, which is greater than the standard value, 0.7. Thus it can be concluded that the measures used in this study are valuable and highly reliable.

### **3.8 Ethical Consideration**

To reach the respondents formal letter was provided to the bank. The respondents were given privileges of not writing their name and no respondents will be forced to fill the questionnaire unwillingly and without making the actual purpose of carrying out the research clear to him/her. The purpose of the study was disclosed in the introductory part of the questionnaire. Furthermore, misleading or deceptive statements were tried to be avoided, in the questionnaires.



## CHAPTER FOUR

### 4. RESULT AND DISCUSSION

#### 4.1 Introduction

This chapter presents the results and discussions of the prospect and challenge of interest free banking: the case of selected commercial banks in Jimma city. A descriptive statistical analysis was used to present and interpret the data collected on various variables of prospect and challenge of interest free banking: the case of selected commercial banks in Jimma city. Frequency tables and Percentages, mean and standard deviation are also employed to analyze the responses of the respondents and inferential analysis which conducted to achieve the aforementioned objective. The researcher distributed a total of three hundred eight one (381) questionnaires for the respondents. Out of which 381 were filled in and returned to the researcher. Among the 381 questionnaires, only 359 (94.22%) were correctly and completely filled in, while the rest 15 (3.93%) questionnaires were returned with incomplete responses and the remaining 7 (1.83%) questionnaires were not returned.

#### 4.2 Demographic Characteristics of the Respondents

This section summarizes the demographic characteristics of the sample, which includes gender, age, education level, marital status and occupation. The purpose of the demographic analysis in this research is to describe the characteristics of the sample such as the proportion of males and females in the sample, age, education level, marital status and occupation, so that the analysis could be more meaningful for readers.

**Table 5: General Respondents Profile**

Variable		Frequency	Percentage (%)
Sex	Male	197	54.87
	Female	162	45.12
	Total	359	100
Age	Below 25	77	21.44
	26-35	193	53.76
	36-45	60	16.71
	Above 46	26	7.24
	Total	359	100

Education level	High School completes	126	35.09
	Diploma	106	29.52
	Degree	41	11.42
	Other	86	23.95
	Total	359	100
Marital Status	Single	183	50.97
	Married	160	44.56
	Divorced	7	1.94
	Widowed	5	1.39
	Total	359	100
Occupation	Trader(business man)	107	29.80
	Entrepreneur/Trader	91	25.34
	Government employee	112	31.19
	Other	49	13.64
	Total	359	100

Source: Authors computation based on survey data, 2021

As I can see from the above table indicated that, male and female in CBE in Jimma city constitutes about 54.87% and 45.12% respectively which shows the samples taken represented male and female is relatively distributed on fairly basis. According to the above table 5, age category of the respondent shows highly dominated by youngsters between ages 26-35 which accounts more than half of the respondents 53.76% followed by 21.44% of the respondents are below age 25, while age group of 36-45 and above 46 constitutes 16.71% and 7.24% respectively. This indicates that most of the respondent are young and highly implies the bank trend focuses on new and young customers. Regarding to the employee education qualification, the above table 5, clearly indicated that majority of the work forces (35.09%) acquired their High School completes and diploma holders constitute 29.52% of the respondent while the rest 11.42% of the respondents are degree holders. This shows that majority of the respondents are degree holders. Since most of the costumers are youngsters, the above table shows almost half of the respondents are single about 50.97% while 44.56% of the

respondents are married. Unluckily, there are 1.94% and 1.39% of the employees are divorced and widowed respectively. Since marital status has its own impact on employee performance, the researcher has accessed this result for comparison between their statuses. Finally, in the same way, the respondents' occupational shows that 31.19% of respondents are government employee, 29.80% had Trader (business man), 25.34% are Entrepreneur/Trader and the remaining 13.64% of respondents are other. This indicates that the majority of the respondents are government employee employees.

### 4.3 Respondents' opinion on the service rendered

**Table 6: Respondents' opinion on the service rendered**

Characteristics	Strongly disagree		Disagree		Neutral		Agree		Strongly agree	
	N	%	N	%	N	%	N	%	N	%
There exists quality IFB banking service delivery	14	3.89	17	4.73	24	6.68	163	45.40	141	39.27
There is quick IFB banking service delivery	16	4.45	15	4.17	20	5.57	156	43.45	152	42.33
Are the service delivery of IFB banking are consistency with Islamic law	12	3.34	19	5.29	22	6.12	143	39.83	161	44.84
I believe IFB banking offers the kind of service and product that I want to use	6	1.67	6	1.67	9	2.50	167	46.51	171	47.63
The bank do sufficient advertisement of IFB banking service and delivery	18	5.01	21	5.84	16	4.45	158	44.01	146	40.66

Source: Authors computation based on survey data, 2021

The above tables show that among respondents' opinion on the service rendered 163 (45.40%) respondents agree that "there exists quality IFB banking service delivery. The majority of the respondents agree and strongly agree with the items, there is quick IFB banking service delivery 156(43.45%) and 152 (42.33%), are the service delivery of IFB banking are consistency with

Islamic law, 143 (39.83%) and 161(%44.84). Concerning to the I believe IFB banking offers the kind of service and product that I want to use171 (47.63%) is strongly agree. Besides, 158 (44.01%) respondents agree among the bank do sufficient advertisement of IFB banking service and delivery. This implies majority of the respondents were agree and strongly agree the service delivery of the banks on the interest free banking services.

