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**FACTORS AFFECTING INTEREST FREE BANKING IN ETHIOPIA:
A CASE STUDY OF COMMERCIAL BANKS LOCATED
SOUTH-WEST ADDIS ABABA**

**THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE
REQUIREMENTS FOR THE AWARD OF DEGREE OF
MASTER OF SCIENCE IN ECONOMICS
(DEVELOPMENT ECONOMICS)**

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Factors affecting interest free banking in Ethiopia

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Master of Science in Economics
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Declaration

I, the undersigned declare that this research paper would be my work. Furthermore, all sources of materials used for the paper has be properly collected and analyzed.

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List of Acronyms and Abbreviation

| | |
|-------------|---|
| AAOIFI..... | Accounting and auditing organization for Islamic Financial Institutions |
| CBE..... | Commercial Bank of Ethiopia |
| GOF..... | Goodness of Fitting |
| IFB..... | Interest free Banking |
| IFPS..... | Interest free Product and Services |
| IFSB..... | International Financial Service Board |
| IMF..... | International monetary fund |
| IRB..... | Islamic Retail Bank |
| NBE..... | National Bank of Ethiopia |
| NIB..... | Nib International Bank |
| PLS..... | Profit Lost Sharing |
| SBB..... | Supervisions of Banking Business |
| SEM..... | Structural Equation Model |
| SFH..... | Special Finance House |
| SME..... | Small and micro enterprise |

Abstract

Banking industry fosters economic growth through financial intermediation. Which helps in meeting a debtor with a creditor and perform host of other financial services. Ethiopia adopted Interest Free Banking window scheme in 2011 and Full-fledged interest-free banking by June, 2021 as alternative banking system in addition to conventional by considering substantial number of unbanked Muslims communities, which estimated more than 38 million or 33.8% of total population. The emergence of Interest free financial system has created a new dimension to the current economic models and financial developments. Hence, use of such innovations is highly appreciated even if its successes depend on the various internal and external factors. Therefore, this study aims to investigate the main factors affecting interest-free banking system. For these purposes, primary and secondary data were collected and analyzed by using descriptively and inferential statistics. Finally, the model suggests that Interest free banking has positive and strong relationships with internal and external factors of qualified and skilled human resource, creation of awareness to community, ,suitable and effective banking policy and procedure, effectiveness of existing banks, overall managerial efficiency, working with Sherian Verdict and Principle, Research and development(RD) while contradict with Treasury risk of liquidity and solvency. Finally, enhancing and enforcing standards of regulatory law, policy and procedure is advisable for all commercial banks to sustain all its strength, and to improve their limitation.

Keywords: Bank, Economic growth, Ethiopia, Investment, interest-free window, full- fledged, legal framework, Policy, Regulatory Law.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Interest free banking has grown rapidly over the past decade, and its banking segment has become systemically important in many countries in a wide range of regions. According to IMF (2015), interest free banking is known as Islamic finance. It projected is to continue to expand in response to economic growth in countries with large and relatively unbanked Muslim populations. It is also fueled by the large savings accumulated by many oil-exporting countries that are seeking to invest in Shari'a-compliant financial products. Islamic banking has emerged as a new reality in the global financial outlook since the 1970s (Tahir et al. 2006).

It is an alternative banking system in line with values and ethos of Islam, and governed by the principles of Sharia Law that requires not charge interest and avoid any unethical practices in achieving its goals and objectives (Gait and Worthington, 2008). According to Fakhrol et al (1998) and Usman (2003), the role and functions of Islamic banking within the banking system in a modern economy are very important, and in fact, it is at the heart of every robust economy. The growing reach of Islamic finance promises a number of possible benefits. For example, it is often argued that Islamic finance is inherently less prone to crisis because its risk-sharing feature reduces leverage and encourages better risk management on the part of both financial institutions and their customers. It is also argued that Islamic finance is more stable than conventional finance, because: (i) Islamic Finance involves prohibitions against speculation; (ii) financing is asset-based and thus fully collateralized; and (iii) it is founded on strong ethical precepts. Moreover, Islamic Financial Institutions (IFIs) are considered to be a good platform for increasing access to financial inclusion, including access to finance for Small and Micro Enterprises (SMEs), thereby supporting growth and economic development (IMF, 2015).

Since, Muslims believe that banking with the conventional banks is against their religious faith; large numbers of potential Muslim customers are not banking with the existing conventional banks available in the country. To satisfy the community that have problem with the current banking system and to provide alternative banking system the National Bank of Ethiopia (NBE) was approve a directive "Business of Interest Free Banking No SBB/51/2011" that paves the

way for the establishment of what was called as the first Interest Free bank in Ethiopia. But not allow the establishment of full-fledged Islamic financial institution rather than to open the door for window service existing commercial banks to create an interest-free banking window alongside of their operations. This come in to force in October 2011, but interest-free banking in Ethiopia started in September 2013, when the Oromia International Bank S.C launched the service. The Commercial Bank of Ethiopia joined the market at the end of October 2013, followed by the United Bank S.C, which began providing the service on May 1, 2014 and currently most of commercial banks give windows and also at branch levels services.

However, by revising of SBB/51/2011 Directives of NBE.s by Authorized SBB/72/2019 has allowed all Ethiopian citizen- by origin to establish a bank exclusively engaged in interest- free banking is governed by Sharia principle and ZAMZAM Bank launched its first full-fledged interest free bank service branch and Head quarter, at Addis Ababa, after two years since June12, 2021. The introduction of interest-free banking in Ethiopian banking industry is important for being a world class bank, and in addition to provide options for the customers. As the document of Commercial Bank of Ethiopia (June, 2014) indicates that the interest-free financial products and services offered under separate windows are Wadiya Amanah account, Qard account, Mudaraba account and Bai – Salam mode of financing, Istisna mode of financing, Ijarah mode of financing, Musharakah, Mudarabah, Qard al Hassen and Kafala.

Factors affecting interest-free banking have been at the forefront of several research works in the developed and some developing world. Nevertheless, there is very much limited published works that investigate the factors influencing the use of interest-free banking in the context of developing countries like Ethiopia. To date there have been very few such studies, a remarkable exception to this is the study conducted by Mohamed, (2012) who studied Islamic banking prospect, opportunities and challenges in Ethiopia, Shaik Abdul Majeed, (2014) that studied the Role and Progress of Islamic Banking in India, Ethiopia and Rest of the World and The Potentiality of Islamic banking in Ethiopia by Sankaramuthukumar &Devamohan ,(2008).

In Ethiopia, understanding about factors affects interest-free banking is far more crucial, mainly because interest-free banks have to compete with the long-established conventional banks in a dual-banking system. The survey research on factors affecting of customer and policies and

procedures to use interest-free banking services is timely and very important. Therefore, this study would try to identify the factors affecting to use interest-free bank and banks expansion in Ethiopia to develop full-fledged banking system in Ethiopia.

1.2 Statement of the Problem

Banking system is one of the most important financial intermediaries in the economy. It plays a key role through receiving (collecting) the deposits from depositors and facilitate this resource for loans to applicants for investors to finance new business or to expand existing business as per loan and credit policy and procedure (Iravani et al, 2012). Business organizations and especially the banking sector are operating in an environment characterized by a complex and competitive climate (Agbolade, 2011). In today's competitive world, banks are striving to endure survival and to get economic benefits, in spite of their vital role playing in the economy. Therefore, the banks need to consider several criteria such as bank's image and performance, speed of transaction, channel of delivery system, banking convenience and product diversity to attract customers to continuously do banking business with them and also changing banking product and service they provided, whereas interest free bank based on Sheria Principles in addition to basic criteria mentioned above.

Such scenario had also led to the changes in the customer's taste and demand for better and high quality banking services. So, banks are indebted to apply the financial innovation to respond to such customers' needs because, innovation is very important to allocate scarce resources for sustainable growth of any industry. Interest free banking product and services, are no exception because financial innovation is typically associated with the production of a new financial product or instrument; it may also involve an entirely new financial intermediary system. This is because, from a functional perspective, financial intermediation pools and optimally allocates scarce financial resources in an uncertain economic environment (Merton, 1995).

The introduction of Islamic banking Window alongside with conventional operations has generated new dimension and phenomenal in banking sector in Ethiopia. Moreover, interest-free banking is a new system in Ethiopia which needs a lot of effort and resources to increase the knowledge of its adopters for proper awareness and better perceive about interest-free banking products and to publicize of the products and services in the banking industry for

privileged investment and encouraging other banks from opening up the separate window. However, some bank still providing deposit service only not yet financing as the result of the ability of banks in giving loans, highly depends on their ability of attracting deposits from their customers. Since the principle does not allow them to finance Murabaha projects from the bank's conventional deposits and other banks does not show initiation to open separate window except some of them. To collect significant interest-free banking deposits banks have to attract customers because its achievement depends on customers perceptions towards the banks product and services. For competitive survival, understanding and adapting the innovations to customer motivation and behavior is not an option but an absolute necessity (Owusu, 1999). However, the study undertaken in Ethiopia regarding Islamic banking by Mohamed,(2012), Shaik, (2014) and Sankaramuthukumar &Devamohan, (2008) not covers Factors affecting towards adoption of interest-free financial products and services at bank level.

Similarly, many have tried to identify the factors affecting the banking sector. Bank reputation and good image (Canals, 1993; Bamberger, 1989), location, number of branches (Canals, 1993; Wilde & Singer, 1993), staff professional knowledge (Canals, 1993; Bamberger, 1989), internal auditing and control (Canals, 1993; Wilde & Singer, 1993), the ability of computerization (Canals, 1993), and deposit acquisition (Canals, 1993; Porter, 1985) can affect the success of a bank. Additionally, the number of and quality of services (Bamberger, 1989; Johnson & Johnson, 1982), staff politeness and kindness (Aaker, 1989; Crag & Grant, 1993), government deregulation policy (Aaker, 1989; Bamberger, 1989), and accurate prediction of future bank business (Porter, 1985; Rochart, 1982) are some of the critical success factors (CSFs) in the banking sector. Therefore, it is important to realize and figure out the potential factors which are internal and external and regulatory related factors that influence the newly adopted banking sector. Which is successive research and studies are needed on the area of account holders, employees, management style and organizational structure. Accordingly, this study would aims to examine the potential factors affecting interest-free banking and its expansion in context of Ethiopia.

1.3 Objectives of the Study

1.3.1 General objective

The general objective of study is to identify the factors affecting interest-free banking.

1.3.2 Specific objectives

- To assess the current status of interest-free banking services and financial products.
- Identify major internal and external factors that affect interest free banking services and financing.

1.4 Research Questions

This study has attempt to answer mainly the following research questions to achieve the intended objectives of the study

- What is the current status of interest-free banking service and financing system in Ethiopia?
- To what extent factors influence the Ethiopian dual banking towards use of interest-free banking service?
- How to National banks of Ethiopian regulate interest free bank industry and control commercial banks?

1.5 Significance of the Study

The study has a contribution of practically and theoretically studies. Theoretically the Research would add to the pool of knowledge and as a basis for further research in the field of interest free banking. And, practically the Ethiopian commercial bankers, from this study, enhance their knowledge on the banking users, i.e potential customers and employees. This study also can assist the bankers in formulating different strategies and policies to attract more customers by expanding their IFB services and products for right people and place. Therefore, in order to capture greater market share, knowing about right customer, location, policy and procedure, Sherian based principles, banking system-technology and management style National bank regulation and fiscal policy of the country. Not only does this study has contribute to the theory, it is also intended to have practical value by investigate the factors affect the business as well.

1.6 Scope of the Study

The study would be bounded by both area coverage and problem addressed. There are many financial product and services provided by banks, and the researcher emphasized on the factors affecting interest free banking. Among 19 commercial banks in Ethiopia, 12 banks provide interest free banking services at windows and branch level. Now a day, Zenzam bank started full-fledged banking services. The researcher conducted factors of interest free banking services and financing at branches and windows level conducted by dual banking located at South-West Addis Ababa around Wolkite and Butajira town.

1.7 Limitation of the Study

The researcher limited the scope to factors affecting interest free bank with specific study area South-West Addis Ababa, Wolkite and Butajira towns. And, employees of 32 branches of 12 commercial banks. The results may not similar with other place having access to expertize and experienced human resource located area like Addis Ababa or other regional towns.

1.8 Organization of the paper

This study has five chapters. The first chapter introduces the background of the study, statement of the problem, objectives, significance, scope and limitation of the study. The second chapter reviews theoretical and empirical literatures related to factors affecting interest free banking and its expansion. The third chapter describes the methodology of the study. The fourth chapter presents and discusses the major results and discussion of the study. The last chapter of the paper presents conclusion and recommendations of the research

CHAPTER TWO

LITERATURE REVIEW

2.1 Theoretical literature review

2.1.1 General concepts and definition

The term “Interest Free/Islamic banking” has no single definition. Many scholars“ gives various meaning to this term Islamic banking. It refers to a system of banking or banking activity that is consistent with the principles of the Shari'a (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'a prohibits the payment or acceptance of interest charges for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims although Islamic banking is not restricted to Muslims. (www.islamicbanking.com).

According to Kamarulzaman & Madun (2013) defined Islamic banking is a system of banking or banking activity that is consistent with the Principles of Islamic Law (Sharia). Sharia prohibits interest charged on loans, the practice of giving or accepting additional money for money that is borrowed and the business involved directly or indirectly in alcoholic drinks, gambling related business, or any type of business that is considered harmful or that could cause disruption to the welfare of the society.

The general secretariat of the Organization of the Islamic Conference, defines an “Islamic bank as a financial institution whose statutes, rules, and procedures expressly state its commitment to the principle of sharia and to the prohibiting of the receipt and payment of interest on any of its operation” (Ali and Sarkar 1995).

In Accordance with NBE’s Directive SBB/51/2019 “Interest Free Banking Business” refers to a banking business in which mobilizing or advancing of funds undertaken in a manner consistent

with Islamic law or Sheria Principles; and mode of operation that avoids receiving or paying interests.

“Factors” means a circumstance, fact, or influence that contributes to a result. The concept of Critical Success Factors was first raised by John Rockart in 2004 in his work on management information needs (Rockart, 1979). Since then many researchers have used the term, interchangeably with Key Success Factors, in heterogeneous disciplines. In all forms of businesses, CSFs are the limited number of areas, if they are well managed, they can ensure fruitful competitive performance for the organization. They are the few pivotal areas that must be right for the organization to flourish. Otherwise, the organization’s efforts will be futile or less than anticipated.

- Interest (Riba)

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

- Prohibition of interest

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

2.1.2 Interest free banking models

Interest free window service

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

Subsidiary/branch Interest free banking service

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

Full-fledged Interest free banking service

Once a conventional bank has operated an Interest free window for some time and has gathered a sizeable customer base for its Interest free banking service activities, it may decide to establish an interest free subsidiary, or even fully convert into a full-fledged Interest free bank. By following either of these two routes, the bank may benefit from economies of scope and concentration of knowledge and expertise. The bank will be able to offer a wider range of Shariah-compliant banking products than through the Islamic window alone. For example, it may be better equipped to fully engage in Islamic investment banking activities, such as underwriting sukuk (bond) issuances or managing Shariah-compliant investment and hedge funds, or to manage its own treasury and money market operations (Sole, 2007).

2.1.3 Sources of Funds for Interest free banks

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

Shareholder Funds

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

Wadiah saving accounts

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

The investment accounts operate fully under the Profit-Lost sharing (PLS) scheme capital is not guaranteed, neither is there any pre-fixed return. Under the savings account the nominal value of the deposit is guaranteed, but they receive no further guaranteed returns. Banks may consider

funds under the savings accounts too as part of their resources and use it to create assets (Abdul-Gafoor, 1995). This is theory in practice; however, the banks prefer, encourage and emphasize the investment accounts. This is because since their assets operate under the PLS scheme they might incur losses on these assets which losses they cannot pass onto the savings accounts depositors on account of the capital guarantee on these accounts. In the process the first aim of the depositor is pushed aside and the basic rule of commercial banking capital guarantee is broken (AbdulGafoor, 1995).

Current Accounts-Quer

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

Investment account deposits

Investment deposits represent the case when owners of the fund seek a return on their funds and are willing to spare these funds for an agreed period. These accounts also operate on the principle of mudarabah, but the modes of investment of the funds and distribution of the profits are customized to suit the needs of the clients. In general, these accounts are linked to special investment opportunities identified by the bank. These opportunities have a specific size and maturity and result from the bank's participation in a pool of investment, private equity, joint venture or a fund (Iqbal and Mirkahor, 2011:154). Investment deposits can have various deposit arrangement options:

- Investment deposit under Mudarabah Option - requires that the contract be explicit on the following matters: goal or purpose of the mudarabah, its tenure, role function

of the concerned parties, profit-sharing ratio, principle for sharing losses, the extent to which indebtedness can be created in the name of the mudarabah and the principle for final settlement There can be more than one line of mudarabah deposits in order to address diverse goals and concerns of the depositors. Each such line of deposits can be for a distinct purpose, and has separate starting and maturity dates. (Sayeed, 2007)

- Investment deposit under Musharakah deposit option-investment accounts operate on the principles of (profit sharing). With this option the banks accepting deposits from investors for either a fixed or unlimited period of time. The accounts are also known as profit and loss sharing accounts. Musharakah option can be construed as sharing in both capital and effort (Bala et.al, 2009).
- Investment deposit under Ijara Option -according to this option, ownership of funds always remains with the depositors, and is at no stage shared with the banks (as opposed to the case of mudarabah or musharakah) or transferred to them (as in the case of a loan). The banks come in the picture as manager of depositors to administer the funds. Under these circumstances, owner of the funds and, hence, all profits belong to the depositors. The banks would be entitled to a fee.

2.1.3 Uses of financial resources in Interest free Banking

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

According to Yahiya Abdurahman, (2010) Interest free banking pays close attention as to whom and what to finance. Interest free banks (IFB) do not finance for example alcohol and gambling related businesses, such as liquor stores or gambling casinos. It also does not finance environmentally irresponsible companies and businesses that are not fair to their employees. IFB does not finance speculative activities that are focused on making money out of money, based on speculations in the different financial, commodities, and real estate markets. It is community banking at heart. It believes in community development. It considers its role to be a

qualified professional entity that is sound, safe, responsible, and trustworthy to attract the deposits and savings of the community. (Abdulrahman, 2010). Offer a broad spectrum of financial structures ranging from simple sharia compliant retail products such as saving and current accounts to leasing trust finances and large scale infrastructure financing. (Bala et.al 2009)

- Murabah Financing

Murabah financing is a popular method used by interest free banks to meet short term trade financing needs for its customers. It is often referred to 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 upon acquiring the asset, the bank sells it to the customer at the predetermined mark up. Murabah financing is the back bone of contemporary interest free banking (Bala et.al 2009). An advantage of murabah is that an interest free bank is usually rigorous financially than its customers, so it can obtain discounts on purchases for its clients. When goods are purchased for several clients at one time, the discount may be larger, this controls costs for clients and contributes to the overall success of murabah (Roy, 1991).

- Musharakah Financing

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

- Mudarabah Financing

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

- **Ijarah**

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

2.2 Empirical Literature Review

2.2.1 Origin, Evolution and Growth of Islamic Banking

The first attempt at Islamic banking system can be seen in Pakistan in the late 1950s with the establishment of Local Islamic Bank in the rural area. During that time, the owners of the land who were obedient to the Islamic teachings deposited their money to the bank, which was later loaned to other land owners for the purpose of agriculture development. The borrowers during that time were not charged for lateness in paying back their loans, other than a small amount for the purpose of bank operation. However, the operation of the bank was met with failure due to a number of factors such as the increase in the number of borrowers compared to the money being kept there, which resulted in vast difference between available capital and credit demanded, as well as the problem of the bank employees not having autonomous power on the bank operation. This was because the depositors of that time were hoping to get more benefits as a return for the money that they lent out (CIFP, 2006).

The second attempt was through setting of banking basic principle and Islamic finance that are to be practiced. The endeavor took place in Egypt from 1963 until 1967 through the establishment of Mit Ghamr Savings Bank in the town of Mit- Ghamr. The establishment of the bank was fully through the effort of Dr Ahmad al-Najjar and was done in a disclosed manner

and did not use the Islamization platform as it might wrongly be interpreted as a manifestation of Islamic fundamentalism (Mustafa, 2005). This attempt was a result of a combination of the idea of German Savings Bank that was based on rural banking, with a general framework of Islamic values. The operation of the bank of that time was based on Islamic principles that are free from elements of interests, either to the depositors or from the borrowers (Joni and Hadenan, 2006). The success of Mit Ghamr received praise and recognition from the Ford Foundation through its report in June 1967 because it had gained the support of the majority of the countryside residents, especially the farmers who regarded the bank as their own (El-Ashker, 1987) later written by Abdul Rafay, 2020.

