



# **ADDIS ABABA UNIVERSITY**

## **College of Law and Governance Studies**

### **School of Law**

#### **Adequacy of Legal Framework Regarding Islamic Banking in Contemporary Ethiopia**

A Thesis submitted to Addis Ababa University, College of Law and Governance Studies, School of Law in Partial Fulfillment of the Requirements for the Degree of Master of Business Law (LL.M)

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## Declaration

I, the undersigned, declare that this thesis is my original work and has not been presented for a degree at any other university, and that all sources of materials used in the thesis have been duly acknowledged.

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## **Acronyms and abbreviations**

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
CBs	Conventional Banks
IBs	Islamic Banks
IFB	Interest-Free Banking
IF	Islamic finance
IFSB	Islamic Financial Services Board
IFIs	Islamic financial institutions
IFSI	Islamic Financial Services Industry
IL	Islamic Law
NBE	National Bank of Ethiopia
PLS	Profit and Loss Sharing
SAB	Sharia Advisory Board
SDLT	Stamp Duty Land Tax
SSB	Sharia Supervisory Board
UK	United Kingdom

**Abstract**

This thesis examines whether Ethiopia's existing legal framework for Islamic banking within its interest-free banking system is adequate. To this end the thesis has focused on *Musharakah*, *Mudarabah*, and *Murabaha* financing. Through a thorough review and analysis of relevant laws, supplemented by modest interviews and comparative experience, the study assesses the alignment of existing legal structures with Islamic banking principles. The findings reveal both areas of congruence and disparity between Islamic banking principles and Ethiopian legal norms, highlighting potential legal hurdles for Islamic banking development. Drawing insights from comparative analyses of Indonesia and the United Kingdom, the study proposes key lessons for Ethiopia. It emphasizes the necessity of regulatory clarity and an improved legal framework to nurture Islamic banking growth while ensuring compliance with Ethiopia's legal and financial stability objectives.



## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background of the Study

The banking sector plays a vital role in the growth and development of economies and societies. Acting as intermediaries, banks receive funds from savers and extend credit to borrowers for investment purposes.<sup>1</sup> This allocation of funds towards productive assets stimulates economic prosperity and growth. Without financial intermediaries like banks, the intertemporal transfer of resources would be constrained, hindering investment and consumption. Banks enable the flow of funds from surplus units to deficit units, allowing firms to finance investments and individuals to access credit for consumption, ultimately driving economic development.<sup>2</sup> The efficacy of commercial banks is assessed by their ability to collect savings from entities with surplus funds in the economy and allocate these resources to those with deficits.<sup>3</sup>

Islamic banking is distinct from conventional banking in many respects but has a common goal in achieving the same economic benefit as conventional finance offers to society. There is a basic difference between the intermediary functions played by conventional banks (CBs) and Islamic banks (IBs) in deposit collection from the savers and allocating the funds to the borrowers. CBs operate on man-made principles where a predetermined rate of interest is the core activity. CBs' main source of profit is the difference between the low interest paid to depositors and the high interest rate they charge when lending to the borrower.<sup>4</sup> Generally, CBs pay at least the minimum legally prescribed interest rate for savers and lend the fund at a higher interest rate to the borrower.

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<sup>1</sup>Alexander Dill, *Bank Regulation, Risk Management, and Compliance: Theory, Practice, and Key Problem Areas* (second edn,2020) 17.

<sup>2</sup>Charles A.E. Goodhart, *Financial Development and Economic Growth* (2004) 38.

<sup>3</sup> Mohammed Obaidullah, *Islamic Finance Service* (Islamic Economics Research Center King Abdulaziz University Jeddah, Saudi Arabia 2005) 4.

<sup>4</sup> Mufti Muhammed Taqi, *An Introduction to Islamic Finance* (1998) 11.

On the other hand, the Islamic banking system is based on the principles of Islamic law (IL), which prohibit dealing with interest as it is against religion and guided by Islamic economics, and also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy.<sup>5</sup> In contrast to conventional banking, where the asset's importance lies solely in terms of collateral security and may not necessarily be a part of the loan transaction, Islamic banking employs various contracts such as *Musharakah* and *Mudarabah* (profit-sharing), *Murabaha* (sale at a profit margin), and *Ijara* (lease).<sup>6</sup> Islamic finance (IF) products are designed with an asset-based feature to provide for economic intermediation, as opposed to financial intermediation for conventional finance products. This feature introduces a layer of complexity, which may render it more vulnerable to abuse by offenders. Furthermore, Islamic banking products may have substantial effects on macroeconomic stability if not well regulated. The banks' key role plays in the economy via dispersion of credit, safeguarding well payment scheme and the risk integral to banking business forced the regulators to apply stringent laws in the banking sector.<sup>7</sup> There is a necessity for enacting laws and regulations to protect IBs from being part of the conventional system.

At the international level, IF traces its origins back to the emergence of Islam 1,400 years ago and has subsequently been widely embraced across the Muslim world.<sup>8</sup> Over the past four decades, Islamic banking has grown from a niche to a significant player in the global financial sector, expanding beyond Muslim-majority nations into non-Muslim countries. The recent rapid growth of IF indicates its transition from an alternative to a mainstream banking option. However, this growth has outpaced the development of regulatory frameworks, prompting many countries to embark on legal reforms to support its global expansion. Despite this, a unified regulatory framework is still lacking, crucial for ensuring stability and investor confidence. Similar to CBs, IBs require robust legal frameworks to protect stakeholders' rights and maintain market stability. Regulatory systems influence the structure and implementation of IF laws,

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<sup>5</sup>Abiola Sekoni, *Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System* (2015) 7.

<sup>6</sup> Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking* (The Islamic Foundation 1983/1403 H Reprinted 1994/1415 H 1982) 22.

<sup>7</sup>*Bank Regulation, Risk Management, and Compliance: Theory, Practice, and Key Problem Areas* (n 1) 16.

<sup>8</sup> *Issues in Islamic Banking* (n 6) 22.

highlighting the importance of establishing effective regulatory measures for the industry's soundness and integration into the global financial system. Islamic banking and finance have been acknowledged by international financial institutions, professional bankers, and academic circles. There are over 200 Islamic financial institutions worldwide, managing investment funds exceeding \$250 billion. The annual growth rate of the global Islamic banking industry exceeds 16%. In certain Muslim nations, there has been a shift, either complete or partial, in favor of Islamic banking.<sup>9</sup>

At the Ethiopian level, the year 2008 marked a watershed moment for Islamic banking in Ethiopia. The country recognized, through Banking Business Proclamation No. 592/2008, the inclusion of interest free banking (IFB), thereby introducing this mode of banking. Subsequently, in 2011, the National Bank of Ethiopia (herein after named as NBE) issued Directive SSB/51/2011 to officially authorize the operation of IFB. This directive permits the offering of IFB service at the window level, aligning with IF principles and adhering to standard conventional regulation, except for the exclusion of interest.

Following this Directive, most conventional commercial banks started IFB on windows level. The research done by Wondwosen Teshome investigates the operational challenges and opportunities faced by IFB in Ethiopia, focusing on five selected commercial banks between 2013 and 2018. The researcher identified the primary operational challenge faced by Ethiopian banks offering Islamic banking and finance services as the misunderstanding and lack of standardization of the IFB products. The second significant challenge identified is lack of a "proper legal and regulatory framework"<sup>10</sup>. The finding underlines the critical nature of having clear legislation governing IFB in Ethiopia. The absence of such a framework limits banks' ability to offer IFB services and creates variations in methodologies, modes, and benchmarks.

In Ethiopia, tax laws were enacted when Islamic banks were not allowed, leading to an absence of clear provisions for *Mudarabah* profit sharing and *Murabaha* cost-plus financing to benefit from tax deductions similar to those for interest expenses. Furthermore, the effective operation of

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<sup>9</sup>Salman Syed Ali and Ausaf Ahmad, *Islamic Banking and Finance: Fundamentals and Contemporary Issues* (Islamic Development Bank 2006) 81.

<sup>10</sup>Wondwosen Teshome Girma, *Operational Challenges and Opportunities Faced by Interest Free Banking in Ethiopia*, Unpublished Master's Thesis Addis Ababa University (2018) 47.

Islamic banks requires the establishment of a Sharia Supervisory Board, and there is currently no specialized body to adjudicate disputes related to Islamic banking.

Article 22(2) of Banking Business Proclamation No. 592/2008 (as amended by Proclamation No. 1159/2019) authorizes the NBE to issue a directive to regulate banking businesses related to non-interest-bearing deposit mobilization and fund utilization. Accordingly, the NBE enacted the initial replacement Directive No. SBB/72/2019 permits commercial banks to engage in IFB in compliance with IL principles. The substance of the SBB/72/2019 closely aligns with the initial Directive No. SSB/51/2011. Thus, Directive No. SBB/72/2019 has limitations that impose IFB on operating following conventional statutes, excluding interest and investment deposits.

In contemporary Ethiopia, the growth of IBs reflects a broader trend towards diversification within the country's financial sector. This expansion is particularly notable as it offers an alternative to the conventional banking system. Currently, Ethiopia boasts four full-fledged IBs, alongside seventeen CBs that offer window-based IFB services.<sup>11</sup> The significance of this expansion can be understood in light of Ethiopia's diverse population composition. According to the 2007 census report on populations and housing, approximately 33.9% of the entire Ethiopian population adheres to the Islamic faith.<sup>12</sup> This sizable portion of the population demonstrates the potential demand for financial services that align with Islamic principles, such as IFB.

As such, the emergence and growth of Islamic banking in Ethiopia not only cater to the specific needs of the Muslim community but also contribute to the overall financial inclusivity within the country. It provides an avenue for individuals and businesses to access banking services that are compatible with their religious beliefs, thereby fostering economic participation and development across diverse segments of Ethiopian society. In light of these developments, the researcher has outlined the following statement of the problem and research questions:

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<sup>11</sup> Interview with Temesegen Menza, 'National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner' (30 April 2024).

<sup>12</sup>Federal Democratic Republic of Ethiopia population census commission Summary and statistical report of the 2007 population and housing census, December 2008.

## 1.2. Statement of the Problem and the research question

Due to concerns about participating in transactions that involve interest, the Muslim community is opting to store their savings in less secure locations or engage in individual financial dealings. This approach helps them avoid situations where large sums of money might flow through conventional banking channels at the national level.<sup>13</sup> The concept of Islamic banking seems to have been specifically crafted to address this disparity, offering a banking system free from interest and aligned with Islamic commercial jurisprudence principles. This alternative is gaining widespread acceptance globally as a dependable substitute for traditional banking. In Ethiopia, Art. 22(2) of Banking Business Proclamation No. 592/2008 (as amended by Proclamation No. 1159/2019) authorize the NBE to regulate the IFB business mobilization and utilization of non-interest-bearing deposits by directives. Based on this enabling provision of the Proclamation, the NBE has enacted Directive No. SBB/72/2019, which enables banks to undertake IFB business in accordance with IL principles. The Directive mandates that banks seeking a license to provide IFB services must adhere to the principles of IL. Likewise, Article 22(1) of Banking Business Proclamation No. 592/2008 empowers the NBE to issue directives specifying the conditions and limitations on banks' investments. In line with this authority, the NBE enacted Directive No. SBB/65/2017, titled 'Limitation of Investment by Banks'.

The NBE Directive No.SBB/72/2019 allows commercial banks to engage in IFB in compliance with IL principles. Article 7 of the same directives obliges IFB to comply with *mutatis mutandis* all regulatory and supervisory requirements expect interest rates. Most of the NBE Directives, particularly Directive No.SBB/65/2017, which limit investments by banks, have enacted for the conventional system rather than the Islamic system before the commencement of Islamic banking and finance. The Islamic banking system is based on IL, which prohibits dealing with interest as it is against one of the cardinal principles of the religion. Therefore, there is a necessity for enacting special laws and regulations to govern IBs distinct from the conventional banking system.

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<sup>13</sup>Alyu Abate, The Regulation and Supervision of Interest- Free Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University(2016) 3.

These being the general problems that this study investigates, the specific questions addressed by the research are the following:

1. Are existing Ethiopian laws applicable to banking adequate for interest-free banking practicing Islamic banking? The specific questions to explore in this regard include:
  - a) Is Article 4.4 of Directive No. SBB/65/2017, which limits a bank holding up to 10% equity shares in a single non-banking business other than insurance, applicable to Islamic banking?
  - b) What about the application of Article 4.6 of Directive No. SBB/65/2017, which limits a bank's aggregate equity investment in all non-bank business to not exceeding 10% of its net worth to Islamic banking?
  - c) Is there a tax deduction for profit earned by the taxpayer and shared with the bank under *Mudaraba* profit sharing Islamic banking principles in the federal tax laws?
  - d) Does *Murabaha* Financing fit within the Ethiopian tax law framework?
2. What legal reforms should be made in order to create conducive environment for the Islamic banking system? For example, is there a need for enacting legislation concerning the *sharia* supervisory Board at the level of the NBE?

### **1.3. Objectives of the Study**

The main objective of this study is to evaluate the existing legal regime in Ethiopia on Islamic banking as well as the adequacy of the legislation to practice Islamic banking in order to come up with suggestions if adjustments are needed. Currently, four full-fledged IBs, along with seventeen CBs, engage in IFB activities. Establishing an appropriate regulatory and supervisory framework is essential to ensuring the efficiency and effectiveness of these operations. Without a level playing field in terms of institutional and legal frameworks, IFB products cannot compete with their conventional counterparts. Unfortunately, the amendment proclamation lacks clarity on the regulatory aspects of the legal framework for IFB. The initial replacement directive inadequately addresses the regulatory and supervisory regimes for IFB, placing them under the existing conventional regulatory framework without thorough consideration.

Given this situation, the focus of this research is to identify, examine, and illustrate the actual gaps, loopholes, and challenges within the current legal, regulatory, and supervisory frameworks.

The aim is to explore issues related to the regulatory regime in general and supervisory practices in particular, providing suggestions to address these problems if reforms in the mentioned regimes are deemed necessary. This research paper's primary objective thus is to shed light on the deficiencies in the existing framework and propose potential solutions for improvement.

