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ASSESSING THE PROSPECTS AND CHALLENGES OF ISLAMIC BANKS IN ETHIOPIA THE CASE OF ZAMZAM BANK

By: Abdulwahid Dino

**Thesis Submitted to Addis Ababa University College of
Business and Economics Department of Management for
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COLLEGE OF BUSINESS AND ECONOMICS
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ZAMZAM BANK**

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Declaration

This is to declare that this research paper is the result of my own work and all the reference materials used in this paper have been well acknowledged. Taking various useful guidance and suggestions from my research advisor Mohammed Seid (PhD), I have developed this research thesis independently. This research paper has not been presented to collect any degree in this or any other University. This research paper is submitted for the partial fulfillment of MBA degree in management.

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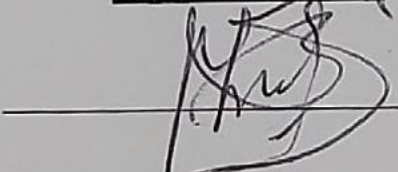
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Thesis Certification Approval Sheet

This is to certify that the research study produced by Abdulwahid Dino entitled **“Assessing the challenges and prospects of Islamic banks in Ethiopia: a case of Zamzam bank branch in Addis Ababa City Kolfe Keraniyo sub-city”** and submitted to fulfill the partial requirements for the degree of masters of Business Administration (MBA) with the regulation of the university and fulfill the accepted standards with respect to originality and quality of the thesis.

Advisor

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signature

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ACRONYMS

ABBREVIATIONS	MEANING
IB	Islamic Banking
IFB	Interest Free Banking
ATM	Automated Teller Machine
CBE	Commercial Bank of Ethiopia
IBS	Islamic Banking Service
IF	Islamic Finance
IFSB	Islamic Financial Services Board
GCC	Gulf Cooperation Council
PSIA	Profit-Sharing Investment Accounts
NBE	National Bank of Ethiopia
R&D	Research and Development

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ABSTRACT

The aim of this study was to evaluate the problem and prospects of Islamic banks in Ethiopia case Zamzam Bank. To achieve this, a descriptive research design was conducted and both a qualitative and quantitative research method was used. This study was conducted using 400 of respondents, which was probably selected using a simple random sampling method from the total number 20,050 target population. The researcher used both primary and secondary source of data to conduct the study. The researcher conducted quantitative and qualitative analysis from the responses collected on research questions. Data that is collected using a structured questionnaire (quantitative data) are coded and analyzed using quantitative analysis with the help of Microsoft Excel 2016 software. Based on the result of the finding, lack of public awareness, lack of guidelines and supervisions, lack of supportive organization, tax policy and monetary policy, lack of legal framework, lack of professional in the sectors, lack of effective government support, lack of secondary market and Islamic insurance were identified as the main challenges of IB. While attraction of investors and potential customers, raising investment opportunity, financial inclusion of marginalized communities, creation of employment opportunities, support and expansion of local businesses, and creation of equitable distribution of income among the communities were identified as the major prospects of IB.

Keywords: *Islamic Bank, challenges and prospects, Addis Ababa, , Zamzam bank branc*

CHAPTER ONE

INTRODUCTION

This chapter provides an overview of the study, beginning with the background information. It then presents the statement of the problem, research questions, objective of the study, significance of the study, scope of the study, and finally, the organization of the study.

1.1 BACKGROUND OF THE STUDY

Islamic finance refers to financial services that are offered in accordance with Islamic law, also known as Sharia. Sharia law prohibits certain practices such as charging interest (Riba), engaging in transactions with uncertain outcomes (Gharar), participating in gambling (Maysir), engaging in short selling, and financing activities that are considered harmful to society. Additionally, Sharia law emphasizes the importance of fair dealing and enforceable contractual principles for both parties involved. It is essential for businesses operating in Islamic finance to have a foundation in the real market and to promote risk sharing in the labor market.

According to a study conducted by Hussain, Shahmoradi, and Turk in 2015, Islamic financial instruments can be categorized into three types. The first category is debt-based financing, which is established through sales contracts. This can take the form of a sale with a signature and deferred payment, known as Murabahah. It can also involve a purchase with deferred delivery of products, such as Salam for basic goods and Istisna' for finished goods. Another type of debt-based financing is leasing, known as Ijarah. In Islamic finance, pure credit, mostly used for deposit requests, is only allowed when it is done in good faith and it is also known as Qard. It is important to note that Islamic financial instruments are based on ethical principles and adhere to Shariah law.

The second financial instrument is similar to Profit and Loss Sharing (PLS) and consists of two models: (I) Profit sharing and loss (Mudarabah), where investors (such as traders and banks) provide capital and beneficiaries contribute labor and skills. The profits are shared based on the agreed terms, and the investors do not have the right to interfere in the management of the financial market, unless there is weak supervision, abuse, or non-compliance with the contract. (II) Pure profits and losses (Musharakah), where

both parties share equal financial responsibility for the project and also share the profits and losses. The third financial instrument includes services such as maintenance contracts (Wadi'ah) for current deposits, and agency contracts (Wakalah), which are increasingly used for money market transactions.

The global Islamic finance market has experienced rapid growth, with total assets reaching approximately \$3.95 trillion in 2021. In the Gulf Cooperation Council region, the value of Islamic banking assets increased from \$1,188 billion to \$2.76 trillion during the same period (Amna Puri-Mirza, 2023). Islamic banking is the most common form of Islamic financial service worldwide, accounting for 70% of the market share. The growth in 2019 was primarily driven by the surge in oil prices and an expansion in credit capacity. Additionally, the number of regions with significant Islamic markets increased from 12 to 13 in that year. However, the Gulf Cooperation Council region continues to hold the largest portion of Islamic market assets worldwide. In 2019, Ayandeh Bank in Iran emerged as the largest sharia-compliant bank, boasting estimated assets of \$26 billion. Iran held the highest amount of Islamic banking assets, closely followed by Saudi Arabia (Amna Puri-Mirza, 2023).

Islamic banks differ from conventional banks because they operate under the principle of interest prohibition. Instead of relying on interest-based transactions, Islamic banks are funded through interest-free checking accounts and profit sharing accounts. These accounts allow investors to earn returns based on the profitability of financial institutions. In terms of asset funding, Islamic banks do not lend on the asset side like conventional banks. Instead, they offer sales, leasing, profit and loss financing, and commission services. The profits generated from these transactions are directly linked to the profitability of the underlying transactions. There are also differences on the Treasury side. Islamic banks are typically not allowed to participate in certain forms of derivatives, such as currency forwards and foreign exchange forwards.

Islamic finance has experienced significant growth in the past decade, with Islamic banking sectors becoming systemically important in many countries. This growth is expected to continue, especially in countries with large Muslim populations that have significant savings and a desire to invest in Shariah-compliant financial products. The development of Islamic finance brings several benefits. It is often argued that Islamic finance is less complex and better at reducing risk for financial institutions and their

customers. This is due to its ability to consolidate assets and its adherence to strict moral rules (Abdul-Majid, M. Dinab, 2010)

Islamic Financial Institutions (IFIs) are also seen as a means to increase financial inclusion by providing financing to small and medium-sized businesses, thereby stimulating economic growth and development. Overall, Islamic finance offers a different approach to banking and has gained popularity for its stability, adherence to ethical principles, and potential for financial inclusion.

Recognizing the significance of Islamic finance, the International Monetary Fund (IMF) emphasizes its importance due to the concerns of its member countries regarding the impact of Islamic finance on economic and financial stability. The IMF has played a crucial role in establishing the Islamic Financial Services Board (IFSB) and has provided technical assistance and training to countries seeking to strengthen the regulation and supervision of their Islamic banking sector and develop their domestic Sukuk markets. The recent growth of Islamic finance has resulted in an increased demand for the IMF to provide policy advice and capacity building in various areas. As the industry continues to expand and gain systemic importance, particularly in relation to Islamic banking, Sukuk markets, and macroeconomic policy, the need for such advice is expected to grow (Interim Report on Digital Financial Inclusion, 2017).

During the global financial crisis, Islamic banks were less affected by the toxic assets that plagued traditional banks but did suffer from the downturn in the real estate sector. On average, Islamic banks have better asset equality and total capital compared to traditional banks, although profitability remains low. It is important to note that there are significant differences between jurisdictions within the industry averages.

Islamic finance has the ability to enhance economic growth by making it more inclusive. It has the potential to contribute positively to the overall development of an economy. By adhering to Islamic principles, such as avoiding interest-based transactions and promoting risk-sharing, Islamic finance can create a more equitable and sustainable financial system.

One of the key advantages of Islamic finance is its focus on ethical and socially responsible investments. This means that investments are made in sectors that are beneficial to society, such as healthcare, education, and renewable energy. By directing funds towards these sectors, Islamic finance can help address social and environmental

challenges, leading to a more sustainable and inclusive economic growth. Ethical principles underlying Islamic finance serve as important foundations for high levels of ethical behavior, good governance, and consumer protection. These principles ensure that financial activities are conducted in a responsible and ethical manner, which further enhances the trust and confidence in the Islamic finance industry.

Another advantages of Islamic banks are their adherence to risk-sharing principles and their strong connection between credit and collateral. This makes them well-suited for lending to small and medium enterprises as well as start-ups, which in turn contributes to more inclusive economic growth. Additionally, Sukuk, which are Islamic financial instruments similar to bonds, have proven to be effective in financing infrastructure projects and can also support investment and economic growth.

Furthermore, Islamic finance promotes risk-sharing between the lender and the borrower. This encourages a more responsible approach to lending and borrowing, as both parties have a stake in the success of the investment. This can help prevent excessive risk-taking and speculative behavior, which were major contributors to the global financial crisis in 2008. By promoting a more stable and responsible financial system, Islamic finance can contribute to higher economic growth in the long run. The principles of risk-sharing and asset-based financing in Islamic finance promote better risk management among financial institutions and their customers, helping to prevent credit booms. Recent research has shown that Islamic finance can reduce macroeconomic volatility and the risk of bank runs (Benes and Kumhof 2012, and Wolf 2014).

In addition, Islamic finance provides access to financial services for underserved populations, such as low-income individuals and small businesses. Conventional financial systems often exclude these groups due to stringent requirements and high interest rates. Islamic finance, on the other hand, offers alternative financing solutions, such as microfinance and profit-sharing arrangements, which are more accessible and affordable for these marginalized groups. By providing financial inclusion, Islamic finance can empower individuals and businesses, leading to higher economic growth and reduced income inequality.

On the contrary, Islamic finance encounters numerous challenges. Despite the efforts made by Islamic finance standard-setters, many countries still subject the industry to

regulatory and supervisory frameworks designed for traditional finance. As a result, the unique characteristics of Islamic finance are not fully taken into account (Al-Maraj 2014). Additionally, the industry is still in its early stages, lacking economies of scale and access to legal and tax regulations, financial infrastructure, financial safety nets, and central bank liquidity.

According to Demirgüç-Kunt, Klapper, and Randall, 2013 a large number of Muslims lack access to traditional financial services, with only 24% of adults having bank accounts and 24% having access to formal finance, compared to 44% and 9% respectively for non-Muslim populations. This highlights the under-supply of financial services to the Muslim community. In the case of Islamic finance, the majority of bank deposits are provided on a profit-share and loss-share basis, with around 55% in the Middle East and North Africa region (Ali 2011). This means that if the banking sector encounters difficulties, it becomes "incompetent" and explicitly bails out its customers. This provides a safety net for depositors and contributes to the stability of the financial system.

Islamic finance is confronted with numerous challenges that hinder its development. Despite the efforts of Islamic regulators and standard-setters in formulating principles and technical standards, there is still a need for their adoption by national authorities, who often prioritize global conventional banking standards. This discrepancy affects the growth of Islamic finance and creates an uneven playing field compared to traditional financing, resulting in lower economies of scale.

Moreover, the lack of standardization and securitization, along with significant variations in practices across countries, introduces uncertainties for clients of Islamic finance. Additionally, the shortage of Shariah scholars with financial expertise and the slow pace of innovation further impede the industry's progress. These challenges not only hinder the development of Islamic finance but also contribute to the emergence of complex practices and products with increased risk. In conclusion, Islamic finance has the ability to enhance economic growth by making it more inclusive. By adhering to ethical principles, promoting risk-sharing, and providing access to financial services for underserved populations, Islamic finance can create a more equitable and sustainable financial system. This can lead to a more stable and prosperous economy for all.

In the context of Ethiopia, despite having a substantial Muslim population estimated at around 41 million, Islamic finance remains relatively small and faces numerous challenges. The establishment of a fully-fledged banking system in Ethiopia is a recent endeavor and is still in its early stages. Therefore, this study aims to explore the challenges faced by Islamic banking in Ethiopia and assess the prospects for its growth. By identifying the main obstacles to implementing an Islamic banking system in Ethiopia and addressing gaps in existing literature, this study will provide valuable guidelines for the industry's advancement.

1.2 STATEMENT OF THE PROBLEM

An "Islamic bank" is a financial institution that operates in accordance with Islamic Shariah principles. It adheres to the beliefs and principles of Islamic philosophy regarding trade and economics, known as *fiqhal-muamalat* or Islamic trading rules. These principles are derived from various sources of Islamic law, including the Qur'an, Sunnah, Ijma, Qiyas, and Ijtehad. Islamic banks avoid engaging in prohibited activities such as usury-interest (*riba*), uncertainty (*gharar*), and financing of forbidden transactions and businesses like alcoholic beverages, pornography, and gambling.