In 1975, a number of Islamic banks that were trade oriented and aimed to offer an alternative in form of Islamic banking and replace the current conventional banking system were established in a few Islamic countries. There were two types of Islamic institutions as well as Islamic principle companies and investments. The first group of institutions was Dubai Islamic Bank, founded in 1975 (Mumin, 1999). From there in 1977 three Islamic banks were established as public limited companies, which were Kuwait Finance House in Kuwait, Faisal Islamic Bank in Egypt and Faisal Islamic Bank in Sudan by Pangeran Muhammad al-Saud. In the same year the International Islamic Bank Association was founded and based in Jeddah for the purpose of advancing the cooperation and coordination all the activities between the Islamic banks (Dakian, 2005). Since the establishment of Dubai Islamic Bank as the pioneer of Islamic trading bank, the world of Islamic banking and Islamic finance has grown rapidly and functioning successfully.

The evidence can be seen around 1980s and 1990s, when the establishment of new Islamic banks were a common phenomenon in the Islamic and non-Islamic countries. The most significant development for Islamic banking can be seen from the granting of license to a big firm which was Al-Rajhi Corporation that conducted foreign money exchange and trading with assets of more than USD 5 billion in Saudi Arabia (Mustafa, 2005).

In the 1977, a multinational investment company under the name Islamic Investment Corporation (ICC Limited) was established in Bahamas (CIFP, 2006). This company owned two branches in Sharjah, United Arab Emirate (UAE) and in Pakistan. In the following year, another public limited company was established in Jordan and became known as Jordan Islamic

Bank for Finance and Investment (Cheah, 1994). The purpose of the establishment was to prepare funding and investment. Later in 1979, two more Islamic finance institutions that acted as public limited company came into reality, which were Bahrain Islamic Bank and United Arab Emirate Islamic Investing Corporation (Siddiqi, 1988). In the consecutive year, International Islamic Bank for investment and development of Egypt was established, followed by International Islamic Bank of Dacca and Masyraf Faysal al-Islami, Bahrain in 1982 (Traute, 1983).

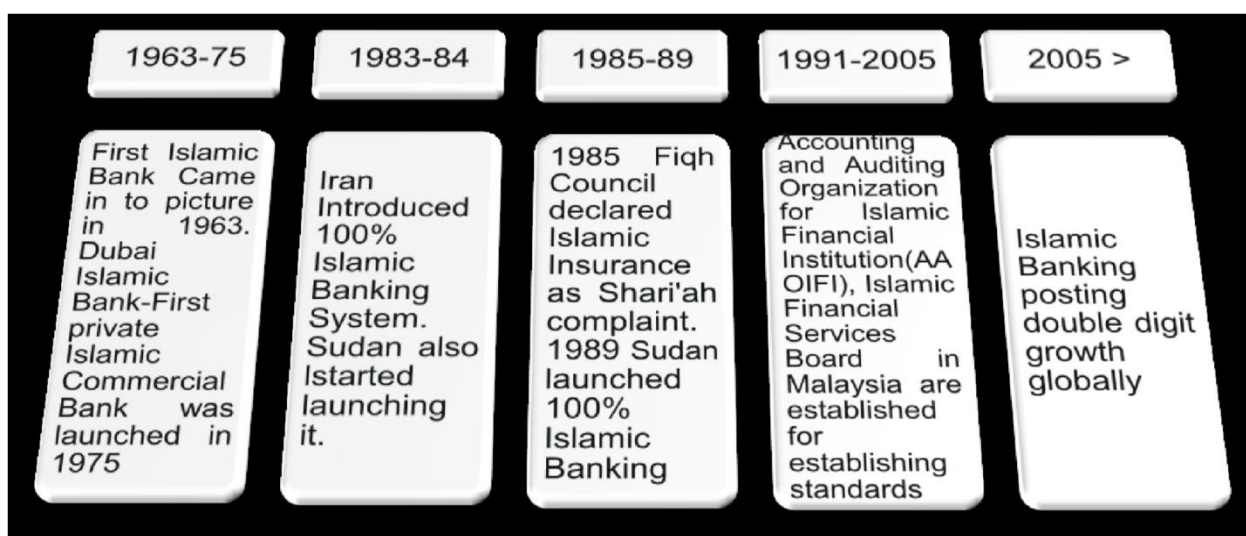
Apart from Islamic countries, the growth of Islamic banks and banking institutions also took place in non-Islamic world, especially in the west and in the countries with Muslim minorities. An example can be seen when Philippines Trust Bank and International Islamic Bank of Denmark were established in 1973, followed in 1978 by the Islamic Banking International Holding in Luxemborg (Ausaf, 1995). The purpose of this bank was to create Islamic banks in different areas that have Muslims communities, as well as to involve in investment projects in both Islamic and non-Islamic countries. The operation of the investment company was further developed when another of its branch was opened in the city of London in June 1983 under the name Islamic Finance House, and another in Denmark, known as Islamic International Bank of Denmark. The growth became steady in 1990s; the market attracted the attention of public lawmakers and institution interested in introducing innovative products.

In 1991 Accounting and auditing organization for Islamic financial institutions (AAOIFI) established in Bahrain and responsible for developing and issuing standards for the Islamic finance industry. AAOIFI has 88 standards including: 48 Sharia; Accounting; Auditing; Governance; Ethics AAOIFI has over 200 members in more than 40 countries. Members include regulatory and supervisory authorities, international/intergovernmental organizations and market players, professional firms and industry associations.

The International Financial Services Board (IFSB) was launched in 2002 and serves as an international standard setting body that provides prudential standards and guidelines for regulatory and supervisory agencies to ensure soundness and stability of the Islamic Financial industry including: retail banking, capital markets and Takaful (Islamic insurance). The IFSB has 13 standards, 5 guide notes, 1 technical note. As of September 2014, the IFSB comprises of

184 members from 41 jurisdictions, including 32 members from the African continent. IFSB has 55 regulatory and supervisory authorities, 8 international/intergovernmental organizations and 121 market players, professional firms and industry associations. Today that Islamic banking industry showing an average growth rate of 17%-20% annually and comprises around 500 institutions in 80 countries, with an asset under management ranging between US \$1.66-2.1 trillion, with expectations of market size to be \$3.4 trillion by end of 2018 (Ernst & Young), according to Standard & Poor's Ratings Services the potential market is \$4 trillion worldwide.

Figures 2.1 : Historical Emergence of Interest-Free Banks ..



Source: Sharia Fortune, December 2011

2.2.2 Underlying Principles of Interest Free Banking

Banking The IFB is governed by the following pillars that basically align to the Sharia Law as articulated by different authors;

- 1) The Interest Free Banking Business is Based on Islamic(Sheria) Law

According to Abdul-Rahman (2010), Shanmugam and Zahari, (2009,) and Hassan and Lewis (2007) the main characteristic of these financial instruments is that they are compliant with the shari'a – the Islamic legal system. The Sharia Law compliance aspect of the IFB is monitored by team of independent Sharia Scholars called Sharia Committee. These laws as referred to the convention are consolidated in (Shari'a Standards for Islamic Financial Institutions, 1432 H-

2010). The principles and sources of Shari'a are: the Qur'an, which is the unchangeable and the proven inculcation of all God's messages to all His prophets, including the Torah and the Gospel; and the way of life and example of living (Sunnah) and sayings (Hadeeth) of Prophet Muhamma. Moreover, they articulate the necessity of independent Sharia Board in that is entrusted give reasonable assurance of the Sharia Compliance aspect of the IFB.

2) Paying or Receiving Interest (Riba)is Forbidden (Haram)

As Islamic banking is interchangeably call interest-free banking paying or receiving interest (riba) is forbidden and this is considered as one of the governing principles of the banking convention. As articulated by Lina (2004) and Shanmugam and Zahari (2009,), lending money at interest has been condemned by men like Plato, Aristotle, Plutarch, Seneca and Cicero, early fathers of the Christian church; the majority of popes and councils up to 1830; likewise modern authors such as Goethe and Wagner. The author then underscores the fight against usury (interest) goes back to the earliest beginnings of civilization. (Ethica"s Handbook of Islamic Finance, 2013 ed.,) stated that the concept of riba was widely recognized among the addressees of the Holy Quran, and it is that concept which is reflected in the legal definition provided for riba either in the hadith or in the later literature of Islamic jurisprudence. According to this definition, any transaction of loan where the payment of an additional amount on the principal is made conditional to the advance of such a loan is called Riba and hence forbidden in Islamic banking. As the convention basis on Sharia Principle that bases on Holy Quran, riba is considered as one of the prohibitions in IFB.

3) Utmost Fairness in All Business Dealing

Fairness I all business dealings is a peculiar feature of the convention irrespective of religion background. According to Meezan bank (2014), if we consider the injunctions of the Holy Quran, it would appear that the system for the distribution of wealth laid down by Islam envisages three objects:

- The establishment of a practicable system of economy,
- Enabling everyone to get what is rightfully due to him, and

- Eradicating the concentration of wealth. It further synthesizes that, of these three objects of the distribution of wealth, the first distinguishes Islam economy from Socialism, the third from Capitalism, and the second from both the same time.

4) Transparency, Consensus and Contractual Agreement between Parties In All Business Dealing

In all business dealing transparency, consensus is a precondition so as all parties make informed decision that will subsequently is substantiated by contractual agreement. Contractual agreements set out the terms and conditions upon and subject to which the person has agreed to purchase the Goods/Service from time to time from the Suppliers and upon which the Institution has agreed to sell the same to the client from time to time by way of facility Shanmugam and Zahari (2009) and Ethica's Handbook of Islamic Finance (2013 ed.).

5) Profit-And-Lost Sharing

The return allocation from IFB is governed by the concept of sharing profit as agreed but loss as per the capital contributed for both the fund mobilization and the financing dimensions. According to Hassan and Lewis (2007), the main difference between an Islamic or interest-free banking system and the conventional interest-based banking system is that, under the latter, the interest rate is either fixed in advance or is a simple linear function of some other benchmark rate, whereas, in the former, the profits and losses on a physical investment are shared between the creditor and the borrower according to a formula that reflects their respective levels of participation. In Islamic finance, interest-bearing contracts are replaced by a return-bearing contract, which often takes the form of partnerships.

6) Forbidden (haram) Business Activities

There are many prohibitions of business activities to engage in IFB convention, but the following will make aqads or contracts invalid as per Islamic Banking Handbook (2010 ed.):

- Businesses that adversely affect public interest;
- Businesses that involve usury/interest(riba);
- Alcohol related trade, Producing and selling goods that are of no use therefore of no value;
- Gharar, i.e. ambiguity or uncertainty;

- Maisir(gambling), i.e. anything that involves betting;
- Pornography; and Pork.

2.2.3 Islamic and Conventional Banking

Islamic banking is operating in the same society where conventional banks are operating and perform all those functions which are expected from a financial institution. However, the philosophy and operations are different. The basic principles underlying Islamic financial transactions are that the purpose of financing should not involve an activity prohibited by Shariah. Islamic banking and finance (IBF) is an ideological discipline that draws on Shariah principles to expunge interest and other exploitative elements from the economic and financial spheres of human society (Khan & Bhatti 2008).

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). Just like conventional, Islamic banks are dependents on their depositors' money as a major source of funds, with the exception that they are not allowed guaranteeing any rate of return on the basis of interest. Moreover, the nominal value of some deposits accounts cannot even be guaranteed, because they are reliant upon the profit- and loss-sharing scheme. While the conventional banks guarantee the capital and rate of return, the Islamic banking system, based on the principle of profit and loss sharing, cannot, by definition, guarantee any fixed rate of return on deposits. In some cases the capital is not guaranteed either, because if there is a loss it has to be deducted from the capital (Mounira 2008).

Although profit sharing and interest-based lending may seem alike, the differences are clearly more than semantic ones. The yield is not guaranteed in the profit-sharing mode. In addition, in interest-based lending the loan is not contingent on the profit or loss outcome, and is usually secured, so that the debtor has to repay the borrowed capital plus the fixed (or predetermined) interest amount regardless of the resulting yield of the capital. Thus, with interest-based lending, the financial losses fall most directly upon the borrower (Kettell, 2011). The utilization of the funds from the institution by a business house or an enterprise is on a profit and loss sharing basis. Gains from the business as well as losses earned due to the business are shared between

the institutions and the enterprise. Investing in Islamic banks may provide more profit and less risk because the financial institution has its own interest as it acts as a partner (Mohammed 2013). Each and every investment based on PLS leads to asset creation rather than debt creation. Islamic banking does not allow the creation of debt through direct lending and borrowing because credit can only be provided through lease or sale-based financing. Consequently, Shariah compliant investments follow the structure of an exchange of ownership in tangible assets or services where money's role is to facilitate the payment mechanism to implement the transfer. Moreover, risks are supposed to be shared among all parties: investors and entrepreneurs bear the business risk for a share in the profits. This contrasts with conventional banking where transactions involving interest payments are common (Chong and Liu, 2009, Kahf, Ahmad, and Homud, 1998).

Islamic banks use the same tools and procedures as conventional banks in those areas where there is no conflict between banking operations and Islamic principles. These activities include foreign exchange transactions, domestic and international transfers, letters of credit and availing safe custody (Al-sultan 1999).

Table 2.1: The difference between Islamic and conventional Banking .

| S. No | Characteristic | Islamic Banking System | Conventional Banking System |
|-------|----------------------------------|---|---|
| 1 | Business framework | Functions and operating modes are based on Sharia'h. Islamic banks must ensure that, and all business activities are in compliance with Sharia'h requirements | Functions and operating modes are based on secular principles, not religious laws or religious guidelines |
| 2 | Interest charging | Financing is not interest (Riba) oriented and should be based on risk-and-reward sharing | Financing is interest oriented, and a fixed or variable interest |
| 3 | Interest on deposits | Account holders do not receive interest (Riba) but may share risk and rewards of investments made by the Islamic bank, not guarantee principal amount in, i.e, Mudarabah Deposits | Depositors receive interest and a guarantee of principal repayment |
| 4 | Risk sharing in equity financing | Islamic banks offer equity financing with risk sharing for a project or venture. Losses are shared on the basis of the equity participation, whereas | Risk sharing is not generally offered but is available through venture capital firms and |

| | | | |
|----|------------------------|--|--|
| | | profit is shared on the basis of a pre-agreed ratio, in Musharakah finance | investment banks, which may also participate in management |
| 5 | Restrictions | Islamic banks are allowed to participate only in economic activities that are Sharia'h compliant. For example, banks cannot finance a business that involves impermissible business activities. | Conventional banks may finance any lawful product or service. |
| 6 | Penalty on default | Islamic banks are not allowed to charge penalties for their enrichment. They may, however, allow imposition of default or late payment penalties on the grounds that these penalties discourage late payments or defaults, which impose administrative costs on banks for processing and collecting the amount owed. Penalties are donated to a charity organization, not income of the Islamic Banks. | Conventional banks normally charge additional money (compound interest) in case of late payments or defaults. |
| 7 | Avoidance of Gharar | Transactions with elements of gambling or speculation are discouraged or forbidden. | Speculative investments are allowed |
| 8 | Customer relationships | The status of an Islamic bank in relation to its clients is that of partner and investor. | The status of a conventional bank in relation to its clients is one of creditor and debiter. |
| 9 | Sharia'h supervisory | Each Islamic bank must have a supervisory board to ensure that all its business activities are in line with Sharia'h requirements. | Conventional banks have no such requirement. |
| 10 | Statutory requirements | An Islamic bank must be in compliance with the statutory requirements of the central bank of the country in which it operates and also with Sharia'h guidelines. | A conventional bank must be in compliance with the statutory requirements of the central bank of the country in which it operates and in some places, the banking laws of state or other localities. |

Source: Shanmugam, B. and Z.R. Zahari, 2009.

2.2.4 Empirical Review at International Level

Diversified studies have been conducted on distinctive country-specific or project-specific topics. Most of them concentrate on risk management, general management issues, the legal

system, and Sharia-related topics. However, in this study we tried to employ a different approach to pinpoint factors affecting interest-free banking and finance industry positively or negatively with their levels of significance, by using the concept of Factors Affecting to distinguish the potential factors of success or failure in the IFB industry in general and the full-fledged IFBs in particular.

Many researchers have studied various topics by using the concept of Critical success Factors(CSF), applied literature reviews, expert interviews, surveys and case studies or a combination thereof (Aerts *et al.*, 2014; Alotaibi & Nufei, 2014). Pickings the experience of other companies or projects to identify success or failure factors is a common occurrence in the CSFs-related studies (Nah & Lau, 2015). Thus, in this study, I used the experiences of selected countries IFBs' or specific Interest-free banks and financial institutions. I used a purposive sampling so as selected the countries which have similar macroeconomic and social status with Ethiopia. Besides, I considered the Islamic Finance Country Index rankings to identify the success factors in selected countries. Accordingly, first, am identified the failure factors of Interest-free banks and institutions and challenges faced in some countries. Secondly, the success factors in some countries cheered as flourishing in the sector. Finally, based on these, I tried to identify the potential factors those affect positively and negatively interest free banking service and financing of commercial banks in Ethiopia.

2.2.5 Identifying Factors Affecting Interest Free Bank

Since the birth of the concept of CSFs, manifold studies have been conducted in broadening disciplines. These works have identified a lot of CSFs in different areas by using various methods. In general, studies on project management and related topics, project management actions, project procedures, human-related factors, project-related factors, and external environment are CSFs (Alias *et al.*, 2014). Similarly, project control, schedules, budget, top management support, access to organizational resources, the competence of the project manager and project team, clarity of project goals, cultural factors, team building, risk management, the motivation of project team members, effective communication between project stakeholders, and effective coordination of project activities can be sources of CSFs in project management (Alotaibi & Nufei, 2014; Pourhanifeh & Mazdeh, 2016).

The concept of Critical Success Factors was first raised by John Rockart in 1979 in his work on management information needs (Rockart, 1979). Since then many researchers have used the term, interchangeably with Key Success Factors, in heterogeneous disciplines. In all forms of businesses, CSFs are the limited number of areas, if they are well managed, they can ensure fruitful competitive performance for the organization. They are the few pivotal areas that must be right for the organization to flourish. Otherwise, the organization's efforts will be futile or less than anticipated. Success, in this context, can be aspects, mainly planned by the organization such as profitability, high market share or high customer size, and so on or other states which can determine the existence of the company. Therefore, the CSFs are areas of serious concern in planning and performing for the management of any organization (Rockart, 1979).

Any manager, at any level, has many areas of concern. However, CSFs are the few key situations in which encouraging results are unambiguously needed to reach his/her goals. Therefore, since these factors are critical, the manager should have the proper knowledge and preparedness to enable him/her to analyze whether things are ensuing satisfactorily well in each aspect. For an organization with forethought to be successful, only setting goals, objectives, and strategies is not enough to be competent in the market (Bullen & Rockart, 1981).

Bullen & Rockart (1981) classify CSFs using three dimensions; the internal-external, the monitoring vs. building – adapting, and the extended classification one. In the third dimension, noticing that CSFs are distinctive for different organizations and level of management, Bullen and Rockart have identified five sources of CSFs.

- 1) *The Industry* – These factors are related to the characteristics of the industry. Every manager of the company in the specific industry pays attention to these factors. These factors include the demand, the technology used, product categories and so on.
- 2) *Competitive Strategy and Industry Position* – Organization's own history, internal situation and current competitive strategy create various CSFs. Besides, its particular niche in comparison to the leading firms in the market and geographic position are sources of CSFs for any company.

- 3) *Environmental Factors* – These are factors which are uncontrolled or insignificantly influenced by the company. Therefore, organizations always try to cope up with the environmental determinants. In this regard, the most common examples of environmental sources of CSFs are the national economy, national politics, population trends, regulatory trends, and energy sources.
- 4) *Temporal Factors* – These are time-bounded sources of CSFs which arising from a lack of resources to implement a strategy or perform an activity. Lack of managerial expertise or skilled workers in a specific but critical activity are the best examples.
- 5) *Managerial Position* – Each managerial position produces many associated CSFs for a company. For example, managers affect the product quality or service quality, inventory control, financial management and so forth.

Similarly, many have tried to identify the Factors affecting the banking sector. Bank reputation and good image, (Canals, 1993; Bamberger, 1989), location, number of branches (Canals, 1993; Wilde & Singer, 1993), staff professional knowledge (Canals, 1993; Bamberger, 1989), internal auditing and control (Canals, 1993; Wilde & Singer, 1993), the ability of computerization (Canals, 1993), and deposit acquisition (Canals, 1993; Porter, 1985) can affect the success of a bank. Additionally, the number of and quality of services (Bamberger, 1989; Johnson & Johnson, 1982), staff politeness and kindness (Aaker, 1989; Crag & Grant, 1993), government deregulation policy (Aaker, 1989; Bamberger, 1989), and accurate prediction of future bank business (Porter, 1985; Rochart, 1982) are some of the CSFs in the banking sector.

