

Addis Ababa
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ADDIS ABABA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE

SCHOOL OF LAW

**INTRODUCING POLICY AND REGULATORY
FRAMEWORK FOR ACCOMODATION OF
ISLAMIC BANKING IN ETHIOPIA**

BY: Melika MohammedAhmed

Addis Ababa, Ethiopia

May, 2020 G.C

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BANKING IN ETHIOPIA

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

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Declaration

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

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Abstract

The accommodation of Islamic banking has to be accompanied by the development of efficient and effective Policy, regulatory and supervisory framework. Historically, Islamic banks operated under the conventional setup, but with the expansion of the Islamic banking industry, countries have adopted separate regulatory structures based on their institutional setup and market dynamics. This segregation of regulatory frameworks establishes the need for separate governance structures, given that the socially responsible objectives and operational efficiency of Islamic banking cannot be achieved under conventional setups. International agreements such as the Basel core principles which aim to provide level-playing field regulations for all banks, in fact, do not take into account the nature of the Islamic banking, hence IFSB standards, Guidelines and core principles were established to compliment the lack of level playing field regulations in BCPs. The countries which accommodate Islamic banking are also adopting these adjusted standards while developing their regulatory framework.

This research paper examines the exiting Ethiopian policy, regulatory and supervisory framework for Islamic banking by taking in to account the international standards and countries experiences. The core purpose of the study is to identify and disclose major policy, regulatory and supervisory gaps, loopholes and challenges. The study was conducted mainly based on regulatory and supervisory analysis, interview and benchmarking international experiences. The findings of the study revealed that yet the country did not yet develop the regulatory, supervisory and institutional framework that enable Islamic banking to operate on a level playing field. Based on the result of the study, this paper opted to introduce appropriate policy, regulatory and supervisory framework for the industry. Having this in mind, it focuses on the proposals and possible recommendations.

Acronyms and Abbreviations

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

BCBS: Basel Committee on Banking Supervision

BCPs: Basel Core Principles

BOD: Board of Directors

CBM: Central Bank of Malaysia

CEO: Chief Executive Officer

CBs: Conventional Banks

CBE: Commercial Bank of Ethiopia

CPIFR: Core Principles for Islamic Finance Regulation (Banking Segment)

GCC: Gulf Cooperation Council

IAHs: Investment Account Holders

IBs: Islamic Banks

IFB: Interest-Free Banking

IFSB: Islamic Financial Service Board

IFSI: Islamic Financial Services Institution

NBE: National Bank of Ethiopia

PLS: Profit and Loss Sharing

IAH: Investment Account Holder

PSIA: Profit Sharing Investment Accounts

SAC: Sharia Advisory Board

SSB: Sharia Supervisory Board

CHAPTER ONE

INTRODUCTION

1.1 Background

The origin of Islamic finance dates back to the emergence of Islam 1,400 years ago.¹ Its practices have been really used across the Muslim world since its inception. Islamic banking has developed from a niche to a prominent feature of the international financial sector since its inception in the 1970s.² The industry has flourished over the last four decades, becoming one of the fastest growing segments of the global banking market.³ It has not taken root solely in Muslim-majority countries but has also spread to non-Muslim countries.

Islamic banking can be defined as a system of banking that is consistent with the principles of Sharia and its practical application through the development of Islamic economics.⁴ The main feature of Islamic banking is the “interest free” banking aspect and the profit and loss sharing paradigm.⁵ The products and services provided by Islamic banks should not only be “interest free” but also should not be, in any way, used to finance Illicit or sinful transactions.

“The recent unprecedented rapid growth of Islamic financial system is gradually changing the status of the Islamic banking system as an alternative to the conventional counterpart to a mainstream contender.”⁶ But the growth of Islamic banking and finance has never been followed by its regulatory and supervisory system. However, “due to its universal growing acceptance and popularity many countries are embarking on legal and regulatory reforms to sustain the global

¹Ahmad Alharbi, ”Development of Islamic Finance in Europe and North America : Opportunities and challenges”, International Journal of Islamic Economic and Finance Studies, Vol.2, Issue.3, 2016 pp.110

² Sara Navid, Extending Our Understanding of Islamic Banking through Questioning Assumptions and Drawing Unprecedented Comparisons, PhD Thesis, Loughborough University, 2018, PP.1

³ Ibid.

⁴ Institute of Islamic Banking and Insurance, Islamic Banking”,

http://www.islamicbanking.com/what_is_ibanking.aspx Accessed on November 10, 2019G.C

⁵ Mohammed Imran, A guide to Islamic banking, (Ed. Darul-Irshad), Karachi, Pakistan, 2002, PP. 14

⁶Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System IIUM Institute of Islamic Banking and Finance (IIiBF) Malaysia Online at <https://mpra.ub.uni-muenchen.de/62332/> MPRA Paper No. 62332, posted 24 Feb 2015 14:38 UTC, pp.6 accessed on November, 2019G.C

development of the system.”⁷In spite of this, a supportive uniform regulatory and legal framework to enhance global integration of the system is yet to be developed.⁸The soundness of the banking and financial sector depends on the establishment and enforcement of suitable regulations and supervision. Similar to the conventional banks, Islamic banks need to have a proper and well-established legal framework to gain the investors’ confidence and protect all the rights of shareholders and stakeholders. The role of regulation extends beyond ensuring stability and confidence in the financial system, as it is also a behavioral shaper of market players.⁹The prevailing legal and regulatory system of a country determines the structure and type, as well as the means of implementation, of its legal and regulatory framework for Islamic finance and banking.

Two distinct approaches have been observed: (i) setting up a comprehensive, separate legal and regulatory framework for Islamic finance that is parallel to and compatible with the existing laws and regulations for conventional banking and finance; and (ii) retaining the existing conventional financial framework and taking incremental steps to accommodate the specificities of Islamic finance, which leads to a gradual extension and differentiation of the legal and regulatory system over time.¹⁰ The adoption of the second one a gradualist approach, however, poses some challenges to the Islamic finance industry, as a number of the existing legal and regulatory provisions are not in line with Sharia principles, while Islamic financial institutions are bound to follow the Sharia.¹¹ A research by the World Bank (2004) observed factors specific to Islamic finance that may become hurdles in developing a legal and regulatory framework for Islamic finance.¹²

“Considering the critical role of sound and robust legal and regulatory framework in the sustainable development of Islamic banking system, it is imperative to align the regulatory and

⁷ Ibid.

⁸ Ibid.

⁹ Siti Muawanah Lajis, Obiyathulla Ismath Bacha and Abbas Mirakhor, Regulatory Framework for Islamic Finance: Malaysia’s Initiative (May, 2016G.C), pp.1 Accessed on November 10, 2019 G.C.

¹⁰ Alamgir, M., Hossain, M.M. and Faisal, N.A. “Issues and Challenges for Islamic Finance and Banking in Bangladesh in the Perspective of Global Development”, Research Monograph 24, 2017, pp.18-19

¹¹ Ibid.

¹² Ibid.

legal framework in line with the development.”¹³The main concern however is the fact that the present laws and regulations, product design and development of the Islamic finance around the world tend to replicate those in the conventional system.¹⁴ Hence, continuing the tradition of mirroring the conventional regulatory framework would arguably be counter-productive to the growth trajectory of Islamic banking.¹⁵ Unlike conventional banking which predominantly operates on risk-transfer mode, the cornerstone of Islamic finance should be risk sharing.¹⁶

An important aspect of the required legal and regulatory framework for Islamic financial institutions is that the central bank or any other regulator must ensure that it addresses the unique nature of Islamic financial system as well as other issues involving all financial intermediations.¹⁷In addition, it has to give room for the dynamic nature of Islamic financial services. The robust legal and regulatory framework with business-friendly policies and initiatives will not only promote a competitive financial environment but also ensures Sharia compliance.

In 2008, the Ethiopian Banking Business Proclamation No.592/2008 was enacted and incorporated a provision for accommodation of Interest Free Banking (IFB). In 2011, the NBE issued a directive to authorize the business of Interest Free Banking (SSB/51/2011). This directive allows the Provision of IFB service at window level in accordance with the principles of Islamic finance by following the same regulations as the other banks except on the interest rate, which does not apply. In addition, the NBE issued the 1st Replacement Directive to License and Authorize Interest Free Banking Business No SBB/72/2019 which permit the establishment of full-fledged Islamic banks. The 1st Replacement Directive also did not provide separate regulatory framework for IBs. Its content is similar with the first directive. Having this in mind, the researcher has identified the following statement of problems.

¹³Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System IIUM Institute of Islamic Banking and Finance (2015), Cited above at note 6, pp.6

¹⁴Siti Muawanah Lajis, Obiyathulla Ismath Bacha and Abbas Mirakhor, (2016),Cited above at note 9,pp.3

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System IIUM Institute of Islamic Banking and Finance (2015), Cited above at note 6, pp.6

1.2 The Research Problem and Questions

As per the World Bank report out of Ethiopia's total population 35% to 40% are Muslims.¹⁸ In Ethiopia, there was a strong public demand for the establishment of full-fledged Islamic banks. Ethiopian Banking Business Proclamation No. 592/2008 pioneered the way for the establishment of interest-free banking business. Article 22 (2) of the proclamation authorizes the NBE to issue directives to regulate banking businesses related to non-interest-bearing deposit mobilization and fund utilization. Then with the sole intention of operating a full-fledged IB "Zemzem Bank" begins the formation process and shareholders subscribed all its shares within a short period of time even though finally it did not get banking business license since the issued directive does not allow the establishment of full-fledged IB. Rather the NBE issued "Directives to Authorize the Business of Interest Free Banking No. SBB/51/2011" which allow Interest Free Banking only at Islamic Window level in conventional banks. The Directive requires those banks that wish to get license and carry on an interest free banking service to comply with the principles of Islamic finance and standard modes of operation and fulfill some other procedural requirements.¹⁹

Allowing Islamic banking serves at window level was not enough response for sizeable Muslim population of the country. Prolonged strong public demand led the reformist Prime Minister Dr. Abiy Ahmed Ali to take a political commitment and make a decision which allows the establishment of full-fledged Islamic banks. Then NBE issued "(1stReplacement) Directive to License and Authorize Interest Free Banking Business No. SBB/72/2019" which Authorizes the establishment of a full-fledged IB as of June 18, 2019. Article 59 (1) of the amendment Proclamation No.1159/2019 also authorizes the NBE to issue a directive to prescribe additional conditions of licensing, supervisions and requirements to IFB. As a result of the legal reform full-fledged IBs are emerging. Six Islamic banks are under formation.