The growth of the Islamic banking industry has led to an increasing demand for Shariah-compliant products, not only from investors in the Middle East and other Islamic countries but also from shareholders worldwide. This has transformed Islamic banking into a global industry (Akram, and M.Raji, 2011)

Islamic banking has expanded rapidly across various financial activities, including retail banking, insurance, and capital market investments. The sector's continued growth can be attributed to three factors: the rising demand from large Muslim communities, including Muslim immigrants in Western countries, the oil resources of GCC countries, and the increasing attractiveness of Shariah-compliant financial services to non-Muslim investors seeking ethical investment and banking options (Alfred Kammer and Mohamed Norat, 2015).

Before 2008, none of the Ethiopian laws authorized the establishment of Islamic finance in Ethiopia. As a result, the need for interest-free Islamic finance from Ethiopian Muslim communities remained unnoticed for several years. In 2008, the National Bank of Ethiopia (NBE) announced Proclamation No: 592/2008, Article 22, Sub-article 2, which addressed concerns related to interest-free banking services. After providing

interest-free banking services through windows for three years, the NBE introduced new directives (Proclamation No: 51/2011) that weakened the demand for fully-fledged Islamic banking in Ethiopia. These directives stated that interest-free banking services were only provided by conventional banks through windows, discouraging the Muslim community. However, in 2019, the NBE issued a new proclamation (No: 1159/2019) that authorized the establishment of fully-fledged Islamic banking in Ethiopia. Following this announcement, numerous business corporations and share companies lined up to request licenses from the NBE to offer comprehensive interest-free banking services in Ethiopia (Sadik Mohammed 2014).

In the past years, the principles and rules of the banking and financial sectors in Ethiopia neglected the ideologies and interests of the Muslim communities. Despite facing numerous challenges, the establishment of Islamic banking in Ethiopia took more than a decade. Finally, in October 2020, the National Bank of Ethiopia granted a license to Zamzam Bank as the first fully-fledged Islamic bank in the country. Therefore, the main objective of this study was to assess the challenges and prospects of the Islamic banking system in Ethiopia, focusing on Zamzam Bank. The study aimed to identify the challenges that Islamic banking would face and the prospects and opportunities it would bring to the Muslim society and the entire community in the future.

1.3 RESEARCH QUESTIONS

Specific research questions are formulated to effectively address the research problem and achieve the desired research goals. In light of this, this study aims to provide answers to the following research inquiries:

1. What are the primary challenges that Islamic banking faces in Ethiopia?
2. What are the potential benefits that Islamic banking can bring to Ethiopia?
3. Will the introduction of sharia-compliant Islamic banks have encouraging economic impacts on the financially excluded community in Ethiopia?
4. What is the perception of the community regarding the operation of a fully-fledged banking system?

1.4 OBJECTIVES OF THE STUDY

1.4.1 General objective

The main objectives of this study was to assess the challenges, prospects and opportunities of fully fledged Islamic Bank in Ethiopia in case of Zamzam Bank.

1.4.2 Specific objectives

This study specifically attempts to achieve the following specific objectives.

- ✓ To investigate the main challenges of Islamic banking in Ethiopia
- ✓ To explore any opportunities which Islamic banking system brings to the community
- ✓ To examine the positive economic impacts of introducing sharia compliant Islamic banks to financially excluded community in Ethiopia
- ✓ To know the perception of the community regarding the operation fully fledged Islamic banking system

1.5 SIGNIFICANCE OF THE STUDY

The findings of this study have significant implications for various communities. Specifically, it can provide valuable insights for the marginalized Muslim community, as well as the business world. Additionally, it can offer guidance to political decision makers in developing effective solutions. Furthermore, this study can serve as a useful reference for future researchers interested in conducting research in this field.

1.6 SCOPE OF THE STUDY

This research focuses on evaluating the challenges and prospects of the Islamic banking system in Ethiopia, with a specific emphasis on Zamzam bank. The study is limited to Zamzam bank branches located in Addis Ababa. The research aims to assess the current challenges and prospects of the Islamic banking system. The data for the study will be collected through questionnaires distributed to participants, along with information obtained from accepted financial and economic theories from secondary sources.

1.7 LIMITATIONS OF THE STUDY

At the time of conducting this study there are various factors that affect the progress of the research. Some of the main constraints are budget, time and inaccessibility of data and lack of related literature review specially in case of Ethiopia. Even though these constraints are encountered finally the research was completed as projected

1.8 ORGANIZATION OF THE PAPER

The paper is organized into five chapters. Chapter one provides background information, discusses the problem, research question, purpose, importance, scope, and limitations of the study. Chapter two presents a literature review. Chapter three outlines the methodology, including the research method, data sources, data collection instruments, sample size, sample technique, and method of data analysis. Chapter four analyzes and discusses the study's results. Finally, chapter five offers an overview of the results, conclusion, and recommendations.

1.9 DEFINITION OF TERM

Amana/Amanah: reliability, trustworthiness, loyalty, honesty. Technically, an important value of Islamic society in mutual dealings. It also refers to deposits in trust

Al Wadia: Resale of goods with a discount on the original stated cost.

Al Wadiah: Safe keeping

Bai Muajjal (Deferred Payment Contract): A contract involving the sale of goods on a deferred payment basis.

Bai Al-Arboon: A sale agreement in which a security deposit is given in advance as a partial payment towards the price of the commodity purchased.

Bai al Salam: This term refers to advance payment for goods which are to be delivered later.

Bai Bithaman Ajil: This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client an agreed price.

Baitul Mal: Treasury

Fatwah: A religious decree.

Fiqh: Islamic jurisprudence. The science of the Shariah.

Gharar: Uncertainty and lack of knowledge of the specific sale descriptions, and this uncertainty can be either in the sold item or in the price of this item.

Hawala: Bill of exchange, promissory note, cheque or draft

Halal: Anything permitted by the Shariah.

Haram: Anything prohibited by the Shariah.

Ijara: A leasing agreement whereby the bank buys an item for a customer and then leases it back over a specific period

Ijara-wa- Iqtina: Similar to Ijara, except that the customer is able to buy the item at the end of the contract.

Ijma: Consensus of all or majority of the leading qualified jurists on a certain Shariah matter in a certain age.

Ijtihad: It refers to an endeavor of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the divine law in a matter on which the revelation is not explicit or certain, on the basis of Nass or evidence found in the Holy Qur'an and the Sunnah.

Istisna (Progressive Financing): A contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job.

Maysir: Gambling.

Mudaraba: An Investment partnership. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, is borne by the investor.

Mudarib: In a mudaraba contract, the person or party who acts as entrepreneur.

Murabaha: A form of credit which enables customers to make a purchase without having to take out an interest bearing loan.

Musharaka: An investment partnership in which profit sharing terms are agreed in advance, and losses re pegged to the amount invested – basically Private Equity

Qard Hasan: (free-interest loan) is giving free money to the one who wants to get benefit of it and return it without interest.

Rab-al-maal: In a mudaraba contract the person who invests the capital.

Riba: This term literally means an increase or addition. Technically it denotes any increase or advantage obtained by the lender as a condition of the loan.

Salam: is a sales contract in which an Islamic bank agrees to supply certain goods to a specific buyer (customer) on a predetermined future date.

Shariah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad.

Shariah Board: is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Shariah compliant products.

Sukuk: Sukuk are certificates representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects.

Sunnah: Custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad (PBUH) other than the Holy Quran known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet.

Takaful: Islamic insurance. Structured as charitable collective pool of funds based on the idea of mutual assistance.

Zakat: A financial obligation to be paid to its designated purposes. It is imposed legally (Compliance with Sharia) on those who have money that reached the nisab (designated amount) and was transferred.

CHAPTER TWO

REVIEW OF RELATED LITERATURE

This section provides a review of the literature and research conducted by various scholars on the challenges and prospects of the Islamic Banking System. It includes an overview of Islamic banking, its definitions, principles, major concepts, and empirical works

2.1. THEORETICAL REVIEW

2.1.1. Overview of Islamic Banking

The rise of a strong Islamic movement in recent years has sparked a renewed interest in Islamic economics, particularly Islamic banking. While countries like Iran and Pakistan have established Islamic banking systems, many other nations have adopted hybrid systems that blend Western and Islamic practices (Yousefi, Abizadeh, and McCormick, 1997). Islamic banking is rapidly gaining significance in the global financial market, being recognized as a valuable and competitive form of financial influence not only in Muslim countries but also beyond the Muslim world. It offers a wide range of financial products and services (Dusuki, 2008).

The industry has experienced a decline since its establishment in the mid-1960s and 1970s, but it has seen significant growth over the past three decades. In fact, it is now one of the fastest-growing sectors, with consistent double-digit growth for nearly 30 years (Iqbal and Molyneux, 2005; Okumus and Genc, as well as Dusuki (2008), emphasize that banks should not only focus on profitability but also on promoting Islamic standards and values and protecting the needs of the Islamic society as a whole. These standards give Islamic banks a greater responsibility to achieve Islamic economic goals, such as equality, fair distribution of wealth, and promoting economic development while upholding welfare and religious beliefs.

Furthermore, Akmel (2015) highlights that the term Islamic banking holds different meanings for various scholars. It refers to business or commercial activities conducted by companies that adhere to the principles of Sharia (Islamic law) and employ strategies aligned with Islamic business development. The principle of prioritizing ethics and morality in any business endeavor has universal appeal. Sharia law prohibits the payment or acceptance of interest rates for lending and borrowing, as well as trade and other activities that are deemed to contradict Sharia law.

Although these principles were used as the foundation for commercial success in the early days, it was not until the 20th century that numerous Islamic banks were established to offer alternative options for Muslims. However, it is important to note that Islamic banking is not limited to Muslims. This article adheres to the definition of Islamic banking provided in the introduction, which states that it is also known as interest-free banking and is governed by Sharia, the Islamic principles. These principles are derived from the Quran, Hadith, Sunnah, Ijma, Qiyas, and Ijtihad, and they strictly prohibit any form of interest or usury (Gait and Worthington, 2008).

Bello and Abubakar (2014) further argue that the concept of Islamic banking revolves around one central aspect: Islamic law (Sharia). Islamic banking is perceived and understood as a banking system that operates in accordance with Islamic law and Sharia principles. In other words, "Islamic banks are commercial institutions that do not engage in interest-based transactions. Their boards of directors operate in compliance with Islamic and Sharia law" (Akram, Rafique, and Alam, 2011).

2.1.2. Principles of Islamic Banking

According to Sharia law, Islamic banking institutions are required to adhere strictly to four principles: Riba, Gharar, Zakat, and Ethical Investment. These principles, as outlined by Samad (2004), make Islamic business unique.

The first principle, Riba, mandates that all business transactions must be interest-free. This means that any form of charging or receiving interest is strictly prohibited. Islamic banking institutions must find alternative ways to generate profits without resorting to interest-based practices. The second principle, Gharar, advises against engaging in activities or work that involve speculation. Speculation is seen as a form of uncertainty and risk, which goes against the principles of Islamic business. Therefore, Islamic banking institutions should avoid any speculative practices and focus on more stable and secure investments.

The third principle, Zakat, is a compulsory Islamic tax. It requires individuals and businesses to contribute a portion of their wealth to help those in need. Islamic banking institutions must ensure that Zakat is collected and distributed appropriately, as it is an essential aspect of Islamic economic and social welfare. The fourth principle emphasizes the importance of not engaging in haram activities. Haram refers to the production or use of goods and services that are forbidden in Islamic terms. Islamic

banking institutions must ensure that their operations and investments are in line with Islamic principles and do not involve any haram practices.

2.1.2.1. Riba

The Qur'an explicitly prohibits riba, but it does allow trade (al-Qur'an, 2:185). However, it does not clearly define whether riba refers to interest or usury. This lack of clarity has caused controversy among Muslim scholars in the past. Nevertheless, now there is a general consensus that riba encompasses any amount charged above the principal. Islamic banking and finance explicitly forbid the payment and receipt of interest, which is a fundamental principle in conventional banking and financing. Therefore, the prohibition of interest, in both payment and receipt, forms the core of Islamic banking and its financial instruments. On the other hand, conventional banking revolves around charging interest in various types of transactions, such as loans, advances, and leasing. It is important to note that Islamic banking goes beyond being simply interest-free. It also considers issues of gharar, haram, zakat, and qarè al-úasan (Bala et al., 2009: 26).

2.1.2.2. Gharar

Gharar, which refers to speculation or gambling, is strictly prohibited in Islam. While Islam permits taking risks in business transactions, it strictly forbids engaging in speculative activities and gambling. Any transaction that involves speculation, such as purchasing shares at a low price with the intention of selling them at a higher price in the future, is considered unlawful. In contrast, conventional banks face no restrictions when it comes to financing investments that involve speculation.

2.1.2.3. Zakat

Zakat is a mandatory religious payment or tax that the wealthy are obligated to give to the poor. It serves as a fundamental aspect of Islam, ensuring the fair distribution of wealth and safeguarding a decent standard of living for those in need. Zakat is one of the five pillars of Islam, making it an essential practice for Muslims. Islamic banks are required to establish a zakat fund and pay zakat on their profits. In addition to any conventional taxes imposed, Islamic banks must also pay zakat, even if the government is non-Islamic. This means that Islamic banks face dual taxation, including zakat and corporate business tax. In contrast, conventional banks that operate on interest-based

systems are only subject to corporate business tax, giving them a distinct advantage over Islamic banks (Bala et.al, 2009, pp. 30)

2.1.2.4. Islamic ethics of investment

In Islam, investment in production and consumption is guided by strict ethical codes. Muslims are not allowed to invest in businesses involved in alcohol, pork, gambling, illegal drugs, and other prohibited activities, even if they are profitable. Providing financing for such activities is illegal in Islam, so Islamic banks are forbidden from financing activities or items that are not permitted by Shariah. This restriction also extends to any activity or business that may be harmful to individuals or society, such as the production or consumption of tobacco, alcohol, or pornography. This limitation affects the profitability of Islamic banks, unlike conventional banks that do not face such constraints.

