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Islamic Banking:
Prospects, Opportunities and challenges in Ethiopia

Mohamed Muhumed Olad

A Thesis Submitted to
The Department of Accounting and Finance

Presented in Partial Fulfillment of the Requirements for the
Degree of Master of Business Administration in Finance

Addis Ababa University
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School of Graduate Studies

This is to certify that the thesis prepared by Mohamed Muhumed Olad: *Islamic Banking: Prospects, Opportunities and challenges in Ethiopia* and submitted in partial fulfillment of the requirements for the degree of Degree of Master Business Administration in Finance complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

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Abstract

Islamic Banking prospects, opportunities and challenges in Ethiopia

Mohamed Muhumed Olad

Addis Ababa University, 2012

While Sharia compliant investment avenues are now becoming available in most countries, in Ethiopia, most of the developments¹ of Islamic finance have taken place in the last four years².

This study presents new evidence on awareness, prospects, challenges and opportunities of Islamic banking in Ethiopia that are actually consistent with what Islamic Banking literature has revealed about the operations of Islamic banking elsewhere. To do so, descriptive research design of cross-sectional survey method which is be observational in its nature is used to realize the objectives of the study.

To be specific, the analysis suggests that there is low level of awareness about the operations of Islamic banking while respondents with different background has shown statistically significant variance in terms of awareness, gross misunderstanding and widely held long standing misconceptions about Islamic banking operations.

In addition, respondent's prospects assessment score with regard to the operations of Islamic banking is high and higher than average expected score while respondents with different background has shown significant variance in terms of their assessment. Moreover, lack of awareness, regulatory and supervisory challenges, institutional challenges, lack of support and link institutions, gap in research and development in Islamic studies as, lack of qualified human resource as well as wrongful association with specific religion and the global terrorism movements in recent times has been reported as one of the major problems facing Islamic banking in Ethiopia.

Key Words: Islamic banking, awareness, understanding, prospects, challenges

¹ However, limited, simple, uncomplicated and relatively uncompetitive products offered by few commercial banks, did not, cater for the wider Muslim consumers and the existence of full set of *Sharia-compliant* financial products in the Ethiopian financial industry is yet something to be seen. i.e the Special Demand Deposit offered by the commercial bank of Ethiopia (CBE) and the *Amanah* (or Safe-guarding) Account and the Micro-credit scheme (*Murabahah* offered by the Somali Micro-finance Institution (SMFI).

² After the 2008 'Banking Regulation and Supervision Proclamation' has been passed. National Bank of Ethiopia (NBE) has only allowed for the "Existing banks" to provide 'interest-free banking windows' while killing the long awaited hope for full-fledged Islamic banking.

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

يَمْنَعُ اللَّهُ الرِّبَا وَيَرْبِي الصَّدَقَاتِ

Allah deprives interest of all blessing, whereas He blesses
charity with growth (al-Baqarah 2:276)

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“All praise and thanks be to Allah, the Lord of existence, the most Gracious, the most Merciful”. Always I wish and become successful, except to be your servant. I also would like to express my deepest indebtedness to my parents, Muhumed Olad Maygag and Meryam Mohamoud Fidin, as always they were there, right beside me in my sorrow and joy, may Allah reward them all with his highest blessings.

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Peace, love and blessings

Thank you all indeed

To my Father and Mother

Muhumed Olad Maygag

And

Meryam Mohamoud Fidin,

‘Always, they were there, right beside me in my sorrow and joy,
Making supplications to Allah in order to make things easy for me,
May Allah reward them all with his highest blessings’?

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Chapter One

1.1 Introduction

Also known as participant banking, 'Islamic banking' refers to a system of banking that is consistent with the principles of *Sharia/Islamic law* and its practical application through the development of Islamic economics. *Sharia* prohibits the payment or acceptance of interest fees for loans of money *Riba* or *usury*, for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles, *Haraam*, such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values¹.

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 apply these principles to Private bank or semi-private Commercial bank institutions within the Muslim community.

During the *Islamic Golden Age*, early forms of proto-capitalism and free markets were present in the Caliphate², where an early market economy and an early form of mercantilism were developed between the 8th-12th centuries, which some refer to as "Islamic capitalism"³. Many of these early capitalist concepts were adopted and further advanced in medieval Europe from the 13th century onwards.^{3,4}

¹ The aim of this is to engage in only ethical investing and moral purchasing.

² A vigorous monetary economy was created on the basis of the expanding levels of List of circulating currencies of a stable, high-value currency, the *dinar* and the integration of monetary areas that were previously independent.

³ Jairus Banaji (2007), "Islam, the Mediterranean and the rise of capitalism", *Historical Materialism* (journal), pp. 47–74, (Brill Publishers)

⁴ A number of economic concepts and techniques were applied in early Islamic banking, including bills of exchange, the first forms of partnerships '*myfawada*' such as limited partnerships '*mudaraba*', and the earliest forms of Capital economics '*al-mal*', capital accumulation '*nama al-mal*', cheques, and promissory notes.

Small-scale "interest-free" savings banks were created from 1963 in Egypt. They were investing mainly in trade and industry. The banks' depositors were paid a share of the profits of the borrowers, acting like Savings & Loan institutions rather than commercial banks⁵.

The Islamic Development Bank was established in 1974 as an intergovernmental bank aimed at providing development funds for projects in less well off member countries⁶. Gradually overtly Islamic banks were developed in the Middle-East through the late 1970's⁷.

Islamic banks were also developed in Malaysia and even in predominantly Catholic Philippines to serve the Muslim population in Mindanao and in India⁸. However, Islamic banks have grown recently in the Muslim world but are a very small share of the global banking system in terms of assets.

Ethiopian financial sector is one of the fastest developing sectors with the establishment of new commercial banks and micro-finance institutions (MFIs) and is in line with the trend of other countries.

Commercial banking has become an essential sector with in the current Ethiopian economy and still is the dominant participant and contributor in the financial sector⁹. The banking products and services induce both public and private sector development.

⁵ The Nasr Social Bank, established in Egypt in 1971, was created as an interest-free commercial bank, but still without specific reference to Islam for fear of offending the political authorities.

⁶ The IDB provides fee based financial services and profit-sharing financial assistance.

⁷ such as the Dubai Islamic Bank, the Faisal Islamic Bank of Sudan, the Faisal Islamic Bank of Egypt, and the Bahrain Islamic Bank.

⁸ Luxembourg has the Islamic Finance House, DMI is based in Geneva and there are Islamic financial institutions in Denmark, Australia and in South Africa.

⁹ These commercial banks are the engines of growth as they provide the lifeblood to the economy, that is, one of the factors of production, capital.

Muslims, and who form a significant portion of the total population and live in all parts of the country, are no exception to this trend. However, the Muslim community has a problem with the current banking system as it stands today and this research aims to address these concerns.

So, a sound, deep and efficient financial sector are vital for high, sustained, private sector-led growth while insufficient access to credit by small and medium-sized enterprises constraints their ability to expand and limits countries' growth potential. However, Muslims, especially most Muslim households and small business owners cannot build formal savings and as a result, their ability to escape from poverty by investing in different sectors is limited.

1.2 Background of the study

The basic principle is that, interest- usury or '*Riba*' used interchangeably is prohibited on the principle of '*no pain no gain*'. The investor takes a share in the profits, if any, of the venture and is liable to lose his capital.

There are various economic and rational reasons put forward as to why interest is banned in Islam. Some say that interest as a fixed cost of production is a brake on employment. There is also a view that interest causes monetary crises and exacerbates trade cycles. For example, the Vatican has put forward the idea that "the principles of Islamic finance may represent a possible cure for ailing markets"¹⁰. Moreover, beyond the question of interest or '*Riba*', is the ethical issue. Islamic investments exclude tobacco, alcohol, gaming and other "undesirable" sectors.

Interest-free banking seems to be of very recent origin. The earliest references to the reorganisation of banking on the basis of profit sharing rather than interest are found

¹⁰ <http://www.bloomberg.com/apps/news?pid=20601092&sid=aOsOLE8uiNOg&refer=italy>

in the late forties¹¹, followed by a more elaborate exposition¹². They have all recognised the need for commercial banks and their perceived "necessary evil," and proposed a banking system based on the concept of '*Mudarabah*'¹³.

In the next two decades interest-free banking attracted more attention, partly because of the political interest it created in Pakistan and partly because of the emergence of young Muslim economists¹⁴.

In the early 1970s, Islamic Banking saw institutional involvement¹⁵. The involvement of institutions and governments led to the application of the theory to practice and resulted in the establishment of the first interest-free banks¹⁶.

Globally, Islamic banking is growing at a rate of 10-15% per year and with signs of consistent future growth¹⁷. Islamic banks have more than 300 institutions spread over 51 countries, including the United States through companies such as the Michigan-based University Bank, as well as an additional 250 mutual funds that comply with Islamic principles.

It is estimated that over US\$ 822 billion worldwide '*sharia*'-compliant assets are managed and this represents approximately 0.5% of total world estimated assets as of 2005¹⁸. According to CIMB Group Holdings, Islamic finance is the fastest-growing

¹¹ Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952)

¹² by Mawdudi in 1950

¹³ profit and loss sharing

¹⁴ The first such work is that of Muhammad Uzair (1955), Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974) were the main contributors.

¹⁵ The Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the First International Conference on Islamic Economics in Mecca in 1976, and the International Economic Conference in London in 1977 were the result of such involvement.

¹⁶ The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process.

¹⁷ <http://www.imf.org/external/pubs/ft/wp/2008/wp0816.pdf> Islamic Banks and Financial Stability: An Empirical Analysis pg 5

¹⁸ http://www.economist.com/world/europe/displaystory.cfm?story_id=14859353 | work=The Economist title=Sharia calling date=200911-12

segment of the global financial system and sales of Islamic bonds may rise by 24 percent growth level¹⁹.

Globally, the prospects for Islamic banking model are promising. Some see the Islamic model as an alternative. Others see it as complementary to the system which has dominated the western world. London is emerging as a major financial centre for Islamic finance. Islamic banking products are also widely used by non Muslims in Malaysia. Major Banks like Britain's HSBC and Citi of the US have set up Islamic banking subsidiaries that are flourishing.

Some of the champions of the Islamic way want to see business expand beyond the natural market of Muslim countries. They believe that now, more than ever, there is a market for non Muslims who share in the values espoused in Islamic economics.²⁰

However, Ethiopian Muslims are not part of this huge potential growth of that is occurring all corners of the world due to many factors in which lack of supportive regulatory and policy regimes that facilitate the establishment of Islamic financial institutions is the most important worth of mentioning.

Finally, responding to a strong public demand, the National Bank of Ethiopia (NBE) was expected to approve a directive that paves the way for the establishment of what was dubbed as the first Islamic bank in Ethiopia. A circulated draft form of the NBE's directive has allowed Ethiopian nationals to establish a bank exclusively engaged in interest-free banking," however, that hope was short living one as the finally issued draft does not allow the establishment of full-fledged Islamic financial

¹⁹ <http://www.iran-daily.com/1388/12/11/MainPaper/3630/Page/5/Index.htm>

²⁰ Project syndicate

institution²¹. However, the directive has only opened the door for 'existing commercial banks' to create an interest-free banking wing.

1.3 Statement of the problem²²

It is simply an accepted fact that there are sufficient Muslim investors and borrowers in both Islamic and non-Islamic countries to warrant the attention of traditional banks who seek to serve such clients and capture a potentially profitable slice of a still relatively untapped market. This study serves to clear away some of the mysteries that surround Islamic financial services and shows how such financial system can fit alongside a conventional interest-bearing banking system.

The basic aspect of Islamic banking is the absence of interest but there are other social and ethical features claimed to be more "pure" or "zealous" such as aiding a more equitable distribution of income and wealth and avoiding undesirable sectors.

There seems to be considerable demand for Islamic banking products both in Muslim and non-Muslim majority countries. To date, for a number of reasons, including lack of focus from policy makers, this need has gone largely unfilled for Ethiopian Muslims.

The need for Islamic banking services and the prohibition of interest does not need any more justification as it just exists through the religious beliefs of Muslims. But it is worth looking at the reasons put forward by some for Islamic banking to assist with understanding and innovation. For example, Islamic Banking will play a major role in the development of financial sector in a country like Ethiopia, where there is a significant Muslim population.

²¹ Capital Ethiopia News - Islamic Banks to enter financial sector.mht

²² akob Christensen, Anne-Marie Gulde & Catherine Pattillo, "Bankable Assets", Finance & Development (www.imf.org/fandd), Dec-2006.

A recent study (An unpublished Project Report²³) undertaken by the author of this study found dramatic results about many factors including how the Muslim Community is unbanked, let alone there, unfortunate desire for having a 'Shariah' based financial institutions that satisfy their financial services need.

Though, Ethiopia is one of the fastest growing economies in Africa and of course in the world, the gap between rich and poor is still wide as in the case for other underdeveloped countries. On the other hand, having only interest based conventional banking system and wholly ignoring to cater the financial services needs of the Muslim population is another setback to the development of the financial sector in Ethiopia.

In addition, a sound, vibrant and market-driven financial services industry can play a vital role in creating opportunities and therefore addressing human development challenges of our societies by efficiently and equitably channelling financial resources towards productive opportunities and employment generation.

So, given its inherent features, the IFSIs²⁴ has the potential to concurrently achieve the goals of sustainable economic development and just social progress, supported by sound and stable financial institutions and markets. Simultaneously, it is also possible to capture demand beyond the Muslim population through the provision of innovative and high-quality Islamic financial services (IFSs).

However, the establishments of fully-fledged Islamic banks, which offers the owners of capital to share the profits made by the entrepreneur who comes up with investment projects, is an untapped concept for the local financial sector.²⁵

²³ (Mohamed M. Olad, *The need for Islamic banking in Ethiopia*, July, 2008, Addis Ababa University)

²⁴ Islamic Financial Services Institutions (IFSIs)

²⁵ Capital Ethiopia News - Islamic Banks to enter financial sector.mht

Since, Muslims believe that banking with the conventional banks is against their religious faith; large numbers of potential Muslim customers are not banking with the existing conventional banks available in the country. Moreover, the poor are not given choices for banking, and hence, they don't find an opportunity to save their small earnings.

The 2008 Banking Business Regulation and Supervision Proclamation have already crafted a room for non interest banking and were expected to enable some already under progress initiatives that envisages the establishment of Islamic banks in Ethiopia.

However, IFSIs face significant challenges as a result of having its own special risk characteristics and unique governance requirements, on the one hand, and operating in a tax, legal and regulatory environment that was originally designed for conventional financial services, on the other hand.

Moreover, in addition to the evolving of the industry in this era of "globalization" where market, technological and regulatory environments are changing rapidly, there are other daunting challenges facing IFSIs which include lack of awareness and misconceptions, lack of qualified human resource for *Shari'ah* compliance, lack of appropriate legal framework and tax neutrality, lack of enabling supervisory framework, unresolved *fiqhi* issues as well as credibility and sustainability issues.

1.4 Research Questions

To explore and assess the prospects and challenges of Islamic banking model in Ethiopia, this study targets Jijiga City residents as survey participants. In order to achieve the intended objectives of the study and to address the research problem properly, certain research questions are designed accordingly.

In light of this, the research ponders to answer the following research questions:

1. Are there a real prospects and opportunities that justify the need to establish interest-free or Islamic banks in Ethiopia so that it will stimulate new waves of bank customers that were not used to banking services?
2. Are there substantial potential customers that are not currently served by the mainstream banking services due to the prohibition of '*Riba*' by '*Sharia*' law and hence need Islamic banking services?
3. Does the Muslim Community generally believe that their calls for financial services that are compatible with their religion have been neglected and economically disadvantaged and marginalized due to lack of supportive legal and policy framework?
4. Will the introduction of '*Sharia*' Complied Islamic banks have positive economic impact to the nation as a whole and the Muslim community in particular?
5. Does lack of awareness and proper understanding about the operations of Islamic banking pose serious challenge to the success of Islamic banking in Ethiopia?
6. Are the existing regulatory and supervisory regimes such as those holding Islamic banks to the same set of regulations as conventional banks and those that block the establishment of full-fledged Islamic banks counterproductive?

1.5 Objectives of the Study

1.5.1 General Objectives

The general objective of this study is to assess the prospects and challenges facing Islamic banking in Ethiopia. The study tries to assess the potentiality, prospects and challenges that IFSIs face in the Ethiopian financial services industry. Therefore, this study tries to find what are the prospects, challenges and problems that Islamic banking model faces in Ethiopia.

Moreover, this research paper tries to address the potentiality of Islamic banking model, whether Ethiopian Muslims have a genuine need for Islamic banking and whether there is a gap in addressing this basic, societal as well as economic need.

1.5.2 Specific objectives

This study specifically strives to achieve the following special objectives. In general this study tries;

- To highlight concepts and various terms connected to Islamic banking in broad terms and discuss the different Islamic banking products and services
- To address the issues involved in introducing Islamic banking system in Ethiopia such as awareness, understanding perceptions and to investigate banking services usage patterns and behaviours so as to determine whether it's the right time.
- To probe the prospects and potentiality as well as the need for Islamic financial services institutions in Ethiopia.
- To analyse and identify the major setbacks and challenge that faces the establishment as well as the operations of Islamic financial services institutions.
- Lastly but not least, the study also tries to identify what benefits will Ethiopia obtain from the establishment of Islamic banking.

1.6 Significance of the Study

The findings of the study will be useful in many ways and too many parties. The results of the study will help the disenfranchised Muslim community in general and the business community in particular. It will also benefit those concerned policy makers to formulate necessary and solution-oriented policies that will in fact have a benefit to all citizens.

To be specific in this regard, this study will help in making decisions with regard to fast tracking policy dimensions that help not only realizing the establishment of Islamic banking but also the effective operation as well as supervision of Islamic financial services institutions.

In addition, this study tries to give an investment tip to both current as well as potential investors to target this untapped market which will help in improving the economy, living standard of citizens as well as competition and efficiency.

The other important benefit that the findings of this study will have is its contribution to knowledge building and academic research by helping other researchers to undertake a further detailed investigation on the subject and providing relevant empirical evidences.

1.9. Organization of the paper

This paper is organized in to five broad categories (chapter), the first chapter deals about the introduction of the study that is background, statement of the problem, objective, significance, and the research questions.

The second chapter discusses the theoretical and empirical literatures about Islamic Banking. The third chapter is about the methodology of the research that is the research design, sampling technique, method of data collection, data collection instruments, method of data analysis and so on.

The fourth chapter of the paper presents the findings as well as the quantitative and qualitative data analysis. Finally the fifth chapter deals with the summary, conclusion and recommendations.

1.7 Limitations and Delimitations of the study

1.7.1 Limitations of the study

The potential limitation in conducting this study includes but not limited to; lack of relevant and exhausted related research works on the subject. The other important limiting factor that is worth of mentioning lies with the participants of the study. Most of the participants don't have clear understanding about the intents of the study and there is inherent risk of extreme reservations in full participation, if any, due to the high sensitivity and versatility when it comes to religious matters, especially this time around.

1.7.2 Delimitations of the study

The scope of this study is delimited to only assessing the prospects and challenges of Islamic banking in Ethiopia by taking Jijiga City as survey participants to this study. The study will only include data collected from the participants of the study through questionnaires that will be distributed and administered to them in addition to the accepted financial and economic theories from secondary sources.

However, it does not attempt to provide any moral justification, rationale or even establish clear rules as to what is Islamic and therefore *Hallal* and what is un-Islamic and therefore prohibited or *Haram*.

1.8 Purposes of the study

The purpose of this research is to provide an insight in to "Islamic" banking by assessing its need, prospects and challenges in Ethiopia. The research tries to examine the need for *Sharia*' compliant Islamic banks, the prospects and challenges facing Islamic banking in Ethiopia by taking a carefully and randomly selected group of participants from different backgrounds and characteristics as a case study.

Chapter Two

Review of Related Literature

In this chapter, the related literature will be reviewed and discussed. The literature concerning the prospects and challenges of Islamic Banking in Ethiopia and elsewhere will be presented. The relevant literature will be collected from different secondary sources and it includes material about the Islamic economic model, evolution of Islamic banking, key financial instruments, and Islamic banking literature versus practice, empirical evidences on Islamic banking, challenges as well as the need for Islamic banking in Ethiopia will be analyzed in the following sections of this chapter.

2.1 The Islamic economic model ²⁶

The beliefs of Islam encompass all aspects of a Muslim's life, determining the articles of their faith, their moral and behavioural code, relationships between man and God, and between human beings as well as giving the framework for their daily activities.

Islamic law or *Sharia*, as revealed in and derived from the Qur'an and *Sunnah* (the sayings and practices of the Prophet Muhammad (PBUH)), governs all economic and social activities and undertakings of Muslims.

While some of these principles and rules are based on clear and explicit rulings of *Sharia*, others are derived from *Sharia* scholars' interpretations and understanding of the law, known as *Fiqh*, as set out in the Qur'an.

These interpretations can and of course do differ between *Sharia* scholars. For example, certain contractual terms deemed to be valid under *Sharia* by the scholars of one school of *Fiqh* may not be acceptable to scholars from another school. This has had significant implications for the development of Islamic finance.

²⁶ Financial Services Authority, Islamic Finance in the UK: Regulation and Challenges, November 2007

The Islamic economic model has been developed over time based on the rulings of *Sharia* on commercial and financial transactions. The Islamic financial framework, as seen today, stems from the principles developed within this model, some of which are outlined below:

2.1.1. Emphasis on fairness.

This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific *Sharia* rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society.

2.1.2. The economic rights of individuals

Islam encourages and promotes the right of individuals to pursue personal economic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For example, transactions involving alcohol, pork related products, armaments, gambling and other socially detrimental activities are not permitted under *Sharia* law.

2.1.3. Strict and explicit prohibition of 'Riba'

One key *Sharia* ruling on economic activities of Muslims is the strict and explicit prohibition of *Riba*, most usually described as usury or interest. *Sharia* scholars consider exchanging interest payments within the conventional banking system as a type of *Riba*.

Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth

generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income.

2.1.4. A risk and profit-sharing (and loss-bearing) philosophy

The Islamic economic model is based on a risk and profit-sharing (and loss-bearing) philosophy. So, in this respect, Islamic transactions are similar to, if not the same as, equity-based transactions in rewarding performance. However, *Sharia* requirements go further to ensure that in distributing profits more emphasis is placed on reward for effort rather than reward for merely owning capital.

