



**ST. MARY'S UNIVERSITY**  
**SCHOOL OF GRADUATE STUDIES**  
**DEPARTMENT OF ACCOUNTING AND FINANCE**

**CHALLENGES AND PROSPECTS OF ISLAMIC  
BANKING FOR RESOURCE MOBILIZATION  
IN ETHIOPIAN COMMERCIAL BANKS**

**BY**  
**AKMEL HAILU**

**JUNE, 2015**  
**Addis Ababa, Ethiopia**

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## **DECLARATION**

I the undersigned declare that this thesis is my original work; prepared under the guidance of Tiruneh Legesse, Assistant Professor. All sources of the used for the thesis have been dually acknowledged. I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institutions for the purpose of earning my degree.

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## ENDORSEMENT

This thesis has been submitted to St. Marry's University, School of Graduate Studies for examination for approval as a university advisor.

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## ACRONYMS

NBE – NATIONAL BANK OF ETHIOPIA

CBE – COMMERCIAL BANK OF ETHIOPIA

UB – UNITED BANK

OIB- OROMIA INTERNATIONAL BANK

IS – ISLAMIC BANKING

IBS- ISLAMIC BANKING SERVIC

IFB – INTEREST FREE BANKING

IFI-ISLAMIC FINANCIAL INSTITUTION

R&D – RESEARCH AND DEVELOPMENT

BBA- BAI BITHMAN AJIL

## **Abstract**

*The recent development of starting Islamic banking service in one window in connection with conventional banking service made to examine the challenges and prospects of Islamic banking service for resource mobilization in Ethiopian commercial banks. The study was conducted based on data collected from staffs of the three banks through questionnaires. To achieve the objectives of the study respondents were drawn from one government and two private commercial banks since they started the service early. Data was collected through questionnaire by using stratified sampling from a sample of 394 and 313 were properly filled and returned. Besides, Semi-structured interview were used to guide for the qualitative data collection tools. The data collected from the questionnaire were analyzed using SPSS version 20 statistical tools such as percentages and mean followed by interpretation.*

*The study focuses that awareness, manpower, legal framework, societal belief, resource requirements as some of the challenges while economic growth, attraction of investors, and fostering investment are the likely prospects of the banks. The study concludes that Islamic banking service will bring additional capacity in the economy in connection with additional resource for banks, investment opportunity, reaching unbanked customers and employment opportunities in the country through effective mobilization and allocation of capital. Based on the above conclusions it is recommended that banks need to create awareness for public acceptance and training of staffs, employ good marketing techniques, governing body need to establish clear set of legal framework, and compliance with sharia issues should be adhered.*

**Key words:** *Islamic Banking, Islamic banking window service, deposit items in Islamic banking, financing modalities of Islamic banking*

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

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

Besides the conventional banking service there is an interest to establish a full-fledged Islamic banking service to play an important role in pooling savings and channeling them into productive investments with the intent of partnership and profit sharing based on Islamic law shariah, but the national bank, the supervisory body of all banks in Ethiopia levied to do interest free banking business in one window with conventional banking as per “ the licensing and supervision of banking business Directives Number SBB/51/2011” .

Recently Islamic banking services come into existence in Ethiopia to play an important intermediary role in attracting savings, especially from customers, and channel the collected fund into productive investments. The banking service mainly focuses on financing primarily based on profit-and-loss sharing, trading, leasing. Both mobilization and investment of funds should be conducted in accordance with the principles of Islamic Shari'a" (www.albarakah.com, 2014).In Islamic banking service

unlike conventional banking service, they are not allowed to charge interest by lending money to their customers, because, under Islamic commercial law, making money from money is strictly prohibited (Chintaman, 2014 p. 5). In contrast to this the conventional banking business charges an interest from the loans made to customers and pay interest to the deposits made by customers'.

In order to attract and retain the specific needs of the Islamic banking service of the market some commercial banks start the Islamic banking service in one segregate window with the conventional banking service as per the requirement of the NBE directive. There are more than 18 private and government owned banks operate in the country. Among these Commercial bank of Ethiopia, United bank S.C and Oromia international bank S.C. start Islamic banking service as per the requirement. (www.nbe.gov.et)

When we saw their services according to the percepts of Islamic finance resource allocated for this service found from interest free activity. This implies that not only their lending but also their funding should make use of halal (interest free) financial instruments. Therefore to start the business the fund allocated for the service should be found from interest free activity. Islamic banks will be offering profit-sharing investment accounts to the depositors. These depositors are not assumed to share the profits/losses of the bank but neither fall into the category of the capital of the bank nor can be regarded as liabilities of the bank, in the accounting sense of the term (Elgar, 2009).

One of the services these banks offer includes that profits/losses sharing banking service. This needs careful screening because of the danger of adverse selection, and careful monitoring because of the dangers of asymmetric information and moral hazard. One factor contributing to adverse selection is that in a mixed financial system with both Islamic and conventional banks, entrepreneurs may not like the idea of profit sharing if they have rosy expectations of the success of their ventures whereas they may prefer profit-sharing finance from Islamic banks if they are less sure of a positive outcome. This might burden Islamic banks with a disproportional share of bad debts. (Khan, 2010)

In implementing this banking business the bank should also to note how the customer should be served and who answers client questions. Everyone who works inside an Islamic bank should understand Islamic finance principles. The bank training of the staffs is not only about religious concepts, the product knowledge that leads the staffs to understand how Islamic banking is different from conventional banking.

## **1.2 Statement of the problem**

Banks are one of the main deposit taking institutions by opening their doors to the general public to give their valuable services by identifying their customers and categorically designing the service need of these special customers through the effort of satisfying their banking requirements. Among these specialized services designed to serve the customers is Islamic banking service window or section besides with their conventional banking service. Islamic banking window is a business model in which conventional banks offer Islamic banking products and services from their existing branch network (Sanusi, 2011). In short, Islamic banking window refers to a situation whereby a conventional banking system provides some of the Islamic banking products or services (Sanusi, 2011). With this Islamic banking service section the banks serve their customer by accepting various types of deposit funds. Among the sources of funds deposit include shareholder investments, savings accounts, current accounts, and investment accounts, classified as either general or special.

These collected funds are used to handle and finance various Islamic financial services i.e. project finance, Islamic trade finance, leasing, mortgage, and health care finance etc. When we see conventional banking the collected resources are used to finance any type of business by granting it as a loan with the intention of charging interest. Where as in islamic banking concept the collected fund was not mixed with the conventional banking resources. This is because the prohibition of accepting and giving of interest (riba) concept of Islamic thought. The aim of Islamic banking service is to attract the business of Muslims who are out of the conventional system, as well as non-Muslim investors, who are seeking to diversify their portfolios or expand their investment base.

In Ethiopia now days, three banks start Islamic banking service windows besides their conventional banking activities. These are Oromia international bank S.C, Commercial bank of Ethiopia, and United bank S.C. by identifying the service needs of Islamic banking service by the business community, Muslim society and to put the first hand after the approval of the government to start Islamic banking in one window besides with their conventional banking service. They start promoting Islamic banking service and accepting non-interest deposits and financing requests i.e. Profit and loss sharing (murabah), a profit sharing joint venture (musharaka), a profit sharing agreement (mudaraba), supplying industrial products to clients order (istisna), a globally recognized mode of leasing (ijara) and other services.

Although the banks start this type of Islamic banking services there is lack of confidence in the business community about the service. This is because they mainly focus on the deposit accepting motives from those who don't want interest only. According to Haque (2009) customer perception about Islamic banking is being influenced significantly by quality of services, confidence in bank, social and religious perspective and availability of services. There is a request of fund by business community for the purpose of financing their trade and commercial activities on a profit and loss sharing mechanism and others mechanism mentioned above as per the principles of Islamic financing. In addition to this the collected fund need to be used for financing of those Islamic products only. Because accepting and paying of interest is prohibited by Islamic law.

On the other hand the ways in which Islamic banks can and do mobilize funds are all non- conventional and in some ways new to the regulators. Several issues and questions arise in the minds of regulators confronted with the task of supervising and regulating Islamic banks. Some methods for mobilizing funds, for example, would require asset management. Due to this involvement of commercial banks in asset management is entirely a new phenomenon in the context of the conventional concept of commercial banking.

The Ethiopian banking institutions starting these Islamic banking services and as based on the above facts will face many challenges in their operational activity of resource mobilization. Beyond this there is also growth prospect. In an attempt to



contribute in bridging the above stated problems, the study will focus on assessing challenges and prospects of Islamic banking service in resource mobilization efforts of Ethiopian commercial banks.

### **1.3. Research Questions**

The study attempts to answer the following research questions.

1. What are the various types of services offered by Islamic banking and their consistency with Islamic law (sharia)?
2. How Islamic banking service will have an effect on resource mobilization efforts of the bank?
3. What are the basic challenges the commercial banks face by starting Islamic banking service?
4. Is the product offered by Islamic banking sections of the commercial banks are sufficient enough to attract potential customers and having a potential to grow and contribute in the economy of Ethiopia?

### **1.4. Objectives of the Study**

#### **General objective**

The general objective of the study was to investigate the challenges and prospects of Islamic banking and finance in the efforts of resource mobilization of Ethiopian commercial banks.

#### **Specific Objectives**

Based on the general objectives the research would have the following specific objectives

- To discuss the various types of service products Islamic banking possesses and their consistency with Islamic law (sharia).
- To identify the effects of starting Islamic banking service in resource mobilization efforts of the banks.
- To identify the challenges encountered by commercial banks when starting Islamic banking service.

- To explore the opportunities and growth prospects of Islamic banking service in resource mobilization.