#### 4.4 Knowledge of IFB customers towards the interest free banking products

**Table 7: Knowledge of IFB customers for interest free banking products**

Characteristics	Fully Aware		Little Awareness		Fully unaware	
	N	%	N	%	N	%
Murabaha (mark-up principle)	163	45.40	129	35.93	67	18.66
Musharaka (joint venture)	171	47.63	146	40.66	42	11.69
Mudharabah (trust financing)	191	53.20	117	32.59	51	14.20
Ijarah (leasing)	140	38.99	146	40.66	73	20.33
Salam (purchase order) financing	168	46.79	160	44.56	31	8.63
Istisnaa (pre-paid purchase)	145	40.38	155	43.17	59	16.43
Wadi'ah (safe-keeping contracts for current deposit)	150	41.78	141	39.27	67	18.66
Wakalah (safe-keeping contracts for agency contracts)	157	43.73	138	38.44	64	17.82
Quard Hassan	161	44.84	149	41.50	49	13.64

Source: Authors computation based on survey data, 2021

The results of the above 7 reveals that majority of respondents were fully aware 163(45.40%) and little awareness 129 (35.93%) on the item” Murabaha (mark-up principle). Regarding to Mudharabah (trust financing) 191 (53.20%) was fully aware and Salam (purchase order) financing with 168 (46.79%.) however this implies the respondent it provides capital to another party (the Mudarib) in order to undertake an investment activity. While profits are shared on a pre- agreed ratio, loss of investment is born by the investor only. The mudarib loses its share of the expected income.

## 4.5 Descriptive statistics

Descriptive analysis is the first step in this study. It helped to describe relevant aspects of phenomena of interest free banking and provide detailed information about each relevant variable. SPSS software has been used for analysis of the different variables in this study. Descriptive statistics shows the mean and standard deviation of the different variables used in the study. The variables of the study whose descriptive statistics were computed included; existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB banking practice, lack of awareness and understanding about IFB banking, regulatory challenge and absence of liquidity instrument and Interest free banking. Thus, for this study the interpretation of mean values as per Zaidaton and Bagheri. A 5 – point Likert scale was adopted to answer each statement where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree, and 5 = strongly agree.

### 4.5.1 Prospects and Opportunities of IFB banking

#### 4.5.1.1 Analysis of interest free banking

**Table 8: Mean and standard deviation score for IFB**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
The bank has knowledgeable and experienced manpower to provide interest free banking service	3.39	1.188
The bank provides its interest free banking product at convenient branch and adequate window with the customer expectation	3.00	1.923
The segregation of fund from the conventional banking service activity is mandatory to attract the potential customer of interest free banking service	3.02	1.975
The bank has well versed shariah board members	3.13	1.775
The bank has enough qualified scholars in IFB banking to ensure that IFB banking service are up to date and fully comply with shariah law.	2.85	1.125
Grand	3.07	1.59

Source: Authors computation based on survey data, 2021

As evidenced in table 8, the findings of the study revealed that respondents respond all the items corresponding to interest free banking to be equivalent to the average. However, notable variations were observed in relation to the different dimensions used to conceptualize interest free banking,

that is to say, the extent to which the respondents respond the system to be The bank has knowledgeable and experienced manpower to provide interest free banking service had the highest mean of 3.39 and a standard deviation of 1.188, this was followed by the extent to which the respondents being the bank has well versed shariah board members with a mean of 3.13 and a standard deviation of 1.775. This implies that these two particular items were accorded more relative importance in explaining interest free banking by the respondents. These particular items were moderate the total mean of 2.95 implying that the respondents did attach much importance to them in regards to measuring interest free banking.

**4.5.1.2 Analysis of existence of potential customers**

**Table 9: Mean and standard deviation score for existence of potential customers**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
There is potential customer in IFB banking service	3.27	1.236
IFB banking helps to attract new customers from the existing bank	2.90	1.211
There is IFB banking service needs in Ethiopia so it will alleviate the financial service deprivation of the Muslim community and those who need interest free banking service	3.09	1.157
IFB banking will enhance banks brand image as ethical	2.81	1.710
Grand	3.01	1.32

Source: Authors computation based on survey data, 2021

As indicated in table 9, in relation to existence of potential customers, the respondents who participated in the study revealed that they preferred a potential customer in IFB banking service with a mean of 3.27 and a standard deviation of 1.236. This was followed by the extent to which respondents believed there is IFB banking service needs in Ethiopia so it will alleviate the financial service deprivation of the Muslim community and those who need interest free banking service with a mean of 3.09 and a standard deviation of 1.157. These particular items were moderate the total mean of 2.91 implying that the respondents did attach much importance to them in regards to the existence of potential customers.

**4.5.1.2 Analysis of deposit mobilization and profitability of IFB service**

**Table 10: Mean and standard deviation score for deposit mobilization and profitability of IFB service**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
IFB banking service is one means of resource mobilization in the banking industry	2.74	1.058
IFB banking system is helpful for the growth of Ethiopian economy	2.65	1.106
IFB banking has a good system to maintain the risk well	3.40	1.095
If the bank offer certain IFB banking product (saving and loan service ) the access to IFB banking will improve the tendency for business expansion and investment activity will increase	3.44	1.154
Grand	3.05	1.10

Source: Authors computation based on survey data, 2021

As shown in table 10, the findings revealed that on average, respondents respond all the issues relating to deposit mobilization and profitability of IFB service. The extent to which respondents believe If the bank offer certain IFB banking product (saving and loan service) the access to IFB banking will improve the tendency for business expansion and investment activity will increase scored the highest mean of 3.44 and a standard deviation of 1.154 and followed by the extent to which the respondents believed the IFB banking has a good system to maintain the risk well (mean=3.40, SD=1.095). These particular items were high the total mean of 3.05 implying that the respondents agreed that the items were measuring deposit mobilization and profitability of IFB service.

**4.5.1.3 Analysis of directives of NBE related to IFB**

**Table 11: Mean and standard deviation score for directives of NBE related to IFB**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
The directives of NBE to issue a new proclamation that permitted the establishment of interest free finance in Ethiopia	3.95	1.691
The current global trend in financial service will have positive manifestation on the future of IFB banking	3.87	1.177
The concentration of the Ethiopian government towards the expansion of IFB banking service	2.65	1.057

Segregation of fund from conventional banking service activity is mandatory to attract the potential customer of IFB banking	3.94	1.006
Grand	3.60	1.23

Source: Authors computation based on survey data, 2021

The directives of NBE related to IFB practice to issue a new proclamation that permitted the establishment of interest free finance in Ethiopia scored the highest mean of 3.95 and a standard deviation of 1.691. This was followed by extent to which respondents were segregation of fund from conventional banking service activity is mandatory to attract the potential customer of IFB banking (Mean= 3.94 and SD=1.006). These particular items were high the total mean of 3.60 implying that the respondents agreed that the items were measuring directives of NBE related to IFB practice.