The emergence of full-fledged Islamic banking in Ethiopian financial sector is a remarkable measure taken by the government. However, the amendment Proclamation No.1159/2019 did not set the policy justification for accommodation of full-fledged IB, it did not state a regulatory

¹⁸ World Bank Report, 2013 G.C

¹⁹ Alyu Abate, The Regulation and Supervision of Interest-Free Banking in Ethiopia, Unpublished Master's Thesis Addis Ababa University, 2016, pp.3

framework that governs IB and on what principle it will be governed as well. It delegated the mandate to the NBE to issue directives. Yet the NBE did not issue additional directives.

The 1st Replacement directive only mention a single policy objective, financial inclusion as justification for authorization of IBs even though there is a possibility to set broader objectives. Article 2(2) of the 1st Replacement directive define interest free banking business as a banking business in which mobilization or advancing of fund is undertaken in a manner consistent with Islamic law or Sharia Principles. However, it did not state what constitute Sharia Principles or what sharia principle mean.

Moreover, Article 7 (1) of the 1st Replacement directive clearly stipulates that in conducting interest free banking business, banks shall comply *mutatis mutandis* with all regulatory and supervisory requirements except the National Bank's directive on interest rate. This shows that IBs are subjected to conventional banking regulatory and supervisory framework. It did not address the specificity in terms of product lines and peculiarity of IBs. IBs are based on compliance with the legal framework referred to as Sharia Law. But the directive did not set the requirement of establishing sharia supervisory board in order to insure sharia compliance. This led IBs to sharia non-compliance risk and reputational risk. This may end up with failure at macro level. IBs are largely investment banking oriented; they are related to or involved in the real economy, especially trade and investment whereas CBs relied on debt financing. Hence, IBs have risks which are specific to their nature that are not covered by the conventional regulatory framework.

“Effective prudential regulation of banks is as necessary and desirable for Islamic banking as it is for conventional banking.”²⁰The currently applicable directive is very broad and do not provide any specificity in terms of product lines, rules and regulations to ensure that the products developed by financial institutions are truly in line with Sharia law. It did not create a level playing field regulation which is specific to their nature for Islamic banks. Therefore, it is necessary to identify gaps and challenges of the existing policy, regulatory and supervisory framework by examining it in light of international standards, Core Principles for Islamic

²⁰ Errico, Luca, and Mitra Farrahbaksh, “Islamic Banking: Issues in Prudential Regulation and Supervision,” IMF Working Paper 98/30, Washington: International Monetary Fund, 1998, pp.11

Finance Regulation (CPIFR) and guidelines set by IFSB as well as different countries experience. Consequently, reviews of current policy, legal, regulatory and supervisory devices are needed to provide viable alternatives to roll out Islamic banking in Ethiopia.

Hence, the question of designing appropriate policy, regulatory and supervisory regime for IBs (a regulation question) is the main theme of this research paper. This study focuses on the issues surrounding these in order to contribute to regulatory development in the country. It, accordingly, focuses on the following research questions:

1. What are the basic principles, features and characteristics of Islamic banking?
2. What are the prudential standards, CPIFR set by IFSB which are specific to Islamic banking?
3. What do the current policy, regulatory and supervisory framework of the Islamic banking in the country and the reforms in the past look like?
4. Is there need for further reform of policy, regulation and supervision of the Islamic banking in the country? And what should the reform be, if any?

1.3 Research Objective

Full-fledged Islamic banking are emerging, conventional banks are dramatically increasing their interest free banking branches and windows. Thus, creating appropriate policy, legal, regulatory and supervisory framework is crucial for their development. Unless the regulatory authority create a level playing field (institutional and legal frameworks) IB are unable to compete with their conventional counter parts. The amendment proclamation is silent on the regulatory aspects of IB. The 1st Replacement directive has scanty provisions which did not properly address the regulatory and supervisory regime of IB and it simply subjected them under existing conventional regulatory regime.

This being the case, this research is dedicated to identify, examine and demonstrate the actual gaps, loopholes and challenges of the existing policy, legal, regulatory and supervisory framework. Exploring the problems related to regulatory regime in general and the supervisory practice in particular as well as forwarding some suggestions to tackle the problems, if the reforms on the said regimes are needed. This is the main objective of the research paper.

With this general objective in mind, the study has the following specific objectives:

- To create awareness of the basic principles, features and characteristics of Islamic banking and its difference with conventional banking.
- To introduce the prudential standards, CPIFR set by IFSB which are specific to IBs.
- To draw lesson from the experiences of countries like Malaysia and UK that had developed robust regulatory framework and to apply for benchmarking.
- To analyze current policy, regulatory and supervisory framework of the Islamic banking of the country.
- To suggest the reforms and measures that must be taken by Ethiopian government and the NBE.

1.4 Significance of the Research

The research is inspired to shed some light on the existing Policy, regulatory and supervisory gaps and challenges. As there is knowledge gap in the area, this study will give the clear picture of the level of the problem from policy, regulatory and supervisory aspects, to policy makers, regulators, CBs and academicians.

The government and the NBE may use the findings and recommendations for the regulatory amendments and reforms .Last but not least, this research is meant to provoke further researches in the field. It may initiate further study on the subject matter as it is unexplored area.

1.5. State of the Literature

There is a fairly large amount of literature on Islamic finance and banking that has been written by the classical and contemporary jurists of the Sharia.²¹ The discussion of Islamic finance which provides legal framework for interest-free banking is also part of the classical legal literature of the Sharia.²² But the intellectual venture of correlating Islamic finance with the modern financial market and banking structure is a recent phenomenon that didn't last for more than four decades.²³

²¹ Alyu Abate, (2016), Cited above at note 19, pp.5

²² Ibid.

²³ M. Kabir Hassan and Mervyn K. Lewis, Islamic Banking: An Introduction and Overview, Handbook of Islamic Banking ,2007, pp. 1; see also, Taqi Usamin, Introduction to Islamic Finance ,1998, pp. 7

Despite the wealth of literature in respect of the theoretical, the legal, regulatory and enforcement regime of Islamic banking and finance at international level, not much is written in Ethiopia. There are only two research paper that I know of which is written on the subject by a certain graduate of the Law School of Addis Ababa University named Alyu Abate²⁴ and Abdulwasi Yusuf.²⁵ The study conducted by Abdulwasi Yusuf is a kind of policy research that tried to pressurize the FDRE government to introduce interest-free banking business into the country's financial system so that the financial transactions of the Muslim population of the country would be channeled into its modern banking system; and to attract the international investors around the world especially those from the Gulf counties who need an interest free banking facilities to run their investment portfolios.²⁶ It also tries to point out some prior legal amendments that should be made before introducing the industry.²⁷

The thesis, being the first to research and bring the idea into attention, has brought up several points, though much has left untouched or not adequately addressed.²⁸ To mention some, the research doesn't provide a general Sharia framework of interest-free banking which is present in the field of Islamic economics and finance; and a detail exposition of the Fiqh rules about financing products and services which is of course at the center of the business.²⁹ The research also doesn't address the standards of regulations developed at the international level and concerned standard setting institutions of Islamic financial institutions.³⁰

The research done by Alyu Abate focuses on the regulation and supervision of interest free banks. It introduces the principles of Islamic financing and the Fiqh (Sharia law) rules governing the financing products and services that are identified to be Sharia-compliant by the classical and contemporary jurists of the Sharia. It introduces the standard setting bodies the IFSB and the AAIFOI. It also tries to analyze "Directives to Authorize the Business of Interest Free Banking No SBB/51/2011" which is already repealed and replaced now.

²⁴ Alyu Abate, (2016), Cited above at note 19.

²⁵ Abudulwasi Yusuf, 'ጥላይካልባባኝ' (2003 E.C), Dire printing SC, pp.101-122.

²⁶ Alyu Abate, (2016), Cited above at note 19, pp.5

²⁷ Ibid.

²⁸ Ibid.

²⁹ Ibid.

³⁰ Ibid.

The study, as the second research in the area brings some ideas into attention, though much has left untouched or in-adequately addressed. To mention some, it did not focus on the policy issues, it only discuss about some points of the regulation and supervision of interest free banking at window level, the study did not address detail regulatory issues for instance about risks specific to IB such as rate of return risk and equity investment risk, sharia compliant liquidity management issues, CAR etc. It didn't discuss in detail about the experiences of countries such as Malaysia and UK which had developed robust regulatory regime to draw lesson from other countries experience. Detail prudential regulations such as CPIFR set by IFSB are also not addressed.

This research discusses the unaddressed topics in detail. It conducts comparative analysis by taking in account experiences of countries such as Malaysia and UK as well as CPIFR set by IFSB. It applies separate analysis and assessment methodology and benchmarks.

1.6. Research Methodology

The study will fundamentally apply qualitative methodology, focusing on the policy, regulatory and supervisory issues. Primary and secondary sources of data are used in this research. It primarily applies comparative approach. It draws the major lessons from the systems and practices of countries like Malaysia and UK. The research examines the regulatory regime in view of the increased international standards such as CPIFR set by IFSB and use international experience for reflection and benchmarking. It principally analyzes relevant legal provisions of Banking Business proclamations, directives issued by NBE and other laws as primary data. In addition to this, to shed some light on the experience of some other countries published and unpublished literature in the area was also consulted. To this end, books, journals etc. were reviewed. Interviews with the NBE senior examiner, CBs directors and manager are carried out to give practical blend to the research paper.

CHAPTER TWO

2. Basic Principles, Features and Characteristics of Islamic Banking and Finance

It is well-known that Sharia is the basis for Islamic banking and finance. The rules and practices of Fiqh Muamalat are derived from the Holy Quran and the Sunnah, and other secondary sources of Islamic law such as opinions collectively agreed among Sharia scholars (Ijma), analogy (Qiyas) and personal reasoning (Ijtihad).³¹ As Islamic financial institutions seek to structure more innovative products for customers, it is, therefore, important to understand the principles of Islamic finance and the specific features of each principle.³²

2.1. Prohibition of Riba (Usury) or Interest

The prohibition of riba, commonly translated as a ban on interest or usury, is the most well-known principle of Islamic finance. Islam prohibits all form of riba. Riba has been understood throughout Muslim history as being equivalent to interest paid on a loan. According to Sharia, "riba technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for taking the loan."³³ Some later Muslim scholars define riba as the explicit increase imposed on the debtor at the maturity of the debt in case he/she fails to repay the principal amount plus any interest and wants to roll it over.³⁴ By and large, the consensus (Ijma') among Muslim scholars and jurists is that riba is generally seen as unjustified earning, where a person could receive a monetary advantage without giving an equitable (a just) counter-value.³⁵

2.2. Prohibition of Gharar (Uncertainty or Speculation)

The second important prohibition in exchange contracts is that of gharar trading. It technically denotes to the sale of probable items whose existence or characteristics are not certain, or a sale

³¹ Alamgir, M., Hossain, M.M. and Faisal, N.A., (2017), Cited above at note 10, PP.6

³² Ahmad M. Abu-Alkheil, Ethical Banking and Finance: A theoretical and Empirical Framework for the Cross Country and Interbank Analysis of Efficiency, Productivity and Performance, PhD Thesis, University of Hohenheim, 2012, PP.2

³³ Ibid.