The research has aimed to achieve the following specific objectives:

1. To evaluate the adequacy of existing laws applicable to banking for the implementation of IFB practices in Ethiopia's Islamic banking regime, focusing on:
  - a) Investigating the applicability of Article 4.4 of Directive No. SBB/65/2017, which restricts a bank from holding more than 10% equity shares in a single non-banking business other than insurance, to Islamic banking;
  - b) Assessing the application of Article 4.6 of Directive No. SBB/65/2017, which limits a bank's aggregate equity investment in all non-bank businesses to not exceeding 10% of its net worth, in the context of Islamic banking;
  - c) Examining the provisions for tax deduction concerning profits earned through *Mudaraba* profit-sharing Islamic banking principles in federal tax laws; and
  - D) Evaluating the accommodation of *Murabah* financing within the Ethiopian federal tax law framework.
2. To identify necessary legal reforms essential for fostering conducive environment for the Islamic banking system, including:
  - a) Assessing the need for legislative actions, such as enacting laws pertaining to the *Sharia* Supervisory Board at the level of the NBE and
  - b) Exploring potential legal amendments or additions to facilitate the effective operation and regulation of Islamic banking practices.

#### **1.4 Review of Related literature**

Scholars from the classical and modern schools of IL have written a good deal about Islamic banking and finance.<sup>14</sup> A section of the classical IL literature also discussed finance, which offers a legal foundation for IFB.<sup>15</sup> However, the concept of linking IF to the contemporary banking system and financial market is quite a new, having emerged a little more than forty years ago.<sup>16</sup> There is limited scholarship in Ethiopia about the theoretical, legal, regulatory, and enforcement framework of Islamic banking, despite the abundance of literature on the subject worldwide.

Alyu Abate's<sup>17</sup> research examines the policy, regulation, and supervision of Islamic financial banking, focusing on Ethiopia's adoption and alignment with international standards. It highlights the NBE's regulatory role, the unique features and risks of IF, and the adaptation of Basel standards for Sharia compliance.

The research by Abdulwasi Yusuf<sup>18</sup> represents a form of policy research aiming to influence the federal government of Ethiopia to integrate IFB practices into the nation's financial system. The objective of the research is to direct the financial transactions of the Muslim population towards the modern banking system. Additionally, the study seeks to appeal to global investors, particularly those from Gulf countries, who require IFB facilities to manage their investment portfolios.

As indicated above, the research done by Wondwosen Teshome<sup>19</sup> investigates the operational challenges and opportunities faced by IFB in Ethiopia, focusing on five selected commercial banks between 2013 and 2018. The researcher identified the primary operational challenge faced by Ethiopian banks offering IFB services as the misunderstanding and lack of standardization of the IFB products. The second significant challenge identified is lack of a "proper legal and

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<sup>14</sup>ibid 5.

<sup>15</sup>ibid.

<sup>16</sup>ibid 6.

<sup>17</sup>ibid 5.

<sup>18</sup>Melika Mohammed Ahmed, Introducing Policy and Regulatory Framework for Accommodation of Islamic Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University(2020)8.

<sup>19</sup>*Operational Challenges and Opportunities Faced by Interest Free Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University* (n 10) 47.

regulatory framework"<sup>20</sup>. The finding underlines the critical nature of having clear legislation governing IFB in Ethiopia. The absence of such a framework limits banks' ability to offer IFB king services and creates variations in methodologies, modes, and benchmarks. The research did not explain the details of the legal framework that hinder the proper operation of IFB.

The research done by Melika Mohammed<sup>21</sup> focuses on detailed regulatory issues about risks specific to IFB, such as rate of return risk and equity investment risk, sharia-compliant liquidity management issues.<sup>22</sup> She argues that, due to financial market volatility, regulatory frameworks must adapt to current and emerging markets. Stagnant regulations become inadequate, putting pressure on regulators to meet the demands of a complex financial system. This has heightened awareness of the unique risks posed by IBs. International agreements, such as the Basel Core Principles, aim to ensure a level playing field.

The present research is different in that it identifies and interrogates the specific NBE directive provisions and other legislation with the view to assessing their sufficiency to govern Islamic banking relations effectively and suggesting possible alternative solutions.

### **1.5. Methodology**

The study employed a combination of qualitative and doctrinal methodologies, focusing on assessing the adequacy of legal frameworks and utilizing primary data sources. To explore the nature and effectiveness of the legal framework for implementing Islamic banking in Ethiopia, the study conducted an analysis of pertinent laws. Moreover, purposive/judgmental sampling facilitated interviews with selected individuals experienced in Islamic banking operations, including commercial bank authorities and personnel from the NBE. Data collection was conducted through semi-structured interviews or questionnaires to gather insights and opinions of Islamic banking practitioners regarding the applicability of existing laws to Islamic banking and suggestions for necessary legal reforms. Data analysis involved themes delineated in relevant topics based on interview responses.

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<sup>20</sup>*Operational Challenges and Opportunities Faced by Interest Free Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University* (n 10).

<sup>21</sup>'Introducing Policy and Regulatory Framework for Accommodation of Islamic Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University(2020)' (n 18) 8.

<sup>22</sup>ibid 50–52.

In explaining the theories of Islamic banking, the study relied on IL alongside insights derived from secondary sources in a literature review. The research adopted a comparative approach, drawing lessons from the legal frameworks of countries such as Indonesia and the United Kingdom (UK). Indonesia, situated in Southeast Asia with a significant Muslim population, has made substantial strides in Islamic banking industry legislation and maintains a dual regulatory framework, considering both conventional and Islamic financial systems, with central banks having full authority to regulate banking activities. The UK, a secular country and hub of international financial institutions, accommodates IF within its legal systems. These countries are compared to glean insights and lessons for enhancing the legal framework for Islamic banking in Ethiopia.

### **1.6. Organization of the Study**

In summary, this study aims to explore and elucidate theoretical discourses, international experiences, the legal framework of Ethiopia, and a comparative analysis of Indonesia and the UK regarding Islamic banking. To achieve this, the writer has chosen to organize the study into five chapters. Chapter 1, generally titled as an “introduction”, comprises the background of the study, statement of the problem, objectives of the study, methodology, significance, and organization of the study.

Chapter 2 provides a brief overview of Islamic banking principles in general. It delves into the fundamental concepts and principles of Islamic banking, highlighting key features that distinguish it from conventional banking.

Chapter 3 delves into current trends in international standards, conducting a comparative analysis of Indonesia and the UK, while also drawing insights from the Islamic banking frameworks of these compared countries. This chapter aims to identify commonalities and differences to glean valuable lessons for the enhancement of Islamic banking practices.

In Chapter 4, attention shifts to addressing challenges and identifying gaps within the Ethiopian Islamic banking sector. Specific laws, regulations, and directives governing Islamic banking in the country are scrutinized, providing a comprehensive overview of the regulatory landscape and its impact on industry development.

Finally, Chapter 5 concludes the research by presenting recommendations and suggestions deemed appropriate by the researcher. These suggestions aim to address identified challenges and gaps, providing a roadmap for the future development and growth of Islamic banking in Ethiopia.

### **1.7. Scope of the Study**

The paper is concerned only with the adequacy of the contemporary legal framework of Ethiopia to practice Islamic banking. The *shariah* (Islamic law) policy consideration and the description for Islamic banking prohibiting interest and different unlawful activities are out of the purview of the research. IL concerning commercial matter is wide. So this research covers only banking business in contemporary Ethiopian legal system not that of the whole world. The focus of the study is on the legal framework to practice Islamic banking and evaluating the legislation of the Country.

## CHAPTER TWO

### 2. OVER VIEW OF SLAMIC BNKING PRINCIPLES

Islamic banking principles are rooted in foundational ethical and economic values that set them apart from conventional banking norms. Central to IF are three core principles: equity, participation, and ownership.<sup>23</sup> These principles not only shape financial transactions but also serve as moral compasses, fostering fairness, transparency, and accountability in financial affairs. In this overview, we explore each principle's significance in shaping the ethos of IF.

Firstly, equity serves as the cornerstone of IF, aiming to safeguard the interests of all parties involved in transactions. The prohibition of *riba* (predetermined payments) is grounded in this principle, ensuring equitable treatment and protection of weaker parties. Moreover, equity addresses excessive *gharar* (uncertainty) by mandating information disclosure to uphold contract integrity.<sup>24</sup>

Secondly, the principle of participation underscores interest-free financing while emphasizing earning returns through active involvement in productive activities. Unlike conventional banking, Islamic banking links capital returns to asset or project performance, fostering risk sharing and connecting financial activities to real economic ventures.<sup>25</sup>

Lastly, ownership principles mandate transactions to be based on tangible assets, highlighting the importance of asset ownership and contract sanctity. IF operates on an asset-backed model, ensuring transactions are grounded in real economic assets and upholding property rights.<sup>26</sup>

Collectively, these principles serve as the foundation of Islamic banking, guiding its operations and distinguishing it as a system that prioritizes fairness, ethical conduct, and economic progress, as elaborated in the following sections.

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<sup>23</sup> 'International Monetary Fund, The Core Principles for Islamic Finance Regulations and Assessment Methodology, May 24, 2018' 6.

<sup>24</sup> *ibid.*

<sup>25</sup> *ibid.*

<sup>26</sup> *ibid.*

## **2.1 Fundamental concepts and principles of Islamic banking**

Islamic banking can be defined as “a faith- based, socially responsible, and community based approach to banking”.<sup>27</sup> Islamic banking is a system that is not built on renting money to those who need it at a price called the interest rate, but is based on renting a tangible asset, such as a home, vehicle, machinery and equipment, and businesses at the prevailing actual market lease rate.<sup>28</sup>

Islamic banking emerged in the 1970s through the proactive endeavors of devout Muslims seeking to tackle the issue of interest. Initially, there was no established framework to follow, aside from the conviction that conventional interest-centric banking could be substituted with a system rooted in PLS. This initiative occurred within a financial landscape predominantly governed by interest-based practices, including the regulatory framework.<sup>29</sup>In 2006, Islamic banking and finance garnered acknowledgment from global financial entities, industry professionals, and academia. In several Muslim nations, there has been a shift, either complete or partial, towards adopting Islamic banking practices.

### **2.1.1 Concept of money in Islamic law**

Money serves as a medium of exchange, facilitating transactions, and functions as a measure of standard of value in various economic activities such as trading, manufacturing, servicing, or construction.<sup>30</sup>“Money and financial deposits are convenient, liquid stores of value for individuals, families, businesses, and other organizations”.<sup>31</sup> Money in conventional banking, serves as medium of exchange and standard of value. CB treats money as a commodity and lends it against interest as its compensation. An interest rate reflects the rate of return that a creditor receives when lending money, or the rate that a borrower pays when borrowing money. An interest rate is the price of borrowing money for the use of its purchasing power. It is the rental price of money. To person borrowing money, interest is the penalty paid for consuming income

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<sup>27</sup>Yehia Abdul-Rahman, *The Art of RF(Riba-Free) Islamic Banking and Finance: Tools and Techniques for Community- Based Banking* (second edn, 2014) 1.

<sup>28</sup>ibid.

<sup>29</sup>Ali and Ahmad (n 9) 81.

<sup>30</sup>William A.Lovett, *Banking and Financial Institutions Law in a Nutshell* (seven Edn, 2009) 1.

<sup>31</sup>ibid.

before it is earned. To a lender, interest is the reward for postponing current consumption until the maturity of the loan.

In IF, the practice of making money from money, such as through interest-based transactions, is prohibited, and money is primarily utilized as a medium of exchange rather than a commodity for speculative purposes.<sup>32</sup> In Islam, money holds no intrinsic value and thus should not be permitted to generate more wealth merely by being deposited in a bank or lent out with a fixed interest rate. Money is perceived as a medium of exchange without inherent value; hence, making a profit through its exchange or trading identical units is not permissible. It is contended that when a debt is repaid later, its purchasing power diminishes due to ongoing increases in general commodity prices. Consequently, the creditor suffers a loss while the debtor gains, effectively repaying less. Conventional economists assert that the interest rate on debt incorporates a premium or compensation for anticipated inflation. It could be deemed unjust if the debtor is not compensated for this loss of purchasing power. A method that Islamic scholars have extensively debated involves directly linking a debt to the currency's purchasing power, or the unit of account, as measured by a macroeconomic commodity price index. Should commodity prices rise, thereby reducing the real value of money, a corresponding increase in the nominal value of the debt would occur.<sup>33</sup> However, this indexing approach has garnered limited support, as some argue that principles such as *riba*(interest) cannot be compromised for man-made issues like inflation.<sup>34</sup> What is deemed necessary is a robust mechanism to control inflation through sensible macroeconomic policies, rather than simply accepting inflation as inevitable.<sup>35</sup>

### **2.1.2 Prohibition of interest**

Islamic banking, also known as IF or *Sharia*-compliant finance refers to financial activities that adhere to ILs. The two fundamental principles of Islamic banking are the exclusion of the payment and receipt of fixed or predetermined interest and the sharing of profit and loss by investors and banks.

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<sup>32</sup>Jahongirbek Burhonov, *Islamic Banking Operations of Commercial Banks under Islamic Banking Scheme(IBS) of Malaysia: The Performance Analysis* (Faculty of Economics, Thammasat University 2006) 22.

<sup>33</sup>ibid.

<sup>34</sup>*Islamic Finance Service* (n 3) 28.

<sup>35</sup>ibid.

Certainly, one of the most extensive and contentious aspects of Islamic economics, particularly when viewed through a conventional banking system, revolves around the prohibition of interest, known in Arabic as *riba*.<sup>36</sup> The Holy Quran explicitly forbids paying and accepting interest, a common practice in conventional banking. Additionally, the *Hadith*(actions and words of Prophet Muhammad, peace be upon him) condemns interest. Historically, similar prohibitions existed in early Christianity, with the Catholic Church denying burials to those involved in charging or receiving interest.<sup>37</sup>

Thus, the prohibition of interest, known as *riba*, is a fundamental principle in Islamic finance and is rooted in the IL. *Riba*, etymologically signifying "increase in" or "addition to," pertains to the augmentation of the principal amount of a loan based on the duration and magnitude of the loan.<sup>38</sup> In the context of IL, any surplus, no matter how minimal, above the principal is considered *riba*(interest).

*Riba* presents itself in two primary forms: *Fadl* and *Nasiah*. *Fadl* refers to the surplus charged in exchanges or sales involving items of similar nature or species, while *Nasiah* refers to interest that is constrained by a time limit and is time-dependent.<sup>39</sup> According to contemporary consensus among Islamic scholars, the concept of interest encompasses all forms, regardless of their magnitude or structure—be it simple or compound, significant or nominal.<sup>40</sup> IL prohibits not only exorbitant rates but also the slightest instances of interest. On the other hand, *Nasiah* involves granting a deferment to the debtor, where the creditor allows a delay in repayment in return for an additional sum beyond the principal. It's important to note that Islam endorses only one type of loan: *qard al-Hasan*, where the lender refrains from charging any extra amount beyond the borrowed sum.<sup>41</sup>

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<sup>36</sup>Abdulkader Thomas, *Interest in Islamic Economics* (2006) 1.

