



INTEREST-FREE BANKING (IFB) DEMAND AND SUPPLY SIDE ASSESSMENT REPORT

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■ Executive Summary

Ethiopia has a financial inclusion strategy developed by the National Bank of Ethiopia (NBE) in 2017 and updated in 2022. Various initiatives were taken including establishment of movable collateral registry, issuance of regulation on digital financial services, consumer protection directives, and others.

Inclusion entails beyond gender and encompasses rural outreach, financial literacy, and religious considerations. One key element in promoting inclusive financial services is the provision of interest-free financial services. In 2011, the NBE issued its first directive allowing interest-free banking, and in 2019, it allowed the licensing of full-fledged interest-free banks. Interest-free banking results from aligning banking principles with Sharia laws. IFB (Interest-Free Banking) services cater to communities not included in conventional banking systems due to religious beliefs and mismatches between conventional and Sharia-compliant banking systems.

This rapid assessment on IFB practices has been conducted to:

1. assess public perception on IFB services by conventional banks vs full-fledged IF banks,
2. to inform MESMER Program's orientation/design on inclusion,
3. share market information with key stakeholders regarding IF banking practices.

The report found that while both conventional and IFB services are used, 73% of the businesses prefer to use full-fledged IF banks to save and finance their business due to the perception that they are more Sharia-compliant.

Although, most of the enterprises (95%) have an awareness on availability of financing/loan provided by interest-free windows/banks, they lack comprehensive knowledge on the various products available.

With the growing interest of inclusion in the financial sector, all the conventional banks assessed have increased the number of branches providing IF services.

Accordingly, the three banks (Awash, Abyssinia and Dahsen) assessed have 2,393 branches offering IFB at window level and 137 full-fledged branches. Hijra and Zam Zam bank being the 1st two full-fledged IFB banks in Ethiopia have shown a rapid growth with over 120 branches established in various regions (38% of the branches being in Addis Ababa) in the last two years.

The challenges faced by the conventional banks include customers mistrust, misunderstanding and lack of information towards IFB services. All IFB services are separately managed and accounted for but this information is not properly delivered to the customers and the general public creating a mistrust in the conventional bank servicing IFB.

In order to bridge the demand and supply gap created, banks need to raise awareness, have a transparent procedure and rules regarding IFB services, and receive support from religious leaders and policy makers.

MESMER, through its targeted technical assistance to financial institutions will directly work with partner banks and selected full-fledged IFB banks to address capacity issues at bank level including marketing and expansion strategies as well as market level constraints such as public perception issues and legal framework to create conducive environment for diversified interest-free financial models/products.

■ Introduction

Interest-free banking (IFB) is a banking and financing activity that complies with the central tenets of Sharia (Islamic law). IFB was adopted in Ethiopian financial sector in 2011 through IFB window in conventional banks, and a full-fledged interest-free bank started operation in 2019. The Government of Ethiopia has issued a new proclamation that permits the establishment of full-fledged IFB in Ethiopia in May 2019 under the proclamation No: 1159/2019 as amendment of banking business proclamation issued in 2008.

IFB is built upon five pillars which are the indispensable measurements of religious validity (Sharia compliance) of any financial activity performed under the umbrella of Islamic finance. **These fundamental pillars are:**

1. Prohibition of interest (Riba),
2. Ban on speculative elements in financial contracts (Gharar),
3. Prohibition of gambling (mayser),
4. Ban on the use of trade and investment involving any element of prohibited asset or activity (Haram),
5. Profit and loss sharing principle and the imperative to have real assets underlying any given financial transaction.

The principles of IFB transactions are regulated by the Figh Al-Muamelat, which only allows profit sharing (PLS) and non-profit sharing agreements. Therefore, IF banks use production sharing agreements, buy and resell the required goods or services with an agreed margin, and collect fees for services provided under the contract to earn income.

IF banks and conventional banks that offer IFB products and services should establish a Sharia Supervisory Board (SSB) – to advise them on whether or not proposed transactions or products follows the Sharia, and ensure that the operations and activities of the banking institutions comply with Sharia principles. (Naceur, 2015).

IFB and finance assets have concentrated historically in the Middle East and Malaysia. These markets currently account for more than 80% of industry's assets. Globally the IFB represents 1% of the financial assets, the base grew from approximately \$200 billion in 2003 to an estimated \$2 trillion at the end of 2016 (White & Case, 2018). The global Islamic finance industry is expected to grow to US\$5.9 trillion by 2026 from US\$4 trillion in 2021, mainly driven by its biggest segments interest-free banks and Sukuk (Sukuk is Islamic bond or “Shari’ah-compliant” bond which is an Islamic financial certificate that represents a portion of ownership in a portfolio of eligible existing or future assets).