³⁴ Ibid, PP.3

³⁵ Ibid.

involving excessive risk or moral hazard. Gharar refers to acts and conditions in exchange contracts, the full implications of which are not clearly known to the parties.³⁶ This is something very similar to ‘asymmetric information’. There are two kinds of gharar: gharar fahish (substantial) and gharar yasir (trivial).³⁷ The first kind is prohibited in Islam while the second is tolerated since this may be unavoidable without causing considerable damage to one of the parties.³⁸ In many cases, it is simply not possible to reveal all information (not because the seller wants to hide anything, but because it is in the nature of the subject matter of the contract).³⁹ Islamic jurisprudence relies on the general condition of trustworthiness of contracting parties to take care of this.⁴⁰

2.3. Prohibition of Maysir or Gambling

The unjustified enrichment through games of pure chance in order to amplify wealth without making effort is called Maysir.⁴¹ Islam prohibits all kinds of gambling and games of chance.⁴² However, it is important to draw a distinction between pure games of chance and activities that deal with uncertainties of life and business activities and involve an element of chance and risk-taking. “Maysir is involved in contracts where the ownership of a good depends on the occurrence of a predetermined but uncertain event in the future.”⁴³ This means that if the business contract is signed, there will be a gain for one party and a loss for the other party, but it is not sure beforehand who will be the winner or the loser.⁴⁴ Overall, the ban of Gharar and Maysir has particular relevance for financial markets, notably the derivatives market and the insurance business.⁴⁵

³⁶ Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance, and Prospects*, (United State, Palgrave Macmillan Ltd, 2005), PP.14

³⁷ Ibid.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Ahmad M. Abu-Alkheil, (2012), Cited above at note 32, pp.7

⁴² Munawar Iqbal and Philip Molyneux, (2005), Cited above at note 36, pp.15

⁴³ Ahmad M. Abu-Alkheil, (2012), Cited above at note 32, pp.7-8

⁴⁴ Ibid.

⁴⁵ Ibid

2.4. Prohibition of Financing Haram (religiously prohibited) Activities

Haram (religiously prohibited) activities refer to those that are either explicitly banned by the Quran and Sunnah, are judged to be inconsistent with the ethical values and objectives of the sharia or are identified as harmful for society.⁴⁶ These include industries such as alcohol, pork-related products, gambling, tobacco, narcotics, companies involved in oppressive regimes (i.e. abusing human rights) and/or environmental degradation as well as industries failing to meet the riba and gharar prohibitions such as conventional banking and finance.⁴⁷

2.5. Profit and Loss Sharing (PLS): No pain, No Gain Principle

The sharia draws a distinction between money and capital.⁴⁸ Money is potential capital, unable to produce a return on its own.⁴⁹ Transformation into capital requires money to be supplemented with entrepreneurial activities i.e. active productive effort, risk taking and the know-how of effectively combining other factors of production to generate additional wealth.⁵⁰ On this incremental wealth (profits), both the borrower and the lender have a residual claim since both contribute to the generation of it.⁵¹

There is a substantial difference between profits resulting from entrepreneurial activities and profits generated by granting loans.⁵² The latter is defined as receiving a monetary advantage without giving a counter value, and is, therefore, forbidden on ethical grounds.⁵³ Islam is not opposed to profit or financial gain, as long as: an effort is performed, liability is accepted for the financial result of a venture, the venture is productive, and the profit is made in line with the Sharia.⁵⁴

⁴⁶ Sara Navid, (2018), Cited above at note 2, pp.24

⁴⁷ Ibid, PP.22

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Ibid

⁵¹ Ibid.

⁵² Ahmad M. Abu-Alkheil, (2012), Cited above at note 32, pp.9

⁵³ Ibid.

⁵⁴ Ibid.

The Islamic solution, commonly referred to as PLS, suggests an equitable sharing of risks and profits between the parties involved in a financial transaction.⁵⁵ Under PLS, "the lender and the borrower assume the investment's risk based on a pre-agreed formula". PLS acquires several forms depending upon the type of contract e.g. Mudaraba (Joint venture) and Musharaka (partnership and collaboration).⁵⁶ In both of these forms, the financier makes the funds available, not as a lender, but rather as an investor.⁵⁷ The financier shares the profit (loss) and is not assured, in advance, of a positive rate of return. Losses must be shared by the financier in proportion to his share in the total financing while profits may be shared in any mutually agreed ratio.⁵⁸ However, the financier liability remains limited to the extent of financing provided by him and no more.⁵⁹ Such a financing approach is in line with both the objective of sharia and the riba prohibition which aim to establish equity and justice in society and business transactions.

2.6. Tangible Asset-Backing Principle (TAB)

Money in Islam is not considered an asset class and, thus, may not necessarily earn a positive return.⁶⁰ Money, therefore, should always be tied to and underpinned by an identifiable and tangible underlying asset.⁶¹ This suggests that all financial transactions should collateralized by a reference portfolio of on-balance-sheet assets of the originator.⁶²

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid.

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Ibid.

⁶² Ibid.

CHAPTER THREE

3. Islamic Banking and Finance Regulation and Supervision: Global Standards and Countries Experiences

3.1. Regulatory and supervisory Standards of Islamic Banking.

“An important objective underlying the regulatory framework for Islamic banking should be to avoid undermining the stability of the financial system.”⁶³“Key elements to achieve this objective include: i) understanding the nature of Islamic banking activities, ii) making appropriate changes to the existing regulatory framework for Islamic banking, and iii) leveling the playing field between Islamic banking and conventional banking.”⁶⁴

However, many Regulatory and supervisory authorities (RSAs), “including those new to the regulation and supervision of the IFSI, face challenges in identifying and applying appropriate principles and benchmarks for assessing the gaps in the existing structures and the policies in their jurisdictions.”⁶⁵ This is in part because the unique features of IFSIs call for special regulation and supervision that effectively address their specificities.

The approach to regulating and supervising IBs needs to reflect: “(a) the nature of risks to which IIFS are exposed; and (b) the financial infrastructure needed for effective regulation and supervision, which will result in additional or different regulation and supervisory practices to address the potential risks inherent in the IIFS’ operations.”⁶⁶

“Ensuring an adequate alignment of the regulatory framework with the guidelines of standard setters is a key to address the main risks inherent in IBs operations.”⁶⁷ The authorities must ensure that the regulatory framework for IBs puts them at a level playing field with CBs.⁶⁸ In some countries where IBs are present, the conceptual regulatory framework of the Basel

⁶³ Inwon Song and Carel Oosthuizen, (2014), Islamic Banking Regulation and Supervision: Survey Results and Challenges, IMF Working Paper, 2014, PP.11

⁶⁴ Ibid.

⁶⁵ IFSB, (April 2015), “Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR),” PP.1

⁶⁶ Ibid.

⁶⁷ <<https://journals.scholarpublishing.org/index.php/ASSRJ/article/download/3368/1928/>> accessed on March, 2020

⁶⁸ Ibid.

Committee on Banking Supervision is the default framework.⁶⁹ However, many countries complement it by the standards of the IFSB and the AAOIFI to give effect to Sharia Law compliance.⁷⁰

3.1.1. Islamic Financial Service Board (IFSB)

“The IFSB is an international standard-setting organization which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003.”⁷¹“The organization promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.”⁷² The first objective of the IFSB is: “To promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Sharia principles, and recommending these for adoption.”⁷³ Thus, the work of the IFSB complements that of the BCBS, the IOSCO, and the IAIS.

As of December 2017, the members of the IFSB comprise 75 regulatory and supervisory authorities and 8 international intergovernmental organizations including the IMF, the World Bank, and the BIS.⁷⁴ Collectively, these members operate in 57 jurisdictions. There are also currently 102 market players who are observer members who can participate in IFSB awareness programs on priority basis and at special members’ rates.⁷⁵ Since its inception, the IFSB has issued 17 Standards, CPIFR, Guiding Principles, and Technical Notes for the Islamic financial services industry.⁷⁶

⁶⁹ Inwon Song and Carel Oosthuizen, (2014), Cited above at note 63, pp.13

⁷⁰ Ibid.

⁷¹ IFSB, (April 2015), Cited above at note 65, pp.1 and: www.ifsb.org

⁷² Ibid.

⁷³ Ibid.PP.2

⁷⁴ World Bank, (2018), The Core Principles for Islamic Finance Regulations and Assessment Methodology, PP.11 and:www.ifsb.org

⁷⁵ Ibid.

⁷⁶ Ibid.

3.1.2. Accounting and Auditing Organization for Islamic Financial Institutions

Another independent standard setter that caters for the IFIs is the AAOIFI which was established in 1991 in Bahrain.⁷⁷ AAOIFI prepares and issues accounting, auditing, and corporate governance standards, as well as ethics and Sharia standards, for Islamic financial institutions.⁷⁸ As of December 2017 AAOIFI has published 81 standards, 26 accounting standards, 5 auditing standards, 7 governance standards, 2 ethics standards, and 48 sharia standards.⁷⁹ AAOIFI has over 200 members in more than 40 countries.⁸⁰ Members include regulatory and supervisory authorities, international/intergovernmental organizations and market players, professional firms and industry associations. AAOIFI standards have introduced greater harmonization among Islamic finance actors across the world.⁸¹

3.1.3. Core Principles for Islamic Finance Regulation (CPIFR):Banking Segment

The CPIFR are “a set of core principles for the regulation and supervision of the Islamic banking industry” issued by IFSB.⁸²

The main objective of the CPIFR is to provide a set of core principles for the regulation and supervision of the IFSI, taking into consideration the specificities of the IIFS in the banking segment and the lessons learned from the financial crisis, and complementing the existing international standards, principally the BCBS’s Core Principles for effective Banking Supervision (BCPs).⁸³

In particular, the objectives of the CPIFR include:

- (a) Providing a minimum international standard for sound regulatory and supervisory practices for the effective supervision of the IIFS;

⁷⁷ Alamgir, M., Hossain, M.M. and Faisal, N.A. (2017), Cited above at note 10, pp.20 and www.aoifi.com

⁷⁸ Ibid, PP.58-59

⁷⁹ Ibid.