<sup>37</sup>*The Art of RF(Riba-Free) Islamic Banking and Finance: Tools and Techniques for Community- Based Banking* (n 27) 16.

<sup>38</sup>ibid.

<sup>39</sup>ibid 47.

<sup>40</sup>ibid.

<sup>41</sup>ibid 39.

In the present financial scenario, the interest prevalent in CBs aligns with *riba al-Nasihah*, where money is exchanged for money with an added surplus and a postponed payment schedule. Derived primarily from the Qur'an and *Sunnah*(the traditions of the Prophet Muhammad, peace be upon him), Islamic doctrine perceives interest as a practice rooted in exploitation and injustice. Consequently, such financial dealings are considered incompatible with Islamic principles of fairness and property rights.

### **2.1.3 Prohibition of financing for Islamic Laws contrary business activities**

Islamic banking prohibits financing or profiting from businesses engaged in activities forbidden by IL, such as gambling, hoarding, dealing in unlawful goods or services, short sales, and speculative transactions. This includes activities like selling non-halal products such as alcohol, pork, or tobacco, as well as entertainment ventures like casinos, cinemas, and music venues.<sup>42</sup> Islamic banks prioritize ethical standards by avoiding financing projects that conflict with Islamic values, such as wineries, casinos, and nightclubs. This reflects their commitment to socially responsible investments. That is why the term 'Islamic banking' is chosen by the researcher instead of 'IFB.' IFB relates only to the exclusion of the receipt and payment of fixed or predetermined interest rates, whereas Islamic banking is a broader concept that not only prohibits interest but also financing activities deemed harmful or prohibited under IL. The Qur'an explicitly forbids *maysir*(gambling), extending this prohibition to any business involving chance or speculation, condemning unjust enrichment through such means.<sup>43</sup> Moreover, IL forbids *gharar*(speculative transactions) involving ventures without sufficient knowledge or excessive risk. Transactions lacking clarity or certainty in terms are prohibited, including scenarios where the seller cannot deliver goods or the subject of sale is not yet acquired. Speculative practices, such as buying goods or shares with the intent to sell at higher prices in the future, are deemed illicit.<sup>44</sup> IL emphasizes fair and ethical dealings, prohibiting activities reliant on chance or uncertainty for profit.

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<sup>42</sup>*An Introduction to Islamic Finance* (n 4) 11.

<sup>43</sup>Ali and Ahmad (n 9) 14.

<sup>44</sup>Burhonov (n 32) 21.

#### 2.1.4 Asset backed financing

One of the most important characteristics of IF is that it is an asset-backed financing.<sup>45</sup> It is a fundamental principle of IF, signifying that the financier is obligated to participate in the financial outcomes, whether there results in profit or loss, emanating from the enterprise in which the capital was arranged.<sup>46</sup> IF is distinct for its emphasis on asset-backed arrangements, unlike conventional banking, which primarily revolves around dealing with money and monetary instruments. In Islam, trading in goods and maintaining inventories is encouraged, as opposed to merely dealing in currency. This is because money, lacking intrinsic value, is not considered a legitimate subject of trade except in specific circumstances. Profit in IF arises from transactions involving items with inherent utility, such as goods or different currencies, rather than from the exchange of money itself, which would constitute interest, deemed impermissible. Consequently, Islamic financing always involves tangible assets, fostering the creation of real assets and inventories.<sup>47</sup> Conventional banking views money as a commodity to be lent out with interest as compensation, establishing a creditor-debtor relationship with customers. In contrast, Islamic banking involves asset-backed products, such as asset trading, asset rental, and profit-sharing arrangements. Profit in IF is generated through the exchange of goods. Gains solely from dealing with money or its representations, like interest, are prohibited. Thus, Islamic financing relies on illiquid assets to create tangible assets and inventories.

The primary and preferred methods of financing according to IL are *musharakah* (Equity participation) and *mudarabah* (profit-sharing),<sup>48</sup> as discussed in the subsequent section. When a financier invests money using these two methods, it must be transformed into assets that have inherent value. Profits are then earned through the sale of these tangible assets.

*Murabahah*, as detailed in the subsequent subtopic, was not originally designed as a mode of financing. However, it has been adapted to serve this purpose in certain situations where other methods like *musharakah*, *mudarabah*, and other products are not feasible. Despite this adaptation, it has sometimes been criticized because its outcomes can resemble those of interest-

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<sup>45</sup>*An Introduction to Islamic Finance* (n 4) 12.

<sup>46</sup>Ali and Ahmad (n 9) 1.

<sup>47</sup>*An Introduction to Islamic Finance* (n 4) 12.

<sup>48</sup>*ibid.*

based borrowing. This criticism is partially justified, leading IL supervisory boards to agree that these methods are not ideal and should only be used when necessary, with strict adherence to IL principles.<sup>49</sup>

In contrast, interest-based financing typically does not result in the creation of tangible assets. The money supplied through loans from financial institutions often does not align with the actual production of goods and services within society. This disparity occurs because loans generate artificial money, leading to an increase in the money supply without a proportional increase in tangible assets. This mismatch between money supply and the production of real assets contributes to or exacerbates inflation.<sup>50</sup> Conversely, financing in an Islamic system is supported by tangible assets, ensuring alignment with actual goods and services produced.

### **2.1.5 Profit and loss sharing (PLS)**

The primary distinction between an Islamic or IFB system and the conventional interest-based banking system lies in their approach to handling profits and losses. In the conventional system, the interest rate is typically predetermined or directly linked to a benchmark rate, while in the Islamic system, profits and losses from physical investments are shared between the lender and the borrower based on a formula that considers their respective levels of involvement.<sup>51</sup> In IF, interest-bearing contracts are replaced by return-bearing contracts, often structured as partnerships. IBs offer savers financial instruments resembling equity, such as *mudaraba* and *musharaka* (discussed below). In these arrangements, profits are shared between investors and the bank according to predetermined terms. The concept of PLS underscores the IB's direct concern for the profitability of physical investments. Conversely, while CBs also prioritize project profitability due to concerns about loan default, their focus is primarily on receiving interest payments at set intervals. As long as these payments are made, the bank's own profitability is not significantly impacted by the project's rate of return. In contrast, IBs must

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<sup>49</sup>ibid 12–13.

<sup>50</sup>ibid 14.

<sup>51</sup>Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007) 49.

concentrate on the return on physical investments because their profitability is directly tied to the actual rate of return.<sup>52</sup>

Islamic principles advocate for Muslims to engage as partners by investing their capital, fostering a collaborative approach to share both the successes and potential challenges of business ventures, rather than merely acting as creditors. This ethos encourages investment across various sectors, including manufacturing, services, and conventional trade. Muslims are urged to invest and shoulder the responsibility for business risks, fostering a communal sense of accountability and ensuring a fair distribution of both profits and losses.

### **2.1.6 Mixture of banking and commerce in Islamic Law**

The concept of blending banking and commerce in IL is integral to Islamic financing, which is characterized by asset-backed principles.<sup>53</sup> Unlike conventional banking, which treats money as a commodity for lending with interest, Islamic banking primarily deals with asset-backed products like asset trading, rental, and profit-sharing arrangements. In many jurisdictions, conventional financing limits involvement in goods trading and inventory management, while IF views money as unsuitable for direct trade, except in specific cases. IF emphasizes generating profit through the exchange of goods or currencies rather than solely dealing with money or its representations, like interest. This approach relies on illiquid assets to create tangible assets and inventories, diverging from conventional practices.

Islamic banking financing favors *musharakah* (equity participation) and *mudarabah* (profit-sharing) as the preferred methods. When financiers engage in these mechanisms, funds are transformed into tangible assets with inherent value, and profits are generated through the sale of these assets.

### **2.1.7 Products delivered by Islamic banking**

There are a number of Islamic products delivered by Islamic banking that are unique compared to those offered by CBs. Only three of them, which are desirable in Islamic law but lack an adequate legal framework in Ethiopia, are discussed briefly.

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<sup>52</sup>ibid.

<sup>53</sup>Muftih Muhammad TaqiUsmani, *An Introduction of Islamic Finance*, (1998)12

### **2.1.7.1 *Musharakah* (Equity participation)**

The term “*Musharakah*” literally means “sharing” and is derived from the Arabic word *shirkah* whose meaning is being a partner.<sup>54</sup> It is a joint venture where both parties, the financier and borrower, supply capital and labour and thus share in profits and losses. The profit is shared according to a specified ratio while any losses are divided according to the capital contributed by each partner.<sup>55</sup> The difference between *Musharakah* contracts and conventional banking contracts is that conventional systems fix a permanent rate of interest on the loan advanced irrespective of any profits or losses that accrue while there is no interest in *Musharakah*. Further, the financier in conventional contracts cannot suffer loss as opposed to *Musharakah* where should the venture fail, the financier would suffer loss.<sup>56</sup> In *musharakah* financing, both parties equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.

### **2.1.7.2 *Mudaraba* (profit-sharing)**

*Mudaraba* is a partnership arrangement wherein one party, known as the *rabb al-mal* (capital provider), provides the financing for a project, while the other party, referred to as the *mudarib* (entrepreneur), assumes the responsibility of managing it.<sup>57</sup> It is a partnership where one party provides capital to another for investment in a commercial enterprise. In this arrangement, of a *mudaraba* contract, the capital provider partners with an entrepreneur, who possesses expertise in deploying capital into real economic activities. The agreement entails sharing profits, with the capital owner exclusively bearing losses, as the *mudarib* does not contribute capital. However, the *mudarib* may be held accountable for losses due to misconduct or negligence. Despite the risk of loss for the capital owner, they do not have authority to manage the funds, which remains the sole responsibility of the *mudarib*.

This partnership reflects a core principle of Islamic jurisprudence that the borrower should not bear the full risk of loss. In contrast to conventional banking, where the bank simply lends

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<sup>54</sup>Hassan and Lewis (n 51) 40.

<sup>55</sup>ibid.

<sup>56</sup>ibid 50.

<sup>57</sup>ibid 51.

money and does not share in the risk of the borrower's enterprise, Islamic banking operates on the principle of PLS. In a *mudaraba* arrangement, for instance, a bank provides capital while the customer manages the project, and profits are shared according to a pre-agreed ratio. This stands in contrast to conventional banks, which typically charge a predetermined rate of interest on loans rather than sharing in the profit or loss of the borrower's enterprise.

The Islamic financial system emphasizes partnership arrangements, which means both entrepreneurs and creditors (banks) encounter an uncertain rate of return or profit. Unlike conventional systems, the Islamic financial system operates on an equity-based model without any debt. Therefore, investment account depositors in IBs do not have their deposits guaranteed to the face value, as returns are contingent on the profits and losses of the bank. Essentially, depositors resemble shareholders in a limited-liability company on the liability side, while the bank earns returns based on its shares in the businesses it finances on the asset side.<sup>58</sup>

### **2.1.7.3 Murabaha (Cost-plus financing)**

The majority of Islamic banks and financial institutions utilize *murabaha* (Cost-plus financing) as a primary Islamic financing method, with a significant portion of their financing operations structured around it.<sup>59</sup> *Murabahah*, despite not initially intended for financing, has been adapted for such purposes in cases where other Islamic financing methods like *musharakah* and *mudarabah* are impractical.<sup>60</sup> In a *Murabahah* transaction, the financier purchases the required commodity on behalf of the client and sells it to the client at a marked-up price, usually with repayment in installments.<sup>61</sup> This ensures that the transaction is initiated only upon the client's confirmed need, and financing is always supported by tangible assets. Despite criticisms for resembling interest-based loans, *Murabahah* remains categorized as an asset-backed financing method in IF, distinct from conventional interest-based borrowing.<sup>62</sup> Unlike conventional financing, where the financier provides cash up front, in *Murabahah*, the financier purchases the desired commodity on behalf of the client, contingent upon the client expressing intent to acquire

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<sup>58</sup>ibid 55.

<sup>59</sup>*An Introduction to Islamic Finance* (n 4) 65.

<sup>60</sup>ibid 71.

<sup>61</sup>ibid 51.

<sup>62</sup> ibid,13

the commodity. Therefore, *Murabahah* inherently ties financing to tangible assets. IBs are obliged to assess the nature of the intended use of funds and cannot engage in *Murabahah* transactions for activities contrary to IL or detrimental to societal morality.<sup>63</sup>

It is a sales contract between a bank and its customers, primarily for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the parties, with repayment by installments within a specified period.<sup>64</sup> Under this contract, the bank purchases goods on behalf of the client and resells them to him for a deferred payment, which includes costs and an agreed profit margin. This form differs from conventional banking in that instead of loaning money to the borrower so that he can buy the goods himself, the bank buys them on his behalf and resells them to him. Many have argued that there is no difference between the profits that accrue to the bank in this contract and the interest that is charged by CBs. However, Islamic scholars have argued that since the bank retains possession of the goods before the customer finishes paying his debt, the bank incurs a lot of risk, and therefore, the profit margin it gains upon resale is to cover the cost of the risk.<sup>65</sup>

### **2.1.8 Source of Islamic Law (IL)**

Islam entails complete submission to the will of Allah, conveyed through prophets from Adam to Muhammad, peace be up on him), with the Quran as the final scripture.<sup>66</sup> Acknowledging Allah as the ultimate authority, Islamic banking aligns with Quranic injunctions and prophetic traditions, constituting IL. Unlike man-made laws, IL encompasses both earthly and afterlife consequences, rewarding virtue and obedience. It regulates not only human interactions but also the relationship with Allah. IL encompasses *Al-Ibadat* (spiritual worship) and *Al-Mu'amalat* (transactions), with Islamic banking law falling under the latter category.<sup>67</sup>

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<sup>63</sup> *ibid*,14

<sup>64</sup>Hassan and Lewis (n 51) 52.

<sup>65</sup>*ibid*.

<sup>66</sup>Liman Sa'adatu Hassan & Elesin Abdulwahab Muhammad Jami'u, *Introduction To Basic Principles of Sharī'ah (Islamic Law)* (Ahmadu Bello University Press Limited, Zaria, Kaduna State, Nigeria 2019) 8.