Likewise, the major CSFs in the banking industry can be categorized into four general areas; administrative factors, human resource factors, technical factors, and regulatory factors (Rus *et al.*, 2016). These are presented in the table below

Table 2.2 *Categories of Major Factors in the Banking Industry .*

| Administrative | Technical | Regulatory | Human Resources |
|---|--|--|---|
| Efficiency of Information System Administrative | Risk Management | Monitoring Mechanisms and Management | Capacity of the Top Management |
| Structure Processes | Security and Functional Safety | Conformity with the National Law | Professional Knowledge Communication Availability |
| Ability of Computerization | Production Innovation | Compatibility with Economy's sectors | Specialist Human Resources |
| Size of the Bank | Trust to Information System | Government Deregulation Policy Number of Bank Branches | Education and Training |
| Bank Reputation and Good Image | CRM (Customer Relationship Management) | Procedures and Internal Regulations | |
| Transparency and Organizational Culture | Soundness of bank System | the Level of Taxes | |
| Strategic Approach | Bank safety | | |
| Quality of Services | Speed of Business Handling | | |
| Software and Techniques | | | |

Source: Adapted from Rus *et al*, 2016.

South Africa

South Africa is one of the Sub Sahara African countries, which introduced an IFB early. Islamic Bank Ltd (IBL), the country's first IFB, established in 1988 as a result of community efforts

and private persuasion sidestepping the clear reservations expressed by the regulator. It was intended to be an initial test of the concept in the country and was granted a license with a condition to follow the Sharia principles. However, its collapse in 1997 created reputational damage to the persistence of the sector in South Africa. Its failure was not by chance or by any concealed reasons.

Nathie (2010) argues that there were some noticeable reasons for the downfall of IBL. The first reason was the unique circumstances seen from the commencement. Rather than following strict regulatory requirements, the bank was established with the special help and efforts of individuals and community leaders. The second reason was the consistent liquidity stress of the bank since its formation. High proportions of assets were tied up in customer advances, which made it unmanageable to collect. As a result, the bank became in jeopardy to liquidity problems since the assets were unable to meet astonishing mass withdrawals. Thirdly, IBL has faced serious management problems. Its management was more concentrating on real estate development projects than the routine but critical daily operations. This made the bank poor in credit risk management, internal control, and related issues. In the end, the regulative body (South Africa Reserve Bank) has observed dubious management practices and was forced to act even though there was a political pressure not to do so. The reserve bank found that the bank was bankrupted mainly due to large insider and unsecured lending practices.

IBL has also faced grave irregularities, Shariah non-compliance risks, and accounting shortcomings (Nathie, 2010). The large proportion of the bank's revenue source was the trade-based Murabaha contracts and real estate contracts. Indeed, these contracts had long tenure spread over longer periods and created a mismatch with the short-term deposits of customers. Besides, such transactions were notified using manipulated accounting figures and resorted reports. Moreover, the bank was forced to secure ribabased loans from other banks using a fixed property as collateral. This was a clear break from the Shariah norms and practices which affected the earlier genuine debt of senior customers. When the problems started, the irregularity was expanded by allowing immense withdrawals by large depositors closely associated with the management of the bank. It is also observed that the Shariah scholars assigned as a supervisory team do not satisfactorily accomplish their duties due to a lack of knowledge of such a complex

financial condition. However, they could only raise the number of Sharia non-compliance practices of the bank.

Turkey - Ihlas Finance House

Ihlas Finance, a subsidiary of Ihlas Holdings, registered as a Special Finance House (SFH) in 1995 to offer interest-free financial services to investors and small savers. It was the first domestic Interest-free financial institution. Its nominal capital was initially 1 trillion Turkish Liras, (which was equivalent to \$12.3 million), and this grew to 6.5 trillion (equivalent to \$80 million) within a year (Ali, 2007). In 1999, the balance-sheet assets reached above 633 trillion Turkish liras. However, when the banking crisis happened in the country in 2000, Ihlas Finance faced a run out of its deposits, and the regulatory body canceled its license in Feb. 2001.

According to Ali (2007), the main reasons for the failure of the bank include macroeconomic factors, banking industry-related factors, SFH SubSector related factors, and some internal problems. The macroeconomic factors were caused as a result of the hyperinflation the country faced. Similarly, the banking industry-related factors were mainly caused by the overall economic crisis and affected the sector in general. When the conventional banks were affected, they withdrew a high amount of money from the Special Finance Houses in which Ihlas Finance had more 40% market share. The internal factors behind the collapse of the institution include its lower capital adequacy ratio than similar financial organizations, controlling failures, management failures, fraud, strategic failures such as allowing withdrawals from investment accounts, regulatory failures, and lack of enough support from the governmental bodies such as the Capital Markets Board. Besides, since it is an Interest free financial institution, the deposits were not protected by the Central Bank's insurance system, and it was impossible to invest in government securities. Furthermore, its ownership structure, in which about 54% were in the hand of a single holding had accelerated its failure.

Jordan – The Islamic Investment House

Jordanian expatriates working in Kuwait and a group of Kuwaiti investors started an initiative to establish a financial institution in Jordan that can work based on Shariah principles. In 1981, they succeed to do so by collecting 4 million Jordanian dinars (JD) out of which about 75%

were covered by Jordanians and started to operate within a year. In the first three years, it recorded an amazing performance by boosting the confidence of its customers. However, in the coming year, it started to lose the Market Value Added (MVA), which is a direct reflection of the market value of equity and became negative in 1986. This is mainly due to weak management. The management was unable to observe the problem early and failed to immediately fill the gap. Consequently, the bank started to collapse and the Central Bank of Jordan started to interfere. When the situation became clear to the public, depositors rush to withdraw their money and the efforts of the Central Bank to save the bank had failed. In the end, an interim committee found that the loss of the bank was far higher than the value of its stockholders. As a result, the military persecutors investigated and directed a number of charges for the management in which a couple of cases of embezzlement, fraud, manipulation of credit, and fabricated financial statements identified (Salamah, 2014).

Morocco

Morocco is one of the African countries, which recently recorded an evident rise in Interest-free Banking and Finance. Its record in gaining the highest increase in a position in the Islamic Finance Country Index from 48th in 2018 to 19th in 2019 is a comprehensive indicator (IFCI Report, 2019). However, it does not mean that everything is going well in a country where the IFB sector is in its unfledged age. The IFB sector in Morocco has been facing some hurdles even though it is in the top 20 major IFB economies list because of its recent signs of progress. The first challenge is the lack of legal and institutional setup. Unlike the conventional banking sector, the IFB in Morocco lacks a proper regulatory and institutional framework. Secondly, there is a huge gap of skilled human power in the industry. So far, those employed in the sector are mostly experiences in general banking operations. Consequently, a lack of educated personal both in Sharia and banking practices are affecting the sector. Thirdly, there is a critical gap in customer knowledge of the sector. It is identified that the appetite for IFB products is high in the population. However, most of the customers are not aware of its services, which affected the penetration of the banks into the market. Finally, the sector is challenged by the lack of enough infrastructures in the sector, which could attract more foreign investment to the economy (Rhanoui & Belkhoutout, 2017).

Moreover, the other critical factor affecting the IFB sector in Morocco is the socio-cultural orientation to the concept of Islamic banking and finance (Rhanoui & Belkhoutout, 2017). Even though most of the clients are accepting the idea of Islamic banking and finance as an economic institution, significant segments of the population do not accept the use of 'Islam' as a promotional term for the economic transaction. They prefer to be attracted by the IFBs' legal and financial rules and strengths than their attachment to the religious moral rules.

Tanzania

One of the countries with magnifying IFB in Eastern Africa is Tanzania. Established in 2011, Amana Bank was the first full-fledged Interest-free bank in the country. Currently, it has eight branches throughout the country, and its total assets reached nearly 100 million dollars. In addition to Amana Bank, two local banks, namely the National Bank of Commerce (NBC) and People's Bank of Zanzibar as well as three foreign banks, Stanbic Bank, Kenya Commercial Bank, and Eximbank have Interest-free banking window services (IFN, 2020). Moreover, there are few Interest-free saving and Credit Cooperative Societies (SACCOS) in the country.

Since the inception of the IFB services in the country, the most vital hurdle of the sector in Tanzania is the lack of a legal framework (IFN, 2020; Issa, 2018; Sulayman, 2015). Despite the growth of the services, there is no dedicated legislation or legal framework for Interest-free banking and finance in Tanzania. There is no recognition of Shariah-compliant banking products in the regulation. Consequently, the IFBs are treated equally with the existing conventional banks. Even though there is no legal support for the establishment of the IFBs, the aspiration of the Muslims in the country has pushed for the existing banks to emerge. However, the success of the sector is not comparable to the aspirations of the people. Primarily, they failed in the financing side to concentrate on deposit services (Issa, 2018). Moreover, in addition to the major legal challenge, they got other reasons for their failure. These include historical, political, taxation, consumer behavior, lack of creativity, lack of research, and lack of effective marketing strategies (Issa, 2018; Sulayman, 2015).

Based on the challenges being faced in the sector in Tanzania, Issa (2018) argue that the challenges can be managed if some solution were implemented. The primary recommendation is the introduction of a special legal system addressing the sector. Secondly, there should be an

effort on promoting disciplined entrepreneurship and ethical values. IFB is based on shariah principles and thus needs to follow the overall Islamic values in practicing the business transaction. Moreover, the banks in Tanzania have to concentrate on overall risk management than specific credit risk. This is because there are tendencies to guarantee capital providers with a fixed and predetermined rate of return. Finally, producing committed and qualified management personnel in the sector is important.

Ghana

The initiative to launch a full-fledged IFB in Ghana has begun in 2008. The proposal of establishing an IFB which concentrates on corporate banking, car financing, house financing, and retail banking products earned an affirmation by the Bank of Ghana and the Ministry of Finance. Consequently, entrepreneurs, small and medium enterprises, and corporations have been prompted to engage in the sector. However, the drive faded because of a high interest-rate in the country which above 17%. Currently, only Access Bank Ghana, Wenchi Rural Bank, Ghana Islamic Microfinance, and Salam Capital offers limited Interest-free banking services in the country (Abdul-Wahab & Abdul Razak, 2019).

In Ghana, even though its importance is recognized and introduced into the banking sector, it has faced some challenges. The first one is a lack of awareness about interest-free banking. Not only non-Muslims but also Muslims have a scanty perception on the issue. The awareness about the sector is too low to attract sufficient clients and investors (Abdul-Wahab & Abdul Razak, 2019; Mbawuni & Nimako, 2016). Secondly, in the mostly non-Muslim populated nation, there is a disinclination of non-Muslims to utilize the services. As a result of a lack of awareness, there is a tendency not to use the IFB services by the non-Muslims. This makes the proportion of the population using the services very low (Abdul-Wahab & Abdul Razak, 2019). Besides, it became wearisome for the interest-free banks to compete with the experienced and strong conventional banks.

Nigeria

Nigeria has introduced IFB operations lately. When the Central Bank of Nigeria issued a new regulation which included the operationalization of non-interest banks in 2011, it paved the way for the establishment of the first full-fledged bank in the country. Later, another full-fledged

bank followed and several conventional banks have introduced window-based services (Dabor & Aggreh, 2017).

Like most of the other new entrant countries to the sector, Interest-free banking and finance service providers in Nigeria have also dealt with various challenges. Religious connotations, lack of human resources, lack of common Shariah board, poor linkages with investment institutions, double taxation challenges, and corruption are the major ones. As a result of the political condition of the nation, the first critical challenge was the misrepresentation of IFB services. Many groups created ethnoreligious sentiments and connotations. Some considered it as a process of 'Islamization' of the country. This has affected the investors' genuine interest in the sector (Dabor & Aggreh, 2017; Abdullahi, 2016). Moreover, the sector has faced a lack of skilled and trained human resources and law awareness problems. Furthermore, the absence of a well-organized and communal Shari'a advisory committee is a potential challenge. Besides, the linkage of the IFB sector with investment institutions is very limited because of the difference in nature. This problem has seriously affected the operation of the IFBs in mobilizing funds for investment (Dabor & Aggreh, 2017; Abdullahi, 2016; Olaoye et al., 2013).

Pakistan

Pakistan is one of the countries, which introduced modern IFB. The introduction of IFB in the country goes back to the 1970s. In 1979, House Building Finance Corporation and another two mutual fund companies (NIT and ICP) have initiated non-interest based operations in Pakistan. With the positive support of the government, currently, Pakistan is the owner of many IFBs with thousands of branches throughout the country. However, the IFB sector has various challenges, even though it is hailed as one of the swiftly growing IFB services in the world (Zaheer & Laila, 2019).

Firstly, the sector in Pakistan, as did in other countries, is facing a lack of innovative products. The products available in the market are very limited. Secondly, there is an absence of a price benchmarking problem. In a country dominated by conventional banking operations, the IFBs also have similar benchmarking for pricing their products. Thirdly, as observed in many countries, there is a lack of public awareness in the sector. Many people do not differentiate the products of the IFBs from conventional banks due to a lack of knowledge. Besides, the IFB

sector in Pakistan has limited operations in financing products with high-return, poor risk management practices, absence of microfinance services, absence of secondary markets, conflict on Shari'a verdict, lack of qualified human resources, and delay in repayment. Furthermore, the presence of Window based IFBs, which operates by fulfilling the minimum requirements of the regulatory body, has created a challenge for the full-fledged banks. This created confusion among the community makes them question the sources of finance and the reality of their operations to be interest-free (Zaheer & Laila, 2019).

According to the Islamic Finance Country Index, Indonesia, Malaysia, Iran, Saudi Arabia, Sudan, Brunei Darussalam, United Arab Emirates, Bangladesh, Kuwait, and Pakistan are the top ten countries in the IFB sector performance (IFCI, 2019). This implies that these countries have higher total rates for the number of full-fledged IFBs, number of non-banking Islamic financial institutions and windows, Sharia supervisory regime, Islamic financial assets, Sukuk, education and training and Islamic law and regulatory system. In general terms, there are some factors for the availability of strong or successful IFB sectors in these countries. However, each country has its strong characteristics.

Indonesia

Being on the top of the list, Indonesia has the strongest IFB sector which includes various interest-free financial institutions. According to the Indonesian Islamic Economic master plan (2019), the IFB sector has been moving ahead due to support from regulators and government bodies, government's vision encouragement of the halal industry and social interest-free finance, the growing number of education programs dealing with interest-free banking at the university level and the development of research outcomes related to it, the enhancement of financial literacy which initiates to broaden the market size of interest-free banking. Moreover, the development of financial technology (fintech) plays a vital role in the great progress of the sector in Indonesia. Moreover, it created a sector accepted as truly sharia-based by the customers and employees of the sector (Widigdo et al., 2016).

Malaysia

Malaysia is the other global leader of the sector. It has been praised as the center of IFB. Even though Indonesia is now on the top because of the vast expansion of the sector to its vast

population, Malaysia has one of the best IFB industries in the world. Some of the factors which helped the country to be a leader include the legal framework, capital growth, product diversification, and strong Sharia governance. Generally, the availability of a strong legal framework created a very constructive environment for the IFBs to grow. Besides, the country attracted huge investments in the sector. The share of the IFB assets in the overall banking sector is one of the top rates in the world. Moreover, Malaysian IFBs have a lot of products to offer their customers (Abdullah, 2017). Furthermore, investment in an information system (IS) infrastructure in Interest-free financial institutions in Malaysia is remarkable. Technological developments play an everincreasing role in providing quality banking services and staying competitive in the market (Kuppusamy et al., 2009).

Brunei Darussalam

Brunei Darussalam is in the other country with a strong IFB sector in the world. In addition to Indonesia and Malaysia, Brunei Darussalam created a favorable environment for the sector. In 2019, the country has jumped to the 6th position from its previous position in the Islamic Finance Country Index ahead of all GCC countries except Saudi Arabia. Consequently, Brunei Darussalam, Indonesia, and Malaysia created the second strongest regional IFB block in the world next to the GCC (IFCI, 2019). The reasons for the emergence of successful IFB sector in Brunei Darussalam are welcoming political condition; well-organized socio-political process; the collaboration of different groups in different economic classes; economic growth; and the enormous oil exports of the country (Yusuf et al., 2019).

Iran

The other country with a strong IFB sector is Iran. Since the enactment of the Law of Usury-Free Banking Operations in 1983, the country has replaced the whole banking industry with the IFB system. According to the law, banks accept three types of deposits; Qard al-Hashanah, general term investment deposits, and project-specific investment deposits. On the asset side, banks have many contracts to provide finance. These include Qard alHashanah, Mudarabah, Musharakah, and Salam (Iqbal & Molyneux, 2005). In addition to this IFB favoring policy, there are other success factors of the sector in Iran. The effective administrative and

management styles, technical and infrastructural strengths and the legal and regulatory frameworks are the most CSFs of the current IFB in Iran (Javadin et al., 2016).

Bangladesh

The IFB sector is also very strong in Bangladesh. It is an influential sector in the overall banking industry (Yousuf et al., 2014). One of the reasons for the strong IFB sector in Bangladesh is strong managerial efficiency (Samad, 2019). The other factors are popular support and vigorous market demand for IFB services, the focus of the IFB on the welfare of the community, the encouragement of equity and justice in the economy, and innovative Interest-free banking services (Rasel et al., 2018). Besides, the Central Bank of Bangladesh has given some special treatments for Interest-free banks. The first is Interest-free banks were permitted to maintain a 10% statutory liquidity rate, which enables them to have excess liquid funds, in so doing, the banks' return rise. The second one is the freedom of fixing profit-sharing ratios and markups. Finally, the recompense of 10% of the comparable administrative cost on a portion of their balances set aside to the central bank that lets them reap a high profit (Perves, 2015).

United Kingdom

IFB sector was also successful in expanding in Western Countries and the United Kingdom has emerged as a hub for Islamic financial activities in the West. In the United Kingdom, IFB has been hailed as a promising element of the banking sector in the last few years as a result of interlinked factors. The first factor of success is the willingness of the UK government. Second, it was clearly stated that there was an ambition to make the country the hub of IFB for economic gains and for ensuring the rights of citizens. The third important factor was the availability of a favorable legal system. The UK has established a single regulatory system that oversees the operations of the whole financial. This later helped the development of the IFB sector. Moreover, the active pressure and commitment of individuals and community leaders have helped a lot in the expansion of IFB in the UK (Belouafi & Chachi, 2014).

Table 2.3 Summary of Factors affects IFB Sector .

| INTERNAL Factors | | |
|--|---|---|
| Administrative Factors | Technical Factors | Human Resources Related Factors |
| Overall Management Efficiency | Liquidity Management | Qualified TopManagement |
| Marketing Strategy | Risk Management | Skilled and Professional Staff |
| Corruption, Fraud And Embezzlement | Software and Technology | Staff Creativity |
| Organizational Culture | Safety and Security | Investment in Research |
| Capital Adequacy | Technical Irregularities Management | Investment in Training And Education |
| Sharia-Based Deposits Management | Accounting and Auditing | |
| Strategic Approach | Product Innovation | |
| Ownership Structure | Investment and Financing Capacity | |
| Administrative Structure | Customer Relationship | |
| Procedures and Internal Regulations | Sharia-Compliant Price Benchmarking | |
| Speed of Business Handling | | |
| Size of the Bank | | |
| Reputation and Image | | |
| EXTERNAL Factors | | |
| Shariah Related Factors | Social Factors | Industry Related Factors |
| Shariah Non-Compliance Risk | Community Awareness | Competition with Management Conventional Banks |
| Religious Connotations Conventional Banks | Readiness of Muslims to Window-Based IFBs | Availability of Microfinance with Others Services Utilize the service Presence of institution |
| Riba-Based Financial Transactions | Community Participation | Disciplined Entrepreneurship and Ethical value |
| Capacity of the Shariah Board Conflict management based on Shariah Verdict | Healthy Aspirations of the Community | Availability of secondary market |
| Availability of a Common Shariah board | | |
| Macroeconomic Factors | Regulatory Factors | |
| Economic Growth Inflation | Legal and Institutional Set Up Controlling Capacity | |
| Money Supply | Positive Support of the Government | |
| International Trade | Infrastructure | |

Source: Compiled from the Countries' Experiences.