2.1.5. The Islamic Law of Contracts

The Islamic Law of Contracts plays a pivotal role within the Islamic financial system. Islamic commercial jurisprudence, '*Fiqhi Al-muamalat*', consists of principles and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under *Sharia law*.

2.1.6. Zakat: a Concern for the Poor

Islam has made *Zakat* compulsory on the wealth of rich Muslims. This is spent for the weaker and distressed sections of the society. *Zakat* not only distributes wealth between the rich and the poor of the society, it also influences investment, savings and allocation of income and resources²⁷²⁸.

²⁷ A detailed study has been made in this regard by Dr. Monzer Kahf in his book "Islamic Economy" American Trust Publications, USA.

²⁸ A rich body of literature has come up in recent times on Zakat.

This is a special feature of Islam and *Zakat* is one institution which testifies to this. In this connection we may refer to *Ayat 5-6 of Sura Qasas* which reads '*We desired to show favour into those who were depressed in the earth, and to make them leaders and to make them inheritors and to establish them on earth.*'

2.2 'Riba' or Usury in Islam

The word "*Riba*" means excess, increase or addition, which according to *Shariah*, implies any excess compensation without due consideration (consideration does not include time value of money). This was accepted to refer directly to interest on loans according to Islamic economists Choudhury and Malik (1992)²⁹. By the time of Caliph Umar, the prohibition of interest was a well-established working principle integrated into the Islamic economic system.

The definition of "*riba*" in classical '*Fiqh*' or Islamic jurisprudence was "surplus value without counterpart", or "to ensure equivalency in real value", and that "numerical value was immaterial."

During this period, gold and silver (used as currencies during that part of times), were the benchmark metals that defined the value of all other materials being traded. Applying interest to the benchmark itself ("*ex natura sua*") made no logical sense as its value remained constant relative to all other materials: these metals could be added to but not created (from nothing).

²⁹ Nevertheless, Choudhury and Malik provide evidence for "a gradual evolution of the institutions of interest-free financial enterprises across the world" (1992: 104). They cite, for instance, the current existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North America.

The criticism of usury in Islam was well established by several verses in the Qur'an dating back to around 600 AD and reinforced by the Prophet Muhammad (S.A.W) during his life and are not questionable³⁰.

2.3 Evolution of Islamic Banking

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

During the middle ages, Islamic finance was popular and was widely accepted and practiced. It helped in furthering the trade and business in the Muslim world. The Islamic merchants began to play a very important role in the European region (Mediterranean, Spain and Baltic States).

Islamic finance has become a global system spreading as far as Asia, the Middle East, and the Western world. Islamic banking is not limited only to the Muslim nations in the Middle East but also exists in the developed economies such as USA, Europe, and the far East. Today, more than four hundred and fifty (450) Islamic banks are operating from China to USA, having assets in excess of one trillion US dollars.

2.4 Islamic Financial Systems in Perspective³¹

The theories and concepts regarding Islamic financing system sent a ripple down the existing financial system base of capitalist values. People used to the existing financial system thought that a system and financial institutions based on non-interest regime could not survive.

³⁰ For instance, Qur'anic verses on usury (interest) are Q2:274: 3: 130 Q3:132-133

³¹ Project syndicate

People who are attaching importance to moral values, beliefs and ethics in society criticized the conventional financial system as relying heavily on capitalistic methods. They believe that conventional financial system maneuvers the charging of high interests on loans and its activities such as forcefully occupying premises if loans are not repaid and mishandling the defaulters, are all on the wrong side of the law.

The trend in clients' dealings with institutions which do not give due cognizance to moral values and ethics is characterized by reluctance. Moreover, socio-demographic trends and the fact that Islamic banking created a portal to invest ethically and in a valuable way to society, have been the catalysts for its continued growth and adoption.

Performing the same financial intermediation as conventional banks, Islamic banks act in accordance with revenue-sharing principles, and structure transactions so as to avoid paying or receiving interest.

Islamic banking services include a broad range of profit-sharing, safekeeping, leasing, cost-plus financing and joint venture agreements. Innovative new technology solutions have enabled banks to meet the increased demand for these services.

Now, virtually every product and service offered by conventional financial institutions has a *Shari'ah*-compliant equivalent ranging from loans to mutual funds and from electronic payment systems to stock indices.

2.5 Key Islamic Financial Instruments

2.5.1 'Mudarabah'

'*Mudarabah*' is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called '*rabb-ul-mal*', while the management and work is an

exclusive responsibility of the other, an entrepreneur borrower, who is called '*mudarib*'³².

Under the principle of '*no pain no gain*', no one is entitled to any addition to the principal sum if he does not share in the risks involved. The '*Mudarabah*' is a contract, with one party providing 100 percent of the capital and the other party providing its specialist knowledge to invest the capital and manage the investment project³³.

Further, '*Mudaraba*' is venture capital funding of an entrepreneur who provides labor while financing is provided by the bank so that both profit and risk are shared³⁴.

2.5.2 '*Musharaka*'³⁵

Financing through equity participation is called '*Musharaka*'. Here the partners or shareholders use their capital through a joint venture, Limited Partnership to generate a profit³⁶. This concept is distinct from fixed-income investing and unlike '*Mudabarah*', All providers of capital are entitled to participate in management, but not necessarily required to do so.

'*Musharakah*' is a relationship between two parties or more, of whom contribute capital to a business, and divide the net profit and loss in a '*pro rata*'³⁷.

³² Hence, the name of the structure; *Mudarabah*. Profits are shared on a pre-agreed basis but losses, if any, however, are wholly suffered by the '*rabbulmal*'. *Mudaraba* has also been called *Shirka*

³³ Compared to *Musharaka*, in a *Mudaraba* only the lender of the money has to take losses.

³⁴ Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing lender to monopolize the economy.

³⁵ Farhad, Rahnema, and Ali (Islamic Economic Systems, Zed books limited, 1994)

³⁶ Profits or losses will be split between the shareholders according to some agreed pre-formula depending on the investment ratio while the loss is borne by each partner strictly in the same ratio in proportion to respective capital (contributions).

³⁷ This is often used in investment projects, letters of credit, and the purchase or real estate or property. In the case of real estate or property, the bank assesses an imputed rent and will share it as agreed in advance.

'*Mudaraba*' and '*Musharaka*' represent the desired forms of Islamic banking even though their current use is not significant. Islamic bank depositors act as '*Rabbulmals*' and place funds with the bank³⁸.

The bank may also act in an off-balance sheet capacity as a fee earning agent on behalf of the fund providers and/or fund seekers or as a traditional fund manager investing in a diversified portfolio of '*Musharaka*' contracts.

There are several other approaches used in business transactions. Islamic banks lend their money to companies by issuing floating rate interest loans³⁹. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded. This practice is called '*Musharaka*'.

If the Bank provides capital, the same conditions apply. It is the financial risk involved according to the '*Shariah*' that justifies the bank's claim to part of the profit.

The difference between '*Musharaka*' and '*Mudaraba*' is that, in *Musharaka*, each partner contributes some capital, whereas in '*Mudaraba*', one partner, e.g. a financial institution provides all the capital and the other partner, the entrepreneur, provides no capital.

2.5.3 Murabaha'

In a '*Murabaha*' transaction, the bank finances the purchase of an asset by buying it on behalf of its client. The bank then adds a "mark-up" in its sale price to its client who pays for it on a deferred basis.

³⁸ The bank is the '*Mudarib*' on its liability side with respect to the depositors. Here the bank is the *Rabbulmal* with respect to the end users of the funds and acts as a principal. The bank uses the funds on the '*Mudaraba*' or '*Musharaka*' basis or any other Islamically approved basis with clients in search of funding.

³⁹ The floating rate of interest is pegged to the company's individual rate of return. Thus the bank's profit on the loan is equal to a certain percentage of the company's profits.

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties⁴⁰. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin⁴¹.

Islamic banks are supposed to take a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods⁴². Title to the goods financed may pass to the bank's client at the outset or on deferred payment.

2.5.4 'Baimuajjal'

It is deemed acceptable to charge higher prices for deferred payments. Such transactions are regarded as trades and not loans. Property financing on such a deferred payment basis is called *Baimuajjal*'.

2.5.5 'Bai' bithaman ajil' (deferred payment sale)⁴³

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. Like '*Bai'-al-'inah*', this concept is also used under an Islamic financing facility. Interest payment can be avoided as the customer is paying the sale price which is not the same as interest charged on a loan⁴⁴.

⁴⁰ The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement.

⁴¹ The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled.

⁴² The bank stands in between the buyer and the supplier and is liable if anything goes wrong. There is thus some form of guarantee with respect to the quality of the goods provided by the bank to the end user in the strict form of '*Murabaha*'. It is argued that the services provided by Islamic banks are substantially different from those of money lenders. This type of transaction is similar to rent-to-own arrangements for furniture or appliances that are common in North American stores.

⁴³ &³³ <http://www.badralslami.com/glossary/> <http://www.azmilaw.com/Article/>

⁴⁴ The problem here is that this includes linking two transactions in one which is forbidden in Islam. The common perception is that this is simply straightforward charging of interest disguised as a sale

2.5.6 '*Bai' al 'inah*' (sale and buy-back agreement)⁴⁵

'*Bai' al inah*' is a financing facility with an underlying buy and sell transactions between the financier and the customer. The financier buys an asset from the customer on spot basis. The price paid by the financier constitutes the disbursement under the facility. Subsequently the asset is sold to the customer on a deferred-payment basis and the price is payable in instalments. The second sale serves to create the obligation on the part of the customer under the facility⁴⁶.

2.5.7 *Ijara* (Lease)

'*Ijarah*' means lease, rent or wage. An Islamic form of leasing is called '*Ijara*'. Generally, '*Ijarah*' concept means selling the benefit of use or service for a fixed price or wage. Here the banks buy machinery or other equipment⁴⁷ such as plant, office automation, or motor vehicle for a fixed period and price and lease it out under instalment plans to end-users⁴⁸.

A bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in instalments. However, the bank's profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks for strict collateral⁴⁹.

An innovative approach applied by some banks for home loans, called '*Musharaka al-Mutanaqisa*', allows for a floating rate according to market rate in the form of rental.

⁴⁶ There are differences of opinion amongst the scholars on the permissibility of *Bai' al 'inah*, however this is practised in Malaysia (A set of strict conditions must be complied) and the like jurisdictions.

⁴⁷ The concept of *Ijarah* is used by some Islamic Banks (the Islami Bank in Bangladesh, for example) to apply to the use of money instead of the more accepted application of supplying goods or services using money as a vehicle. A fixed fee is added to the amount of the loan that must be paid to the bank regardless of the loan generates a return on investment or not. The reasoning is that if the amount owed does not change over time, it is profit and not interest and therefore acceptable under *Sharia*.

⁴⁸ As in conventional leasing contracts there may be an option to buy the goods built into the contracts. The instalments consist of rental for use and part-payment.

⁴⁹ The goods or land is registered to the name of the buyer from the start of the transaction. This arrangement is called '*Murabaha*'. Another approach is '*Eljara wa Elqtina*', which is similar to real estate leasing. Islamic banks handle loans for vehicles in a similar way (selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid).

The bank and borrower form a partnership entity, both providing capital at an agreed percentage to purchase the property.

The partnership entity then rents out the property to the borrower and charges rent. The bank and the borrower will then share the proceeds from this rent based on the current equity share of the partnership⁵⁰. At the same time, the borrower in the partnership entity also buys the bank's share of the property at agreed instalments until the full equity is transferred to the borrower and the partnership is ended.

2.5.8 '*Ijarah thumma al bai*' (hire purchase)

Parties enter into contracts that come into effect serially, to form a complete lease/buyback transaction. The first contract is an '*Ijarah*' that outlines the terms for leasing or renting over a fixed period, and the second contract is a '*Bai*' that triggers a sale or purchase once the term of the '*Ijarah*' is complete⁵¹.

The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin for the money being invested in purchasing the product to be leased for the intended term. The combining of these three figures becomes the basis for the contract between the Bank and the client for the initial lease contract⁵².

2.5.9 '*Ijarah-wal-iqtina*'

A contract under which an "Islamic bank" provides equipment, building, or other assets to the client against an agreed rental together with a unilateral undertaking by

⁵⁰ If default occurs, both the bank and the borrower receive a proportion of the proceeds from the sale of the property based on each party's current equity.

⁵¹ For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed amount over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed to price.

⁵² Some western scholars argue that this type of transaction is similar to the '*contractum trinius*', a legal manoeuvre used by European bankers and merchants during the Middle Ages to sidestep the Church's prohibition on interest bearing loans. In a *contractum*, two parties would enter into three concurrent and interrelated legal contracts, the net effect being the paying of a fee for the use of money for the term of the loan. The use of concurrent interrelated contracts is also prohibited under *Shariah* Law.

the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

2.5.10 'Bai-salam'

When a manufacturer seeks to finance the production of goods he seeks '*Baisalam*' financing. This involves the bank paying for the producer's goods at a discount before they have been delivered or even made.

'*Bai-salam*' means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver, or currencies based on these metals. Barring this, '*Bai-Salam*' covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship.

2.5.11 'Musawamah'

'*Musawamah*' is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated, they are under no obligation to reveal these costs as part of the negotiation process.

This difference in obligation by the seller is the key distinction between '*Murabaha*' and '*Musawamah*' with all other rules as described in '*Murabaha*' remaining the same. '*Musawamah*' is the most common type of trading negotiation seen in Islamic commerce.

2.5.12 'certificates of sale'

It has been suggested that consumers buying consumables on credit would issue 'certificates of sale' similar to letters of credit. These could be encashed by the seller at the bank at a discount. This seems very similar in structure to '*Bai-salam*'.

2.5.13 No fee accounts

There is a substantial Muslim population in South Africa and they are serviced by two small Islamic banks. The main product being offered is the "no fee" current account which is also provided by the conventional banks by arrangement.

Transaction charges are waived and interest is not paid on current accounts. Interest is charged on loans by conventional banks. These are similar to Special demand deposit provided by the Commercial Bank of Ethiopia.

2.5.14 *Hibah* 'gifts'⁵³

Gifts to depositors are given entirely at the discretion of the Islamic banks on the basis of the minimum balance. These gifts may be monetary or non-monetary and are based on the banks' returns⁵⁴.

This is a token given voluntarily by a debtor to a creditor in return for a loan. '*Hibah*' usually arises in practice when Islamic banks voluntarily pay their customers a 'gift' on

⁵³ <http://www.rhbislamicbank.com>

⁵⁴ Iran and Pakistan have both attempted to fully islamise their entire banking. Iran converted to Islamic banking in August 1983 with a three-year transition period. In Iran banks accept current and savings deposits without paying any return. The banks are permitted to offer bonuses and prizes on these deposits very similar to the UK's premium bonds. This is apparently not regarded as gambling by the Iranian Islamic banking units.

savings account balances, representing a portion of the profit made by using those savings account balances in other activities.

It is important to note that while it appears similar to interest, and may, in effect, have the same outcome, '*Hibah*' is a voluntary payment made (or not made) at the bank's discretion, and cannot be 'guaranteed'. However, the opportunity of receiving high '*Hibah*' will draw in customers' savings, providing the bank with capital necessary to create its profits; if the ventures are profitable, then some of those profits may be gifted back to its customers as '*Hibah*'.

2.5.15 *Qard hassan*⁵⁵(good/benevolent loan)⁵⁶

This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor.

In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on '*riba*', since it is the one type of loan that truly does not compensate the creditor for the time value of money.

2.5.16 '*Sukuk*' (Islamic bonds)

'*Sukuk*', plural of صك '*Sakk*', is the Arabic name for financial certificates that are the Islamic equivalent of bonds. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, '*Sukuk*' are securities that comply with the Islamic law

⁵⁵ *Qardul hassan*

⁵⁶ http://www.irfi.org/articles/articles_301_350/is_islamic_banking_islamic.htm

'*Shariah*' and its investment principles, which prohibit the charging or paying of interest⁵⁷.

2.5.17 Takaful (Islamic Insurance)

"*Takaful*" is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers. See Takaful for details.

2.5.18 Islamic equity funds⁵⁸

Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system. Currently, there are approximately 100 Islamic equity funds worldwide. The total assets managed through these funds currently exceed US\$5 billion and is growing by 12–15% per annum.

With the continuous interest in the Islamic financial system, there are positive signs that more funds will be launched. Some Western majors have just joined the fray or are thinking of launching similar Islamic equity products.

Despite these successes, this market has seen a record of poor marketing as emphasis is on products and not on addressing the needs of investors. Over the last few years, quite a number of funds have closed down. Most of the funds tend to target high net

⁵⁷ Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

⁵⁸ Since the launch of Islamic equity funds in the early 1990s, there has been the establishment of credible equity benchmarks by Dow Jones Islamic market index (Dow Jones Indexes, pioneered Islamic investment indexing in 1999) and the FTSE Global Islamic Index. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets. Series The Web site failaka.com monitors the performance of Islamic equity funds and provides a comprehensive list of the Islamic funds worldwide.

worth individuals and corporate institutions, with minimum investments ranging from US\$50,000 to as high as US\$1 million.

Target markets for Islamic funds vary; some cater for their local markets, e.g., Malaysia and Gulf-based investment funds. Others clearly target the Middle East and Gulf regions, neglecting local markets and have been accused of failing to serve Muslim communities.

2.6 Retail Islamic Banking Products

2.6.1 Current Account (*Alwadiyah*)

At a retail level, Islamic banks provide current, savings, and investment accounts. The current account is basically safekeeping or '*Al-wadiyah*' account and used for day to day cash management. In '*Al-Wadiyah*', a bank is deemed as a keeper and trustee of the funds.

A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it and permits the bank to use the depositors' money. It is very similar to such accounts in conventional banks. No return is paid to depositors, however, at the bank's discretion, may be rewarded with '*Hibah*' (see below) as a form of appreciation for the use of funds by the bank⁵⁹.

⁵⁹ Cheque-books are provided along with bill payment facilities, bank drafts, bills of exchange, travellers' cheques. Credit cards are unlikely to be provided but debit cards do not seem to be a problem. Most banks have no charges for such account.

2.6.2 Savings Account

'*Alhwadiah*' structures are also used for higher return savings account. Banks may as they see fit pay the savers a return, depending on their own profitability⁶⁰. This seems to be allowed as the bank's payment, if any, is level and is not determined in advance.

2.6.3 Investment Account

The investment accounts use the '*Mudaraba*' format. Deposits are fixed term and cannot be cashed in before maturity. In practice there are only profit sharing and no loss sharing for retail investors⁶¹. The lower risk means a lower profit share.

There are considerable variations on the '*Mudaraba*' principle⁶² and the frequency of payment and declaration of profits⁶³.

2.7 Islamic laws on trading⁶⁴

The 'Qur'an' prohibits *gambling* (games of chance involving money) and insuring ones' health or property (also considered a game of chance). The '*hadith*', in addition to prohibiting gambling (games of chance), also prohibits '*bayu al-gharar*' (trading in risk, where the Arabic word "*gharar*" is taken to mean "risk" or excessive uncertainty).

The '*Hanafi madhab*' (legal school) in Islam defines "*gharar*" as "that whose consequences are hidden." The *Shafi* legal school defined "*gharar*" as "that whose

⁶⁰ Savings account holders do not have the same level of service as current account holders but get savings books and instant or short notice access. There may or may not be a service charge incurred. Losses are not, in practice, passed on to depositors and are absorbed through the banks' reserves.

⁶¹ The profit-sharing ratio varies between institutions and could be a function of the bank's profitability or that of the portfolio of end borrowers.

⁶² The Islamic Bank of Bangladesh has been offering Profit and Loss sharing Deposit Accounts, PLS Special Notice Deposit Accounts, and PLS Term Deposit accounts. Bank Islam Malaysia provides wholesale and retail investment accounts both on the PLS principle.

⁶³ Profits are declared and distributed monthly in Malaysia, whilst in Egypt there is a quarterly distribution. In Bangladesh and Pakistan distributions tend to be half-yearly.

⁶⁴ http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IES_Articles

nature and consequences are hidden" or "that which admits two possibilities, with the less desirable one being more likely."

The *Hanbali* school defined it as "that whose consequences are unknown" or "that which is undeliverable, whether it exists or not." Ibn Hazm of the *Zahiri* School wrote "'*Gharar*' is where the buyer does not know what he bought, or the seller does not know what he sold." The modern scholar of Islam, Professor Mustafa Al-Zarqa, wrote that '*Gharar*' is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling." Other modern scholars, such as Dr. Sami al-Suwailem, have used Game Theory to try and reach a more measured definition of '*Gharar*', defining it as "a zero-sum game with unequal payoffs".

There are a number of '*hadith*' that forbid trading in '*gharar*', often giving specific examples of '*gharhar*' transactions (e.g., selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb etc.). Jurists have sought many complete definitions of the term. They also came up with the concept of '*yasir*' (minor risk); a financial transaction with a minor risk is deemed to be '*halal*' (permissible) while trading in non-minor risk ('*bayu al-ghasar*') is deemed to be '*Haraam*'⁶⁵.

What '*gharar*' is, exactly, was never fully decided upon by the Muslim jurists. This was mainly due to the complication of having to decide what is and is not a minor risk. Derivatives instruments (such as stock options) have only become common relatively recently. Some Islamic banks do provide stock brokerage services for stock trading.

⁶⁵ <http://www.ruf.rice.edu>

2.8 Microfinance⁶⁶

Microfinance is a key concern for Muslims states and recently Islamic banks also. Microfinance is ideologically compatible with Islamic finance, capable of '*Shariah-compliance*', and possesses a sizeable potential market. Islamic microfinance tools can enhance security of tenure and contribute to transformation of lives of the poor.

The use of interest found in conventional microfinance products and services can easily be avoided by creating microfinance hybrids delivered on the basis of the Islamic contracts of '*mudaraba*', '*musharaka*', and '*murabaha*'. Already, several microfinance institutions (MFIs) such as FINCA Afghanistan have introduced Islamic-compliant financial instruments that accommodate '*sharia*' criteria.

2.9 Risk management and Innovations in Islamic Financial Services

Islamic financial institutions have taken numerous efforts to be an innovative vehicle for their respective economies. These institutions introduced several products since the year 2006, considered to be the first in the world in order to sustain their customer's loyalty and perceptions.

New investment models and business tools are being developed by Islamic financial experts which are not only hundred percent *Shari'ah* compliant but also highly profitable. These tools or investment portfolios can be used both by Muslim and non Muslim alike.