Bello & Abubakar (2014) explain the basic principles of Islamic banking. Islamic banking is a unique system that avoids all transactions prohibited in Islam. To be classified as an Islamic bank, the following principles must be adopted:

- Prohibition of interest (Riba): Islamic banks must not engage in any interest-related transactions but instead focus on profit and loss sharing.
- Prohibition of speculation (gharar): Islamic banks avoid transactions with excessive risk or linked to gambling, as Islam prohibits speculation.
- Profit, loss, and risk sharing: Islamic banks distribute business risk and profits between the providers of funds and entrepreneurs based on mutual agreement, promoting income distribution, social justice, and poverty alleviation.
- Shari'ah approved activities: Islamic banks only participate in transactions or activities approved by Shari'ah advisors, avoiding activities prohibited by Islamic law, such as alcohol and gambling.
- Social justice: Islamic banks are prohibited from engaging in transactions that lead to injustice or exploitation of any kind.
- Compulsory payment of zakat: Islamic banks are required to pay zakat, one of the five pillars of Islam.

→ Oversight by Shari'ah advisors: Islamic banks are regulated by experts in Islamic law who audit their operations and products to ensure compliance with Shariah guidelines.

Furthermore, Sole (2007) mentioned that in addition to the well-known Quranic prohibition against *riba* (interest), *gharar* and *maisir* (contractual uncertainty and gambling), and *haram* industries (such as those related to pork products, pornography, or alcoholic beverages), practitioners and supervisors must also adhere to other principles to ensure compliance with Islamic principles. These include compliance with Shariah (Islamic law), segregation of Islamic and conventional funds, adherence to accounting standards, and conducting awareness campaigns. The following sections will discuss the author's perspective on compliance with Shariah, segregation of funds, accounting standards, and awareness campaigns. Bello and Abubakar (2014, p. 28) propose a working model of Islamic banking, highlighting the diverse operating models of Islamic banks and the potential for further innovation within the boundaries of Sharia principles. They outline the following popular Islamic banking models:

2.1.2.5.1. Qard Hasan Loan

The Qard Hasan Loan is a loan provided by Islamic banks to eligible customers with the aim of alleviating poverty. According to Sharia law, the beneficiary is only required to repay the principal amount to the Islamic bank. However, customers have the option to express their gratitude by paying an additional fee. It is important for customers not to disclose this intention to the bank during the initiation of the transaction (Bala et al., 2009, p. 30).

2.1.2.5.2. Mudarabah (Silent Partner)

The Mudarabah contract involves a financial transaction between two partners. One partner, known as *Rabb-ul-Maal*, provides the necessary resources, while the other partner, known as *Mudarib*, enters into the business venture. Islamic banks act as the capital provider (*Rabb-ul-Maal*). Under this type of contract, the Islamic bank and the investor (customer) share the profits based on a predetermined agreement. However, in the event of a loss, the Islamic bank (or the depositor) bears the loss, and the investor loses their effort unless the loss was caused by their negligence (Bala et al., 2009, p. 25).

2.1.2.5.3. Murabahah (Additional Purchase Fees)

The Murabahah contract is commonly used for the purchase of goods. It is a sales contract between an Islamic bank and its customers, involving a fixed amount of money known as a markup. In this contract, the customer provides all the specifications of the desired product, and the Islamic bank takes on the risk of purchasing the product on behalf of the customer at an additional cost. The payment to the customer is made either at a specified time or on the spot (Bala et al., 2009, p. 25).

2.1.2.5.4. Ijarah (lease)

Ijarah refers to a traditional lease agreement offered by Islamic banks. In this arrangement, the bank purchases a property and leases it to the customer, who then makes regular payments to the bank, typically on a monthly basis. At the end of the contract, the customer may also have the option to purchase the property from the bank (Bala et al., 2009 p. 31).

2.1.2.5.5. Musharakah (Equity Partnership)

Musharakah is a partnership agreement where multiple individuals contribute capital to establish a specific business. Each partner has the choice to actively participate or not in the management of the business, allowing for flexibility in their involvement. In interest-free banks, the profits in the contract may not be directly proportional to each partner's capital contribution, but any losses incurred are shared in proportion to their individual investments. Islamic banks act as partners in such transactions to facilitate capital formation and distribute profits and losses accordingly.

2.1.2.5.6. Salam (Forward Trade Contract)

Salam is a sales contract in which an Islamic bank agrees to supply certain goods to a specific buyer (customer) on a predetermined future date. The customer pays the full amount upfront, and the bank delivers the product to the customer at the agreed-upon date. It is important to consider the perspectives of other authors on this topic, as their insights are valuable. While Bello and Abubakar (2014) provide relevant viewpoints, it is also necessary to explore the opinions of other authors such as Hussain, Shahmoradi, and Turk (2015) and Samad (2004). These authors emphasize that Islamic trade is based on the principles of avoiding interest-based transactions and utilizing money without interest. Profit and loss sharing is a fundamental aspect of Islamic banking and finance,

with various instruments available in the market that operate on the basis of profit and loss sharing.

Some of these instruments are equity-based contracts, as highlighted by Siddiqi (1983), Ahmad (1984), Iqbal and Mirahoor (1987), and Ahmad (1987) (cited in: Samad, 2004). Examples of such equity products include Musharakah (partnership) and trust money.

Mudarabah (*Silent Partnership*) - A mudarabah contract is a financial arrangement between two partners. One partner, known as the Rabb-ul-Maal, provides the necessary resources, while the other partner, known as the Mudarib, enters into the business venture. This type of partnership is widely accepted by Islamic banks and is considered one of the best Islamic investments. In a mudarabah partnership, the investor provides the capital for investment, while the other partner contributes labor and skills to manage the capital. The profit from the investment is shared according to the agreed terms.

Qard Hasan Loan or Amanah (*Mercy Loan*) - Islamic banks offer charitable loans, known as Qard Hasan loans, to eligible customers in order to alleviate poverty. According to Sharia law, the beneficiary is only required to repay the principal amount to the Islamic bank. However, customers may choose to pay an additional fee as a gesture of gratitude, but they should not disclose this intention to the bank during the loan initiation process.

Musharakah (*Partnership*) - Musharakah is a type of investment where partners share the profits of a joint venture based on an agreed-upon share, while losses are distributed in proportion to the capital invested by each partner. All partners have the right to participate in the management of the business. In other words, Musharakah is a contract where two or more individuals share capital to start a business, and each partner has the choice to actively participate in the management or not. In interest-free banks, the profits may not be equal to the individual's capital, but the losses are distributed according to the capital contribution. Interest-free banks act as partners in contributing to capital formation and distributing profits and losses.

Ijara (*Leasing*) - Ijara is a form of investment where the owner of an asset, such as a car or house, rents it to a user or tenant in exchange for a specified amount of rent. The owner retains ownership of the asset. The purpose of this investment is for investors or property owners to recover the capital cost and generate rental income from the property.

Bai-salam or Salam - This refers to a contract where advance payment is made for goods that will be delivered in the future. The seller agrees to supply specific goods to the buyer at a later date in exchange for full payment at the time of the contract.

Istisna - Istisna is a contract that can be made before the production contract. It is unique in that no exchange takes place at the time or place of the contract. This type of contract is often made between the end user and the developer, but can also involve a third party, such as a bank, acting as an intermediary.

Wadiah - Wadiah refers to the concept of safekeeping and maintenance.

2.1.3. Islamic Banking Service Models

According to Sole (2007), Sanusi (2011), and Audu and Mika'ilu (2014) (as cited in Akmel, 2015), the Islamic banking service model can be categorized into three types: Islamic Banking Window services, service centers/offices for Islamic financial services, and Islamic banking services.

2.1.3.1. Islamic banking window service

The first type is the Islamic Banking Window, which refers to a specific window within a conventional bank where customers can conduct their transactions using only Sharia-compliant tools. This model allows conventional banks to offer Islamic products and services through their existing branches. In simpler terms, the Islamic banking window enables the provision of certain Islamic banking products or services within the transaction process. It can be viewed as a financial institution that adheres to the profit, loss, and risk-sharing standards of specific Islamic banking products (Bala et al., 2009, p.34).

2.1.3.2. Affiliate/Branch Islamic Banking Services

The second type is Affiliate/Branch Islamic Banking Services, which involves the commercial banking sector offering Sharia-compliant products and services exclusively in certain branches. These branches function as quasi-bank offices and engage in banking activities such as accepting deposits or providing loans outside of the bank's headquarters. This type of bank is established when a larger bank identifies a region with potential customers and aims to serve them effectively.

2.1.3.3. Islamic banking services

The third aspect is Islamic banking services. When a traditional business company operates an Islamic window and gains a significant number of customers for its Islamic business, it may choose to establish an Islamic organization or even convert into a fully Islamic bank. By adopting these approaches, banks can benefit from resource efficiency, knowledge, and expertise. The bank will be able to offer a wider range of Sharia-compliant banking products through the Islamic window. For instance, it would be advantageous to engage in investments in the Islamic market or handle financial and fiscal matters such as issuing financial Sukuk (bonds) or managing Sharia-compliant investments and funds.

2.1.4. Retail Islamic Banking Products

Retail Islamic banking products refer to the services provided by Islamic banks directly to individual customers. These products include:

- i. **Current Account (*Alwadiyah*):** A current account is a management account or Al-wadiyah account used for daily cash management. In Islamic banking, the concept of Al-Wadiyah is followed, where banks act as custodians and guardians of the deposited money. The funds in a current account are fully repayable on demand, and the account operates based on the principles of trust (*wadia*) or trustworthiness (*amanah*). Islamic banks promise to protect and defend the interests and property of the depositors.
- ii. **Savings Accounts:** Islamic banks operate customer savings accounts based on the principles of *wadia*. Customers deposit their money in these accounts, allowing the banks to use the funds at their discretion. While banks do not disclose the benefits they derive from these deposits, they guarantee the safety of the deposits. As a token of appreciation, banks may offer rewards to customers for granting access to their savings accounts.
- iii. **Investment Account:** An investment account is a deposit where the owner of capital seeks a return on their money and agrees to participate in a fund for a specified period. This account operates on the principles of *Mudarabah*, but the investment structure and dividends are tailored to meet the needs of the customers. By offering these retail Islamic banking products, Islamic banks cater to the financial needs of individual customers while adhering to the principles of Islamic finance.

2.1.5. Islamic Banking Vs Conventional Banking

The main difference between Islamic and conventional banks is the use of money. In conventional banks, money is used as a commodity that is bought and sold through the interest's usage (Pasha 2014).

2.1.5.1 Conventional Banking System

The conventional banking system charges interest on loans and primarily serves the interests of shareholders. It supports industries that may harm the environment, exploit children, or contribute to the arms industry. Loans are given to individuals who have a guarantor or collateral, without considering the purpose of the loan.

Consumers have no say in where their money is invested and are not provided with information about how the bank uses their deposits. Additionally, the system rewards companies even if they engage in irresponsible behavior. It is designed for those who have money and do not prioritize the ethical use of their funds.

2.1.5.2 Islamic Banking System

In contrast, Islamic Banking System do not charge interest. Riba (interest) is considered unjust and usurious in Islamic law. This term encompasses any financial gain obtained by the lender as a condition of a loan or in a commodity trade. It also includes any disparity in quantity or time of delivery, making such transactions illegal (Martins, 1997; Chong & Liu, 2008).

Instead, Islamic banking practices zero-return loans, prohibiting the charging or receiving of interest. A distinctive feature of Islamic banking is its profit-and-loss sharing paradigm, primarily based on the concepts of mudarabah (profit-sharing) and Musharakah (joint venture) in Islamic contracting (Chong & Liu, 2008).

In Islamic banking, the principal stakeholder is God (Allah), and the aim is to serve Him. The clients and the general public are considered stakeholders as well. Clients are seen as partners, and decisions are made in the interest of society. Shariah law imposes restrictions on business activities. It prohibits trading in alcohol, tobacco, products containing pork, defense and weapon production, as well as certain entertainment activities like gambling and pornography (Chong & Liu, 2008).

Islamic principles advocate for an economic system that eliminates all forms of exploitation. Another principle is Mudarabah, which involves a profit-sharing

agreement between two parties. One party provides the finance, while the other provides entrepreneurial and management skills.

Islamic banks have a vested interest in how borrowed money is utilized. They ensure that funds are not used for economic activities that harm society. Those who lend to Islamic banks expect their money not to be invested in non-Shariah-compliant businesses. Islamic banks exclusively invest in activities that align with Shariah principles.

Furthermore, Islamic banks share both profits and losses with their clients. Murabahah, a cost-plus financing arrangement, involves the sale of goods between the bank and its client at a price that includes a profit margin for both parties. Overall, Islamic banking operates on the principles of fairness, ethical conduct, and adherence to Shariah law.

2.2. EMPIRICAL LITERATURE REVIEW

2.2.1. Empirical Literature Review-General

2.2.1.1 Prospects of Islamic banking

The concept of banking was relatively new to Islamic society; as ancient Muslims were not familiar with business practices. Initially, many Muslims did not understand the significance and role of banks in their daily lives, even in non-Islamic countries. However, as they became aware that the interest charged by conventional banks conflicted with the prohibition of riba (usury), they began to seek alternative financing methods. A significant portion of the Muslim population lacks access to traditional financial services, with only 24% of adults having a bank account and 7% having access to financial services, compared to 44% and 9% respectively for non-Muslims (Demirgüç-Kunt, Klapper, and Randall, 2013).