2.2.5 The potential Factors of full-fledged IFBs in Ethiopia

Interest-free banking and finance is at its infancy stage in Ethiopia. Like most of the countries, especially African countries, the sector is facing challenges, but also progressed into another phase. The ascendancy of Window-Based IFB services may be challenged soon by the commencement of full-fledged IFBs. The banking industry is not a well studied area; few studies were conducted on the attributes of IFB. Noble (2019)”Factors Affecting Implementation of Interest Free Banking Services in Ethiopia: The Mediation Role of Customer Involvement” investigate major factors affecting the implementation of Interest free banking services among customers in recognizing factors that need consideration in implementing IFB service in Commercial Bank of Ethiopia, Addis Ababa, Ethiopia. Results showed that, except relative advantage, all the other variables: Awareness, compatibility, complexity, observability, perceived risk, religious beliefs and customer involvement were significant on the implementation of IFB services.

On the other hand Teferi’s (2015) study about the “Contribution of IFB to economic development and its prospect in Ethiopia”. He assessed the contribution of the inclusion of the Muslim population in the banking (financial system) to the economic development and GDP growth.

Another study by Debebe (2015) has conducted a study on “Factors Affecting Customers to Use Interest Free Banking in Ethiopia”. The study is centered on “customer” 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 effect on the attitude towards interest free banking in commercial bank of Ethiopia.

Akmel (2015) the study focused on assessing challenges and prospects of Islamic banking service in resource mobilization efforts in three commercial banks in Ethiopia. This study is more concentrated on the challenges in the banks’ operational activity of resource mobilization.

The research made by Kerima (2016) finds out the following challenges: lack of capacity to deliver IFB product at full rage, lack of awareness of customer about IFB products, lack of trust and confidence of customers, inadequate marketing and promotion, double taxation, nature of

IFB products, unavailability of IFB products in all of its branches and the IFB being delivered in a Window model. Accordingly, the following recommendations were forwarded by her aggressive promotion and marketing campaign about IFB products, provide sustainable and continuous training to build the capacity of the manpower, the bank shall increase accessibility of its products with the expected services attached to the products, the bank has to have Sharia'h Advisor, give the required attention and focus for the business and the bank has to be transparent in its IFB business undertaking, in addition to these NBE directives, tax and ECX law shall include exceptions for IFB business.

Finally a research conducted by Abraham (2017) has studied “determinants of customers’ intention to use interest free banking products and factors affecting employees’ product knowledge”. Unstructured questionnaire was used to collect qualitative data on customers’ use intention. In general, eight and three hypotheses were developed and tested on customers’ intention (the study was conducted by TRA Model) and employees’ product knowledge of the CBE with a sample size of 369 and 77 individuals respectively. Both descriptive and inferential analytical techniques were used. To analyze the relationships among the variables, on the other hand, multiple regression and structural equation modeling (SEM) were employed. The results that of the study on customers’ intention showed that, except for Knowledge, all the other variables: Attitude, Social Effect, Perceived Financial Cost and Religious Belief have significant on IFB use intention. Moreover, except for Underlying Arabic Terminology, the other two variables: Underlying Sharia’ Principles and Training have significant on Product Knowledge of employees. Furthermore, chi-square test was used to analyze the association between selected demographic factors and IFB usage intention. The findings of this study have shown that, except for educational level, all other demographic factors found to have an insignificant on IFB adoption intention.

Mohammed (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 and development in Islamic studies, lack of qualified human resource as well as wrongful association with specific religion and the global terrorism. In such

a dual banking system, to analyze the potential Factors, it is important to deduce some general nature of the internal and external environment.

First, there is an enormous demand for full-fledged interest-free banking and finance in the country (Abdukadir, 2019). This demand is very vast considering the immense Muslim population of the country. Second, the banking and finance services in the country are highly condensed in urban areas, which is not more than 15% of the total. Only 34.8% of the population, above the age of 15, has an account in any financial institutions including microfinance institutions. This rate is far below the world average (67.1%) and Sub – Saharan Africa average of 42.6% (World Bank, 2017). Third, the banking sector in Ethiopia is closed for any foreign financial institutions. Only local banks and financial institutions function in the country. Besides, the IFB industry commenced in 2013, still now giving service at Windows level. Most of them have a high rate of deposits using sharia-based products.

Considering these facts, we can try to identify the potential factors for the full-fledged IFB banks in Ethiopia from the global experiences presented above. From the administrative CSFs category, Overall Management Efficiency, Ownership Structure, Sharia-Based Deposits Management, Size of the bank, Reputation and Image, and Marketing Strategy are very critical to the Ethiopian IFB sector. Overall management efficiency is an obvious factor of success in any business organization so as in the IFB global practices. However, the ownership structure of IFB is a critical factor that needs serious attention. Some people try to generally promote the strength of the IFB sector in some countries. But the ownership structure of interest free banking and finance industry in many countries, especially the GCC, has been highly dominated by three or four families such as Prince Mohamed Al-Faisal, Sheikh Saleh Kamil, and Sheikh Suleiman Al-Rajhi, all from Saudi Arabia (Iqbal & Molyneux, 2005). If some groups or individuals have extraordinary influence in the IFB, the sector is always at risk of failure.

Sharia-Based Deposits Management and Financing is determine the fate of the full-fledged IFB sector in Ethiopia. Central banks usually pay interest on deposits conventional banks are required to make. Similarly, the central banks offer interest-based loans to the banks. These are impossible for the IFBs. This problem can be managed if there are interest free markets for securities (Pita, 2014). However, if the full-fledged banks in Ethiopia failed to manage the

deposits made by their clients as a result of such snag, it may create a risky situation. Like Nigeria, the reputation and image of the banks in the community are critical factors (Dabor & Aggreh, 2017). Nigeria and Ethiopia have some common macroeconomic, social, and political characteristics. They are both emerging economies with high economic growth recorded in the last couple of decades. They are the leading highly populated African nations. Besides, they have a similar social structure of almost equally populated Muslim and non-Muslim populations. Likewise, the IFB sector in Tanzania, where the socio-political and economic characteristics are similar to Ethiopia, has faced a similar challenge (Abdul-Wahab & Abdul Razak, 2019). Besides, the same problem is challenging the IFB sector in Ghana even though the socio-economic situation is different from Ethiopia (Issa, 2018). As a result, the full-fledged IFB sector may have various reputations, religious connotations, and an image in the non-Muslim community in Ethiopia too. This in return affects the success of the IFB sector in general and the full-fledged banks, in particular (Canals, 1993; Bamberger, 1989). This needs serious work on awareness creation and effective marketing strategy.

In the technical factors category, product innovation, Sharia-compliant price benchmarking and risk management, need attention in the Ethiopian full-fledged IFB sector. One of the criticisms of the IFB industry, in general, is the lack of product innovation. There is a huge gap in innovating sharia based new products, which can attract more customers and enable the banks to win the competition with conventional banks. The service is highly dominated by Murabaha products (Mustafa, 2019). Within the general product categories of Murabaha, Musharakah, and all the others, it needs to develop specific Sharia-compliant products, which fit the needs of the local markets. Moreover, as many countries are facing, the IFB in Ethiopia has a potential critical factor of using a Sharia –noncompliant price benchmarking. Using the interest rates offered by the conventional banks as a benchmark in pricing all products of IFB is very common (Zaheer & Laila, 2019). This is becoming a critical concern on the degree of sharia-compliance of the IFB industry worldwide.

Furthermore, risk management is one of the key success factors in the banking sector. Generally, interest-free banking and finance face four major risks; business risk, governance risk, financial risk, and treasury risk. Business risk includes a rate of return risk and displaced commercial risk

while governance risk includes operational risk, reputation risk, and Shariah – noncompliance risk. Financial risk has credit risk, market risk, and equity risk categories. Liquidity and solvency risk and hedging risk are the two categories of treasury risk (Rahahleh et al., 2019). Even though the degree of facing each risk is different, the full-fledged IFBs in Ethiopia need to pay attention to risk management to successfully penetrate the market.

In the next category of CSFs, human resources seem to be a critical challenge in the IFB sector worldwide. Almost in all the collapsed IFB projects, there were unqualified top managers and a lack of skilled staff. The lessons from South Africa, Turkey, Jordan, Morocco, and Nigeria are more than enough to consider this issue as a serious one in Ethiopia too. The absence of Islamic finance education and training institutions in the country makes the problem more severe.

In the external factors group, there are some factors to consider too. However, these are mostly out of the control of the specific bank. They need collaboration among all the IFB stakeholders. In this group, the Sharia-related CSFs are the primary ones to be considered. The first one is managing conflict on Sharia verdict. In some countries, the sector has faced a critical challenge because of the different judgments given by various scholars on a similar issue (Zaheer & Laila, 2019). This confuses customers and became a pushing factor towards conventional banking, or simply a withdrawal from the financial services. It also creates a relaxing and a favorable working environment for the IFB windows that can help them easily dominate the full-fledged IFBs. Secondly, as clearly observed in South Africa, the lack of capacity of the Sharia board can be a failure factor in IFB (Nathie, 2010). A board consists of skilled and knowledgeable Sharia scholars can make the bank effective in various aspects and vice versa. However, the availability of a strong Sharia board in each bank does not determine the success of the IFB sector. Lack of a common Sharia board in the IFB market is very important. As Nigerian IFBs have faced (Dabor & Aggreh, 2017; Abdullahi, 2016), this challenge leads to a lack of consensus on many issues on the IFB industry in general. In Ethiopia, where every IFB window is recruiting particular Sharia advisers, lacking a common Sharia board may be a solemn factor for the emerging full-fledged IFBs.

The full-fledged IFBs in Ethiopia may also face social CSFs. The first one is the lack of awareness in the community in general. As a result of the absence of education and training

institutions in the country, little has been done to create social awareness on the sector. Besides, as discussed above, there is a possibility of facing religious connotations like the cases in Nigeria, Ghana, and Tanzania. However, the most important factor in the social CSFs category is getting disciplined entrepreneurial culture and ethical values. IFBs are founded based on the ethical values of Islam. These values have to be respected on both sides in order to promote a successful IFB sector in any country. Therefore, to utilize the IFB products, creating a disciplined entrepreneurial culture is very critical.

The other external critical factor which can determine the fate of the banks is the regulatory system. The first one is the legal and institutional set up which affects many aspects of the basic foundational issues of the taxation and property ownership rights of the IFBs. It is the legal framework which played a major role in the unsuccessful projects presented above. On the other side, it is the legal framework which supported the successful IFB industry in Malaysia (Abdullah, 2017), Indonesia (Indonesian Islamic Economic master plan, 2019), Brunei Darussalam (Yusuf et al., 2019), Iran (Javadin et al., 2016), Bangladesh (Rasel et al., 2018), and UK (Belouafi & Chachi, 2014). Another example, in this aspect is the favorable legal environment created for the expansion of the IFB sector in Kenya. The country has amended banking and finance regulations to integrate the IFB industry to the banking sector (Salim, 2017).

In addition to the existence of an attentive legal and institutional setup, the encouraging support of the government is an important factor. The common thing which the IFB sector in Malaysia, Indonesia, Iran, Sudan, Pakistan, Bangladesh, the GCC, Turkey, the UK, Nigeria, Kenya, and some others share is the explicit engagement of the government. Nonetheless the engagement must be limited. Otherwise, either it creates a dependent and weak IFB sector, or it fails when the government changes (Iqbal & Molyneux, 2005). In Ethiopia, positive support of the government can be a critical factor for the expansion of the full-fledged IFBs. Conversely, if it is not supported by a strong legal system any political change in the country can simply impede the sector.

The potential Factors affecting IFB sector in Ethiopia also include industry related factors. The most important factor is the existence of the dual banking in the IFB sector; the window model

and the forthcoming full-fledged IFB services. Even though there are different Shariah verdicts on the sharia-compliance nature of the window model, it is yet an important element of the global IFB industry. Currently, all commercial banks are using IFB windows and few at branch to deliver services in Ethiopia. Including the Commercial Bank of Ethiopia, the largest commercial bank in the country, there is an inclination to involve more in the IFB sector. They are expanding their IFB services throughout the country. The full-fledged banks may be challenged by the windows because of the experience gap, size of capital, customer base, and the existence of established infrastructure. Moreover, it needs high investment and financing capacity of the full-fledged banks to attract customers by competing with the windows. Therefore, this is a clear and very important success factor for the full-fledged IFBs.

Finally, the macroeconomic factors are also an important part of the potential external CSFs. The country's economic growth, international trade, and rate of inflation can affect the sector's journey in Ethiopia.

Conclusion

Every individual, company, sector, or an economy has various factors, which can determine the fate of its success. These are called as Factors affecting or Success Factors. Similarly, there are many factors-success or fail in the interest-free banking and finance industry. Most of these factors are the reasons for the failure of specific Interest-free banks in some countries, or they are challenging the IFB industry not to expand. The aim of our study was, therefore, to identify the factors that can determine the success of the newly establishing IFBs in the country. Based on these facts, plus considering the socio-cultural, economic, and political situations of Ethiopia, we can draw some conclusions.

First, the experiences of many of the most successful nations in the IFB industry cannot be taken as raw reality or a role model for the basic foundation of the sector in Ethiopia. Because in these countries either there are extremely wealthy families who own a great deal of the shares or the government's role is very high. In the GCC countries, for example, the ownership structure is highly dominated by some affluent families. In Iran, Sudan, Malaysia, Indonesia, Turkey, and many others, the assistance of the government is very bold. Therefore, the success and failure factors or the overall benchmarking must consider these facts.

Second, the internal and external environment of the IFB industry is relatively similar to the environment in Nigeria, Tanzania, Kenya, South Africa, and somehow Pakistan and Bangladesh. Based on this reality, the most important potential CSFs which can determine the fate of the full-fledged IFBs in Ethiopia are Overall Capacity of the Management, Legal, Regulatory and Institutional Setup, Sharia-Based Deposits Management, Risk Management, Reputation and Image, Product Innovation, Conflicts on Sharia Verdict, the Absence of a Common Sharia Board, and Disciplined Entrepreneurship and Ethical Values.

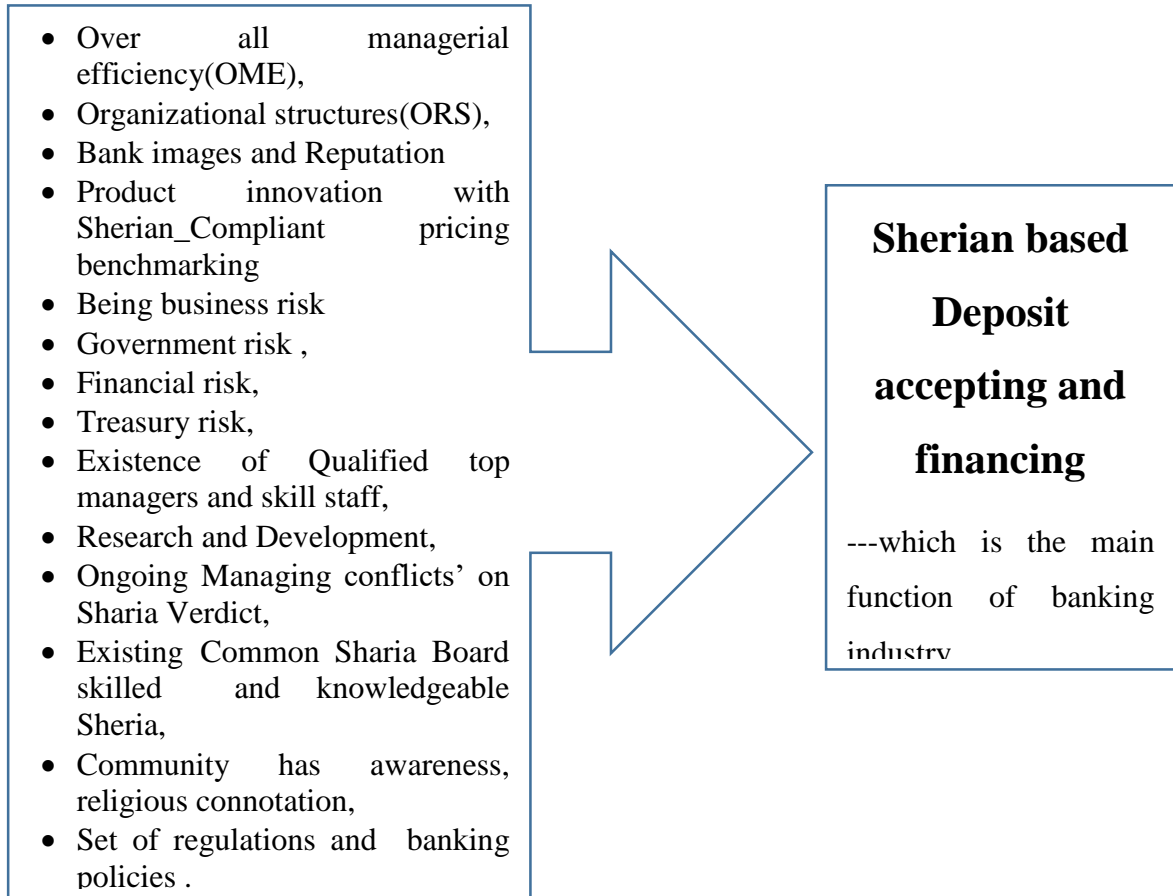
Finally, the presence of Window-Based IFBs must get a special policy consideration in Ethiopia. The international experiences, such as Qatar, Kuwait, and Bahrain, shows that windows are discouraged through time. However, they are still an important part of the industry in general in some countries. In Ethiopia, without a consensus on this dual IFB banking issue, the leading Sharia scholars are advising different IFB windows. When the full-fledged ones start to operate, this may create confusion in the community and the sector's growth will be affected. This is mainly because of two reasons. First, once the products of the dual banking system start to vary, the Sharia verdict on the products and the acceptance of the windows may be different. Second, if the leading Sharia scholars working with the window-based service delivering banks continue serving them, it will pave the way for the users to continue using the conventional banks under the mostly deposit – oriented window services. Consequently, the share of the full-fledged banks will be marginal and it will let the sector to be limited to some deposit-based products we have today. Moreover, if things settle and the dual banking system continues smoothly, for the full-fledged banks, it will not be an easy matter to compete with the windows which are big and experienced enough. Therefore, there must be a special regulation which treats the window-based IFBs differently.

According to different empirical evidences different factors affecting interest free banking and future expansion visions. Based on different literatures this study expects as following variables will affect banking industries. These variables may include as a dependent variable Sherian based Deposit accepting and financing which is the main function of banking industry and factor affecting the business such as Overall managerial efficiency(OME), Organizational structures(ORS), Bank images and Reputation(IMAGE_REPUTITION), Product innovation

with Shariah-Compliant pricing benchmarking (PROINNOV), Being affected by business risk-rate of return affect, government risk, Financial risk, treasury risk, the existence of Qualified top managers and skill staff, qualified human resource, research and development, ongoing Managing conflicts' on Sharia Verdict, existing Common Sharia Board skilled and knowledgeable Sharia, Community has awareness, religious connotation, set of regulations and banking policies. The study has been analysis how these variables affect interest free banking industry.

2.3 Conceptual framework

Figures 2.2 Conceptual framework..



Source: Summery of empirical study

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This part of the study attempts to explain the research methods and tools that were applied to collect and analyze information gathered from a sample of 32 branches of different commercial banks found around Wolkite and Butajira towns.

3.2 Sources and Types of Data

Basically there are two sources of information used for research purposes – primary and secondary sources. Primary sources are those in which require to conduct a new survey for gathering information at different levels with regard to the inquiry. Secondary sources are those which are made available or have been collected for other research purposes (Adams, Khan, Raeside, and white, 2007).

In order to meet the objective of this study, the researcher has used various primary and secondary sources. Primary data would be collected from selected employees and branch managers of all Commercial Bank located South-West Addis Ababa (Wolkite, Butajira and surrounding towns that banks exist area) in the form of structured questioner.

Secondary source in a bid to understand the afore stated determinants including books, journal articles, various postgraduate studies, academic conference proceedings, the web particularly Google Scholar, Emerald, Science Direct, NBE report and internal documents of the all Commercial Bank provide IFB service in Ethiopia - Divisions Procedure and Training documents of the bank.