As of 2021, Africa has a Muslim population of approximately 636 million as of 2021 where almost 53 % are Africans. Countries like South Africa, Nigeria, Kenya, Senegal, Djibouti, Uganda and Morocco have all introduced legal and regulatory frameworks to promote the development of IFB. Several conventional banks across the continent have also started to offer Sharia-compliant banking products through “Islamic windows” (White & Case, 2018).

■ Objective

This quick assessment report is prepared to: i) assess public perception on IFB services provided through conventional banks vs full-fledged IF banks, ii) to inform the Program's orientation/design on inclusion, iii) share market information with key stakeholders regarding IF banking practices. The report touches on both demand and supply side of the IFB market and draws on market insight.

Demand Side: the assessment was carried to understand the demand for IFB financing and gauge appetite of those who are assumed to be excluded from the conventional banking system.

Supply Side: the assessment is made to understand the extent to which IFB service are being offered by conventional banks through IFB windows as well as the full-fledged interest-free banks.

A total of 20 MSMEs in Addis Ababa (Bethel and Merkato areas), Afar (Logia), and Amhara (Bahirdar) participated in the interview. On the supply side, five banks were assessed. The enterprises shared their knowledge and experience towards IFB. The team also had a chance to interview five bank managers (two from full-fledged and three from conventional banks) to understand the service from banks' perspective.

■ Methodology

The assessment has primarily deployed primary data collection method but also used some secondary data sources to establish assessment context. Structured questionnaire was used for interviews with banks and customers (enterprises).

■ Demand Side

Access to IFB Services

From the interviews conducted, 75% of the enterprises used full-fledged interest-free banks like Zam Zam and Hijra banks for deposit. The customers of full-fledged interest-free banks also have accounts with other banks that provide both interest-free and conventional banking services. Most have three or more banking accounts with different banks. Most businesses prefer to use banks that provide both the interest-free and conventional banking products to transfer money and conduct other business transactions because the banks are well established, reaching out many people through their several branches. From the total 20 interviewees, all have conventional IFB accounts and 15 have full-fledged IFB accounts.

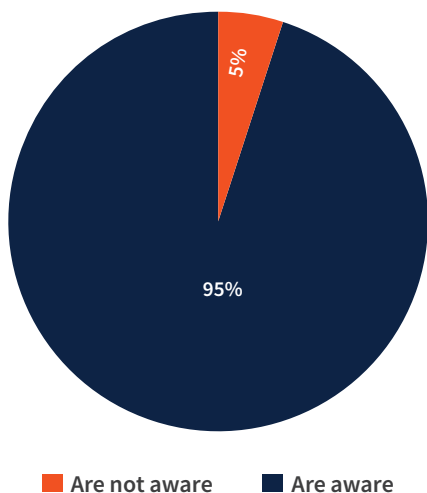
Awareness on IFB Financing

The concept of risk sharing is central to IFB; some modes of Islamic banking are profit-sharing and loss-bearing (Mudarabah), safekeeping (Wadiah), joint venture (Musharaka), cost-plus (Murabaha), leasing (Ijara). Most banks (conventional and full-fledged) use Murabaha financing structure, where the buyer and the seller agreed on the markup or cost plus for the item being sold.

All of the enterprise that participated in the interview said that they were not accessing financing/loan, because they were not aware of the IFB service that these banks gave. Some said they were not confident on the compliance nature of taking loans from both full-fledged and conventional IFB banks. One enterprise owner who tried to get a financing service from full-fledged IFB bank said, the strict bureaucratic procedures and collateral request that the bank requested made him lose interest in pursuing the financing from the bank.

95% of the interviewees have the awareness on the existence of IFB financing but lack the product types that IFB caters. No enterprise knew what kind of products were being provided at the banks regarding IFB. For all enterprises, the request of collateral for IFB services was the major drawback to access financing. Some enterprises were not sure whether IFB financing should even request collateral in its Sharia compliant nature. Again, there is a gap in understanding the Sharia law when it comes to IFB financing among the public which results in low number of accessing IFB financing.