⁸⁰ Ibid, PP.20

⁸¹ Ibid.

⁸² IFSB, (April 2015), Cited above at note 65, PP.2

⁸³ Ibid.

- (b) Protecting consumers and other stakeholders by ensuring that the claim to Sharia compliance made explicitly or implicitly by any IIFS is soundly based;
- (c) Safeguarding systemic stability by preserving the linkages between the financial sector and the real economic sector which underlie Islamic finance; and
- (d) Ensuring that IIFS act in accordance with their fiduciary responsibilities in all their operations, especially in regard to PSIA.s.⁸⁴

“The IFSB envisages that these Core Principles will be used by jurisdictions as a benchmark for assessing the quality of their regulatory and supervisory systems, and for identifying future work to achieve a baseline level of sound regulations and practices for Islamic finance.”⁸⁵ The CPIFR “will promote further integration of Islamic finance with the international architecture for financial stability, while simultaneously providing incentives for improving the prudential framework across jurisdictions so that it is harmonized and consistently implemented across the globe.”⁸⁶

The CPIFR is largely modeled after the BCP as revised in September 2012, with modifications to address Islamic banking-specific issues in regulation and supervision. Each CPIFR is supported by assessment criteria. These are divided between essential and additional criteria. The Secretariat of the Basel Committee on Banking Supervision participated as a member of the working group in the development of the CPIFR together with 18 country authorities, the AsDB, the IsDB, the IMF, and the World Bank. A mapping between the BCP and the CPIFR are already drawn.⁸⁷ In general CPIFR incorporate 33 Core Principles. These are listed under

- Nine BCPs are retained un-amended in the CPIFR in view of their common applicability to both conventional and Islamic banking;
- Nineteen BCPs have been amended at the level of the assessment criteria rather than the Principles themselves; and

⁸⁴ Ibid

⁸⁵ Ibid.

⁸⁶ Ibid.

⁸⁷ Ibid, PP.66

- Five additional principles of CPIFR and their corresponding methodology have been developed by the IFSB.

CPIFR are applicable both in full-fledged Islamic banking level and in Islamic “windows” (see CPIFR- 32) level. The IFSB expect its members to start implementing the CPIFR standard as of January 2016.⁸⁸

3.1.4. Principles Specific to Islamic Banks in the CPIFR: Prudential Regulations

3.1.4.1. Treatment of Investment Account Holders (PSIA/IAHs) (CPIFR 14)

“Profit Sharing Investment Account (PSIA) is a contract by which an investor/depositor opens an investment fund with an Islamic bank mainly under the terms of Muḍārabah contract.”⁸⁹“The bank could have RIA or full discretionary power in making investment decisions URIA.”⁹⁰The contracting parties agree on a ratio of profit sharing, which has to be disclosed and agreed upon at the time of opening the account. “Profits generated by the IBs are shared with the PSIA holder in accordance with the terms of the Muḍārabah agreement while losses are borne solely by the PSIA holder up to the amount invested, unless they are due to the IB’s misconduct, negligence, or breach of the contract terms.”⁹¹ Since the investor/depositor bears the risk of losing their funds invested by the bank, the management of PSIA raises issues of governance and disclosure, and risk-absorbency features in assessing capital adequacy become paramount.⁹² Thus, IFSB set the following core principle and assessment criteria.

[CPIFR 14: The supervisory authority determines how IAHs are treated in its jurisdiction. The supervisory authority also determines the various implications (including the regulatory treatment, governance and disclosures, and capital adequacy and associated risk-absorbency features, etc.) relating to IAHs within its jurisdiction.]⁹³

⁸⁸ Ibid, PP.4

⁸⁹ World Bank, (2018), cited above at note 74, PP.6

⁹⁰ Ibid.

⁹¹ Ibid.

⁹² Ibid.

⁹³ IFSB, (April 2015), Cited above at note 65, PP.32

The detailed assessment criteria are listed under “**Essential criteria.**”⁹⁴

3.1.4.2.Sharia Governance Framework (CPIFR -16)

Sharia compliance is vital for ensuring legality of contracts and integrity and credibility of IBs.⁹⁵ This is one of the key responsibilities of IB boards, hence, a mechanism needs to be in place to obtain rulings from Sharia scholars and monitor Sharia compliance. The risk of Sharia non-compliance can lead to non-recognition of an IB’s income or losses.⁹⁶ It may also manifest itself as reputational risk, leading to loss of future business, or even the withdrawal of deposits and investments placed with the IB.⁹⁷ Thus, the Sharia governance arrangement (policies and effectiveness of implementation) is important to ensure its compliance with Sharia rules and principles. Hence, IFSB set the following core principle and assessment criteria.

[CPIFR 16: The supervisory authority determines that IIFS have a robust Sharia governance system in order to ensure an effective independent oversight of Sharia compliance over various structures and processes within the organizational framework. The Sharia governance structure adopted by an IIFS is commensurate and proportionate with the size, complexity and nature of its business. The supervisory authority also determines the general approach to Sharia governance in its jurisdiction, and lays down key elements of the process.]⁹⁸

The detailed assessment criteria are listed under “**Essential criteria.**”⁹⁹

3.1.4.3.Equity Investment Risk (CPIFR 24)

Investments made via profit-and-loss sharing instruments may contribute substantially to IB’s earnings, but they entail significant market, liquidity, credit, and other risks potentially giving rise to volatility in earnings and capital.¹⁰⁰ The capital invested through these instruments may be used to purchase shares in a publicly traded company or privately held equity or invested in a

⁹⁴ See Ibid, PP.32-34

⁹⁵ World Bank, (2018), cited above at note 74, PP.7

⁹⁶ Ibid.

⁹⁷ Ibid.

⁹⁸ IFSB, (April 2015), Cited above at note 65, PP.35

⁹⁹ See Ibid, PP.36-37

¹⁰⁰ World Bank, (2018), cited above at note 74, PP.8

specific project, portfolio or through a pooled investment vehicle.¹⁰¹ In the case of a specific project, IBs may invest at various stages of the project. In addition, the delays and variation in cash flow patterns and possible difficulties in executing a successful exit strategy may pose a challenge.¹⁰² The capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to capital impairment risk in the event of losses.¹⁰³ Thus, IFSB set the following core principle and assessment criteria.

[CPIFR 24: The supervisory authority satisfies itself that adequate policies and procedures including appropriate strategies, risk management and reporting processes are in place for equity investment risk management, including Muḍārabah and Mushārah investments in the banking book (i.e. financing on a profit-and-loss sharing basis), taking into account the IIFS’s appetite and tolerance for risk. In addition, the supervisory authority ensures that the IIFS: have in place appropriate and consistent valuation methodologies; define and establish the exit strategies in respect of their equity investment activities; and have sufficient capital when engaging in equity investment activities.]¹⁰⁴

The detailed assessment criteria are listed under “**Essential criteria.**”¹⁰⁵

3.1.4.4. Rate-of-Return Risk (CPIFR 26)

IBs are exposed to rate-of-return (ROR) risk in the banking book. IBs are funded primarily by shareholder’s equity, deposits and PSIA.¹⁰⁶ On the asset side, IBs do not engage in “conventional lending,” but in “cost-plus” financing or sales with deferred payments, leases, PLS financing, and fee-based services.¹⁰⁷ ROR risk has some parallels with “interest rate risk in the banking book in conventional banks as defined by the BCBS, but it differs from interest rate risk in that IBs are concerned with the returns on their investment activities at the end of the investment

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ Ibid.

¹⁰⁴ IFSB, (April 2015), Cited above at note 65, PP.50

¹⁰⁵ See Ibid, PP.50-51

¹⁰⁶ World Bank, (2018), cited above at note 74, PP.8

¹⁰⁷ Ibid.

holding period and the impact on net income and cash flow after the sharing of returns with IAHs.”¹⁰⁸ Thus, IFSB set the following core principle and assessment criteria.

[CPIFR 26: The supervisory authority determines that IIFS have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate rate of return (ROR) risk in the banking book on a timely basis. These systems take into account the IIFS’s risk appetite, risk profile and market and macroeconomic conditions. The supervisory authority also assesses the capacity of an IIFS to manage the ROR risk and any resultant DCR, and obtains sufficient information to assess its IAHs’ behavioral and maturity profiles.]¹⁰⁹

The detailed assessment criteria are listed under “**Essential criteria.**”¹¹⁰

3.1.4.5. Islamic “Windows” Operations (CPIFR 32)

Islamic windows heighten Sharia governance issues because of the risk of commingling of funds and regulatory arbitrage, thus there is need for IBs to establish appropriate firewalls and disclosures.¹¹¹ Islamic windows raise supervisory issues beyond those posed by full-fledged IB, because of the potential for commingling of funds and regulatory arbitrage.¹¹² Hence, IFSB set the following core principle and assessment criteria.

[CPIFR 32: Supervisory authorities define what forms of Islamic “windows” are permitted in their jurisdictions. The supervisory authorities review Islamic windows’ operations within their supervisory review process using the existing supervisory tools. The supervisory authorities in jurisdictions where windows are present satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with Sharia rules and principles; (b) appropriate risk management policies and practices are followed; (c) Islamic and non-

¹⁰⁸ Ibid.

¹⁰⁹ IFSB, (April 2015), Cited above at note 65, PP.52

¹¹⁰ Ibid, PP.52-54

¹¹¹ World Bank, (2018), Cited above at note 74, PP.9

¹¹² Ibid.

Islamic business are properly segregated; and (d) the institution provides adequate disclosures for its window operations.]¹¹³

The detailed assessment criteria are listed under “**Essential criteria.**”¹¹⁴

3.2. Countries Experiences in Islamic Banking Regulation and Supervision:

This section will analyze the policy, legal and regulatory frameworks for Islamic banking in the Malaysia and UK with a view of identifying best practices as well as benchmark which Ethiopia can apply for reforming its Islamic banking regulatory regime. Malaysia and UK were selected because they have made significant contribution in development of Islamic finance in their respective geographic location. According HM Treasury the government of UK have introduced series of tax and regulatory amendments for development IF and to give a level playing field with conventional counterparts.¹¹⁵ So as a whole, the growth of IF is equally supported by government policy of ‘no obstacles, but no special favors and active role of FSA to reduce the regulatory hurdles for IFI.¹¹⁶ Malaysia is in the forefront among the countries which have dual regulatory Framework, with completely harmonized and developed regulatory systems for IBs.¹¹⁷ In addition, the two countries provide a necessary contrast with Malaysia being a Muslim country having dual regulatory systems and the UK non-Muslim country which have single regulatory systems.