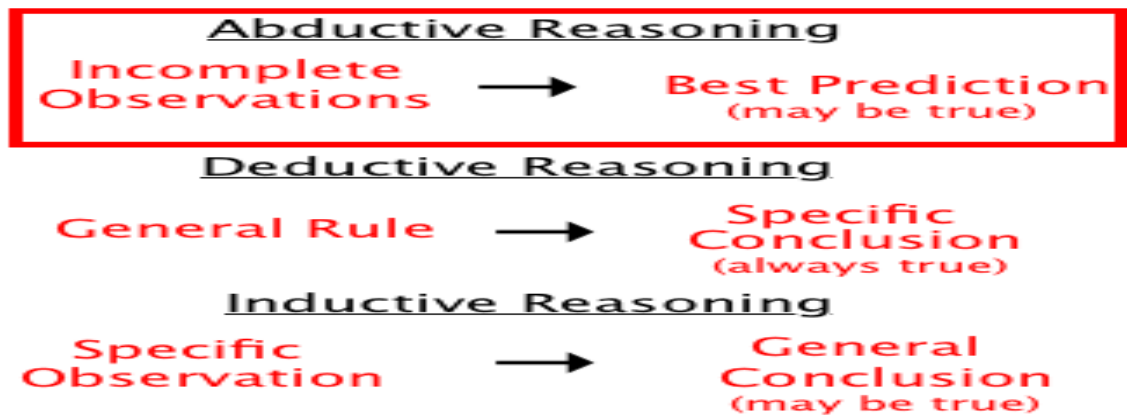
3.3 Research Approach

The study was based on primary data and secondary collected from commercial bank employees located the two town Wolkite and Butajira and surrounding banks. A structured questionnaire is used to collect the primary data. The survey sample of employees were purposely selected from branches. Meaning that our focused study area is identifying factors affecting interest free banking and its expansion. Therefore, we give priority to employees working at interest free

branches and delegated window due to the have better information about IFB. While to fulfill our sampling size, giving chance for managers and senior staff

3.4 Research Design

Research Design refers to the framework into which the research fits depend on the theory and nature of the research problem. This will underpin all of the research activities (Walliman, 2006). According to Creswell (2009), there are three research designs are Inductive, Deductive and Abductive Research approaches.



Abductive Research approach used- data were collected from world experience which have similar demography to Ethiopia (Deductive approach) and sample survey used to generalize (Inductive). Therefore, my thesis has used both inductive and deductive research approach (characteristic) .

3.5 Target Population

The study target on 128 employees of commercial bank located Wolkite and Butajira town would be considered as sample frame of current research.

In research methods, population is the entire aggregation of items from which samples can be drawn. In this study, the target population is comprised of employees of commercial banks located Wolkite and Butajira town, Ethiopia. Data collected from 32 branches of 12 different corresponding banks. Among 3 branches gives full-fledged interest free bank services at branch level i.e NIB and Abyssinia Bank S.C Wolkite branch and Fetih CBE located Butajira. Whereas the remaining giving service at window level with total employees of 552 of 475 clerical staffs and 77 were branch managers and senior staff.

3.6 Sampling Method and Sample Size

3.6.1 Sampling Techniques

It is extremely important to choose a sample that is truly representative of the population so that the inferences derived from the sample can be generalized back to the population of interest. Improper and biased sampling is the primary reason for divergent and erroneous inferences (Bhattacharjee 2012, pp, 66). By using appropriate sampling techniques which best suites the purpose and situation, sampling was to be performed to select representative sampling from clerical employees, senior staffs and branch managers. As of my primitive assessment reports shows, out of 552, 82 employees were assigned at Interest free banking branches and delegated windows. This led to focus group and purposive sampling techniques to reach at the specific respondents. Which can be consider them as strata clerical employees and managers.

3.6.2 Sample Size Determination

Determining sample size is a very important issue because samples that are too large may waste time, resources and money, while samples that are too small may lead to inaccurate results. Sample sizes determine base on statically drafted sampling of branch employees has been determined using the following techniques and the detail is presented as follows. It has used

- Carvalho (1984), sample size determination techniques.

A method developed by Carvalho (1984) has been used to determine the branch sample size.

Table 3.1: Sample size determination.

| N | 51-90 | 91-150 | 151-280 | 281-500 | 501-1,200 | 1,201-3,200 | 3,201-10,000 | 10,001-35,000 | 35,001-150,000 |
|--------|-------|--------|---------|---------|-----------|-------------|--------------|---------------|----------------|
| Small | 5 | 8 | 13 | 20 | 32 | 50 | 80 | 125 | 200 |
| Medium | 13 | 20 | 32 | 50 | 80 | 125 | 200 | 315 | 500 |
| Large | 20 | 32 | 50 | 80 | 125 | 200 | 315 | 500 | 800 |

Source: Carvalho (1984)

- krejcie and morgan sample size determination

Sample size determination is an important element in any survey research. According to Israel (2009), there are four strategies to determine sample size – using a census for small population, using the sample size of similar studies, using published tables like the table of Krejcie and Morgan (1970), or using formulas to calculate a sample size.

Accordingly, the minimum sample size n,

$$n = [Z^2 * p * (1-p) / e^2] / [1 + (Z^2 * p * (1-p) / e^2 * N)].$$

$$n = \left[\frac{Z^2 * p * (1-p)}{e^2} \right] \div \left[1 + \frac{Z^2 * p * (1-p)}{(e^2 * N)} \right]$$

Where: z = 1.96 for a confidence level (α) of 95%, p = proportion (expressed as a decimal), N = population size, e = margin of error. z = 1.96, p = 0.5, N = 552, e = 0.05.

$$n = \left[\frac{Z^2 * p * (1-p)}{e^2} \right] \div \left[1 + \frac{Z^2 * p * (1-p)}{(e^2 * N)} \right] \quad \dots\dots\dots\text{substitute values of variables}$$

$$n = \left[\frac{[(1.96)^2 * 0.5 * (1 - 0.5)]}{(0.05)^2} \right] \div \left[1 + \frac{(1.96)^2 * 0.5 * (1 - 0.5)}{((0.05)^2 * 552)} \right]$$

$$n = \underline{146.28}$$

From above two sample size determination, Carvalho methods of sample size determination chosen to more analysis this paper work. Based on Carvalho sample size determination method, for population size between 500 to 1200, a large sample size is 125 employees. Whereas am collected 128 structured questionnaire out of 140 disseminate from different commercial bank branches from the total population 552 employees, specially I give the chance for all employees working at deducted IFB windows and managers of all branch.

Finally, convenience sampling method was 128 samples respondent questionnaires' collected out of 140 disseminated questioner. Convenience sampling is a non-probability sampling technique

in which a sample is drawn from that part of the population that is close to hand, readily available, or convenient.

3.7 Data Collection Methods

3.7.1 Primary Data Collection

A structural questionnaire is designed for sampled branch staffs of all Commercial Bank located in the Wolkite and Butajira town. The questionnaire also developed based on previous empirical literature-closed ended questionnaires are used for the study. These close-ended questions developed on a five point -scales ranging from 5 (strongly agree) to 1 (strongly disagree) and Agree (Yes) or Disagree (No) form the questionnaire began with an introductory statement, which specified the purpose of the research as purely academic. And also respondents encouraged to be objective in their responses since they were assured of confidentiality.

3.7.2 Secondary Information

Secondary data that is obtained from Books, journal articles, various post graduate study, Google Scholar, Emerald, Science Direct, NBE Directives, different bank internal guidance, memorandum, policies and procedures, and MIS data internet web used in theoretical and empirical study.

3.8 Data Analysis

Data Analysis, particularly in case of survey or experimental design, involves estimating the values of unknown parameters of the population and testing of hypotheses for drawing inference. Analysis may be categorized as descriptive analysis and inferential analysis (statistical analysis). Descriptive analysis is largely the study and description of one variable (Kothari, 2004). Inferential analysis is used to analyze the relationship between two or more variables and to assess how the independent variables explain the dependent variable (Bisrat, 2015). Unlike descriptive analysis, with inferential statistics, conclusions to be reached extend beyond the immediate data alone (Trochim, 2000). For the study at hand, descriptive and inferential analysis was used. Data is run using structural equation model (SEM). An inferential analysis which involved structural linear regressions, a coefficient of determination, and correlations analysis were involved.

Structural Equation Modeling (SEM)

SEM - establishing the fit and validity of a structural model and requires testing of the structural model, including for the significance of the structural relationships. The validity and acceptability of the structural model can be evaluated in terms of (1) model fit, that is, GOF indices; (2) comparing factor loadings of the structural model to that of the underlying measurement model; (3) the magnitude of variance explained, that is, R^2 ; and (4) the size, direction and significance of the estimated structural parameters. The above provides a description of the above tests and the rule of thumb criteria for what constitutes as acceptable value based on recommendations of SEM literature.

Assessment of Goodness of fit by SEM- step one process

Whether a measurement model is considered valid is dependent on goodness of fit (GOF) indices. GOF indices indicate how well the model reflects the data, in other words, how well the specified model reproduces the root mean square error approximation based on residual among the indicator items (Hair et al. 2006). There are various GOF indicators, although usually only a couple of which are reported. Generally GOF indicators can be grouped into three categories: absolute measures, incremental measures and parsimonious fit measures. To ensure rigor in the empirical assessment, as suggested in the literature (Ho, 2006; Kline, 2005) multiple GOF indices are used. The literature is divided over the amount of fit indices that should be reported (e.g. Kline (2005) suggests at least four), which fit indices are most appropriate, as well as the acceptable cut-off threshold (Hair et al, 2006; Kline, 2005). This study follows the advice by Weston and Gore, (2006); Mac Callum and Austin, (2000); Hu and Bentler, (1998) and McDonald and Ho, (2002) and presents the following fit indices: chisquare, normed chi-square, RMSEA, RMR and CFI.

Table 3.2 An Illustration of Recommended Cut off Values of Indices from SEM stata output.

| Category | Indices with Abbreviation | Definition | Cut off values | References |
|-----------------------------|---|--|-----------------------------------|--|
| Chi-Square | Chi square (x2) | Difference between observed and estimated covariance matrices | p-value of >.05 | Abdul Razak and Abduh (2012) |
| | Degrees of freedom (df) | Covariance in the observed matrix less the number of estimated coefficients , must ≥ 0 | | |
| | Probability statistic (p) | Probability that the observed and estimated covariance matrices are actually equal | | |
| | Normed chi-square (x2 /df) | Ratio of chi-square to degrees of freedom for a model , Schreiber et al. 2006 | ≤ 0.3 < 5 | Kline,1998 Schreiber et al. 2006 |
| Absolute Fit measures | Goodness of fit index (GFI) | Measure indicating how well a model reproduces the variance/covariance matrices of the observed Sample | ≥ 0.90 >0.85 | Matsunaga,2010 Abdul Razak and Abduh (2012) |
| | Root mean square error of approximation (RMSEA) | Badness-of-fit index measuring how well a model fits a population taking into account both model complexity and sample size | <0.10 <0.08 | Matsunaga,2010 Abdul Razak and Abduh (2012) |
| | Root mean square residual (RMR) | Represents the average residual value derived from the fitting of the variance–covariance matrix for the hypothesized model | <0.05 <1.00 | Hair et al ,1988 Schreiber et al., 2006 |
| | Normed fit index (NFI) | Assesses how well a specified model fits relative to some alternative baseline model (often a null model that assumes all observed variables are uncorrelated) | Values $\geq .90$ and sample size | Hair et al, (2010) |
| Comparative fit index (CFI) | | | | |
| Tucker-Lewis index (TLI) | | | | |
| Parsimony fit indices | Parsimony comparative fit index (PCFI) | Evaluates the parsimony ratio of the model compared to the GOF such as CFI and NFI | Values $\geq .5$ | Hair et al, (2010) |

Source: Hair et al, (2010)

A structural Equation and regression (SR) model is a path model with latent variables, thus combining principles of path and measurement models. The goal is to take measurement errors of observed variables into account when evaluating a path model. This is the most general kind of core model that is widely applied in SEM. A fully latent SR model has only latent variables in the path model whereas a partially latent SR model is a mix of observed and latent variables. Similar to path and measurement models, an important phase of analysis in an SR model is model identification. Model identification is a property that determines whether the model allows for unique parameter estimates. The two basic conditions for identification are (1) model degrees of freedom equal to or greater than zero (\geq) and (2) a known scale for every latent variable.

The total degrees of freedom for an SR model is, where n is the number of observed variables. This total corresponds to the number of variances and unique covariance's in a variance covariance matrix for variables. The model degrees of freedom, is the total degrees of freedom minus the number of estimated parameters. A *just-identified* model have unique parameter estimates, but an *over identified* model is desirable for model testing and assessment. An *under identified* model will not have unique solutions for all parameters. *Empirical under identification* occurs when the effective degrees of freedom are reduced due to two or more observed variables that have a very high correlation (e.g., correlation ≥ 0.90), in turn leading to problems with parameter estimation. Kline proposed two basic ways to deal with extreme collinearity removing one of the variables or combining redundant ones into a composite variable. Scale is a property of each latent variable. Because a latent variable is not measurable, it must take on the scale or units of measure from one of its observed variables. A way to assign scale is by imposing a unit loading identification (ULI) constraint by fixing a factor loading of one observed variable at a value of 1.0.

3.9 Model Specification

A model is said to be correctly specified when it reproduces the sample covariance matrix well. When instances of specification error are noticed, the critical ratios (t-values), the squared multiple correlations (SMC) values, the standardized residuals and the modification indices (MI) were examined to re-specify the model. SMC values should be greater than 0.5. Standardized residual covariance should also be less than the benchmark value of |4| but

preferably less than |2.58| (Hair et al, 2010). A large residual covariance between any two measurement items indicates that the association between these two items is not accounted for sufficiently by the model. This suggests a problem with one or both of the measurement items. A standardized residual value of |2| indicates that a particular covariance is not well reproduced by the hypothesized model (at $\alpha = 0.05$ significance level) and a standardized residual value of |4| relates to $\alpha = 0.001$ significance level. When a consistent pattern of large standardized residuals is associated with either a single item or several of the items within the factor, the necessary re-specification was made to account for this association between the variables, such as by dropping an item and re-running the measurement model (Hair et al, 2010).

MI also suggests a potential source of model re-specification. A MI is calculated for each nonfree parameter and represents a possible decrease in X^2 if the parameter is freely able to be estimated in the re-specified model. A chi-square of 3.84 with one degree of freedom has a $p = 0.05$ and a MI value greater than |4| suggests that the chi-square could be significantly reduced if the corresponding parameter were estimated. Based on this guideline, this study examined the measurement items that reveal high MI; that is, above |4| (Byrne, 2010; Hair et al, 2010), and made appropriate re-specification to the model.

3.10 Hypotheses and Processes

Application of SEM requires a set of well-defined hypotheses generated from theoretical considerations, previous knowledge, and personal observation. In this study, the processes of interest free Banking (Sherian based Deposit accepting and financing and it's expansion are affected by- Sherian based Deposit accepting and financing which is the main function of banking industry and factor affecting the business such as Overall managerial efficiency(OME), Organizational structures(ORS), Bank images and Reputation(IMAGE_REPUTITION), Product innovation with Sherian_Compliant pricing benchmarking(PROINNOV), Being affected by business risk- rate of return affect, Government risk , Financial risk, treasury risk, the existence of Qualified top managers and skill staff, or qualified human resource, Research and development on HR, ongoing Managing conflicts' on Sheria Verdict,, existing Common Sheria Board skilled and knowledgeable Sheria, Community has awareness, Religious connotation, Set of regulations, banking policies and Muslim Religious followers.

- H_0 = there is no relation between the dependent and independent variables of Sharia based deposit and financing, they have no effect and estimated parameter is zero
- H_1 (ALT)= dependent variable positively or negatively affected by independent variables and all parameters differ from zero.

The following model was formulated for this research in order to test the research Hypothesis.

| variables (exogenous and endogenous) | Substituted by | Short definition |
|---|----------------------------|--|
| Shebadepo(Y) | Y- (dependent variable) | Sharia based deposit and financing |
| maneff | X ₁ | Overall managerial efficiency effects on IFB |
| orgstr | X ₂ | Types of organizational structure |
| IFB and Muslim religion | X ₃ | relation between Muslim religion and IFB |
| image_reputation | X ₄ | Banks good image and reputation |
| Proinnov | X ₅ | product innovation and differentiate techniques with |
| Business_risk | X ₆ | Rate of interest or interest rate(riba), Monthly and annual calculated Interest rate |
| government_risk | X ₇ | all operational risk associated with government regulation |
| financial_risk | X ₈ | Credit and market risk |
| treasury_risk | X ₉ | liquidity and solvency risk |
| Quahumres | X ₁₀ | Existence of enough qualified human resource on IFB |
| Rd | X ₁₁ | Research and development enough to overcome gap HR problems |
| Confmansherianverdict | X ₁₂ | managing conflict with sharia verdict fitted or successful |
| Existingcombsk | X ₁₃ | Knowledge and skills of existing common sharia board about IFB |
| community_awareness | X ₁₄ | the community society awareness about IFB |
| edu_andtraining | X ₁₅ | there is sufficient education and training and advertising to overcome community information gap |

| | | |
|---|-----------------|--|
| govbyreg | X ₁₆ | Governor laws and Regulation |
| suitablebpol | X ₁₇ | common suitable commercial banks policy an procedure |
| ifballivatefin_deprivative | X ₁₈ | Well established IFB alleviate the existing problem |
| ** ε denotes the error terms. Moreover, β ₀ = intercept/constant, β ₁₋₁₉ = slope coefficients | | |

Form above table, I drive the following questions:-

$$\begin{aligned}
Y = & \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 \\
& + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} + \beta_{13} X_{13} + \beta_{14} X_{14} \\
& + \beta_{15} X_{15} + \beta_{16} X_{16} + \beta_{17} X_{17} + \beta_{18} X_{18} + \epsilon
\end{aligned}$$

When, β values substitute we get

$$\begin{aligned}
Y = & (-2.762) + 0.06156 X_1 + 0.05032 X_2 + 0.38016 X_3 + 0.02322 X_4 + 0.01151 X_5 \\
& - 0.02308 X_6 - 0.0083 X_7 - 0.00049 X_8 + 0.0675 X_9 + 0.49614 X_{10} \\
& + 0.14693 X_{11} + 0.5288 X_{12} + 0.0587 X_{13} - 0.0760 X_{14} \\
& + 0.2576 X_{15} - 0.1109 X_{16} + 0.06163 X_{17} + 0.3305 X_{18} + \epsilon
\end{aligned}$$

Data would be analyzed by using descriptive, inferential and correlation with the aid of STATA. Also, analysis of variance which carried out to examine the variation in the performance of enterprises related to the variation in each of independent variables of the study. After careful consideration of all independent variables and the dependent variable of the study, the following hypotheses are developed to be tested using Structural Equation Modeling (SEM) using t-test statistical technique. The hypotheses of this study are about the relationship between independent variables and performance of the enterprises in relation to them.

3.11 Ethical Considerations

As suggested by (Trochim, 2000; Sekaran, 2006), the researcher has ensured the strict adherence of the following ethical conducts:

- Respondents take part in the research voluntarily and data collected based on the consent of the individual.
- The purpose of the research clearly explained to respondents.
- Information provided by respondents treated with strict confidentiality and the researcher ensured that participants will remain anonymous throughout the study.

There couldn't misrepresentation or distortion of the actual data collected from respondents.

CHAPTER FOUR

RESULTS AND DISCUSSIONS

4.1 Introduction

The purpose of this chapter is to present finding which were collected from the actual questionnaire survey data analysis according to the research methodology discussed in the previous chapter. Accordingly, I used descriptive and inferential analysis to present and discussed. Descriptive method used for demographic characteristic of respondents' profile analysis, while inferential statistics were used to test the model goodness of fit and also correlation of the model used to test the relation of the variable -by using Structural Equation Modeling, and Linear regression for further hypothesis testing analysis respectively.

4.2 Descriptive analysis of Demographic Characteristics of respondents

To gain understanding on the factors affecting interest free banking and its expansions in Ethiopia a survey was conducted on 32 branches of 12 commercial banks operating in Wolkite, Butajira and surrounding branches exists near to Wolkite town. This chapter presents the findings from the survey of 128 questionnaires out of 140 designed and disseminate to collect information on the situation surrounding from a total of 552. As per Carvalho, 1984 sample size determination, 125 is large sample size for population range between 500 to 1200(see App-4), whereas I was collected 128 questionnaires' out of 140, the remaining was deny to response. The following results are analysis from the survey. This part is divided into two main sections: The first section summarizes the characteristics of the respondents, the second presents the information related with the major factors affecting interest free banking and future expansion for the surveyed banks.

Sex of respondents

The results showed that the majority of respondents were male (74.22%, N=95) while the rest were female 25.78%, (N=33). Given the fact that the people who filled the questionnaires were expected to be the banks' employees who are affiliated with the IFB system, this implies that the majority of people with knowledge about IFB in the banks are males.