⁶⁶<http://ifptest.law.harvard.edu>
<http://www.learnislamicfinance.com>, <http://knowledge.insead.edu/islamicmicrofinance080205.cfm>,
<http://asia.news.yahoo.com/070905/3/37gee.html>,
<http://www.humanitarianinfo.org/sumatra/reliefrecovery/livelihood/docs/doc/pdf>,
<http://www.unhabitat.org/downloads/docs>

2.9.1 Islamic Derivatives

For example, with the help of Bahrain-based International Islamic Financial Market and New York-based International Swaps and Derivatives Association, global standards for Islamic derivative were set in 2010⁶⁷.

2.9.1.1. *Wiqā'* Forward Rate Agreement (WFRA)

Considered to be first of its kind, was introduced as a '*shariah-compliant*' financial hedging tool on August 15, 2006⁶⁸ to facilitate their in-house risk management and in the same time ensures that customers have access to hedge profit rates whilst enhancing their (customer) balance sheet management.

By having WFRA, Islamic Banks minimize their *risk exposure to fixed rate* payments, by swapping some of them with a conventional bank (non-'*Shariah-compliant*') for floating rate payments.

2.9.1.2. *Wiqā'* Profit Rate Swaps (WPRS)

As an extension from WFRA, *Wiqā'* Profit Rate Swap (WPRS) was also introduced. It is an agreement between two parties to exchange a series of profit payments denominated in a single currency for another series of profit payments denominated in the same currency, based on a notional principal amount over agreed tenor.

2.9.1.3. Islamic Cross Currencies Swap (ICCS)

Enhancing the capabilities for Islamic Hedging, those Islamic financial institutions pioneering Islamic financial services and Risk management successfully initiated the first ICCS in the world, where the bank and its customers altering their exposure to

⁶⁷ "<http://www.isda.org/media/press/2010/press030110.html> Hedging Master Agreement]" provides a structure under which institutions can trade derivatives such as profit-rate and currency swaps.

⁶⁸ *Bank Islam Malaysia Berhad* (Bank Islam) and *Standard Chartered Bank Malaysia, Berhad* (*StanChart*), broke new ground in Islamic finance.

interest-rate fluctuations, by swapping fixed-rate obligations for floating rate obligations.

This product heavily being used with the expectation of a change in interest rates or the relationships between them, where on the Islamic framework the existence of interest rates being eliminated with Profit Rate.⁶⁹ *Commodity Murabahah*⁶⁹ will be used as the main vehicle for ICCS and WFRA.

2.9.1.4. Commodity '*Murabahah*'⁶⁹

Commodity '*Murabahah*' is a trade-related transaction. The main structure of this transaction will be based on the actual trading of steel in *London Stock Exchange* through a nominated broker. The trade entails a spot purchase of '*Shariah*' compliant commodities for immediate delivery and forward sale on deferred payment term (cost plus basis).

2.9.2. SMART chip Card

Pioneering Islamic financial institutions have introduced Credit Card Chip Based (SMART Chip). The SMART Chip Card is based on three '*Shariah*' concepts, and is considered to be the first in the world:

- *Bai Inah* - The sale of the land by the bank on a deferred payment basis, which the bank then buys back the land by cash at a lower price
- *Wadiah* - Guaranteed safe custody of cash by cardholder, which allows the cardholder to make use of the cash.
- *Qardhul Hassan* - It is the over limit usage of cash by the cardholder. The cardholder will not be levied with extra charges or fees but will be required to repay the over limit amount used.

⁶⁹Commodity *Murabahah* has the features such as: "Fixed rate of return", "Fixed maturity period", and "Known risk profile"

2.9.2.1. Services of the Card⁷⁰

The services offered by the Bank Islam Card include; *Retail* purchases, Cash withdrawal facilities *ATMs*, Easy payment accessibility and cash withdrawals at any branches and *ATMs* of the Bank, Transfer of balance service; Emergency *cash* withdrawal and emergency card replacement when overseas; and *24 hours* customer service.

2.10 *Shariah* Advisory Council/Consultant^{71,72}

Islamic banks and banking institutions that offer Islamic banking products and services (IBS banks) are required to establish a '*Shariah*' Supervisory Board (SSB) to advise them and to ensure that the operations and activities of the banking institutions comply with '*Shariah*' principles⁷³.

A number of '*Shariah*' advisory firms have now emerged to offer '*Shariah*' advisory services to the institutions offering Islamic financial services. Issue of independence, impartiality and conflicts of interest have also been recently voiced. The "'WDIBF'" World Database for Islamic Banking and Finance has been developed to provide information about all the websites related to this type of banking⁷⁴.

2.11 Islamic Banking Literature versus Practice

Recent years have brought an increasing flow of empirical studies of Islamic banking. The earliest systematic empirical work was undertaken by Khan (1983)⁷⁵. Khan's

⁷⁰ Based on the '*Shariah*' contract that is free from '*riba*' (interest) and *gharar*'. It has contract tenure of three to five years, with profit margins fixed for the tenure. The card accepts transactions from '*halal*' (permissible by Islamic law) sales merchants only and has a financing limit on par with that offered by other issuers and user.

⁷¹ On the other hand, there are also those who believe that no form of banking that involves interest payments can ever comply with the '*Shariah*'.

⁷² In Indonesia the *Ulama* Council serves a similar purpose.

⁷³ <http://zakatpages.com/2007/01/19/alhamdulillah-for-lloyds-tsb-bank>.

⁷⁴ <http://www.wdibf.com/> World Database for Islamic Banking and Finance.

⁷⁵ His observations covered Islamic banks operating in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan, and Egypt.

study showed that Islamic banks had little difficulty in devising practices in conformity with *Shariah*.⁷⁶

Khan's study reported profit rates ranging from 9 to 20 per cent which were competitive with conventional banks in the corresponding areas. The rates of return to depositors varied between 8 and 15 per cent, which were quite comparable with the rates of return offered by conventional banks.

Khan's study revealed that Islamic banks had a preference for trade finance and real estate investments. The study also revealed a strong preference for quick returns, which is understandable in view of the fact that these newly established institutions were anxious to report positive results even in the early years of operation.

2.11.1 Empirical Evidences on Islamic Banking

Nienhaus (1988) suggests that the relative profitability of Islamic banks, especially in the Middle East in recent years, was to a large extent due to the property (real estate) boom. He has cited cases of heavy losses which came with the crash of the property sector.

The IMF study earlier by Iqbal and Mirakhor (1987) also contains extremely interesting empirical observations, although these are confined to the experience of Iran and Pakistan, both of which have attempted to Islamize the entire banking system on a comprehensive basis.

Iran switched to Islamic banking in August 1983 with a three-year transition period⁷⁷. Iqbal and Mirakhor have noted that the conversion to Islamic modes has been much

⁷⁶ On the asset side, the banks under investigation had been resorting to *mudaraba*, *musharaka* and *murabaha* modes.

slower on the asset than on the deposit side⁷⁸⁷⁹. The Pakistani experience differs from the Iranian one in that Pakistan had opted for a gradual Islamization process⁸⁰.

The Pakistani model took care to ensure that the new modes of financing did not upset the basic functioning and structure of the banking system. This and the gradual pace of transition, according to the authors, made it easier for the Pakistani banks to adapt to the new system.

The rate of return on profit-and-loss sharing (PLS) deposits appears not only to have been in general higher than the interest rate before Islamization but also to have varied between banks, the differential indicating the degree of competition in the banking industry. The authors noted that the PLS system and the new modes of financing had accorded considerable flexibility to banks and their clients. Once again the study concluded that the effectiveness of monetary policy in Pakistan was not impaired by the changeover.

The IMF study, however, expressed considerable uneasiness about the concentration of bank assets on short-term trade credits rather than on long-term financing. The authors found this undesirable, not only because it is inconsistent with the intentions of the new system, but also because the heavy concentration on a few assets might increase risks and destabilize the asset portfolios⁸¹.

⁷⁷ The Iranian system allows banks to accept current and savings deposits without having to pay any return, but it permits the banks to offer incentives such as variable prizes or bonuses in cash or kind on these deposits. Term deposits (both short-term and long-term) earn a rate of return based on the bank's profits and on the deposit maturity.

⁷⁸ It appears that the Islamic banking system in Iran was able to use less than half of its resources for credit to the private sector, mostly in the form of short-term facilities, i.e., commercial and trade transactions.

⁷⁹ The slower pace of conversion on the asset side was attributed by the authors to the inadequate supply of personnel trained in long-term financing. The authors, however, found no evidence to show that the effectiveness of monetary policy in Iran, broadly speaking, was altered by the conversion.

⁸⁰ This began in 1979. In the first phase, which ended on 1 January 1985, domestic banks operated both interest-free and interest-based 'windows'. In the second phase of the transformation process, the banking system was geared to operate all transactions on the basis of no interest, the only exceptions being foreign currency deposits, foreign loans and government debts.

⁸¹ The study also drew attention to the difficulty experienced in both Iran and Pakistan in financing budget deficits under a non-interest system and underscored the urgent need to devise suitable interest-free instruments. Iran has, however, decreed that

There are also some small case studies of Islamic banks operating in Bangladesh (Huq 1986), Egypt (Mohammad 1986), Malaysia (Halim 1988b), Pakistan (Khan 1986), and Sudan (Salama 1988b). These studies reveal interesting similarities and differences. For example, the current accounts and Savings deposits in all cases are operated on the principles of *alwadiah*.⁸² There are also interesting variations in the pattern of resource utilization⁸³, profit-sharing ratios and the modes of payment from place to place and from time to time⁸⁴.

A striking common feature of all these banks is that their investment deposits are mostly short-term, reflecting the depositors' preference for assets in as liquid a form as possible⁸⁵.

The case studies also show that the structure of the clientele has been skewed in favour of the more affluent segment of society, no doubt because the banks are located mainly in metropolitan centres with small branch networks.

The two main problems identified by the case studies are the absence of suitable non-interest-based financial instruments for money and capital market transactions and the high rate of borrower delinquency⁸⁶.

government borrowing on the basis of a fixed rate of return from the *nationalized* banking system would not amount to interest and would hence be permissible. The official rationalization is that, since all banks are nationalized, interest rates and payments among banks will cancel out in the consolidated accounts. (This, of course, abstracts from the banks' business with non-bank customers.)

⁸² But 'gifts' to depositors are given entirely at the discretion of the Islamic banks on the minimum balance, so that the depositors also share in profits. Investment deposits are invariably based on the *mudaraba* principle, but there are considerable variations.

⁸³ For example, *musharaka* has been far more important than *murabaha* as an investment mode in Sudan, while the reverse has been the case in Malaysia. On the average, however, *murabaha*, *bai'muajjal* and *ijara*, rather than *musharaka* represent the most commonly used modes of financing.

⁸⁴ Thus, for example, profits are provisionally declared on a monthly basis in Malaysia, on a quarterly basis in Egypt, on a half-yearly basis in Bangladesh and Pakistan, and on an annual basis in Sudan.

⁸⁵ Even in Malaysia, where investment deposits have accounted for a much larger proportion of the total, the bulk of them were made for a period of less than two years. By contrast, in Sudan most of the deposits have consisted of current and savings deposits, apparently because of the ceiling imposed by the Sudanese monetary authorities on investment deposits which in turn was influenced by limited investment opportunities in the domestic economy.

⁸⁶ The former problem has been partially redressed by Islamic banks resorting to mutual interbank arrangements and central bank cooperation, as mentioned earlier. The Bank Islam Malaysia, for instance, has been placing its excess liquidity with the central bank which usually exercises its discretionary powers to give some returns.

The delinquency problem appears to be real and serious. *Murabaha* payments have often been held up because late payments cannot be penalized, in contrast to the interest system in which delayed payments would automatically mean increased interest payments⁸⁷.

In the Southeast Asian context, two recent studies on the Bank Islam Malaysia by Man (1988) and the Philippine Amanah Bank by Mastura (1988) deserve special mention.

2.11.2 Growth and Profitability of Islamic Banking

The Malaysian experience in Islamic banking has been encouraging. Man's study shows that the average return to depositors has been quite competitive with that offered by conventional banks⁸⁸.

Finally, in the most recent contribution to the growing Islamic banking literature, Nienhaus (1988) concludes that Islamic banking is viable⁸⁹. Nienhaus points out that there are some failures stories⁹⁰ in which he has noted as troubles of individual banks that had specific causes and would be inappropriate to draw general conclusions from particular cases.

Nienhaus notes that the high growth rates of the initial years have been falling off, but he rejects the thesis that the Islamic banks have reached their 'limits of growth' after

⁸⁷ To overcome this problem, the Pakistani banks have resorted to what is called 'mark-down' which is the opposite of 'mark-up' (i.e., the profit margin in the cost-plus approach of *murabaha* transactions). 'Mark-down' amounts to giving rebates as an incentive for early payments. But the legitimacy of this 'mark-down' practice is questionable on *Shariah* grounds, since it is time based and therefore smacks of interest.

⁸⁸ However, 90 per cent of its deposits had maturities of two years or less, and non-Muslim depositors accounted for only 2 per cent of the total. Man is particularly critical of the fact that the *mudaraba* and *musharaka* modes of operation, which are considered most meaningful by Islamic scholars, accounted for a very small proportion of the total investment portfolio, while *bai'muajjal* and *ijara* formed the bulk of the total.

⁸⁹ But Nienhaus dismisses the proponents' ideological claims for superiority of Islamic banking as 'unfounded'. He also points out that there are some failure stories⁸⁹.

⁹⁰ Examples cited include the Kuwait Finance House which had its fingers burned by investing heavily in the Kuwaiti real estate and construction sector in 1984, and the Islamic Bank International of Denmark which suffered heavy losses in 1985 and 1986 to the tune of more than 30 per cent of its paid-up capital.

filling a market gap⁹¹. But rather, the growth performance of Islamic banks has been relatively better in most cases than that of conventional banks in recent years. According to Nienhaus, the market shares of many Islamic banks have increased over time, notwithstanding with the deceleration in the growth of deposits⁹²⁹³.

2.12 Challenges Facing Islamic Banking Services

2.12.1 Lack of Awareness and understanding

Despite the growth of Islamic banking over the last 30 years, one of the main challenges facing Islamic banking is the poor understanding about its operations in the Muslim and non-Muslim world⁹⁴.

2.12.2 Lack of Supportive Institutional and Market links

Islamic banking is at an early stage of learning and experience, lacking the flexibility to choose arrangements which best suits their need in reacting to structural shifts in the economic setting as well as changes in consumer preferences.

For example, Islamic banks, without having an interest-free money and capital market, will not have adequate instruments to meet the pre-condition for liquidity management and effective maturity transformation⁹⁵.

So, adequate financial mechanism still has to be developed, without which financial intermediation, especially the risk and maturity transformation, will not be performed properly⁹⁶⁹⁷.

⁹¹ The falling growth rates might well be due to the bigger base values

⁹² (9)

⁹³ The only exception was the Faisal Islamic Bank of Sudan (FIBS) whose market share had shrunk from 15 per cent in 1982 to 7 per cent in 1986, but Nienhaus claims that the market shares lost by FIBS were won not by conventional banks but by newer Islamic banks in Sudan.

⁹⁴ However, the basic principle is clear, that it is contrary to Islamic law to make money out of money and that wealth should accumulate only from trade and ownership of real assets⁹⁴.

⁹⁵ On the other hand, Islamic banks can enhance term transformation if there is an interest-free bond market or a secondary market for Islamic financial papers.

Moreover, however well integrated it may be, any system cannot thrive exclusively on its built-in elements. It has to depend on a number of link institutions and Islamic banking is not an exception to this rule⁹⁸.

They also need research and training forums in order to promote entrepreneurship amongst their clients. Such support services properly oriented towards Islamic banking are yet to be developed in many countries.

2.12.3 The Regulatory Challenges

The relationship between Islamic banks and monetary authorities is a delicate one. Whatever the goals and functions are, Islamic banks came into existence in an environment where the laws, institutions training and attitude are set to serve an economy based on the principles of interest. For example, the operations of Islamic banks are on a profit and loss share basis (PLS), which actually does not come fully under the jurisdiction of the existing civil laws⁹⁹.

In non-Muslim countries (i.e. countries with less than 50% Muslim population), central banks are very stringent in granting licenses for Islamic banks to operate. Islamic banks must also meet the additional requirements of other government and non-government authorities. (So, apart from legal constraints, there are economic measures that result operations of Islamic banks in non-Muslim world difficult)¹⁰⁰.

⁹⁶ In the absence of Interest-free money market, Islamic banks cannot invest their surplus fund i.e., temporary excess liquidity to earn any income rather than keeping it idle.

⁹⁷ Naturally, Islamic banks cannot invest the permissible part of their Security Liquidity Reserve and liquid surplus in those securities. As a result, they deposit their whole reserve in cash with central banks. Similarly, the liquid surplus also remains idle. On the contrary, the conventional banks of the country do not suffer from this sort of limitations. As such, the profitability of IFSIs is adversely affected.

⁹⁸ For identifying suitable projects, Islamic banking can profitably draw the services of different link institutions economists, lawyers, insurance companies, management consultants, auditors, research, and training institutions and so on.

⁹⁹ For example, if there are disputes to be handled, civil courts are not sufficiently acquainted with the rationale of the operations of IFSIs.

¹⁰⁰ In Muslim countries also they face economic restrictions and difficult in finding acceptable investment outlets.

2.12.4 Absence of Liquidity Instruments

Many Islamic banks lack liquidity instruments such as treasury bills and other marketable securities, which could be utilised either to cover liquidity shortages or to manage excess liquidity. This problem is aggravated since many Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap should occur¹⁰¹.

2.12.5 Use of Advanced Technology and Media

Many Islamic banks do not have the diversity of products essential to satisfy the growing needs of their clients. The importance of using proper advanced technology in upgrading the acceptability of a product and diversifying its application cannot be over emphasized. Given the potentiality of advanced technology, Islamic banks must have to come to terms with rapid changes in technology, and redesign the management and decision-making structures and, above, all introduce modern technology in their operations.

Many Islamic banks also lack the necessary expertise and institutional capacity for Research and Development (R & D) that is not only necessary for the realization of their full potential, but also for its very survival in this age of fierce competition, sophisticated markets and an informed public. Islamic banking cannot but stagnate and wither without dynamic and ongoing programmes. In addition, Islamic banks have so far not used the media appropriately. For example, even Muslims are not very much aware that the Islamic banking is being practiced in the world. Islamic banks have not ever used an effective media to publicise their activities.

¹⁰¹ The absence of suitable long term assets available to Islamic banks is mirrored by lack of short term tradable financial instruments. Trading of financial instruments is also difficult to arrange when rates of return are not known until maturity. At present there is no equivalent of an inter-bank market in Ethiopia where banks could place, say, overnight funds, or where they could borrow to satisfy temporary liquidity needs.

2.12.6 Need for Professional Bankers¹⁰²

There is a need to institute professionalism in banking practice to enhance management capacity by competent bankers committed to their profession. Because, the professionals working in Islamic banking system have to face bigger challenge, they must have a better understanding of industry, technology and the management of the business venture.

They also have to understand the moral and religious implications of their investments with the business ventures. There is also a need for banking professionals to be properly trained in Islamic banking and finance. Most banks' professionals have been trained in conventional economics. They lack the requisite vision and conviction about the efficiency of the Islamic banking.

2.13 Islamic Banking as a serious alternative Proposition¹⁰³

Despite scepticism regarding accommodation between Islamic and global finance, leading banks are forming subsidiaries specifically to conduct Islamic finance. Special laws have been enacted in non-Muslim financial centres to facilitate the operation of Islamic banks and associated financial institutions¹⁰⁴.

Not so long ago, Islamic finance was superficially dubbed a zero-interest-rate system that would lead to inadequate and inefficient resource mobilization and utilization. Ironically, mainstream central bankers today routinely use precisely such policies when pursuing massive "quantitative easing." Interestingly, the best economic

¹⁰² Md. Abdul Awwal Sarker, *Islamic Banking In Bangladesh: Performance, Problems & Prospects*, *International Journal of Islamic Financial Services* Vol. 1 No.3

¹⁰³ Project syndicate

¹⁰⁴ i.e. London, Singapore, and Hong Kong

rationale for a zero-interest-rate system is provided in John Maynard Keynes's *The General Theory*.¹⁰⁵

Keynes suggested that only a very low or zero interest rate could ensure continuous full employment and distributional equity. Keynes's endorsement of such a policy does not necessarily make it right, but his analysis does suggest that it should be regarded as a serious proposition.

Islamic finance contrasts with the current dominant system based on interest-bearing debt, in which risks are theoretically transferred to debt holders, but in practice are socialized during crises. Other things being equal, most economists will agree that debt finance leads to greater instability than equity finance¹⁰⁶.

It follows from the second major tenet of Islamic finance that if people adhered strictly to its ethical requirements, there would be fewer moral-hazard problems in Islamic banking. Moral hazard exists in all systems in which the state ultimately absorbs the risks of private citizens.

But, whether any particular system is efficient in avoiding moral hazard is a matter of practice, rather than of theory. Many would agree that, historically, Christian morality played an important role in the rise of Western capitalism. Secular capitalism, however, has experienced an erosion of values, whereby the financial sector has put its own interests above those of the rest of society.

If the ethical values in Islamic finance – grounded in *Sharia* religious law – can further deter moral hazard and the abuse of fiduciary duties by financial institutions,

¹⁰⁵ "Provisions against usury are amongst the most ancient economic practices of which we have record... In a world, therefore, which no one reckoned to be safe, it was almost inevitable that the rate of interest, unless it was curbed by every instrument at the disposal of society, would rise too high to permit of an adequate inducement to invest."

¹⁰⁶ Importantly, although interest is prohibited under Islamic finance, profit which is derived from various arrangements that combine finance and enterprise ensures profit-sharing and risk-sharing system that is based entirely on equity finance.

Islamic finance could prove to be a serious alternative to current models of derivative finance¹⁰⁷.

The test of any alternative financial system depends ultimately on whether it is – or can be – more efficient, ethical, stable, and adaptable than the prevailing system. For now, there is no Islamic global reserve currency and no lender of last resort. But the Islamic world is the custodian of huge natural resources that back its trading and financial activities.

As the Islamic world grows in stature and influence, Islamic finance will become a formidable competitor to the current financial system. The world would have much to gain if the two systems were to compete fairly and constructively to meet people's needs for different types of finance.

2.14 Islamic finance in Ethiopia

Most of the developments of Islamic finance in the Ethiopia have taken place in the last four years, but the existence of *Sharia-compliant* transactions in the Ethiopian financial industry is yet something to be seen.