The establishment of Islamic banks in Egypt, India, Malaysia, Pakistan, Saudi Arabia, and later Iran and Sudan in the early 1960s marked a turning point for Islamic finance, as it became recognized as a distinct financial institution. This led to an increasing demand for Shariah-compliant financial institutions worldwide, as these institutions became more sophisticated and organized within the traditional financial system, offering a range of services. According to a 2015 report by the Economist Intelligence Unit, 67% of Sub-Saharan Africa's population is Muslim, with Ethiopia alone having a Muslim population of over 30 million. This indicates a promising future for Islamic

banking, as the Muslim population in the region represents a significant customer base that cannot be overlooked.

Islamic banks have demonstrated a greater ability to withstand external shocks and maintain financial stability compared to conventional banks (Hassan and Zaher, 2001; Cihak and Hesse, 2008). This is attributed to the Profit and Loss Sharing (PLS) system, which reduces the risk for Islamic banks by minimizing financial capital. A report published in 2015 by the Economist Intelligence Unit suggests that the lower the financial crisis, the higher the likelihood that a bank will be unable to meet repayment terms. As a result, some investors are now inclined to invest in Islamic banks, which have shown a strong financial track record globally in recent years. This can be attributed to their increased capital and the growing trend of countries with small Muslim populations adopting Islamic economics as part of their economic strategy. South Africa, for example, has embraced Islamic economics, making it an export destination for halal products.

In Nigeria, Audu Bello et al. (2014) identified the challenges faced by Islamic banking and proposed solutions based on the experiences of Islamic banking in a pluralistic secular country like Nigeria. The challenges were categorized into two groups: institutional challenges and operational challenges. Institutional challenges include inadequate structures, weak legal frameworks, lack of equity institutions, weak governance systems, disparity in business models, absence of secondary financial markets, limited financial instruments, and short-term orientation.

Operational challenges encompass religious and cultural differences, lack of innovation in financial products, limited financial sharing, sharia-related issues, scarcity of knowledgeable personnel, lack of information, and competition. Overall, Islamic banking has proven to be resilient in the face of external shocks and has gained recognition for its stability. By addressing the challenges specific to each country, Islamic banks can further enhance their performance and contribute to the growth of their respective economies.

2.2.1.2 Challenges of Islamic Banking System

Research conducted by Iqbal (2001) highlighted several challenges facing Islamic finance. These challenges include the lack of adequate medium and long-term financial instruments, limited disbursement of Islamic finance, concentration of Islamic banking

business, weak risk governance, and regulatory framework differences between Islamic finance and conventional finance. These issues pose significant theoretical and practical problems for Islamic banks.

Shukat et al. (2011) also conducted a study on the challenges facing Islamic finance. Their research revealed that there is no final law regulating Islamic finance, a shortage of human resources and Sharia law expertise in the industry, absence of long and short-term investment options in Islamic assets, and a lack of Sharia supervision. Additionally, the scarcity of capital goods and employee standards in the short term were identified as challenges for the Islamic banking system. Other challenges include a lack of innovation, non-compliance with local laws and regulations, lack of transparency and accountability, manual work processes, and a lack of quality service.

A study by Louis S. Nkwatoh et al. (2014) focused on the operational complexity of Islamic banks in Nigeria, with a specific focus on JAIZ International Bank Plc. The study utilized descriptive and quantitative methods and found that the legal framework for Islamic banking in Nigeria is quite restrictive. It also identified religious, human, and moral risks that contributed to the decline of Islamic banks after their launch, as well as competition with traditional banks, which poses a major challenge for the Islamic economy in Nigeria. The study concluded that competition negatively impacts the performance of Islamic banks in Nigeria.

2.2.1.2.1 Lack of Knowledge and Understanding

The lack of knowledge and understanding about Islamic banking poses a significant challenge to its development. This issue is particularly prevalent in countries with diverse religions and beliefs, such as Nigeria. It is crucial to address this problem effectively to ensure the acceptance and growth of the Islamic banking sector. Misunderstandings about the system can lead to its rejection by the public, as different cultures and religious beliefs may perceive it differently. Non-Muslims may view Islamic banking as a means of Islamization, while Muslims see it as a religiously grounded moral practice as Obaidullah (2005), Brown, Hassan and Skully (2007), Louis S. Nkwatoh et al. (2014).

2.2.1.2.2 Legal Principles

Islamic banking operates based on Sharia principles, which presents challenges in terms of regulatory frameworks. The existing financial system, which supports conventional banks, does not heavily rely on Islamic banking. This creates a sensitive relationship between Islamic banks and financial authorities. Islamic banks operate on a profit and loss account basis, which differs from the traditional interest-based system. As a result, they are not regulated by existing public laws, and there is a need for a regulatory framework that allows Islamic banks to compete with conventional banks.

2.2.1.2.3 Lack of Liquidity Tools

The absence of financial tools specific to Islamic banking poses a challenge to its growth. Islamic banking operates according to Sharia law, which prohibits interest-based transactions. This limits the availability of liquidity tools, such as overnight money and loans, compared to traditional banking. Additionally, there is a lack of institutions that provide long-term financing options like bonds and stocks, which are essential for the growth of Islamic banking. Furthermore, there is a need for better understanding and implementation of accounting and auditing standards that reflect the unique nature of Islamic products.

2.2.1.2.4 Insufficient Human Resources

The sustainability of the Islamic economy sector relies heavily on having qualified and trained personnel, particularly in the field of Islamic finance studies. This is crucial due to the numerous challenges faced by the banking industry, especially with the rapid advancement of technology. It is essential for banking professionals to have a deep understanding of the ethics and beliefs that govern their business. However, most banking professionals are trained in traditional banking and lack the necessary vision and belief in the functioning of the Islamic economy (Mohammed, 2012).

2.2.1.2.5 Lack of Supportive Organizations and Business Contacts

Islamic banking is still in its early stages of development and lacks the flexibility to adapt to changes in the market and customer preferences. For instance, Islamic banks, which operate without interest and investment capital, often lack the necessary tools to meet the requirements for financial management and positive change. Therefore, it is crucial to establish an appropriate financial system that can mitigate financial risks and facilitate development (Hassan and Skully, 2007).

2.2.1.2.6 Shariah-Related Issues

Due to the religious dimension of Islamic banking, any innovation introduced by banks must comply with the requirements of Shariah law. This means that all new financial products in Islamic banking can only be offered after approval by the Shariah Advisory Board and subsequent Shariah audit. However, this process can delay the ability of Islamic banks to adapt to the changing financial environment, as significant time is required to obtain final approval from the Shariah Board (Audu Bello et al., 2014).

2.2.1.2.7 Insufficient Research and Development

Many Islamic banks lack the necessary research and development (R&D) skills and capabilities to fully realize their potential and compete at a high level. In order to survive in a competitive global market, it is crucial for Islamic banks to invest in dynamic and consistent R&D programs. Additionally, Islamic banks have not effectively utilized media platforms to promote their activities. For example, even many Muslims are unaware that Islamic banking is practiced worldwide. Islamic banks need to improve their communication strategies and publicize their activities through positive news coverage (Mohammed, 2012).

In conclusion, various studies have identified several common challenges and expectations for interest-free banks. These include the need for improved financial instruments, increased disbursement of Islamic finance, stronger risk governance, regulatory framework alignment, a comprehensive legal framework, enhanced human resources and Sharia law expertise, diversified investment options, effective Sharia supervision, addressing scarcity of capital goods, fostering innovation, ensuring compliance with local laws and regulations, promoting transparency and accountability, streamlining work processes, and delivering high-quality service.

2.2.2. Empirical Literature Review-Ethiopian Context

2.2.2.1. Brief history of Islamic banking in Ethiopia

Ethiopia is a country with a substantial Muslim population, accounting for 34% of the total population, according to the 2007 Ethiopian Central Statistical Authority Census report (CSA, 2007). Unfortunately, access to banking services in Ethiopia is severely limited. The 2017 Global Fundex database reveals that only 34.8% of adults aged 15 and older utilize a bank, leaving a significant portion of the population, 65.2%, without access to basic financial services (Demirgüç-Kunt et al., 2018). The absence of Shariah-

compliant financial products and services in Ethiopia has played a significant role in the financial crisis (Hailu, Kapusuzoglu, and Ceylan, 2019).

Before 2008, Ethiopian law did not allow for the establishment of Islamic finance in the country. As a result, Ethiopian Muslims had been requesting interest-free financial services for many years. In 2007, representatives of the Ethiopian Muslim diaspora community raised various issues with the late Prime Minister Meles Zenawi, including the request to establish Islamic businesses in Ethiopia (Feyissa, 2012).

Years later, a group of businessmen and community leaders approached former Prime Minister Meles Zenawi to explain the needs, benefits, and role of Islamic finance in the community. Following their discussion, the National Bank of Ethiopia (NBE) published a new report that would enable the creation of interest-free financing in the country (Al-Hashimi, 2012). This marked the first step towards implementing Islamic finance in Ethiopia, as stated in proclamation No. 592/2008, article 22, sub article 2, which designates that "The Central Bank may issue procedures to legalize the banking business associated with interest-free banking service and products, resource mobilization, and fund utilization."

According to the statement, all conventional banks in Ethiopia began accepting interest-free deposits from customers interested in interest-free banking services. A significant amount of money was deposited in these banks, with depositors seeking nothing more than a safe place to keep their funds. Meanwhile, organizers of Zamzam Bank started selling shares in December 2010 to establish a full-fledged interest-free bank. Despite the minimum paid-up capital requirement of 75 million Ethiopian Birr (2.7 million USD) to establish a bank, Zamzam Bank was able to collect 137 million Birr (4.9 million USD) within four months from over 6800 subscribers (Zam-zam Bank Under formation, 2012). However, the hope of establishing a full-fledged Islamic banking system in Ethiopia was undermined by a new directive issued by the NBE.

This directive, known as "Directives to Authorize the Business of Interest-Free Banking No. SBB/ 51/2011," stated that only established conventional banks could offer interest-free banking services through window modes. An interest-free banking window was defined as a unit within a conventional bank exclusively offering interest-free banking services (Article 2: sub-article 3). The government did not provide an explanation for why this directive was issued, effectively outlawing the previous one.

Following this directive, the Commercial Bank of Ethiopia (CBE) and Oromia International Bank (OIB) received endorsement from the NBE to offer interest-free banking window services in 2013. Currently, almost all conventional banks in Ethiopia offer interest-free banking windows.

Although the National Bank of Ethiopia (NBE) initially rejected the idea of establishing a full-fledged interest-free bank in the country, the Muslim communities persisted in their demand. After seven years of practicing exclusive interest-free banking, the NBE finally issued a new proclamation in May 2019, allowing for the establishment of such banks. This proclamation, known as proclamation No: 1159/2019, amended the banking business proclamation and dedicated article 59 to "interest-free bank." Sub-article 1 states that the NBE may issue a directive to prescribe additional conditions for licensing, supervision, and requirements for establishing an interest-free bank. The term "interest-free bank" refers to a company licensed by the NBE to solely engage in interest-free banking.

The issuance of proclamation No: 1159/2019 made the dream of establishing a full-fledged interest-free bank in Ethiopia a reality. This proclamation came after Prime Minister Dr. Abiy Ahmed promised to permit the establishment of such banks during his speech at the Ramadan Iftar program organized by the Ethiopian Islamic Affairs Supreme Council (EIASC) on May 22, 2019. Following the prime minister's promise and the proclamation, several share companies have applied for a license from the NBE to provide full-fledged interest-free banking services in Ethiopia. As of July 2019, four banks named Zem-zem, Hijira, Nejashi, and Zad were in the process of establishment, while four other share companies were in the process of obtaining a license from the NBE.

Although the permission to establish full-fledged interest-free banking in Ethiopia is an exceptional opportunity for those who have been advocating for it, there are challenges that may affect its performance. These challenges include the lack of a conducive legal framework, a shortage of skilled professionals, and aggressive attitudes towards Islamic banking.

2.2.2.2. Islamic Banking Prospect in Ethiopia

According to a report by the Economist Intelligence Unit in 2015, Africa is showing a growing interest in Islamic finance, including banking, insurance, bonds, and capital

markets, as well as Halal products and services compliant with Sharia law. In Sub-Saharan Africa, 67% of the Muslim population practices Islam, making it one of the main religions in the region alongside Christianity. Ethiopia, as part of Sub-Saharan Africa, also has the potential to develop Islamic banking, with the Muslim population accounting for 33.9% of the total population according to a 2007 report from the Central Statistical Agency of Ethiopia.

This presents an opportunity for the growth of Islamic banking in Ethiopia. By catering to the needs of Ethiopian customers, Islamic banking can also provide an advantage for the Ethiopian government in financial transactions with Muslim-majority countries. This can be particularly beneficial in attracting investments from Gulf countries, as highlighted by Mohammed (2012).

2.2.2.3. Islamic Banking challenges in Ethiopia

The development of Islamic banking in Ethiopia began in 2008 when the Commercial Bank of Ethiopia (CBE) introduced interest-free savings accounts. However, it was not until 2013 that Shariah-compliant transactions were implemented. The National Bank of Ethiopia (NBE) issued guidelines in 2013, allowing banks to offer Islamic banking services through separate outlets alongside conventional banking services. Some commercial banks, such as Oromia International Bank SC, Commercial Bank of Ethiopia, and United Bank S.C., started implementing this system in 2013.

In 2011, the NBE enacted a directive titled "Directives to Authorize the Business of Interest-Free Banking No. SBB/51/2011," which authorized conventional banks to engage in interest-free banking. This directive requires banks wishing to offer interest-free banking services to comply with the principles of Islamic finance and standard modes of operation, as well as fulfill other procedural requirements, as stated in the SBB/72/2019 Licensing and Authorization of Interest-Free Banking Business.