IFB Financing Awareness



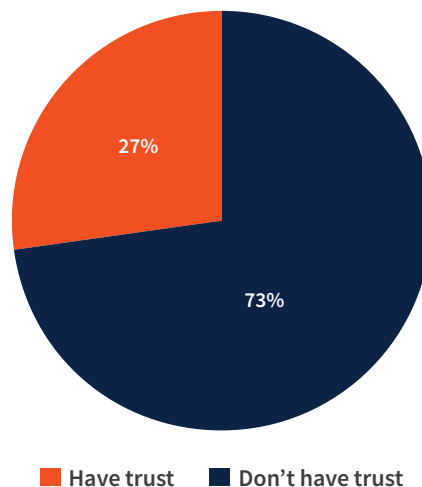
During the interview, enterprises were asked how they fulfill their financing needs and the majority said they use informal ways to get loans like Equb, or from family and friends. For the question where they would like to access financing for their business, the majority said they prefer to use the full-fledge banks as they have more trust on Sharia compliant aspect of the nature of the banks than the conventional banks.

In conclusion, almost all the enterprises claim that if banks lowered their collateral expectations, they prefer to get financing from full-fledged banks as opposed to conventional windows or branches. IFB positively influences financial inclusion as it increases the number of borrowers accessing credit which will eventually have impact on their growth and employment creation.

Public Preference

IFB branches in conventional banks like Noor (CBE), Ameen (Abyssiniya) and Iklhas (Awash) are popular among the Muslim community, especially to conduct business transactions. Nevertheless, 73% of the respondents prefer the full-fledged Islamic banks to save and finance their businesses because they trust the banks on being more Sharia-compliant than the other banks that provide different products even in an IFB branch set up. It was clear that there is a mistrust when it comes to financing/loans as some of the respondents do not know if the banks are separating the operations and management of the IFB window from main conventional bank operation in providing IFB services.

Public trust of conventional banks' compliance to Sharia



■ Supply Side

Full-fledged Interest-Free Banks

After the full-fledged banks (ZamZam and Hijra) started giving services, some businesses have started using services of these banks but without dropping out from the conventional banks. ZamZam and Hijra have tried to expand their branch network to most regions, even if they have only one branch in some regions. As seen in the table below, the two banks have total of 120 branches of which 38% are in Addis Ababa and the rest are in the regions. This is still very limited seen in light of the Muslim community, and compared to IFB windows provided by conventional banks. The full-fledged interest-free banks have not started providing ATM and mobile banking services, which is also another plan the banks have yet to implement.

		Banks		
		Zamzam	Hijra	Total
Branch Network	Total no. of branches	65	55	120
	Regions covered	6	10	
	Branches in Addis	31	14	45
	Branches outside Addis	34	41	75

Source: Compilation based on data from each bank.

In theory, full-fledged interest-free banks are expected to have all the financing models that are compliant with Sharia principles available. However, both conventional banks with IFB windows as well as full-fledged IFBs mostly offer Murabaha (cost plus markup) out of the multiple product options for financing businesses, mainly because the legal framework and regulations are not conducive for implementing other IFB financing products. Moreover, the banks lack adequate risk management systems to protect them from excessive risk taking or losses. For example, Musharaka which is a joint venture type of financing, cannot be implemented by banks as the NBE directive limits banks to participate in any non-banking business (NBE Directive No. SBB/65/2017), and joint venture type business is not categorized as banking model. Banks can not engage in profit sharing businesses hence creating difficulty to implement Mudarabah, another financial model available. Thus, IFB financing needs an accommodating legal framework in order for the IFB business to expand and attract more SMEs.

The enterprises interviewed mentioned that they started using IFB as window and full-fledged banks from the time it was available to the public. Yet, information gap is observed when it comes to the service that these banks provide to their customers and how they can benefit from them.

Most of the interviewees indicated the difficulty of accessing large loans in both full-fledged IFB banks and conventional banks as both banks require collateral. To avoid the risk of possible default, Islamic banks can hold valuable assets, titles, and other form of assurances/collateral.

Conventional Banks and Interest-Free Banking

An IFB window is simply a window within a conventional bank via which customers can conduct business, utilizing only Sharia compatible instruments/services. Muslim scholars debate the compliance of this form primarily because of where the funds for these windows come from. According to Adebayo and Hassen (2013), the ethical values of IFB system need to be strongly reiterated and compliant with the following conditions for any conventional bank to set up IFB, windows or funds;

- Complete segregation of fund
- Sharia supervisory board;
- Managerial commitment;
- Safeguarding Muslim investors' funds; and
- Compliance with accounting and auditing standards organization for Islamic financial institutions

Conventional banks like Awash, Abyssinia, Dashen, and others are providing IFB service through a dedicated window and/or dedicated branches. The implementation of window service for IFB was allowed by NBE in 2011, Commercial Bank of Ethiopia and Oromia International Bank being the first two banks to start giving the service (Mehammed & Bushera, 2020). The next table shows the branch network of the stated banks and their IFB windows. The four banks have 137 dedicated IFB branches distributed throughout the country and also provide IFB services in all their branches.