A few banks began to offer simple products such Special Non-interest Savings Accounts (i.e Special Demand Deposit offered by the commercial bank of Ethiopia (CBE)) to give a slight degree of choice flexibility to the Muslim Community. This did not, however, cater for the wider Muslim consumers. These products are relatively uncomplicated in structure and fell outside the scope of the mainstream consumers and did not generate significant volumes of customers and transactions,

¹⁰⁷ Moreover, the basic tenets of Islamic finance force us to re-think the ethical basis of modern monetary arrangements, which have evolved into a global reserve-currency system founded on fiat money. In the past, gold had been the anchor of monetary stability and financial discipline, even if it was deflationary.

However, these compared unfavourably with their conventional equivalents in several respects, including their generally uncompetitive structure and negative real rate of return they offer.

The growth of the Islamic Financial services remained stuck for almost half a decade since the first individual and group initiatives surfaced in early 2008.

Much has not changed since then. Not a single commercial bank has announced yet that it will engage Islamic financial products whether publicly or privately owned, whether through '*Special Window*' or subsidiary. Not a single 'Full-fledged' Islamic Financial Institution has come out still from so many publicized initiatives to establish what was dubbed as the first Islamic Financial Institution in Ethiopia. Not a single government initiative or program has still yet to come from the concerned authorities.

2.15 The Need for Islamic Banking in Ethiopia

As horrendous disparities exist between different segments of the Ethiopian society, the government must provide the disadvantaged classes with the tools they need to improve their condition¹⁰⁸.

Access to finance by the poor and the vulnerable groups is a prerequisite for poverty reduction and social cohesion. Such "financial apartheid" is one of the main causes of exclusion of the majority of the population in terms of growth. Islamic banking is one way to ameliorate the poor and the disadvantaged segments of the society.

The Ethiopian banking sector has opened up considerably in the past decade or so and openness to interest-free banks is a logical next step. The potential benefits of allowing Islamic banking include; decreased economic disparity between the haves and the have nots, better integration, and consequently accelerated economic growth.

¹⁰⁸ The majority of the unorganized sector; workers, semi-skilled persons, small farmers are all non-bankable.

Government of Ethiopia can leap a step closer towards the fulfilment of the much cherished dream of "Middle Income Country" by reforming its banking sector and allowing the establishment of Islamic Banks¹⁰⁹.

Islamic faith prohibits the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk) results in some Ethiopians, including those in the economically disadvantaged strata of the society, not being able to access banking products and services due to reasons of faith.

While interest-free banking is provided in a limited manner through SMFI, it's recommended that measures be taken to permit the delivery of interest-free finance on a larger commercial scale. This is in consonance with the objectives of inclusion and growth through innovation. Also, it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

2.16 Prospects and Opportunities for Islamic Banking in Ethiopia

The prospect of Islamic Banking looks very bright. Ethiopian Muslims everywhere want Islamic Banking. In addition, Ethiopia having more than 30 million Muslims offers huge opportunities to exploit. The size of the market will be very large as majority of Ethiopian Muslims, in the name of religious faith, are looking for interest free financial services. It is pertinent to mention here that Islamic banking is not meant for Muslims only but non Muslims may also avail the benefit of it. And it is feasible to have a parallel banking system: one based on *Sharia* along with a conventional one.

¹⁰⁹ Banking products which comply with Islamic law are becoming increasingly popular, not only in the Gulf countries and far eastern states like Malaysia, but also in other developed markets such as the United Kingdom

The Growth and Transformation Plan, third five year economic plan, envisages inclusive growth with development in all sectors of the economy. Islamic banking is an effective mechanism to subjugate the liquidity and inflation problems while allowing inclusive growth. For real inclusive growth, which requires increase in income and employment should be ensured for all segments of the society.

If Islamic banking is introduced, the inadequate labor capital ratio, for informal sector workers and farmers associated with agriculture and manufacturing industries could be resolved through equity finance, which might be a revolution in our agriculture and unorganized sector. With improved labor capital ratio, our vulnerable workers associated with agriculture and unorganized sector might be able to compete effectively with the formal sector workers. Thus Islamic Banking may financially empower majority of Ethiopian workers and farmers.

Islamic banking may induce our political leaders to substitute grants and subsidies with equity finance which helps achieve self-reliability that never comes through grant and subsidies schemes, through specialized financial institutions.

Moreover, with introduction of Islamic banking, Ethiopian government will certainly gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from the gulf countries¹¹⁰. Finally, Islamic banking should not be regarded as religion based banking business, but could be profitably used to resolve issues pertaining to economy.

¹¹⁰ www.islamicequity.co.in

2.17 Status of Islamic Banking in Ethiopia

Islamic banking is at an incipient stage. The existing legal framework does not permit full-fledged Islamic Banking. A lot of amendments need to be carried out in the prevalent legal set up while appropriate models need to be selected and implemented to suit society's diverse financial needs¹¹¹.

To accommodate Muslims, who are by *Sharia'h* – Islamic law – prohibited from taking or giving interest (riba), commercial banks are currently offering zero interest. However, fully-fledged establishments of Islamic banks, which offers the owners of capital to share the profits made by the entrepreneur who comes up with investment projects, is an untapped concept for the local financial sector¹¹².

¹¹¹ The reputed domestic banks with the collaboration of NBE should involve in the process of establishing Islamic Banking products.

¹¹² <http://www.ifc.org/ifcext/africa.nsf/Content/Home> , <http://www.isdb.org>

Chapter Three

Research methodology

3.1 Research Design

The research tries to investigate the prospects and challenges in introducing Islamic financial services institutions in Ethiopia. To conduct this study and to realize the objectives of the study, descriptive research design of survey method which was observational in its nature was used due to its appropriateness.

The research also tries to explore the prospects, opportunities, problems and challenges that face Islamic financial institutions. Both qualitative and quantitative data were collected to examine the awareness of the respondents.

3.2 Study Area

The study area was residents from Jijiga City which is mainly inhabited by Muslims. The study focused on group of participants drawn from Jijiga City, officials from financial institutions, government employees and some selected businessmen.

3.3 Population

The study population consisted of residents from Jijiga City. To be specific, the population of Somali Micro-finance Institution employees is 20 and the sample taken is 10 employees, commercial banks employees have a total number of 120 employees while the sample taken is 40 employees, Somali regional level government employees are 1200 employees while the sample taken from this population is 40 employees.

In addition, the total number of traders that have business premises in Jijiga's Central Business District known as 'Taiwan' is 800 while the sample taken from this population is 40. Finally, 38 respondents characterized as others were selected from 06 kebele residents randomly. The total numbers of respondents are 168.

3.4 Sampling and Sample size

The rationale behind the decision to use stratified sampling and simple random sampling system to select from each strata as well as the decision with regard to the sample size is that of simplicity, less time consuming, and of course, cost effectiveness.

The research will apply multi level sampling method in which the population is classified in to independent stratus in the first level by stratified random sampling. From each of them, respondents will be chosen using simple random sampling technique.

Thus, accordingly the participants are grouped into five categories, namely, Somali Micro finance (SMFI) employees, commercial banks employees, government employees, Entrepreneurs/Traders and others. A total sample size of 168 respondents will be considered for this study.

The study population consisted of residents from Jijiga City. The population of Somali Micro-finance Institution employees is 20 and the sample taken is 10 employees, commercial banks employees have a total number of 120 employees while the sample taken is 40 employees, Somali regional level government employees are 1200 employees while the sample taken from this population is 40 employees. In addition, the total number of traders that have business premises in Jijiga's Central Business District known as 'Taiwan' is 800 while the sample taken from this population is 40.

Finally, 38 respondents characterized as others were selected from 06 kebele residents randomly. The total numbers of respondents are 168.

3.5 Sample Selection

Jijiga city was purposely selected for three reasons. Firstly, Jijiga city is Muslim dominated city. Secondly, Jijiga city is vibrant and near border city that located in the eastern trade corridor. Finally, the demographic characteristics of Jijiga city were also considered important as there are differences among respondents' background that will show differences in their view and assessment of Islamic banking.

Due to consideration from their different background, the research considered different respondent categories and different background such as Somali Micro-finance Institution, commercial banks, government employees, entrepreneurs/traders and others was considered. In line to this order, 40 samples for each category of respondents except for Somali Micro-finance Institution and respondents labelled as 'others' which (7) and (38) respondents were included in this study respectively. It's assumed that their different background may exhibit different assessment and understanding about the awareness, prospects and challenges about Islamic banking.

The units of analysis on which the investigation is focused are group of individual participants from the residents of Jijiga city, officials from financial institutions and some selected entrepreneurs and traders. The group of participants will be drawn from different backgrounds and occupations.

A sample consisted of 168 respondents was selected using stratified random sampling from different backgrounds. For example, (40) samples each were selected from commercial banks, governmental employees, entrepreneurs/traders categories. While

samples of (38) and (10) were selected from respondents labelled as 'others' and Somali Micro-finance Institution employees respectively.

To select the sample from government employees, regional government employees were targeted as the population and four major regional sector bureaus in which 10 employees each were selected randomly.

In addition, the shop serial number of Jijiga city main market centre also known as 'Taiwan' was used as identification purpose to select from entrepreneurs /traders category while four commercial banks that have branches in jijiga were targeted as the population to this study in which 10 employees each were selected randomly.

As far as Somali Micro-finance Institution employees were concerned, (10) respondents were selected from a total number of (20) employees. However, only (7) respondents completed the questionnaire.

Finally, a total of 168 (40 commercial banks employees, 40 government employees, 40 entrepreneurs/ traders, 38 classified as others and 10 Somali Micro-finance Institution) participated in the study.

3.6 Method of data collection, source and instruments

Document review questions and personal interviews were used to gather data for the study. Research papers on Islamic banking, textbooks, magazines, and websites were used to analyze information for the purpose. Questionnaire were prepared with the help of some banking experts and structured in a way that would enable everyone to answer and contribute something. The main source for secondary data is the *Qur'an* and *hadith* narrations, unpublished project reports, data extracted from websites,

CSA, IMF's Finance & Development Manuals, Academic Journals, texts and newspapers, etc.

Primary data have been collected from the residents of Jijiga city by using cross – sectional survey method and structured questionnaire in order to obtain relevant reliable and sufficient information. The sample selected can be used to describe a larger population at a time.

3.7 Data Collection Instruments

For the purpose of this study, a data collection tool, namely structured questionnaire was developed based on literature review. The data collection tool is supposed to measure respondents' awareness on Islamic banking as well as their assessment of the prospects and challenges facing Islamic banking.

The data collection instrument consists of four parts: part one, awareness type items was intended to measure the awareness of respondents while part two is about items that would measure prospects and opportunities of Islamic banking. Moreover, part three is intended to measure respondents' assessment of challenges facing Islamic banking and the measures as well as suggestions to be taken to address this challenges. Finally, part four is about respondents' personal information.

The questionnaire was originally developed in English and was translated to Somali language so that Somali speaking participants could understand very well.

Questionnaire consisted 47 items (18 awareness type items, 10 prospects and opportunities type, 9 challenges type items, 4 supplementary questions and 6 questions regarding the demographic variable).

Then, the questionnaire was given to 3 experts (1 measurement and evaluation student, 1 Islamic finance student and 1 financial expert) for content validity. All instruments were revised according to their feedback.

The awareness scale was organized in such a way that 16 items were stated positively and 2 items were presented negatively with 3-point scale (Agree, I do not know and Disagree). The prospects scale was organized in such a way that 8 items were stated positively and 2 items were presented negatively with 3-point scale (Agree, I do not know and Disagree).

The scale values are three for agree, two for I do not know and one for disagree for the items stated positively. However, negatively stated items were scored reverse manner i.e, three for disagree, two for I do not know and one for agree.

3.8 Plan of data analysis

The collected data was sorted and screened for any errors and then tallied to prepare tables for making analysis. Besides, the study attempts to analyse the various issues that evolve around prospects and challenges of Islamic banking in Ethiopia, such as misconceptions, awareness, legal and regulatory frame work, etc.

The primary data was analyzed using the applicable statistical tools after all the necessary primary and secondary data are gathered and edited for any errors as well as omissions. The data was presented in a useful and organised manner suitable for analysis. The data collected using the structured questionnaire was coded and analysed using Statistical Package for Social Sciences (SPSS), a computer aided programme,.

Descriptive statistics mainly of percentiles of the distributions of participant's response was used with the help of SPSS. The results was shown using tabular and

other forms of presentation in order to convey the intended meaning and be convenient for interpreting the findings of the research.

In order to analyze the data, One-way ANOVA (analysis of variance) was used to examine overall awareness mean scores as well prospects score for possible subgroup differences in their assessment.

Where appropriate, post-hoc comparison was made by using *Tukey* HSD test to further analyze the overall significance shown by ANOVA. Statistical significance was determined based on, 0.05 level of significance. The 17th version SPSS (Statistical Package for Social Science) program was used for data analyses.

Moreover, percentage analyses were used for background information and analysing items that measure the challenges facing Islamic banking in Ethiopia. While mean and standard deviation were used to check for central location and the variations in the awareness and prospects mean scores.

Chapter four

Data Presentation and Analysis

In this chapter, the results of the study on prospects and challenges of Islamic Banking in Ethiopia will be presented. The data collected from participants and secondary sources about the awareness, general understanding, misconceptions, challenges as well as the need for Islamic banking in Ethiopia will be analyzed in the following sections of this chapter.

4.1 The current status of Islamic banking

In Ethiopia, most of the developments of Islamic finance have taken place in the last four years and limited *Sharia-compliant* products are offered by few commercial banks like Commercial Bank of Ethiopia (CBE), Somali Micro-finance Institution (SMFI) and NIB Bank. But, the existence of full set of *Sharia-compliant* transactions in the Ethiopian financial industry is yet something to be seen.

In Ethiopia, few banks began to offer simple financial products (i.e the Special Demand Deposit offered by the Commercial Bank of Ethiopia (CBE) and the *Amanah* (or Safe-guarding) Account and the Micro-credit scheme (*Murabahah*) offered by the Somali Micro-finance Institution (SMFI)), to give a slight degree of choice and flexibility to the Muslim Community.

This did not, however, cater for the wider Muslim consumers. These products are relatively uncomplicated in structure and fell outside the scope of the mainstream consumers and did not generate significant volumes of customers and transactions.

Moreover, these simple products compared unfavourably to their conventional equivalents in several respects, including their generally uncompetitive structure and the negative real rate of return they offer.

To be specific, the 2008 ‘Banking Regulation and Supervision Proclamation’ has already crafted a room for non interest banking. However, the particulars on the regulations of such services were left to be covered by subsequent National Bank of Ethiopia’s directives, the first of which its draft has come two years later on 2010¹¹³.

The first NBE’s draft directive, which entitled ‘Directives for Conducting Interest-Free Banking’, and has been circulated to stakeholders for feedback was expected to enable some already under progress initiatives that envisages the establishment of Islamic banks in Ethiopia for the first time’.

However, the final directive issued by the National Bank of Ethiopia (NBE) has only allowed for the “Existing banks” to provide ‘interest-free banking windows’ while killing the long awaited hope for full-fledged Islamic banking in Ethiopia.

4.2 Data Presentation

4.2.1 Respondent’s Demographic Variables

Respondents were asked to give their personal information and the results were presented in the following tables and sections.

Table (1) Respondents’ Demographic Variables

Demographic Variable	Category	N	%
Sex	Male	141	85.5%
	Female	24	14.5%
Group Total		165	100.0%
Age Group	18-30 Years	89	53.9%

¹¹³ Capital Ethiopia News - Islamic Banks to enter financial sector.mht

		31-50 Years	73	44.2%
		51-70 Years	3	1.8%
Group Total			165	100.0%
Educational Level	Illiterate	8	4.8%	
	Primary Education	19	11.5%	
	High School Complete	33	20.0%	
	University/College Degree/Certificate/Diploma	105	63.6%	
Group Total			165	100.0%
Marital	Single	50	30.7%	
	Married	100	61.3%	
	Divorced	2	1.2%	
	Widowed	11	6.7%	
Group Total			163	100.0%
Type of Occupation	SMFI	7	4.2%	
	Commercial Bank employees (CBE, AIB and WB)	40	24.2%	
	Entrepreneur/Trader	40	24.2%	
	Government	40	24.2%	
	Others	38	23.0%	
Group Total			165	100.0%
Religion	Muslim	98	59.4%	
	Orthodox Christian	56	33.9%	
	Protestant	11	6.7%	
Group Total			165	100.0%

NB: Three respondents were excluded due to missing data

As table 1 indicates, from the total sample of 165 respondents, 141 (85.5%) of the respondents were male and 24 (14.5%) of them were Female. Table (1) also shows the age characteristics of the respondents. According to the data shown in the table (1), 89 (53.9%) of the respondents fall in the age category between 18-30Yrs, 73

(44.2%) of them are in the age category between 31-50Yrs, 3 (1.8%) of them are in between 51-70Yrs.

With regard to the educational background of the respondents, 8 (4.8%) of them do not have any formal education in their entire lifetime, 19 (11.5%) of the respondents have some primary education level, 33 (20.0%) of the respondents have completed high school education while 105 (63.6%) of the respondents have some tertiary level education (i.e. university degree or college certificate)

The above table has also revealed some data regarding the marital status of the respondents. As the table indicated, 50 (30.7%) of the respondents were single, 100 (61.3%) of the respondents were married, 2 (1.2%) of them have divorced, while 11 (6.7%) of the respondents were widowed.

Table (1) also shows the occupational distribution of respondents. According to table (1), 7 (4.2 %) of the respondents were Somali Micro-finance Institution (SMFI) employees, 40 (24.2%) of them were commercial banks employees, 40 (24.2%) were entrepreneurs or traders while 40 (24.2%) and (38) 23.0 % of the respondents were government employees and 'Others' ¹¹⁴ respectively. Finally, 98 (59.4%) of the respondents were Muslims, 56 (33.9%) of them were orthodox Christians while 11 (6.7%) of them were Protestants.

4.2.2 Awareness, Misconceptions and General understanding about Islamic banking

Awareness and general understanding is crucial if Islamic Banking is to thrive in Ethiopia. One of the research questions was *'Is there low level of awareness and*

¹¹⁴ Respondents characterized in this study as 'Other' are respondents that do not have specific characteristics,

understanding regarding the operations of Islamic banking and does it pose serious challenge to the success of Islamic banking in Ethiopia?’

4.2.2.1 Awareness about Islamic Banking Operations

Respondents were asked to answer certain items that will scale their assessment regarding awareness about Islamic banking operations. The following table shows the results for respondents’ mean awareness score and their understanding about Islamic banking operations. The result is showed on table (2) as below.

Table (2) Awareness Score of Respondents

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Awareness	154	22.00	45.00	33.3442	6.40402
Valid N (listwise)	154				

NB: 11 respondents were excluded due to missing data

As depicted on table (2), the mean value for respondents awareness scores was found to be (33.34) with standard deviation of (6.404) while the minimum and the maximum scores were (22) and (45) respectively. However, the mean value (33.34) is less than the expected average score of (36). This indicates that the respondents’ awareness level regarding the operations of Islamic banking is low.

Thus, in general, respondents have been exhibiting low awareness and understanding regarding the operations of Islamic banking and finance.. This finding is actually consistent with what Islamic Banking literature has revealed about the operations of Islamic Banking elsewhere.¹¹⁵

To further respondents’ awareness and understanding about Islamic banking operations, it’s pertinent to look deeply in to the matter and consider relevant items for

¹¹⁵Islamic Banking As Exclusion Model In Nigeria Financialnigeria_com.mht

further analysis. So, one item in awareness scale asked respondents: ‘*Do you ever heard about Islamic banking?*’ In this question respondents were asked to judge whether they have heard about Islamic Banking or not. The result was presented in Table (3) as below.

Table (3) did you ever heard about Islamic Banking?

	Valid	Frequency	Valid Percent
	No	34	20.7%
	I Do not Know	12	7.3%
	Yes	118	72.0%
Group Total		164	100.0%

As the data on table (3) shows, only 34 (20.7%) of the respondents did not heard about Islamic banking, while 118 (72.0%) % of the respondents have heard about Islamic banking while 12 (7.3%) of the respondents do not know.

According to above findings we can say that most of the respondents did heard about Islamic banking. But, the important question is, ‘why do respondents show over all low awareness score if majority of them actually did ‘*heard about it*’.

However, the likely explanation to the overall low awareness score may be attributed to respondents’ lows core for the items that measure lack of awareness and proper understanding about the nature and operations of Islamic banking. Another likely explanatory factor may be due the fact that most of the respondents are familiar or heard about the prohibition of ‘*Riba*’ and hence have heard about Islamic banking in one way or the other.

Another important item in the awareness scale was whether respondents ‘*think that Islamic Banking is relevant and has role to play in the Ethiopian Economy?*’ The result for this question is presented in the following table.

Table (4) Relevance and Importance of Islamic Banking to Economy

	Valid	Frequency	Valid Percent
	No	58	36.3%
	I Do not Know	33	20.6%
	Yes	69	43.1%
Group Total		160	100.0%

As the data in Table (3) shows, the number of respondents that believe '*Islamic Financial Services are relevant and has a role to play in the development and growth of the Ethiopian economy*', 69 (43.1%), is so not so much significant but high when compared to other respondent categories.

In addition, only (58) 36.3 % of the respondents believe that *Islamic Financial Services* is not '*relevant*' and does not have any '*role to play in the development and growth of the Ethiopian economy*' while 33 (20.6) % of the respondents do not know whether *Islamic Financial Services are relevant and has a role to play in the development and growth of the Ethiopian economy*'.

So, we can conclude from this observation that significant number of respondents 91 (56.9%), either donot think that Islamic banking is something relevant and beneficial to the growth and development of the Ethiopian economy or in fact, do not know at all.

So, this observation is a testimony to how far people misunderstood the nature of Islamic banking, its relevance and whether it has any role to play in the growth and development of the Ethiopian economy.

4.2.2.1.1 Respondents' view about the Difference between Islamic and Conventional Banking

To further explore respondents' awareness and understanding about Islamic banking, another item in the awareness scale asked respondents to judge '*what best describes*

their understanding regarding the difference between conventional and Islamic banking'? Responses as obtained from the survey were presented below in Table (5).