### **1.5 Significance of the Study**

The findings of the study would have theoretical and practical contributions. Theoretically, the findings of this study fills an important gap to serve as a reference material to the existing body of the literature and initiate other interested researchers as a starting point to carry out more extensive studies in the area.

On the practical side, this study help to acquire knowledge and practical experience to the researcher, bank managers (both governmental and private banks), bank policy and decision makers to identify and understand the challenges and prospects of Islamic banking services in resource mobilization.

### **1.6 Scope of the Study**

This study specifically was focus on the challenges and prospects of Islamic banking service in resource mobilization efforts of three commercial banks (Oromia international bank S.C, Commercial Bank of Ethiopia and United bank S.C) found in Addis Ababa. While starting the banking service the testing, training of staffs, launching of the service and procedures development for the service made at the head office and big branches and hence the scope of the study considered in the study are head office branches and departments. Additionally the data was collected from employees, managers, and supervisors of the three banks on these big branches and the potential area branches selected by the banks. The findings have a paramount importance if more banks are included but only these three banks start the service currently.

### **1.7 Limitation Of the Study**

The research was covered by using employees (customer officers and managers) considering (Oromia international bank S.C, Commercial Bank of Ethiopia and United bank S.C) found in Addis Ababa and employees working in the Head Office

and bigger branches located in Addis Ababa. Due to the recency of starting Islamic banking service and the wrong belief of attaching the concept with the religion there is lack of sufficient references. Thus, it was difficult to get adequate data from the materials published in Ethiopia. As result of this, the study was only considers from published materials by various scholars abroad and employees point of about challenges and prospects of Islamic banking service in resource mobilization of Ethiopian commercial banks performance.

## **1.8 Organization of the Study**

This research was organized into five chapters. Chapter one contained background of the study, statement of the problem, research objectives, hypothesis of the study, significance of the study, justification of the study, limitations and scope of the study. Chapter two provide a literature review informing the reader of what is already known in this area of study. Chapter three discussed the methodology employed in this study, including, research design, sample size and sampling technique, data source and collection method, procedure of data collection and method of data analysis. Chapter four presented about data analysis and discussion of results. Finally, chapter five contains summary, conclusions and recommendations.

## CHAPTER TWO

### REVIEW OF RELATED LITERATURES

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*This part of the study attempts to present a brief theoretical framework, views of different scholars which are one way or the other pertinent to the study as well as ends with presentation of the knowledge gap in Ethiopia banking industry and conceptual framework are presented in this section.*

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#### **2.1 Theoretical Review**

##### **2.1.1 Concepts and definition of Islamic Banking**

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'ah (Islamic rulings) and its practical application through the development of Islamic economics. The principles which emphasize moral and ethical values in all dealings have wide universal appeal. Shari'ah prohibits the payment or acceptance of interest charges 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.islamic-banking.com](http://www.islamic-banking.com)).

According to Yahiya Abdul-Rahman, (2010), Islamic banking defined as conventional banking minus the word "interest" with a new contract that does not include the word "interest" and that is structured in a convoluted version of buy/sell, in which the seller changes ownership to the bank and then the bank sells it to the eventual buyer. Many participants in "Islamic" banking business thought, with good intentions, that these guidelines made the contract Islamic.

Islamic banking according to Sandrararajan, (2011) consists of mobilizing funds through noninterest bearing deposits and through investment deposits based on "profit-sharing and loss-bearing" contracts and channeling these funds to finance

permissible (under the Shari'ah law ) investments activities, using various forms of Islamic finance contracts.

Islamic banking as described according to Yahiya Abdul-Rahman, (2010) it is a brand of banking that is socially responsible and is community-based in both spirit and intent. This brand of banking is the manifestation of Judeo-Christian-Islamic values. In addition to this Islamic banking does not discriminate, because discrimination in service and financing and in dealing with others is a major sin in all Abraham faiths.

Islamic banking is a system of banking that mobilizes saving on the basis of profit and loss sharing that is considered to be fairer and more conducive to measurement and development. Owing to the growing demand by the Muslim population in Western countries and also to the increasing interest of Islamic investors to diversify geographically their portfolios, conventional banks are increasingly becoming interested in entering the market of Islamic financial products. (Hassen and Lewis, 2007)

### **2.1.2. 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 Islamic economic society. All covers the meaning to load additional money on funds lent to borrower. As such it is fundamental to understand the Islamic economics to have fair idea about Islamic banking.

Kahn, (1986) also defines an interest-based, or traditional, banking system is symmetrical, with interest being paid and charged for the use of funds. 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 fungibles including wheat, barley, dates, etc (Qasaymeh, 2011)

### **2.1.3. 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)

Prohibition of interest is not exclusive to Muslims. The origin of norms in Christianity prohibits interest. It is said in the Bible

'Thou shalt not lend upon usury to thy brother, usury of money, usury of victuals, usury Of anything that is lent upon usury' (The Holy Bible (King James Version) Old Testament, Deuteronomy 23: 19 183)

## **2.1.4 Islamic banking Service Models**

### **2.1.4.1 Islamic banking window service**

According to Juan Sole, (2007) An Islamic banking window is simply a window with a conventional bank via which customer can conduct business utilizing only sharia compatible instruments. Sanusi (2011) defines Islamic banking window as a business model in which conventional banks offer Islamic banking products and services from their existing branch network. In short, Islamic banking window refers to a situation whereby a conventional banking system provides some of the Islamic 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 Islamic banking for some of its products. (Audu and Mika'ilu, 2014)

### **2.1.4.2 Subsidiary/branch Islamic banking service**

The commercial banking unit, which offers shariah 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 are found in the area want to serve these customers.

#### **2.1.4.3. Full-fledged Islamic banking service**

Once a conventional bank has operated an Islamic window for some time and has gathered a sizeable customer base for its Islamic banking service activities, it may decide to establish an Islamic subsidiary, or even fully convert into a full-fledged Islamic 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)

#### **2.1.5 Sources of Funds for Islamic banks**

The institution of Islamic banking forms a cornerstone required to create an Islamic financial environment. Islamic banking plays a vital role in the economic development of Islamic societies by facilitating the mobilization and allocation of dormant savings, which used to be intentionally kept out of interest-based financial channels. Islamic 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, 1991:438)

Islamic 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 Islamic bank can be used for borrowing by corporate investors to fund specific project. (Bala et.al (2009: 24)

### **2.1.5.1 Shareholder Funds**

An Islamic 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: 23)

### **2.1.5.2 Wadiah Saving accounts**

Islamic 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)

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

The situation is very different in the Islamic banks. Here too the depositor's first aim is to keep his savings in safe custody. Islamic bankers divide the conventional savings account into two categories. Savings account and investment account. The investment accounts operate fully under the 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, 1995:14)

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 (Abdul-Gafoor, 1995:14)



It is suggested that all Islamic banks guarantee the capital under their savings accounts. This will satisfy the primary need and expectation of an important section of the depositors and, in Muslim countries where both Islamic and conventional banks co-exist, will induce more depositors to bank with the Islamic banks. At the same time, it will remove the major objection to establishing Islamic banks in non-Muslim countries. **Siddiqi, (1980:219.)**

### **2.1.5.3 Current accounts**

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: 25) 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, 2011:154)

### **2.1.5.4 Investment account deposits**

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

### **2.1.5.5 Investment deposits can have various deposit arrangement options**

#### **(a) Investment deposit under Mudarabah Option**

A mudarabah transaction 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, 2007:87)

#### **(b) 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).

#### **(c) 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.

### **2.1.6 Uses of Financial resources in Islamic 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, 2007:279)

According to Yahiya Abdurahman, (2010) Islamic banking pays close attention as to

whom and what to finance. Islamic banks (IFB) do not, for example, finance 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 banking 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, 2010:198)

Islamic banks 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: 26)

### **2.1.6.1 Murabah Financing**

Murabah financing is a popular method used by Islamic banks to meet short term trade financing needs for its customers. It is often referred to us “cost Plus-financing “or mark up financing. In this type of financing the bank agrees to fund the purchase of specific asset or goods from a supplier at the request of customers up on acquiring the asset, the bank sells it to the customer at the predetermined mark up. Murabah financing is the back bone of contemporary Islamic banking. Bala et.al, (2009: 30)

An advantage of murabaha is that an Islamic bank is usually sounder financially than its customers, so it can obtain discounts on purchases for its clients. If goods were purchased for several clients at one time, the discount may be even larger, which controls costs for clients and contributes to the overall success of murabaha. (Roy, 1991:434)

### **2.1.6.2 Musharakah Financing**

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

limited to the contributions of the shareholders. In other words, investors cannot be liable for more than the amount of capital they invest in the partnership. (Shanmugan and Gupta, 2007)

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

### **2.1.6.3 Mudarabah Financing**

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

### **2.1.6.4 Ijarah**

Ijara means to give something on a loan. 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. Upon the expiration of the lease the lessee returns the asset to the bank (lessor). Ijara is typically used for high cost assets with long life span. (Bala et.al (2009: 32)

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

incorporate both murabaha and ijara if the eventual sale to the client is agreed upon at the time the original contract is made.

#### **2.1.6.5 Bai' bithman Ajil (BBA)**

Bala et.al (2009: 28) defines bai' bithman ajil is the sale of goods by the bank to a customer on a deferred payment basis over a specified period at a price that included a markup or profit margin agreed to by both parties. Bai' bitman ajil plan is commonly used for financing the purchase of real property, vehicle or consumer goods.