Table 4.1: Sex of sample respondent.

| Sex | Frequency | Percent |
|--------|-----------|---------|
| Female | 33 | 25.78 |
| Male | 95 | 74.22 |
| Total | 128 | 100.0 |

Source: Author, 2021

Religion of Sample respondents

Religions of sample respondents were also among the characteristics examined to understand if there was a person who had an understanding of the Shariah principles and hence would provide a boost to the bank's IFB services. The results (See Table 4.2) revealed that among the respondents who were all bank employees only 32.03%(N=41) were Muslims, whereas the biggest proportion 63.28% were Christian the remaining 4.69%(N=6) whereas the remaining 4.69 % were other religion followers.

This may imply that this service is being operated by people who may not even have a clear understanding of what it stands for, unless special trainings have been delivered this could have effects on the IFB successes and expansion

Table 4.2 : Religions of Respondent

| Religion of respondent | Frequency | Percent |
|------------------------|-----------|---------|
| Muslim | 41 | 32.03 |
| Christian | 81 | 63.28 |
| Other | 6 | 4.69 |
| Total | 128 | 100% |

Source: Auther,2021

Work experience of sample respondents

The results revealed that the majority of respondents are young employee's having less than 6 years i.e 74.22%, between 7 to 10 years are 21.1% and the remaining 4.68% have between 11 and 15 years. This implies that the surveyed employees had enough knowledge and well experienced on the subject under study.

Table 4.3 Work experience of respondents .

| Work Experience(in years) (N=128) | Freq. | Percent | Cumulative |
|-----------------------------------|-------|---------|------------|
| 1 | 15 | 11.72 | 11.72 |
| 2 | 27 | 21.09 | 32.81 |
| 3 | 4 | 3.13 | 35.94 |
| 4 | 23 | 17.97 | 53.91 |
| 5 | 15 | 11.72 | 65.63 |
| 6 | 11 | 8.59 | 74.22 |
| 7 | 16 | 12.50 | 86.72 |
| 8 | 5 | 3.91 | 90.63 |
| 9 | 4 | 3.13 | 93.75 |
| 10 | 2 | 1.56 | 95.31 |
| 11 | 1 | 0.78 | 96.09 |
| 12 | 1 | 0.78 | 96.88 |
| 13 | 2 | 1.56 | 98.44 |
| 14 | 1 | 0.78 | 99.22 |
| 15 | 1 | 0.78 | 100.00 |
| Total | 128 | 100 | |

Source: Author, 2021

Education level of respondents

Education level of respondent is another variable that used to investigate in the course of this study. The results showed that only 1.56% (N=1) had a certificate and diploma level. On the other hand 91.41% had a bachelor level whereas 7.03 % had achieved post graduate education level. This reveals that the people who were assigned to fill the questionnaires of this research

had a great knowledge about their profession and therefore could contribute by providing insights necessary for this study. The respondents were expected to be people with knowledge about IFB system.

Table 4.4 Level of education of respondents.

| Level of education of respondents | Frequency | Percent |
|-----------------------------------|-----------|---------|
| Certificate | 1 | 1.56 |
| Diploma | 1 | 1.56 |
| Bachelor | 117 | 91.41 |
| Masters | 9 | 7.03 |
| Total | 60 | 100 |

Source: Author, 2021

Position of respondents in the bank

Regarding the positions of respondents in the Banks, it found that the majority were Customers service officers who were the main respondents for this study with 48.44% (N=62), managers also participated at 16.41% , Senior Customer Service Officer(SCSO) held 14.84%, Junior Customer Service Officer and trainee (JCSO) were 18.75% and the remaining 1.56(N=2) was cash support officer what we called cash attendants. Habitually the senior customer relation officer and the managers both hold most of the time important information related with the Bank's activities and therefore, the information collected in this paper is good.

Table 4.5 Position of respondents in the bank.

| Current position in the bank | Freq. | Percent |
|------------------------------|-------|---------|
| Manager | 21 | 16.41 |
| SCSO | 19 | 18.75 |
| CSO | 62 | 48.44 |
| JCSO | 24 | 18.75 |
| CASHATTENDAT | 2 | 1.56 |
| Total | 60 | 100.00 |

Source: Author, 2021

4.3 Major Factors Affecting interest free banking and Its Expansion in Ethiopia

Interest Free Banking, means Shariah based Deposit without interest bearing and financing was dependent variables which give answer what done in the banking operation. The last target was to alleviate the anticipated banking demand. Emergence of modern Islamic finance is to provide alternative Sharia-compliant *financial services* and products. In Ethiopia there is a huge potential *for Islamic/interest free banking service*. It is a benevolent loan given to deserving customers by Islamic banks to *alleviate* poverty.

Over all Managerial efficiency (OME)

Managerial efficiency-was a variable investigated to understand whether the respondents perceived that Interest Free Banking services were well effective or not in line with the Shariah's principles. Among them 38.28 % strongly agree, 56.25% were agree and the remaining 0.78, 3.91 and 0.78% was neutral, agree and strongly disagree respectively (see Appendix 6 and 7).

Organizational structure (ORS)

Mainly organizational type is the main factor for business success or not. As per our investigation most of questioners' respondents shows that they are disagree on that interest free banking is not have direct relations with organizational structure. As an usually strongly agree and agree shares of 1.56 percent' only. Whereas remaining 1.56% neutral (see Appendix 6 and 7).

Bank Images and Reputation

Creating a positive brand image might be more important than you think. Studies also show that a positive brand image bolsters customer satisfaction and loyalty. Building a satisfied and loyal customer base can help ensure long-term success for your business. Your brand image is more public than ever before. With a strong brand image, you can have higher customer retention and attract new customers who will also become loyal to your brand. This ensure business to achieve its objectives more easily if it has a good reputation among its stakeholders, especially key stakeholders such as its largest customers, opinion leaders in the business community, suppliers, and current and potential employees. As our research respondents also shows it is necessary for effective Interest free banking business run and future successive expansions. This is true from my respondent, most of them agree on good banking image and reputation(see Appendix 6)

Effects of Product innovation with Shariah-Compliant price benchmarking

The successful exploitation of new ideas is crucial to a business being able to improve its processes, bring new and improved products and services to market, increase its efficiency and, most importantly, improve its profitability. But this is not true for interest free banking service which enhance good business expansion and sustainable growth. From Table 4.5 below shows that most of the respondent had negative response to product innovation and differentiate technics, 35.16 and 62.50 were strongly disagree and disagree but a few of our respondent (2.34%) remain neutral(see Appendix 6 and 7).

Being business risk- rate of return affect IFB

The IFB *Business* is based on Islamic (Sharia) Law and mediating role of customer involvement and moderating *effects* of religious belief on. Islamic banking depositor faces a relatively high *risk* as the amount to be earned is not. Yet, most of customers are willing to save their money within this banking. As our respondent they also reflects this characters, i.e 23.44% and 64.84% are strongly disagree and disagree(see Appendices 6 and 7).

Being government-operational risk affect IFB

The area has not been given due attention to by government debt managers in developing a risk management framework. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

In light with the current situations in many Muslim communities around the world with the ideology of radicalization of Islam. Evidences have showed that many developed countries do not receive the Muslims in the simplest terms as they receive Christians. This may therefore impede on the development of systems like IFB and needs government attention. It was under the same premise that the researcher assed whether IFB was also facing trouble from the government. The results of the survey indicated that 18.75 % respondents did not agree with the statement that IFB was facing trouble from the Government and but more than half of the respondent 62.5% agree on it. However, number of respondents (18.75%) indifferent their position on this question (see Appendices 6 and 7).

Financial risk (credit and market risk) is a type of danger that can result in the loss of capital to interested parties. It is the possibility of losing money on an investment or business venture. For governments, this can mean they are unable to control monetary policy and default on bonds or other debt issues. Hence in interest free banking engaged in under the ijara financing 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 leases as well as physical position of the asset. In addition to this mudarabah and musharak financing are acknowledge for short period of trade business. I think most respondents disagree due to the above mentioned reasons. (see Appendices 6 and 7).

Being treasury risk- liquidity and solvency risk affect Interest free bank

Treasury Risk- is risk associated with the management of an enterprise's holdings – ranging from money market instruments through to equities trading. Liquidity and Capital (solvency) Risk is generally defined as the risk associated with an enterprise's ability to convert an asset or security into cash to prevent a loss. In this regard, IFB mainly leases financing it may create solvency seriously. When I observe my data analysis IFB will affected by such risk. 4.69% only disagree the not affected of treasure risk, but majority 95.31% accept or agree having negative effect on IFB service and future expansions (see Appendices 6 and 7).

Qualified top managers and skill staff has effect on effectiveness and expansion of Interest Free Bank.

If you're hoping to progress into a management role, you'll need a more finely tuned skill set. And also skilled staff also have special talent of Affordability, Job Availability, Daily Practice of Skills, Flexibility, and Career Growth (see Appendices 6 and 7). There are enough qualified human resource in Islamic banking to ensure that Islamic banking Services are up to date and fully comply with Sha'riah law.

Even qualified human resource and management is necessity were believed by most of respondent as table 4.1.6.11 but the existence of such manpower is under question as per my respondents response given. When we describe results that 99 %(N=128) strongly disagreed and disagree with the statement that IFB system in Ethiopian is suffering from lack of professionals specialized on the issue (see Appendices 6 and 7). This is further supported by

the average of the sample respondents 1.64(SD=0.57) which is higher and manifests a tendency of the sample to agreeing with the statement that IFB lack human resource.

Research and development in interest free banking services and interest free finance modalities to fill the gap in qualified human resource.

Need for research on IFB by sample respondents, It was indicated by there is a need for research on issues related with interest free banking manpower . The results indicated that to it alleviate unqualified human resource (see Appendices 6 and 7).

Managing conflicts' on Sheria Verdict is necessary for IFB success and future expansion

Strategies for *managing conflict* include styles, improving organizational practices, special roles and can be identified and solved by removing obstacles and creating a new environment of individual *growth*. Now a day, based of concepts of our respondent it is very weak on managing conflicts based on Sherian Law (see Appendices 6 and 7).

Existing Common Sheria Board skilled and knowledgeable, Sheria scholars is capable to manage the individual commercial bank sheria board.

As it's usual says , most of our commercial bank has run there IFB based on Sheria Law with its own Board committee manages works of the business with referring National bank SSB, internal policy and procedure what to manage the existing business markets and future path independently and also my respondent reflect the co-existing problems as true for conventional bank.

The Community has awareness about Interest Free Banking system

This variable was investigated to understand from the banks side what they thought about the level of awareness among their customers and communities. Our respondents also reflect the truth that for what reason shall be used IFB is yet not indifferent by customer (see Appendices 6 and 7), results showed that 70% is indifferent for why, when and where the they use.

By increasing awareness in the community by education and training institutions avoid religious connotation about Interest Free Bank.

In this study on —Financial literacy education (FLE) and behaviour unhinged: combating bias and poor product design have examined the absence of a clear link between and financial literacy

education financial decisions and behaviours. Author has opinion that financial literacy education programs are generally assumed to improve consumer behaviour in relation to financial products and services. However, there is scant evidence that demonstrates the causal link between education, literacy and behaviour. His finding show that the actions of individuals who are financially literate do not necessarily mean they will demonstrate good financial behaviour. He propose that in order to improve the financial behaviour of consumers, two critical areas need to be addressed. The aims and objectives of FLE programs should be not only to educate consumers about financial markets and products but to highlight to individuals the personal biases and limitations that they, as humans, cannot easily avoid. The second area looks to greater regulation of financial products aimed at retail consumers as well as product disclosure redesign aligned with a knowledge-based decision level in the context of interface design.

Interest free banking and governing rule and regulations

Interest free banking should be governed by different set of regulations as they differ from conventional banks in many aspects such as risk structure, form of ownership and governance. The study also tried to assess whether the respondents perceived any institutional threats for IFB system. The results revealed that the majority of respondents, in fact more than 96.88 % (N=128) agreed with the fact that IFB system must be governed by well-established banking regulation (see Appendices 6 and 7).

There are two international regulatory bodies in the Islamic finance industry, which have been widely used as standard setting bodies and benchmarks for Islamic and IFB products: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Financial Services Board (IFSB See Appendix 2), details the role of these institutions and how they have been adopted in other countries.

Comments- are further supported by a remark that was mentioned on the questionnaire by a respondent who stated the following: “strong legal and institutional framework of regulatory system in the Ethiopian financial sector make IFB foster the bank successions...” And this can be also indicated by the statement of one of the respondents who mentioned on the questionnaire

the following: “Government should provide favorable regulations regarding taxes, title transfer and others...”

There is suitable banking policies for Interest free banking.

This topic mainly related to internal operation of correspondent banks. And also they have their own internal operational policy and procedure mainly drive from different National Bank Regulation and principles of accounting -how to run business. As the basic principles of Islamic finance are originated from Sharia *rules*, it is expected to be Muslims are the primary customers for *Interest free* banking. Due to the inexistence of relevant legislation, each bank has adopted their own methodology, models and benchmarks for launching IFB products with little coherence or commonality in the market.

This statement was raised to try to get the attention of respondents towards lack of uniqueness of IFB system in the Ethiopian context and their views on the subject. The results of the survey indicated that only 25 % and 57.03% strongly disagree and disagreed respectively with the statement (see Appendices 6 and 7).

4.4 Inferential and Correlation Regression Analysis

In this topic I deeply observed Inferential statistics analysis by using structural equation modeling. With two main modeling fit-step processing. SEM - establishing the fit and validity of a structural model and requires testing of the structural model, including for the significance of the structural relationships. The validity and acceptability of the structural model can be evaluated in terms of (1) model fit, that is, GOF indices; (2) comparing factor loadings of the structural model to that of the underlying measurement model;(3) the magnitude of variance explained, that is, R^2 ; and (4) the size, direction and significance of the estimated structural parameters. The above provides a description of the above tests and the rule of thumb criteria for what constitutes as acceptable value based on recommendations of SEM literature.

4.4.1 Assessment of Goodness of fit by SEM- step one process

Whether a measurement model is considered valid is dependent on goodness of fit (GOF) indices. GOF indices indicate how well the model reflects the data, in other words, how well the specified model reproduces the root mean square error approximation based on residual among the indicator items (Hair et al. 2006). There are various GOF indicators, although usually

only a couple of which are reported. Generally GOF indicators can be grouped into three categories: absolute measures, incremental measures and parsimonious fit measures. To ensure rigor in the empirical assessment, as suggested in the literature (Ho, 2006; Kline, 2005) multiple GOF indices are used. The literature is divided over the amount of fit indices that should be reported (e.g. Kline (2005) suggests at least four), which fit indices are most appropriate, as well as the acceptable cut-off threshold (Hair et al, 2006; Kline, 2005). This study follows the advice by Weston and Gore, (2006); MacCallum and Austin, (2000); Hu and Bentler, (1998) and McDonald and Ho, (2002) and presents the following fit indices: chisquare, normed chi-square, RMSEA, RMR and CFI

Table 4.6 of Estat-Postestimation tools for sem-goodness of fit statistics.

```
. estat gof, stats(all)
```

| Fit statistic | Value | Description |
|-----------------------------|----------|--|
| Likelihood ratio | | |
| chi2_ms(0) | 0.000 | model vs. saturated |
| p > chi2 | . | |
| chi2_bs(18) | 289.803 | baseline vs. saturated |
| p > chi2 | 0.000 | |
| Population error | | |
| RMSEA | 0.000 | Root mean squared error of approximation |
| 90% CI, lower bound | 0.000 | |
| upper bound | 0.000 | |
| pclose | 1.000 | Probability RMSEA <= 0.05 |
| Information criteria | | |
| AIC | 2382.680 | Akaike's information criterion |
| BIC | 2439.721 | Bayesian information criterion |
| Baseline comparison | | |
| CFI | 1.000 | Comparative fit index |
| TLI | 1.000 | Tucker-Lewis index |
| Size of residuals | | |
| SRMR | 0.000 | Standardized root mean squared residual |
| CD | 0.896 | Coefficient of determination |

(Source: SEM output from researcher samples)

From table 4.6, Chi square(X^2) of my study the difference between observed and estimated covariance matrices is zero with p-value zero at 18 degree of freedom. Root mean square error

of approximation (RMSEA) and Root mean square residual (RMR) is zero which is less than 0.1.

****Therefore, when compared our SEM output of the model from cutoff points, most of measurements fulfil GOF criteria****

4.4.2 Assessment of model fit in SEM step two process

First: step involves testing the full measurement model's fit, as well as its construct validity. The goal of testing the measurement model is to establish how well the observed variables of a hypothesized construct relate to one another. This was reported in the previous section 4.2.1 and the result shows acceptable model fit and validity. However, the test of the full measurement model does not investigate the nature of the relationships between constructs beyond simple correlations. As such, a measurement model is a means towards establishing the fit and validity of a structural model, rather than an end in itself (Hair et al, 2006). But the second-step: requires testing of the structural model, including for the significance of the structural relationships. This provides a description of the above tests and the rule of thumb criteria for what constitutes as acceptable value based on recommendations of SEM literature. Tests for Structural Model Validity fulfil the following, the first is to test Structural model fit, it assesses extent of the structural model fit of the sample data using the GOF indices used for the measurement model (See Table 4.6 and 4.7). Second is Comparison of loadings of the structural model and the measurement model which assesses closeness of the parameter loadings of the structural and measurement models the acceptable value difference in loading should be 0.05 or less. The third is Variance explained (R^2), it is Extent to which variance is explained by the estimates of the model the acceptable value 0.8962 and above 0.70 is great; between 0.50 and 0.70 is very good. The last is Size and significance of parameter which is to estimates significance of the parameter estimates based on the corresponding the acceptable t-values $p(t) < 0.05$ and/or t-value above 2.00.

Table 4.7 Structural Linear Regression .

| Source | SS | df | MS | Number of obs | = | 128 |
|----------|------------|-----|------------|---------------|---|--------|
| Model | 38.4192252 | 18 | 2.1344014 | F(18, 109) | = | 52.21 |
| Residual | 4.45577481 | 109 | .040878668 | Prob > F | = | 0.0000 |
| | | | | R-squared | = | 0.8961 |
| | | | | Adj R-squared | = | 0.8789 |
| Total | 42.875 | 127 | .337598425 | Root MSE | = | .20218 |

| shebadepo | Coef. | Std. Err. | t | P> t | [95% Conf. Interval] | |
|----------------------------|-----------|-----------|-------|-------|----------------------|-----------|
| maneff | .0615559 | .0259598 | 2.37 | 0.019 | .0101044 | .1130075 |
| orgstr | .0503181 | .2071461 | 0.24 | 0.809 | -.3602387 | .4608749 |
| image_reputation | .0232246 | .0298172 | 0.78 | 0.438 | -.0358722 | .0823214 |
| proinnov | .0115046 | .0379246 | 0.30 | 0.762 | -.0636607 | .0866698 |
| business_riskr | -.023082 | .0263295 | -0.88 | 0.383 | -.0752663 | .0291022 |
| government_risk | -.0083256 | .0181172 | -0.46 | 0.647 | -.0442333 | .0275821 |
| financial_risk | -.0004874 | .0188024 | -0.03 | 0.979 | -.0377531 | .0367783 |
| treasury_risk | .0675266 | .0282709 | 2.39 | 0.019 | .0114946 | .1235585 |
| quahumres | .4961389 | .1223412 | 4.06 | 0.000 | .2536625 | .7386152 |
| rd | .1469313 | .0666988 | 2.20 | 0.030 | .0147365 | .2791262 |
| confmansherianverdict | .5288405 | .2256938 | 2.34 | 0.021 | .0815227 | .9761583 |
| existingcombsbk | .058657 | .101403 | 0.58 | 0.564 | -.1423204 | .2596345 |
| community_awareness | -.0760137 | .0689403 | -1.10 | 0.273 | -.2126512 | .0606237 |
| edu_andtraining | .2576391 | .0743263 | 3.47 | 0.001 | .1103267 | .4049514 |
| ifballivatefin_deprivative | -.330624 | .1313252 | -2.52 | 0.013 | -.5909064 | -.0703417 |
| govbyreg | -.1108815 | .0749188 | -1.48 | 0.142 | -.2593682 | .0376051 |
| suitablebpol | .0616249 | .0230026 | 2.68 | 0.009 | .0160345 | .1072153 |
| IFBand_otherreligion | .3801636 | .1243029 | 3.06 | 0.003 | .1337993 | .6265279 |
| _cons | -2.796125 | 1.335602 | -2.09 | 0.039 | -5.443245 | -.1490057 |

Source: SEM data estimation regression output(Researcher 2021)

Table 4.8 criteria for SEM fitting derived from above statistical table 4.6, and 4.7.