It is worth noting that Islamic banking is a relatively recent phenomenon in Ethiopia. Limited research has been conducted on the challenges and prospects of interest-free banking in the country. Some recent studies, such as those by Kerima Ali (2016) and Abraham (2017), have examined the challenges faced by the Commercial Bank of Ethiopia in providing interest-free banking services and the factors influencing customers' intention to use interest-free banking products, respectively.

A study conducted by Mohammed in 2012 examined the prospects, opportunities, and challenges of Islamic banking in Ethiopia. The study identified several main challenges, including lack of awareness, regulatory and supervisory challenges, institutional challenges, lack of support and institution, gap in research and development in Islamic studies, lack of qualified human resources, and wrongful association with specific religion and global terrorism.

In 2015, Akmel conducted a study on the challenges and prospects of Islamic banking service for resource mobilization in Ethiopian commercial banks. The study used questionnaires and semi-structured interviews with staff from three selected banks. The results indicated that challenges included awareness, manpower, legal framework, societal belief, and resource requirements, while prospects included economic growth, attraction of investors, and fostering investment. The researcher recommended creating awareness for public acceptance, staff training, employing effective marketing techniques, establishing clear legal frameworks, and adhering to sharia issues.

Debebe's 2015 study assessed the willingness of Ethiopian customers to use interest-free banking and the factors influencing their decision. The results showed that perceived relative advantage, perceived compatibility, customers' level of awareness, and subjective norm had a significant positive impact on the attitude towards interest-free banking in the Commercial Bank of Ethiopia.

In 2016, Kerima conducted a study on the challenges of interest-free banking services in Ethiopia, specifically focusing on the Commercial Bank of Ethiopia. The research identified challenges such as lack of commitment from the bank, lack of a Shariah advisor, lack of supportive regulatory directives, problems related to the Ethiopian Commodity Exchange (ECX) law, lack of capacity to deliver IFB products fully, lack of customer awareness about IFB products, lack of customer trust and confidence, inadequate marketing and promotion, double taxation, nature of Islamic Bank products, unavailability of Islamic Bank products in all branches, and the IFB being delivered in a Window model.

Abraham's 2017 study investigated the determinants of consumers' willingness to use interest-free products and the factors affecting employees' knowledge about these products in Ethiopian companies. The results showed that knowledge was the only variable related to the purpose of use, while other variables such as behavior, social

influence, perceived financial value, and IFB were believed to be related to religious beliefs.

2.3. SYNTHESIS OF THE REVIEW

From the population of the African continent, Islam and Christianity are the dominant religions, with 67% of Muslims residing in Sub-Saharan Africa. Ethiopia, being part of this region, presents a significant opportunity for the development of interest-free banking. However, the challenges and prospects of interest-free banking in the Ethiopian banking sector have not been thoroughly studied.

This study aims to identify the main challenges faced by interest free banks in implementing interest-free banking and provide solutions for the banking sector. While previous studies have focused on the challenges faced by banks, the potential benefits of interest-free banking have not been well explored. Additionally, existing research conducted in 2012 by Mohammed only examined the need for Sharia-compliant Islamic banks before their implementation by commercial banks. This indicates a time gap in the research.

To address these gaps, this research would focus on the perspective of national level rather than a single organization. Qualitative methods of data collection would be used, along with an analysis of existing literature on specific organizations. By conducting this study, it provides valuable insights into the challenges and prospects of interest-free banking in Ethiopia's banking sector.

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter focuses on the research methodology employed in this study, including data collection and analysis. It covers the research design, data collection instrument, sample size and sampling technique, and the data analysis technique used for the investigation.

3.1 RESEARCH DESIGN

The research design refers to the method and procedures used to collect and analyze the necessary data. The choice of research design is driven by the goals and research questions of the study. According to John (2007), the research design is determined by the desired outcomes of the study. Kothari (2004) defines research design as the alignment of data collection and analysis with the research objectives.

For this study, a descriptive survey design was employed to achieve the research objective of describing respondents' views on the challenges and prospects of Islamic banking. This design allows for the collection of data that describes the current state of affairs. Therefore, a descriptive study design was used in conducting this study.

3.2 RESEARCH APPROACH

According to Kothari (2004), the research design provides a blueprint for data collection, measurement, and analysis. Creswell (2009) identifies three types of research approaches: qualitative, quantitative, and mixed approach. Qualitative research approaches, as defined by Kothari (2004), involve subjective assessments of attitudes, opinions, and behavior. The results are presented in a non-quantitative format or in a format that does not undergo rigorous quantitative analysis. This type of research often utilizes focus group interviews, projection techniques, or in-depth interviews. On the other hand, quantitative research involves the use of methods such as questionnaires and structured interviews to generate statistical data through large-scale research studies. Dawson (2003) explains that qualitative research examines attitudes, behavior, and experiences, while quantitative research focuses on generating statistics.

In this study, both qualitative and quantitative research methods were employed. Questionnaires were used to collect the necessary data from branch managers, employees, and customers of Zamzam Bank in Addis Ababa Kolfe Keraniyo sub city.

This allowed for a comprehensive analysis of the challenges and prospects of Islamic banking.

3.3 SAMPLING DESIGN AND PROCEDURE

3.3.1. Target Population

A target population refers to the individuals or objects (units of analysis) whose characteristics we aim to study (Kothari, 2004). In the case of Zamzam Bank, there are currently 68 branches in Ethiopia, with 38 branches located in Addis Ababa city. For the purpose of this study, one branch of Zamzam Bank in the kolfe Keraniyo Sub-city was selected to ensure manageability.

The focus of this study is to identify the challenges and prospects of Islamic banks in Ethiopia. Therefore, the target audience consists of all employees and customers of the Zamzam Bank branch in kolfe Keraniyo, Addis Ababa. The table below provides information on the number of Zamzam Bank branches, employees, and customers in the kolfe Keraniyo sub-city.

Branch's	Target population from each branch	percentage
Betel 1	3110	15.51
Betel 2	2906	14.49
Alembank	3409	17.00
Torhayloch	3007	15.00
Grar	3830	19.10
Kolfe	3788	18.89
Total	20050	100.00

Source: Own Questionnaires May 2023

Table 1 Target population

3.3.2. Sampling Technique and Sample Size

The participants in this study were customers and employees of the Zamzam Bank branch in kolfe Keraniyo sub-city who utilized Islamic banking products and services and worked at the branch. The researchers distributed questionnaires to employees who were responsible for providing Islamic banking services to customers at various branches and banks, and they also conducted interviews with branch managers.

According to research methodologists like Kothari (2004), it is important for the sample size to be neither too large nor too small. The sample should be optimal in order to meet efficiency and flexibility requirements (Kothari, 2004). Based on this, Roscoe (1975),

Abranovic (1997), and Hill (1998) have stated that a sample size of more than 30 is acceptable. In this study, a large sample size was chosen to represent the population. The researchers used a simple random sampling method to select the sample and distribute the questionnaires. Sampling is a technique used to select a sample or a portion of a population. With a 95% level of accuracy, a sample size of 400 was selected from a total population of 20,050 employees and customers. The sample size was calculated using the sample sizing formula developed by Biruk (2017) to obtain the required sample from the total population. The formula used was:

$$n = N / (1 + N(e^2))$$

Where: n = sample size N = population size

e = margin of error (0.05) or maximum tolerable error.

$$400 = \frac{20050}{1 + 20050 * 0.0025}$$

Branch Name	total population from each branch	sample from each branch
Betel 1	3110	62.04
Betel 2	2906	57.98
Alembank	3409	68.01
Torhayloch	3007	59.99
Grar	3830	76.41
Kolfe	3788	75.57
Total	20050	400.00

Source: Own Questionnaires May 2023

Table 2 Sample size Determination

3.4. DATA COLLECTION TECHNIQUES AND PROCEDURES

3.4.1 Data Source

There are two main sources of information used for research purposes: primary and secondary sources. Primary sources involve conducting new surveys to gather information directly related to the research inquiry. Secondary sources, on the other hand, are data that have already been collected for other research purposes.

For this study, primary data was collected through interviews with branch managers and the distribution of questionnaires to employees and customers of the bank. A questionnaire is a carefully structured list of questions designed to obtain reliable responses from a selected sample (Hussey and Hussey 1997). Close-ended questions

were used in the questionnaire to collect primary data on the opinions of employees and customers regarding the challenges and prospects of Islamic banking. In addition to primary data, various secondary data sources were utilized to understand the challenges and prospects of Islamic banking. These included journal articles, postgraduate studies, bank reports and internal documents, and information from different websites.

3.4.2. Data Collection Instrument

The researcher used questionnaires that were previously used by Zaki and Ahmed (2017) as the data collection instrument. The questionnaire consisted of structured questions using a Five-Point Likert Scale (Agree, Disagree, Neutral, Strongly Agree, and Strongly Disagree). Data interpretation was done based on a Mean Score Interpretation range table.

Mean score	Interpretation
(1) Strongly Agree (SA)	4.30 to 5.00
(2) Agree (A)	3.50 to 4.20
(3) Neutral (N)	2.70 to 3.49
(4) Disagree (DA)	1.90 to 2.69
(5) Strongly Disagree (SDA)	0 to 1.89

To increase the response rate, a cover letter was included in the research process. This cover letter explained the purpose of the research, emphasized its importance, outlined the reasons for selecting the subjects, and assured the respondents of the confidentiality of their information. The questionnaire consisted of four parts. The first part focused on gathering demographic information from the respondents. The second part aimed to assess the challenges faced by Islamic banks. The third part explored the prospects of Islamic banks.

In addition to the questionnaire, interviews were conducted with branch managers to collect primary data. This method allowed for the opportunity to ask specific questions that could clarify or explore issues raised by the respondents. However, it should be noted that interviews can be time-consuming and require significant resources. To collect secondary data, relevant and supportive information was extracted from the banks involved in the study. The researcher personally conducted face-to-face interviews with the branch managers to obtain the necessary data.

3.5 DATA ANALYSIS TECHNIQUES

The researcher has conducted both quantitative and qualitative analyses on the collected responses to the research questions. The quantitative data, obtained through a structured questionnaire, has been coded and analyzed using Microsoft Excel 2016 software. Descriptive statistics have been employed to analyze the data, and the results have been presented in tables and graphs to illustrate frequencies and percentages, making it easier for readers to understand. For the qualitative data, which was gathered through interviews, written notes were taken during the interviews. The analysis of this data involved summarizing and interpreting the information provided by the interviewees, relating it to the main objectives of the study. [Data analysis.xlsx](#)

3.6 ETHICAL CONSIDERATIONS

Ethical conduct dictates that researchers have a responsibility to carefully assess the potential harm to participants in their studies. They should make every effort to minimize any possible harm (Bryman & Bell, 2007). In the process of collecting and interpreting data, the researcher assured participants that any confidential information they shared would be kept private. The researcher emphasized that the study aimed to benefit the bank and its employees. Participants were also informed that the exercise was solely for academic purposes and that their confidentiality would be protected. They were assured that no one would face negative consequences due to any adverse findings related to their professional duties. This approach aimed to encourage participants to provide their responses freely and without reservation. Each questionnaire was accompanied by a cover letter that clearly explained the purpose of the survey. The questionnaire did not require respondents to provide their names, ensuring their anonymity and protecting their identity. Consequently, participants were fully aware of the researcher's intentions, the purpose of the information collected, and how it would be used.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 INTRODUCTION

This chapter presents the results and analysis of data collected from primary and secondary sources through surveys and interviews. Analyzed and interpreted the collected data. According to the design, 400 surveys were distributed to Zamzam Bank customers and employees. Of all surveys distributed, 376 (94%) were deemed to have been written correctly and used for further analysis, while the remaining 24 (6%) surveys were not returned. In addition to surveys, data were also collected from interviews and the answers were recorded and presented.

	Distributed		Collected		Uncollected	
	number	percentage	number	percentage	number	percentage
Sample	400	100%	376	94%	24	6%

Source: Own Questionnaires May 2023

Table 3 Questionnaire Response Rate

PART ONE: DEMOGRAPHIC INFORMATION OF THE RESPONDENTS

The following part of the paper describes only the basic information of sample respondents.

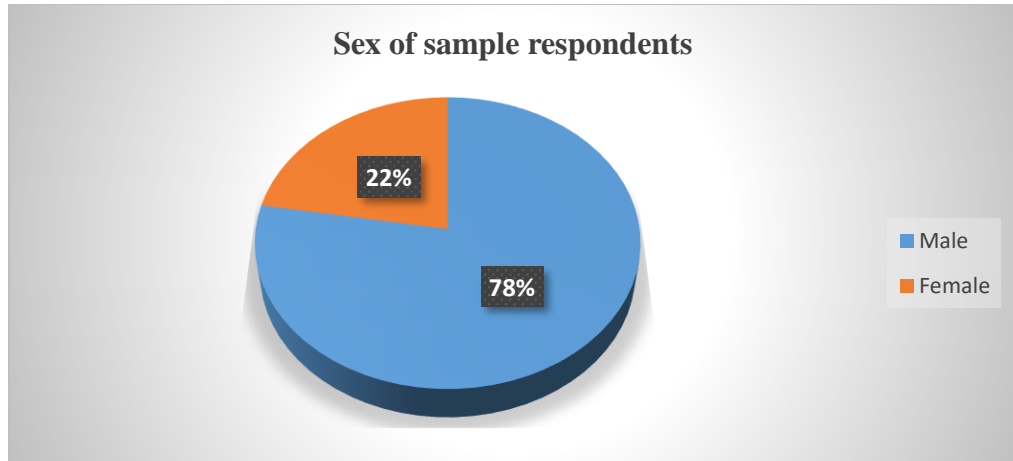
4.1 Sex of respondent

Sex	Frequency	Percent
Male	292	77.66
Female	84	22.34
Total	376	100.00
Mean	1.22	

Source: Own Questionnaires May 2023

Table 4 Sex of sample respondents

Table 5 describes about sexual category of the respondents. According to the table the majority of the respondents were male (77.66%, N=376) whereas the remaining of the respondents were female.