#### 4.5.2 Challenges of IFB banking

##### 4.5.1.1 Analysis of lack of awareness and understanding about IFB banking

**Table 12: Mean and standard deviation score for lack of awareness and understanding about IFB banking**

Characteristics	Mean	SD
Muslim community has awareness about IFB banking system	2.24	1.206
People believe non –Muslim cannot use product of IFB by wrong association with religious	2.40	1.227
Customer have awareness about the major types of interest free banking product	2.46	1.247
The bank have enough qualified staff and scholar in the IFB banking to ensure that IFB banking service are up to date and fully comply with sharia law	2.42	1.279
Grand	2.38	1.23

Source: Authors computation based on survey data, 2021

The above table indicated that, in relation to lack of awareness and understanding about IFB banking, the respondents who participated in the study revealed that customer have awareness about the major types of interest free banking product with a mean of 2.46 and a standard deviation of 1.247. This was followed by the extent to which respondents the bank have enough qualified staff



and scholar in the IFB banking to ensure that IFB banking service are up to date and fully comply with sharia law with a mean of 2.42 and a standard deviation of 1.279. These particular items were low the total mean of 2.38 implying that the respondents didn't attach much relative importance to the items used to measure lack of awareness and understanding about IFB banking.

**4.5.1.2 Analysis of regulatory challenge**

**Table 13: Mean and standard deviation score for regulatory challenge**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
There is legal, supervisory and regulatory institutional challenge	2.84	1.393
There is lack of suitable banking police for interest free banking	2.75	1.371
There is lack of supportive and link institutional such as sharia board and consultancies successful practice of interest free banking	2.58	1.407
The bank give the service in compliance with the service requirement of interest free banking	3.08	1.525
Grand	2.81	1.42

Source: Authors computation based on survey data, 2021

As shown in table 13, the findings revealed that on average, respondents respond all the issues relating to regulatory challenge. The extent to which respondents believe The bank give the service in compliance with the service requirement of interest free banking scored the highest mean of 3.08 and a standard deviation of 1.525 and followed by the extent to which the respondents is legal, supervisory and regulatory institutional challenge mean=2.84,SD=1.393. These particular items were moderate the total mean of 2.81 implying that the respondents did attach much importance to them in regards to the regulatory challenge.

**4.5.1.2 Analysis of absence of liquidity instrument**

**Table 14: Mean and standard deviation score for absence of liquidity instrument**

<b>Characteristics</b>	<b>Mean</b>	<b>SD</b>
Lack of institution like interest free money market and capital market would create liquidity and other operational difficulties to IFB practice	2.34	1.220
lack of infrastructures suitable for interest free banking operation	2.25	1.145
Shortage of IFB banking financial experts	2.27	1.164
Shortage of short-term investment security	2.22	1.215

Grand	2.26	1.18
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Source: Authors computation based on survey data, 2021

As supported in the above table indicated that, the findings of the study revealed that respondents respond all the items related to absence of liquidity instrument. However, notable variations were observed in relation to the different dimensions used to conceptualize absence of liquidity instrument, that is to say, the extent to which the respondents respond the lack of institution like interest free money market and capital market would create liquidity and other operational difficulties to IFB practice had the highest mean of 2.34 and a standard deviation of 1.220. These particular items were low the total mean of 2.27 implying that the respondents didn't attach much importance to them in regards to measuring absence of liquidity instrument.

### **Interview result**

Based on the respondents response recently customers are getting familiar with the IFB service now days. The proclamation accepted by the government to open an Islamic bank has made awareness on the customers. However, it is still low based on the target of the banks. Respondents imply that most of the customers are satisfied with what is served.

The respondents vastly responded a lot of challenges including the following. Lack of Awareness about IFB products from customers: generally, users do not know the types of IFB products and their rules and regulations. Inadequate marketing and promotion; the respondents have identified the weak marketing and promotion conducted by the bank has indirectly and negatively affected the utilization of IFB products. The marketing and promotion was not done to help the products to be known by the public.

Double taxation: refers to the tax that would be levied on Islamic banks as a result of stamp duties that is payable upon asset transfer. Nature of IFB products: The principles of IFB does not allow the direct receipt of cash as financing rather the cash is used directly for the asset to be purchased in the name of the bank and later the bank will sale the asset to its customers. Such practice is unfamiliar to both the customer and the bank which has created inconvenience and problem. Unavailability of IFB products/services in most of branches bank: According to the secondary data obtained from the bank, it is currently providing IFB services in its selected branches and the financing products are processed centrally unlike its conventional structure. This has created accessibility problem to utilize IFB products at customers" convenience. Being Window model: Internationally IFB services

are being provided through different model that range from full-fledged Islamic banks to a window model in a conventional bank. However, all of the models have their own acceptance level from the customers" side. Lack of trust and confidence:

According to the responses obtained from the staffs, lack trust and confidence as to the bank's capacity and commitment to deliver Shariah compliant IFB product and services. Per the response customers believed that there is mixing of IFB and conventional banking transaction and the bank is not even committed to give truly IFB services this has eroded the customers" trust.

To sum up the findings on major challenges to deliver and use IFB products are: lack of awareness about IFB products from customer, inadequate marketing and promotion, double taxation, nature of IFB products, inaccessibility of IFB products, the IFB being delivered in a Window model, lack of trust and confidence, non-availability of other services attached to the products, lack of commitment and focus from the bank, lack of Shariah board, lack of supportive supervisory directive, problem related to Ethiopian Commodity Exchange (ECX) law and lack of capacity to deliver full range of IFB products.

The respondents reply that it is better if the government scaled the IFB on creating business and investments. All respondents agree that all the customers of IFB were Muslims and there were no Christian customers. Most of the respondents agree that the IFB service being given is comfortable for customers. Respondents reply that IFB has somewhat similarity with the Islamic law.