In the interview with Hibret bank IFB branch Manager, key challenge that conventional banks are facing were raised mainly on customers' mistrust, misunderstanding and lack of information they have towards the IFB service. The Manager said, **"We observe that there is a gap in 'fatwa' (interpretation of the Islamic banking from religion leaders)"** where there is also a lack of understanding from scholars themselves on the way IFB services are being served to the public.

	Banks			
	Awash	Abyssinia	Dashen	Total
Total no. of branches	800	819	774	2393
Total branches offering IFB window	800	819	774	2393
Dedicated IF branches	42	33	62	137
Regions covered	13	13	13	
Branches in AA	272	319	247	838
Branches outside Addis	528	500	527	1555

Source: Compilation based on data from each bank.

In fact, according to one of the IFB service managers, banks follow strict Sharia principles that does not mix assets and resources from its conventional parent bank. All IFB services are managed in different portfolio for only IFB users, but this information is not properly delivered to the customers and the general public. He also added that different banks use different way and procedure for IFB financing which is causing the confusion added with lack of information that the public is not accessing. The manager suggested that all bank should have the same guideline, procedure, rule and regulation in order to solve the misunderstanding that they have with IFB customers.

Service from Supply Side

Most conventional banks in Ethiopia provide IFB service through window or fully dedicated branch for IFB services. The three banks we had interviewed give similar services to their customers. The most popular product used by them all is the Murabaha product which is cost-plus asset-based product.

The interviews entail that the reason most banks use this product is because the legal framework of Ethiopia's financial sector is not optimal for other products to be used. Besides, there is no risk management framework that backs up the banks for loss. Moreover, Murabaha financing is very simple to implement as it only involves purchase and sales of goods to the customer on a specified margin of profit. Furthermore, study conducted by Abebe (2019) states that financing products like Musharaka need partnership of the bank with the customer which is not supported by the legal framework of the country. Istisna which focuses financing of construction is also not supported by the legal framework of the country since the lease system considers interest.

■ Conclusion and Recommendation

Most of the participants of the survey from the demand side know the existence of IFB financing services in different kind of banks (both conventional and full-fledged) but there is a lack of awareness on the type of financing products available and mode of operation. The trust level on the conventional IFB windows and branches was very low due to the question of mixing the conventional bank system and the IFB portfolio.

The other issue regarding accessing finance from full-fledged IFBs and conventional banks was the loan criteria of collateral requirements. The main constraint mentioned by different studies and participant banks for not using other IFB product besides Murabaha is the lack of accommodative financial legal system. Thus, there is a need for revising the legal and regulatory systems to accommodate other IFB products irrespective of the service being given by conventional banks nor IF banks.

The public's wariness on IF windows/branches is due to lack of confidence of resources separate management, and hence doubting adherence to Sharia principle. There seems to be a strong need to work on public perception and gain confidence on

the way conventional banks handle resources in the IF window and that ethical values of IFB models are well respected.

Thus, both conventional and full-fledged banks need to do more community awareness programs on the services of IFB service provisions. The fact that the IFB financing product type is not known by users is another constraint for businesses not to access finance from IFB services. Awareness creation on IFB services can be facilitated through different mediums like, workshops, trainings, mainstream and social media and other platforms.

As one focus area of MESMER program is promoting inclusive financial service for MSMEs, it will collaborate with different stakeholders to work on awareness creation to clear the doubts of potential customers on IFB. This will be coordinated under the program's technical assistance to financial institutions. Moreover, the program will work on availing funds for IFB, through retail IFB window of conventional banks or fully-fledged IF banks either directly from the program or through wholesale lending facilities to be availed by selected partner banks.

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MESMER is a 5-year program launched in October 2022 to support 72,200 MSMEs and 410,800 jobs by creating access to finance for micro, small and medium enterprises (MSMEs) to realize their growth prospects and resilience. MESMER will also work to provide support to MSMEs through business development support, psychosocial services and technical assistance to financial institutions. MESMER is a nationwide program implemented by First Consult in partnership with the Mastercard Foundation as part of the Foundation's Young Africa Works strategy and will strive to create dignified and fulfilling work for the youth, the majority of whom are women. The FDRE Ministry of Labour and Skills will be the main government counterpart for the program. Other partners include financial institutions (microfinance institutions, banks, and digital financial service providers), BDS, and psychosocial support providers.

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