<sup>67</sup>*ibid* 20.

### 2.1.8.1 Primary sources of Islamic Laws

The Quran and the *Sunnah* form the fundamental sources of IL, bridging reason and revelation. Muslims revere the Quran as the ultimate foundation, while the *Sunnah*, comprising the actions and words of Prophet Muhammad documented in Hadith, offers practical application and behavioral guidance for Muslims.<sup>68</sup>

### 2.1.8.2 Secondary Sources of Islamic Laws

Secondary sources of IL, known as Usul al-Fiqh, assist Islamic jurists in deriving legal rulings from the primary sources of the Quran and Sunnah.<sup>69</sup> These sources provide a framework for interpreting Islamic principles and adapting to evolving societal contexts. While Islam offers comprehensive guidance, it doesn't explicitly cover every aspect of life, necessitating scholars' involvement in new situations.<sup>70</sup> *Ijma* (consensus) and *Qiyas* (analogical reasoning), along with *Istihsan* (juristic preference) and *Istislah* (public interest), offer flexibility in legal rulings when primary sources lack guidance. *Urf* (customary practices) also influences Islamic jurisprudence. Together, these sources ensure adaptability and relevance in addressing contemporary challenges in Islamic banking while upholding foundational teachings.<sup>71</sup>

### 2.1.9 Summary

Chapter Two provides an in-depth exploration of the core concepts and principles underlying Islamic banking. It begins by outlining the principles of equity, participation, and ownership, which shape financial transactions in IF. The chapter discusses the prohibition of *riba* (interest) and its grounding in Islamic scripture, along with the role of money as a medium of exchange in IL.

Furthermore, it examines the prohibition of financing activities contrary to IL, emphasizing asset-backed financing and PLS as key features of Islamic banking. The chapter also explores the

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<sup>68</sup>Rafat Y Alwazna, 'Islamic Law: Its Sources, Interpretation and the Translation of It into Laws Written in English' (2016) 29 International Journal for the Semiotics of Law - Revue internationale de Sémiotique juridique 251.

<sup>69</sup>Muhammad Ayub, *Understanding Islamic Finance* (Repr January 2011, Wiley 2011) 22.

<sup>70</sup>ibid.

<sup>71</sup>Ala Eddine Kharoufa, *Philosophy of Islamic Shariah and Its Contribution to the Science of Contemporary Law*, (Islamic Research and Training Institute Islamic Development Bank 2000) 35.

fusion of banking and commerce in IL, highlighting equity participation and asset-backed arrangements in financing methods like *musharakah* and *mudarabah*.

Lastly, it discusses Islamic banking products and the primary and secondary sources of IL. Overall, Chapter Two establishes a solid foundation for understanding Islamic banking principles and their practical implications.

## **CHAPTER THREE**

### **3. INTERNATIONAL STANDARDS AND COMPARATIVE ANALYSIS OF ISLAMIC BANKING SUPERVISION**

The advancement and prosperity of Islamic banking hinge upon the establishment of a robust legal structure. Effective implementation of Islamic banking rests on the appropriate handling of its legal supervision. Islamic financial entities are obligated to adhere to IL principles while also complying with other legal statutes, whether substantive or procedural. This chapter aims to examine the regulatory landscape of Islamic banking internationally, to pinpoint regulatory hurdles in Ethiopia, and to identify exemplary practices that can foster the ongoing progress and advancement of Islamic banking.

#### **3.1 The International Legal and Institutional Framework for Islamic Banking**

Over the past three decades, the Islamic financial services industry has grown significantly, with Islamic banking institutions seeking to adapt conventional banking systems to their unique needs. However, these systems have proven insufficient, leaving IBs vulnerable to financial crises due to their close ties to the real sector and potential shortcomings in risk management. While risks in the real sector have decreased, those in the financial sector have risen, exposing Islamic financial institutions to systemic risks from major economic shocks. As a result, there has been a push to establish specialized institutions to support the growth of the Islamic financial

industry.<sup>72</sup> It is crucial to align the regulatory framework with standard guidelines to mitigate the main risks associated with IB operations. Authorities need to ensure that the regulatory framework for IBs places them on equal footing with CBs. In certain countries where IBs operate, the regulatory framework often defaults to the Basel Committee on Banking Supervision's conceptual framework. However, many countries enhance it by incorporating standards from the IFSB and the AAOIFI to ensure compliance with IL.<sup>73</sup>

### **3.1.1. Islamic Financial Service Board (IFSB)**

The IFSB, an international standard-setting organization, was formally established on November 3, 2002, and commenced operations on March 10, 2003. Its mission is to foster the solidity and resilience of the Islamic financial services industry by issuing comprehensive global standards and guiding principles across the banking, capital markets, and insurance sectors. The primary goal of the IFSB is to advance a robust and transparent Islamic financial services sector by introducing new standards aligned with IL principles or adapting existing international standards accordingly and proposing them for implementation.<sup>74</sup> To achieve this objective, the efforts of the IFSB align with those of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.

As of August 2023, the IFSB consists of 188 members spanning 58 jurisdictions, including 81 regulatory and supervisory authorities (RSAs), 10 international organizations, and 97 market participants such as financial institutions, professional firms, industry associations, and stock exchanges. These members, encompassing international, regional, and national bodies, along with market players, share a common goal with the IFSB in advocating for and maintaining the principles of Islamic finance.<sup>75</sup>

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<sup>72</sup> Angelo M Venardos (ed), *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific 2010) 4.

<sup>73</sup> *ibid.*

<sup>74</sup> 'The Islamic Financial Services Board ,<https://www.ifsb.org/?id=1>, Accessed on May 15,2024'.

<sup>75</sup> 'The Islamic Financial Services Board, Implementation Guidelines Report 2023,[https://www.ifsb.org/Wp-Content/uploads/2024/01/Implementation-Guidelines\\_2023\\_December.Pdf](https://www.ifsb.org/Wp-Content/uploads/2024/01/Implementation-Guidelines_2023_December.Pdf), Accessed on May 15,2024' 8.

Since its establishment, the IFSB has been instrumental in releasing 42 standards, guidance notes, and technical notes aimed at regulating and advising different facets of the Islamic Financial Services Industry (IFSI). This demonstrates the organization's steadfast commitment to upholding rigorous standards and fostering adherence to IL principles across the worldwide Islamic financial sector. The materials published by the IFSB cover three main sectors: Islamic Banking, Islamic Capital Markets, and *Takaful* (Islamic Insurance that shares risks among members).<sup>76</sup>

The IFSB issued the second edition of its Implementation Guidelines report in 2023, which highlights key areas of legislation and laws, and Sharia governance. Legislation is instrumental in fostering the Islamic financial services industry, with countries often amending or introducing new laws to support Sharia-compliant finance, aligning with their priorities over time. The Implementation Guidelines report illustrates how jurisdictions adapt their legal frameworks to promote Islamic banking, ensuring equitable treatment between Islamic and CBs.<sup>77</sup>

Establishing an effective system to oversee Islamic financial institutions (IFIs) is crucial for ensuring adherence to Sharia principles. Regulatory authorities have the flexibility to tailor Sharia governance systems to their specific market contexts. The report outlines diverse practices for enforcing Sharia governance requirements across jurisdictions. Clarity on Sharia governance aids compliance for IFIs, facilitating discussions between jurisdictions and the IFSB for additional guidance as necessary.<sup>78</sup>

### **3.1.1.1 Core Principles for Islamic Finance Regulation (CPIFR)**

The IFSB formulated the Core Principles for Islamic Finance Regulation (CPIFR) to offer regulatory and supervisory guidance tailored to the Islamic banking sector. These principles,

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<sup>76</sup> *ibid.*

<sup>77</sup> *ibid* 21.

<sup>78</sup> *ibid.*

which are structured similarly to the Basel Core Principles on Effective Banking Supervision (BCP), incorporate specific considerations for IBs.<sup>79</sup>

The CPIFR aims to strengthen the global financial stability framework and enhance prudential regulations for the global Islamic banking sector. Many regulatory authorities, including those new to overseeing IB, face challenges in identifying and implementing appropriate principles to assess existing structures and policies. The regulatory approach for IB should address specific risks and financial infrastructure needs, potentially leading to revised regulatory practices tailored to Islamic banking operations.<sup>80</sup> The CPIFR includes essential and additional assessment criteria and comprises 33 core principles applicable to both full-fledged Islamic banking institutions and Islamic windows. This study focuses solely on the equity investment risk and Shariah governance principles of CPIFR.

### **3.1.1.2 Equity Investment Risk (CPIFR 24)**

Investments made through PLS instruments can significantly contribute to an IB's earnings, but they also entail considerable market, liquidity, credit, and other risks. These risks can potentially lead to volatility in earnings and capital. The capital invested through such instruments may be utilized to purchase shares in publicly traded or privately held equity, or it may be invested in a specific project, portfolio, or through a pooled investment vehicle.<sup>81</sup> In the case of a specific project, IBs may invest at various stages. Moreover, delays and variations in cash flow patterns, as well as potential difficulties in executing a successful exit strategy, may pose challenges. It is important to note that the capital invested by the provider of finance does not guarantee a fixed return but is explicitly exposed to the risk of capital impairment in the event of losses.<sup>82</sup>

CPIFR 24 outlines requirements for managing equity investment risk in Islamic financial institutions. It stresses the need for adequate policies, including risk management strategies,

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<sup>79</sup> 'International Monetary Fund, The Core Principles for Islamic Finance Regulations and Assessment Methodology, May 24, 2018' (n 23) 1.

<sup>80</sup> *ibid* 2.

<sup>81</sup> *ibid* 11.

<sup>82</sup> *ibid*.

tailored for *Mudarabah* and *Musharakah* investments. It emphasizes consistent valuation methodologies, defined exit strategies, and sufficient capital for equity investment activities.<sup>83</sup>

### **3.1.1.3 Shariah Governance Framework (CPIFR 16)**

Sharia compliance is critical to the operations of IBs, and these requirements must be integrated throughout the organization and their products and activities. Depositors' perception of IBs' compliance with IF principles is crucial for their sustainability. Non-compliance could result in transactions being cancelled and the income generated from them being deemed illegitimate.<sup>84</sup>

CPIFR 16 ensures IIFIs maintain robust Sharia governance, tailored to their operations' size and complexity. The supervisory authority also sets the general approach to Sharia governance and outlines key process elements in its jurisdiction.<sup>85</sup>

### **3.1.2. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)**

AAOIFI is an international nonprofit organization established in 1991 and headquartered in Bahrain. It is responsible for developing and issuing standards for the global Islamic finance industry. AAOIFI has issued a comprehensive set of 100 standards covering areas such as Sharia, accounting, auditing, ethics, and governance. Supported by various institutional members from over 45 countries, including central banks, regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, AAOIFI's standards are widely adopted by leading Islamic financial institutions worldwide. They have played a significant role in harmonizing international Islamic finance practices.<sup>86</sup> The organization's primary objectives are centered around developing accounting, governance, and ethical standards pertinent to Islamic financial institutions, with a specific focus on matters of auditing.

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<sup>83</sup> *ibid* 29.

<sup>84</sup> *ibid* 21.

<sup>85</sup> *ibid* 25.

<sup>86</sup> 'Accounting and Auditing Organization for Islamic Financial Institutions, <https://Aaoifi.Com/Our-History/?Lang=en>, Accessed on May 15, 2024'.

## **3.2 Contemporary Development of Islamic banking legal structures in other selected Countries**

This section will compare the policy, legal, and regulatory frameworks for Islamic banking in Indonesia and the UK, aiming to identify best practices and benchmarks that Ethiopia can adopt for reforming its Islamic banking regulatory regime. Indonesia and the UK were chosen due to their significant roles in Islamic finance development in their respective regions. Indonesia, with a majority Muslim population, operates under a dual banking system where both conventional and Islamic banks are overseen by the central bank. In contrast, the UK, despite being secular, has implemented tax and regulatory changes to support IF, ensuring fair competition with its conventional counterparts. The growth of IF in both countries is facilitated by government policies that provide support without granting special privileges and by the active involvement of regulatory bodies like the Financial Services Authority (FSA) in reducing regulatory barriers for IFIs.

Indonesia stands out among countries with dual regulatory frameworks, boasting fully harmonized and developed regulatory systems for Islamic banks. These two countries offer a valuable contrast: Indonesia represents a Muslim-majority nation with a dual regulatory system, while the UK is a non-Muslim country with a single regulatory system.

### **3.2.1 Indonesia**

#### **A. The Government's Approach—Principles and Policies for IBs**

Indonesia is the world's most populous Muslim country, with nearly 90% or Approximately 220 million people are followers of the religion of Islam.<sup>87</sup> Islamic banking law enactment and development in Indonesia have evolved significantly over the years. The concept of IF in Indonesia can be traced back to the 1960s, when *BaitulMaalwaTamwil*, or BMT (Islamic cooperatives) started operating. However, it was not until the late 1980s that the Indonesian government officially recognized Islamic banking.<sup>88</sup>

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<sup>87</sup>Venardos (n 72) 66.

<sup>88</sup>Jefik Zulfikar Hafizd, 'Pean Bank Syariahmandiri (BSM) Bagi Perekonomian Idonesia Dimasa Pandemi Covid-19' (2020) 5 Al-Mustashfa: Jurnal Penelitian Hukum Ekonomi Syariah 138, 143.

The first significant step towards Islamic banking regulation was the enactment of Law No. 7 of 1992 on Banking. This law paved the way for the establishment of IBs and financial institutions in Indonesia. Subsequently, in 1998, the government issued Government Regulation No. 72/1992 concerning Sharia banks.<sup>89</sup> Over the years, there have been amendments and enhancements to the regulatory framework governing Islamic banking in Indonesia. For example, Law No. 21 of 2008 concerning Sharia Banking Institutions further strengthened the legal basis for IBs and provided clearer guidelines for their operations.<sup>90</sup>

The first Islamic bank in Indonesia, Bank Muamalat Indonesia, was established in 1992. Since then, several other IBs have been established, including Bank SyariahMandiri (BSM) and Bank SyariahBukopin (BSB).<sup>91</sup>

## **B. Enabling legal and Regulatory framework for IBs**

IF relies on a robust and enabling legal framework to operate effectively, ensuring proper legal recognition, support, and protection. In Indonesia, Bank SyariahMandiri (BSM) and Bank SyariahBukopin (BSB) offer *Mudarabah* financing contracts. *Mudarabah* financing entails BSM providing all the necessary working capital, with profits distributed according to agreed-upon ratios. The facility, including profits, is shared as per the flexible financial return mechanism and revenue-sharing calculations. Similarly, BSB employs *Mudarabah* contracts, where the bank provides all the capital and customers act as managers, with profits shared based on agreed ratios. This product targets both individuals and businesses for specified project durations, requiring collateral worth 125% of the financing amount to mitigate the bank's risk.<sup>92</sup>

However, IBs in Indonesia face challenges in offering *Mudarabah* and *Musharakah* contracts due to additional risks borne by the banks.<sup>93</sup> While Indonesian IBs strive to implement such

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<sup>89</sup>Venardos (n 72) 104.