Source: Own Questionnaires May 2023

Figure 4.1 sex of sample respondents

4.2 Religion of the respondents

Religion	Frequency	Percent
Muslim	368	97.87
Orthodox	5	1.33
Protestant	3	0.8
Other	0	0
Total	376	100.00
Mean	1.03	

Source: Own Questionnaires May 2023

Table 5 Religion of sample respondents

Table 5 describes about the religion of the respondents. According to the table the highest number of the respondents were Muslim (97.87, N=376), and only (1.33% and 0.8, N=376) respectively were orthodox and protestant.

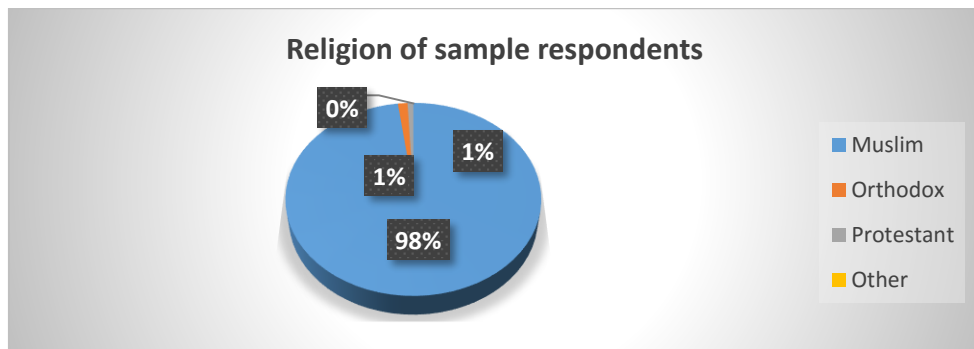


Figure 4.2 Religion of sample respondents

4.3 Educational Background of sample respondents

Education level of the respondents	Frequency	Percent
Certificate	60	15.96
Diploma	132	35.11
Bachelor	146	38.83
Masters	38	10.11
Total	376	100
Mean	1.92	

Source: Own Questionnaires May 2023

Table 6 Education Background of sample respondents

Table 6 describes about the educational background of the respondents. According to the table the number of the respondents which have Bachelor were (38.83%, N=376), Masters (10.11%, N=376), Diploma (35.11%, N=376) and Certificate (15.96%, N=376).

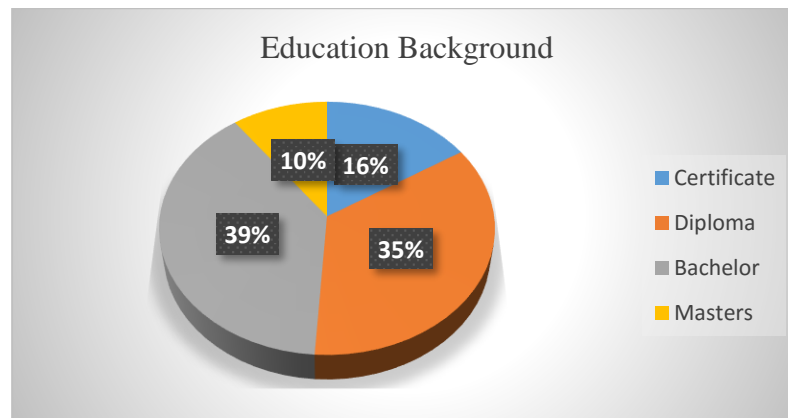


Figure 4.3 Educational background of sample respondents

4.4 Work experience of sample respondents

Work experience of the respondent	Frequency	Percent
>=0 year	120	31.91
>=1 year	194	51.60
>=2 year	49	13.03
>=3 year	10	2.66
4 & above year	3	0.80
Total	376	100
Mean	1.89	

Source: Own Questionnaires May 2023

Table 7 work experience of the respondent

Table 7 demonstrates about work experience of the respondent. It describes about respondent's years of experience in areas of Islamic banking service. According to the table respondents' year of experience in Islamic Banking were zero year (31.91%, N=376), more than one-year experience (51.60%, N=376), more than two years of experience (13.03%, N=376), more than three years of experience (2.66%, N=376) and only (0.80%, N=376) of respondents have more than four years of experience. Based on this result very small number of the respondents were experienced which means most of employees working in Islamic banking were not well experienced in implementing and using Islamic banking service and product. Most of the respondents (51.60%) have more than one years of experience. Therefore, the professional and user of Islamic banking system have lack of experience and it's in infant stage.

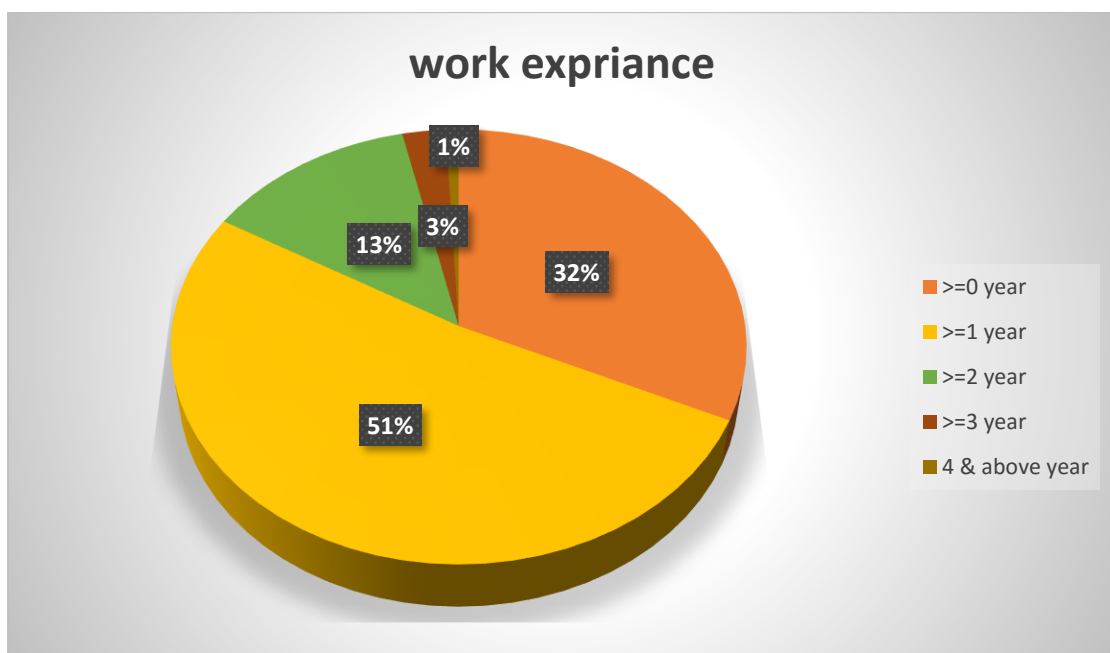


Figure 4.4 Work experience of sample respondents

DISCUSSION ON CHALLENGES OF ISLAMIC BANKING

The following part of the paper briefly discuss and interpret the view of the respondents about challenges of Islamic banking.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
The general population is not well-informed about this particular banking in Ethiopia	N	0	0	0	129	247	376	4.66
	%	0%	0%	0	34.31%	65.69%	100	%

Regarding having public awareness Islamic banking, result shows that 65.69% of the respondents believes there is lack of public awareness about Islamic Banking, which means they are strongly agree with the ideas about there is lack of public awareness about Islamic banking. And also the remaining 34.31% the respondents agree with this idea. The average value (4.66) also indicates that most of the respondents agreed on that statements. Therefor the finding of this study indicated that there is lack of public awareness and acceptance about Islamic Banking service and products.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
There exists a deficiency in the field of research and development in Islamic studies.	N	0	7	10	143	216	376	4.51
	%	0%	1.86	2.66	38.03	57.45	100	%

According the study regarding the ideas of there is a gap in research and development about 57.45% of the respondents strongly agree, 38.03% of them are agree, 2.66% of them are neutral and only 1.86% of them are disagree about having research and development gaps in areas of Islamic banking. The mean score value (4.51) show that most of the respondents were agreed on that statements. Therefor the findings of the

study confirm that there is lack of prior findings/literatures in areas of Islamic banking services and products in Ethiopia.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
The absence of proper regulations and supervision	N	0	0	3	122	251	376	4.66
	%	0%	0%	0.80%	32.45%	66.76%	100%	

The result of the study indicates that about 66.76% of the respondents were strongly agree and the remaining 32.45% of the respondents were agree with having lack of regulations and supervision that leads Islamic bank losing their profits in order to pay comparable returns to investments account holders and depositors. The average value (4.66) of the data also show that most of the respondents were agreed on that statements. Based on the findings of the study there is lack of guidelines and supervisions that protects Islamic Bank to manage and controls their profits and losses.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
Islamic financial institutions should be managed by distinct set of regulations	N	0	11	0	170	195	376	4.46
	%	0%	2.93%	0%	45.21%	51.86%	100%	

According to the data 51.86% of the respondents were strongly agree, 42.21% respondents were agreeing and 2.93% of the respondents were disagree with ideas of Islamic financial organization should be administrated by different set rules and regulations as they differ from conventional banks in many features like risk structure, form of ownership and governance. The mean score value (4.46) also confirms that most of the respondents were agreed on that statements. Based on this result almost all respondents of this study needs Islamic financial institutions/banks must be governed by different set of rules and regulation as they differ from conventional banks.

Item	Response Rate						Total	Mean
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		SDA	DA	N	A	SA		
There is lack of supportive institutions	N	0	0	0	210	166	376	4.44
	%	0%	0%	0%	55.85%	44.15%	100%	

Regarding the ideas about Islamic banking system lacks supportive organization like interest free money market and capital markets 44.15% of the respondents were strongly agree and 55.85% were agree. The mean (4.44) of the data indicates that the respondents were agreed on that statements. Therefor the results of the study indicated the establishments of interest free market and capital market will enhance the productiveness of Islamic financial institutions/banks.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
The current Ethiopian tax policy and monetary policy	N	0	0	5	151	220	376	4.57
	%	0%	0%	1.33%	40.16%	58.51	100%	

The data shown that 58.51% of the respondents were strongly agree, 40.16% of the respondents were agree and only 1.33% of the respondents were neutral about the current Ethiopian tax policy and monetary policy system will be another challenging issues for Islamic banking service and product. The mean (4.57) of the data implies that the respondents were agreed on that statements. Based on the result all most all respondents of this study believes that current Ethiopian tax and monetary policy would be another challenges of Islamic banking.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
There is Negative attitude of people regarding Islamic banking service	N	0	0	0	137	239	376	4.64
	%	0%	0%	0%	36.44%	63.56%	100%	

**(wrong association
with religion)**

According to the data described above about 63.56% of the respondents were strongly agree and the remaining 36.44% of the respondents agree with the ideas of negative attitude of people regarding Islamic banking as they associate wrongly with religion. And also mean value (4.64) of this data indicates the respondents' agreement on that statements. This suggest that the majority of the people were wrongly associated Islamic banking service with the religion of Islam.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
Separating funds from conventional banking	N	0	0	0	184	192	376	4.51
	%	0%	0%	0%	48.94%	51.06%	100%	

As shown in a table above more than half of the respondents (51.06%) were strongly agree and the remaining 48.94% of the respondents agree with the ideas of separating fund from conventional banking is necessary to attract the potential customers of Islamic banking. The mean value (4.51) of this data indicates the respondents' agreement on that statements. From this result it is clear that to invite potential customers the majority of the people are interested in separating Islamic financial fund from conventional banking.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
The adoption of an interest- based banking standard	N	0	0	4	231	141	376	4.36
	%	0%	0%	1.06%	61.44%	37.50%	100%	

Another promising finding was that around 61.44% of the respondents were shown their agreement that interest based banking standard creates negative perceptions among stockholders. The remaining 37.50% of the respondents also strongly supports this idea. Only 1.06% of the respondents stay silent about this idea. The mean value (4.36) of this

data shows the respondents' agreement on that statements. The results of the finding demonstrated that standards implemented on conventional banking was another challenging issues for Islamic banking stakeholders or investors.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
Shortage of trained human resources	N	0	0	0	120	256	376	4.68
	%	0%	0%	0%	31.91%	68.09	100%	

The table 9 above clarifies that majority of the respondents (68.09%) were strongly support that there is lack professionals in Islamic banking service and products. And 31.91% of the respondents shown their agreement. The average value (4.68) of this data indicates that most of respondents were strongly support that statements. Therefor the result of the findings found clear support for there is lack of human resources trained in Islamic banking profession.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
It will face difficulty by Financial Services Authorities	N	10	23	31	179	133	376	4.07
	%	2.66%	6.12%	8.24%	47.61%	35.37%	100%	

Based on the data above in a table most of (47.61%) the respondents the study believes that national financial service authorities were another challenging issues for Islamic finance. Whereas about 6.12% of the respondents were not agreed on this idea. But 35.37% of the respondents were highly supporting that Islamic banking service would face a lot of difficulty by financial service authorities. The remaining 8.24% and 2.66% of the respondents stay silent and strongly agree with this idea respectively. The average value (4.07) of this data show that respondent's agreement on that statements.

Item	Response Rate	Total	Mean
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		SDA	DA	N	A	SA		
Shariah laws and the existing legal framework in Ethiopia are perfectly matched	N	203	151	5	10	7	376	1.58
	%	53.99%	40.16%	1.33%	2.66%	1.86%	100%	

From these result it is clear that only 1.86% and 2.66% of the respondents were strongly agree and agree with that sharia laws and the existing legal framework in Ethiopia are perfectly matched. However greater than half of the respondents (53.99%) were strongly disagree and 40.16% of them also disagree with this idea. The mean value (1.58) of this data indicates that most of respondents were strongly disagree on that statements.