| Indices with Abbreviation Fit statistic | Description | actual statistical value | Cut off values | Remark |
|---|--|---|----------------|--|
| chi square(18) | Difference between observed and estimated covariance matrices(MS /SS) | t-cal 1103.06(p=0 .00) t-value 18 df 5%=28.27 | p-value<0.05 | t-cal > t- tabular value and fitted |
| chi2_ms(0) | model vs. saturated | 0 | p-value<0.05 | Eligible |
| p > chi2 | Probability that the observed and estimated covariance matrices are actually equal | 0 | p-value<0.05 | Eligible |
| chi2_bs(18) | baseline vs. saturated | 289.803(P= 00) | p-value<0.05 | Eligible |
| df)(18,109) | Covariance in the observed matrix less the number of estimated coefficients | 52.21 | | |

| | | | | |
|---|---|-------------------|--|-------------------------|
| Normed chi-square (χ^2 / df) | Ration of chi-square to degrees of freedom for a model | 10.26 | <5/0.3 | |
| RMSEA (root mean squared error approximation) | Badness-of-fit index measuring how well a model fits a population taking into account both model complexity and sample size | 0.00 | <0.1 | fitted |
| CI- | Comparison of loadings of the structural model | 00 | 90% CI, lower bound, ≤ 0.05 | Fitted |
| Root mean square residual (RMR) | Represents the average residual value derived from the fitting of the variance-covariance matrix for the hypothesized model | 0 | <0.5 | Fitted |
| | | 0 | <0.1 | Fitted |
| Normed fit index (NFI) | Assesses how well a specified model fits relative to some alternative baseline model | 1 | Values ≥ 0.90 | Eligible |
| | | 1 | Values ≥ 0.90 | Eligible |
| CFI (comparative fit model) | (often a null model that assumes all observed variables are uncorrelated) | 1 | >90% | Eligible |
| TLI Tucker-Lewis index | | 1 | >90% | Eligible |
| BIC | Bayesian information criterion | 2439.721 | | |
| Parsimony comparative fit index (PCF) | Evaluates the parsimony ratio of the model compared to the GOF such as CFI and NFI | 1 | Values $\geq .5$ | Eligible |
| SRMR | Standardized root mean squared residual | 0 | <1 | Eligible |
| (SMC) | (R^2 squared multiple correlations) Variance explained | 0.8961 | >0.7 very good or bn .07 to 0.5 | Eligible |
| SS | sum of squared differences from the mean | 42.875 | | |
| KMO | KMO (Kaiser-Meyer-Olkin) | 0.69 | >0.5, whereas >0.6 ITS GOOD | significant correlation |
| MS (mean square) | mean square | 0.337598 | < 4 , best when < 2.58 | Pass but weak |
| Adj RS | | 0.8789 | | |
| CD | Coefficient of determination | 0.896 | | |
| t-test Critical value | Coefficient divided by standard error | See table 4.2.2.1 | t-values $p(t) < 0.05$ and/or t-value above 2.00 | |

Source: from SEM sample data estimation output summarized and comparison of cut value

Table 4.9 Regression weight of researcher samples data SEM estimate outputs.

| Hypothesis | Variables | Coef. | Std. Err. | t-test CR | P>t | [95% Conf. | Remark |
|-----------------|----------------------------|----------|-----------|-----------|-------|------------|----------------|
| | Shebadepto(explained | | | | | | |
| H ₁ | Maneff | 0.06156 | 0.02596 | 2.37 | 0.019 | 0.01010 | Significance |
| H ₂ | Orgstr | 0.05032 | 0.20715 | 0.24 | 0.809 | -0.36024 | Insignificance |
| H ₃ | image_reputation | 0.02322 | 0.02982 | 0.78 | 0.438 | -0.03587 | Insignificance |
| H ₄ | Proinnov | 0.01151 | 0.03792 | 0.3 | 0.762 | -0.06367 | Insignificance |
| H ₅ | business_riskr | -0.02308 | 0.02633 | -0.88 | 0.383 | -0.07527 | Insignificance |
| H ₆ | government_risk | -0.00833 | 0.01812 | -0.46 | 0.647 | -0.04423 | Insignificance |
| H ₇ | financial_risk | -0.00049 | 0.01880 | -0.03 | 0.979 | -0.03775 | Insignificance |
| H ₈ | treasury_risk | 0.06753 | 0.02827 | 2.39 | 0.019 | 0.01149 | Significance |
| H ₉ | Quahumres | 0.49614 | 0.12234 | 4.06 | 0 | 0.25366 | Significance |
| H ₁₀ | Rd | 0.14693 | 0.06670 | 2.2 | 0.03 | 0.01474 | Significance |
| H ₁₁ | confmansherianverdict | 0.52884 | 0.22569 | 2.34 | 0.021 | 0.08152 | Significance |
| H ₁₂ | Existingcombsk | 0.05867 | 0.10140 | 0.58 | 0.564 | -0.14232 | Insignificance |
| H ₁₃ | community_awareness | -0.07601 | 0.06894 | -1.1 | 0.273 | -0.21265 | Insignificance |
| H ₁₄ | edu_andtraining | 0.25764 | 0.07433 | 3.47 | 0.001 | 0.11033 | Significance |
| H ₁₅ | Govbyreg | -0.11088 | 0.07492 | -1.48 | 0.142 | -0.25937 | Insignificance |
| H ₁₆ | Suitablebpol | 0.06163 | 0.02300 | 2.68 | 0.009 | 0.01603 | Significance |
| H ₁₇ | IFBand_muslim religion | 0.38016 | 0.12430 | 3.06 | 0.003 | 0.13380 | Significance |
| H ₁₈ | ifballivatefin_deprivative | -0.33062 | 0.13133 | -2.52 | 0.013 | -0.59091 | Significance |
| | _cons | -2.7961 | 1.3356 | -2.09 | 0.05 | -5.4433 | |

(Source: Regression out put of sample data by SEM)

Estimation output provides CR values cosponsoring to the unstandardized estimates only. In journal papers usually the standardized estimates are quoted along with the t-values and p-values. The structural model shown in table 4.6, which shows the relationship between constructs variables are easy to understand. 18 items were co-varied because they have high the highest modification indices (MI). Support for and the acceptability of the structural model is evaluated based on the three criteria outlined in previous. And also the underlying premise of factor analysis is the relevant relations among the original variables. Using KMO (Kaiser-Meyer-Olkin) and Bartlett's test of Sphericity, the value of KMO statistics is from 0 to 1, the more close to 1 of KMO value indicates the more common factors of variables, and the more suitable analysis. According to the view of scholars Kaiser (1974), factor analysis requires KMO coefficient to be at least 0.5 whereas my work KMO is 0.69 which is acceptable and fulfill the criteria.

From above description, the model suggests that Interest free banking-i.e deposit mobilization and financing service based on sharian principle has the strongest associated with qualified and skilled human resource(4.06), creation of awareness to community(awared society) (t-values 3.47), suitable and effective banking policy and procedure(t-values 2.68), effectiveness of existing banks(t-values 2.52), overall managerial efficiency(t-values 2.37), working with Sherian Verdict and Principle(t-values 2.34), Treasury risk of liquidity and solvency problem(t-values 2.39), Research and development(RD) of to enhance human resource excellency(t-values 2.2) are highly affect the interest free bank services and future expansion.(see tab 4.4.2.4)

4.5 Discussion of Empirical Finding

Hypothesis 1, null hypothesis H_0 is rejected and choose ALT hypothesis H_1 , Proposed that Overall managerial efficiency has a positive effect on IFB service and future banking expansion, As can be observed from the table 4.7 above. Overall managerial efficiency have β estimate value of 0.062 which is differ from zero and t-statics 2.37 with a p value of 0.019, found to be significantly and positively affecting. Hence, hypothesis_1 is supported. The results showed that overall managerial efficiency has significance effect on the effectiveness of free banking.

This finding is in accordance with the findings of the studies by (Abdullah and Abdul Rahman, 2007; Rammal and Zurbrugg, 2007; Thambiah et al., 2011; Echchabi and Aziz, 2012b; Ayinde and Echchabi, 2012; Bizri, 2014). Nevertheless, the result contradicts the findings of (Doraisamy et al., 2011; Abdul-Hamid et al., 2011; Aziz et al., 2015), Echchabi et al. (2014), which indicated that Overall managerial efficiency did have a significant relation with the interest free Banking service . Since the p-value of the normality is 0.019, which is less than alpha level (0.05), we to reject the null and, we accept alternative hypothesis.

Hypothesis H4: Even our structural modeling estimation output parameter and t-critical measurement criterion fitted due to p-value 0.438 greater than 5% level of significance we reject our t-statistics. But it does not mean that Banks-image and reputation is completely insignificant for interest free banking. Hence, Hypothesis-3 is not support by neither null nor alternative hypothesis, p-values. Due to this reason t-test with statistics-p-values ($\beta=0.0232246$, S.Error 0.0298172) t-test 0.78 with p-value 0.438 greater than 5% levels of significance. Therefore, we are neither reject nor accepted both null hypothesis (H_0) and alterative hypothesis. Hence, it may previous bank history and performance of the business may not be as much supportive for future career. What we call banks-image and reputation insignificant factor for effectiveness interest free banking Ethiopia and future success, which support the statement business run complain with Sherian Principle.

Hypothesis H8: Controlling Treasury risk is highly significant which affect interest free banking service. From out table summarize β has estimate value of 0.348 and t-statics 2.39 with a p value of less than 0.019. Thus the alternative hypothesis (H_9) is not rejected, which is accepted. This means in contrary, the underlying null hypothesis is rejected. The problem of liquidity and solvency high observed from the business sector. Due to none interest bearing (riba) financing service best for customer to use the fund for long period of time.

Hypothesis H9: Qualified human resource has great effects on interest free banking service. Supporting these statement variables that has β estimate value of 0.4961389 and t-statics 4.06 with a p value of less than 0.00 or near zero value. Thus the null hypothesis (H_{10}) is failed rejected, i.e accepted it. If high qualified human resource available, the more likely that IFB products will be sells by bank.

Hypothesis H₁₀: Research and Development related with human resource. As mentioned in the hypothesis-H₁₀, to increase efficiency and effectiveness of employee, investing in HR, which induce service Excellency and qualified managers and staffs.

Hypothesis H₁₁: Managing conflict with sharia Verdict has great effects on interest free banking service and financing. Which is significant has β estimate value of 0.5288405 and t-statistics 2.34 with a p value of 0.021. Thus the alternative hypothesis (H₁₂) is not rejected this means the greater the qualified human resource available, the more likely that IFB products will be sells by bank.

Hypothesis H₁₂: Pre-Existing common Sheria board is not strong, skilled and knowledgeable to manage factors affects interest free banking service. But if strong and equipped common Sherian Board committee has positive effect the business. Which is significant has β estimate value of 0.5288405 and t-statistics 2.34 with a p value of 0.021. Thus the alternative hypothesis (H₁₃) is not rejected, the banking sector must be supported by strong common sherian Board.

Hypothesis H₁₃: The community society has no awareness about IFB why they use interest free banking service and indifferent Muslim religion and Interest free baking. Even regress output supported, β estimate value of -0.0760137 and t-statistics -1.1 p-value of 0.273, existence of qualified human resource available, the more likely that IFB products will be sells by bank. There is significant relationship between creating awareness for the society to avoid religious connotation

Hypothesis H₁₄: As per our respondent, currently most of Muslim society were not use bank to save their money, with reason of interest rate and financial support to interest free banking service and indifferent with Muslim religion. Which is significant has β estimate value of 0.5288405 and t-statistics 2.34 with a p value of 0.021. this Thus support hypothesis (H₁₅) is not rejected this means any banking sector engaged on this sector, must be improve marketing strategy by creating awareness facilitating education and training using social media, internets-web and magazine and brochures.

Hypothesis H₁₅: the research output shows that there is no organized relation between Regulation and Law to control interest free banking. Once start running business, cannot be

controlled by macro-economic policy or regulatory system. As our research output shows β estimate value of -0.11088 and t-statistics -1.48 with a p value of 0.142 that we develop best regulatory system that need to manage financial sector. Thus even the alternative hypothesis and null hypothesis of (H_{15}) is rejected, whereas support and developed strong Regulatory Laws is necessary.

Hypothesis H_{16} : this also associated with regulatory system of days to today activity. Most of the time each commercial bank has their own banks policy and procedure to run their business. They have no such common procedure how to business run. So, my respondent response estimation shows and recommend the necessity of common and suitable banking policy to effectively and efficiently managing and control the growth demand. We reject null hypothesis whereas accepted alternative with β value 0.06163, CR 2.68 and p-value 0.009.

Hypothesis H_{17} : Proposed that Religious Belief has a positive effect on the effectiveness of interest free banking service. Supporting these statement variables β estimate value of 0.3801636 and t-statistics 4.324 with a p value of less than 0.003. Thus the alternative hypothesis (H_{18}) is not rejected this means the greater the religious belief, the more likely that IFB products will be utilized by bank customers.

Hypothesis 18 due to successive interest free banking implemented and building good images, attract more customers and needs to successive expansion of the IFB branches. This action led to alleviate the deprived customer demand for interest free banking. And service and governance enhance good banking service to alleviate the existing derivate IFB demand. The alternative hypothesis recognized

CHAPTER FIVE

SUMMARY, CONCLUSIONS, POLICY IMPLICATIONS, AND RECOMMENDATION

5.1 Introduction

This chapter presents the final part of the study based on the result obtained in the study; a discussion of theoretical and practical implication are presented on this chapter. Furthermore, some recommendations were suggested for banks and any concerned organs Contribution of this study, its limitations and future research also presented in this chapter. Further, this study intends to examine further examining on factor affecting interest free banking sector, in the Ethiopian context.

5.2 Summary of the study

The purpose of this research is to identify factors affecting interest free banking and its expansion in Ethiopia. According to empirical evidences, eighteen factors identified that affecting interest free banking and future expansion visions. Based on literatures, this study expects as following variables will affect banking industries. These variables may include as a explanatory variable Sherian based Deposit accepting and financing-which is the main function of banking industry and factor affecting the business such as Overall managerial efficiency(OME), types of organizational structures(ORS), Bank good images and Reputation (IMAGE_REPUTITION), Product innovation and differentiates with Sherian_Compliant pricing benchmarking(PROINNOV), Business risk- rate of return affect, Government risk , Financial risk, treasury risk, the existence of Qualified top managers and skilled staff i.e qualified human resource, Research and development on HR, ongoing conflicts' management system and Sheria Verdict, existing Common Sheria Board skilled and knowledgeable on Sheria principles, Community awareness about interest free banking and religious connotation, Set of regulations and banking policies . The study has be analysis how those variables affect interest free banking industry both positively and negatively.

For this purpose, the researcher able to collect 128 questionnaires out of total 140 disseminated questionnaires' and the collected edited and inserted into STATA. To achieve the objective of

the research the Structural Equation Model was applying factor analysis called exploratory factor analysis by reducing not producing useful factors.

Finally, the research findings are presented as follows:

The major demographic results were 74.22% of the respondents were Male, 64.1% of respondents were having BA/BSC; 89.06%, the remaining 5.47 MA , 3.9 certificate and diploma.

From the model, seven (8) factors were statistically significant in affecting IFB service. the model suggests that Interest free banking-i.e deposit mobilization and financing service based on sharian principle has the strongest associated with qualified and skilled human resource(4.06), creation of awareness to community(awared society) (t-values 3.47),suitable and effective banking policy and procedure(t-values 2.68), effectiveness of existing banks(t-values 2.52), overall managerial efficiency(t-values 2.37), working with Sherian Verdict and Principle(t-values 2.34), Treasury risk of liquidity and solvency problem(t-values 2.39), Research and development(RD) of to enhance human resource excellency(t-values 2.2are highly affect the interest free bank services and future expansion.

5.3 Conclusion

This study was constructive by four basic questions: What is the current status of interest-free banking service and financial products in commercial bank in Ethiopia? To what extent factors influence the Ethiopian dual banking towards use of interest-free banking service? Which factors has most impact on interest-free banking services, financing and banking expansion in Ethiopia? And, How National banks of Ethiopian to regulate interest free bank industry and control commercial banks?

Finally, even all variables parameter (β) differ from zero, while some p-values is greater than 5% level of significance, which is statistical insignificant. The model suggests that Interest free banking-i.e deposit mobilization and financing service based on sharian principle has the strongest associated with qualified and skilled human resource(4.06), creation of awareness to community(awared society) (t-values 3.47),suitable and effective banking policy and procedure(t-values 2.68), effectiveness of existing banks(t-values 2.52), overall managerial

efficiency(t-values 2.37), working with Sherian Verdict and Principle(t-values 2.34), Treasury risk of liquidity and solvency problem(t-values 2.39), Research and development(RD) of to enhance human resource excellency(t-values 2.2) are highly affect the interest free bank services and future expansion.

5.4 Policy Implication

The Conner study, examines the factor affecting interest free banking by focusing on the account holder in commercial bank in Ethiopia. Thus, it gives hindsight for the practitioner and stakeholders on the Commercial bank in Ethiopian and it will benefit those who want to establish Interest free bank. The overall results of the present study suggest qualified and skilled human resource, creation of awareness to community (awered society), suitable and effective banking policy and procedure, effectiveness of existing banks, overall managerial efficiency, working with Sherian Verdict and Principle, Treasury risk of liquidity and solvency problem, Research and development (RD) of to enhance human resource excellency are highly affect the interest free bank services and future expansion.

The bank or the Common Sherian Board should improve customers awareness through focusing and continuing the Awareness creation programs like Religious Institutions, Edirs, medias, brochure and use different occasional mechanism, Family, Religious persons and making adjustment on the media used on their marketing and promotion strategy to create customers awareness on the Shariah position on business transaction, a concept of profit-and-loss-sharing practice and for whom it offered, teaching regarding the benefit they will get if they use the products and services, design product according to customers preference, transparency practice in transaction with customers and full compliance of product with Shariah practice, availability of Interest free banking products and government support on Interest free financing structure.

The bank has to develop well planned and intensive marketing and promotion strategy like reaching the target market through the religious leader, use praying days where significant number of the target population easily available to advertise the IFB products in addition to the mainstream media and customer session. The present findings clearly imply that religious beliefs are still instrumental in influencing the factors of IFB products and services.

The findings of the this study have significant contributions that can be categorized under contribution to the body of knowledge, contribution to the practitioners and stakeholders, as well as the contribution to the policy makers and regulators. This research serves to offer valuable contributions to existing literature. First, this study has contributed to theoretically better understand the dynamics of interest free banking in Ethiopian context.

5.5 Recommendations

- 1) In considering the major findings of the study and the conclusions drawn, some efforts were made to forward possible recommendations for the attainment of a better result interest free banking service, financing and expansion in Ethiopian banking industry for the better achievement of the objectives.
- 2) It is important to ensure uniformity and harmonization of shariah standards and practices across the board. There, is a need to have one shariah board to support the system. This will also help in enhancing the credibility and confidence in the interest free banking system.
- 3) To continuously develop Research and Development office to enhance human resource excellence as much equipped. An extreme focus, attention, and generous investment should be given and allocated to develop and train a new generation of experts in interest free banking regulations and laws. The bank should have given training to various topics related to interest free banking on a regular basis to maximize the skill and knowledge of employees.
- 4) The bank should have given training and advertise consecutively at various topics related to interest free banking on a regular basis to maximize the skill and knowledge of employees.
- 5) There should be intensive educate the community through different communication method create awareness to the community to avoid religions connotation and development in the area of Interest-Free Banking through the establishment of research centers and capacity building workshops to develop cognate experience.
- 6) Enhancing and enforcing the standards for effective corporate governance to protect and safeguard customers, as well as for effective market discipline and

transparency, to provide timely and reliable information. The enforcement of these standards will help in enhancing industry credibility and will create confidence among all stakeholders. In order to minimize the religion difference in Ethiopia makes difficult to introduce interest free banking services due to currently the target customers for interest free banking service are both Muslims and non-Muslims.

- 7) Finally, Enhancing and enforcing the standards of Regulatory laws, standard baking procedure and policy for effective corporate governance to protect and safeguard customers and baking system. National Bank of Ethiopia developed its capacity as much as possible to control commercial banking engaged in interest free banking industry.

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

5.6 Limitation and future area of the study

This study has focused on users of interest free bank and the respondent were employees of different commercial bank located wolkite and Butajira town. Thus the results from this case might not be generalized Interest free banking service out of this two town.

Therefore, future study should

- ✓ Carried out on sample of all banks and all regions of the country to investigate factors affecting interest free banking.
- ✓ A replica of this research can be carried out with longitudinal data and on a wider scale (nation-wide) so that cross-regional similarities and differences can be studied.
- ✓ The approach of this paper can be extended to analyze IFB by including variables such as culture, trust, and reward.
- ✓ A Comprehensive study of the IFB ecosystem can be conducted by concurrently analyzing the effect of managerial efficiency, government regulations, Human resource infrastructure and organizational factors.