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

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

#### **2.1.6.7 Istisna**

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

#### **2.1.6.8 Tawaruk**

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

#### **2.1.6.9 Bai Salam**

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

### **2.1.6.10 Qard Hassen**

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

## **2.2 Empirical Evidence**

Abdulmajid et. al (2010) writes about the efficiency in Islamic banking and conventional: banking an international comparison investigates the efficiency of Islamic and conventional banks using an output distance approach . They obtain measures of efficiency after allowing the environmental influences such as country microeconomic conditions accessibility of banking services and the bank type. The parameter estimates highlight that Islamic banks appear to be associated with higher input usage. Furthermore by allowing for bank size and international differences in the underling inefficiency distributions, it demonstrate statically significant differences in inefficiency related to these factors even after controlling for specific environmental characteristics and Islamic banking. Due to this Islamic banks are found to have high returns to scale than conventional banks. While this suggests that Islamic banks may benefit from increased scale, they emphasis and the results suggest that identifying and overcoming the factors that cause Islamic banks to have relatively low potential output for a given input usage levels will be the key challenges for Islamic banking in the coming decades.

Ismaeil, et al. (2010) writes the recent development of insolvency of many conventional banks made the Central Banks to initiate the acquisition of some banks while others were ordered to merge. This was a strong signal to seek for alternative banking system. However, the advocacy for the Islamic banking system as alternative to conventional banking system has been received with mixed feelings.

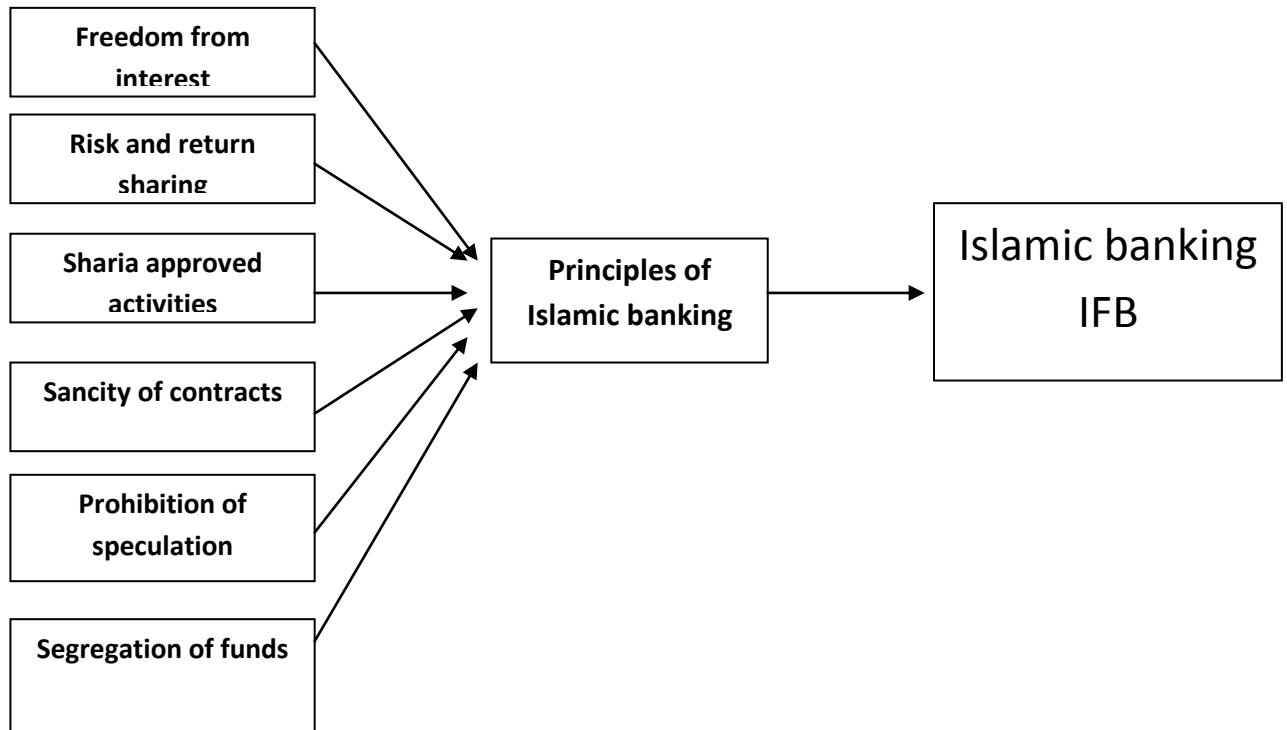
Islamic financial system in perspective, operations of Islamic financial system as well as the challenges and prospects for the country's economy. It posits that awareness, manpower, legal framework, societal belief, cash requirements as some of the challenges while economic growth, attraction of investors, and fostering of egalitarian

society are the likely prospects for the establishment of the Islamic banking. It concludes that Islamic banking system will bring transformation to all sectors of the economy vis-a viz eradication of poverty, equitable distribution of income and employment opportunities in the country through effective mobilization and allocation of capital.

Rodney Wilson, (2000) writes that Islamic finance has become increasingly significant in financial centers in the West, notably London, despite the regulatory hurdles presented by operating in a non Muslim financial environment. The growth of Islamic finance partly reflects demand from Muslim resident and non-resident clients for Islamic deposit facilities and fund management services which involve shari'ah compliance. At the same time Islamic financing methods are viewed as a challenge and opportunity by Western bankers, many of whom have sought to get involved in this growing industry. In client driven societies there is willingness by those in financial services to listen and learn from the experiences of Islamic banks, which in the longer run may bring a major breakthrough for Islamic banking at the retail level in the West.

Hanudin Amin, (2013) in his article of some view points of Islamic banking retail deposit products in Malaysia writes that our illuminations are centered on the current accounts, saving accounts and investment accounts. A brief note on negotiable Islamic certificate of deposits (NICD) is also provided. These deposit products are examined in terms of their definitions, features and calculations. On the same note, some discrepancies between deposit facilities offered by Islamic and conventional banks are exposed. The purpose of such exposition is to provide novice readers a basic but profound explanation concerning the difference between the two categories of deposit facilities.

## **2.3. Conceptual framework**



### **2.3.1. Principles of Islamic Banking Service**

According to Bala et.al, (2009) Islamic finance is based on the themes of community banking, ethical banking, and socially responsible investing. Its goal is to be an ethical, indigenous, and equitable mode of finance.

**The five key principles that govern Islamic banking are as follows**

#### **2.3.1 Freedom from interest**

The Quran, the Muslim holy book, expressly forbids Interest, which includes any payment of interest (not only excessive interest) on monetary loans. A loan with a fixed return to the lender regardless of the outcome of the borrower's course of action is viewed as unfair. Interest is also believed to be exploitative and unproductive because it is considered to represent sure gain to the lender without any possibility of loss as well as a reward in return for no work. These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation. (Bala et.al, (2009)



### **2.3.2 Risk-and-Return Sharing**

The profit and loss sharing is related to the principle that profits are distributed according to contractually agreed shares but liability to losses should be proportionate to the capital contribution. Monzerkahf and Khan, (1992). Risk sharing principle applied because interest is prohibited, pure debt security is eliminated from the system and therefore suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses. (Iqbal & Mirkahor, 2011)

An Islamic banking service provider shares in the profit and loss of each borrower's business transaction. In turn, the bank divides its share of profits and losses with its general and special investors who have deposited funds in the bank. (Bala et.al, 2009)

Shari'a prohibits Muslims from earning income by charging interest but permits income generation through the sharing of risks and rewards between the parties to a transaction. This profit-sharing mechanism is believed to encourage people to become partners and work together rather than to enter into a creditor-debtor relationship. Partnership promotes mutual responsibility for the outcome of the financed project, which is believed to increase the likelihood of success of the venture. A tangential aim of the partnership approach is that such increases in successful projects also provide stimulus to the economy. (Bala et.al, (2009)

### **2.3.3 Shari'a-Approved Activities**

Islamic banking service providers may engage in or finance only activities that do not violate the rules of Shari'a and are permitted by Islam. To ensure that all products and services offered are Shari'a compliant, each Islamic banking service has an independent Shari'a supervisory board.

### **2.3.4. Sanctity of Contract**

Yahiya Abdul-Rahman, (2010:200) explains that Interest free banking service providers cannot finance alcohol-related businesses, gaming, gambling, polluting businesses, or other unethical activities. They finance businesses in a fair and just

way and serve all customers of all backgrounds. They scrutinize the businesses they finance to ensure that the business owners treat their employees fairly and without discrimination

### **2.3.5 Prohibition of speculative behavior**

An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainty, gambling, and risk. (Iqbal and Mirkahor, 2011:10) Islam views contractual obligations and the related full disclosure of information as a sacred duty. Full disclosure is intended to reduce financial speculation (gharar), which is strictly prohibited by Islam, by providing as much information as possible for investors to make accurate assessments about the risks and rewards of an investment. The conditions that are necessary for a contract to be valid include a competent understanding of the underlying asset(s) and the profit-sharing ratio, as well as the presence of a willing buyer and seller. Contracts must also not offend Islamic religious and moral principles; if they do, they will be deemed illegal and unenforceable. (Bala et.al, (2009: 7-8)

### **2.3.6. Segregation of Funds**

An important principle behind Islamic finance is the desire to maintain the moral purity of all transactions. The funds intended for Shariah-compatible investments should therefore not be mixed with those of non-Islamic investments. This requirement is not based on the assumption that the activities of non-Muslims are intrinsically impure. The rationale behind this principle is rather one of prudence, in the sense of taking all the necessary precautions to ensure that Islamic funds do not become mixed with other funds that may be involved with riba, gharar, or haram activities.