#### **4.6 Correlation Analysis**

Correlation analysis is a method of statistical evaluation used to study the strength of a relationship between the two dependent (Interest free banking) and independent variables (Existence of potential customers, Deposit mobilization and profitability of IFB service, Directives of NBE related to IFB banking , Lack of awareness and understanding about IFB banking, Regulatory challenge and Absence of liquidity instrument).The particular type of analysis is useful when researcher wants to establish if there are possible connection between variables. It's often misunderstood that correlation analysis determines cause and effect., however ,this is not the case because other variable that are not present in the research may have impacted on the results., so the researcher uses correlation to analysis the direct and inverse relationship between the variables each other's. The result of Pearson correlation is presented in the following table and interpreted by the guide line suggested by Field (2006); mentioned that the Pearson correlation coefficient shows the relationship

and direction between the predictor and outcome variable. Accordingly, if the relationship is measured in the range of 0.1 to 0.29 it is a weak relationship, 0.3 to 0.49 is moderate, above 0.50 shows strong relationship; while the positive and negative sign tell us the direction of their relationship.

**Table 15: Pearson correlation coefficient**

		IFBP	EPC	DMPS	DNBE	LAU	RC	ALI
Interest free banking	Pearson Correlation Sig. (2-tailed) N=359	1						
Existence of potential customers	Pearson Correlation Sig. (2-tailed) N	.874 .000	1					
Deposit mobilization and profitability of IFB service	Pearson Correlation Sig. (2-tailed) N =359	.566 .000	.629 .000	1				
Directives of NBE related to IFB banking practice	Pearson Correlation Sig. (2-tailed) N =359	.546 .000	.673 .000	.665 .000	1			
Lack of awareness and understanding about IFB banking	Pearson Correlation Sig. (2-tailed) N =359	-.232 .000	.351 .000	.292 .000	.406 .000	1		
Regulatory challenge	Pearson Correlation Sig. (2-tailed) N =359	.315 .000	.335 .000	.311 .000	.406 .000	.619 .000	1	
Absence of liquidity instrument	Pearson Correlation Sig. (2-tailed) N =359	-.217 .000	.261 .000	.143 .000	.238 .000	.414 .000	.578 .000	1

Source: Authors computation based on survey data, 2021

The above table indicated that the correlation between dependent and independent variable was considered, based on the classification of Dancey and Reidy's (2004). The findings in table 15 show that there was a statistical and significant strong relationship between interest free banking and existence of potential customers,  $r=0.874$ ,  $N=359$ ,  $p<.005$ ). Correlation analysis was done to determine a statistical and significant strong relationship between interest free banking and deposit mobilization and profitability of IFB service  $r=0.566$ ,  $N=359$ ,  $p<.005$ ). The findings that there was a statistical and significant strong relationship/ association between interest free banking and directives of NBE related to IFB banking practice,  $r=0.546$ ,  $N=359$ ,  $p<.005$ . In this section, correlation analysis was done to determine the association between interest free banking and lack of

awareness and understanding about IFB banking, the findings show that there was a statistical and insignificant relationship, ( $r = -0.232$ ,  $N=359$ ,  $p < .005$ ). Correlation between interest free banking and regulatory challenge was considered. The findings show that there was a statistical and significant strong relationship between interest free banking and regulatory challenge,  $r = 0.315$ ,  $N=359$   $p < .005$ ). It was also clear that there was an insignificant correlation between interest free banking and absence of liquidity instrument with a correlation figure of  $r = -0.217$ ,  $N=359$   $p < .005$ ). This implies that when respondents of the study area have consideration for the interest free banking, they are more able to keep the banks.

#### 4.7 Testing Assumptions of Classical Linear Regression Model (CLRM)

In this study as mentioned diagnostic tests were carried out to ensure that the data fits the basic assumptions of classical linear regression model. Consequently, the results for the model assumptions test are presented as follows:

##### 4.7.1 Test for Normality assumption

A normal distribution is not skewed and is defined to have a coefficient of kurtosis 3. BeraJarque formalizes this by testing the residuals for normality and testing whether the coefficient of skeweness and kurtosis are zero and three respectively. Skewness measures the extent to which a distribution is not symmetric about its mean value and kurtosis measures how far the tails of the distribution are. The Bera Jarque probability statistics/P-value is also expected not to be significant even at 10% significant level. The study develops the following hypothesis to check the normality.

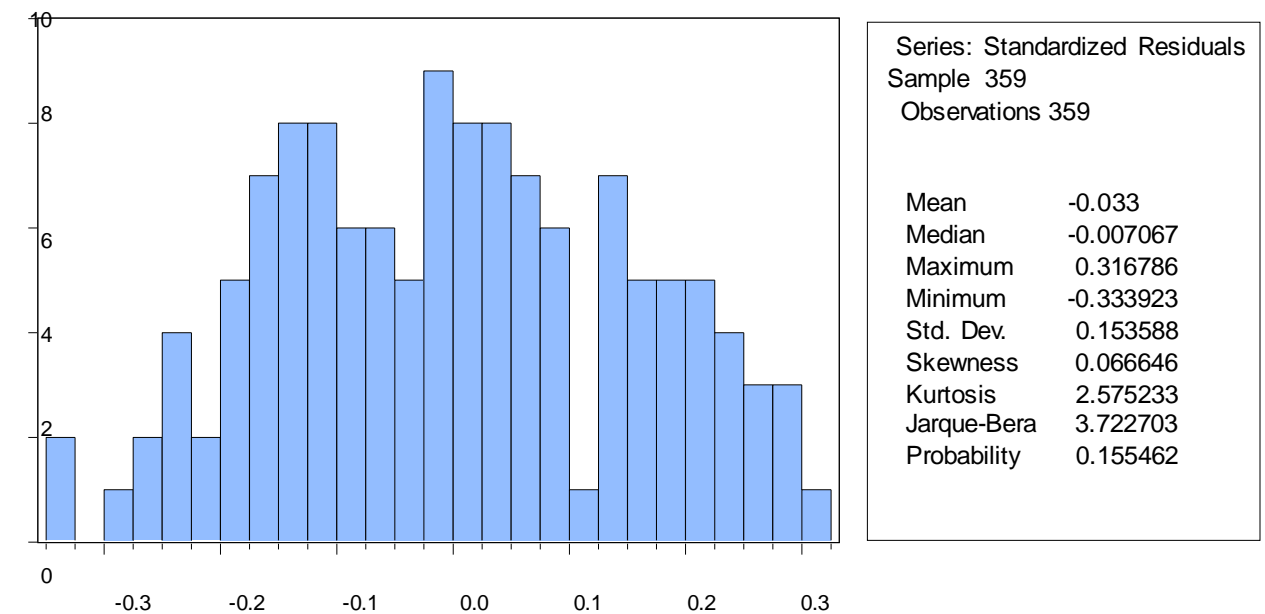


Figure 4.1 Test for normality

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#### 4.7.2 Test for Homoscedasticity assumption