3.2.1. The Regulatory and supervisory Framework of IBs in Malaysia

A. The Government’s Approach –Principles and Polices for IBs

The legislature inserted a specific and clear policy provision that requires the CBM to promote Malaysia as an international hub for the Islamic financial services.

Section 60 of the CBA 2009 provides that the CBM;

¹¹³ IFSB, (April 2015), Cited above at note 65, PP.61

¹¹⁴ Ibid, PP.61-63

¹¹⁵ Asad Khan, The Evolution of Regulatory and Supervisory Framework of Islamic Banks A Growing Global Divergence International Journal of Information, Business and Management, Vol. 8, No.4, 2016, PP,114

¹¹⁶ Ibid.

¹¹⁷ Ibid, PP.101-108

“Shall incorporate with the authority or international or supranational organization, develop and promote Malaysia as an international Islamic financial center.”¹¹⁸

In addition to this “the CBM is also allowed by the legislator to provide financing ‘for the development and promotion of Malaysia as an international Islamic financial center.’”¹¹⁹

Malaysia introduced a dual regulatory framework, which enables the conventional and Islamic financial services to operate in parallel. The creation of a dual regulatory framework is an indication of a serious effort by the government to treat all IFSIs on a level-playing field. This can be proved by the enactment of IBA 1983, which specifically governed the fully fledged Islamic banks, which is separate from BAFIA 1989, that governed the CBs. The repletion of these two legislations followed by the enactment of IFSA 2013 and FSA 2013 that aim to provide a better regulatory framework for both conventional and Islamic financial institutions.

Moreover, Section 27 of CBMA 2009 provides: “The financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system.”The greater legal and regulatory accommodation for Islamic finance Shows Malaysia’s government political will.

The regulatory principles and policies for IBs in Malaysia have evolved from detailed and prescriptive rule based towards a principles-based approach.”¹²⁰ Malaysia’s regulatory framework gives special attention to the specificity of the Islamic financial contracts. The regulatory framework governing Islamic banks in Malaysia is also a contract-based regulatory framework.

B. Enabling legal and Regulatory framework for IBs

Islamic finance requires a good and facilitative legal framework so that it can operate effectively, with adequate legal recognition, support and protection. This is the main reason Malaysia started its Islamic banking and finance operations only after the legal framework had been set in place. It began with the enactment of the Islamic Banking Act (IBA) (1983), which allowed the licensing of full-fledged Islamic banks and defined the scope of Islamic banking

¹¹⁸ Section 60 (1) Central Bank Act 2009

¹¹⁹ Section 60 (2) (b) Central Bank Act 2009

¹²⁰ Bank Negara Malaysia (BNM), Financial Stability and Payment Systems Report 2012, p.90

business.¹²¹ Islamic banks operate within a specified legal framework, which involves the application of a number of laws. Therefore, amendments to a number of other laws were also necessary to support Islamic banking operations, such as the amendment to the Government Investment Act (1983) to enable the Government of Malaysia to issue Sharia-compliant, non-interest bearing certificates known as Government Investment Certificates (GIC).¹²² This arrangement enabled Islamic banks to hold high quality liquid papers to meet the statutory liquidity requirements and its other liquidity needs.¹²³“The IBA made possible the establishment of the first Malaysian Islamic bank, Bank Islam Malaysia Berhad (BIMB) in 1983.”¹²⁴ In addition, a number of amendments and exemptions had been made to the taxation laws so as to provide a level playing field for Islamic financial institutions.¹²⁵

A major change in the Malaysian law that gives clear-cut statutory recognition to Islamic banking and finance is the passage of the new Central Bank of Malaysia Act (CBMA) (2009) that repealed the earlier CBMA 1958. ¹²⁶For the first time, the CBMA (2009) unequivocally declared that Malaysia is to have a dual financial system under Section 27.

Another major change in the Malaysian legal framework is the introduction of two omnibus legislations effective on 30 June 2013 for the dual financial system in Malaysia. They are the Financial Services Act 2013 that caters for the licensing and regulation of conventional banks and financial institutions (including insurance); and the Islamic Financial Services Act (2013) that caters for the licensing and regulation of Islamic banks and financial institutions (including Takaful).

The unique feature of IFSA is the requirement for Islamic banks to segregate the moneys placed by customers into either (1) Islamic deposits or (2) Investment account. The former treats the placement as risk-free hence its principal is guaranteed and the latter treats the placement as risk-sharing where the placement is no longer protected/ guaranteed. Section 2, which is the

¹²¹ Engku Rabiah Adawiah Engku Ali, Umar A. Oseni, (2017) "Towards an effective legal and regulatory framework for Islamic financial transactions: Major initiatives of the Central Bank of Malaysia", *International Journal of Law and Management*, Vol. 59 Issue: 5, pp.652-672, <https://doi.org/10.1108/IJLMA-04-2016-003>

¹²² Ibid.

¹²³ Ibid.

¹²⁴ Ibid.

¹²⁵ Ibid.

¹²⁶ Ibid.

interpretation section of IFSA 2013 re-defines Islamic deposit and distinguishes it from Islamic investment account, to legally recognize the different Sharia requirements in each of the underlying contracts. This ensures alignment in terms of legal and regulatory treatment of Islamic financial transactions with the underlying contractual principles as per the Sharia requirements.

On 14 March 2014, BNM issued a Policy Document on Investment Account to outline the regulatory requirements on the conduct of investment accounts.¹²⁷ In general, investment accounts use contracts that have non-principal guarantee features, such as, mudārabah, mushārahah and wakālah bil istithmā. The policy document clarifies that credit and market risk weighted assets funded by investment accounts that fulfill the requirement of the policy document shall be excluded from the calculation of capital adequacy ratio (CAR) of the IFI.¹²⁸ The banks will also conduct necessary risk management, disclosure and fair assessment, and facilitate informed decision-making by the RIA holders, as per the requirements laid down in the Investment Account Policy Document 2014.¹²⁹ Notwithstanding this, the policy document reiterates that IFSA 2013 provides adequate legal basis to support the further strengthening of investment account operation that provides appropriate protection to IAHS, while ensuring stability of the Islamic financial system.¹³⁰

“Since then, the IFSI in Malaysia has continued to flourish and now 16 fully-fledged IBs and IFIs, 11 Islamic windows, four international IFIs, and 16 Takaful companies are operating.”¹³¹ “Strong governmental support for the IFSIs sector has positioned Malaysia as one of the most developed Islamic finance markets in the world.”¹³² Several bodies were established by the Malaysian government such as the Islamic Capital Market, the Law Harmonization Committee, the Malaysia International Islamic Financial Centre, the Malaysian Deposit Insurance Corporation, Islamic Inter-Bank Money Market, academic and research centers.¹³³

¹²⁷ Ibid.

¹²⁸ Ibid.

¹²⁹ Ibid.

¹³⁰ Ibid.

¹³¹ Zolkapli Nuramarina, (2017), Level-playing field: the regulatory framework for Islamic banks in the United Kingdom and Malaysia, PhD Thesis, SOAS, University of London, PP.254

¹³² Ibid

¹³³ Ibid, 255-256

Malaysia is also the member and host country for the IIFSB and the International Islamic Liquidity Management Corporation.¹³⁴

C. Sharia Governance Framework

The principal regulatory objectives of IFSA 2013, as enumerated in Section 6 of the new law are the promotion of financial stability and ensuring compliance with Sharia principles. In the effort to ensure Sharia compliance in the Islamic finance industry, IFSA 2013 provides for two major things: (1) the strengthening of the Sharia governance framework; and (2) statutory framework for the introduction of Sharia Standards to regulate Islamic financial contracts. Section 28 of IFSA 2013; impose on institutions duty to ensure compliance with Sharia. Moreover, Section 30 of the act oblige a licensed person (bank) to establish a Sharia committee for purposes of advising the licensed person in ensuring its business, affairs and activities comply with Sharia. Section 31-36 states in detail about: the appointment, duty, cessation, information to be provided and privilege of Sharia committees. It also mentions about Audit on Sharia compliance under section 37 and 38.

“The Central Bank Act 2009 mandated the establishment of the CBM’s Sharia Advisory Council (SAC) by virtue of Section 51 of the Act, making the SAC highest authority to be referred to for issues pertaining to Islamic financial business.”¹³⁵“Part VII of CBA 2009 provides the rulings, which include its appointment, functions and the scope of the jurisdiction of the SAC.”¹³⁶“The SAC comprises of 11 members appointed by the Yang di-Pertuan Agong on the advice of the Minister after consulting the CBM ‘who are qualified in the Sharia or who have knowledge or experience in the Sharia and in banking, finance, law or such other related disciplines.”¹³⁷

Notably, the functions of the SAC are mainly:-(a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part (Part VII);(b) to advise the Bank on any Sharia issue relating to Islamic financial business, the activities or transactions of the Bank; (c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and (d) such other functions as may be determined by the Bank (CBM).¹³⁸

¹³⁴ Ibid.

¹³⁵ Ibid, PP.271

¹³⁶ Ibid.

¹³⁷ Ibid

¹³⁸ Section 52 of Central Bank Act 2009

The Malaysian courts and arbitral tribunals are also obliged to refer any Sharia matters in the Islamic banking and finance proceedings before them to the SAC or its resolutions, and such resolutions shall be binding upon them.¹³⁹ To avoid future controversy and enhance the process and procedure for Sharia resolutions, SAC has issued the Reference Manual for Courts and Arbitrators for Referrals to Sharia Advisory Council of BNM.¹⁴⁰ The manual, which was issued on 10 February 2014, details the procedure for making reference in case there is a need to ascertain any Sharia matter relating to Islamic banking and Takaful business during the court or arbitral proceedings.¹⁴¹

Under section 29 (1) of IFSA, the Bank Negara Malaysia (BNM) may, in accordance with the advice or ruling of the SAC, specify standards: (a) on Sharia matters in respect of the carrying of business, affair or activity by an institution which require the ascertainment of Islamic law by the SAC; and (b) to give effect to the advice or rulings of the SAC. In addition to the Sharia Standards, operational guidelines will also be issued to guide the market players on the practical implementation of the requirements of the contracts as laid down in the Sharia Standards, taking into consideration aspects of risk management, governance, legal requirements, disclosure and market conduct.¹⁴² Eventually, these Sharia standards are expected to promote uniformity of Sharia rulings across institutions while enhancing certainty and public confidence in the Islamic financial transactions.¹⁴³

3.2.2. The Regulatory and supervisory Framework of IBs in United Kingdom (UK)

A. The Government's Approach –Principles and Polices for IBs

IF has grown remarkably in the UK over the last decade. The pioneering IB Islamic Bank of Britain (IBB) began operations as an authorized firm in 2004.¹⁴⁴ The Islamic banking sector continues to offer its products in the UK market where the latest report has revealed that at least 20 Islamic financial institutions are operating in the UK and five of them are fully Sharia-

¹³⁹ Engku Rabiah Adawiah Engku Ali, Umar A. Oseni, (2017), cited above at note 121.