<sup>90</sup>ibid.

<sup>91</sup>ibid 106.

<sup>92</sup>Aulia Fitria Yustiardi , Aulia Arifatu Diniyya, Fariyah Amirah Ahmad Faiz, Nur Shazni Subri, Zahra Nabila Kurnia, 'Issues and Challenges of the Application of Mudarabah and Musharakah in Islamic Bank Financing Products' (2020) 19 International Islamic University Malaysia Kuala Lumpur, Malaysia 31.

<sup>93</sup>ibid.

financing schemes, they often resort to exchange-based contracts in financing distributions to ventures. Despite some Indonesian IBs offering these financing contracts, the terms primarily resemble exchange-based financing, featuring collateral requirements and predetermined installments.<sup>94</sup>

In Indonesia, Bank Syariah Bukopin offers *Musharakah* financing. This financing arrangement involves a *Musharakah* contract, wherein the bank and the customer pool their funds or capital for a specific business venture, and profits are distributed according to a pre-determined profit-sharing ratio. *Musharakah* financing is available for both individual and business entities, requiring a minimum self-financing contribution of 30% of the total capital. However, similar to *Mudarabah* financing, the bank also mandates collateral worth 125% of the financing amount.<sup>95</sup>

Otoritas Jasa Keuangan (OJK), or Indonesia Financial Services Authority, issued a circular letter in 2015 concerning the codification of Islamic banking products and activities. This regulation aimed to assist the Indonesian Islamic banking sector in developing and offering *Shariah*-compliant products, encompassing both funding and financing services. Additionally, it governs the application of *Mudarabah* and *Musharakah* contracts in funding and financing products.<sup>96</sup> The OJK regulation provides overarching guidelines for the utilization of Islamic contracts in banking products and services.

Indonesia maintains a dual regulatory framework that addresses both the conventional and Islamic financial systems.<sup>97</sup> As such, the central bank possesses complete authority to establish the necessary laws, policies, and regulations governing Islamic financial institutions. The Financial Services Authority plays a crucial role in supervising and regulating IBs. It ensures compliance with IL principles and oversees the stability and soundness of the Islamic banking sector. IBs in Indonesia have been actively innovating and diversifying their product offerings to

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<sup>94</sup>ibid.

<sup>95</sup>ibid.

<sup>96</sup>ibid 34.

<sup>97</sup>Fazlurrahman Syarif, 'Regulatory Framework for Islamic Financial Institutions: Lesson Learnt between Malaysia and Indonesia' (2019) 2 Journal of Halal Product and Research 79, 606.

cater to the needs of their customers. They offer a range of *Shariah*-compliant products and services, including Islamic financing, investment products, and *Takaful* (Islamic insurance).<sup>98</sup>

Following the amendment of the Income Tax Act of Indonesia in 2010, *Shariah*-based commercial activities became subject to regulation under Government Regulation No. 25/2009. However, this regulation only addresses overarching matters. Therefore, in 2011, the Ministry of Finance of Indonesia issued two additional documents: Income Tax Treatment of Sharia-based Financing Activities (No. 136/PMK.03/2011) and Income Tax Treatment of Sharia Banking (No. 137/PMK.03/2011) to provide more detailed guidance on tax treatment.<sup>99</sup>

Furthermore, specific taxable aspects of *Murabahah* financing were addressed through the introduction of a special tax treatment aimed at supporting the Islamic finance industry. To prevent double value-added taxation (VAT) on *Murabahah* transactions, the government amended Act No. 42/2009 on the Value-added Tax of Goods and Services and Luxury Goods, removing the double VAT for Islamic banks.<sup>100</sup> According to the provision, *Murabahah* transactions do not carry inventory-holding risk; hence, profits from such contracts are not treated as profits from value-added goods but are considered profits from financing instead.

### **C. Sharia Governance Framework**

In Indonesia, specialized Islamic courts handle cases related to Islamic banking and finance. As outlined in Law No. 3 of 2006, which was amended by Law No. 7 of 1989 and further revised by Law No. 50 of 2009, legal disputes within Islamic banking in Indonesia, are under the jurisdiction of the Religious Courts.<sup>101</sup> Therefore, dispute resolution through litigation falls under the authority of the religious courts. Consequently, the Sharia court plays a vital role in the advancement of Islamic finance in Indonesia. Members of the Shariah court must be knowledgeable judges and experts in Islamic finance, possessing an understanding of both

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<sup>98</sup>‘Issues and Challenges of the Application of Mudarabah and Musharakah in Islamic Bank Financing Products’ (n 92) 36.

<sup>99</sup> ‘The Islamic Financial Services Board, Implementation Guidelines Report 2023, [https://www.ifsb.org/wp-content/uploads/2024/01/Implementation-Guidelines\\_2023\\_December.Pdf](https://www.ifsb.org/wp-content/uploads/2024/01/Implementation-Guidelines_2023_December.Pdf), Accessed on May 15, 2024’ (n 75) 27.

<sup>100</sup> *ibid.*

<sup>101</sup> Syarif (n 97) 606.

*Shariah* principles and legal matters. Additionally, they are required to have a foundational understanding of modern finance, as many Islamic cases involve contemporary financial concepts.<sup>102</sup>

Indonesia has also been actively engaging in international collaborations and partnerships to enhance its Islamic banking industry. It has participated in initiatives such as the IFSB and the AAOIFI.<sup>103</sup>

Overall, Islamic banking law enactment and development in Indonesia have witnessed significant progress, with a robust regulatory framework in place to support the growth and stability of the Islamic banking sector.

### **3.2.2 United Kingdom (UK)**

#### **A. The Government's Approach –Principles and Policies for**

In the UK, the growth of IF has been influenced by various factors, notably political and regulatory considerations, which have played a pivotal role in driving this expansion. A significant aspect of this progress is the implementation of supportive government policies aimed at broadening the market for Islamic financial products, catering to both Islamic banking institutions and conventional firms offering Islamic financial services through 'Islamic windows'.<sup>104</sup> Over the past decade, the development of IF has garnered bipartisan support, driven by two primary policy objectives: firstly, to establish and uphold London as the foremost gateway to international Islamic finance within Europe, and secondly, to ensure equitable access to competitively priced financial products for all individuals in the UK, regardless of their religious beliefs.<sup>105</sup> In the UK, IBs operate within the existing legal and regulatory framework governing financial institutions, with adaptations made to accommodate IL principles.

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<sup>102</sup>ibid.

<sup>103</sup> 'Issues and Challenges of the Application of Mudarabah and Musharakah in Islamic Bank Financing Products' (n 92) 36.

<sup>104</sup>Nuramarina Zolkapli, 'Level-Playing Field: The Regulatory Framework for Islamic Banks in the United Kingdom and Malaysia, Thesis Submitted for the Degree of PhD 2016' 159.

<sup>105</sup>ibid.

## B. Enabling legal and Regulatory framework for IBs

Although there is not specific legislation addressing Islamic banking, the UK government has introduced measures to facilitate IF activities. UK authorities have long been familiar with IF services and products, leading to significant developments within the industry. These advancements were carefully integrated into policies by British officials, facilitating the gradual growth of IF in the UK. Despite the government's ambitious intentions for IF development, decisions and policies were made cautiously, resulting in changes primarily occurring over the past few years. Notable milestones include the removal of the double charge of Stamp Duty Land Tax (SDLT) for *Murabahah* and *Ijarah*<sup>106</sup> contracts, enabling individuals to purchase homes in 2003; the extension of the SDLT removal to diminishing *Musharakah*, another mode of alternative finance, in 2005; and the legislative measures regarding SDLT, Capital Gains Tax, and capital allowance rules for land transactions involved in structuring UK Islamic finance instruments in 2009.<sup>107</sup> Tax relief was implemented for transactions related to Islamic mortgages to avoid the duplication of SDLT payments for individual consumers. This relief was granted because the taxation associated with certain Islamic financial transactions tends to be higher compared to conventional financial transactions, which could diminish the competitiveness of Islamic financial products.<sup>108</sup>

The UK's banking regulations do not specifically address compliance with IL. However, authorities may indirectly consider IL compliance when evaluating aspects like governance, internal controls, reputation risk, and consumer protection.<sup>109</sup> Overall, the legal framework for Islamic banking in the UK involves a combination of existing financial regulations, specific

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<sup>106</sup>*Ijarah* is indeed another type of Islamic banking product. It refers to a contract in which one party (the lessor) leases a tangible asset or property to another party (the lessee) for an agreed period of time and at an agreed rental price. In this arrangement, the lessor retains ownership of the asset, while the lessee has the right to use it in exchange for payment.

<sup>107</sup>'Level-Playing Field: The Regulatory Framework for Islamic Banks in the United Kingdom and Malaysia, Thesis Submitted for the Degree of PhD 2016' (n 104) 160.

<sup>108</sup>*ibid.*

<sup>109</sup>Elsie Addo Awadzi, 'IMF Working Papers Resolution Frameworks for Islamic Bank(2015)' 8.

adaptations to accommodate IL principles, and legal mechanisms to ensure compliance and enforceability within the UK legal system.

### **C. Sharia Governance Framework**

One of the distinguishing features regarding the governance of IBs compared to CBs is the establishment of a Sharia Supervisory Board (SSB). Sharia supervision is mandated for Islamic banks to ensure that their activities adhere to Sharia principles. In the UK, there is no specific requirement for this additional unit.<sup>110</sup>

### **3.3 Key Lessons for Ethiopia from Indonesia:**

#### **A. The Government's Approach—Principles and Policies for IBs**

Indonesia, with its predominantly Muslim population, has established a robust legal framework for Islamic banking since the 1960s, culminating in official recognition by the late 1980s. Key legislation like Law No. 7 of 1992 and Government Regulation No. 72/1992 paved the way for Islamic banks such as Bank Muamalat Indonesia. Amendments like Law No. 21 of 2008 further strengthened this framework. The dual regulatory structure, overseen by the Indonesia Financial Services Authority (OJK), addresses both conventional and IF, allowing for consistent regulation and support. Ethiopia can draw lessons from Indonesia's experience to establish a centralized regulatory framework under the NBE, ensuring coherence and fostering an environment conducive to Islamic banking growth. Moreover, by establishing a Shariah supervisory body within the NBE, Ethiopia can enhance oversight and promote innovation in Islamic banking, aligning with Indonesia's approach.

### **C. Sharia Governance Framework**

Specialized Islamic courts handle legal disputes related to Islamic banking and finance in Indonesia. Under the jurisdiction of the Religious Courts, these courts play a vital role in advancing IF. International collaborations, such as participation in the IFSB and the AAOIFI, further enhance Indonesia's Islamic banking industry. Overall, Indonesia's experience

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<sup>110</sup>'Level-Playing Field: The Regulatory Framework for Islamic Banks in the United Kingdom and Malaysia, Thesis Submitted for the Degree of PhD 2016' (n 104) 188.

demonstrates significant progress in Islamic banking law enactment and development, supported by a robust regulatory framework.

### **3.4 Key Lessons for Ethiopia from the UK:**

#### **A. The Government's Approach**

Principles and Policies for IBs in the UK, the growth of IF has been driven by political and regulatory factors, with supportive government policies aimed at expanding the market for Islamic financial products. Over the past decade, bipartisan support has focused on establishing London as Europe's primary hub for international IF and ensuring access to competitive financial products for all individuals. IBs in the UK operate within the existing legal and regulatory framework, with adaptations made to accommodate IL principles. Ethiopia should learn from the UK's approach to implementing supportive government policies aimed at broadening the market for Islamic financial products. By fostering a conducive regulatory environment and providing incentives for the growth of IF, Ethiopia can stimulate the development of its Islamic banking sector.

#### **B. Enabling a Legal and Regulatory Framework for IBs**

While there is no specific legislation addressing Islamic banking in the UK, the government has introduced measures to facilitate IF activities. Long-standing familiarity with IF services and products has led to significant industry developments. Policy changes, primarily in recent years, include the removal of double charges for certain transactions and tax relief for Islamic mortgages. Although banking regulations in the UK do not explicitly address compliance with Islamic law, authorities indirectly consider Islamic law compliance in evaluating governance, internal controls, and consumer protection. Ethiopia should consider implementing tax relief or financial incentives to encourage IF activities, taking cues from the UK. Establishing clear regulations regarding VAT and exemptions for title transfer fees in *Murabaha* financing products could enhance the competitiveness and accessibility of Islamic banking for consumers.

#### **c. Sharia Governance Framework**

Unlike conventional banks, Islamic banks typically have a SSB to ensure adherence to Sharia principles. However, in the UK, there is no specific requirement for this additional unit. Despite this difference, the UK's legal framework for Islamic banking combines existing financial regulations, specific adaptations for IL principles, and legal mechanisms to ensure compliance and enforceability within the UK legal system. While not a requirement in the UK, SSBs play a crucial role in ensuring that Islamic banking activities align with Sharia principles. Evaluating the necessity and effectiveness of such a board within the Ethiopian context can contribute to the integrity and stability of its Islamic finance sector.

### **3.5 Ethiopian Dispute Resolving Mechanism in Islamic Banking conflicts**

When investors choose to partner with IBs, a key concern is protecting their businesses in case of disputes. Therefore, it is crucial to develop a strong legal framework for resolving disputes to strengthen the position of IBs in Ethiopia.

Article 4 of Ethiopian Federal Sharia Court Establishment Proclamation No. 188/1999 stipulates that the courts have jurisdiction over any matter concerning marriage, divorce, maintenance, guardianship of minors, and family relations. This jurisdiction applies when the marriage in question was concluded according to IL or the parties have consented to adjudication under IL. Additionally, the courts have jurisdiction over matters concerning *Wakf* (endowment), gift, succession, and wills, provided the endower or donor is a Muslim or the deceased was a Muslim at the time of death.