The condition of classic linear regression model implies that there should be homoscedasticity between variables. This means that the variance should be constant and same. Variance of residuals should be constant otherwise, the condition for existence of regression, homoscedasticity, would be violated and the data would be heteroscedasticity. To check for this, Breusch-Pagan-Godfrey test were applied. The Breusch-pagan tests of the null hypothesis that the error variances are all equal versus the alternative that the error variance are a multiplicative function of one or more variables. Hence, following the general null hypothesis of Breusch-pagan tests, the study develops the following hypothesis to check the presence of heteroscedasticity:

**Table 16: Heteroscedasticity Test: Breusch-Pagan-Godfrey**

F-statistic	1.309167	Prob. F(6,352)	0.2582
Obs*R-squared	7.802882	Prob. Chi-Square(6)	0.2529
Scaled explained SS	4.652238	Prob. Chi-Square(6)	0.5891

Source: Authors computation based on survey data, 2021

The finding of the above table reveals that both F-statistic and chi-square ( $\chi^2$ ) tests statistic were used. As can be presented in the above Heteroscedasticity test both the F- and  $\chi^2$  -test statistics give the same conclusion that there is no significant evidence for the presence of Heteroscedasticity. Since the p-values in all of the cases were above 0.05, the null hypothesis of homoscedasticity is failed to reject at 5 percent of significant level. This implying that there is no significant evidence for the presence of heteroscedasticity in these research models. Generally, in all of the regression models used in this study it was proved that the variance of the error term is constant or homoscedasticity.

#### 4.7.3 Test for absence of autocorrelation assumption

Another basic assumption of regression model says that the covariance between error terms should be zero. This means that error term should be random and it should not exhibit any kind of pattern. If there exists covariance between the residuals and it is non-zero, this phenomenon is called autocorrelation.

The Breusch Godfrey serial correlation linearity model test was run. Breusch Godfrey tests were area joint test for autocorrelation that will allow examination of the relationship between  $u^t$  and several of its lagged values at the same time. Following the general null hypothesis of Breusch Godfrey serial

correlation linearity model test, the study develops the following hypothesis to check the absence of autocorrelation:

**Table 17: Breusch Godfrey Serial Correlation linearity model Test:**

F-statistic	0.851376	Prob. F(2,349)	0.4294
Obs*R-squared	1.806553	Prob. Chi-Square(2)	0.4052

Source: Authors computation based on survey data, 2021

The above table 17 indicated that, F test result and the P value of F-statistic is 0.4052 which is way beyond the significance level of 5%. Hence, the null hypothesis of no autocorrelation is failed to reject at 5 percent of significant level. This implying that there is no significant evidence for the presence of autocorrelation in this model. The Chi-Square P-value of the model also supports the absence of autocorrelation. Therefore, we concluded that, the covariance between residuals is zero, data is normal and absence of autocorrelation problem was found conclusively from the linearity model test.

#### 4.7.4 Multicollinearity Test

Multicollinearity exists when there is strong correlation between two or more predictors in a regression model Saunders et.al (2007). This research data multicollinearity assumption is checked by the Pearson correlation coefficient and collinearity statistics.

Checking the multicollinearity assumption is that by looking SPSS analysis output regression table of colinearity statistics value of Tolerance and Variance Inflation Factor /VIF (Field, 2006). The tolerance column value less than 0.2 and VIF value greater than 10 create a multicollinearity problem. Having this, the tolerance and VIF value is shown that there is a minimum tolerance value of 0.311 which is greater than 0.2 and the maximum VIF value is 3.220 which is less than 10. Therefore, the predictors don't significantly correlate each other; hence, there is no problem of multicollinearity in the model.

**Table 18: Collinearity Statistics value**

Model	Collinearity statistics	
	Tolerance	VIF
EPC	.311	3.220

DMPS	.364	2.747
DNBE	.736	1.358
LAU	.632	1.583
RC	.526	1.900
ALI	.427	2.635

Source: Authors computation based on survey data, 2021

#### 4.8 Regression Analysis

In this topic the study is going to describe the relationship between the dependent variable (Interest free banking) and the independent variable; (existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice, lack of awareness and understanding about IFB banking, regulatory challenge and absence of liquidity instrument). To do this, let start with the overall significance positive/negative of the regression model test.

##### 4.8.1 Analysis of Variance (ANOVA)

Analysis of variance (ANOVA) is a collection of statistical models and their associated estimation procedures (such as the "variation" among and between groups) used to analyze the differences among group means in a sample. Analysis of variance is based on the law of total variance, where the observed variance in a particular variable is partitioned into components attributable to different sources of variation. Also, it provides a statistical test of whether two or more population means are equal, and therefore generalizes the t-test beyond two means.

**Table 19: ANOVA**

ANOVA <sup>a</sup>						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	283.602	6	47.267	226.44	.000 <sup>b</sup>
	Residual	78.902	353	.209		
	Total	362.504	359			
a. Dependent Variable: Interest free banking						

Source: Survey data, 2021

As I see from the above ANOVA table the P value is 0.00 which is less than the level of significance or 0.05. Therefore, this is to mean that the model is significant /acceptable from a statistical perspective. To explain more, accepting at least one of existence of potential customers, deposit mobilization and



profitability of IFB service, directives of NBE related to IFB practice and regulatory challenge had a significant positive influential relationship on interest free banking.