¹⁴⁰ Ibid.

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid

¹⁴⁴ Financial Services Authority,(2007), Islamic Finance in the UK: Regulation and Challenges, PP.10 www.fsa.gov.uk Accessed on March, 2020.

compliant.”¹⁴⁵“With the existing numbers of Islamic banks operating in the UK, it has also been reported that the country is now accommodating the largest number of Islamic banks in comparison with any other Western countries.”¹⁴⁶

An important feature of this development is the supportive government policies intended to broaden the market for Islamic products for both Sharia compliant institutions and firms with ‘Islamic windows. Firstly, the UK government and its officials set clear policy objective to establish and maintain London as Europe’s gateway to international Islamic finance. The UK Prime Minister; David Cameron announced at the 9th World Islamic Economic Forum that he and his government plan to make the UK an International Financial Centre for IF.¹⁴⁷In the words of the UK Chancellor of the Exchequer, George Osborne, is to turn the City of London into the “unrivalled western Centre for IF”.¹⁴⁸

Secondly, the UK government’s aim is to attract more investments from the Gulf region. “Therefore, the extent of regulatory accommodation for IBs is geared towards attracting more liquidity from Arab world.”¹⁴⁹George Osborne, the British Finance Minister, summarizes this policy in a crystal clear manner in the article that he wrote on the FT newspaper as follows: “Whether it is attracting money from China, rejecting damaging protectionism and financial transaction taxes, or issuing the first sovereign Islamic bond in the western world this government is doing what it takes to open Britain up for business, and for new sources of finance and extra jobs”.¹⁵⁰This show the greater regulatory accommodation based on economic justification.

Thirdly, to ensure that everybody, irrespective of their religious beliefs, has access to competitively priced financial products. To indicate the inclusiveness approach adopted by the

¹⁴⁵ Zolkapli Nuramarina, (2017), Cited above at note 131, PP.26-27

¹⁴⁶ Ibid.

¹⁴⁷ Ahmed Belouafi and Abdelkader Chachi,(2014),Islamic Finance in the United Kingdom: Factors Behind its Development and Growth, PP.38 <https://www.researchgate.net/publication/282852113> accessed on March, 2020

¹⁴⁸ Ibid.

¹⁴⁹ Zolkapli Nuramarina, (2017), Cited above at note 131, PP.160

¹⁵⁰ Ahmed Belouafi and Abdelkader Chachi, (2014), Cited above at note 147, PP.39

British authorities to make sure that everyone in the British society, regardless of faith and ethnicity, has access to a competitive and appropriate level of financial services and products.¹⁵¹

“The UK’s regulatory approaches for the Islamic financial sector are based on three principles fairness, collaboration and commitment.”¹⁵² Fairness in the FSA’s approach can be summed up as ‘no obstacles’, but ‘no special favors.’“The principle of collaboration represents the Government’s objective of working together with the financial services industry and the international standards setting bodies to ensure that the Islamic financial industry could become competitive in the financial market.”¹⁵³“Finally, the commitment by the UK government to the Islamic financial sector is seen through the establishment of several working groups to assist the development of the sector.”¹⁵⁴“Although the size of the IFs in the UK is comparatively small, the Government has established the Islamic Finance Experts’ Group, the Tax Technical Working Group, an Islamic Finance teams in the then FSA and the formation of the new Islam Finance Task Force.”¹⁵⁵“The latter is primarily aimed to promote the development of the Islamic financial sector, to increase inward investment and to strengthen the UK economy.”¹⁵⁶

B. Enabling legal and Regulatory framework for IBs

UK is country with completely secular legal system. IBs in UK are governed entirely by the conventional setup.¹⁵⁷As of 1997 FSA is acting as single regulator for the entire financial sectors.¹⁵⁸ It took reactive incremental regulatory steps to accommodate the specificities of Islamic.¹⁵⁹Since early 2000 the UK government, for reasons of accommodating and creating level-playing field for IB, has introduced a series of tax and legislative changes specifically

¹⁵¹ Ibid.

¹⁵² Zolkapli Nuramarina, (2017), Cited above at note 131, PP.258-260

¹⁵³ Ibid.

¹⁵⁴ Ibid.

¹⁵⁵ Ibid

¹⁵⁶ Ibid

¹⁵⁷ Asad Khan, (2016), Cited above at note 115, PP.116

¹⁵⁸ Financial Services Authority,(2007), Cited above at note 144, PP.8

¹⁵⁹ Ibid.

designed to remove obstacles to the development of Islamic finance. “Tax Technical Working Group was established by the UK government in the year 2003.”¹⁶⁰

“Following this, in 2003, there were two legislative changes made to the Finance Act 2003 (FA 2003) under ‘Alternative Property Finance’.”¹⁶¹ “Firstly, the FA 2003 introduced ‘relief to prevent multiple payment of Stamp Duty Land Tax (SDLT) on Islamic mortgages’ and the relief from SDLT on a ‘series of chargeable land transactions that are not necessary under conventional mortgage structures.’”¹⁶² In addition, amendments were made in the Finance Act 2005 and the Finance Act 2006 for borrowing arrangement products (Murabaha and Diminishing Musharaka, Ijara); deposit arrangement products (Mudaraba and Wakala); asset finance products (Tawarruq, Istisna’); investment certificates (Sukuk) and derivatives (Option, Profit Swap, ‘Urbun).¹⁶³ “Notably, in the year 2009 SDLT relief was granted on issuance, transfers or redemption of Sukuk subject to the conditions set out in the Finance Act 2009.”¹⁶⁴ These abolish the double-taxation treatment.

Treating Islamic banks on a level-playing field within the conventional regulatory framework, however, certainly causes regulatory concerns.¹⁶⁵ UK’s regulator was selective when making regulatory amendments for specific Islamic financial products and consequently, all the issues within the Islamic financial sector at the substantive level were not considered.¹⁶⁶ “In terms of the authorization process, substantive compromises have to be made by Islamic banks wishing to operate in the UK.”¹⁶⁷ For instance, despite the fact that the nature of Islamic banks is based on the PLS model, IBs have had to compromise the PLS model in order to fulfill the regulatory standards set by FSA such as capital certainty requirements.¹⁶⁸ Under these regulations, IBs obliged to use the Deposit Guarantee Scheme in which funds are pooled and mixed with the

¹⁶⁰ Zolkapli Nuramarina, (2017), Cited above at note 131, PP.234

¹⁶¹ Ahmed Belouafi and Abdelkader Chachi, (2014), Cited above at note 147, PP.65

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴ Ibid.

¹⁶⁵ Zolkapli Nuramarina, (2017), Cited above at note 131, PP.244-249

¹⁶⁶ Ibid.

¹⁶⁷ Ibid.

¹⁶⁸ Ibid.

conventional one.¹⁶⁹“This has led IBs to become exposed to operational risk and reputational risk.”¹⁷⁰“The capital certainty requirements have also led Islamic banks to compromise the PLS model in order to fulfill the formal equality requirement because they are regarded as depository institutions.”¹⁷¹In the UK, Islamic mortgages have been structured under two different Sharia-compliant contracts, namely, Murabaha and Ijara. This method of financing falls within the definition of a regulated mortgage contract and has been regulated by the FSA alongside conventional mortgages since October 2004.¹⁷²“This led to a lack of regulatory certainty and clarity due to the terminology used by IBs and the definition of Home Purchase Plan provided by the regulators.”¹⁷³“With regards to the authorization of IBs, the categorization of IBs as a deposit-taking business also conflicts with the inherent nature of Islamic banking business.”¹⁷⁴

C. Sharia Governance Framework

In UK SSB are available only at bank level, with no link to FSA.¹⁷⁵“With regards to the SSB functions, the regulator acknowledged the importance of the SSB’s role in supervising the Islamic bank’s products and transactions particularly to ensure that the Sharia-compliant requirement has been met.”¹⁷⁶The adoption of international regulatory standards by IB are encouraged since this would convince them that IBs adhere to the standards.¹⁷⁷“UK’s financial services regulations represent the regulator’s neutrality towards all banking and financial services institutions.”¹⁷⁸

“It is expected, therefore, that no requirements were imposed on the composition of an SSB in the UK.”¹⁷⁹“The establishment of an SSB depends on whether the bank is a fully fledged IB or a CB that operates ‘Islamic windows’ or a financial institution handling Islamic finance

¹⁶⁹ Ibid.

¹⁷⁰ Ibid.

¹⁷¹ Ibid.

¹⁷² Financial Services Authority, (2007), Cited above at note 144, PP.20

¹⁷³ Zolkapli Nuramarina, (2017), Cited above at note 131, PP.244-249

¹⁷⁴ Ibid, PP.168-169

¹⁷⁵ Financial Services Authority, (2007), Cited above at note 144, PP.16

¹⁷⁶ Ibid.

¹⁷⁷ Ibid

¹⁷⁸ Ibid.

¹⁷⁹ Zolkapli Nuramarina, (2017), Cited above at note 131,PP.193

transactions on an ad-hoc basis.”¹⁸⁰“The UK’s regulator did not impose any specific requirements in regard to the competency of an SSB member; neither is there a defined term for the competency requirement for an ‘approved person’ in the FCA/PRA Handbook.”¹⁸¹ The UK’s regulator leaves the matter to IBs to decide what constitutes ‘relevant experience’ for an SSB member.¹⁸²

¹⁸⁰ Ibid.