As evident from this provision on the jurisdiction of Sharia courts, Islamic law applies only to personal and family matters in civil cases. Consequently, Sharia courts are not empowered to handle commercial matters.

As banking business falls under federal jurisdiction and is governed by the federal government, the adjudication of banking disputes typically falls under the purview of ordinary federal courts. Since judges in these courts are trained in the Ethiopian legal system rather than IL, it is not appropriate for Islamic banking disputes to be adjudicated in ordinary courts. Therefore, there is a need for a mechanism to empower the already established Sharia courts or establish a new body specializing in IL and banking to handle such disputes more effectively.

The researcher recommends amending Federal Sharia Court Establishment Proclamation No. 188/1999 to align with Islamic banking dispute resolution practices similar to those in Indonesia. When amending the proclamation, specific criteria should be outlined for the appointment of judges to the Islamic banking bench, and provisions should be made regarding the finality or appeal ability of Shariah court decisions to ordinary courts, including the cassation bench. These amendments could streamline the process of establishing and administering a new specialized court, saving both time and costs.

### **3.6 summary**

Chapter Three delves into international standards and a comparative analysis of Islamic banking supervision. It underscores the significance of robust legal structures and effective supervision for advancing Islamic banking services such as *Musharakah*, *Mudarabah*, and *Murabaha*. The chapter examines global regulatory landscapes, spotlighting exemplary practices from Indonesia and the UK. From Indonesia, it emphasizes the importance of a comprehensive legal framework and a dual regulatory system addressing both conventional and Islamic financial systems. From the UK, it highlights the impact of supportive government policies aimed at expanding the market for Islamic financial products, facilitating IF activities, and introducing tax exemptions for *Murabaha* financing. These lessons offer valuable insights for Ethiopia in strengthening its regulatory framework and dispute resolution mechanisms in Islamic banking.

## **CHAPTER FOUR**

### **ASSESSING THE SUITABILITY OF ETHIOPIA'S CURRENT LEGAL FRAMEWORK FOR IMPLEMENTING ISLAMIC BANKING**

#### **4.1 Examination of adequacy of Ethiopian Legal framework to Practice Islamic banking**

For the first time, Banking Business Proclamation No. 592/2008<sup>111</sup> authorized the NBE to issue directives to regulate banking businesses related to non-interest-bearing deposit mobilization and fund utilization. Subsequently, the NBE issued Directives to Authorize the Business of Interest-Free Banking No. SBB/51/2011, which solely permitted conventional banks to market and launch their products with the introduction of 'Islamic windows' alongside their conventional

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<sup>111</sup>Banking Business, Proclamation No.592/2008, Negarit Gazeta, year 14, No.57, Article 22(2).

operations. Since then, the majority of CBs have obtained IFB window operation licenses from the NBE and operate at the window level. This continued until the Banking Business Amendment Proclamation No. 1159/2019<sup>112</sup> which also granted the NBE the mandate to issue directives to prescribe additional conditions for licensing, supervision, and requirements to establish IFB. Following the banking business proclamation amendment, the NBE enacted Directive No. SBB/72/2019 to authorize fully engaged IFB. As a result, full-fledged interest-free banks were established.

At the end of December 2023, there were 32 domestic banks operating in Ethiopia. Among these, four were full-fledged interest-free banks, namely Zamzam, Hijra, Ramis, and Shebelle banks, while 22 were conventional commercial banks.<sup>113</sup> Seventeen conventional banks provided IFB services both at the window level and through dedicated branches.<sup>114</sup> These demonstrate the availability of funds mobilized by banks through Islamic banking as well as the high demand of the population eager to utilize IFB in Ethiopia. The NBE, as the regulatory body of the country's banking sector, is required to ensure the availability of a working legal framework that enables Islamic banking products and services to be effective, efficient, and compatible with those of conventional banking.

The purpose of the NBE "(1st Replacement) Directive to License and Authorize Interest-Free Banking Business No. SBB/72/2019" is outlined in the preamble as follows:

Firstly, the first line of the preamble of the Directives emphasizes the promotion of IFB businesses for "greater financial inclusion".

Secondly, it underscores the importance of conducting IFB business in a "safe and sound manner", highlighting the necessity for robust risk management practices.

Lastly, the preamble suggests the need to review the regulatory framework related to IFB in light of ongoing banking sector reforms.

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<sup>112</sup>Banking (amendment), Proclamation No. 1159/2019, Negarit Gazeta, year 25, No. 88, Article 59(1).

<sup>113</sup>'National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner' (n 11).

<sup>114</sup>ibid.

The policy justification for the government's promotion of financial inclusion, explicitly provided in the very first line of the preamble, aligns with the strong public demand of the Muslim population of Ethiopia. As of the time of writing this paper, the NBE has authorized four full-fledged interest-free Islamic banks.

The second line of the preamble, dealing with the importance of conducting IFB business in a "safe and sound manner," also aligns with the key role banks play in the economy through the dispersion of credit in conventional banking or financing in the case of Islamic banking. Safeguarding well-payment schemes and addressing the risks inherent in banking business have led regulators to apply stringent laws in the banking sector, including those pertaining to Islamic banking, which are crucial.

The last line of the preamble of the directive that suggests the need to review the regulatory framework concerning IFB in light of ongoing banking sector reform is questionable.

First of all, in the same directive provides, "In conducting interest free banking business, banks shall comply mutatis mutandis with all regulatory and supervisory requirements except National Bank's directives on interest rate."<sup>115</sup>

Secondly, almost all of the directives from the NBE and other banking laws enacted during the period when Islamic banking was not permitted are incompatible with Islamic banking practices. One such directive that notably conflicts with Islamic banking products and services is the 'Limitation on Investment of Banks (2nd Replacement) Directive No. SBB/65/2017'. Until the final write-up of the present thesis, NBE did not review the regulatory framework concerning Islamic banking.

The NBE Directives outlined in the preamble of the 'Limitation on Investment of Banks (2nd Replacement) Directive No. SBB/65/2017' highlight the following three focus areas:

Firstly, the directives emphasize the importance of implementing sound and prudent practices in investment-related activities by banks to effectively manage associated risks.

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<sup>115</sup>(1stReplacement) Directive to License and Authorize Interest Free Banking Business No. SBB/72/2019 Art.7(1).

Secondly, they underscore the significance of diversifying business activities and establishing clear limits for investments as essential tools for effective risk management within banks.

Lastly, the directives stress the need for banks to maintain focus on their core business activities, particularly debt financing conducted at arm's length. This suggests that while banks may engage in various investment ventures, their primary emphasis should remain on providing financing services while upholding an appropriate level of independence in their operations.

The purpose of enacting the directive is stated in the third line of the preamble, which is to restrict banks from focusing on their main business activities of debt financing. This practice is strictly prohibited in Islamic banking. The government considers this issue and allows interest-free banking conducted by CBs and full-fledged IBs. However, the law restricts “a bank may hold up to 10% equity shares in a single non-banking business other than insurance.”<sup>116</sup>

#### **4.1.1 Limits a bank holding up to 10% equity shares in a single non-banking business**

Article 4.4 of Directive No. SBB/65/2017 imposes a limitation on a bank's equity shares in a single non-banking business, other than insurance, to 10%. This provision aims to regulate the exposure and risk concentration of banks in non-banking activities, a critical measure for maintaining financial stability and preventing excessive risk-taking.

In the context of Islamic banking, especially concerning *Musharakah* contracts, ensuring compliance with regulatory requirements, including investment limits, is essential. Since Islamic banking operates on the principles of PLS, it is imperative for banks engaging in *Musharakah* to diversify their investments and manage risks effectively. *Mudarabah* contracts do not apply to a bank's equity share in a single non-banking business because, from the beginning, the bank provides the entire capital while the customer manages the business.

Hence, the limitations on equity shares outlined in Article 4.4 would also apply to IBs offering *Musharakah* products. Adhering to these limits assists IBs in mitigating risks associated with overexposure to a single non-banking entity, thereby safeguarding the interests of depositors and investors while fostering a sound and stable financial system.

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<sup>116</sup>Limitation on Investment of Banks (2 nd Replacement) Directive No. SBB/65/2017,Art. 4.

Until April 2024, Zamzam Bank and Hijra Bank, both established to provide comprehensive Islamic banking services, predominantly employed *Murabaha* as their financing method.<sup>117</sup> *Murabaha*, a type of financing based on markup, involves the bank acquiring the product or service and then selling it to the client at the original cost plus an agreed-upon markup fee. This fee serves as compensation for the risk the bank undertakes during the period between purchasing the product and selling it to the customer. Due to the limitation on equity shares outlined in Article 4.4 by the NBE, Islamic banks are hesitant to offer *Musharakah* products.<sup>118</sup>

#### **4.1.2 Limits a bank’s aggregate equity investment in all non-bank business to not exceeding 10% of its net worth**

A potential method of blending banking and commerce involves banks holding equity stakes in other companies. Therefore, countries aiming to maintain the division between banking and commerce establish restrictions on the extent to which banks can invest in other enterprises. Accordingly, the NBE enacted the following regulation: “[a] bank’s aggregate equity investment in all non-bank businesses, including insurance companies, shall not exceed 10% of its net worth.”<sup>119</sup> As stated in the preamble of the directive, its purpose is to emphasize the significance of diversifying business activities and establishing clear limits for investments as essential tools for effective risk management within banks. The directives stress the need for banks to maintain focus on their core business activities, particularly debt financing conducted at arm's length. The main objectives of banking are to collect deposits from customers who do not immediately need the money and to provide financing for those who require funds for investment purposes. Banking operates as an intermediary between these two parties.<sup>120</sup>

However, Directive No. SBB/65/2017 poses a significant legal challenge for Islamic banks in Ethiopia due to its restriction on bank investments. Article 4(6) of the directive stipulates that a

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<sup>117</sup>Interview with Hanan Desalegne, ‘Zamzam Bank Share Company, Financing and Investment Appraisal Director’ (20 April 2024); Interview with Yasin Manza, ‘Hijra Bank Share Company, Customer Relation Manager’ (23 April 2024).

<sup>118</sup>‘Zamzam Bank Share Company, Financing and Investment Appraisal Director’ (n 117); ‘Hijra Bank Share Company, Customer Relation Manager’ (n 117).

<sup>119</sup>Limitation on Investment of Banks (2 nd Replacement) Directive No. SBB/65/2017, Art. 4.

<sup>120</sup>Interview with Samuel Hussen Jemal, ‘Awash Bank S.C Interest Free Banking Director’ (29 April 2024).

bank's total equity investment in non-bank businesses, including insurance companies, must not exceed 10% of its net worth. This limitation directly impacts Islamic banking products like *Musharakah* and *Mudarabah*, which rely heavily on equity-based financing mechanisms. When conducting an interview with Mr. Temesgen <sup>121</sup> on April 30, 2024, he expressed his belief that the directive directly affects Islamic banking, particularly full-fledged banks. Officials from these banks have conveyed their concerns to both the NBE and the government on various occasions. However, Mr. Temesgen noted that the NBE's permission for full-fledged banking appears to be an incidental policy decision by the government, lacking proper investigation and the enactment of appropriate laws to create conducive working environment for full-fledged banking. Unlike the permission granted for full-fledged Islamic banking, currently the NBE, in collaboration with the government, is attempting to investigate before permitting foreign banks to enter, requiring a comprehensive legal framework encompassing the entirety of the country's laws to enable foreign banks to operate in Ethiopia. He now believes that the government is actively seeking solutions to address this issue.<sup>122</sup>

*Mudarabah* and *Musharakah* financings are equity-based financing models that represent pure Islamic banking structures and should be promoted as a priority. However, in Ethiopia, not many banks are set up to handle equity-based financing due to the legal framework that prohibits investing in non-banking businesses more than 10% of their equity.<sup>123</sup> This provision of the NBE directive materially limits the operations of Islamic banks. It affects *Mudaraba* (where the bank provides the capital and the entrepreneur provides the business acumen) and *Musharakah* (a joint venture). If Islamic banks continue to be governed by the principles applied to conventional banks and the provision cannot be amended, they will not be able to offer products such as *Mudarabah* and *Musharakah*, which are among the most common products associated with Islamic banks.<sup>124</sup>

In Islamic banking, equity investments differ from conventional banking as they prohibit interest-based transactions and emphasize profit-sharing arrangements. IBs prioritize asset-

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<sup>121</sup> 'National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner' (n 11).

<sup>122</sup> *ibid.*

<sup>123</sup> 'Hijra Bank Share Company, Customer Relation Manager' (n 117).

<sup>124</sup> *ibid.*

backed financing grounded in tangible assets, such as property or commodities. Moreover, Islamic banking operates under ethical and social principles derived from IL, prohibiting involvement in certain industries like alcohol, gambling, and pork-related businesses while prioritizing investments with positive social impacts.

Hence, Article 4.6 of Directive No. SBB/65/2017 may hinder IBs' ability to engage in equity-based financing, impacting their capacity to diversify investments and generate returns. This limitation particularly affects *Musharakah* and *Mudarabah* agreements, where partnership arrangements between banks and businesses are central and the bank shares profits and losses with the business.

Therefore, compliance with the directive presents a challenge for IBs in Ethiopia, as it limits their ability to operate within their established financing frameworks while adhering to IL principles.

#### **4.2 Absence of tax deduction for profit earned by the taxpayer and shared with the bank under *Mudaraba* profit sharing Islamic banking principles in the federal tax laws**

The unique nature of Islamic banking, with its emphasis on profit-sharing arrangements like *Mudarabah*, raises questions about the tax treatment of such profits within existing tax frameworks. The tax treatment of profits earned under *Mudarabah* profit-sharing arrangements in Islamic banking within the framework of federal tax laws is a crucial aspect that should be examined. *Mudarabah*, a foundational principle in Islamic finance, involves a partnership where one party provides capital (the investor, or "*rab al-mal*") and another party provides expertise and labor (the manager, or "*mudarib*"). While profits generated from *Mudaraba* are shared based on a pre-agreed profit-sharing ratio, losses are borne solely by the investor.

In conventional banking, customers borrow from a bank, run businesses, and deduct interest paid to the bank as expenses when fulfilling their tax obligations to the relevant tax authority. In Islamic banking *Mudarabah* arrangements, customers who share profits with the bank should have a mechanism to deduct these shared profits as expenses when paying taxes to the relevant government authority.