Table (5) Respondents' view on the Major Difference between Islamic and Conventional Banking

	Valid	Frequency	Valid Percent
	No	26	15.8%
	I donot Know	39	23.6%
	Yes	100	60.6%
Group Total		165	100.0%

As the data on table (5) shows, when respondents were asked about what best describes their understanding regarding the difference between Islamic and conventional banking, 100 (60.6%) of the respondents differentiate on the criteria that in fact *'one is interest-oriented while the other is profit –oriented*, (26) 15.8% of the respondents do not agree that while (39) 23.6% of the respondents do not know the difference between them at all.

To look deeply at the respondents' *'understanding regarding the difference between Islamic and Conventional Banking'*, it is clear from this observation that significant number of respondents did not understand or in fact has misunderstood the major difference between Islamic and conventional banking.

There is an extensive research and rich literature that has clearly shown that there are in fact great differences between these two divergent systems, however, people do not understand the important differences between them.¹¹⁶

4.2.2.2 Respondents' Awareness Mean Score of Based on Religion

The data about the awareness mean score of respondents presented in earlier section was an aggregate overall score for all the respondents combined. The study further

¹¹⁶Mahmoud Amin El-Gamal, A Basic Guide to Contemporary Islamic Banking and Finance Rice University, June 2000 (elgamal@rice.edu. <http://www.ruf.rice.edu/~elgamal>)

explored if the respondents' different background had an impact on the awareness level of respondents.

So, the first point to start with is to explore whether religion of respondents had an impact on the awareness of the respondents about the operations of Islamic banking. The results of statistical analysis for these observations are shown in Table (6).

Table (6) Comparison of respondents' Awareness Mean scores by Religion

Comparison of Awareness Mean Score among Respondents belonging to different Religion			
Awareness			
Religion	Mean	Std. Deviation	N
Muslim	36.0879	5.05887	91
Orthodox Christian	27.8462	5.06965	52
Protestant	36.6364	5.33428	11
Total	33.3442	6.40402	154

The mean awareness score of Muslims was found to be (36.09) and that of Orthodox Christians was found to be (27.85) while that of Protestants was (36.64).

However, what is important about this finding and needs caution when interpreting is the fact that Protestants has showed higher level of awareness than Orthodox Christians and even Muslims to some extent.

However, the likely reason for that may be the fact that protestants who responded to this survey was highly educated, (nearly 73% of them where university or college graduates), as well as commercial banks employees (nearly 50% of them works for some sort of financial institution) and even more importantly some of them works for Somali-Micro-finance Institution which engages in *Sharia-compliant* financial services.

As table (6) shows, the mean awareness score for respondents of different religion shows variance. So, to understand if there is a significant statistical difference in terms

of awareness scores about the operations of Islamic banking between different followers, One-way ANOVA was used and the results were presented on Table (6).

Table (7) ANOVA Results for respondent’s Awareness Mean Scores by religion

ANOVA Table							
			Sum of Squares	df	Mean Square	F	Sig.
Awareness * Religion	Between Groups	(Combined)	2376.148	2	1188.074	46.016	.000
	Within Groups		3898.611	151	25.819		
	Total		6274.760	153			

The difference in awareness mean scores due to religion was significant {F=46.2, p<.05}. This implies that different followers had shown different levels of awareness about the existence and operations of Islamic banking.

To determine which religion was the source of awareness difference, *Tukey* HSD test was applied. The test results show that mean value of respondents who are Orthodox Christians is significantly lower than mean values for all other religions.

The fact that non-Muslims negatively affect the awareness and understanding towards the operations of Islamic Banking goes in line with other studies that focus on awareness and attitude on many issues.¹¹⁷

4.2.2.2 Awareness Mean Score of Respondents by Level of Education

Respondents were also asked to indicate the highest educational levels they have attained and the results of statistical analysis for these observations are shown in table (8). The study further explored if respondents’ different educational background had an impact on their awareness level about the operations of Islamic banking.

¹¹⁷

As the data on table (8) shows, the overall results indicate that awareness mean score variation between respondents of different educational level exists. Table (8) summarises these findings as below.

Table (8) Comparisons of Respondents' Awareness Mean Score by Educational Level

Comparisons of Awareness Mean Score among Respondents Having Different Level of Education

Awareness			
Educational Level	Mean	Std. Deviation	N
Illiterate	31.1250	.99103	8
Primary Education	29.2105	4.23712	19
High School Complete	28.3333	4.60072	33
University/College Degree/Certificate/Diploma	36.1277	5.99863	94
Total	33.3442	6.40402	154

As shown above in table (8), the educational levels attained by respondents and their awareness scores are presented. According to the result, the highest mean value is observed in the informants whose educational level is university or college degree as (36.13) while the lowest awareness score, (28.33) is reported for high school level respondents.

What is more interesting from this observation is that the awareness mean score varies with educational level. Thus, the highly educated respondents are more aware about the nature and operations of Islamic banking than all other respondent categories.

However, what is unconventional about these findings is the awareness score for the illiterate category which is slightly higher than the primary and higher education categories¹¹⁸.

This may be explained by the fact that significant numbers of illiterate category are traders or entrepreneurs (nearly 63% of them are traders or entrepreneurs) and are

¹¹⁸ When *Tukey* HSD test is applied to see source of difference in awareness score by level of level of education, the University/College degree category is significantly higher than the mean value for all other categories while the illiterate, primary and Higher education categories are not significantly different

Muslims (100%) at the same time. So, the combination of these two factors may have positive effect on the awareness score of the illiterate category and hence, higher than the primary and high school categories.

To test whether the awareness score differences between respondent categories due to educational level is significant, ANOVA test is applied while *Tukey* HSD is used to analyze the source of variances. The results for this test is shown as below in Table (9).

Table (9) ANOVA Results for respondent’s Awareness Mean Scores by Educational Level

ANOVA Table						
			Sum of Squares	df	Mean Square	F
Awareness * Educational Level	Between Groups	(Combined)	1920.925	3	640.308	22.060
	Within Groups		4353.834	150	29.026	
	Total		6274.760	153		
						Sig.
						.000

According to the results by ANOVA test, { F (3,150) = 22.06, P<.05}, it is observed that there is significant differences in awareness score between respondents due to different levels of education.

However, to determine which educational level was the source of awareness difference, *Tukey* HSD test is applied. The test results show that mean value of respondents who are highly educated (University/College Degree=36.1277) is significantly higher than mean values for all other categories while the mean scores for other categories, (High School Complete=28.3333, Primary Education=29.2105, and Illiterate=31.1250), are not significantly different from each other.

It also indicates that lower level education has negative effect on awareness about the operations of Islamic banking while highly educated respondents positively affect.

4.2.2.3 Respondents' Awareness Mean Scores by Occupation

The study also investigated occupations of respondent to determine the extent to which their occupation has an impact on their awareness score regarding their understanding about the nature and operations of Islamic Banking. Table (10) below summarizes the result and findings while figure (1) gives a portrait of it.

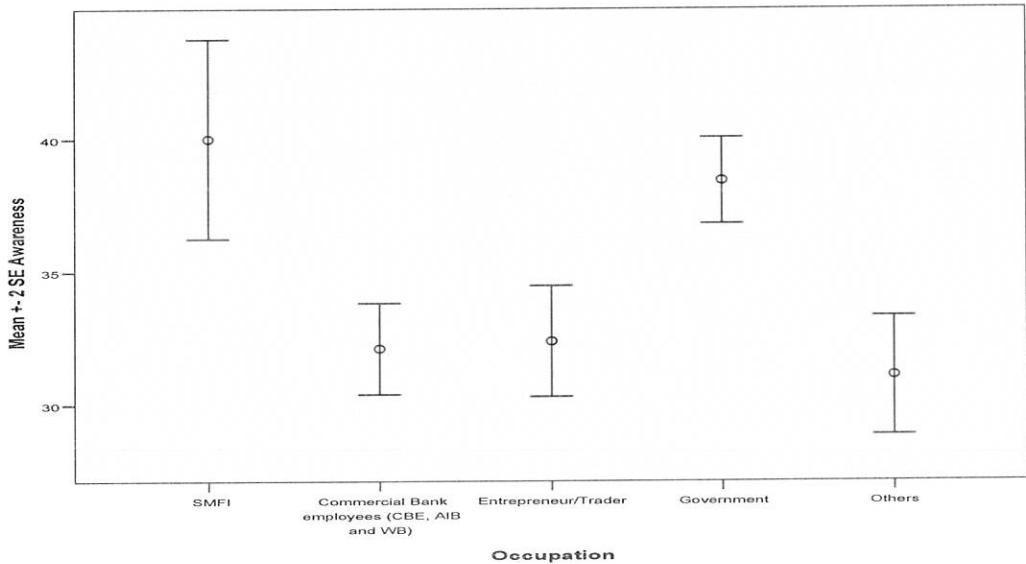
Table (10) Comparisons of Respondents' Awareness Mean score by Occupation

Comparison between mean score of SMFI, Commercial Bank employees (CBE, AIB and WB), Entrepreneur/Trader, Government and Others on Awareness scale

Awareness			
Type of Occupation	Mean	Std. Deviation	N
SMFI	40.0000	4.96655	7
Commercial Bank employees (CBE, AIB and WB)	32.1000	5.43870	40
Entrepreneur/Trader	32.3750	6.60104	40
Government	38.4194	4.52971	31
Others	30.1389	5.55571	36
Total	33.3442	6.40402	154

As Table (10) and figure (1) shows, the highest awareness mean value is observed in the respondents who are Somali Micro-finance Institution (SMFI) employees (40), government employees (38.42), Entrepreneurs/traders (32.38), Commercial Banks employees (32.1) and the lowest, (30.12), is for respondents whose occupation is labelled as 'Others'.

Figure (1) Comparisons of Respondents' Awareness Mean score by Occupation



To determine if the variation in Awareness score between respondents due to their occupation is statistically significantly, ANOVA test is applied while *Tukey* HSD is applied to identify the occupation that is the source of variance. Results for this test are shown below in table (11).

Table (11) The ANOVA Results of Respondents’ Awareness scores by occupation

ANOVA Table							
			Sum of Squares	df	Mean Square	F	Sig.
Awareness * Ty pe of Occupation	Between Groups	(Combined)	1577.931	4	394.483	12.514	.000
	Within Groups		4696.829	149	31.522		
	Total		6274.760	153			

According to results of ANOVA test { $F(4,149) = 12.514, P<.05$ }, it is observed that there is significant awareness score differences between respondents with different occupation. In addition, *Tukey* HSD test was used to identify the occupation (s) that was the main source of awareness difference.

The test results for *Tukey* HSD stat have shown that awareness mean score for SMFI and government employees, (Mean=40.0) and (Mean= 38.42) respectively, are significantly higher than that of all other respondents categories including that of commercial banks employees. According to above results, it can be concluded that SMFI and government employees have high levels of awareness score than the other three respondent categories.

4.2.2.4 Impact of Lack of Islamic Banking on Muslim Community’s Welfare

The degree of respondents’ assessment of the impact of the absence of Islamic banking in Ethiopia on Muslim community’s economic and social welfare was considered important to this study because it was crucial to reflect about the Muslim community’s feelings and assessments about the absence of Islamic banking and how it will impact their livelihoods, welfare and economic aspirations.

In addition, one of the research questions that need to be answered was ‘*Does the Muslim Community generally believe that their calls for financial services that are compatible with their religion have been neglected due to the absence of enabling and necessary legal and policy framework and as a result of this, economically disadvantaged and marginalized by?*’

So, to explore an answer to this question, respondents were asked to share their view regarding the impact of the absence of Islamic Banking in Ethiopia on the welfare of the Muslim community.

Table (12) Respondents’ view on the Impact that absence of Islamic Banking has on Muslim Community’s Welfare

	Valid	Frequency	Valid Percent
	Yes	107	65.6 %
	I Do not Know	13	8 %
	No	43	26.4
Group Total		163	100.0%

Table (12) indicates that 107 (65.6%) of respondents believe that the Muslim community is economically disadvantaged due to the fact that they do not have alternative financial services that are in line with their religion and that it will affect their social mobility, progress and affluence in the long run.

4.2.2.5 Misconceptions about Islamic Banking

There are wide spread misconceptions and wrong understandings about the nature and operations of Islamic banking everywhere whether they are operational in that area or not. Many people look Islamic banking on suspicion and give it a wrong labelling and associations. So, this study tries to explore whether this phenomenon is an exception, here in Ethiopia, or not and there were certain questions devised to measure how people perceive.

To get an insight in to what people make up their mind about the nature and operations of Islamic banking, respondents were asked whether ‘they think that Islamic banking is ‘only-Muslim’ affair?’

Table (13)

	Valid	Frequency	Valid Percent
	Yes	81	49.4%
	I Do not Know	8	4.9%
	No	75	45.7%
Group Total		164	100.0%

As figures in table (13) indicates, 81 (49.4%) respondents believe that ‘Islamic banking is only-for-Muslims affair’, 8 (4.9%) of respondents believe the other way while 68 (45.7%) of respondents do not know whether or not ‘Islamic banking is only-for-Muslims affair’.

Therefore, we can generalize that the majority of the respondents did not know that Islamic banking is for all communities and is not something that is intended or used by only Muslims. Only, nearly (38%) percent fully understood its sense its right sense. Moreover, these findings are not in line with what has been observed for Islamic banking all over the world and it’s not true that Islamic Banking is something that serves the Muslim community’s interest only.

For example, *L’Osservatore Romano*, a daily newspaper in the Vatican regarded as the mouthpiece of the Pope, has endorsed the values of *Shari’ah-compliant* finance as a solution to the problems in the world of conventional, interest-based finance.

The paper suggested that the ethical foundations of Islamic finance should be adopted by conventional banks as a way of restoring the trust of their depositors and

shareholders. It also stated the belief of the Vatican that the Islamic financial system could help the global financial system overcome the crisis.¹¹⁹

The other item that is supposed to measure respondents' views and perceptions about Islamic banking is whether *'they think that Islamic banking is something equally beneficial to other communities?'*

Table (14)

	Valid	Frequency	Valid Percent
	No	55	33.5%
	I Do not Know	31	18.9%
	Yes	78	47.6%
Group Total		164	100.0%

As shown in table (14), when respondents were asked whether they *'think that Islamic banking is something equally beneficial to other communities'*, 78 (47.6%) of respondents *'think that Islamic banking is something equally beneficial to other communities'*, while majority of the respondents 86 (52.4%) either did not, 55 (33.5%) think or did not know at all, 31(18.9%), whether *'Islamic banking is something equally beneficial to other communities'*.

As substantiated by the results for this item, majority of the respondents have shown another misconception about Islamic banking as something that is only beneficial to the Muslim Community and not as something that is equally beneficial to other communities.

Moreover, this contradicts what has been observed for Islamic banking in economic and finance literature. Islamic financial experts has developed new investment models and business tools that are *Shari'ah compliant* as well as highly profitable and used both by Muslim and non Muslim alike.

¹¹⁹ New horizon magazine (<http://www.ifc.org/ifcext/africa.nsf/Content/Home>)

Finally, Islamic banking is growing rapidly due to the importance that it accords moral beliefs and society. The *Shari'ah* law is driven by ethical values that are good for mankind; hence, it is well accepted by not only Muslims but also non Muslim communities¹²⁰.

To further explore respondents' views and perceptions about Islamic Banking, respondents were asked whether *'they think that interest is prohibited in all major religious scriptures and not only in the Holly Qur'an?*

Table (15)

	Valid	Frequency	Valid Percent
	No	34	20.7%
	I Do not Know	68	41.5%
	Yes	62	37.8%
Group Total		164	100.0%

According to table (15), only respondents 62, which accounts (37.8%), agree the that *'interest is prohibited in all major religious scriptures and not only in the Holly Qur'an'*, while majority of the respondents, (62.2%) either disagreed, 34 (20.7%), or did not know, 68 (41.5%), whether *'interest is prohibited in all major religious scriptures and not only in the Holly Qur'an'*.

So, we can conclude that the *majority* of the respondents either, did not agree or do not know the idea that interest is prohibited in all major religious scriptures and not only in the *Holly Quran*.

However, the respondents' believe does not stand up to what has been revealed in all major religious scriptures. Even in non Muslim literature, in the great western classics, the Old and New testaments considers interest as evil.

¹²⁰Islamic Banking Can Ethiopia Really Afford To Ignore It Business Opinion.Mht , (Mohamed M. Olad, Ethiopian Reporter)

In addition, the 19th century writers such as William Shakespeare, famous writers such as Charles Dickens and others repeatedly raised their voice against the evil side of interest and money lenders and championed the campaign of equal distribution of money among all classes¹²¹.

4.2.2.6 General Understandings about Islamic Banking

It's also important to explain how people understand about the basics of Islamic banking if one is ever to explore the public's awareness level as well as prospects and challenges facing Islamic banking in Ethiopia. Towards this end, the study reveals some fascinating results about the respondents' understanding about Islamic Banking.

To get an insight in to the respondents' basic understanding about the nature and operations of Islamic Banking, informants were asked whether *'they think that Islamic banking operates in non-Muslim majority countries(i.e. western countries.) that have a small number of Muslim communities on side-by-side with their well established conventional banking and while appreciated by significant number of Non-Muslim customers?'*

Table (16)

	Valid	Frequency	Valid Percent
	No	25	15.2%
	I Do not Know	85	51.8%
	Yes	54	32.9%
Group Total		164	100.0%

According to the data in table (16), 25 (15.2%) of respondents, disagree or did not know, 85 (51.8%) at all, that *'Islamic banking operates in non-Muslim majority countries as well as western countries that have a small number of Muslim communities and well established conventional banking and a significant number of*

¹²¹ Famous Indian authors such as Rabindranath Tagore, Munshi Premchand, Sarat Chandra also showed the dark side of the prevalence of interest charges in an country.

Non-Muslim customers are using them where they exist'. While only 54 (32.9%) of the respondents acknowledge this fact.

However, Islamic finance has become a global system spreading as far as Asia, the Middle East, and the Western world. Islamic banking is not limited only to the Muslim nations in the Middle East but also exists in developed economies such as the USA, Europe, and the Far East as far as to China.

The other item that is important in measuring respondents' understanding about the basics of Islamic banking is whether *'they believe that Islamic financial system proposes strong alternative system with profitable, well governed, transparent and sustainable institutions that would provide a successful and comparable set of financial products?'*

Table (17)

	Valid	Frequency	Valid Percent
	No	39	23.8%
	I Do not Know	25	15.2%
	Yes	100	61.0%
Group Total		164	100.0%

As per the data in table (17), only 100 (61.0%), of the respondents believe that *'Islamic finance proposes strong alternative system with profitable, well governed, transparent and sustainable institutions that would provide a successful and comparable set of financial products'*, while nearly 64 (40 %) of the respondents, either disagree, 39 (23.8%), or do not know, 25 (15.2%) , about this issue.

However, there is an extensive research on the growth pattern and trend of Islamic banking and has shown it has become an alternative mode in which its viability and practicability has been accepted by economists and bankers in most Muslim and non-

Muslim countries. Moreover, many consider this system superior in some respects. A body of literature has already come up on this subject.

Islamic finance, which works on profit and risk-sharing, contrasts with the current dominant system based on interest-bearing debt, in which risks are theoretically transferred to debt holders, but in practice are socialized during crises. Other things being equal, most economists will agree that debt finance leads to greater instability than equity finance¹²².

Moreover, Islamic banking requires strict ethical standard and hence, fewer of the moral-hazard that exists in all systems in which the state ultimately absorbs the risks of private citizens¹²³. So, Islamic finance – grounded on *sharia*– can further deter moral hazard and abuse, it could also prove to be a serious alternative to current models of derivative finance.

In addition, respondents were asked whether *‘they think there are financial Institutions in Ethiopia that currently provides financial services that are in line with Islamic banking services?’*

Table (18)

	Valid	Frequency	Valid Percent
	No	49	29.9%
	I Do not Know	59	36.0%
	Yes	56	34.1%
Group Total		164	100.0%

As the data on table (18) shows, majority of the respondents, 108 (65.9%), either do not think, 49 (29.9%), or donot know, 59 (36%), at all whether there is *‘any financial Institution in Ethiopia that currently provides financial services that are in line with*

¹²² Project syndicate

¹²³ But, whether any particular system is efficient in avoiding moral hazard is a matter of practice, rather than of theory as Christian morality played an important role in the rise of Western capitalism while Secular capitalism has experienced an erosion of moral values-the financial sector has put its own interests above those of the rest of society.

Islamic banking services'. Only 56 (34.1%) of the respondents knew that there were any '*financial Institution in Ethiopia that currently provides financial services that are in line with Islamic banking services*'.

Again this is another indicator of the level of awareness that respondents have exhibited. However there some selective institutions like Somali Micro-finance Institution provides some basic *Sharia-Compliant* products and some commercial Banks that provide non-interest bearing but also non-rewarding special demand deposit accounts that roughly matches Islamic Financial Institutions (IFI)'s *Amanah Accounts*.

4.3 Prospects and Opportunities of Islamic banking in Ethiopia

The prospect of Islamic Banking in Ethiopia looks very bright. Ethiopian Muslims everywhere want Islamic banking. Ethiopia with around 30 million Muslims, offers huge opportunities to exploit.

The significant Muslim population and the high population growth rate provide great potential for Islamic banking in Ethiopia. With this growth, customers are seeking Islamic banking and finance products that will provide opportunities to invest and borrow.

It is pertinent to mention here that Islamic banking is not meant for Muslims only but non Muslims may also avail the benefit of it. Moreover, the Growth and Transformation Plan, third five year economic plan, envisages inclusive growth with development in all sectors of the economy. Moreover, Islamic banking is an effective mechanism to subjugate the liquidity and inflation problems along with inclusive growth.

While *Sharia* compliant investment avenues are now becoming available in most countries, Ethiopia has not yet seen that development¹²⁴ which would have attracted large number of Muslims who are considered unworthy of credit and other dealings by the existing commercial banks.

To examine the prospects and opportunities awaiting Islamic banking in Ethiopia, certain specific questions that relates to the prospects as well as opportunities where addressed to the participants of this study so that they will measure, of course as a proxy, and quantify respondents’ assessment of the prospects and opportunities of Islamic banking in Ethiopia. The results for respondents’ assessment about the prospects of Islamic banking are shown on table (19).

Table (19) Prospects Mean Score by Respondents

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
Prospects	159	13.00	30.00	23.3333	5.48608
Valid N (listwise)	159				

NB: 6 respondents are not included due to missing data.

As depicted on table (19), the mean value of Prospects Score for the respondents was found to be (23.33) with standard deviation of (5.49) while the minimum and the maximum scores were (13) and (30) respectively. The mean value (23.34) is higher than the expected average score of (20).