#### 4.8.2 Model Summary

**Table 20: Model Summary**

<b>Model Summary<sup>b</sup></b>				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
<b>1</b>	.885 <sup>a</sup>	.782	.779	.45688
a. Dependent Variable: Interest free banking				

Source: Authors computation based on survey data, 2021

A measure of the strength of the computed equation is R-square, sometimes called the coefficient of determination. R-square is simply the square of the multiple correlation coefficients R in the model summary in the above table, and represents the proportion of variance accounted for in the dependent variable (Interest free banking) by the predictor variable. As I can see from the above table, the correlation coefficients are .885, and the R-square is .782. Thus, the predictor variables have shown 78.2% of the variance in the dependent variable. Therefore, the Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable, from the findings in the above table the value of adjusted R squared was .779, an indication that there was variation of 77.9 % on dependent variable due to changes in the independent variable. Hence, the value of R is .885 which implies that about 88.5% of variation in Interest free banking is expressed in the variation existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice , lack of awareness and understanding about IFB banking, Regulatory challenge and Absence of liquidity instrument.

#### 4.8.3 Multiple Linear Regression Coefficients

Regression coefficient is to identifying the relationship between a dependent variable and one or more independent variables. A model of the relationship is hypothesized, and estimates of the parameter values are used to develop an estimated regression equation. Various tests are then employed to determine if the model is satisfactory. If the model is supposed satisfactory, the estimated regression equation can be used to predict the value of the dependent variable given values for the independent variables.

**Table 21: Regression Coefficient**

Model	Unstandardized Coefficient		Standardized Coefficient	t	Sig.
	B	Std.Error	Beta		
(Constant)	.180	.208		.790	
EPC	.351	.084	.292	4.162	.000
DMPS	.490	.075	.425	6.514	.000
DNBE	.274	.088	.227	3.109	.000
LAU	-.275	.047	.129	3.688	.120
RC	.203	.037	.024	3.819	.000
ALI	-.311	.041	.103	2.790	.200
a. Dependent Variable: Interest free banking					

Source: Authors computation based on survey data, 2021

The above table shows that, the P value of the four independent variables (existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice and regulatory challenge.) is less than 0.05. That is the variables existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice, and regulatory challenge has a positive significance effect on the interest free banking. The coefficient of existence of potential customers is 0.351 this value tells about, if the existence of potential customers is increased by one percent, Interest free banking is improved by 35.1%. According to the above table 21, the coefficient of deposit mobilization and profitability of IFB service, directives of NBE related to IFB banking and regulatory challenge is 0.490, 0.274, and 0.203 respectively. This table tells about if the deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice, and regulatory challenge is increased by one percent automatically the value of Interest free banking can improve with 49%, 27.4%, and 20% respectively. The Standardized Coefficient result showed the P value of the remaining two independent variables (lack of awareness and understanding about IFB banking and absence of liquidity instrument) have a negative significance effect on the interest free banking is -0.275 and -0.311 respectively.

The regression result presented in table 20 is summarized into the model specified in the methodology section of this study which is presented as follows.

$$EC = \beta + \beta_1 (EPC) + \beta_2 (DMPS) + \beta_3 (DNBE) + \beta_4 (LAU) + \beta_5 (RC) + \beta_6 (ALI) + e$$

Therefore Interest free banking described in the form of the multiple regression equation Existence of potential customers (EPC), deposit mobilization and profitability of IFB service (DMPS), directives of NBE related to IFB practice (DNBE), lack of awareness and understanding about IFB banking (LAU), regulatory challenge (RC) and absence of liquidity instrument (ALI) would be:

$$\text{Interest free banking} = .180 + .351 (EPC) + .490 (DMPS) + .274 (DNBE) + .275(LAU) + .203(RC) + .311(ALI) + e$$

#### **4.9 Discussion**

The main findings of the present study about the situation regarding IFB services revealed that main challenges faced by surveyed banks in implementing IFB system included lack of awareness by potential customers about IFB services, institutional challenges including taxation, desire for special regulations and lack of specialized human resource. In addition, the difficulty in segregation of funds for effective implementation of IFB was another problem expressed by respondents. On the other side, IFB in Ethiopia was believed to still have a huge untapped opportunity to be exploited by other financial services providers which would use customer satisfaction as a niche in offering IFB services. Other potential opportunities mentioned included global trends, economic growth in Ethiopia and within Muslim communities. The findings of this study are supported by those of previous researches conducted regarding the Interest free banking in Ethiopia. Those studies include Mohamed (2012) Shaik(2014) Sankara muthukumar & Devamohan (2008), and Debebe (2015) which showed that the Islamic banking, had a huge untapped opportunities in Ethiopia to serve more than 30 million Ethiopian Muslims but still needed to address challenges related with lack of awareness and understanding, legal, supervisory, regulatory and/or institutional challenge, and negative attitude of people towards Islamic banking (wrong association with religion), lack of trained human resource, capital resource constraints and lack of suitable banking policies. Furthermore, as indicated in by the IMF (2005) the current trend seems to be toward separation between interest free and conventional banks.

## CHAPTER FIVE

### 5. Summary of Major Findings, Conclusion and Recommendations

This chapter includes summary of the major findings, conclusion drawn from the findings and the study recommendation.

#### 5.1. Summary of Major Findings

The purpose of this study was to examine the prospect and challenge of interest free banking the case of selected commercial banks Jimma city.

The mean value of descriptive statistics revealed that the deposit mobilization and profitability of IFB service with a mean of 3.05 and standard deviation 1.10, directives of NBE related to IFB practice with a mean of 3.60 and standard deviation 1.23, existence of potential customers with a mean of 3.01 and standard deviation 1.32 is in the level of high level. Besides, the regulatory challenge a mean of 2.81 and standard 1.42 is moderate level and also absence of liquidity instrument a mean of 2.26 and standard deviation 1.18, lack of awareness understanding about IFB banking a mean of 2.38 and standard deviation 1.23 is in the level of low level. According to the correlation matrix, the Pearson Correlation coefficients are statistical and significant positive because the significant value is less than the 5% level of significant. Therefore the correlation between interest free banking against existence of potential customers, deposit mobilization and profitability of IFB service, Directives of NBE related to IFB practice and regulatory challenge is 0.874, 0.566, 0.546 and 0.315 respectively. The correlation between existence of potential customers, deposit mobilization and profitability of IFB service, Directives of NBE related to IFB practice and regulatory challenge is strong and positive and the correlation between Existence of potential customers and interest free banking is strong and positive. The findings that there was a significant negative relation between Interest free banking and Lack of awareness and understanding about IFB banking and Absence of liquidity instrument, -0.232, and -0.217 respectively.