¹⁸¹ Ibid, PP.198

¹⁸² Ibid, PP.200

CHAPTER FOUR

4. Policy, Regulatory and Supervisory Accommodations for Islamic Banking and Finance in Ethiopia

4.1. The Development of Islamic Banking in Ethiopia

Most of the growth of IB in Ethiopia has taken place in the last seven years, but the initiation and public demand for the existence of Sharia-compliant transactions goes back to the early 2007 when the organizing team for Zamzam bank was formally setup by individuals and a company.¹⁸³ Since Article 22(2) of Banking Business Proclamation No. 592/2008 authorizes the NBE to issue directive to regulate banking businesses related to non-interest bearing deposit mobilization and fund utilization there was a great hope that the directive will allow the establishment of full-fledged IB. As a result, Zamzam bank had floated shares with the sole intention of operating a full-fledged IB even though it did not succeed.¹⁸⁴

However, the NBE issued Directives to Authorize the Business of Interest Free Banking No SBB/ 51/2011 which only authorize conventional banks to market and launch their products with the introduction of ‘Islamic windows’ alongside of their conventional operations. Since then around eleven conventional banks received interest free banking window operation licenses until 2020G.C.¹⁸⁵ Oromia International Bank S.C (OIB) received on September 16, 2013, Commercial Bank of Ethiopia (CBE) on September 17, 2013.¹⁸⁶ Accordingly, CBE using its 23 pilot branches and OIB using its 24 branch offices launched IFB operation on October 24, 2013 and December 16, 2013 respectively.¹⁸⁷ On May 1, 2014, United Bank S.C. began providing IFB service and recently, Cooperative Bank of Oromia, Nib International Bank, Awash Bank, Dashen Bank, Wegagen Bank, Abyssinia Bank, Buna Bank and Abay Bank have joined the IFB business.¹⁸⁸ In

¹⁸³ ZamZam Bank S.C (Under Formation), (2010), Prospectus for the Sale of Ordinary Shares, PP.1-26

¹⁸⁴ Ibid.

¹⁸⁵ An interview conducted with Ms. Frehiwot Kiros, Senior Examiner at NBE, (24/4/2020 G.C)

¹⁸⁶ Abraham Redi Awol, Determinants of Customers’ Intention to Use Interest Free Banking Products and Factors Affecting Employees’ Product Knowledge Unpublished Master’s Thesis, Addis Ababa University, 2017, pp.3.

¹⁸⁷ Ibid

¹⁸⁸ Ibid

addition, as of 2019 G.C CBE, OIB, Awash Bank, Cooperative Bank of Oromia and Abyssinia Bank had launched dedicated interest free branches.

Moreover, due to high commitment and greater political will of Prime Minister Abiy Ahmed's government the NBE issued "(1st Replacement) Directive to License and Authorize Interest Free Banking Business No. SBB/72/2019" which Authorize the establishment of a full-fledged IBs as of June 18, 2019. Article 59 (1) of Banking Business amendment Proclamation No.1159/2019 also give the NBE mandate to issue directive to prescribe additional conditions of licensing, supervisions and requirements to establish IFB. Sub-article 2 of this article mention that the provision of Islamic window service along with conventional banking is also remained in operation. As a result within a few months after authorization around six exclusively full-fledged IBs Zamzam Bank, Hijra Bank, Zad Bank, Ramis Bank and Shebelle Banks are under formation and they are subscribing shares.¹⁸⁹ Two of them ZamZam Bank and Hijra Bank already floated their shares and applied to receive license from NBE.¹⁹⁰ Till now there is no full-fledged Interest Free bank that receive business license.

On the same year, Insurance Business Amendment proclamation No.1163/2019 was enacted. Article 60 of the amendment proclamation provides legal recognition to Takaful business. Within short period of time after authorization two insurance companies applied to receive Takaful insurance business license to provide the service at window level.¹⁹¹ However, they did not receive the license since NBE did not issue the directive to regulate the business.¹⁹²

In Ethiopia Islamic banking is at its infancy stage. Even though there are large numbers of banks that provide Islamic banking services through window and dedicated branches the products they are offering are limited to Wadia, Amana, Mudaraba deposit and Murabaha financing.¹⁹³ They are not offering PLS investment services such as Mudaraba and Musharaka financing due to

¹⁸⁹ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

¹⁹⁰ Ibid.

¹⁹¹ An interview conducted with Mr. Belay Tulu, Insurance Supervision Director at NBE, (24/4/2020 G.C)

¹⁹² Ibid.

¹⁹³ Interviews conducted with Mr. Geleta Bekele, Interest Free Banking Director at CBE, Mr. Fuad Sultan Customer Relationship Manager at OIB and Mr. Abdulkadir Redwan Interest Free Banking Director at Abyssinia Bank (23/4/2020, 27/4/2020 and 28/4/2020 respectively)

various hurdles.¹⁹⁴ There financial product service is largely depending on Murabaha financing.¹⁹⁵

4.2. The Government Policies and Principles for Accommodation of Islamic Banking and Finance

Over the last two decades, the Ethiopian Government has formulated and issued policies over a wide diversity of issues and anchored government projects and plans around these policies. In spite of that the government has not yet issued an official policy document for accommodation of Islamic Finance.¹⁹⁶ Ethiopia has a long-established tradition of mentioning policy statements on preamble of the laws. However, Banking Business amendment Proclamation No.1159/2019 did not mention the policy objectives for accommodating IFB.

In spite of this, Financial and social inclusions are taken as the policy objectives for accommodation of Interest Free Bank. These policy justifications are stated on the preambles of the directives issued by NBE. The first line of the 1st Replacement Directive provides that “interest free banking business has to be promoted for greater financial inclusion” and the first directive which authorize business of interest free banking SBB/51/2011 mention that “increasingly strong public demand for interest free banking products in Ethiopia” is a reason for issuance of the directive.¹⁹⁷ Since Ethiopia is the country which has significant number of Muslim population this policy stance can be taken as important beginning.

However, the Ethiopian government can set additional comprehensive public policy and political economic objectives for further accommodation and development of IBs as UK and Malaysia did. The government is working towards attracting more foreign direct investment (FDI) from Middle East, South East Asia and other Muslim majority countries such as Turkey. Hence, the extent of regulatory accommodation for Islamic Finance geared towards attracting more liquidity from Muslim countries. The government has to do what it takes to open the country up for

¹⁹⁴ Ibid.

¹⁹⁵ Ibid

¹⁹⁶ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

¹⁹⁷ See: the preamble of the NBE (1st Replacement) Directive to License and Authorize Interest Free Banking Business No. SBB/72/ 2019 and Directives to Authorize the Business of Interest Free Banking Directives No. SBB/51/2011

business and for new sources of finance and extra jobs. It can also aim to promote and develop the Islamic financial market to become one of the leading Islamic financial centers in the East Africa Region.

Ethiopia's government regulatory approach for the Islamic financial sector is not principle based. The regulatory framework did not give special attention to the specificity of the Islamic financial contracts. "In conducting interest free banking business, banks shall comply mutatis mutandis with all regulatory and supervisory requirements except National Bank's directives on interest rate."¹⁹⁸ Interest free banks are governed under the same regulatory and supervisory framework with conventional banks. The government did not make serious effort to treat all financial services on a level-playing field by enacting separate proclamation or by issuing comprehensive directives that governs IBs.

It is difficult to say the government is working in collaboration with the international standards setting bodies to ensure that the Islamic financial industry could become competitive in the financial market. Neither the NBE as a regulatory authority nor Ethiopia as a country are members of the international standard setting bodies such as BCBS, Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).¹⁹⁹ The NBE did not adopt the International standards, Core Principles for Islamic Finance Regulation (CPIFR), guidelines and technical notes which had been developed by international standard setting bodies.²⁰⁰ The service provider banks as well are not members of the international standard setting bodies and did not fully adopt the standards, CPIFR and guidelines to develop their products in order to create harmonization.²⁰¹ This will inhibit the integration of Islamic financial institutions and the development of Islamic banking industry both at national and international level.²⁰²

¹⁹⁸ Article 7(1) of (1stReplacement) Directive to License and Authorize Interest Free Banking Business No. SBB/72/2019

¹⁹⁹ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

²⁰⁰ Ibid

²⁰¹ Interviews Conduct with Directors and Manager, Cited above at note 193.

²⁰² Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems", IMF Working Paper (2007), PP.6 Available at:<<https://www.imf.org/external/pubs/ft/wp/2007/wp07175>> accessed on March,2020

4.3. Legal and Regulatory Framework for Islamic Banking in Ethiopia

Ethiopia has single regulatory authority the NBE for both IBs and CBs. In 2008, Ethiopian Banking Business Proclamation No.592/2008 gave legal recognition to Interest free banking business. Article 22(2) of the proclamation grant the NBE mandate to issue directive to regulate banking businesses related to non-interest bearing deposit mobilization and fund utilization. In 2011, the NBE issued a directive to authorize the business of IFB (SSB/51/2011). This directive allow the Provision of IFB service at window level in accordance with the principles of Islamic finance by following the same regulations as the other banks except on the interest rate, which does not apply.²⁰³ The directive is very broad and does not provide any specificity in terms of product lines, rules and regulations to ensure that the products developed by financial institutions are truly in line with Sharia law.

On June 2019, the NBE issued (1st Replacement) Directive to License and Authorize Interest Free Banking Business No SBB/72/2019 which repealed and replaced the first directive. Article 59 (1) of Banking Business amendment Proclamation No.1159/2019 also give the NBE mandate to issue directive to prescribe additional conditions of licensing, supervisions and requirements to establish Interest Free Bank. However, yet the NBE did not issue additional directives. The proclamations did not contain regulatory provisions rather than delegating the legislative power to the NBE.

The currently applicable law, the 1st Replacement directive did not bring major regulatory framework difference with the repealed one except the provisions that authorize the establishment of fully-fledged IFBs and that provide BOD of IFB with the power to develop detail policies and procedures on Sharia oversight.²⁰⁴

Article 2(2) of the 1st Replacement directive define interest free banking business as a banking business in which mobilization or advancing of fund is undertaken in a manner consistent with Islamic law or Sharia Principles. However, it did not state what constitute Sharia Principles or what sharia principle mean. It set vague definition when we see in comparison with definition of Islamic banking business stated under Section 2 of IFSA 2013, which include (a) accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or

²⁰³ See Article 2(3), 2(2) & 7(1) of Directives to Authorize the Business of Interest Free Banking Directives No. SBB/51/2011

²⁰⁴ See Article 7(2) of (1st Replacement) Directive, Cited above at note, 193

without the business of paying or collecting cheques drawn by or paid in by customers; or (b) accepting money under an investment account; and (c) provision of finance; and (d) such other business as prescribed under section 3.

Moreover, Article 7 (1) of the 1st Replacement directive clearly stipulates that in conducting interest free banking business, banks shall comply *mutatis mutandis* with all regulatory and supervisory requirements except National Bank's directive on interest rate. This underlines that a single integrated regulatory framework applied to all banks in Ethiopia. All IB are subjected to BCBS framework for bank regulation and supervision as its conventional counterparts. The conventional regulatory system did not squarely fit with specific nature of Islamic banking transactions. In some cases it is in direct conflict with prospective IBs products offerings. These conflicts may cause IBs products to be less competitive or in some cases make it impossible to launch certain products unless revisions are made to cater for these products.