This indicates that the prospects score of respondents with regard to the operations of Islamic banking is high and higher than average which shows how respondents are keen to regarding the operations of Islamic banking and finance¹²⁵. This finding is

¹²⁴ (www.islamicequity.co.in)

¹²⁵ See also Mohamed M. Olad, *The Need for Islamic Banking in Ethiopia*, an unpublished project paper, July 2008, AAU

actually consistent with what all the Islamic Banking literature has revealed about the operations of Islamic Banking.¹²⁶

4.3.1 Respondents' Prospects Mean Score by Based On Religion

To get the full picture of the prospects and opportunities of Islamic banking in Ethiopia, it is important to explore whether respondents' different background had an impact on their assessment of the prospects and opportunities of Islamic banking in Ethiopia.

So, the study tries to explore if respondents' religion had an impact on respondents' assessment of the prospects and opportunities of Islamic banking in Ethiopia. Respondents were also asked about their religion and their assessment of the prospects and opportunities of Islamic banking in Ethiopia. The results of statistical analysis for these observations are shown in table (20).

Table (20) Comparison of respondents' Prospects Mean scores by Religion

Comparison of Prospects Mean Score among Respondents belonging to different Religion

Prospects			
Religion	Mean	Std. Deviation	N
Muslim	26.5851	2.45567	94
Orthodox Christian	17.8519	4.61910	54
Protestant	22.4545	6.62365	11
Total	23.3333	5.48608	159

As the data on table (20) depicts, the mean Prospects score for Muslims was found to be (26.59) and that of Orthodox Christians was found to be (17.852) while that of Protestants was (22.5).

¹²⁶ S. sankaramuthukumar and a.devamohan has found in their paper entitled '*the potentiality of Islamic banking in Ethiopia*' and presented at the sixth conference on the Ethiopian Economy, June 2008 – Addis Ababa

However, what is important about this finding and needs caution when interpreting is the fact that Protestants has showed higher score on the prospects Mean scale and hence, higher assessment for the prospects of Islamic banking in Ethiopia than Orthodox Christians.

But the likely reason for this follows the same explanation given for their higher Awareness Mean Score discussed in the previous sections of this chapter. This may be due to the fact that protestants who responded to this survey was highly educated, (nearly 73% of them where university or college graduates), commercial bank employees (nearly 50% of them works for some sort of financial institution) and even more importantly some of them work for Somali-Micro-finance Institution which engages in *Sharia-compliant* financial services.

As Table (20) shows, the prospects mean score for respondents by different religion shows variance. So, to understand if there is a significant statistical difference in terms of Prospects score and the assessment of the opportunities that awaits Islamic Banking in Ethiopia between different followers, One-way ANOVA was used while *Tukey* HSD is used in identifying the source of difference. The result was found as presented on Table (21).

Table (21) ANOVA Results for respondent’s Prospects Mean Scores by religion

ANOVA Table						
			Sum of Squares	df	Mean Square	F
Prospects * Religion	Between Groups	(Combined)	2624.972	2	1312.486	96.109
	Within Groups		2130.361	156	13.656	
	Total		4755.333	158		
						Sig.
						.000

The difference in Prospects mean scores due to religion was significant { $F=96.11$, $p<.05$ }. This implies that different followers had shown different assessment for the prospects and opportunities that awaits Islamic Banking.

To determine which religion was the source of difference in prospects mean score, *Tukey* HSD test was applied and results shows that mean value of respondents who are Orthodox Christians and protestants do not differ significantly in terms of their assessment regarding the prospects and opportunities of Islamic banking in Ethiopia.

However, what is important from these findings is that Muslims submit higher positive assessment and expectations for the prospects and opportunities that awaits Islamic Banking when compared to other respondents categories.¹²⁷¹²⁸

4.3.2 Respondents' Prospects Mean Score by Occupation

The study further explored if the occupation of respondents had an impact on respondents' assessment of the prospects and opportunities of Islamic banking operations in Ethiopia. The results of statistical analysis for the respondents' prospects mean score by occupation are shown in Table (22).

Table (22) Comparison of respondents' Prospects Mean scores by Occupation

Comparison between mean score of SMFI, Commercial Bank employees (CBE, AIB and WB), Entrepreneur/Trader, Government and Others on Prospects scale

Prospects			
Type of Occupation	Mean	Std. Deviation	N
SMFI	28.0000	3.05505	7
Commercial Bank employees (CBE, AIB and WB)	21.2000	4.59766	40
Entrepreneur/Trader	22.4000	6.42032	40
Government	25.6944	3.09672	36
Others	23.4722	6.23578	36
Total	23.3333	5.48608	159

^{127 127} See also Mohamed M. Olad, *The Need for Islamic Banking in Ethiopia*, an unpublished project paper, July 2008, AAU

¹²⁸ S.sankaramuthukumar and a.devamohan has found in their paper entitled '*the potentiality of Islamic banking in Ethiopia*' and presented at the sixth conference on the Ethiopian Economy, June 2008 – Addis Ababa

The highest prospects mean score, (Mean=28), is observed for Somali Micro-finance institution employees while the lowest score is recorded for commercial banks employees.

As table (22) shows, the prospects mean score for respondents with different occupation shows variance. This variance is explained by different factors including their exposure to different occupation and their different backgrounds.

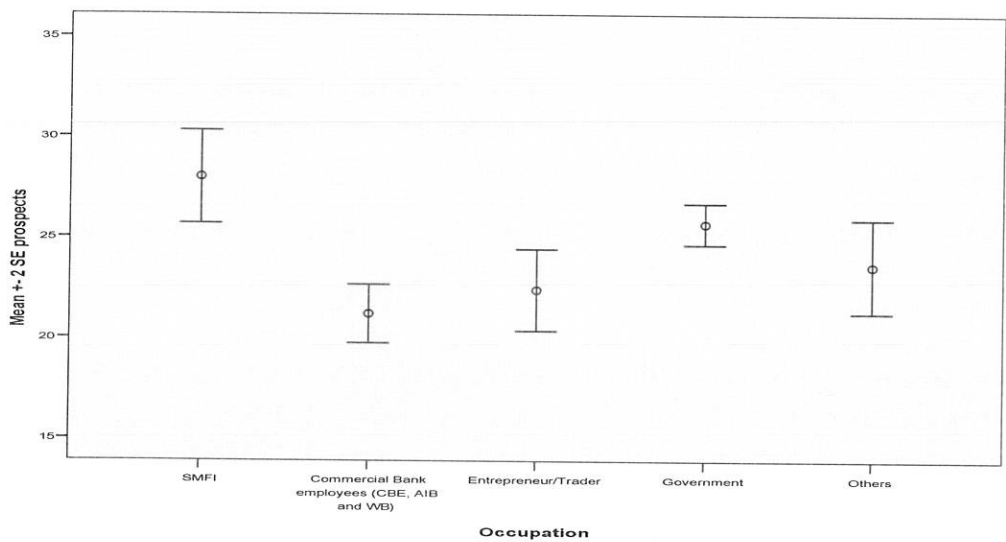


Figure (2) respondents’ prospects mean score by occupation

For example, Somali Micro-finance Institution employees are expected to understand better about the nature and status of Islamic banking in Ethiopia and hence higher level of assessment, than all other categories.

In addition, commercial banks employees’ overall low assessment score for the prospects and opportunities for Islamic banking in Ethiopia is not surprising. They work for financial that differ from Islamic banking in many respects including business philosophy, customer base, values and principles and of course may see Islamic banking as a threat.

To understand if there is a significant statistical difference in terms of prospects score and the assessment of the opportunities that awaits Islamic Banking in Ethiopia due to occupation, One-way ANOVA was used while *Tukey* HSD is used in identifying the source of difference. The result was found as presented on Table (23).

Table (23) ANOVA Results for respondent's Prospects Mean Scores by occupation

ANOVA Table							
			Sum of Squares	df	Mean Square	F	Sig.
Prospects * Type of Occupation	Between Groups	(Combined)	570.722	4	142.681	5.251	.001
	Within Groups		4184.611	154	27.173		
	Total		4755.333	158			

The difference in prospects mean scores due to occupation was significant { $F=5.251$, $p<.05$ }. This implies that there is significance difference in the assessment of the prospects and opportunities of Islamic banking in Ethiopia due to difference in occupation.

To determine which occupation was the source of prospects difference, *Tukey* HSD test was applied and results shows that prospects mean value of Somali Micro-finance Institution employees, (Mean=28) and Commercial Banks Employees, (Mean 21.2), differ significantly from the other respondents' categories.

The fact that a Somali Micro-finance Institution Employees show the highest Prospects Mean Score while Commercial Banks Employees Show the lowest Prospects score is not any surprising. Simple explanation to this may be their business philosophy, customer orientation and other characteristics (composition of their religion etc).

However, what is important from this finding is the fact that the prospects mean score for the other three respondents' categories are not statistically and significantly

different. Or in another language, all other respondents categories show similar good prospects for Islamic banking due to the fact that Mean Prospects Score for all the three categories is equal to (or higher than) the expected value for Prospects (Expected Value=20) (Note, that Entrepreneur/trader=22, Government=25.69, Other=23.47)

4.3.4 Respondents’ Prospects Mean Score by Level of Education

The other respondents’ variable that is important for understanding respondents’ different assessment for the prospects and opportunities of Islamic banking in Ethiopia is respondents’ educational level.

So, the study further explored if the respondents’ level of education had an impact on their prospects Mean Score and of course, their assessment regarding the prospects and opportunities of Islamic banking in Ethiopia. The results and statistical analysis for this observation are shown in table (24).

Table (24) Comparison of respondents’ Prospects Mean scores by Occupation
Comparisons of Prospects Mean Score among Respondents
Having Different Level of Education

Prospects			
Educational Level	Mean	Std. Deviation	N
Illiterate	26.2500	.88641	8
Primary Education	21.2353	7.10220	17
High School Complete	21.9091	7.58849	33
Univ ersity /College Degree/Certificate/ Diploma	23.9208	4.30740	101
Total	23.3333	5.48608	159

As the data on table (24) indicates, the highest prospects mean score, (Mean=26.25) is observed for the Illiterates while the lowest Prospects Mean Score, (Mean=21.24) is recorded for primary education.

According to table (24), the prospects mean score for respondents with different level of education shows variance. To understand if there is a significant statistical difference in terms of respondents’ prospects score and their assessment of the

prospects of Islamic banking in Ethiopia due to level of education, One-way ANOVA was used while *Tukey* HSD is used in identifying the source of difference. The result was found as presented on table (25).

Table (25) ANOVA Results for respondent’s Prospects Mean Scores by Level of Education

ANOVA Table						
			Sum of Squares	df	Mean Square	F
Prospects * Educational Level	Between Groups	(Combined)	244.681	3	81.560	2.803
	Within Groups		4510.652	155	29.101	
	Total		4755.333	158		

According to table (25) the difference in prospects mean scores due to level of education was significant {F=2.803, p<.05}. This implies that there is significance difference in the assessment of the prospects and opportunities of Islamic banking in Ethiopia due to difference in level of education.

However, the overall assessment of each respondent category for the prospects and opportunities of Islamic banking in Ethiopia is high and illuminating regardless of their level of education due to the fact that the mean scores for each respondent category is higher than the expected value of (20) for prospects mean score.

Moreover, to determine which level of education was the source of difference in prospects score, *Tukey* HSD test was applied and results shows that prospects mean value of illiterates, (Mean=26.25) and Primary education, (Mean 21.24), respondents differ significantly from the other respondents’ categories.

Furthermore, what is important about this finding and needs caution when interpreting is the fact those illiterate respondents has showed higher Prospects Mean Score for the Prospects and opportunities for Islamic Banking.

But the likely reason for this may be due to the fact that the illiterate respondents covered under this study, 65% of them were traders while they were all Muslims, i.e. 100%, and that is why they have shown such over enthusiastic assessment about the prospects and opportunities that waits Islamic Banking in Ethiopia.

4.3.5 Respondent’s view about the need for Islamic banking in Ethiopia

To further investigate the prospects and opportunities of Islamic banking in Ethiopia, certain items that are relevant for the better understanding of this issue will be presented in the following sections.

Towards this end, one important item of this type that was addressed to the respondents was whether *‘they think there is a need for Islamic banking in Ethiopia so that it will alleviate the financial services deprivation of the Muslim community?’*

Table (26)

	Valid	Frequency	Valid Percent
	No	21	12.7%
	I Do not Know	31	18.8%
	Yes	113	68.5%
Group Total		165	100.0%

According to table (26), 113 (68.5%) respondents feel that to *‘alleviate the financial services deprivation of the Muslim community, there is a need for Islamic banking in Ethiopia*. In addition, 21 (12.7%) do not think there is a *‘need’* while 31(18.8%) do not know actually which way to choose.

This finding supports the notion that, in Ethiopia, where there is significant Muslim population, the potential customers that would patronize Islamic banking system is enormous particularly since Islamic banks are also known to favor a great number of less privileged people through financing small and medium scale enterprises.

Moreover, a soundly financed and prudently managed Islamic financial institution would not only be 'good for Muslim consumers' but also would do good for innovation and diversity in our markets and good for Ethiopia as a regional, middle income economic power house.

Yet even today, horrendous disparities exist while different segments of the Ethiopian society are un-banked. And this is the main causes of exclusion of the majority of the population in terms of growth. The potential benefits of allowing Islamic banking include; decreased economic disparity between the haves and the have not's, better integration, and consequently accelerated economic growth.

The Ethiopian banking sector has opened up considerably in the past decade or so and openness to interest-free banks is a logical next step. Islamic banking is one way to ameliorate the disadvantaged classes. So, the government of Ethiopia can leap a step closer towards the fulfilment of the much cherished dream of "Middle Income Country" by reforming its banking sector and allowing the establishment of Islamic Banks¹²⁹.

The non-availability of interest-free banking products results, many Ethiopians, including those in the economically disadvantaged strata of society, to be excluded from financial services due to reasons of their faith.

So, the necessary measures and policy tools should be taken to facilitate the establishment of Islamic banking in consonance with the objectives of inclusion and growth through innovation without any adverse systemic risk impact.

¹²⁹ Mohammad Ghous Ikhtiyaruddin Bagsiraj *Islamic Financial Institutions Of India Progress, Problems And Prospects*, Scientific Publishing Center, King Abdulaziz University, Jeddah, Saudi Arabia

Interest free banking is another area that falls broadly in the ambit of financial infrastructure. Islamic banking can eliminate unaccountable economic activities, as every economic activity has to be financed through legal contract and physical verification of real assets under contract. There is no room for diversion of funds.

Therefore, investment in consonance with Islamic banking principles will surely boost the engine of economic growth in our country. Moreover, Islamic banking helps the weaker and hapless section of the society through various financial products (Joint ventures, partnerships and leasing). Such inclusive growth will aggrandize the Ethiopian economy.

4.3.6 Respondents’ Bank Services Usage Pattern and Behaviour

If the prospects and opportunities for Islamic banking are to be understood ever, the current banking service users’ behaviour and rationality should be understood firstly. Towards this end, participants to this survey were asked several items that help in measuring and understanding respondents’ banking services usage and behaviour.

One of the questions that were addressed to respondents to understand their usage pattern, behaviour as well as purpose was, *‘If you are banking services user currently, do you think that ‘Safety / keeping money safe’ is your first priority?’*

Table (27)

	Valid	Frequency	Valid Percent
	No	41	25.0%
	I do not Know	7	4.3%
	Yes	116	70.7%
Group Total		164	100.0%

According to the above table, significant number of those respondents, (116) (70.7%), who *‘use banking services’*, use banking services to *‘safeguard or keep the safety of*

their money'. in addition, 41(25%) of them *'use bank services'* *'To earn interest on savings account'* while (7) (4.3%) respondents do not know or in fact *do not use bank service*.

So, we can say that overwhelming number of respondents do not *'use banking services'* to *'Gain interest'* while majority of the respondents make *'guarantying the safety of their money'* as their first priority.

This provides and ample opportunity for Islamic banking to thrive by providing financial products that guarantee the safety of customers' savings and additional features that allows the opportunity for higher returns than those offered by conventional banks.

Moreover, respondents were asked whether *'they have ever cancelled (or would cancel) a plan for business expansion and/or new investment opportunity to be financed by bank loan due to the fact that the interest based banking system does not encourage Muslim business community to consider all possible business and investment opportunities?'*

Table (28)

	Valid	Frequency	Valid Percent
	No	50	30.3%
	I Do not Know	29	17.6%
	Yes	86	52.1%
Group Total		165	100.0%

When respondents were asked whether they *'Have ever cancelled (or in fact would cancel in the future) a plan for business expansion and/or new investment opportunity to be financed by bank loan due to the fact that bank (investment) loan involves interest?'*, 86 (50.1%) of them responded *'Yes'*, 50 (30.3%) of them responded *'No'*,

while 29 (17.6%) of them *‘do not know’* if they have cancelled (or would ever cancel), or are undecided.

According to table (28), significant number of respondents believes that *‘interest based banking system’* do not *‘encourage Muslims to consider all possible business and investment opportunities’* and such sentiments signal market gap that offer significant opportunity for Islamic banking to fill.

This also clear sign that significant number of Muslims would not look for banking services or loans that involve interest to *‘cover their short and long term financial shortage’* but rather would opt for unconventional ways of financing such as borrowing *‘from relatives and friends’*, or the *‘liquidation of fixed assets’*,

Finally respondents were asked whether *‘they think that, if the existing banks offer certain Islamic products (i.e. Saving and Loan Service), the access to Islamic banking will improve and the tendency for business expansion and investment activity will increase?’*

Table (29)

	Valid	Frequency	Valid Percent
	No	28	17.3%
	I Do not Know	35	21.6%
	Yes	99	61.1%
Group Total		162	100.0%

In response to this question as shown on table (29), 99 (61.1%) of the respondents believe that *‘the tendency of business expansion and investment activity will increase’* and access to Islamic banking would increase if the existing banks began to offer financial products that are in line with Islamic banking. However, 28 (17.3%) of the respondents do not share that view while 35 (21.6%) of them submit their responses as *‘do not know’* or are undecided.

So, we can understand from the above analysis that significant number of respondents believe that *'the financial service usage pattern will increase'*, and of course including theirs, if the existing banks offer certain Islamic financial products.

4.4 Challenges Facing Islamic Banking in Ethiopia

4.4.1 Awareness of the Respondents about Islamic Banking

In order to achieve the intended objectives of the study and to address the research problem properly, certain research questions were raised in this study and of course, equal effort has been made in answering them accordingly.

One of the research questions raised earlier in the paper was *'Does lack of awareness and proper understanding about the operations of Islamic banking pose serious challenge to the success of Islamic banking in Ethiopia?'*

So, to assess the level of public awareness and specially that of the Muslim community, about Islamic banking, respondents were asked to assess and share their view regarding the Muslim community's awareness on Islamic Banking.

To get an insight in to the Muslim community's *'awareness regarding the operations of Islamic banking'* and eventually give their assessment of level of Muslim community's awareness, respondents were asked whether *'they think that the Muslim Community have awareness about Islamic banking system?'*

Table (30)

	Valid	Frequency	Valid Percent
	No	63	38.2%
	I Do not Know	58	35.2%
	Yes	44	26.7%
Group Total		165	100.0%

According to table (30), 63 (38.2%) of the respondents believe that the Muslim community does not have ‘*sufficient awareness*’ about the operations of Islamic banking while 44 (26.7%) of the respondents claim that the Muslim Community have ‘*sufficient awareness*’. However, (58) 35.2% of the respondents do not know whether the Muslim community has an appropriate awareness or are undecided.

As the data on the above table shows, the findings of this study supports what has been reported in Islamic banking literature as one of the main problems facing Islamic banking worldwide.

Despite, the growth of Islamic banking over the last 30 years, poor understanding in the Muslim and non-Muslim world about Islamic banking actually exist. However, the basic principle that it is contrary to Islamic law to make money out of money and that wealth should accumulate only from trade and ownership of real assets is clear¹³⁰.

4.4.2 Regulatory, Supervisory and Institutional Challenges

The growth and progress of Islamic Financial services remained stuck for almost half a decade since the first individual and group initiatives surfaced in early 2008. Nothing much has changed since then. Not a single commercial bank has announced yet that it will engage Islamic financial products whether publicly or privately owned, whether through ‘*Special Window*’ or subsidiary.

Not a single ‘Full-fledged’ Islamic Financial Institution has come out yet though there were so many publicized initiatives to establish what was dubbed as the first Islamic Financial Institution in Ethiopia. Moreover, any government led-initiative or program has yet to come from the concerned authorities.

¹³⁰ Md. Abdul Awwal Sarker, *Islamic Banking in Bangladesh: Performance, Problems & Prospects* International Journal of Islamic Financial Services Vol. 1 No.3

4.4.2.1 Regulatory Challenges

One of the major challenges facing Islamic banking in Ethiopia in its current situation is legal or regulatory challenges. To understand if regulatory challenges include one of the major challenges facing Islamic banking in Ethiopia, one of the research questions was *‘Does the existing regulatory and supervisory regimes such as those holding Islamic banks to the same set of regulations as conventional banks and those that block the establishment of full-fledged Islamic Financial Institutions (IFIs) discourage Islamic banking in Ethiopia?’*

To answer this research question, certain items were designed to search out an answer and proper explanation. One of these questions addressed to respondents for further understanding about the regulatory challenges facing Islamic Banking in Ethiopia was whether *‘think NBE’s 2010 banking supervision Directive has actually blocked ongoing initiatives for full-fledged Islamic Financial Institutions while allowing the opening of ‘Special Windows’ by the existing commercial banks and was not constructive?’*

Table (31)

	Valid	Frequency	Valid Percent
	No	20	12.1%
	I Do not Know	52	31.5%
	Yes	93	56.4%
Group Total		165	100.0%

According to table (31), 93 (56.4%) of the respondents believe that the *‘2010 NBE banking supervision Directive’* that blocked the initiatives for full-fledged Islamic Financial Institutions while allowing the opening of *‘Islamic Windows’* through the existing commercial banks *‘was not constructive’* or help full. Responding to the same

question, 20 (12.1%) of the respondents do not believe that specific directive was constructive while 52 (31.5%) of the respondents do not know or are undecided.