Therefore, in order to ensure compliance with Islamic principles, conventional banks wishing to offer IB products must guarantee and publicize that the funds devoted to conventional activities will not be mixed with those destined for Islamic activities. In operational terms, this requires that banks establish different capital funds, accounts, and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, to a large degree, it is in fact establishing a separate entity from the rest of the bank. (Sole, 2007: 5)

### **2.3.2 Functional roles Islamic banks play**

Financial institutions, Islamic or otherwise, play indispensable roles in financial systems. The first role is providing support for various financial markets. For instance, exchanges of various types are institutions that facilitate the functioning of markets, by setting rules of trading and providing clearinghouse and margin logistical support. (Iqbal and Mirkahor, 2011)

#### **➤ Efficient Capital Mobilization**

The ultimate function of a financial system is to perform efficient resource allocation through capital mobilization between savers and users of capital. This function is performed efficiently when the economic agents have access to capital through a liquid market for varying maturity structures; that is, from the very short to the very long term needs. Access to capital has to be easy, transparent, and cost effective, with minimal transaction costs and free of information asymmetries. (Iqbal and Mirkahor, 2011)

#### **➤ Efficient Risk Allocation**

Under uncertainty and volatile market conditions, the function of risk sharing, risk transfer, and risk pooling becomes critical in a financial system. In the absence of such functionality, the financial system will discourage projects that attract high risk but also high value-added to the economy. The “insurance” function is vital for any financial system and the availability of efficient risk sharing facilities promotes diversification and allocation efficiencies. (Iqbal and Mirkahor, 2011)

#### **➤ Pooling of Resources and Diversification of Ownership**

A financial system provides a mechanism for the pooling of funds to undertake large-scale indivisible investments that may be beyond the scope of The Islamic Financial System any one individual. They also allow individual households to participate in investments that require large lump sums by pooling their funds and then subdividing shares in the investment. The pooling of funds allows for a redistribution of risk as well as the separation of ownership and management. (Iqbal and Mirkahor, 2011)

➤ **Efficient Contracting**

A financial system should promote financial contracting that minimizes incentive and agency problems arising from modern contractual arrangements among owners, managers, regulators, and other stakeholders. Both financial institutions and financial markets have distinct incentive problems arising from the conflicting interests of investors, managers, owners, and regulators. A financial system should therefore encourage financial contracting which minimizes distortion and enhances allocation efficiency. (Iqbal and Mirkahor, 2011)

➤ **Transparency and Price Discovery**

A financial system should promote the efficient processing of information such that all available information pertaining to the value of an asset is available at the lowest cost and is reflected in the value or price of the asset. This price-discovery function leads capital being allocated to the most productive use in the most efficient manner. (Iqbal and Mirkahor, 2011)

➤ **Better Governance and Control**

Advances in modern finance have highlighted the importance of good governance, especially with respect to financial institutions and markets. A financial system should facilitate transparent governance and promote discipline in management through external pressures or threats, such as takeovers, so that any misallocation and misappropriation is minimized. (Iqbal and Mirkahor, 2011)

It is important to sharpen the tools of corporate governance, the most important of which are: internal controls, risk management, transparency, loan accounting and disclosure, shari'a clearance and audit, external audit, and prudential regulation and supervision. (Elasrag, 2014)

➤ **Operational Efficiency**

A financial system should provide for the smooth operation of financial intermediaries and financial markets by minimizing any operational risk due to failures in processes, settlement, clearing, and electronic communication. The

smooth and transparent execution of financial transactions develops reputation and “trust” among economic players and therefore is beneficial in attracting external resources. This is especially applicable in the case of emerging economies that are eager to attract foreign investors. (Iqbal and Mirkahor, 2011)

# CHAPTER THREE

## RESEARCH DESIGN AND METHODOLOGY

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*This part of the study attempts to explain the research methodology applied to obtain representative data from a sample of three commercial banks found I Addis Ababa. The research design, sampling design, sources of data, methods of data collection and data analysis method used pertinent to the study were presented in this section.*

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### 3.1 The Research Design

In order to achieve the main objective of the study an exploratory and descriptive research design used to gather as much information as possible to show the challenges and prospects of Islamic banking service for resource mobilization of Ethiopian commercial banks. According to Ghauri and Gironhaug, (2005) the basic difference between the three main classes of research designs are exploratory, descriptive and explanatory. The research can be exploratory when it deals with unknown problem, Descriptive when there is an awareness of the problem and Explanatory when the problem is clearly defined. In addition to this According to Yin (1994) exploratory research is designed to allow the researcher to just look around with respect to some phenomenon, with aim to develop suggestive ideas.

### 3.2 Sampling Design

The total number of banks in Addis Ababa was eighteen. Among this, three banks were starting Islamic banking service in one window namely Oromia International Bank S.C, Commercial Bank of Ethiopia and United bank S.C. The researcher used employees, managers, supervisors and selected customers of the three banks. In selecting the research subject sample the researcher applied stratified random sampling in order to find representative sample. Thus, accordingly the researcher groups the target population of the worker based on educational level, work experience. The sample size of the respondents will be set randomly by using sample determination formula developed by Yemane (1967).

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

Where n is the sample size,

N is the population size, and

e is the level of precision or sampling error = ( 0.05)

$$n = \frac{27,165}{1 + 27,165 (0.05)^2}$$
$$= 394$$

Hence, the total sample size is 394. Since the number of people in each bank is not the same, the number of samples for each bank was calculated by the following formula:

$$n1 = \frac{nN1}{N}$$

Where **n**= total number of samples

**N**= total number of population

**N1**= total number of population in each bank

**n1**= number of samples in each bank

The study was conducted on 3 commercial bank's offices (CBE, United bank and Oromia international banks and the total population of the study was 27,165 on the second quarter of the year.

**Table 3.2: Number of employees and proportion of samples taken from each bank**

<b>Banks</b>	<b>Total number of Population</b>	<b>Total number of Sample</b>
Commercial bank of Ethiopia	22,000	319
United Bank S.C.	2,855	41
Oromia International bank S.C.	2,310	34
<b>Total</b>	<b>27,165</b>	<b>394</b>

Source: Developed by the researcher

After each bank sample size was determined, the researcher used systematic random sampling method to select the target employees since their job is directly related to the work. The researcher did not go beyond this sample size because of the assumption that increasing the number of sample size more than the specified doesn't increase additional information. Rather it could be duplication of information

### **3.3 Source of Data**

In conducting this research both primary and secondary data were used. The sources of primary data were from employees, managers and supervisors of the three banks. The secondary data also collected and used to describe and elaborate the conceptual aspects of the Islamic banking and financing services and their applicability. In addition to this different websites, books written by various authors, bulletins released by foreign banks and national bank of Ethiopia, etc.

### **3.4 Methods of Data Collection**

#### **3.4.1 Types of Data**

For accomplishing the research work and research objectives both primary and secondary data was collected.

The primary data was collected from those employees of the banks i.e. Employees, supervisors and managers of the banks. Thus, in order to obtain the reliable and



sufficient information, structured questionnaires were used as data collecting instruments.

In an effort to make the research more valid, credible and applicable secondary data were used for the issues raised on the research. For this purpose published sources i.e. different books, web pages, policy directives, journal articles and various project papers etc were investigated.

### **3.4.2 Procedure for data collection**

In order to collect sufficient data that can answer the research questions, the researcher designed questionnaires to bank staffs and management members who have related to their day to day activities. The questionnaires were distributed to staff members. Data from both sources were collected and organized in structural form of tables and graphs.

### **3.5 Data Analysis Methods**

The collected data was checked, sorted and screened for any errors and then they were tallied to prepare tables for making analysis. Besides, the researcher also attempts to analyze the various issues that were involved in the introduction of Islamic banking service in the country based on the principles, Legal and regulatory requirements. The researcher was used both qualitative and quantitative data analysis techniques. Finally the data was processed and analyzed by statistical package for social science (SPSS) version 20. To analyze the data descriptive statistics method was made based on the results of the tables and figures using mean value and percentage rank order. The results of the study were presented using tables.

# CHAPTER FOUR

## DATA PRESENTATION, INTERPRETATION AND ANALYSIS

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*This chapter deals with the data presentation, interpretation and analysis of the study. It has two parts. The first is background of the respondents; and the second part deals with major components on challenges and prospects of Islamic banking (interest free banking) in three Ethiopian commercial banks.*

*The implementation of the service of interest free banking service in the country encountered challenges and has future growth prospect, which can be observed in terms of the perspectives of the participants..*

*To achieve the main objectives of the research a total of 394 questionnaires were prepared and distributed to Employees, supervisors, managers and directors of the three banks. Out of these questionnaires, 335 of them were collected with a response rate of 85%. However, only 313 responses were valid with complete answers. Therefore, only 313 questionnaires were used for further analysis.*

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### **4.1 Background of the Respondents**

#### **4.1.1 Back ground of the respondents**

Description of the characteristics of the sample target population gives some basic information about the sample and their composition. The demographic characteristics include: Gender, Work experience, level of education, and occupation. This aspect of the analysis deals with the personal data of respondents. The table below shows the details of background information of the respondents.