The value of  $R^2$  is 0.782 which implies that about 78.2% of variation in interest free banking is expressed in the variation on Existence of potential customers, Deposit mobilization and profitability of IFB service, Directives of NBE related to IFB practice, Lack of awareness and understanding about IFB banking, Regulatory challenge and Absence of liquidity instrument.

The coefficient results show that the interest free banking is primarily and positively affected by Deposit mobilization and profitability of IFB service ( $\beta= 0.490$ ), Existence of potential customers ( $\beta= 0.351$ ), absence of liquidity instrument ( $\beta=-0.311$ ), lack of awareness and understanding about IFB banking ( $\beta= -$

0.275), directives of NBE related to IFB practice ( $\beta= 0.274$ ) and regulatory challenge ( $\beta=0.203$ ). This table tells about if the deposit mobilization and profitability of IFB service and existence of potential customers, directives of NBE related to IFB practice, and regulatory challenge is increased by one percent automatically the value of interest free banking can improve with 49%, 35%, 27.4% and 20.3% respectively. This implies that the deposit mobilization and profitability of IFB service is the most important predictor of the interest free banking, existence of potential customers also has a significant impact ( $\beta= 0.351$ ) and appears to be the second determinant of a respondents interest free banking.

Moreover, existence of potential customers and deposit mobilization and profitability of IFB service has an indirect influence, on directives of NBE related to IFB practice and regulatory challenge on the interest free banking which indicated that existence of potential customers and deposit mobilization and profitability of IFB service has both direct and indirect influences on the interest free banking.

## **5.2 Conclusion**

The main objective of this study was to examine the prospect and challenge of interest free banking the case of selected commercial banks Jimma city with respect to the variables. The study has provided empirical justification for the framework that identifies six constructs of the independent variables and describes the relationship among the constructs and interest free banking within the context of commercial banks Jimma city. The existence of potential customers were there is potential customer in IFB banking service and IFB banking service needs in Ethiopia so it will alleviate the financial service deprivation of the Muslim community and those who need interest free banking service. The deposit mobilization and profitability of IFB service if the bank offers certain IFB banking product of saving and loan service the access to IFB banking will improve the tendency for business expansion and investment activity will increase. Directives of NBE related to IFB the directives of NBE to issue a new proclamation that permitted the establishment of interest free finance in Ethiopia. Lack of awareness and understanding about IFB banking of customer has awareness about the major types of interest free banking product. The regulatory challenge of the bank gives the service in compliance with the service requirement of interest free banking. Absence of liquidity instrument is a lack of institution like interest free money market and capital market would create liquidity and other operational difficulties to IFB practice.

Based on the findings the mean value of descriptive statistics revealed that the deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice, existence of potential customers is in the level of high level. Besides, the regulatory challenge is moderate level and also absence of liquidity instrument, lack of awareness understanding about IFB banking is in the level of low level. Further findings, the study concludes that there is a relationship between the independent variables and dependent variables; the correlation relationship shows that they have strong and a positive correlation with existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice and regulatory challenge on interest free banking. And also Lack of awareness and understanding about IFB banking and absence of liquidity instrument are negative correlation on interest free banking. The coefficient results of the deposit mobilization and profitability of IFB service and existence of potential customers, directives of NBE related to IFB practice, and regulatory challenge is increased by one percent automatically the value of interest free banking and also absence of liquidity instrument and lack of awareness and understanding about IFB banking is negative.

In general, the study concludes that existence of potential customers, deposit mobilization and profitability of IFB service, directives of NBE related to IFB practice and regulatory challenge effect on interest free banking at commercial banks Jimma city.

### **5.3 Recommendations**

Based on the finding of the study, conclusions drawn in line with the study objectives; the following points are recommended in order to improve interest free banking of commercial banks Jimma city.

- The National Bank of Ethiopia should give attention to the IFB system and facilitate regulations that allow effective implementation of IFB system in Ethiopia
- National Bank of Ethiopia and the Shariah Supervisory Board in Ethiopia has to provide more training and create awareness to the staff and public in order to get more opportunities and minimize the equipped challenges by providing the training centre.
- The federal revenue authority should check the issues related with taxation of IFB system.
- Recruitment of more Muslims in banks who would be watching over the IFB system should be considered as it may ensure the conformity of the services and the shariah law.
- Training of necessary manpower specialized on matters of IFB would add an advantage for the banks.
- Research focusing on studying the challenges faced by banks in implementing IFB is desirable as it may provide more details on the subject.

- NBE should adopt Islamic Financial Services Board that provides prudential standards and guidelines for regulatory and supervisory agencies to ensure soundness and stability of Islamic Financial industry including: retail banking, capital markets and Takaful (Islamic insurance).

#### **5.4 Further research and limitation**

It is suggested that there is a need for deep investigation regarding prospects and challenges of interest free banking in the study area. In the future research, the recommendation and the limitation of this research will be addressed and overcome. Furthermore, through applying different research model can enhance the accuracy of the result. The research model can be expanded so that it can fully reflect the challenges and prospects facing interest free banking and financial institutions industry in Ethiopia. Researchers of this study envisions that additional new independent variables can be substituted or add on to the existing independent variables.