More importantly, respondents were asked their assessment about the current banking regulatory regime in Ethiopia. A specific question was addressed to respondents regarding whether *‘they think that the current Financial Institutions regulatory and supervisory regime such as those governing initial paid up capital, reserve requirements and risk management approaches poise certain setbacks to any ongoing or future initiatives to establish Islamic financial institutions?’*

Table (32)

	Valid	Frequency	Valid Percent
	No	21	13.1%
	I Do not Know	51	31.9%
	Yes	88	55%
Group Total		160	100.0%

As table (32) depicts, 88 (55%) believe that the current Financial Institutions regulatory and supervisory regime poise certain setbacks to the establishment of Islamic banks. In addition, 21 (13.1%) disagree while 51 (31.9%) do not know or are unsure about it.

So, the responses to the above two observations indicate that significant number of respondents believe that the current legal and regulatory regime the controls the Ethiopian financial sector is not help full for Islamic banking to succeed and flourish in Ethiopia.

4.4.2.2 Institutional Challenges

Islamic banks in different countries are in early stages of learning and experience lacking the flexibility to choose arrangements which best suits their need in responding to structural shifts in the economic setting as well as to changes in consumer preferences.

So, In addition to the regulatory challenges facing Islamic banking, it's also important to explore the institutional challenges as well. So, to see what institutional challenges respondents are observing, respondents were asked whether they *'think that NBE needs Institutional rearrangements in re order to accommodate the special institution need that Islamic banking requires?'*

Table (33)

	Valid	Frequency	Valid Percent
	No	34	20.9%
	I Do not Know	42	25.8%
	Yes	87	53.3%
Group Total		163	100.0%

According to table (33), 87 (53.3%) of the respondents believe that *'NBE needs Institutional rearrangements in order to accommodate the special institutional need that Islamic banking requires'*. Responding to the same question, 34 (20.9%) of the respondents do not believe that NBE requires institutional rearrangements to accommodate Islamic banking while 42 (25.8) % of the respondents do not know or are undecided.

Moreover, respondents were asked if they think *'Conventional' Financial Institutions will ever win the hearts and minds of the Muslim community and the services they offer will be perceived as pure while appealing to the more zealous customers though*

these banks will deal with interest and business sectors that are prohibited /Haram/ under Islamic law.

Table (34)

	Valid	Frequency	Valid Percent
	No	83	51.2%
	Yes	33	20.4%
	I Do not Know	46	28.4%
Group Total		162	100.0%

As data on table (34) depicts, 33 (20.4%) of the respondents believe that the '*Non-Islamic Financial Institutions*' will '*win the hearts and minds of the Muslim community and seduce them to use financial services they deliver through subsidiary or 'Specialized Windows*'. 83 (51.2 %) of the respondents disagree while 46 (28.4%) of the respondents do not know or are undecided.

The data on table (34) shows that '*Conventional*' Financial Institutions will have hard time to promote its products *as purely Islamic and appeal to the more zealous customers* while they are dealing with *interest or /Riba/*.

The other item that respondents were addressed to examine the institutional challenges facing Islamic banking was whether '*they believe that Full-Fledged and independent Financial Institutions are the only way to ensure broad based and*

Table (35)

	Valid	Frequency	Valid Percent
	No	35	21.6%
	I Do not Know	20	12.4%
	Yes	107	66.%
Group Total		162	100.0%

When the question '*Do you think that Islamic banking service should be provided separately rather than through 'Special Window' of conventional banks*' was brought

to the respondents, 107 (66%) of them think that it's better that *'Islamic financial services are provided separately'*.

However, 35 (21.6%) of the respondents do not think necessary that *'Islamic financial services are provided separately'* and they don't mind if *'Islamic financial services are provided by the existing commercial banks'* while 20 (12.4%) of the respondents are undecided or do not know.

Furthermore, respondents were also asked whether *'they believe there is a gap in research and development in Islamic studies in general and Islamic finance and economics in particular and that the that the government should initiate Islamic Studies Programmes in Higher Education Institutions (HEIs) to fill the gap in qualified human resource?'*

Table (36)

	Valid	Frequency	Valid Percent
	No	36	22.2%
	I Do not Know	33	20.4%
	Yes	93	57.4%
Group Total		162	100.0%

According to the data on table (36), 93 (57.4%) of the respondents believe that there is a gap in research and development in Islamic studies in general and Islamic finance and economics in particular and that the government should initiate Islamic Studies Programmes in Higher Education Institutions (HEIs). 36 (22%) disagree while 33 (32.7%) do not know or are undecided.

This finding is consistent for what have been reported for any system building including Islamic banking system. Any system, however well integrated it may be, cannot thrive exclusively on its built-in elements. It has to depend on and so is the case with Islamic banking which needs research and training forums in order to

prompting entrepreneurship amongst their clients. Such support services properly oriented towards Islamic banking are yet to be developed in Ethiopia.

For example, in Ethiopia, most banks’ professionals have been trained in conventional finance and economics and they lack the requisite vision and conviction about Islamic banking, there should be well trained and competent human resource professionals in Islamic banking and finance that understand the moral and religious implications of their profession.

The other item that explains the intuitional challenge facing Islamic Banking in Ethiopia is about the absence of support and link institutions like interest-free Money and Capital Markets. To assess this specific challenge, this question, *‘Do you think that lack of supportive and link institutions like Interest free Money Market and capital markets would create liquidity and other operational difficulties to Islamic Banking?’*, was raised to respondents to get their view about the issue.

Table (37)

	Valid	Frequency	Valid Percent
	No	37	23.2%
	I Do not Know	38	24%
	Yes	84	52.8%
Group Total		159	100.0%

As the data on table (37) shows, 84 (52.8%) of the respondents think that lack of supportive and link institutions like Interest free Money Market and capital markets would create liquidity and other operational difficulties to Islamic banking. 37 (23.3%) disagree while 38 (24%) do not know or undecided.

In line with these findings is, the main problems identified by a number of case studies of Islamic banks operating in different countries are the absence of suitable non-interest-based financial instruments for money and capital market transactions without

which Islamic banks will not have adequate instruments to meet the pre-condition for liquidity management and effective maturity transformation¹³¹.

So, if Islamic banking is to be realized in Ethiopia, adequate financial mechanisms and a number of link institutions still has to be developed, without which financial intermediation, especially the risk and maturity transformation, will not be performed properly¹³²

4.4.2.3 Supervisory Challenges

The top banking regulator on land, the National Bank of Ethiopia (NBE), has not been open to the development of Islamic finance in the Ethiopia at least for now though the first important signal was given in a meeting with the prime minster by a group of organizers and Muslim business men with Prime Minster Meles, in 2008

This was a recognition to the ‘growing importance of Islamic banking in Ethiopia and its emergence on the international stage’ as well as the need to put Islamic banking in the context of social equity and fairness.

Finally respondents were enquired whether they think it appropriate that *‘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 from conventional banks?’*

Table (38)

	Valid	Frequency	Valid Percent
	No	21	13.0%
	I Do not Know	58	36%
	Yes	82	51%
Group Total		161	100.0%

¹³¹ Bangladesh (Huq 1986), Egypt (Mohammad 1986), Malaysia (Halim 1988b), Pakistan (Khan 1986), and Sudan (Salama 1988b).

¹³² For identifying suitable projects, Islamic banking can profitably draw the services of economists, lawyers, insurance companies, management consultants, auditors and so on.

As the data on table (38) shows, 82 (51 %) believe that ‘Islamic financial institutions (IFIs) should be governed by different set of regulations’. 21 (13%) oppose while 58 (36%) do not know or are undecided.

The findings of this study acknowledge that Islamic banking poises a lot of supervisory challenges that needs to be looked down. However, the supervisory issues that need to be raised are similar in many respects to those of conventional banks, but one should also note that there are a number of potentially difficult questions to resolve, such as liquidity and risk management. But the problems concerned should prove ‘more tractable’, the more they were understood by supervisors and regulators.¹³³

4.4.3 Socio-Cultural Challenges

One of the major problems facing Islamic banking in its current time is the wrong association with specific religion. To make the situation a little bit complicated, what was even more unfortunate is the recent wrongful and unfounded association of Islamic banking with the global terrorism movements and geopolitics that dominated world affairs in the past decade.

To get respondent’s view on this specific issue, respondents were asked whether they ‘think that Islamic Banking is wrongly associated with specific religion and is the victim of the global events of terrorism and geopolitics?’

Table (39)

	Valid	Frequency	Valid Percent
	No	34	21%
	I Do not Know	42	26%
	Yes	87	53.%
Group Total		163	100.0%

¹³³ Financial Services Authority, Islamic Finance in the UK: Regulation and Challenges, November 2007

According to data on table (39), 87 (53%) of the respondents believes that the ‘*think that Islamic Banking is wrongly associated of with the global events of terrorism and geopolitics?*’ while 34 (21%) of the respondents disagree. However, (26) % of the respondents do not know or undecided.

4.4.4 Respondents’ Rating of Major challenges facing Islamic Banking in Ethiopia

The different categories of respondents to this study were asked to mention the major challenges that are facing Islamic banking currently. Respondents gave rating to their assessment for each of the following items identified as major problems facing Islamic banking by putting them in the order of their difficulty according to their assessment. They gave a rating of (No.1) for the challenge that they believe as the most serious challenge, (No. 2) for the second most serious challenge, (No.3) for the third most serious challenge and so forth.

Table (40) Respondents’ Rating of the Major Challenges Facing Islamic Banking in Ethiopia

Major Challenges Facing Islamic Banking	N=(165)	
	F	%
Lack of Awareness and Understanding	66	40
Legal, Supervisory, regulatory and/or institutional challenge	59	35.75
Negative attitude of people (wrong association with religion)	20	12.1
Lack of Trained Human Resource	11	6.7
Capital Resource Constraints	9	5.5
Lack of demand and market potential	-	-
Lack of suitable banking policies	2	1.2

The above table shows that the major challenges that are facing Islamic banking in Ethiopia are in the order of their seriousness as rated by respondents. The most serious challenge was lack of awareness and understanding (40%), legal, supervisory, regulatory and/or institutional challenge (35.75%), negative attitude of people towards

Islamic Banking (wrong association with religion) (12.1%), lack of trained Human resource (6.7%) ,capital resource constraints(5.5%), lack of suitable banking policies(1.2%) where the main challenges according to respondents' assessment.

4.4.5 Respondents' Suggestions for how to facilitate the establishment of Islamic banking in Ethiopia

The respondents to this survey were asked to suggest what measures they think should be taken to stream line the process of establishing Islamic banks in Ethiopia and how to do away with the challenges facing Islamic banking. The suggestions of their respondents are presented in Tables (41) below.

Table (41) Respondents' Rating of suggestions (N=165)

Measures/Actions to be taken	N	%
To create awareness to the general public and to Muslim community in Particular	38	35.33
To remove any legal or regulatory obstacle that will unnecessarily hinder the progress of Islamic Banking	19	28.67
To initiate institutional restructuring and capacity building for the regulatory and supervisory authorities (i.e NBE), their employees and officials	10	13.67
To fill the gap observed in Human resource by arranging training and capacity building programs at the HEIs	7	11.67
To promote Islamic Banking by arranging different academic and business forums	2	6.37
To promote banking policies that will encourage innovation and competition in the financial industry	1	5.96

As table (41) indicates, respondents suggested the most important measures that should be taken in order to address the challenges facing Islamic Banking in Ethiopia. The most important measures respondents suggested were, to create awareness to the general public and to Muslim community in Particular (35.33%), to remove any legal or regulatory obstacle that will unnecessarily hinder the progress of Islamic Banking (28.67%), initiate institutional restructuring and capacity building for the regulatory and supervisory authorities (i.e NBE), both their employees and officials (13.67%), to fill

the gap observed in Human resource by arranging training and capacity building programs at the HEIs (11.67%), to promote Islamic Banking by arranging different research, academic and business forums (6.37%), to promote banking policies that will encourage innovation and competition in the financial industry (5.96%).

Chapter five

Conclusions and Recommendations

In this chapter the conclusions recommendations about the results of the study on prospects and challenges of Islamic Banking in Ethiopia and the will be presented. The major and important conclusions and recommendations about the prospects, awareness, general understanding, misconceptions, challenges as well as the need for Islamic banking in Ethiopia will be summarized in the following sections of this chapter.

5.1 Conclusions

In Ethiopia, most of the developments of Islamic finance have taken place in the last four years and limited, simple, uncomplicated and relatively uncompetitive *Sharia-compliant* products that compared unfavourably to their conventional equivalents are offered by few commercial banks¹³⁴. However, these, did not, cater for the wider Muslim consumers¹³⁵ and the existence of full set of *Sharia-compliant* financial products in the Ethiopian financial industry is yet something to be seen¹³⁶.

To be, specific, the 2008 ‘Banking Regulation and Supervision Proclamation’ has already crafted a room for non interest banking¹³⁷ while the sequent directive issued by National Bank of Ethiopia (NBE) has only allowed for the “Existing banks’ to provide ‘interest-free banking windows’ while killing the long awaited hope for full-fledged Islamic banking.

¹³⁴ like Commercial Bank of Ethiopia (CBE), Somali Micro-finance Institution (SMFI) and NIB Bank

¹³⁵ Moreover, these products fell outside the scope of the mainstream consumers and did not generate significant volumes of customers and transactions.

¹³⁶ I.e the Special Demand Deposit offered by the commercial bank of Ethiopia (CBE) and the *Amanah* (or Safe-guarding) Account and the Micro-credit scheme (*Murabahah* offered by the Somali Micro-finance Institution (SMFI).

¹³⁷ Capital Ethiopia News - Islamic Banks to enter financial sector.mht

5.1.1 Demographic Variables of the Respondent

From the total sample of 165 respondents, 141 (85.5%) of them were male while the rest was female, 89 (53.9%) of them fall in to the age category between 18-30Yrs, 73 (44.2%) of them are in the age category between 31-50Yrs while (31.8%) of them are in between 51-70Yrs.

8 (4.8%) of the respondents do not have any formal education, 190 (11.5%) of them have some primary education, 33 (20.0%) of the respondents have completed high school education while 105 (63.6%) of the respondents have some tertiary level education.

With regard to occupation, 7 (4.2%) respondents were Somali Micro-finance Institution (SMFI) employees, 40 (24.2%) of them were commercial banks employees, 40 (24.2%) of them were entrepreneurs or traders while 40 (24.2%) and 38 (23.0%) of the respondents respectively were government employees and respondents labelled as Others'. Finally, 98 (59.4%) of the respondents were Muslims, 56 (33.9%) of them were orthodox Christians while 11 (6.7%) of them were Protestants.

5.1.2 Major Findings of this study

The mean value for awareness (33.34) is less than the expected average score of (36). This indicates low level of awareness about the operations of Islamic banking¹³⁸. In addition, most of the respondents, 118 (72.0%), did heard about Islamic banking. However, the overall low awareness score may be attributed to lack of understanding and awareness about its nature and operations or may be due the fact that most of the respondents are familiar with the prohibition of *Riba*.

¹³⁸ These findings are actually consistent with what Islamic Banking literature has revealed about the operations of Islamic Banking

Moreover, significant number of respondents does not understand that Islamic banking is something relevant and beneficial to the growth and development of the Ethiopian economy which is a testimony to how far people misunderstood about the relevance of Islamic banking to the Ethiopian economy.

When respondents' awareness about Islamic banking were further explored, (100) 60.6 % of the respondents differentiate on the criteria that in fact '*one is interest-oriented while the other is profit –oriented*', (26). It is clear from this observation that significant portion of respondents', (40%) did not understand or in fact has misunderstood the difference between Islamic and conventional banking. However, there is an extensive research and rich Literature that has shown there difference¹³⁹.

The research further explore if awareness score among different followers exist. The mean awareness score for respondents, (Muslims= (36.09), Orthodox Christians= (27.85) while that of Protestants= (36.64)) shows significant variance, { $F=46.2$, $p<.05$ }, *Tukey* HSD test results shows that Orthodox Christians have significantly lower awareness score than mean values for all other religions¹⁴⁰.

According to the result, the awareness Mean score (university or college degree=36.13, high school=28.33 the highest and the lowest awareness score respectively), shows variance, ($F(3,150) = 22.06$, $P<.05$), due to educational level and *Tukey* HSD test results shows that awareness score for value of highly educated respondents is significantly higher than mean values for all other categories¹⁴¹. Thus,

¹³⁹ Mahmoud Amin El-Gamal, A Basic Guide to Contemporary Islamic Banking and Finance Rice University, June 2000 (elgamal@rice.edu.<http://www.ruf.rice.edu/~elgamal>)

¹⁴⁰ The fact that non-Muslims negatively affect the awareness and understanding towards the operations of Islamic Banking goes in line with other studies that focus on awareness and attitude on many issues.¹⁴⁰

¹⁴¹ The mean scores for other categories, are not significantly different in statistical terms.

the highly educated respondents are more aware about Islamic banking and positively affect the awareness towards the operations of Islamic Banking¹⁴².

Moreover, ANOVA test for awareness mean value, ((SMFI) employees= (40), government employees= (38.42), Entrepreneurs/traders= (32.38), Commercial Banks employees= (32.1), others= (30.12), shows there is significant awareness score differences, ($F(4,149) = 12.514, P < .05$), due to different occupation while the test results for *Tukey HSD* test have shown that wareness Mean score for SMFI and government employees, (Mean=40.0) and (Mean= 38.42) respectively, are significantly higher than that of all other respondents category.

As substantiated by the results for this observation, majority of the respondents have shown a lot of misconceptions about Islamic banking. For example, 81 (49.4% of) respondents believe that '*Islamic banking is only-for-Muslims affair*', (62.2%) do not agree that '*interest is prohibited in all major religious scriptures and not only in the Holly Qur'an*' or did not know¹⁴³ while another 86 (52.4%) of respondents either do not think '*that Islamic banking is something equally beneficial to other communities*' or actually donot know at all¹⁴⁴.

Moreover, the results for this study demonstrate respondents' gross misunderstanding regarding the operations of Islamic banking. For example, 110 (67%) of the respondents either disagree or donot know totally about this fact that '*Islamic banking operates in non-Muslim majority countries as well as western countries that have a small number of Muslim communities and well established conventional banking and*

¹⁴² This goes in line with other studies that focus on awareness and attitude on many issues.

¹⁴³ However, interest is considered as evil even in non Muslim literature, such as the great western classics, the Old and New testaments and in 19th century literature and writings.

¹⁴⁴ This contradicts what has been observed for Islamic banking in economic and finance literature.

*a significant number of Non-Muslim customers are using them where they exist*¹⁴⁵.

While nearly 64 (40%) of them do not believe that *‘Islamic finance proposes strong alternative system with profitable, well governed, transparent and sustainable institutions that would provide a successful and comparable set of financial products’*.

Finally, majority of the respondents, (108) 65.9%, do not know *‘any financial Institution in Ethiopia that currently provides financial services that are in line with Islamic banking services’*. Again this is another indicator of the level of awareness that respondents have exhibited¹⁴⁶.

5.1.3 Prospects and Opportunities of Islamic banking in Ethiopia

The prospect of Islamic Banking in Ethiopia looks very bright. More than 30 million Ethiopian Muslims everywhere want Islamic Banking and offers huge opportunities to exploit. Also, it is pertinent to mention here that Islamic banking is not meant for Muslims only but non Muslims may also avail the benefit of it.

While *Sharia* compliant investment avenues are now becoming available in most countries, Ethiopia has not yet seen that development¹⁴⁷ which would have attracted large number of Muslims who are considered unworthy of credit and other dealings by the existing commercial banks.

To examine the prospects and opportunities of Islamic banking in Ethiopia, certain questions that relates to its prospects and opportunities where addressed to the participants of this study to quantify respondents’ assessment of the prospects of Islamic banking in Ethiopia.

¹⁴⁵ Islamic finance has become a global system spreading as far as Asia, the Middle East, and the Western world. Islamic banking is not limited only to the Muslim nations in the Middleast but also exists in developed economies such as the USA, Europe, and the Far East as far as to china.

¹⁴⁶ There some selective institutions like Somali Micro-finance Institution provides some basic *Sharia-Compliant* products and some commercial Banks that provide non-interest bearing but also non-rewarding special demand deposit accounts that roughly matches Islamic Financial Institutions (IFI)’s *Amanah Accounts*.

¹⁴⁷ (www.islamicequity.co.in)

The mean value of Prospects Score for the respondents was found to be (23.33, SD= (5.49), Min= (13), Max= (30)). This indicates that the prospects score of respondents with regard to the operations of Islamic banking is high and higher than average expected score (20) and is actually consistent with other studies regarding the prospects of Islamic Banking in Ethiopia.¹⁴⁸

The mean Prospects score, (Muslims= (26.59), Orthodox Christians= (17.852) while that of Protestants= (22.5), show significant variance, {F=96.11, p<.05}, while *Tukey* HSD test results shows that mean value for Orthodox Christians and Protestants do not differ significantly in statistical terms.

The Prospects mean score for respondents with different occupation, (SMFI= (Mean=28) commercial banks employees= (21.2), the highest and the lowest respectively), shows significant statistical variance, {F=5.251, p<.05}, while *Tukey* HSD test results shows that prospects mean value of SMFI employees and commercial banks employees, differ significantly from other respondent categories while other three respondents' categories are not statistically and significantly different. This shows higher assessment, equal or higher than the expected value, for prospects of Islamic banking.

The Prospects mean score, (Illiterates= 26.25, primary education= 21.24 the highest and the lowest respectively), shows variance that is statistically significant, {F=2.803, p<.05}¹⁴⁹.

¹⁴⁸ S.sankaramuthukumar and a.devamohan has found in their paper *entitled the potentiality of Islamic banking in Ethiopia* and presented at the sixth conference on the Ethiopian Economy, June 2008 – Addis Ababa

¹⁴⁹ While *Tukey* HSD test results show that prospects mean value of Illiterate, (Mean=26.25) and Primary education, (Mean 21.24), respondents differ significantly from the other respondents' categories.

The study further investigated the prospects and opportunities of Islamic banking in Ethiopia. for example, *113 (68.5%) respondents feel that there is a need for Islamic banking in Ethiopia so that to alleviate the financial services deprivation of the Muslim community while 65.5% of respondents believe that the Muslim community is economically disadvantaged due to the fact that they do not have alternative financial services that are in line with their religion and that it will affect the social mobility, progress and affluence in the long run.*

The significant Muslim population in Ethiopia offers the opportunity for substantial customers that would patronize Islamic banking system is enormous¹⁵⁰. Moreover, a soundly financed and prudently managed Islamic institution would not only be ‘good for Muslim consumers’ but also would do good for innovation and diversity in our markets and good for Ethiopia as a regional, middle income economic power house.