**Table 4:1 Respondents background**

Variables	VARIABLE CATAGORIES	Frequency	Percent
Sex	Male	210	67.1
	Female	103	32.6
	<b>Total</b>	<b>313</b>	<b>100</b>
Work experience	0-5 years	135	43.1
	6 - 10 years	97	31
	11- 15 years	36	11.5
	16-20 years	15	4.8
	Above 21 years	30	9.6
	<b>Total</b>	<b>313</b>	<b>100</b>
Educational level	Diploma	27	8.6
	Degree	249	79.6
	Master	37	11.8
	<b>Total</b>	<b>313</b>	<b>100</b>
TYPES OF POSITION	Director	5	1.6
	Manager	45	14.4
	Customer Service Manager	45	14.4
	Accountant	23	7.3
	Customer Service Official	146	46.6
	Credit Analyst	49	15.7
	<b>Total</b>	<b>313</b>	<b>100</b>

*Source: Own Survey, 2015*

As depicted in table 4.1 showed that there were more males as compared to females. Male respondents represented 210 (67.1%); on the other hand 103 (32.6%) were females. This shows that the major respondent was dominated by male.

The respondents in the study were asked to state their duration of stay in their respective current position in the banking industry. As displayed in the table 4.1, 135 (43.1 %) of the respondents are in the range of 5-10 years, followed by 97 (31.0 %) of them who worked with the range of 6-10 years, 36 (11.5%) of employees who participated in the study have an experience of 11-15 years, 15 (4.8 %) of employees who participated in the study have an experience of 16-20 years,. The rest 30 (9.6%) respondents have an experience of above 21 years. Thus, the respondents are mostly below fifteen years of work experience in the current position.

Table 4.1 also indicates among the responding employees in the three banks 249 (79.6% ) employees acquired their bachelor’s degree , 27 (8.6%) employees acquired their diploma and the rest of respondents 37 ( 11.8%) have master’s degree in a specific field of study. This result of the study was an indication of the educational level of employees’ capacity for delivering services and they can be easily trained for the required interest free banking Industry service requirement.

Concerning the respondent’s current job title in three banks as per the findings of the study came up with varied jobs titles based on different job classifications. Table 4.1 shows that the highest no which is 146 (46.6%) was customer service officials. Next to this 49 (15.7%) credit analysts. 45 (14.4%) contains manager and customer service managers respectively and Directors and accountants contains 5(1.5%) and 23 (7.3%) respectively were among the respondents list.

## 4.2 ANALYSIS AND PRESENTATION

This section deals with the analysis and interpretation of data that obtained from the response collected through the distributed questionnaire. It also presents the data obtained via interview with the management position staff and secondary data also analyzed.

Note: SD=strongly disagree, D=disagree, N=neutral, A=agree, SA=strongly agree

Table 4.2 Category of mean value

Mean value	Extent of the response
1.00-1.50	Strongly Disagree
1.51-2.50	Disagree
2.51-2.75	Neutral
2.76-3.50	Agree
3.51-5.00	Strongly Agree

*Source: Own Survey, 2015*

### 4.2.1 General awareness of IFB

The study sought to find out how respondents perceived Islamic banking (interest free banking) and their operational activity in the fund management activity

**Table 4.3 Response regarding attitude and awareness of the people towards Islamic banking**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	Wrong association with religion	F	39	44	61	102	67	4.43
		%	12.5	14.1	19.5	32.6	21.4	
2	Lack of awareness about Islamic banking system	F	36	70	63	111	33	3.11
		%	11.5	22.4	20.1	35.5	10.5	
3	Segregation of fund is mandatory from the conventional banking service is mandatory	F	13	23	28	114	135	4.07
		%	4.2	7.3	8.9	36.4	43.1	

*Source: Own Survey, 2015*

As shown in item (1) of the table 4.3, about 102(32.6%) of the respondents agree about there is wrong association Islamic banking service with the religion. In addition to this 67(21.4%) of the respondents strongly agree and 61(19.5%) responded neutral to the issue. 44(14.1%) and 39(12.5%) disagree and strongly disagree on the issue raised. More over the mean distribution of the response was found 3.36, which is closer to the value of “agree”. Accordingly it can be concluded that the wrong association with religion has a challenge for the banking industry. This implies that making promotional campaign is a major first step to boost the banking service.

As shown in item (2) of the table 4.3, about 111(35.5%) of the respondents agree that the people has lack of awareness 70(22.4%) also disagree on it. On the other hand 63(20.1%) has neutral idea on the issue and 36(11.5%) and 33(10.5%) of the respondents were indifferent by strongly disagree and strongly agree on this respect. Moreover, the mean value of the distribution of the response was found 3.11, which is closer to the value of agree.

In this regard the response from interview results also show that there is lack of awareness of the people towards interest free banking service and they replied that some customer feel the service is provided only for Muslim community only. But the service is given also to those who don't want interest and want to use the credit modalities on investment options Accordingly it can be concluded that most of the respondents agree they have awareness about Islamic banking services. This implies that making awareness campaign to the staffs and the general public through the appropriate mechanisms increase the deposit need and to attract the unbanked customers.

As shown in item (3) of the table 4.3, about 135(43.1%) of the respondents strongly agree that segregation of fund is mandatory 114(36.4%) also agree on it. On the other hand 28(8.9%) has neutral idea on the issue and 23(7.3%) and 13(4.2%) of the respondents were indifferent by disagree and strongly disagree on this respect. Moreover, the mean value of the distribution of the response was found 4.07, which is closer to the value of "strongly agree".

On this issue the response from interview of the respondents also show that even if a separate accounting system implemented for IFB some customers think that the fund collected from the interest free banking was mixed with the books of accounts of the conventional banking. They say Sharia compliance is not adhered fully and most of the time this issue rose by the customers. This is because they don't want to be mixed their fund in the accounting system with the conventional banking funds, because according to the sharia regulation accepting and paying of interest is prohibited.

Accordingly it can be concluded that most of the respondents strongly agree segregation of the fund that is collected from Islamic banking is mandatory and also use as a potential for attracting the customer for the deposit mobilization scheme of the banks. This implies deviation from the service requirement may discourage the attraction of the customers and analysis adhering to this requirement enhances the acceptability by the customers.

## 4.2.2 Legal and Directive issues

Generally the commercial banking establishment laws contain issues that are narrowly defined and prohibit the scope of Islamic banking service activities within conventional banking service limits.

**Table 4.4 Response regarding NBE directive initiative, legal, supervisory & Regulatory challenges and governing regulations**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	NBE initiative toward full fledged banking vs. window service through the existing commercial banks	F	32	23	70	93	95	3.63
		%	10.2	7.3	22.4	29.7	30.4	
2	There is Legal, supervisory and institutional challenge	F	2	27	54	152	78	3.89
		%	0.6	8.6	17.3	48.6	24.9	
3	lack of suitable banking polices for Islamic banking	F	26	86	72	96	33	3.08
		%	8.3	27.5	23	30.7	10.5	
4	The regulatory organ has future initiative to establish Islamic financial institution	F	59	81	69	89	15	2.74
		%	18.8	25.9	22	28.4	4.8	
5	Islamic financial institution (IFS) should be governed by different set of regulation as they differ in many aspects from conventional banks	F	9	40	32	106	126	3.96
		%	2.9	12.8	10.2	33.9	40.3	

*Source: Own Survey, 2015*

As a result found shown in item (1) of the table 4.4, about 95(30.4%) of the respondents strongly agree about there is NBE blocked full fledged Islamic banking while allowing one window service. In addition to this 93(29.7%) of the respondents also agree on it and 70(22.4%) responded neutral to the issue. 32(10.2%) and 23(7.3%) strongly disagree and disagree respectively on the issue raised. More over the mean distribution of the response was found 3.63, which is closer to the value of

“strongly agree”. Accordingly it can be concluded that it is a challenge for the banking sector development in specializing a fully fledged Islamic banking service provision. This implies that the banks should make more effort to show the NBE the capacity and viability of the sector.

As shown in item (2) of the table 4.4, about 152(48.6%) and 78(24.9) of the respondents agree and strongly agree respectively that there was legal, supervisory, regulatory and institutional challenge. 54(17.3%) has neutral idea on the issue. On the other hand 2(0.6%) and 27(8.6%) of the respondents were indifferent by strongly disagree and disagree respectively on this respect. Moreover, the mean value of the distribution of the response was found 3.89, which is closer to the value of “strongly agree”. Accordingly it can be concluded that most of the respondents strongly agree there was legal, supervisory, regulatory and institutional challenge that hinder the operational performance of the existing banks that start the service and new banks who aim to start the service. This implies that the existing banks to insist the government to implement recent practices followed abroad banks by benchmarking their best practices which fit to our country.

As shown in item (3) of the table 4.4, about 96(30.7%) of the respondents agree that there is lack of suitable Islamic banking service policies in and 33(10.5%) also strongly agree on it. On the other hand 86(27.5%) and 26(8.3%) disagree and strongly disagree respectively. 72(23%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 3.08, which is closer to the value of “agree”. Accordingly it can be concluded that most of the respondents agree that there is lack of suitable banking policy challenge in IFB. This implies the banks operating in the country to prepare a work shop with the concerned stake holders on the issue to create a ground and show how it hinders their operation.

As shown in item (4) of the table 4.4, about 89(28.4%) of the respondents agree that there a future initiative by the regulator organ to allow a full fledged Islamic banking. in contrary to this 81(25.9%) disagree on it. On the other hand 59(18.8%) strongly disagree in addition to this 69(22%) has neutral idea on the issue and 15(4.8%) of the respondents were indifferent by strongly agree on this respect. Moreover, the mean



value of the distribution of the response was found 2.74, which is closer to the value of neutral. Accordingly it can be concluded that there is no clear information regarding whether the governing body allow full fledged Islamic banking or not. This implies that it has effect on the confidence of the general public and discourages new entrants to the industry.