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Website

www.cbe.mail.com.et

www.nationalmaster.com

APPENDICES

Appendix I: Researcher structured Questioner

WOLKITE UNIVERSTY
COLLEGE OF BUSSINESS AND ECONOMICS
DEPARTEMENT OF ECONOMICS

Researcher: Fikru Asera

Contact Address: +251-912282145

Email: fikrsha@gmail.com

Dear Respondents, I am conducting a research on “Factors affecting interest free banking -and its expansion in Ethiopia”. This research questionnaire is designed to collect data about factors affecting interest free banking _and its expansion in Ethiopia -for the partial fulfillment of the requirement for MSc. program in Developmental Economics. The result of this study is intended to serve for academic purpose only. I would like to remind you that you genuine response is highly valuable and has great contribution for the quality of the research.

Confidentiality of your information is kept and the results will be aggregated and presented only in summery form and the information obtained will be used only for academic purpose.

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

INSTRUCTION:

Writing your name is unnecessary.

Put “√” mark as per the questions required in the box or answer in the space provided.

Part One: Respondents Profile

1. Gender

Male Female

2. Religion

Muslim Christian other

3. Educational Level

Certificate Diploma Degree Master PhD

4. Number of years you have worked with the Bank(in years).

5. Your current position _____

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

Next, there are listed of items which deal with respondents view on factors affecting interest free banking and expansion of banking industries. These items will explore respondents' assessment of factors affecting interest free banking and its expansion in Ethiopia. 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).

| Items(Variables) | Strongly disagree (1) | Disagree (2) | Neutral (3) | Agree (4) | Strongly Agree(5) |
|--|-----------------------|--------------|-------------|-----------|---------------------|
| 1. Managerial Efficiency | | | | | |
| 1.1 over management efficiency needs to overcome an obvious to continue business in competitive market and future expansion of interest Free Bank in Ethiopia. | | | | | |
| 1.2 Types of organizational structure has role on business success and continuity. | | | | | |
| 1.3 Keep their money Sheria-Based deposit without interest bearing is acceptable by all IFB customer | | | | | |
| 1.4 Bank images and reputation has role in business success or exists and future expansion of IFB. | | | | | |
| 2. Technical Factors | | | | | |

| | | | | | |
|--|--|--|--|--|--|
| 2.1 There is sufficient product innovation or product differentiate technics with Sheria-Compliant price benchmarking to win the market competition and support to enhance business success. | | | | | |
| 3. Risk Management | | | | | |
| 3.1 Being business risk affect interest free banking | | | | | |
| 3.2 Being government-operational risk affect IFB | | | | | |
| 3.3 Being Financial risk _credit and market risk affect IFB | | | | | |
| 3.4 Being treasury risk- liquidity and solvency risk affect Interest free bank | | | | | |
| 4. Human Resource | | | | | |
| 4.1 Qualified top managers and skill staff has effect on effectiveness and expansion of Interest Free Bank. | | | | | |
| 4.2 There are enough qualified human resource in Islamic banking to ensure that Islamic banking Services are up to date and fully comply with Sha'riah law | | | | | |
| 4.3 Research and development on HR, enhance interest free banking services and interest free finance modalities to fill the gap in qualified human resource. | | | | | |
| 5. External factor | | | | | |
| 5.1 Managing conflicts' on Sheria Verdict is necessary for IFB success and future expansion | | | | | |
| 5.2 the existing Common Sheria Board skilled and knowledgeable Sheria scholars is capable to manage the individual commercial bank sheria board. | | | | | |
| 6. Social Factors | | | | | |
| 6.1 The Community has awareness about Interest Free Banking system | | | | | |
| 6.2 By increasing awareness in the community by education and training institutions avoid religious connotation about Interest Free Bank. | | | | | |
| 6.3 Interest free banking service need in Ethiopia so that it will alleviate the financial | | | | | |

| | | | | | |
|---|--|--|--|--|--|
| services deprivation of community those who need interest free service. 1. No 2. YES | | | | | |
| 6.4 IFB will be affected by Muslim religion? 1. No 2. YES | | | | | |
| 7. Regulatory system | | | | | |
| 7.1 Interest free banking should be governed by different set of regulations as they differ from conventional banks in many aspects such as risk structure, form of ownership and governance. | | | | | |
| 7.2 There is suitable banking policies for Interest free banking. | | | | | |
| 7.3 The offering of interest free banking products (saving and loan service) will improve the tendency for business expansion and investment. | | | | | |

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

9. If you have any other opinion related to factors affecting Interest free banking?

Appendix II: Respondents working Branch

| | Numbers of line and branch Managers | Employee (clerical) | total empl | employees deligated to ifb |
|-------------------------|--|----------------------------|-------------------|-----------------------------------|
| Abyssenia(Yejoka) | 2 | 8 | 10 | 3 |
| NIB(wolkite br) | 2 | 17 | 19 | - |
| CBE-Wolkite Br | 4 | 33 | 37 | 2 |
| Oromiya Cooperative | 2 | 9 | 11 | 2 |
| Wegagen Wolkite br | 2 | 7 | 9 | 2 |
| BUNA Wolkite br | 2 | 7 | 9 | 2 |
| HIBRET Wolkite br | 2 | 9 | 11 | 2 |
| AWASH Wolkite br | 2 | 10 | 12 | 2 |
| CBE-YEJOKA | 4 | 21 | 25 | 2 |
| Debub global Wolkite br | 2 | 8 | 10 | 2 |
| BIRHAN Wolkite br | 2 | 11 | 13 | 2 |
| NIB-YEJOKA | 2 | 18 | 20 | - |
| CBE-BEKUR br | 4 | 21 | 25 | 2 |
| DASHEN Wolkite br | 2 | 10 | 12 | 2 |
| Oromiya international | 2 | 11 | 13 | 2 |
| ABESSINIA-Wolkite br | 2 | 15 | 17 | - |
| NIB-AMANA br | 2 | 6 | 8 | 11 |
| Erinzaf cbe butajira | 2 | 16 | 18 | 2 |
| Gubre cbe | 2 | 17 | 19 | 2 |
| Gubre nib | 2 | 18 | 20 | 2 |
| Agena cbe | 3 | 16 | 19 | 2 |
| Emdibir cbe | 4 | 19 | 23 | 2 |
| Emdirbir nib | 2 | 17 | 19 | 2 |
| Abessenia Emdibirr | 2 | 9 | 11 | 2 |
| Agena BranchNib | 2 | 13 | 15 | 2 |
| Gubre NIB out late | 2 | 8 | 10 | 2 |
| Butajira cbe | 4 | 36 | 40 | 2 |
| Butjira nib | 2 | 19 | 21 | 2 |
| Dashenbutajira | 2 | 17 | 19 | 2 |
| Bresha cbe butajira | 3 | 22 | 25 | 2 |
| Fith cbe butajira | 3 | 13 | 16 | 16 |
| Awash butajira | 2 | 14 | 16 | 2 |
| | | | 552 | 82 |



National Bank of Ethiopia
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4. Licensing and Authorizing Interest Free Banking Business

- 4.1 Persons who intend to establish an interest free bank shall apply to the National Bank for a license in line with Directive No. SBB/56/2013.
- 4.2 A bank shall obtain a written authorization from the National Bank to carry on interest free banking window.
- 4.3 A bank which wishes to obtain an authorization to carry on interest free banking window shall submit a duly completed application in the prescribed format together with documents specified below:
- a) a report on resource mobilization and use;
 - b) planned balance sheet structure for interest free banking window and the whole bank;
 - c) maximum share of planned interest free banking window in total consolidated balance sheet of the bank;
 - d) risk management framework for all interest free banking window products;
 - e) a statement on availability of adequate capacity and facilities to run interest free banking window;
 - f) accounting aspects, such as accounting policies to be followed and profit and loss sharing mechanisms;
 - g) evidence of financial strength as reflected in capital adequacy, asset quality, earnings capability, future earnings prospects, and current liquidity position and forecast for the next 12 months;
 - h) track records of adherence to prudential regulations, credit discipline, quality of customer services;
 - i) a statement on the convenience as well as the needs of the population of the area to be served by interest free banking window;
 - j) methods of segregating the funds of interest free banking window from all other business; and
 - k) such other information as may be required by the National Bank while processing the application.





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4.4 The National Bank shall evaluate the application for authorization of interest free banking window submitted by a bank in view of risk management, Banking Business Proclamation, applicable directives issued by the National Bank as well as other rules and regulations for authorization.

5. Prohibition

5.1 Banks shall not alter maximum share of interest free banking window in their consolidated balance sheet without prior approval of the National Bank.

5.2 Failure to comply with sub-article 5.1 of this Article may result in the closure of interest free banking window.

6. Maintenance of Accounts and Financial Statements by Interest Free Banking Window

A bank engaged in interest free banking window shall:

6.1 keep separate books of accounts in respect of operations of interest free banking window and ensure proper maintenance of records for all transactions for segregation of funds.

6.2 report its interest free banking window activities every month to the National Bank.

7. Compliance with Regulatory and Supervisory Requirements

7.1 In conducting interest free banking business, banks shall comply mutatis mutandis with all regulatory and supervisory requirements except National Bank's directive on interest rate.

7.2 Board of directors of a bank engaged in interest free banking business shall develop detail policies and procedures on Shariah oversight.

8. Repeal

“Directives to Authorize the Business of Interest Free Banking No. SBB/51/2011” are hereby repealed and replaced by this Directive.

9. Effective Date

This Directive shall enter into force as of the 18th day of June 2019.




Yinager Dessie (PhD) 3
Governor

Appendix **IV**: statistical definition .

Structural model: Represents the theory that shows how constructs are related to other constructs.

Structural equation modeling is also called casual modeling because it tests the proposed casual relationships. The following assumptions are assumed:

Linearity: A linear relationship is assumed between endogenous and exogenous variables.

Outlier: Data should be free of outliers. Outliers affect the model significance.

Sequence: There should be a cause and effect relationship between endogenous and exogenous variables, and a cause has to occur before the event.

Non-spurious relationship: Observed covariance must be true.

Model identification: Equations must be greater than the estimated parameters or models should be over identified or exact identified. Under identified models are not considered.

Sample size: Most of the researchers prefer a 200 to 400 sample size with 10 to 15 indicators. As a rule of thumb, that is 10 to 20 times as many cases as variables.

Uncorrelated error terms: Error terms are assumed uncorrelated with other variable error terms.

Data: Interval data is used.

Steps:

Defining individual constructs: The first step is to define the constructs theoretically. Conduct a pretest to evaluate the item. A confirmatory test of the measurement model is conducted using CFA.

Developing the overall measurement model: The measurement model is also known as path analysis. Path analysis is a set of relationships between exogenous and endogens variables. This is shown by the use of an arrow. The measurement model follows the assumption of unidimensionality. Measurement theory is based on the idea that latent constructs cause the

measured variable and that the error term is uncorrelated within measured variables. In a measurement model, an arrow is drawn from the measured variable to the constructs.

Design the study to produce the empirical results: In this step, the researcher must specify the model. The researcher should design the study to minimize the likelihood of an identification problem. Order condition and rank condition methods are used to minimize the identification problem.

Assessing the measurement model validity: Assessing the measurement model is also called CFA. In CFA, a researcher compares the theoretical measurement against the reality model. The result of the CFA must be associated with the constructs' validity.

Specifying the structural model: In this step, structural paths are drawn between constructs. In the structural model, no arrow can enter an exogenous construct. A single-headed arrow is used to represent a hypothesized structural relationship between one construct and another. This shows the cause and effect relationship. Each hypothesized relationship uses one degree of freedom. The model can be recursive or non-recursive.

Examine the structural model validity: In the last step, a researcher examines the structural model validity. A model is considered a good fit if the value of the chi-square test is insignificant, and at least one incremental fit index (like CFI, GFI, TLI, AGFI, etc.) and one badness of fit index (like RMR, RMSEA, SRMR, etc.) meet the predetermined criteria

Appendix V: International Regulating Bodies.

In addition to the country specific banking and IFB regulations and guidelines, there are a couple of international Islamic finance agencies responsible for providing regulations, standards and procedures for enforcing and regulating the soundness of Islamic banking industry. This section will give an overview of these key bodies, their role and also the list of countries which has adopted these standards either at the regulatory level or on a financial institution's level to follow the best practices in Islamic banking and finance.

International Financial Services Board (IFSB)

IFSB was launched in 2002 in Kuala Lumpur and serves as an international standard setting body that provides prudential standards and guidelines for regulatory and supervisory agencies to ensure soundness and stability Islamic Financial industry including: retail banking, capital markets and Takaful (Islamic insurance). The IFSB has:

- 13 standards
- 5 guide notes
- 1 technical note

As of September 2014, IFSB members comprise of 184 members from 41 jurisdictions, including 32 members from the African continent. IFSB has 55 regulatory and supervisory authorities, 8 international/intergovernmental organisations and 121 market players, professional firms and industry associations. (source: IFSB)

Several non-predominantly Muslim countries have adopted IFSB rulings including: China, Hong Kong, Japan, Korea, Luxembourg, Singapore and Thailand.

Accounting and Auditing organization for Islamic financial institutions (AAOIFI)

AAOIFI is responsible for developing and issuing standards for the Islamic finance industry. AAOIFI has 88 standards including:

- 48 Sharia
- 26 Accounting
- 5 Auditing
- 7 Governance
- 2 Ethics

AAOIFI has over 200 members in more than 40 countries. Members include regulatory and supervisory authorities, international/intergovernmental organisations and market players, professional firms and industry associations.

- Countries adopting AAOIFI include: Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria.

- Countries with guideline based on AAOIFI: Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, South Africa and United Kingdom.

AAOIFI standards have introduced greater harmonisation among Islamic finance actors across the world.

Appendix IV: Descriptive statistics summary

> ion

| Variable | Obs | Mean | Std. Dev. | Min | Max |
|--------------|-----|----------|-----------|-----|-----|
| maneff | 128 | 4.257813 | .7658673 | 1 | 5 |
| orgstr | 128 | 4.3125 | .6115683 | 1 | 5 |
| ifballivat~e | 128 | .9375 | .2430126 | 0 | 1 |
| image_repu~n | 128 | 4.320313 | .6632489 | 2 | 5 |
| proinnov | 128 | 1.671875 | .5190751 | 1 | 3 |
| business_r~r | 128 | 1.9375 | .7397595 | 1 | 5 |
| government~k | 128 | 3.570313 | 1.127212 | 1 | 5 |
| financial_~k | 128 | 2.109375 | 1.165342 | 1 | 5 |
| treasury_r~k | 128 | 4.523438 | .7313545 | 2 | 5 |
| quahumres | 128 | 1.640625 | .5714242 | 1 | 5 |
| rd | 128 | 4.34375 | .5240289 | 2 | 5 |
| confmanshe~t | 128 | 1.679688 | .6139275 | 1 | 5 |
| existingco~k | 128 | 1.625 | .4860252 | 1 | 2 |
| community_~s | 128 | .125 | .3320184 | 0 | 1 |
| edu_andtra~g | 128 | 4.375 | .5174133 | 3 | 5 |
| govbyreg | 128 | 4.320313 | .5314309 | 3 | 5 |
| suitablebpol | 128 | 2.039063 | .8909196 | 1 | 5 |
| IFBand_oth~n | 128 | 1.929688 | .2566776 | 1 | 2 |

Appendix VII: Descriptive statistics tabulation

Appendix VII: Statistical output of estimation values of Goodness of Fitt

```
. estat gof, stats(rmsea residuals)
```

| Fit statistic | Value | Description |
|---------------------|-------|--|
| Population error | | |
| RMSEA | 0.000 | Root mean squared error of approximation |
| 90% CI, lower bound | 0.000 | |
| upper bound | 0.000 | |
| pelese | 1.000 | Probability RMSEA <= 0.05 |
| Size of residuals | | |
| SRMR | 0.000 | Standardized root mean squared residual |
| CD | 0.896 | Coefficient of determination |

```
. estat eqgof
```

Equation-level goodness of fit

| depvars | fitted | Variance predicted | residual | R-squared | mc | mc2 |
|-----------|----------|--------------------|----------|-----------|----------|----------|
| observed | | | | | | |
| shebadepo | .3349609 | .3001502 | .0348107 | .8960752 | .9466125 | .8960752 |
| overall | | | | .8960752 | | |

mc = correlation between depvar and its prediction
mc2 = mc^2 is the Bentler-Raykov squared multiple correlation coefficient

```
. estat eqgof
```

Equation-level goodness of fit

| depvars | fitted | Variance predicted | residual | R-squared | mc | mc2 |
|-----------|----------|--------------------|----------|-----------|----------|----------|
| observed | | | | | | |
| shebadepo | .3349609 | .3001502 | .0348107 | .8960752 | .9466125 | .8960752 |
| overall | | | | .8960752 | | |

mc = correlation between depvar and its prediction
mc2 = mc^2 is the Bentler-Raykov squared multiple correlation coefficient

Appendix IIIV: Factor Test analysis

```

. factortest shebadepo maneff orgstr image_reputation proinnov business_riskr government_risk financial_risk treasury_risk quahumr
> es rd confmansherianverdict existingeomsbak community_awareness edu_andtraining ifballivatefin_deprivative govbyreg suitablebpol
> IFBand_etherreligion

Determinant of the correlation matrix
Det          =    0.000

Bartlett test of sphericity

Chi-square    =    1755.004
Degrees of freedom =    171
p-value       =    0.000
H0: variables are not intercorrelated

Kaiser-Meyer-Olkin Measure of Sampling Adequacy
KMO          =    0.690

```

Appendix IIIIV: Definition of Some terms and concepts

| | |
|-----------|---|
| Amanah | A contract under which an object or a bank deposit is held on trust |
| Al-Qur'an | Muslims' Holy book, means the noble Qur'an |
| Damam | Responsibility |
| Fatwa | ruling by a scholar of Islamic jurisprudence such as those serving on the shari'ah boards of Interest free banks |
| Fiqh | Islamic jurisprudence |
| Gharar | legal uncertainty such as contractual ambiguity which could result in one of the parties to a contract exploiting the other |
| Ghorm | Risk Taking |
| Halal | permissible under Islamic law by being Shari'ahcompliant |
| Harām | Prohibited |
| Ijara | an operational leasing contract where the owner responsibilities justifies the payment of rent. |

| | |
|------------|---|
| Ijma‘ | Consensus of opinions collectively agreed among Shariah scholars |
| Ijtihad | The interpretation by a trained scholar, such as those serving on the Shari'ah boards of Islamic financial institutions, of how Shari'ah should be applied in new circumstances. |
| Istisna'a | The sales contracts that requires the manufacturer of the good or the contractor of facility to exact specifications that are stipulated before the work commences. |
| Kasb | Work and Effort |
| Maysir | A game of chance involving gambling. Activities such as spread betting financial markets are prohibited under <i>Shari'ah</i> as they are regarded as addictive and contribute nothing to society or an economy. |
| Mudaraba | A partnership contract between an investor, the <i>rabb al maal</i> , and a business manager, the <i>mudarib</i> , which provides for profit sharing, with the <i>rabb al maal</i> receiving a return on their financial investment while the <i>mudarib</i> receives a share of the profit assessed on the basis of the value of their effort. |
| Murabaha | a sale contract whereby an Islamic financial institution sells a good to a client who makes deferred payments including a profit markup. |
| Musharaka | a partnership contract between investors whereby they obtain predetermined shares in any profits generated. The partners take an active role in management, the extent of that activity being defined in the contract. |
| Qard Hasan | an interest-free loan, the only type of loan agreement permissible under Shari'ah. Although Islamic financial institutions cannot profit from the loan, they may levy a set-up fee and an annual management levy to cover administrative expenses. |

| | |
|-----------------|---|
| Qiyas | Analogy |
| Riba | An addition to the principal of a loan, which is usually equated with interest |
| Riba al Nasi'ah | Riba of Delay |
| Riba al- fadl | Riba of excess |
| Salam | Advance payments in full for a commodity for delivery at a future date. This contract was originally used for the financing of agricultural production with the advance payment being used by farmers to cover labour, seed, irrigation and other costs during planting and cultivation while benefiting from a fixed price on harvesting |
| Shari'ah | The Islamic law based on the Divine guidance provided by the Quran and the Sunnah, practices or 'way' of the Prophet during his life |
| Sunnah | Teachings of the prophet Mohammad PBUH); they said about anything, they act anything is called as Sunnah |
| Wadiah | a peculiar non-earning type of IFB deposit that operates under the contract of Wadiah Yad Dh amanah (guaranteed custody). |