One significant issue arises from the absence of specific tax deductions or exemptions for profits earned and shared under *Mudarabah* principles. This absence may create a disparity in tax treatment between conventional and Islamic banking practices, potentially impacting the competitiveness and viability of Islamic banking products and services.

#### **4.3 Accommodating Murabaha Financing within the Ethiopian Tax Law Framework**

Interest-free banks in *Murabaha* transactions face a significant challenge due to double taxation. For a *Murabaha* transaction to be considered valid, it is essential that the financier take ownership and hold physical or constructive possession of the commodity before selling it to the customer on *Murabaha* terms. During a period, the financier must bear the risk associated with the commodity. Without assuming ownership or bearing the commodity's risk by financier, even for a brief period, the transaction would not be deemed acceptable under Islamic law.<sup>125</sup> *Murabaha* is the sale of a commodity the price of which is deferred to a specific date. *Murabaha* transactions aim to provide commodities with a markup profit rather than conventional interest-based loans to customers.

According to Ethiopian Value Added Tax Proclamation No. 285/2002, a sale of goods constitutes a taxable transaction. When the bank purchases commodities for *Murabaha* financing, it must pay VAT. Subsequently, in *Murabaha* financing, banks sell goods at their original prices with transparent costs and added VAT. This model frequently leads to double taxation: initially when the bank procures from suppliers, then again when the customer acquires from the bank. To mitigate this issue, banks refrain from direct commodity purchases; instead, customers purchase on behalf of the bank under a granted agency contract.<sup>126</sup> This arrangement allows the customer to purchase directly from the supplier and take delivery of the goods themselves, while the bank provides direct financing to the supplier.<sup>127</sup>

In the writer's view, although there are similarities between conventional interest systems and *Murabaha* financing, Islamic scholars permit *Murabaha* with the condition that the bank retains possession of the goods until the customer completes payment. Despite arguments equating the

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<sup>125</sup>*An Introduction to Islamic Finance* (n 4) 107.

<sup>126</sup>Zamzam Bank Share Company, Financing and Investment Appraisal Director' (n 117).

<sup>127</sup>*ibid.*

bank's profit to interest, scholars maintain that the profit margin in *Murabaha* serves to compensate for the risk assumed by the bank.<sup>128</sup> The markup incorporates the risk undertaken by the bank from the moment of acquiring the goods to selling them to the customer. Several factors influencing this charge include the scale of the transaction, the buyer's reputation, and the characteristics of the goods or services. Generally, payments are distributed over installments or delayed, and there is no fee for the deferral.<sup>129</sup>

Financing the supplier based on trust in the customer, who has entered into a contract with the bank and been given agency power, raises concerns about the diversification of funds for purposes other than *Murabaha* financing.<sup>130</sup> This would also contradict the main principles of IF, which include risk and profit sharing as well as asset-backed financing. One major cause of non-performing loan returns in CBs in Ethiopia, as observed by the writer during their banking career, is the diversification of loans beyond the purposes specified in the contract. This occurs despite clauses in the contract expressly forbidding such diversification. To prevent finance diversification by customers and ensure asset-backed finance in *Murabaha* Islamic banking, the legal system should permit it, and the bank must take the necessary risks and ownership of the goods, transferring them to the buyer.

When examining Ethiopia's VAT tax legislation, Article 7 of Value Added Tax Proclamation No. 285/2002<sup>131</sup> stipulates that a tax, referred to as value-added tax, shall be imposed and remitted at a rate of 15% (fifteen percent) on the value of goods supplied or services rendered in Ethiopia in the course or advancement of a taxable activity, except for those exempted under the proclamation or other laws.

Although Article 8(2) (b) of Value Added Tax Proclamation No. 285/2002 excludes the supply of goods or rendering of services by financial institutions from VAT, the Banking Business Proclamation does not classify *Murabaha* Islamic banking as financial services. However, the

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<sup>128</sup>Hassan and Lewis (n 51) 52.

<sup>129</sup>Shelagh A Heffernan, *Modern Banking* (John Wiley & Sons 2005) 325.

<sup>130</sup>Interview with Adanch Shifa Mohammed, 'Global Bank Ethiopia S.C Interest Free Banking Division Manager' (28 April 2024).

<sup>131</sup>Value Added Tax Proclamation No. 285/2002. Federal Negarit Gazeta of the Federal Democratic Republic of Ethiopia. 18th Year No. 33, Addis Ababa: 4th July, 2002.

amendment Directive to License and Authorize Interest-Free Banking Business NBE Directive No. SBB/72/2019, Article 2.2, defines "interest-free banking business" as "a banking business in which mobilization or advancing funds is undertaken in a manner consistent with Islamic law or Sharia principles."

In the present researcher's view, as the NBE is empowered to regulate banking businesses related to non-interest-bearing deposit mobilization and fund utilization by Article 22(2) of Banking Business Proclamation No. 592/2008 (as amended by Proclamation No. 1159/2019), it defines "interest-free banking business" as banking conducted in accordance with IL principles. Therefore, *Murabaha* financing provided by banks to customers, adhering to IL, should be considered a financial service and thus exempt from VAT. This implies that a bank could purchase goods for *Murabaha* financing while paying the taxes and subsequent buyers should not be subject to these taxes.

However, Ethiopia faces several challenges in this regard. Firstly, Islamic banking is in its emerging stages, with limited awareness among governmental bodies and bankers regarding its financing practices.<sup>132</sup> Without clear legislation on how banks procure goods for *Murabaha* financing, banks are reluctant to engage in such transactions independently. Furthermore, both banks and IB customers lack confidence in the application of tax laws, given the early stage of Islamic banking development.

To address these issues, until an adequate legal framework is established, specific directives should be issued by the Minister of Finance in collaboration with the NBE<sup>133</sup>. Without clear legislation, buyers may hesitate to engage in *Murabaha* financing with banks, fearing VAT implications, and banks have an obligation to pay fees in relation to the title transfer of immovable properties.

The second issue is that even in the contemporary financing methods of Ethiopian Islamic banking, it is not always feasible for customers to utilize *Murabaha* financing instead of the

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<sup>132</sup>Interview with Siraj Mehdi, 'Commercial Bank of Ethiopia, Senior Interest Free Banking Legal Service Advisor' (25 April 2024).

<sup>133</sup>'Awash Bank S.C Interest Free Banking Director' (n 120).

conventional banking system. Assuming a certain businessperson, Mr. X, engaged in retail business in the Merekato area, wants to borrow working capital from the Commercial Bank of Ethiopia amounting to Birr 3,000,000.00 (three million birr) for one year with a 15% interest per annum. The individual would return the principal amount of Birr 3,000,000.00 plus Birr 450,000.00 in interest, totaling Birr 3,450,000.00. On the other hand, another individual, Mr. Y, who is engaged in a similar retail business in the Merekato area, seeks to finance his working capital. However, due to the religious prohibition against paying or receiving interest, he approaches the IFB division of the Commercial Bank of Ethiopia for alternative financing. He advises the bank to finance his working capital of Birr 3,000,000.00 through *Murabaha* financing. The bank agrees to this arrangement and disburses the money directly to the suppliers of the goods, applying a markup of Birr 450,000.00. Consequently, the bank finances Mr. Y with Birr 3,450,000.00 and Mr. Y returns the entire amount to the bank at the end of the year.

The Ethiopian Federal Income Tax Proclamation No. 979/2016 treats Mr. X and Mr. Y differently. According to Article 23 of the aforementioned income tax proclamation, in determining the taxable income for a tax year, Mr. X shall be allowed a deduction of Birr 450,000.00 for any interest incurred in the tax year, to the extent that he has used the proceeds or benefits of the debt or other instruments or agreements that give rise to the interest to derive business income. However, Mr. Y may not be entitled to deduct the cost of Birr 450,000.00 paid to the bank in *Murabaha* financing. Consequently, Mr. X and Mr. Y, who operate similar businesses in the same location, are treated differently under the Ethiopian Federal Income Tax Law for similar expenses and purposes, but utilizing different financial products from the same organization. This would also reduce customers' willingness to utilize this facility. Consequently, this Islamic banking product may lose its competitiveness compared to conventional banking credit financing.

#### **4.4 Absence of central organized Sharia Supervisory Board(SSB)**

One distinctive aspect of governance in IB and CB is the establishment of a SSB. Sharia compliance is crucial for ensuring the legality of contracts and upholding the integrity and credibility of IBs. Sharia supervision is necessary for IBs to ensure that their activities adhere to Sharia principles.

In Ethiopia, Article 7.2 of the amended Directive to License and Authorize IFB Business, NBE Directive No. SBB/72/2019, mandates that the "board of directors of banks engaged in interest-free banking develop detailed policies and procedures for Sharia oversight."

While the initial Replacement Directive does not explicitly mandate the formation of a Sharia board for full-fledged Islamic banks or the Islamic windows of CBs, the NBE Directive requires the board of directors of banks engaged in IFB to develop detailed policies and procedures on Sharia oversight. However, it does not mandate the establishment of a Sharia board at the bank level for both IB and CB engaged in IFB. Nevertheless, these banks have chosen to establish a Sharia advisory board at each bank level. However, there is variation in the composition and qualifications of board members among different banks. Additionally, many banks tend to prioritize hiring prominent Islamic scholars to exert influence in the market without necessarily considering their expertise in both IL principles and banking practices.<sup>134</sup>

Interviews were conducted with Temesgen<sup>135</sup> on April 29, 2024, Siraj<sup>136</sup> on April 25, 2024, Samuel<sup>137</sup> on April 29, 2024, Adanech<sup>138</sup> on April 28, 2024, Mustefa<sup>139</sup> on April 23, 2024, Yasin<sup>140</sup> on April 23, 2024, and Hanan<sup>141</sup> on April 20, 2024, to gather their opinions on the importance of enacting specific legislation regarding the formation and operations of SSBs at the NBE, aimed at supporting Islamic banking practices. The shared opinion indicates a potential requirement for such legislation. SSBs could play a pivotal role by providing guidance to bank-level established SABs and offering oversight to ensure that financial institutions providing Islamic financial services adhere to IL principles and comply with Shariah.

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<sup>134</sup>Global Bank Ethiopia S.C Interest Free Banking Division Manager' (n 130).

<sup>135</sup>National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner' (n 11).

<sup>136</sup>Commercial Bank of Ethiopia, Senior Interest Free Banking Legal Service Advisor' (n 132).

<sup>137</sup>Awash Bank S.C Interest Free Banking Director' (n 120).

<sup>138</sup>Global Bank Ethiopia S.C Interest Free Banking Division Manager' (n 130).

<sup>139</sup>Interview with Mustefa Kewete, 'Oromia Bank S.C Interest Free Department, Investment and Appraisal Senior Officer' (23 April 2024).

<sup>140</sup>Hijra Bank Share Company, Customer Relation Manager' (n 117).

<sup>141</sup>Zamzam Bank Share Company, Financing and Investment Appraisal Director' (n 117).

The consensus among those interviewed indicates that enacting specific legislation to mandate the formation of SSBs at the NBE could standardize the procedure for ensuring adherence to IF principles. This legislation could outline the composition, qualifications, duties, and decision-making protocols of these boards, as well as establish mechanisms for overseeing and enforcing compliance. Having dedicated legislation governing SSBs could provide transparency and uniformity to the regulation of Islamic banking in Ethiopia. Moreover, it could enhance investor trust and promote the expansion of IF in the country by creating a framework to guarantee the legitimacy and credibility of Islamic financial offerings.

Implementing specific legislation regarding the establishment and functioning of SSBs at the National Bank of Ethiopia could serve to support and advance Islamic banking practices in the country.

Mr. Samuel,<sup>142</sup> in his interview on April 29, 2024, suggests that SSBs should ideally consist of individuals with expertise in both business and *Shariah* principles. Similarly, Mr. Siraj,<sup>143</sup> in his interview on April 25, 2024, recommends the following composition for SSBs: The supervisory board should comprise qualified *Shariah* scholars who possess in-depth knowledge of IF principles and practices. Including legal experts who are well-versed in both IL and Ethiopian financial regulations would be essential to ensuring compliance with existing laws. The inclusion of professionals with hands-on experience in the IF industry would offer practical insights into the effective implementation of *Shariah*-compliant practices. Regarding the scope of *Shariah* supervisory, the Interest-Free Banking Director at Awash Bank suggests that it should encompass all aspects of Islamic financing principles. Additionally, the supervisory board should provide guidance to the NBE concerning matters related to Islamic banking.<sup>144</sup> Mr. Siraj, in his interview on April 25, 2024, suggests that the supervisory board could offer guidance on interpreting *Shariah* principles regarding financial transactions, ensuring alignment with IL. Additionally, it could advise on how Islamic financial institutions can comply with Ethiopian financial regulations while maintaining adherence to IL principles. Moreover, the board could provide input on developing IF products and services that meet *Shariah* compliance standards

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<sup>142</sup>Awash Bank S.C Interest Free Banking Director' (n 120).

<sup>143</sup>Commercial Bank of Ethiopia, Senior Interest Free Banking Legal Service Advisor' (n 132).

<sup>144</sup>Awash Bank S.C Interest Free Banking Director' (n 120).

and market demands. Lastly, it could be engaged in providing training and education on IF principles for financial institutions and regulators in Ethiopia.

Challenges and obstacles in enacting and implementing legal reforms and regulations for Islamic banking in Ethiopia, as suggested by Mr. Temesegen<sup>145</sup>, in his interview on April 30, 2024, and Mr. Siraj<sup>146</sup>, in his interview on April 25, 2024, are summarized as follows:

The primary challenge is the limited awareness and understanding of Islamic banking principles among policymakers, regulators, and the general public in Ethiopia, which can impede the development and implementation of effective legal frameworks. Currently, Ethiopia lacks a dedicated regulatory framework for Islamic banking, making it difficult to regulate and supervise Islamic financial institutions. Developing a comprehensive regulatory framework aligned with IL principles and international standards is crucial for the successful implementation of Islamic banking in the country. Furthermore, there is a deficiency in expertise and capacity in Islamic finance among regulators, policymakers, and financial institutions in Ethiopia. Offering training and education programs on Islamic banking principles and practices can help bridge this gap and equip stakeholders with the necessary skills and knowledge for effective regulation. Lastly, engaging with key stakeholders, including Islamic financial institutions, scholars, and community leaders, is essential for developing and implementing legal reforms for Islamic banking in Ethiopia. Building consensus and fostering collaboration among stakeholders can help overcome challenges and promote the growth of IF in the country.