As shown in item (5) of the table 4.4, about 126(40.3%) and 106(33.9%) of the respondents strongly agree that Islamic financial institution should be governed by different set of regulation rather than the conventional banking regulation. 40(12.6%) and 9(2.9%) disagree and strongly disagree respectively on it. On the other hand 32(10.2%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 3.96, which is closer to the value of strongly agree. Accordingly it can be concluded that most of the respondents “strongly agree” that Islamic financial institution should be governed by different set of regulation rather the conventional one. This implies the very nature of their activity differs in various aspects should need to consider by the regulating body and allow their operation to the fulfillment of this requirement.

### **4.2.3 The status of Islamic banking in research & development and resource constraints**

Recent application and implementation of IFB service in Ethiopia encounter challenges in the research and development, human resource availability of sharia advisory board for financing (lending) activities of the banks and attracting of the deposits from those far from the conventional banking service.

**Table 4.5 Response regarding gap in research and development, lack of Resources (HR and Capital)**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	Research and development gap in Islamic banking service and financial modalities to fill the gap in HR	F	10	27	34	112	130	4.43
		%	3.2	8.6	10.9	35.8	41.5	
2	There is lack of trained HR in Islamic banking	F	25	52	13	95	128	3.78
		%	8	16.6	4.2	30.4	40.9	
3	There is lack of capital resource constraints	F	11	48	42	106	106	3.79
		%	3.5	15.3	13.4	33.9	33.9	
4	The banks have qualified staffs and scholars to insure the banking service is up-to-date and fully comply with sharia law	F	135	109	37	18	14	1.94
		%	43.1	34.8	11.8	5.8	4.5	

*Source: Own Survey, 2015*

As shown in item (1) of the table 4.5, about 130(41.5%) and 112(35.8%) of the respondents strongly agree and agree that there is research and development gap in Islamic banking financial modalities respectively. 34(10.9%),27(8.6%) and 10(3.2%) have given their opinion as neutral , disagree and strongly disagree on it respectively. Moreover, the mean value of the distribution of the response was found 4.04, which is closer to the value of strongly agree. Accordingly it can be concluded that gap research and development has challenge for IFB may lead to far from the service requirement and for the development of new type of service product which may attract the potential customers. This implies that fostering the growth of the Islamic banking service sector should be achieved through R&D and the existing banks should promote the practice.

As shown in item (2) of the table 4.5, about 128(40.9%) and 95 (30.4%) of the respondents strongly agree and agree that there is lack of trained human resource in specializing Islamic banking. 13(4.2%), 52(16.6%) and 15(8%) have given their

opinion as neutral, disagree and strongly disagree on it respectively. Moreover, the mean value of the distribution of the response was found 3.78, which is closer to the value of “strongly agree”. This implies the banks should work in the capacity building and training of their workers by filling the gap of knowledge and using the potential for the resource mobilization.

As shown in item (3) of the table 4.5, about 106(33.9%) and 106(33.9%) of the respondents strongly agree and agree equally that there is lack of financial resource constraints in Islamic banking financial modalities 42(13.4%) ,48(15.3%) and 11(3.5%) have given their opinion as neutral , disagree and strongly disagree on it respectively. Moreover, the mean value of the distribution of the response was found 3.79, which is closer to the value of”strongly agree”. This implies the need for promoting the service and appropriately implementing the financing modalities to attract those potential customers hold their idle fund in their custody at home.

As shown in item (4) of the table 4.5, about 135(43.1%) and 109(34.8%) of the respondents strongly disagree and disagree that there is banks have qualified staff in compliance with sharia rulings on Islamic banking activities. 37(11.8%), 18(5.8%) and 14(4.5%) have given their opinion as neutral, agree and strongly agree on it respectively. Moreover, the mean value of the distribution of the response was found 1.94, which is closer to the value of “strongly disagree”.

Regarding this issue the interview results also reveal that there is lack of equipped human resource. The service providing staff assigned on the post by giving them short term training. They were not providing quality service and were not properly communicated about the service products to the customers. There is also lack of professionals in the field of sharia advisory board members. In our country there are religious persons who have better knowledge on the religion but have no business knowledge. To be a member of sharia advisory both knowledge is mandatory.

The result indicate that in order to implement the genuine service there is a need to appoint shairia advisor board who have knowledge on the business as well as the religion to give direction by understanding the common concepts of banking.

#### 4.2.4 Supportive financial institution and market potential

In conventional commercial banking, medium term and long-term finance is provided through long-term bonds and equities. Without deposits collected from the general public, the important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds, but islamic banks do not deal with interest bearing bonds. Therefore, there is a need for the same supportive financial markets are necessary.

**Table 4.6 Response regarding lack of supportive financial institution, potential and banks Capacity**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	There is lack of supportive link institution like interest free money market and capital markets that create liquidity and other operational difficulties	F	10	27	64	152	60	3.72
		%	3.2	8.6	20.4	48.6	19.2	
2	Most commercial banks feel lack of market potential for resource mobilization	F	45	129	28	101	10	2.49
		%	14.4	41.2	8.9	32.3	3.2	
3	The current commercial banks have sufficient capacity to serve customers and mobilize the required resource	F	45	142	46	70	10	2.55
		%	14.4	45.4	14.7	22.4	3.2	

*Source: Own Survey, 2015*

As a result found shown in item (1) of the table 4.6, about 152(48.6%) of the respondents agree about there is there is lack of supportive link institutions. In addition to this 60(19.2%) of the respondents strongly agree and 64 (20.4%) responded neutral to the issue. 10(3.2%) and 27(8.6%) strongly disagree and disagree

respectively on the issue raised. More over the mean distribution of the response was found 3.72, which is closer to the value of “strongly agree”. Accordingly it can be concluded that it is a challenge for the banking sector development because of not founding supporting financial institution for gaining additional financial resource when they require the fund beyond their existing liquidity problems. This implies that the banks urge to search mechanism to alleviate the shortages.

As shown in item (2) of the table 4.6, about 129(41.2%) and 101(32.3%) of the respondents disagree and agree respectively. 28(8.9%) has neutral idea on the issue. On the other hand 45(14.4%) and 10(3.2%) of the respondents were to the extremes which is strongly disagree and strongly agree respectively on this respect. Moreover, the mean value of the distribution of the response was found 2.49, which is closer to the value of “disagree”. Accordingly it can be concluded that there is a potential for those who want to start the service. This implies that the banks should device new products and sell aggressively them for a better performance.

As shown in item (3) of the table 4.6, about 142(45.4%) and 45(14.4%) of the respondents disagree and strongly disagree respectively that the banks have the capacity for giving Islamic banking service. On the other hand 70(22.4%) and 10(3.2%) disagree respectively on the issue. 46(14.7%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 2.55, which is closer to the value of “disagree”. Accordingly it can be concluded even if it was a challenge for the banks the response shows the banks have the capacity to serve the customer requirement. This implies the banks to make training in the fields of Islamic banking, marketing and communicating to address the required customer need.

#### **4.2.5 Customer satisfaction with regard to service quality and service requirement**

Lack of well known standard for Islamic banking services and products can be a cause of ambiguity in the customer side and create dissatisfaction.

**Table 4.7 Customer Satisfaction**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	The current commercial banks customers are fully satisfied with the range of products that the banks provide or demanding more flexible and suitable products	F	95	91	62	38	27	2.40
		%	30.4	29.1	19.8	12.1	8.6	
2	The current commercial banks give the service in compliance with the service requirements of commercial banks	F	84	87	57	77	8	2.48
		%	26.8	27.8	18.2	24.6	2.6	

*Source: Own Survey, 2015*

As a result found shown in item (1) of the table 4.7, about 95(30.0%) and 91(29.1%) of the respondents strongly disagree and disagree about the current commercial banks customers satisfied with the range of products when compared with the demand required by the customer respectively.. In addition to this 62 (19.8%) responded neutral to the issue. 38(12.1%) and 27(8.6%) strongly agree and disagree respectively on the issue raised. More over the mean distribution of the response was found 2.4, which is closer to the value of “disagree”.

On this issue there is also found response from interviewing the staffs. According to the respondents some customers were not aware about the service and the type of services products offered in it and no adequate media promotion was made. The staff also most of the time they provide information for conventional banking service products but they fail to adequately communicate the service types of IFB.

Accordingly it can be concluded that it is a challenge for the banking sector that the banks customers are not satisfied with the range of products provided. This implies in order to satisfy and attract the potential customers they may device mechanisms for creating new type of services that benefit both parties.

As shown in item (2) of the table 4.7, about 87(27.8%) and 84(26.8%) of the respondents disagree and strongly disagree respectively. 57(18.2%) has neutral idea on the issue. On the other hand 77(24.6%) and 8(2.6%) of the respondents were to the extremes which is agree and strongly agree respectively on this respect. Moreover, the mean value of the distribution of the response was found 2.48, which is closer to the value of “disagree”. Accordingly it can be concluded that banks who start Islamic banking service window are not working in compliance with the service requirement. This implies that in order to retain the existing customers, attract new ones and to build the confidence of them the bank should comply sharia requirements.

#### 4.2.6 IFB –As a Means for Resource Mobilization and global trend in Ethiopia

**Table 4.8 IFB – As a Means for Resource Mobilization and global trend**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	Islamic banking service (IFB) is one means of resource mobilization	F	8	6	11	107	181	<b>4.43</b>
		%	2.6	1.9	3.5	34.2	57.8	
2	The current global trend in financial services will have positive manifestation on the future of Islamic banking service in Ethiopia	F	9	10	41	182	71	<b>3.95</b>
		%	2.9	3.2	13.1	58.1	22.7	

*Source: Own Survey, 2015*

Table 4.8 item no 1 illustrates IFB serves as a means of resource mobilization. The result presented indicate that most of respondents 181(57.8%) and 107(34.2%) of the respondents strongly agree and agree respectively. 11(3.5%) has neutral idea on the issue. On the other hand 6(1.9%) and 8(2.6%) of the respondents were to the extremes which was disagree and strongly disagree respectively on this respect. Moreover, the mean value of the distribution of the response was found 4.43, which is closer to the value of “strongly agree”. This implies that starting the service has a potential for deposit mobilization and a good reason for those who want to start the service to acquire additional banking option for their customer.