Item		Response Rate					Total	Mean
		SDA	DA	N	A	SA		
There is lack of secondary market	N	0	0	0	101	275	376	4.73
	%	0%	0%	0%	26.86%	73.14%	100%	

As shown by the table above almost all (73.14) of the respondents confirms that there is lack of secondary market and Islamic insurance and the remaining 26.86% of them also shows their agreement. The mean (4.73) of the data demonstrate that almost all of the respondents were agreed on that statements.

DISCUSSION ON PROSPECTS OF ISLAMIC BANKING

The following part of the paper briefly discuss and interpret the view of the respondents about prospects of Islamic banking.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
The current global trends in financial services	N	0	4	6	122	244	376	4.61
	%	0%	1.06%	1.60%	32.45%	64.89%	100%	

Table 10 show that about 64.89% of the respondents were strongly supporting that current global trends in financial service would have positive indicators on the future of Islamic banks in Ethiopia. And also 32.45% of them show their agreement on this idea. However, the remaining 1.06% and 1.60% of the respondents disagree and stay neutral on this idea respectively. The mean (4.61) of the data show that most of the respondents had positive opinion on that statement. Based on the finding the current global trends in financial service affect Islamic finance positively.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
Islamic banking service will attract all communities in Ethiopia	N	5	10	0	160	201	376	4.44
	%	1.33%	2.66%	0	42.55%	53.46%	100%	

Based on the data more than half of the respondents (53.46%) strongly supporting that Islamic banking service will attract all societies of Ethiopian. About 42.55% of them also puts their agreement on this idea. But around 1.33% of the respondents were strongly disagreed and the remaining 2.66% of them also not supporting the idea will Islamic banking service attract all communities of Ethiopia. The mean value (4.44) also indicate the respondent's agreement on that statements. The result of the findings confirmed that there is a hope that Islamic banking service attracts all societies of Ethiopians.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
There is untouched potential growth and opportunity that Islamic banks provide	N	0	0	0	180	196	376	4.52
	%	0%	0%	0%	47.87%	52.13%	100%	

As shown by table above more than half (52.13%) of the respondents strongly supports the idea that there is untouched potential growth and opportunity that Islamic banks provides to the society around the world. The remaining 47.87% of them also agree with this idea. The average value (4.52) show that most of the respondents were agreed on that statements. From this result it is clear that the developments of Islamic finance will brings huge opportunities for the communities.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
Islamic banking will have contribution to support and expand local business	N	0	0	0	140	236	176	4.63
	%	0%	0%	0%	37.23%	62.77%	100%	

The data show that about 62.77% of respondents were strongly agree that the rise of Islamic banking will have positive contribution by providing saving and loan service to the communities. And also the remaining 37.23% of them were agree with this idea. The mean value (4.63) of this data indicates respondent agreement on that statement.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
Islamic banking facilitates financial inclusion	N	0	0	0	170	206	376	4.55
	%	0%	0%	0%	45.21%	54.79%	100%	

As shown by the data above about 54.79% of the respondents were strongly supporting that the growth of Islamic banking service will facilitates financial inclusions by inviting potential stakeholders and clients who were not interested by conventional

banking service (interest based service). The remaining 45.21% of the respondents also agree with ideas. The mean value (4.55) implies that most of the respondents were highly supports that statements. Therefor the result confirmed that the growth of Islamic finance will creates a lot of opportunities for the discouraged group by including them into financial sectors by providing interest free banking service.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
Islamic banking contributes to expand employment opportunities	N	0	0	0	159	217	376	4.58
	%	0%	0%	0%	42.29	57.71%	100%	

The table above showed that about 57.71% the respondents were strongly supporting that the emergence of Islamic banking service will play important role in increasing employment opportunities in the country and also 42.29% of them were put their agreement on it. Therefor the result of findings found clear support for Islamic banking contribution to countries by enhancing employment opportunity. The mean value (4.58) of the data also confirms most of the respondents were agreed on that statements.

Item	Response Rate					Total	Mean	
	SDA	DA	N	A	SA			
Islamic banking promotes equitable distribution of income	N	0	2	7	160	207	376	4.52
	%	0%	0.53%	1.86%	42.55%	55.05%	100%	

As shown by table more half (55.05%) of the respondents were strongly supporting that the presence of Islamic finance/banking promotes equal distribution of incomes in the communities. And also around 42.55% of them were show their support on it. However, the remaining 0.53% and 1.86% of the respondents were refuse to accept it and stay silent respectively. The average value (4.52) show that most of the respondents were agreed on that statements Another promising finding was that Islamic finance plays important roles in providing fair distribution of income among the communities.

Item	Response Rate							Mean
	SDA	DA	N	A	SA	Total		
Islamic banking system will be helpful in fulfilling society's need and have positive impact in enhancing economy	N	0	0	0	270	106	376	4.28
	%	0%	0%	0%	71.81%	28.19%	100%	

The data on a table presents that about 71.81% of the respondents were strongly supporting the idea that growth of Islamic banking will be useful in fulfilling society's need and have positive impact on countries economy. And the remaining 28.19% of them were also shown their agreement on it. The mean value (4.28) show that most of the respondents were agreed on that statements The finding confirmed that Islamic banking plays important role in fulfilling communities' need and influences countries economy positively.

Item	Response Rate						Total	Mean
	SDA	DA	N	A	SA			
The emergence of fully-fledged Islamic banking system will improve the inclinations for business expansion and investment	N	1	1	0	204	170	276	4.44
	%	0.27%	0.27%	0%	54.26%	45.21%	100%	

Regarding the idea that emergence of fully-fledged Islamic banking system will increase the feeling for business expansion and enhance investment opportunities, more than half of 54.26% of the respondents were supports the idea, and 45.21% of them were strongly support it. However, the remaining 0.27% of the respondents doesn't accept it. The average value (4.44) show that most of the respondents were agreed on that statements. The result of the finding obviously shown that the developments of fully-fledged Islamic Banking recovers the interest of investors and stakeholders to

advance their business activity and investment opportunity. Generally, the respondents had a positive attitude in the majority of the statements.

Based on the result of finding lack of public awareness about Islamic banking service and product was one of major challenges that Islamic Banking encounter. Public understanding about product and service of any organization is the most important thing. The absence of proper regulations and supervision results in Islamic banks experiencing a loss of profits as they strive to provide comparable returns to investment account holders (IAH) and depositors. This lack of oversight hinders their ability to maintain financial stability and profitability. And also study confirms that there is lack of prior findings/literatures and development in Islamic studies. This gap hinders the progress and advancement of knowledge in this area. It is imperative to address this issue in order to foster a more comprehensive understanding of Islamic principles and practices.

Administrating Islamic financial organizations by the same set of rules and regulations with conventional financial system is another challenges of Islamic banking system and it was also identified by the result of this study. Islamic financial institutions should be subject to a distinct set of regulations due to their differences from conventional banks in various aspects, including risk structure, form of ownership, and governance. These institutions require specific guidelines that cater to their unique characteristics. Separating funds from conventional banking services is a necessary step to attract potential customers to Islamic banking. This measure ensures a professional approach and helps in maintaining the integrity of the Islamic banking system

The adoption of an interest-based banking standard may lead to a negative perception among investors who tend to associate the Islamic financial system with the conventional financial system. This could potentially deter them from engaging in Islamic banking practices. It is important to address this issue and ensure that investors understand the distinctiveness and benefits of the Islamic financial system

The Islamic banking system is currently facing a shortage of trained human resources. This shortage is hindering the smooth functioning of the system. The lack of skilled professionals in this field is a major concern that needs to be addressed. One of the main reasons for this shortage is the limited availability of educational programs and courses that specifically focus on Islamic banking. As a result, there is a lack of individuals who

possess the necessary knowledge and expertise to work in this sector. Furthermore, the existing training programs are often insufficient in providing the required skills and understanding of Islamic banking principles. This leads to a gap between the theoretical knowledge gained through education and the practical skills needed to effectively operate in the industry.

Islamic banking faces challenges due to the lack of a sufficient legal and supervisory framework. This hinders its growth and development. The current framework does not adequately address the unique features and requirements of Islamic banking, which operates based on Sharia principles. As a result, there is a need for comprehensive regulations and supervision that specifically cater to the Islamic banking industry. One of the main issues is the absence of clear guidelines and standards for Islamic financial products and services. This creates uncertainty and confusion among both customers and financial institutions. Without a well-defined framework, it becomes difficult to ensure transparency and accountability in Islamic banking operations.

Furthermore, the lack of a strong supervisory framework poses risks to the stability and integrity of the Islamic banking sector. Effective supervision is crucial to identify and mitigate potential risks, such as non-compliance with Sharia principles or dishonest activities. Without proper oversight, the reputation of Islamic banking can be tarnished, leading to a loss of trust from customers and investors.

There is a shortage of financial innovation in Islamic banking products. The current offerings are limited and do not meet the diverse needs of customers. This lack of innovation hinders the growth and development of the Islamic banking industry. The result of this study also indicates that the current Ethiopian tax policy and monetary policy was also identified as challenges of Islamic banking system in Ethiopia. Associating Islamic banking system with the religion of Islam was found to be another challenges for implementation of Islamic banking system. This result indicates that there is lack of public understanding about Islamic banking or sharia compliant banking system.

The prospects of the Islamic finance industry in Ethiopia are promising. With a growing Muslim population and increasing awareness about Islamic banking and finance, there is a significant potential for the industry to thrive in the country. Furthermore, the Ethiopian government has shown support for the development of Islamic finance by

establishing a regulatory framework and issuing licenses for Islamic banks and financial institutions. This has created a conducive environment for the growth of the industry.

The current global trends in financial services are expected to have a positive impact on the future of Islamic banks in Ethiopia. These trends indicate promising prospects for the growth and development of Islamic banking in the country and we can easily understand the potential benefits that these trends bring to the Islamic banking sector in Ethiopia. As more people around the world seek ethical and socially responsible banking options, Islamic banks are well-positioned to cater to this demand. This presents a significant opportunity for Islamic banks in Ethiopia to expand their customer base and attract new clients who value Islamic principles in their financial dealings.

Additionally, the advancements in technology and digitalization within the financial services industry have opened up new avenues for Islamic banks in Ethiopia. With the rise of fin-tech and digital banking solutions, Islamic banks can leverage these innovations to enhance their customer experience, streamline operations, and offer a wider range of Sharia-compliant products and services. This technological progress presents an opportunity for Islamic banks in Ethiopia to stay competitive and meet the evolving needs of their customers.

Islamic banking services have the potential to appeal to and benefit all communities in Ethiopia. With its unique principles and ethical framework, Islamic banking offers a viable alternative to conventional banking systems. One of the key advantages of Islamic banking is its focus on fairness and justice. The prohibition of interest (riba) ensures that customers are not burdened with excessive debt, promoting a more equitable financial system.

Islamic banking services promote social responsibility and ethical investments. Islamic banks are prohibited from investing in sectors that are considered harmful or unethical, such as gambling, alcohol, or tobacco. Instead, they prioritize investments in sectors that contribute to the well-being of society, such as healthcare, education, and renewable energy. This ensures that customers' funds are utilized in a manner that aligns with their values and supports sustainable development.

There is immense untapped potential for growth and opportunity that Islamic banks offer in Ethiopia. This opens up opportunities for the unbanked and underbanked

segments of the population to access financial services and participate in economic activities. Moreover, Islamic banking can contribute to the overall economic growth of Ethiopia. By attracting investments from Islamic financial institutions, the country can benefit from increased capital inflows. This can stimulate various sectors, such as infrastructure development, agriculture, and small and medium-sized enterprises (SMEs), leading to job creation and poverty reduction.

Likewise, Islamic banking promotes risk-sharing and discourages speculative behavior. This can contribute to a more stable financial system, as it discourages excessive risk-taking and promotes responsible lending practices. Also, Islamic banking plays a significant role in supporting and expanding local businesses by offering saving and loan services. This contribution is crucial for the growth and development of the local economy.

Additionally, Islamic banks offer various saving options that deliver the needs of individuals and businesses. These savings accounts provide a secure and ethical way to save money, as they are based on profit-sharing principles. This means that the bank invests the deposited funds in Sharia-compliant activities and shares the profits with the account holders. It contributes to the overall well-being of the local community

Islamic banking promotes financial inclusion by attracting potential customers who may have been discouraged by the interest-based system of conventional banking. This alternative banking system offers a simple and accessible approach to banking services, making it easier for individuals from diverse backgrounds to participate in the financial sector.

Islamic banking plays a significant role in enhancing employment opportunities within a country. It promotes economic growth and development, leading to job creation and reduced unemployment rates. Islamic banking aims to foster a fair and just distribution of income within the country. This system promotes an equitable sharing of wealth among individuals and discourages the concentration of wealth in the hands of a few.

The Islamic banking system can play a crucial role in meeting the needs of society and positively impacting the economy. Its principles and practices can contribute to the overall enhancement of the economy. The development of a comprehensive Islamic banking system in Ethiopia will enhance the prospects for business growth and

investment. This will create a favorable environment for expanding businesses and attracting more investments.

The interview analysis was focused on three key aspects of the Islamic banking system. Firstly, the respondents were asked about the current status of Islamic banking services in Ethiopia. Presently, there are three fully-fledged interest-free banks in the country, namely Hijra Bank, Zamzam Bank, and Shebelle and Rammis Banks. Although Ethiopia adopted interest-free banking relatively late, these banks now offer comprehensive services, and the sector is expected to experience rapid growth.