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**Annex I**  
**JIMMA UNIVERSITY**  
**COLLEGE OF BUSINESS AND ECONOMICS**  
**SCHOOL OF GRADUATE STADIES**  
**MASTERS OF BUSINESS ADMINISTRATION**

**Questionnaire for Bank customers to collect data**

This questionnaire is designed to collect information on the state of IFB banking in Ethiopia. The information gathered is meant to be used in a study that the researcher is covering under the topic, *IFB banking: Prospects, and Challenges in Ethiopia.* any information gathered will be used only and only for academic purpose only. Therefore, you are cordially requested to give an accurate and honest response so that we can produce quality paper that will serve the interest of the Muslim community.

Thank you in advance for your time and honest response.

**Instructions:-**

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

**Part one:**

**Personal information**

**Instruction:** The following are items which deal with your background information. After I read you each item, you tell me the answer.

**1. Sex** 1. Male 2. Female

**2. Age:**

- 1. 18-30 yrs. 2. 31-50 yrs.
- 3. 51-70 yrs. 4. 71 yrs. & above

**3. Educational status:**

- 1. Illiterate 2. Primary education 3. High School completes 4. University/ College Degree/ Certificate/Diploma

**4. Marital status:**

- 1. Single 2. Married 3. Divorced 4. Widowed

**5. Respondents Occupation (Business Activity)**

- 1. Trader (business man) 2. Entrepreneur/Trader 3. Other 4. Government employee

**6. Kebele** \_\_\_\_\_

**7. Religion**

1. Muslim
2. Orthodox Christian
3. Protestant

**Part two: Dependent variable**

<b>IFB</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	The bank has knowledgeable and experienced manpower to provide interest free banking service					
2	The bank provides its interest free banking product at convenient branch and adequate window with the customer expectation					
3	The segregation of fund from the conventional banking service activity is mandatory to attract the potential customer of interest free banking service					
4	The bank has well versed shariah board members					
5	The bank has enough qualified scholars in IFB banking to ensure that IFB banking service are up to date and fully comply with shariah law.					

**Part three: Independent variables**

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

<b>Existence of potential customers</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	There is potential customer in IFB					

	banking service					
2	IFB banking helps to attract new customers from the existing bank					
3	There is IFB banking service needs in Ethiopia so it will alleviate the financial service deprivation of the Muslim community and those who need interest free banking service					
4	IFB banking will enhance banks brand image as ethical					
<b>Deposit mobilization and profitability of IFB service</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	IFB banking service is one means of resource mobilization in the banking industry					
2	IFB banking system is helpful for the growth of Ethiopian economy					
3	IFB banking has a good system to maintain the risk well					
4	If the bank offer certain IFB banking product (saving and loan service ) the access to IFB banking will improve the tendency for business expansion and investment activity will increase					
<b>Directives of NBE related to IFB practice</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	The directives of NBE to issue a new proclamation that permitted the					

	establishment of interest free finance in Ethiopia					
2	The current global trend in financial service will have positive manifestation on the future of IFB practice					
3	The concentration of the Ethiopian government towards the expansion of IFB banking service					
4	Segregation of fund from conventional banking service activity is mandatory to attract the potential customer of IFB banking					

**Part four: Knowledge of IFB customers towards the interest free banking products**

To what extent are you aware of the following Interest free banking products?

No	IFB products	Fully Aware	Little Awareness	Fully unaware
1	Murabaha (mark-up principle)			
2	<i>Musharaka</i> (joint venture)			
3	<i>Mudharabah</i> (trust financing)			
4	<i>Ijarah</i> (leasing)			
5	Salam (purchase order) financing			
6	Istisnaa (pre-paid purchase)			
7	<i>Wadi'ah</i> (safe-keeping contracts for current deposit)			
8	<i>Wakalah</i> (safe-keeping contracts for agency contracts)			
9	Quard Hassan			

**Part five: Respondents' opinion on the service rendered**

Please tick the number that you feel most appropriate, using the scale from 1 to 5

(Where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree and 5 = strongly agree).

No	Items	Strongly disagree	Disagree	Neutral	Agree	Strongly agree
1	There exists quality IFB banking service delivery					
2	There is quick IFB banking service delivery					
3	Are the service delivery of IFB					

	banking are consistency with Islamic law					
4	I believe IFB banking offers the kind of service and product that I want to use					
5	The bank do sufficient advertisement of IFB banking service and delivery					

**Independent variables challenge**

**Part five: Respondents opinion investigation important aspects of IFB banking** Next, there are listed of items which deal with respondents view on challenges facing IFB Banking in banking industries. So Please tick the number that you feel most appropriate, using the scale from 1 to 5 (Where 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree and 5 = Strongly Agree).

<b>Lack of awareness and understanding about IFB banking</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	Muslim community has awareness about IFB banking system					
2	People believe non –Muslim cannot use product of IFB by wrong association with religious					
3	Customer have awareness about the major types of interest free banking product					
4	The bank have enough qualified staff and scholar in the IFB banking to ensure that IFB banking service are up to date and fully comply with sharia law					
<b>Regulatory challenge</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	There is legal, supervisory and regulatory institutional challenge					

2	There is lack of suitable banking police for interest free banking					
3	There is lack of supportive and link institutional such as sharia board and consultancies successful practice of IFB					
4	The bank give the service in compliance with the service requirement of IFB banking					
<b>Absence of liquidity instrument</b>						
No	Statement	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly agree 5
1	Lack of institution like interest free money market and capital market would create liquidity and other operational difficulties to IFB practice					
2	lack of infrastructures suitable for interest free banking operation					
3	Shortage of IFB banking financial experts					
4	Shortage of short-term investment security					

**THANK YOU!!**

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**Interview questionnaire for IFB managers and Employees to collect data**

1. What do you think about the current status of IFB practice?
  2. What types of interest free banking product does the banking currently made available to its customer? Does customer demand for other IFB product, that the bank currently not providing?
  3. What are the challenges, the banks face in delivering IFB banking product?
  4. What do you think about support from government body on initiation, government regulation and expansion?
  5. As the IFB is in accordance of sharia law do you believe non-Muslim accept sharia law and adopt these service? Is there non-Muslim customer in your bank those used these service?
  6. Do you think the current service delivery of IFB banking are quality, quick and meet the customers need?
  7. Do think that the service delivery of IFB banking are consistency with Islamic law?
- .
- .