From the above table 4.8 item no 2 depicted the current global trend in financial service manifestation toward future of IFB. About 182(58.1%) and 71(22.7%) of the respondents agree and strongly agree respectively. 41(13.1%) has neutral idea on the issue. On the other hand 10(3.2%) and 9(2.9%) of the respondents were to the extremes which is disagree and strongly disagree respectively on this respect. Moreover, the mean value of the distribution of the response was found 3.95, which is closer to the value of “strongly agree”. This implies that our country directly or indirectly influenced by external factors and in order to mitigate this situation our banks should adjust them to the external world situation.

#### 4.2.7 Benefits of Islamic Banking, Banks plan to engage in IF Banking and Investment loan

**Table 4.9 Benefits of Islamic Banking Service and their future plan**

Item	Statements	Response	Response Categories					Mean values
			SD	D	N	A	SA	
1	If the existing banks offer certain Islamic banking products , the access to Islamic banking will improve the tendency for business expansion and investment activity	F	1	13	18	154	127	<b>4.26</b>
		%	0.3	4.2	5.8	49.2	40.6	
2	Banks have any short term/medium term plan to engage in IFB activities and take advantage of the untapped potential growth and opportunity that Islamic banking provide	F	2	7	46	150	108	<b>4.13</b>
		%	0.6	2.2	14.7	47.9	34.5	
3	People would use investment loan service due to its attractiveness and ease of access	F	10	41	54	114	94	<b>3.77</b>
		%	3.2	13.1	17.3	36.4	30	

Source: Own Survey, 2015



According to the respondent reply for the question 1 raised indicates as per the above table 4.9 that about 154(49.2%) and 127(40.6%) of the respondents agree and strongly agree respectively the access to IFB will improve the tendency of business expansion and investment activity. 18(5.8%) has neutral idea on the issue. On the other hand 13(4.2%) and 1(0.3%) of the respondents were to the extremes which is disagree and strongly disagree respectively on this respect. Moreover, the mean value of the distribution of the response was found 4.26, which is closer to the value of “strongly agree”. This implies that upon handling the customers their Islamic banking services it will create the investment opportunity for both the banks and customers and help the banks to play their intermediary role.

Table 4.9 item no 2 indicates about banks short/medium term plan effects on their business toward getting potential growth and market opportunity. The data reveals about 150(47.9%) and 108(34.5%) of the respondents agree and strongly agree respectively. 46(14.7%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 4.13, which is closer to the value of “strongly agree”. This implies the banks must plan and prepare themselves accordingly to take and get the advantage of the untapped potential.

Among the service product IFB bring to reality is investment loan facility. Respondent on this issue replied as per the above table 4.9 item no 3 indicates that about 114(36.4%) and 94(30%) of the respondents agree and strongly agree respectively. 54(17.3%) has neutral idea on the issue. On the other hand 41(13.1%) and 10(3.2%) of the respondents were to the extremes which is disagree and strongly disagree respectively on this respect. Moreover, the mean value of the distribution of the response was found 3.77, which is closer to the value of “agree”. This implies the banks to promote the service to acquire marketing potential depositors, who want to deposit in a profit and loss sharing and those potential borrowers, who want to be financed by the bank having a business idea but shortage of capital.

## 4.2.8 Interest Effects on the IFB business

**Table 4.10 Interest Effects on the IFB business**

I t e m	Statements	Resp onse	Response Categories					Mea n valu es
			SD	D	N	A	SA	
1	A plan for business expansion and investment opportunity to be financed by bank loan cancelled due to interest involvement	F	15	40	65	93	100	3.71
		%	4.8	12.8	20.8	29.7	31.9	
2	There is Islamic banking service need in Ethiopia so that it will alleviate the financial service deprivation of the concerned IFB service need	F	0	1	20	126	166	4.33
		%	0	0.3	6.4	40.2	53.0	
3	banking services user currently think that "safety/ keeping money safe " is their first priority	F	5	31	54	140	83	3.45
		%	1.6	9.9	17.3	44.7	26.5	
4	the current commercial banks will engage in Islamic banking services that will address those who don't want interest	F	13	24	24	165	87	3.92
		%	4.2	7.7	7.7	52.7	27.8	
5	The likely reasons that many Muslims are not using banking services currently due to e saving and loan services involve interest	F	13	62	32	78	128	3.79
		%	4.2	19.8	10.2	24.9	40.9	
6	The "high prohibitive interest rate" that conventional banks charge is the main reason that loan services are not currently widely used	F	20	67	56	71	99	3.51
		%	6.4	21.4	17.9	22.7	31.6	

*Source: Own Survey, 2015*

Those banks that early start IFB has access potential to reach the customers. As a result found shown in item (1) of the table 4.10, about 100(31.9%) of the respondents strongly agree and 93(29.7%) of the respondents agree that most of the time investment options to be financed by bank cancelled due to involvement of interest. In addition to this and 65 (20.8%) responded neutral to the issue. 40(12.8%) and 15(4.8%) strongly disagree and disagree respectively on the issue raised. More over the mean distribution of the response was found 3.71, which is closer to the value of “strongly agree”. This implies IFB helps as a means to reach those potential customers who were far from the banks due to interest application.

As shown in item (2) of the table 4.10, the majority of the respondents i.e. 166(53 %) and 126(40.2%) of the respondents strongly agree and agree respectively that IFB alleviate the financial need of customers. 20(6.4%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 4.33, which is closer to the value of “strongly agree”. This implies that properly implementing IFB answer the requests of those deprived from the conventional banking service. It is also a potential for the banks to reach customers and answer the need of those customer who don't want interest and avoided themselves using the conventional banking service.

Most of the customers have second priority for interest option. As shown in item (3) of the table 4.10, about 140(44.7%) and 83(26.5%) of the respondents agree and strongly agree respectively that keeping money is safe is their first priority. On the other hand 31(9.9%) and 5(1.6%) disagree respectively on the issue. 54(17.3%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 3.45, which is closer to the value of “agree”. This implies if the banks start IFB, they get potential customers and their deposit.

IFB service providing banks start their service to reach those customers who don't want interest and to gain from it. As a result found shown in item (4) of the table 4.10, about 165(52.7%) and 87(27.8%) of the respondents agree and strongly agree that they start the service to reach these customers. In addition to this 24(7.7%) of the respondents disagree, 24 (7.7%) responded neutral to the issue. and 13(4.2%) strongly

disagree respectively on the issue raised. More over the mean distribution of the response was found 3.92, which is closer to the value of “strongly agree”. The result implies it helps to creates additional source of deposit to the banks and attract the potential customers who were discouraged by the conventional banking interest application.

As shown in item (5) of the table 4.10, about 128(40.9%) and 78(24.9%) of the respondents strongly agree and agree respectively. 32(10.2%) has neutral idea on the issue. On the other hand 62(19.8%) and 13(4.2%) of the respondents were to the extremes which is strongly disagree on this respect. Moreover, the mean value of the distribution of the response was found 3.79, which is closer to the value of “strongly agree”. This implies application of interest discourages some customers and the bank benefited if it starts IFB by applying other deposit and loan service modalities which Islamic banking (IFB) applies.

Interest accepting prohibition by religion makes some customer to avoid using conventional banking services. Respondents of this study indicated as shown in item (6) of the table 4.10, about 99(31.6%) and 71(22.7%) of the respondents agree and strongly agree respectively that the main reason for not using credit facility is high prohibitive interest rate application of commercial banks. On the other hand 67(21.4%) and 20(6.4%) disagree and strongly disagree respectively on the issue 56(17.9%) has neutral idea on the issue. Moreover, the mean value of the distribution of the response was found 3.51, which is closer to the value of “strongly agree”. This indicates those banks that start IFB have a potential to get and serve these customers.

## **CHAPTER FIVE**

### **CONCLUSIONS AND RECOMMENDATIONS**

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*The primary purpose of this study is to assess the challenges and prospects of Islamic banking/interest free banking/ service for resource mobilization in Ethiopian commercial banks. This chapter based on the findings of the study, presents the summary, conclusions and recommendations.*

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#### **5.1 SUMMARY**

The main objective of the paper is to assess what challenges face by those banks starting IS/IFB/ and what prospects poses the banking service sector for their resource mobilization efforts of the case of commercial bank of Ethiopia, Oromiya international bank S.C and United bank S.C . The view of different scholars which was in one way or the other pertinent to the study was used. Questionnaires and interviews conducted with the workers of the three banks. The study results show that

- Lack of awareness about Islamic banking services and wrong association with religion.
- No segregation of fund due to this sharia compliance issues raised and Islamic banking service window are not working in compliance with the service requirement.
- Lack of manpower for the service provision and sharia advisory members who have both religious as well as business knowledge.
- Lack of research and development has challenge for IFB and may lead to far from the service requirement and for the development & innovation of new type of service product which may attract the potential customers.
- Lack of a comprehensive legal framework aimed at facilitating instead of regulating and Islamic financial institution should be governed by different set of regulation rather the conventional one.