The second question addressed the challenges faced by Islamic banking services. Several obstacles were identified, including the difficulty in determining profit and loss within short periods, which restricts the ability to borrow or lend for short durations. Other challenges include the lack of a legal framework, insufficiently trained human resources, inadequate government support, and a lack of public awareness.

Lastly, the respondents were asked about the opportunities presented by the Islamic banking system in Ethiopia. Islamic finance brings numerous benefits to society, such as the creation of Sharia-compliant banking options that allow Muslims to invest without compromising their faith. Additionally, it offers employment opportunities, access to a substantial customer base, easy deposit mobilization, profitability, and the promotion of equality and fairness. Overall, the interview shed light on the current state, challenges, and opportunities of Islamic banking in Ethiopia.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 SUMMARY and CONCLUSION

This section summarizes the major findings of the study, provides recommendations, and suggests future research directions. The main objectives of the study were to assess the challenges and prospects of a fully-fledged Islamic banking system in Ethiopia, focusing on Zamzam Bank and its branch in Addis Ababa. To achieve its objective, a descriptive research design was conducted and both a qualitative and quantitative research method was used. This study was conducted using 400 of respondents, which was probably selected using a simple random sampling method from the total number 20,050 target population of Zamzam banks branch located in Addis Ababa. The researcher used both primary and secondary source of data to conduct the study. The researcher conducted quantitative and qualitative analysis from the responses collected on research questions. Data that is collected using a structured questionnaire (quantitative data) are coded and analyzed using quantitative analysis with the help of Microsoft Excel 2016 software. Based on the findings of the following conclusions and recommendations were drawn.

The finding of this study show that lack of public awareness about Islamic banking service and product was one of major challenges that Islamic Banking encounter. Public understanding about product and service of any organization is the most important thing.

The absence of proper regulations and supervision results in Islamic banks experiencing a loss of profits as they strive to provide comparable returns to investment account holders (IAH) and depositors. This lack of oversight hinders their ability to maintain financial stability and profitability. And also study confirms that there is lack of prior findings/literatures and development in Islamic studies. This gap hinders the progress and advancement of knowledge in this area. It is imperative to address this issue in order to foster a more comprehensive understanding of Islamic principles and practices.

Administrating Islamic financial organizations by the same set of rules and regulations with conventional financial system is another challenges of Islamic banking system and it was also identified by the result of this study.

The adoption of an interest-based banking standard may lead to a negative perception among investors who tend to associate the Islamic financial system with the conventional financial system.

The Islamic banking system is currently facing a shortage of trained human resources. This shortage is hindering the smooth functioning of the system. The lack of skilled professionals in this field is a major concern that needs to be addressed.

Islamic banking faces challenges due to the lack of a sufficient legal and supervisory framework. This hinders its growth and development. Furthermore, the lack of a strong supervisory framework poses risks to the stability and integrity of the Islamic banking sector.

There is a shortage of financial innovation in Islamic banking products. The current offerings are limited and do not meet the diverse needs of customers. The result of this study also indicates that the current Ethiopian tax policy and monetary policy was also identified as challenges of Islamic banking system in Ethiopia. Associating Islamic banking system with the religion of Islam was found to be another challenges for implementation of Islamic banking system.

Regarding the prospects of the Islamic banking in Ethiopia the result of this study confirms that with a growing Muslim population and increasing awareness about Islamic banking and finance, there is a significant potential for the industry to thrive in the country. Furthermore, the Ethiopian government has shown support for the development of Islamic finance by establishing a regulatory framework and issuing licenses for Islamic banks and financial institutions. This has created a conducive environment for the growth of the industry.

The current global trends in financial services are expected to have a positive impact on the future of Islamic banks in Ethiopia. The growing awareness and acceptance of Islamic finance principles by governments and regulatory bodies worldwide also play a crucial role in the future success of Islamic banks in Ethiopia.

Islamic banking services have the potential to appeal to and benefit all communities in Ethiopia. Additionally, Islamic banks engage in profit-sharing (mudarabah) and risk-sharing (Musharakah) arrangements, which encourage a mutually beneficial

relationship between the bank and its customers. This cooperative approach fosters trust and strengthens the bond between the bank and the community it serves.

Islamic banking services promote social responsibility and ethical investments. Islamic banks are prohibited from investing in sectors that are considered harmful or unethical, such as gambling, alcohol, or tobacco. There is immense untapped potential for growth and opportunity that Islamic banks offer in Ethiopia.

Moreover, Islamic banking can contribute to the overall economic growth of Ethiopia. By attracting investments from Islamic financial institutions, the country can benefit from increased capital inflows. This can stimulate various sectors, such as infrastructure development, agriculture, and small and medium-sized enterprises (SMEs), leading to job creation and poverty reduction.

Likewise, Islamic banking promotes risk-sharing and discourages speculative behavior. This can contribute to a more stable financial system, as it discourages excessive risk-taking and promotes responsible lending practices. Also, Islamic banking plays a significant role in supporting and expanding local businesses by offering saving and loan services. Additionally, Islamic banks offer various saving options that deliver the needs of individuals and businesses. These savings accounts provide a secure and ethical way to save money, as they are based on profit-sharing principles. This means that the bank invests the deposited funds in Sharia-compliant activities and shares the profits with the account holders.

Islamic banking promotes financial inclusion by attracting potential customers who may have been discouraged by the interest-based system of conventional banking. This alternative banking system offers a simple and accessible approach to banking services, making it easier for individuals from diverse backgrounds to participate in the financial sector.

Islamic banking plays a significant role in enhancing employment opportunities within a country. It promotes economic growth and development, leading to job creation and reduced unemployment rates. Islamic banking aims to foster a fair and just distribution of income within the country. As well, Islamic banking emphasizes the importance of social welfare and philanthropy. Islamic banks are encouraged to allocate a portion of their profits to charitable causes and initiatives that support the less fortunate.

In conclusion, the prospects of the Islamic finance industry in Ethiopia are bright. With a supportive regulatory environment, increasing demand for Islamic financial products, and the potential to contribute to economic development, the industry is poised for growth. By addressing the challenges and seizing the opportunities, Ethiopia can become a hub for Islamic finance in the region. However, there are challenges that need to be addressed for the Islamic finance industry to reach its full potential in Ethiopia. These include the need for further education and awareness about Islamic finance among the general public, the development of a skilled workforce in the industry, and the establishment of a robust regulatory framework to ensure transparency and consumer protection.

5.2 RECOMMENDATIONS

Islamic banks should focus on creating awareness through advertisements and promotional campaigns. The managers and CEOs of these banks should take an active role in educating the public about Islamic banking products and services. Additionally, training programs should be implemented to ensure well-trained staff. It is important to note that Islamic banking services are not limited to Muslims; followers of other religions can also access these services. However, there is a lack of knowledge about Islamic banking among the majority of non-Muslims.

Therefore, banks must work on marketing strategies to introduce the service as non-interest-based rather than religiously exclusive. Deposits are crucial for the existence of any financial organization, including Islamic banks. To increase deposits, banks should employ effective marketing techniques to encourage clients to place their deposits with Islamic banking.

To promote Islamic banking, it is essential for banks to offer attractive products that appeal to the majority of the population. By using effective marketing techniques, banks can attract large deposits. The National Bank of Ethiopia (NBE) should establish a clear legal framework to regulate the establishment of Shariah Advisory Committees in Islamic banks. As Islamic banking has a religious dimension, financial innovations in this sector must comply with Shariah requirements. Public acceptance of Islamic banking is hindered by the lack of knowledge among non-Muslims. Therefore, it is important to create awareness about Islamic banking products and services. Based on the finding of the study the researcher recommends the following recommendations

- Create public awareness about Islamic banking products and services.
- Educate the public about the major goals, guidelines, principles, and rules of Islamic banking.
- Provide training and development programs for managers and staff.
- Establish strong guidelines and a legal framework that aligns with Islamic banking principles and Shariah law.
- Develop an interest-free capital market to support Islamic banking.
- Establish separate rules and regulations for Islamic banking in line with conventional banking systems.
- Review tax and monetary policies to ensure compatibility with Islamic banking principles.
- NBE should support and prioritize the effective implementation of Islamic banking.
- Design and launch research and development programs to further enhance the significance of the Islamic banking system.

5.3 Future Research Direction

The following content proposes potential areas for future research in Islamic Finance/banking. Islamic Finance is a rapidly growing field that combines financial principles with Islamic law (Shariah). As this industry continues to evolve, there are several areas that warrant further research and exploration.

Islamic Finance operates under a different set of principles compared to conventional finance. Therefore, there is a need to develop robust risk management frameworks that are tailored to the unique characteristics of Islamic financial products. Research in this area could explore the effectiveness of existing risk management practices and propose improvements. The regulatory environment plays a crucial role in shaping the growth and stability of Islamic Finance. Further research is needed to assess the effectiveness of existing regulatory frameworks and identify areas for improvement. This research could also explore the harmonization of Islamic Finance regulations across different jurisdictions. Sightseeing these suggested areas, future researchers can contribute to the growth and development of Islamic Finance while addressing the evolving needs of the industry.

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Appendix Appendix 1



College of Business and Economics

MBA program (in management)

Questionnaire

Dear Respondent:

My name is Abdulwahid Dino I am a graduate student in Addis Ababa University and currently I am conducting a research entitled "**Assessing the challenges and prospects Islamic banking in Ethiopia**" in the case of Zamzam Bank in Addis Ababa. This questionnaire aims to collect a primary data for the partial fulfillment of the Masters of business Administration (MBA) Program at Addis Ababa University and this will be used for academic purpose only. Therefore, I kindly request you to provide me reliable information in all regards. Your response will be kept confidential.

No need of writing your name

Thank you in advance for your cooperation!

PART ONE: DEMOGRAPHIC INFORMATION

1. **Sex:** Male Female
2. **Age:** Below 25 years From 26-35 year
From 36-45 year from 46-55 year Above 56
3. **Educational background:**
High school Diploma Bachelor's Degree Masters and above
4. **Occupation:** Government employee Private-employee Self-employed
Student Pensioned
5. **Religion:** Muslim Orthodox Christian Protestant other
6. **How many years of experience do you have in banking industry? (for employee only)**
Zero years 1 years 2 years 3 years 4 years > 4 years
7. **How many years of experience do you have in Interest Free Banking service? (for employee only)**
Zero years 1 years 2 years 3 years 4 years > 4 years
8. **Position (for employee only):** Branch Manager Customer service officer
Accountant other

PART TWO: CHALLENGE ITEMS

Below are items which deal with respondents' view on challenges that will face Islamic banking system in Ethiopia. **So please tick (√) on the item given below that you feel most appropriate**

1. Strongly Disagree (SDA) 3. Disagree (DA) 5. Neutral (N)
 2. Agree (A) 4. Strongly Agree (SA)

NO	Item	SDA	DA	N	A	SA
1.	There is lack of public awareness about Islamic Banking Service in Ethiopia					
2.	There is a gap in research and development in Islamic studies					
3.	There is lack of regulations and supervision that leads Islamic banks losing their profits in order to pay comparable returns to investment account holder (IAH) and depositors					
4.	Islamic financial institutions should be governed by different set of regulations as they differ from conventional banks in many aspects such as risk structure form of ownership and governance					
5.	There is lack of supportive institutions like interest free money market and capital markets					
6.	The current Ethiopian tax policy and monetary policy system will be another challenging issues in providing Islamic banking service					
7.	There is Negative attitude of people regarding Interest free banking (wrong association with religion)					
8.	Separation of fund from the conventional banking service activity is mandatory to attract the potential customer of Islamic banking					
9.	Interest based banking standard will creates a negative perception among investors who tend to associate Islamic financial system with conventional financial system					

10.	There is lack of Trained Human Resource in Islamic banking system					
11.	Islamic banking system will face difficulty by Financial Services Authorities					
12.	Shariah laws and the existing legal framework in Ethiopia are perfectly matched					
13.	There is inadequate legal and supervisory framework					
14.	There exists inadequate infrastructure for information dissemination					
15.	There is lack of experience in Islamic Shariah					
16.	There is lack of secondary market (Such as Takaful/Islamic Insurance)					
17.	There is lack of financial innovation (in Islamic banking products)					
18.	The use of staff trained in traditional banking than Islamic banking is a challenge					
19.	There is lack of adequate banking law for Islamic banking in Ethiopia					

PART THREE: PROSPECTS OF FULL FLEDGED ISLAMIC BANKING

NO	Item	SDA	DA	N	A	SA
1.	The current global trends in financial services will have positive manifestations on the future of Islamic banks in Ethiopia					
2.	Islamic banking service will attract all communities in Ethiopia					
3.	There is untapped potential growth and opportunity that Islamic banks provide					
4.	Islamic banking will have contribution to support and expand local business (by providing saving and loan Service)					

5.	Islamic banking facilitates financial inclusion (attract the potential customers who were discouraged by the conventional banking interest application					
6.	Islamic banking has an important role to attract investors /investment to the country					
7.	Islamic banking contributes to expand employment opportunities in the country					
8.	Islamic banking promotes equitable distribution of income in the country					
9.	Islamic banking system will be helpful in fulfilling society's need and have positive impact in enhancing Ethiopian economy					
10.	Islamic banking system is more flexible and easy to implement in financial sectors					
11.	The emergence of fully-fledged Islamic banking system will improve the tendency for business expansion and investment in Ethiopia					
12.	Islamic banking represents additional deposit to bank					
13.	There is a vision that there will be more of Islamic financial system liberalization					

PART FOUR: INTERVIEW FOR BRANCH MANAGER

1. What do you think about the current status of Islamic banking service in Ethiopia?
2. What do you think about the challenges of Islamic banking service in Ethiopia?
3. What do you think about the prospects of Islamic banking for Ethiopians?