#### **4.5 Summary**

The chapter examines Ethiopia's legal framework for Islamic banking, tracing its evolution from initial regulations allowing non-interest-bearing activities to later directives permitting CBs to offer Islamic products, culminating in the establishment of full-fledged interest-free banks. Challenges persist, notably the compatibility of existing directives with Islamic banking principles. For instance, regulations conflict with PLS mechanisms, hindering equity-based financing like *Musharakah* and *Mudarabah*. Additionally, restrictions on equity shares in non-

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<sup>145</sup>National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner' (n 11).

<sup>146</sup>Commercial Bank of Ethiopia, Senior Interest Free Banking Legal Service Advisor' (n 132).

banking businesses persist, impacting Islamic banks' operational capacity. Directive No. SBB/65/2017 imposes a 10% equity share limitation on banks on a single business, aiming to regulate risk concentration and maintain financial stability, which is crucial for IBs who are vulnerable to risks in equity participation. On the other hand, the 10% equity share limitation in non-financial business poses a challenge for Islamic banks engaging in *Musharakah* and *Mudarabah* contracts, hindering diversification and adherence to IL principles. The absence of tax deductions for profits shared under *Mudarabah* principles raises concerns about fairness compared to conventional banking practices, affecting the competitiveness of Islamic banking products. Interest-free banks face double taxation issues in *Murabaha* transactions, as current tax laws do not recognize profit-sharing models. VAT exemption challenges persist due to limited awareness and unclear legislation. The absence of a central SSB poses challenges for Islamic banking, with varying SABs lacking standardization. Interviews suggest a need for specific legislation mandating SSBs at the NBE to ensure compliance with Islamic finance principles. Challenges in practicing IBs include limited awareness, the absence of dedicated regulation, capacity gaps, and stakeholder engagement. Addressing these challenges through education, regulatory frameworks, and stakeholder collaboration is crucial for advancing Islamic banking in Ethiopia.

## CHAPTER FIVE

### FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

#### 5.1 Findings

- **Legal Framework and Compliance:** The establishment of interest-free banking in compliance with Islamic law principles, as per NBE Directive Number SBB/72/2019, marked a significant step. However, most directives were initially tailored for conventional banking, necessitating specific regulations for Islamic banking. The delay in proactive steps by the NBE poses challenges.
- ***Musharakah* and *Mudarabah* Islamic Banking-finance legal challenges:** Islamic banking adheres to principles prohibiting interest-based transactions and uncertainty, promoting ethical and transparent financial practices. *Musharakah* and *Mudarabah* are key Islamic financing methods, emphasizing profit and loss-sharing and equity participation. Article 4.6 of NBE Directive No. SBB/65/2017 poses challenges for *Musharakah* and *Mudarabah* by restricting equity shares in non-banking businesses, hindering their ability to offer equity-based financing and contribute to economic development.
- ***Murabaha* Financing:** *Murabaha* Financing faces double taxation issues when the bank purchases and sells goods, as there are no specific tax law provisions exempting double taxation during these transactions. This situation creates potential competitive disadvantages compared to conventional banking products, which go against Islamic law's permission of *Murabaha* under specific conditions, especially when ownership transfer is required.
- **Absence of Tax Deductions for *Murabaha* Cost-Plus:** The federal income tax proclamation lacks clear provisions enabling customers to claim tax deductions for *Murabaha* cost-plus transactions. This absence of deductions for profits earned under these arrangements raises concerns about equitable tax treatment within CBs.

- **Sharia Supervision and Dispute Resolution:** While banks are required to establish Sharia oversight policies, the absence of a central SSB complicates operations. Disputes in Islamic banking are not under the jurisdiction of Sharia courts, necessitating specialized bodies or empowering existing Sharia courts for effective resolution. The writer suggests empowering existing Shariah courts to handle Islamic banking disputes.

## 5.2 Conclusions

- **Legal Framework and Compliance:** The introduction of NBE Directive Number SBB/72/2019 was a significant milestone, permitting commercial banks to engage in IFB under IL principles. However, the majority of directives were crafted for conventional banking systems, necessitating tailored regulations to protect IBs from assimilation into conventional practices. This underscores the critical need for laws and regulations specifically tailored to Islamic banking institutions, ensuring compliance with Islamic principles while operating within legal frameworks.
- **Islamic Banking Principles:** Islamic banking is founded on principles of ethical and transparent financial practices, rejecting interest and uncertainty to uphold fairness, stability, and social justice in financial transactions. By employing innovative financial instruments and risk-sharing mechanisms, Islamic banking offers sustainable alternatives to conventional banking, fostering economic growth. The emphasis on equitable risk-sharing and investment in productive ventures aligns with Islamic values, promoting communal prosperity and discouraging undue wealth accumulation. Adherence to ethical guidelines ensures that Islamic investments benefit society as a whole, reflecting principles of equitable wealth distribution and societal well-being. Furthermore, Islamic banking prohibits *gharar* (transactions involving uncertainty or speculation), ensuring transparency in contracts and discouraging predetermined profits, except in certain minimized-risk transactions like deferred sales and hire contracts. Additionally, Islamic investments must steer clear of forbidden or discouraged activities such as the alcohol trade or gambling, ensuring the financial system operates fairly and benefits society in line with Islamic principles of equitable wealth distribution and societal well-being.
- **Major Islamic Financing Methods:** *Musharakah* is a partnership where multiple parties invest capital in a venture, sharing profits and losses based on their investment ratios,

aligning with the principle of true profit and loss sharing in Islam. *Mudarabah* involves one party providing capital (the investor) and another offering labor and expertise (the entrepreneur), with profits shared based on a predetermined ratio while the investor bears any losses. *Murabaha* is a sale contract where the bank purchases a commodity and sells it to the customer at a marked-up price agreed upon in advance, structuring transactions as sales rather than conventional loans with interest, ensuring transparency and compliance with Islamic principles. These methods are fundamental to IF. *Musharakah* emphasizes true PLS through partnerships, while *Mudarabah* involves profit-sharing arrangements between investors and entrepreneurs. *Murabaha* financing, widely used internationally and in Ethiopia, serves as a structured sale contract, providing transparency in transactions and adhering to Islamic principles.

- **Regulatory Challenges and Preferences for *Murabaha* Financing:** The NBE directive, limiting banks to a 10% equity share in a single non-banking business, plays a crucial role in managing risk concentration and ensuring financial stability. Compliance with these provisions, especially concerning *Musharakah* and *Mudarabah* contracts, is vital in Islamic banking. However, Islamic banks like Zamzam Bank and Hijra Bank have shown a preference for *Murabaha* financing due to hesitation caused by the equity share restriction by the NBE. This preference affects their capacity to diversify investments and operate within Islamic banking principles, thereby hindering their ability to generate returns. Addressing this challenge is essential to enabling IBs to offer diverse products and contribute effectively to Ethiopia's financial sector.
- **Regulatory Challenges to practice *Murabaha*:** Unlike conventional banking, where interest payments are tax-deductible expenses, Islamic banking's profit-sharing model lacks specific provisions for deducting shared profits as expenses. This disparity in tax treatment may affect the competitiveness and viability of Islamic banking products and services, highlighting the need for examination and potential amendments to ensure fairness and consistency within the tax framework. The absence of specific provisions for tax treatment of profits earned under *Murabaha* profit-sharing arrangements in Ethiopian tax laws poses a challenge for interest-free banks engaging in *Murabaha* transactions. Despite the bank's adherence to IL principles, the lack of clarity in tax regulations results

in potential double taxation, impacting the viability of Islamic banking products. Additionally, the distinction in tax treatment between conventional and Islamic banking transactions further complicates matters, potentially reducing customer willingness to utilize Islamic banking facilities. Addressing these challenges requires specific directives from the Minister of Finance in collaboration with the NBE to provide clarity and consistency in tax regulations for *Murabaha* financing.

- **Sharia Supervision and Dispute Resolution:** The absence of a central SSB and limited Sharia court jurisdiction over Islamic banking disputes in Ethiopia pose operational challenges. Mandating SSBs at the NBE and within each IB could standardize operations, enhance transparency, and bolster investor trust. Additionally, empowering existing Sharia courts or establishing specialized bodies for dispute resolution is essential to strengthening the legal framework. This would ensure effective handling of Islamic banking conflicts and enhance the overall regulatory environment for IF in Ethiopia.

### 5.3 Recommendations

To better align the legal framework with the principles and needs of Islamic banking in Ethiopia and establish an adequate legal, regulatory, and institutional framework for governing Islamic banking, a comprehensive approach is necessary. Here is how the recommendations can be streamlined and made more coherent:

- **Develop adequate Regulatory Framework:** Create specific regulations and guidelines which accommodating the unique principles and requirements of Islamic banking, ensuring compliance with IL alongside local laws. This framework should encompass clear guidelines on product structuring, risk management, and disclosure requirements, drawing insights from regulatory frameworks in countries like Indonesia.
- **Ensure Taxation Clarity and Fairness:** Address the unclear tax treatment of Islamic banking products by introducing specific provisions within tax laws to ensure fairness and consistency. This may involve allowing tax deductions for profits earned and shared under profit-sharing arrangements such as *Mudarabah* and considering cost adjustments by banks in *Murabaha* financing against the buyer, akin to practices in the UK.

- **Promote Investment Diversification:** Encourage investment diversification by relaxing regulatory restrictions on equity investments and introducing incentives for financing modes like *Musharakah* and *Mudarabah*. Learning from countries like Indonesia, where Islamic banks engage in equity-based financing, Ethiopia can foster a more diverse investment portfolio.
- **Establish a Central Sharia Supervisory Body at the NBE Level:** Enhance regulatory oversight and supervision of Islamic banks by creating a central SSB within the NBE. This body should comprise scholars and experts in IL and finance, similar to Shariah boards in Indonesia, ensuring consistency and adherence to ILs principles across the industry.
- **Implement Specialized Dispute Resolution Mechanisms:** Set up specialized dispute resolution mechanisms dedicated to resolving Islamic banking conflicts efficiently and in accordance with Sharia principles. These mechanisms could be integrated into the recommended SSB at the NBE level or empower existing Sharia courts to handle Islamic banking conflicts, effectively.
- **Facilitate Capacity Building and Education:** Promote Sharia compliance through training programs for regulators, bankers, and other stakeholders to deepen their understanding of Islamic banking principles.
- **Encourage Government Support and Collaboration:** Foster collaboration and partnership between Islamic and CBs to promote IF growth, possibly through incentives or tax breaks. This involves collaboration between government agencies, regulatory bodies, industry stakeholders, and international partners to support the growth and development of IF in Ethiopia.

By implementing these recommendations, Ethiopia can create an enabling environment for Islamic banking to thrive, fostering financial inclusion, meeting the needs of the Muslim community, promoting ethical practices, and driving sustainable economic growth in line with Islamic principles.

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## **Interviewees÷**

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Interview with Hanan Desalegne, ‘Zamzam Bank Share Company, Financing and Investment Appraisal Director’ (20 April 2024)

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Interview with Samuel Hussien, ‘Awash Bank S.C Interest Free Banking Director’ (29 April 2024)

Interview with Siraj Mehdi, ‘Commercial Bank of Ethiopia, Senior Interest Free Banking Legal Service Advisor’ (25 April 2024)

Interview with Temesegen Menza, ‘National Bank of Ethiopia Bank Supervision Directorate Senior Banking Examiner’ (30 April 2024)

Interview with Yasin Manza, ‘Hijra Bank Share Company, Customer Relation Manager’ (23 April 2024)X

## **ANNEXES**

My name is Agrani Sabito, and I am currently pursuing an LL.M. in Business Law at Addis Ababa University, School of Law. As part of my research, I am investigating the adequacy of the legal framework concerning Islamic banking in contemporary Ethiopia.

To gather valuable insights for my study, I am reaching out to regulatory authorities and commercial banks that practice interest-free banking. I would greatly appreciate your collaboration in the form of interviews or by completing the enclosed questionnaire. Please be assured that all responses will be treated confidentially and will only be used for the purpose of this research. Your participation is vital to the success of this study, and I am grateful for your time and cooperation.

**I. Personal Information**

1. What is your name? \_\_\_\_\_
2. What is the name of your institution? \_\_\_\_\_
3. What is your job position? (Please indicate with a cross mark (√) in the relevant boxes.)  
Director  Manager  Principal  Senior officer  Officer
4. What is your educational level? (Please indicate with a cross mark (√) in the relevant boxes.)  
Diploma  First Degree  Second Degree and Above

**II. Islamic Philosophy**

5. Could you provide your insights on Islamic philosophy in general, particularly concerning its philosophies for banking?

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6. Could you provide your general views on the merits and demerits of allowing Islamic banking operations in Ethiopia?

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7. Could you provide your general views on your personal assessment of the ongoing window-based or full-fledged Islamic banking practices in Ethiopia?

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**III. Legal and Policy Framework**

8. Can you provide your understanding of the applicability of Article 4.4 of Directive No. SBB/65/2017 to Islamic banking (*Musharakah* and *Mudarabah*), specifically regarding the limitation on a bank's equity shares in a single non-banking business other than insurance to 10%?

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9. How does Article 4.6 of Directive No. SBB/65/2017, which limits a bank's aggregate equity investment in all non-bank businesses to not exceeding 10% of its net worth, affect Islamic banking operations?

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10. Do you believe the current federal tax laws accommodate tax deductions for running the business and apply for profits earned through *Mudarabah* profit-sharing Islamic banking principles? Please elaborate on any existing provisions or lack thereof.

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11. Do you think the Ethiopian tax law framework accommodates practicing *Murabaha* financing in compliance with Islamic law? Why?

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12. Do you see a need for specific legislation concerning the establishment and functioning of Sharia Advisory Boards at the level of the National Bank of Ethiopia to support Islamic banking practices?

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13. If you favor the establishment of Sharia Advisory Boards at the National Bank of Ethiopia level, what could be the composition and scope of their advisory?

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14. How do you think the absence or presence of Sharia advisory boards impacts the development and implementation of Islamic banking products within the existing legal framework?

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15. From your perspective, what challenges or obstacles exist in enacting and implementing legal reforms as well as regulating Islamic banking in Ethiopia, and how might these be addressed?

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16. Do you have any recommendations for better aligning the legal framework with the principles and needs of Islamic banking in Ethiopia?

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Thank you for your participation in this interview or questionnaire.