- There is no clear information regarding whether the governing body allow full fledged Islamic banking or not specializing a fully fledged Islamic banking service provision.
- There was supervisory, regulatory and institutional challenge that hinder the operational performance of the existing banks that start the service and new banks who aim to start the service.
- Lack of supporting financial institutions for gaining additional financial resource when they require the fund beyond their existing liquidity problems.
- IFB helps as a means to reach those potential customers who were far from the banks due to interest application and answer the requests of those deprived from the conventional banking service.
- It helps to creates additional source of deposit to the banks and attract the potential customers who were discouraged by the conventional banking interest application.
- Due to application of various loan service modalities which Islamic banking (IFB) applies help for attraction of investors and it fosters economic growth and investment.

## **5.2 CONCLUSIONS**

Based on the findings of the study the following conclusions are made.

The study revealed that people who want the service lacks the required information that is necessary to use interest free banking service. In this regard, banks official who are expected to help the customers have no proper knowledge that the service requires and they also are not aware of the service products.

For every organization profit or nonprofit manpower is the most important element to do business the findings of the study also reveal that as an institution Islamic banking system have no sharia board members who have a business knowledge as well as religious knowledge, there is need to prepare a good foundation of human resources for the operation of Islamic banking system.

National bank of Ethiopia as a supervisor and regulator of the banking industry is expected to come up with relevant regulations governing the operation of Islamic banking (interest free banking) that conforms to the principles. The study reveals the banks started the service were not fully equipped with the required material resource, manpower and service requirement that the Islamic banks required. They start the service only to gain competitive advantage on early entrance in the market.

Government policies play a very important role for the successful implementation of interest free banking. However even if it approves one window service there no legal frame work issued for a full fledged interest free banking.

The findings of the study reveals supportive financial institutions like Equity Capital markets are necessary for financing modalities that was required to handle the requests of customer. This means in order to finance the investment of the customer requests dependant only on the customers deposit is sometimes creates liquidity problem on the banks to solve thus equity markets are helpful.

The findings of the study reveal also there is a bright future for Islamic Banking and financial system. Conventional banks recently opened separate Islamic banking windows. The situation seems to continue due to those started the service has gain additional deposit resource and income generating source when compared from their conventional banking counterparts. These help them to reach those who refuse conventional banking.

The findings of the study reveal also Islamic banking service has a potential to attract investors. An interest free investment climate will naturally attract investors who would want to benefit from the support of the interest free financial system. Investment can only thrive successfully in an environment where there is no stringent conditions attached to getting funds to finance investment. This means that Islamic banking system has the potential to facilitate and speed up the development of infrastructures which the country has been required.

The establishment of the Islamic banking service and financial system will help in furthering trade and businesses among the business community. This increases in the development and growth of the real sector of the economy. The study reveals that through the various financing modalities of Islamic banks those who have appropriate knowledge but shortage of capital can get access for the business opportunity on dual benefit basis. It also opens the door of employment opportunities, human capacity development as well as productivity.

### **5.3. RECOMMENDATIONS**

Based on the aforementioned conclusions, the researcher within the limitation of the study recommends the following points.

In order to exploit the benefits that can be achieved from provisions of starting Islamic banking service (interest free banking service), banks starting the service and those who want to start the service need to create awareness by using the marketing tools. Officials of these banks should play a vital role in educating the public about Islamic banking products. More effort should be made by Islamic banks to market their products. Several promotional campaigns should be planned.

In order to create the appropriate knowledgeable staff, banks should design training programs in the field of Islamic banking, and marketing, communication, Internal marketing to their employees is of high priority. Since many of their employees do not know the difference between their products, and those of conventional banks.

Since deposit works as life blood for any bank's Progress. Therefore, in order to promote Islamic banking, it is also fundamental for Islamic banks to offer good products for mass majority in order to induce them to place their deposits with Islamic banks. Banks can capture large deposits by employing good marketing techniques.

In order to properly implement the service requirement, national bank of Ethiopia needs to establish a clear set of legal frame work to control the proper establishment of the Shari'ah Control Committee of Islamic Banks, Due to the fact that Islamic



banking has religious dimension, financial innovations in this institution needs to meet Shari'ah requirements.

Majority Muslims only know that Islamic banking is based on non-interest basis, while the majority of the followers of other faiths have little or no knowledge about it at all. This creates lag to Islamic banking by creating lack of public acceptance. The awareness to enhance public acceptance of the institution should be made

#### **5.4. LIMITATION TO THE STUDY**

The researcher believes that the following had significant bearing on the quality of the research findings.

- Limited collaboration from different stakeholders to fully cooperate for the in-depth interviews.
- Lack of related literatures in the Ethiopian context and reference books.

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## APPENDICES

### Appendix-A

#### QUESTIONNAIRE

#### St. Mary University

#### School of Graduate Studies

#### MBA Programm In Accounting and Finance

**Researcher: Akmel Hailu**

**Contact Address: +251-913-88-12-82**

**Email: [mediak2020@yahoo.com](mailto:mediak2020@yahoo.com)**

**Dear Respondents,**

This questionnaire is designed to collect data's on the topic '**challenges and prospects of Islamic Banking (interest free banking) in resource mobilization in Ethiopian Commercial banks**'. The purpose of the study is for the partial fulfillment of the requirement for MBA program. For the successful accomplishment of the study, the response of employees of the bank will have pivotal role by being used as valuable input for the study. I assure you that the information to be shared by you will be used only for academic purpose and kept confidential. So, you are kindly requested to genuinely fill the questionnaire.

**Thank you in advance for your cooperation!**

#### ***Instructions:-***

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

0-5                   6-10                   11-15                   16-20                   21 Yrs& above

3. Educational Level    Certificate     Diploma     Degree

   Master                   PhD

5. Your current position \_\_\_\_\_

## Part Two: Respondents opinion investigation important aspects of Islamic banking

Next, there are listed of items which deal with respondents view on challenges facing Islamic Banking in banking industries. These items will explore respondents' assessment of challenges facing Islamic banking. 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).

### A. Challenges Facing Islamic Banking

	Items	Strongly Disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	There is Negative attitude of people regarding Islamic banking (wrong association with religion).					
2	The Muslim Community has awareness about Islamic banking system.					
3	Segregation of fund from the conventional banking service activity is mandatory to attract the potential customer of Islamic banking.					
4	The NBE Directive blocked ongoing initiatives for full-fledged Islamic banking while allowing the opening of Islamic special windows through the existing commercial banks.					
5	There is a gap in research and development in Islamic banking services and Islamic finance modalities to fill the gap in qualified human resource.					
6	There is Legal, Supervisory, and regulatory and/or institutional challenge.					

<b>7</b>	The current Financial Institutions regulatory and supervisory organ has future initiatives to establish Islamic financial institutions.					
<b>8</b>	There is Lack of suitable banking policies for Islamic banking.					
<b>9</b>	Islamic financial institutions (IFIs) 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.					
<b>10</b>	There is Capital Resource Constraints.					
<b>11</b>	Lack of supportive and link institutions like Interest free Money Market and capital markets would create liquidity and other operational difficulties to Islamic Banking.					
<b>12</b>	There is Lack of Trained Human Resource in Islamic banking.					
<b>13</b>	The banks have enough qualified staffs and scholars in Islamic banking to ensure that Islamic banking Services are up to date and fully comply with <i>Sha'riah</i> law.					
<b>14</b>	Most commercial banks feel Lack of market potential for resource mobilization in Islamic banking.					
<b>15</b>	The current commercial bank customers are fully satisfied with the range of products that the banks provide or, simply, they are not demanding more flexible and suitable products.					
<b>16</b>	The current commercial banks give the					

	service in compliance with the service requirement of Islamic banking.					
17	The current commercial bank have sufficient capacity to serve the customers and mobilize the required resource.					

### B. Prospects and Opportunities of Islamic banking

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

	Items	Strongly Disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
18	Islamic banking service is one means of resource mobilization in the banking Industry.					
19	The current global trends in Financial Services will have positive manifestations on the future of Islamic banking in Ethiopia.					
20	A plan for business expansion and/or new investment opportunity to be financed by bank loan cancelled due to the fact that the interest based banking system does not encourage Muslim business community to consider all possible business and					



	investment opportunities.					
<b>21</b>	There is Islamic banking service need in Ethiopia so that it will alleviate the financial services deprivation of the Muslim community and those who need interest free service.					
<b>22</b>	If the existing banks offer certain Islamic banking products (Saving and Loan Service), the access to Islamic banking will improve the tendency for business expansion and investment activity will increase.					
<b>23</b>	Banks have any short/medium term plan to engage in Islamic commercial banking activities and take advantage of the untapped potential growth and opportunity that Islamic banking services provide.					
<b>24</b>	The current commercial banks, public or private, will engage in Islamic banking services that will address the Muslim community need for Interest free banking any time					

	soon.					
25	Banking services user currently think that “Safety / keeping money safe” is their first priority.					
26	The likely reason(s) that many Muslims are not using banking services currently is due to the fact that Savings and loan services involve interest.					
27	People would use <i>investment</i> loan service due to its attractiveness and ease access.					
28	The “high prohibitive interest rates” that conventional banks charge is the main reason that loan services are not currently widely used.					

29. If you have any other opinion regarding to Islamic banking challenges and prospects?

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\_\_\_\_\_End!!!!\_\_\_\_\_

## **Appendix-B**

### **Interview questions**

The following are question prepared and communicated with some selected staffs of the banks

1. Do you think that there is adequately prepared and trained staff for Islamic banking /interest free banking / service?
2. What training and/or support would help to make the service easier?
3. What are the major problems that you encounter as a department while rendering IFB?
4. What are the major complaints from customers on the service you provide?
5. Do you have reached a satisfying number of clients through the provision of Islamic banking /IFB/?