Significant number of respondents, (116) (70.7%), who ‘*use banking services*’, use banking services to ‘*safeguard or keep the safety of their money*’. These respondents put ‘*guarantying the safety of their money*’ as their first priority rather than ‘*earning interest*’.

86 (52.12%) of the respondents ‘*Have cancelled (or would cancel) a plan for business expansion and/or new investment opportunity to be financed by bank loan due to the fact that bank (investment) loan involves interest?*’ While another significant number of respondents believe that ‘*interest based banking system*’ do not ‘*encourage Muslims to consider all possible business and investment opportunities*’ and such sentiments offer significant opportunity and prospects for Islamic banking.

¹⁵⁰ Particularly since Islamic banks are also known to favor a great number of less privileged people through financing small and medium scale enterprises.

This also clear sign that significant number of Muslims would not look for interest based banking services or loans to '*cover their short and long term financial shortage*' and of course they will opt for unconventional ways of financing such as '*borrowing from relatives and friends*', or the '*liquidation of fixed assets*', For example, (99) 61.1% of the respondents believe that '*the tendency of business expansion and investment activity will increase*' and access to Islamic banking would improve if the existing banks began to offer financial products that are in line with Islamic banking.

5.1.4 Challenges Facing Islamic banking in Ethiopia

5.1.4.1 Lack of Awareness about Islamic banking

Despite the growth of Islamic banks over the last 30 years, lack of awareness has been reported as one of the major problems facing Islamic banking. In Ethiopia, the growth and progress of Islamic Financial services remained stuck for almost half a decade since the first individual and group initiatives surfaced in early 2008¹⁵¹.

So, to assess this, respondents were asked to rate and share their view regarding Muslim community's awareness on Islamic Banking. In response, (63) 38.2% of the respondents believe that the Muslim community does not have '*sufficient awareness*' about the operations of Islamic banking¹⁵².

5.1.4.2 Regulatory Challenges

Regulatory challenges are among the main challenges facing Islamic banking in Ethiopia. So, for further understanding about the regulatory challenges facing Islamic

¹⁵¹ Nothing much has changed since then. Not a single 'Full-fledged' Islamic Financial Institution has come out yet though there were so many publicized initiatives to establish what was dubbed as the first Islamic Financial Institution in Ethiopia. Moreover, any government led-initiative or program has yet to come from the concerned authorities.

¹⁵² The findings of this study support what has been reported in Islamic banking literature as one of the main problems, despite the growth of Islamic banks over the last 30 years.

Banking in Ethiopia, specific items that that will reveal respondents' assessment about the current banking regulatory regime were addressed to them.

of the respondents believe that the '*2010 NBE banking supervision Directive*' that blocked the initiatives for full-fledged Islamic Financial Institutions while allowing the opening of '*Islamic Windows*' through the existing commercial banks '*was not constructive*'.

According to the findings of the study, 78 (47%) of the respondents believe that '*the banking proclamation of 2008 provides the first legal clue for Islamic banking services and the NBE has allowed that Islamic financial services to be offered through 'Special Windows*'. Another, 93 (56.4%) of the respondents believe that the '*2010 NBE banking supervision Directive that blocked the initiatives for full-fledged Islamic Financial Institutions 'was not constructive*' or help full while another 88 (55%) believe that the current Financial Institutions regulatory and supervisory regime poise certain setbacks to the establishment of Islamic banks.

5.1.4.3 Institutional Challenges

Islamic banks in different countries are in early stages of learning and experience lacks the flexibility to choose arrangements which best suits their need in responding to structural shifts in the economic setting as well as to changes in consumer preferences. So, in addition to the regulatory challenges facing Islamic Banking, it's also important to explore the institutional challenges as well.

In this regard, 87 (53.4%) of the respondents believe that '*NBE needs Institutional rearrangements in re order to accommodate the special institutional need that Islamic banking requires* while only 83 (51.2%) of the respondents believe that that the '*Conventional Financial Institutions*' will not '*win the hearts and minds of the Muslim*

community and seduce them to use financial services they deliver through subsidiary or 'Specialized Windows'.

Moreover, 107 (66%) of the respondents believe it would have been better, if *'Islamic financial services are provided separately'* while 93 (57.4%) of the respondents believe that there is a gap in research and development in Islamic studies in general and Islamic finance and economics in particular and that the government should initiate Islamic Studies Programmes¹⁵³.

This shows that *'Conventional'* Financial Institutions will have hard time to promote its products *as purely Islamic and appeal to the more zealous customers* while they are dealing with *interest or /Riba/*.

The other item that explains the intuitional challenge facing Islamic Banking in Ethiopia is about the absence of qualified human resource as well as support and link institutions, like interest-free Money and Capital Markets. For example, in Ethiopia, all banking professionals have been trained in conventional finance and economics and they lack the requisite vision and conviction about Islamic banking.

To assess these specific challenges, 84 (52.8%) of the respondents think that lack of -supportive and link institutions like Interest free Money Market and capital markets would create liquidity and other operational difficulties to Islamic banking.

These findings go in line with the main problems identified by a number of case studies of Islamic banks operating in different countries. Some of these are the

¹⁵³ This finding is consistent for what have been reported for any system building including Islamic banking system.

absence of suitable non-interest-based financial instruments for money and capital market transactions¹⁵⁴¹⁵⁵.

5.1.4.5 Supervisory Challenges

The top banking regulator on land, the National Bank of Ethiopia (NBE), has not been open to the development of Islamic finance in Ethiopia at least for now¹⁵⁶¹⁵⁷.

The findings of this study acknowledge that Islamic banking poses a lot of supervisory challenges that needs to be looked down. For example, 82 (50.9%) believe that *Islamic financial institutions (IFIs) should be governed by different set of regulation*.

However, the supervisory issues that need to be raised are similar in many respects to those of conventional banks, but one should also note that there are a number of potentially difficult questions to resolve, such as liquidity and risk management. But the problems concerned should prove ‘more tractable’, the more they were understood by supervisors and regulators.¹⁵⁸

5.1.4.6 Socio-cultural Challenges

One of the major problems facing Islamic banking in its current time is the wrong association with specific religion and even more unfortunate was the wrongful and unfounded association of Islamic banking with the global terrorism movements in the recent times. For example, 87 (53.4%) of the respondents believes that the ‘*think that*

¹⁵⁴ without which Islamic banks will not have adequate instruments to meet the pre-condition for liquidity management and effective maturity transformation

¹⁵⁵ Bangladesh (Huq 1986), Egypt (Mohammad 1986), Malaysia (Halim 1988b), Pakistan (Khan 1986), and Sudan (Salama 1988b).

¹⁵⁶ the first important signal was given in a meeting with the prime minster by a group of organizers and Muslim business men with Prime Minster Meles, in 2008

¹⁵⁷ Capital Ethiopia News - Islamic Banks To Enter Financial Sector.Mht

¹⁵⁸ Financial Services Authority, Islamic Finance in the UK: Regulation and Challenges, November 2007

Islamic Banking was wrongly associated of with the global phenomenal events of terrorism and geopolitics?'

5.1.5 Respondents' Rating of Major challenges facing Islamic Banking in Ethiopia

The major challenges that are facing Islamic banking in Ethiopia are in the order of their seriousness according to respondents' rating and assessment. Respondents put in this order, lack of awareness and understanding (40%), legal, supervisory, regulatory and/or institutional challenge (35.75%), negative attitude of people towards Islamic banking (wrong association with religion) (12.1%), lack of trained human resource (6.7%), capital resource constraints (5.5%), lack of suitable banking policies (1.2%) and lack of demand and market potential (0%).

5.2 Recommendations

The Ethiopian banking sector has opened up considerably in the past decade or so and openness to interest-free banks is a logical next step. The potential benefits of allowing Islamic banking include; decreased economic disparity between the haves and the have not's, better integration, and consequently accelerated economic growth. Such inclusive growth will aggrandize the Ethiopian economy.

Interest free banking is another area that falls broadly in the ambit of financial infrastructure. Government of Ethiopia can leap a step closer towards the fulfilment of the much cherished dream of "Middle Income Country" by reforming its banking sector and allowing the establishment of Islamic Banks¹⁵⁹. To date, the NBE has authorised the establishment of 'Special Islamic Windows' by the existing financial institutions but not wholly Islamic banks.

¹⁵⁹ An article on IB in india

As banking regulator, the National Bank of Ethiopia (NBE), should take an open approach and show unmistakably that they had 'no objection in principle to the idea of Islamic banking by recognizing it's growing importance in Ethiopia and its emergence on the 'international stage' as well as the need to put Islamic banking in the context of social equity and fairness.

Ethiopia has 'a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in Ethiopia. A soundly financed and prudently managed Islamic institution would be 'good for Muslim consumers, good for innovation and diversity in our markets and would be instrumental for Ethiopia to be a regional, middle income economic power house.

The supervisory issues that need to be raised are similar in many respects to those of conventional banks, but one should also note that there are a number of potentially difficult questions to resolve¹⁶⁰. However, these problems should prove 'more tractable', the more they were understood by supervisors.

To translate these sentiments into practice, a high-level working group reinforced by working level contact by financial institutions and chaired by top financial regulators, with representatives from the government, the Muslim community should be established to pave the way for Islamic finance in the Ethiopia. These and other links would lay the foundation on which the NBE would be able to consider the authorisation of wholly Islamic firms.

For successful adoption, Islamic banking can profitably draw the services of different link institutions including research and training institutions and forums in order to promote entrepreneurship amongst their clients. Such and similar support services are

¹⁶⁰ I.e liquidity and risk management.

instrumental and needs to be properly oriented towards the success of Islamic banking¹⁶¹.

Moreover, in Ethiopia, all banking professionals have been trained in conventional economics and finance and hence, they lack the requisite vision and conviction about the efficiency of the Islamic banking. So, there is a need for qualified banking professionals that are trained in Islamic banking and finance.

Here, in Ethiopia, interest-free banking is provided in a limited manner through SMFI, it's recommended that measures be taken to create a framework for the delivery of interest-free finance on a larger commercial scale through full-fledged Islamic Financial Services Institutions (IFSIs) without any adverse systemic risk impact. This is in consonance with the objectives of inclusion and growth through innovation.

Ethiopian banking laws do not explicitly prohibit Islamic banking but there are provisions that make Islamic banking almost an unviable option.

Islamic banking and finance products will provide opportunities to invest and borrow according to Islamic ethical principles as defined in *Shari'ah* law, while still offering the benefits of diversification and a full range of banking products. Moreover, large number of Muslims who are considered unworthy of credit by commercial banks would welcome Islamic banking.

In addition, Islamic banking could be a huge political issue. Certain parties might abhor the use of the word "Islamic" and could term it as anti-Ethiopian by arguing that the very concept of *Sharia* banking would go against the secular fabric of our nation. Equally true is the, compartmentalization of *Sharia* compliant and Non *Sharia*

¹⁶¹ So, if Islamic banking is to be realized in Ethiopia, adequate financial mechanisms and a number of link institutions still has to be developed, without which financial intermediation, especially the risk and maturity transformation, will not be performed properly¹⁶¹

Compliant banking might be used by certain vested interest to communalize the finance sector in Ethiopia. Such questionably sane but unquestionably dangerous trend must be prevented with full might.

Table (41) Respondents' Rating of suggestions (N=165)

Measures/Actions to be taken	N	%
To create awareness to the general public and to Muslim community in Particular	38	35.33
To remove any legal or regulatory obstacle that will unnecessarily hinder the progress of Islamic Banking	19	28.67
To initiate institutional restructuring and capacity building for the regulatory and supervisory authorities (i.e NBE), their employees and officials	10	13.67
To fill the gap observed in Human resource by arranging training and capacity building programs at the HEIs	7	11.67
To promote Islamic Banking by arranging different academic and business forums	2	6.37
To promote banking policies that will encourage innovation and competition in the financial industry	1	5.96

As table (41) indicates, respondents suggested the most important measures that should be taken in order to address the challenges facing Islamic Banking in Ethiopia. The most important measures respondents suggested were, to create awareness to the general public and to Muslim community in Particular (35.33%), to remove any legal or regulatory obstacle that will unnecessarily hinder the progress of Islamic Banking (28.67%), initiate institutional restructuring and capacity building for the regulatory and supervisory authorities (i.e NBE), both their employees and officials (13.67%), to fill the gap observed in Human resource by arranging training and capacity building programs at the HEIs (11.67%), to promote Islamic Banking by arranging different research, academic and business forums (6.37%), to promote banking policies that will encourage innovation and competition in the financial industry (5.96%).

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Appendix A

Glossary of Islamic Banking and Finance

Allah: The Creator, an Administrative of the Universe; God

Amanah: Trust, with associated meanings of responsibility, truthfulness and sincerity. As an important secondary meaning, the term also identifies a contract where one party keeps another's funds. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. Now a day's HSBC has maintained Amanah bank accounts.

Arbun: Down payment; a non-refundable deposit paid by the buyer to the seller upon finishing a contract of sale, with the condition that the contract will be completed during the prearranged period.

Gharar: (Uncertainty) is a sophisticated concept that covers certain types of insecurity or contingency in an agreement. The prohibition on gharar is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.

Halal: Any activity or transaction that is according to law and also permitted in Islam is known as Halal.

Haram: Any business or contract that is unlawful and also prohibited in Islam is known as Haram.

Islamic banking: Financial services that meet the requirements of the Sha'riah or Islamic law. While designed to meet the specific religious requirements of the Muslim customers, Islamic banking is not restricted to Muslims: both the financial services provider and the customer can be non-Muslim as well as Muslim.

Ijara: Ijara is a kind of lease; it allows the bank to earn profits by charging rentals on the assets leased to the customer. Ijara wa Iqtinah extends the concept to a hire purchase agreement.

Maysir: (Gambling) one of three fundamental prohibitions in Islamic finance. The prohibition on maysir is often used as the grounds for criticism of conventional financial practices such as assumption, traditional insurance and derivatives.

Mudaraba: is an investment partnership, whereby the investor (the Rub ul Mal) provides capital to another party (the Mudarib) in order to undertake an investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The

mudarib loses its share of the expected income.

Mudarib: The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investors funds in a project or portfolio in exchange for a share of the profits.

Murabaha: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity from a third party and resells it at a prearranged higher price to the capital user. By paying this higher price over instalments, the capital user has successfully obtained credit without paying interest.

Musharaka: profit and loss sharing. It is a partnership where profits are shared as per as agreed ratio whereas the losses are shared in proportion to the investment of each partner.

Prophet: Hazrat Muhammad Mustafa (PBUH)

Quran: The Holy book of Muslims revealed on Hazrat Muhammad Mustafa (PBUH)

Qard: A Qard is a loan, free of interest. Bank use this arrangement for current accounts holders. In essence, it means that Current Account is a loan to the bank, which is used by the bank for investment and other purposes.

Riba: Interest, Usury. The legal concept extends beyond just interest but in simple terms

Riba covers any return of money on money-whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in Islam.

Sha'riah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Sha'riah compliant product meets the requirements of Islamic law. A

Sha'riah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of sha'riah compliant products.

Sha'riah advisor: An independent professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the sha'riah, or Islamic law. While some Islamic banks consult individual Sha'riah advisor, most establish a committee of Sha'riah advisors.

Sha'riah Compliant: An act or activity that complies with the requirements of sha'riah or Islamic law.

Sukuk: Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed income, interest bearing bonds are not

permitted in Islam, hence Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Sukuk is a certificate of equal value representing entire shares in ownership of tangible assets and services or the assets of particular projects or investment activity.

Sunnah: way of life of Prophet Hazrat Muhammad Mustafa (PBUH); They said about anything, they act anything is called as Sunnah.

Surah: Chapters of Quran; there are 540 Sura in Quran.

Takaful: Islamic insurance. Planned as charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of traditional insurance (i.e., interest and gambling) that are challenging for Muslims.

Tawarruq: Reverse Murabaha. As used in personal financing, a customer with an actual need buys something on credit from bank on a deferred payment basis and then instantly resells it for cash to a third party. In this way, the customer can take cash without taking an interest-based loan.

Wakala: Wakala is an agency contract which generally includes in its terms a free for the skill of the agent.

Zakat: Zakat is one of the five pillars of Islam. It is obligatory for Muslims to pay their wealth to specified categories in society when their annual wealth exceeds a minimum level.

Appendix B

Questionnaire distributed to the respondent

Addis Ababa University

School of Graduate Studies

Masters of Business and Administration

Questionnaire for Data Collection

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

Thank you in advance for your time and honest response.

Important aspects of the questionnaire

1. There is no need to write your name or any other personal identity
2. For multiple choice questions, mark or circle the answer of your choice
3. You can select more than one answer, if applicable

Part I: Awareness Items

Instruction: Below are items which deal with respondents’ awareness about the nature and operations of Islamic banking, and items that will rate respondents’ score of prospects and challenges facing Islamic banking. The items included in this questionnaire are all closed-ended questions. The respondents will be instructed for a list of statements and they will tell whether they agree, disagree or do not know as their answer to that specific item.

No.	Awareness items	Agree	Disagree	I don't know
1.	Do you ever heard about Islamic banking?			
2.	Do you think that Islamic financial services are relevant and have a role to play in the development and growth of the Ethiopian economy?			
3.	Do you think that the interest factor under conventional banking and profit factor under Islamic banking system are two different concepts?			
4.	Do you think that Islamic banking is the fastest growing financial sector globally?			
5.	Do you know that interest is prohibited in all major religious scriptures and not only in the Holly Qur'an?			
6.	Do you think that Islamic banking is 'only-Muslim' affair?			
7.	Do you think that Islamic banking is something equally beneficial to other communities?			
8.	Do you know that Islamic banking operates in non-Muslim majority like western countries that have a small number of Muslim community side-by-side with their well established conventional banking and has a significant number of Non-Muslim customers?			
9.	Is there any financial Institution in Ethiopia that currently provides financial services that are in line with Islamic banking services?			
10.	Do you believe that Islamic financial system proposes strong alternative system with profitable, well governed, transparent and sustainable institutions that would provide a successful and comparable set of financial products?			
11.	Do you believe that the Muslim community is economically disadvantaged due to the lack of alternative financial services that are in line with their religion and it will jeopardize the social mobility and progress of the Muslim			

	community?			
12.	Does interest is prohibited in Islam?			
13.	Do you think that Islamic banking is wrongly associated with the global phenomenon of extremism and terrorism?			
14	Do you think that payment and receipt of interest is what best describes the difference between conventional and Islamic banking?			
15	Do you think that the notion 'Islamic banking is for only Muslim society while conventional bank is for others' is true?			
16	do you think that the profit factor under Islamic banking and the interest factor under conventional banking are two different concepts?			
17	Do you think that Somali Micro finance institution provides any <i>Sharia-complaints</i> products?			
18	Do you think that some commercial banks provide some simple <i>Sharia-compliant</i> financial products such as the 'Interest-free savings accounts?			

Part Two
Prospects and Opportunities of Islamic banking

		Agree	Disagree	I don't know
1.	Do you believe that the current global trends in Financial Services will have positive manifestations on the future of Islamic banking in Ethiopia?			
2.	Have you ever cancelled (<i>or would cancel</i>) a plan for business expansion and/or new investment opportunity to be financed by bank loan due to the fact that the interest based banking system does not encourage Muslim business community to consider all possible business and investment opportunities?			
3.	Do you think there is a need for Islamic banking in Ethiopia so			

Part Three Challenges Facing Islamic Banking

	that it will alleviate the financial services deprivation of the Muslim community?			
4.	Do you think that, if the existing banks offer certain Islamic products (Saving and Loan Service), the access to Islamic banking will improve and the tendency for business expansion and investment activity will increase?			
5.	Do you think that SMFI 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?			
6.	Do you believe the current commercial banks, public or private, will engage in Islamic banking services that will address the Muslim community's need for Islamic banking services any time soon?			
7	If you are banking services user currently, do you think that 'Safety / keeping money safe' is your first priority?			
8	Do you think that the likely reason(s) that many Mslims are not using banking services currently is due to the fact that 'Savings and loan services involve interest?			
9	Do you think that people would use <i>investment</i> loan service 'due to its attractiveness and ease access?			
10	Do you think that the 'high prohibitive interest rates' that conventional banks charge is the main reason that loan services are not currently widely used?			

Part three

Challenge Items

Instruction: Below are items which deal with respondents' view on challenges facing Islamic Banking. These items will explore respondents' assessment of challenges facing Islamic banking. The items included in this questionnaire are all closed-ended questions. Respondents will be instructed for a list of statements and they will tell whether they agree, disagree or do not know as their answer to that specific item. Moreover, respondents will give a rating according to their understanding for certain identified challenges facing Islamic Banking in Ethiopia.

No	Item	Agree	Disagree	I Do not Know
1.	Do you think that the Muslim Community has awareness about Islamic banking system?			
2.	Do you think that the banking proclamation of 2008 provides the first legal clue for Islamic banking services and NBE's 2010 banking supervision Directive blocked ongoing initiatives for full-fledged Islamic Financial Institutions while allowing the opening of 'Islamic special windows' through the existing commercial banks? (review)			
	Do you think that NBE needs Institutional rearrangements in re order to accommodate the special institution need that Islamic banking?			
4.	Do you believe there is a gap in research and development in Islamic studies in general and Islamic finance and economics in particular and that the that the government should initiate Islamic Studies Programmes in Higher Education Institutions (HEIs) to fill the gap in qualified human resource?			
5.	Do you believe that the current Financial Institutions regulatory and supervisory regime such as those governing initial paid up capital, reserve requirements and risk management approaches poise certain setbacks to any ongoing or future initiatives to establish Islamic financial institutions?			
6.	Do you believe that 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?			
7.	Do you think that lack of supportive and link institutions like Interest free Money Market and capital markets would create liquidity and other operational difficulties to Islamic Banking?			
8.	Do you think that SMFI have enough qualified scholars in Islamic banking to ensure that Islamic banking Services are up to date and fully comply with <i>Sha'riah</i> law?			
9.	Do you think that the current SMFI's/CB customers are fully satisfied with the range of products that you provide or, simply, they are not demanding more flexible and suitable products?			

1. For the following table, give your rate for each of the following items identified as major problems facing Islamic banking by putting them in the order of their difficulty according to your assessment. You will give 1 in the rate column in front of the description for the challenge that you assess as the most serious challenge, 2 for the second most serious challenge, 3 for the third most serious challenge and so forth.

Personal information

After I read you each item, you tell me the answer.

6. Kebele _____