For instance all banks found in Ethiopia providing interest free window services are not engaged in PLS investment service such as Musharakah and Mudarabah financing. The main reason they raised as a challenge is Limitation on Investment of Banks.²⁰⁵ Article 4(6) of (2nd Replacement) Directive No SBB/65/2017 set a cap, that a bank's aggregate equity investment in all non-banking business, including insurance companies shall not exceed 10% of its net worth. With some exceptions stated under article 6 such as the investment take place by RIAH. The directive wants to insure the banks focus on debt financing. As it is discussed, in the previous chapters, IBs are largely investment banking oriented, as they typically relate to or involve in the real economy, especially trade and investment. They engage in PLS business rather than debt financing only. The limitations stated under the directive poses a danger on the effectiveness and profitability of Islamic banking business because it severely hampers their investment activities. Thus, the directive did not enable them to operate and compete on a level playing field with their conventional counterpart. There are also many other regulatory challenges and gaps some of which will be discussed in the next subsections.

4.3.1. Sharia Governance Framework

One of the idiosyncratic features with regards to the governance of an IB and a CB is the establishment of a Sharia Supervisory Board (SSB). Sharia compliance is central to ensure legality of contracts, integrity and credibility of IBs. Sharia supervision is required for an IB to

²⁰⁵ Interviews Conduct with Directors and Manager, Cited above at note 193.

ensure that the activities conducted by IBs are in accordance with Sharia principles. In Ethiopia the NBE mandated the board of directors of a bank engaged in interest free banking business to develop detail policies and procedures on sharia oversight.²⁰⁶ It seems that the regulator prefer neutral position by leaving the sharia supervision matter to the banks. This is major regulatory gap when we see it in comparison with Section 6 of IFSA 2013, which set ensuring compliance with Sharia principles as one of its regulatory objective.

The 1st Replacement Directive does not expressly require the setting up of Sharia board for full-fledged Islamic banks as well as Islamic windows of the conventional banks. It is in contrast with Malaysian practice which obliges the establishment of SSB for IB. In addition, the NBE as a regulator did not prepare guidelines which clearly demonstrate the role of SSB in IBs, their mandate, reporting line, responsibility, acceptable “fit and proper” criteria, composition, well-defined operating procedures, assessment of the effectiveness the member etc.²⁰⁷ This is not in line with the CPIFR 16 which had been discussed in chapter three. Ethiopia has similar practice with UK where there is no regulatory accommodation for Sharia supervision.

However, Supervisory authority should be aware of the risks when there is no requirement for an IB to have Sharia board and sharia compliance. “Firstly, the purpose of establishing a sound regulatory framework for Sharia supervision or governance is to preserve market confidence in the Islamic financial services industry.”²⁰⁸ “Secondly, without proper guidelines for Sharia supervision or a corporate governance framework, IBs could potentially be exposed to several types of risk such as regulatory risk, operational risk, and Sharian on-compliance risk.”²⁰⁹ “The existence of these risks could ultimately lead to reputational risk, which eventually may cause the collapse of the Islamic financial sector at a macro level.”²¹⁰ “Thirdly, it is needed to monitor the prudential aspect and market discipline for Islamic banks to promote the stability of the Islamic financial sector.”²¹¹

Even though there is no specific requirement set by NBE, some of the CBs that are providing IFB services through dedicated branch and Islamic window such as CBE, OIB and Abyssinia

²⁰⁶ Article 7(2) of (1st Replacement) Directive, Cited above at note, 193

²⁰⁷ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

²⁰⁸ Global Islamic Finance Report 2011, p.217-219

²⁰⁹ Ibid.

²¹⁰ Ibid, PP.219

²¹¹ Ibid.

banks have SSB who are free-standing external organs.²¹² Since there is no standards and guidelines set by NBE the practice of one bank vary from the other. CBE and OIB have SSB which have five members while Abyssinia bank's SSB has three members according to AAOIFI standards.²¹³ OIB and Abyssinia bank's SSB directly report to BOD while CBE's SSB members report to CEO.²¹⁴ There is also difference in "fit and proper" criteria, composition, operating procedures. The Sharia ruling and fatwas rendered by SSB may also vary.

Since the industry is expanding and full-fledged banks are on the way to join the market leaving the regulatory and Sharia supervision matters solely to the banks may lead to serious contradictions and regulatory arbitrages.

In spite of this fact, at the central bank level the NBE have neither the Sharia Advisory Board nor have a single internal expert advisor.²¹⁵ Ethiopia can learn a lot from the Malaysian robust Sharia governance experience which had been discussed in the previous chapter. In Malaysia banks with Islamic windows have SSB at institution level and CBM has National Sharia Advisory Council (NSAC) at the Central bank level as legislator and advisor on sharia issues. Central Bank of Malaysia Act (2009) accorded NSAC with the status of sole authoritative bodies on Sharia matters in their respective industries. The rulings of the NSAC shall prevail over any contradictory ruling by a Sharia body or committee in Malaysia. The Malaysian courts and arbitral tribunals are also obliged to refer any Sharia matters in the Islamic banking and finance proceedings before them to the NSAC or its resolutions, and such resolutions shall be binding upon them. Guidelines on Sharia Governance Framework for Islamic Financial Institutions were issued in 2010.²¹⁶ Eventually, these Sharia standards are expected to promote uniformity of Sharia rulings across institutions while enhancing certainty and public confidence in the Islamic financial transactions. Thus, Ethiopia should learn a lesson from the Malaysian experience to fill the regulatory gaps and reduce the Sharia non-compliance and governance challenges.

In view of these considerations, it is proposed that NBE has to issue directives which require IBs, dedicated branch or windows to establish SSB at institutional level and central bank level to

²¹² Interviews Conduct with Directors and Manager, Cited above at note 193.

²¹³ Ibid.

²¹⁴ Ibid.

²¹⁵ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185

²¹⁶ Engku Rabiah Adawiah Engku Ali, Umar A. Oseni, (2017), Cited above at note 121. pp.657

set Sharia Advisory Board for supervising the Sharia side of Islamic banking are constituted. In addition, it necessary to prepare directive or guidelines/manuals that clearly demonstrate the role of SSB in IFB, their mandate, reporting line, responsibility, acceptable “fit and proper” criteria, composition, well-defined operating procedures, assessment of the effectiveness of the member.

4.3.2. Treatment of investment account holders (IAHs) and Capital adequacy Requirement (CAR)

Profits generated by the IBs are shared with the IAH holder in accordance with the terms of the Muḍārabah agreement while losses are borne solely by the IAH holder up to the amount invested, unless they are due to the IB’s misconduct, negligence, or breach of the contract terms. As stated under CPIFR 14 and its essential criteria the assets financed by the funds of the UIAH can be excluded from the denominator of the standard capital adequacy formula and where there is risk absorbency by the investors. The fact that capital and return on investment for IAH depend on the IB’s profitability indicates that transparency in the IBs should go beyond the requirements in the conventional banking sector to include profit calculation and distribution, and investment strategies and risk exposures.

A supervisory authority, therefore, has a role in reinforcing market discipline by requiring timely and relevant information disclosures, including clear guidelines on the use of smoothing mechanisms such as a profit equalization reserve (PER) or investment risk reserve (IRR), and specifying prudential limits on the percentage of UIAHs’ funds that may be invested in real estate and large exposure limits. When managing the investments of the IAH, the IB as Muḍārib should clearly demonstrate to the supervisory authority and external third parties that it has the level of competence necessary to fulfill its fiduciary duties and that adequate policies and procedures are in place. This is to ensure that the IAHs’ assets are safeguarded, and that the IB as Muḍārib has operated within the objectives agreed with the IAHs.

The NBE did not issue directives, standards or guidelines to determine treatment of IAH.²¹⁷The 1st replacement directive did not redefine and segregate customer deposit in to Islamic deposit and Investment deposit. The assets financed by the funds of the UIAH are not excluded from the denominator of the standard capital adequacy formula, there is no separate regulatory treatment,

²¹⁷ An interview conducted with Ms. Firehiwot Kiros, Cited above at note 185

governance, disclosures, and associated risk-absorbency features such as PER, IRR etc.²¹⁸ There is no distinct prudential regulation other than those set for CBs. Since the dedicated branches and Islamic windows of IFB did not begin providing PLS Mudarabah and Musharaka services this regulatory challenge was not taken as an issue by the NBE. However, when the full-fledged banks began their operation and start providing the services it will become a serious challenge. Therefore, it is advisable for the NBE to issue the directives, standards or guidelines to determine treatment of IAH by taking into account CPIFR 14 and its essential criteria as well as Malaysian experience of segregation of deposit and issuance of Investment Account Policy Document 2014. Moreover, the 1st Replacement Directive does not provide separate capital adequacy requirements for Islamic bank, window and dedicated branch which are different from the conventional banks. Ethiopia is striving for compliance with the BCBS capital framework Basel I.²¹⁹ Thus single CAR is applying, no distinction is made between the CARs that apply to IBs and CBs. Malaysia adhere to CAR contain prescriptions that are often based on IFSB prudential standards and guiding principles on needed adjustments to the BCBS capital framework to cater for certain Islamic banking features.²²⁰ IFSB issued CPIFR 18 by making amendments to BCP-16 in a way applicable for Islamic banks.²²¹ Hence, it is preferable for the NBE to take into account and align their regulation with CPIFR 18 issued by the IFSB for assessment of CAR for Islamic banking.

4.3.3. Risks Specific to Islamic Banks

As financial institution Both Islamic and Conventional banks are exposed to various types of risks such as credit risk, market risk, operational risk, solvency risk and liquidity risk. However, Islamic banks are exposed to additional risks which are unique to Islamic finance such as rate of return (ROR) risk and equity investment risk.

“The rate of return risk is generally associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers.”²²²“It also stems from

²¹⁸ Ibid.

²¹⁹ Ibid.

²²⁰ Song and Oosthuizen (2014), cited above at note 63, p.18-20

²²¹ IFSB, (April 2015), Cited above at note 65, PP.41-43

²²² Song and Oosthuizen (2014), cited above at note 63, p.27

uncertainty in the returns earned by Islamic banks on their assets.”²²³“It arises when an increase in benchmark rates results in expectations of higher rates of return on investment accounts.”²²⁴ROR risk has some parallels with interest rate risk in the banking book in conventional banks as defined by the BCBS, “but it differs from interest rate risk in that IBs are concerned with the returns on their investment activities at the end of the investment holding period and the impact on net income and cash flow after the sharing of returns with IAHS.”²²⁵ A consequence of ROR may be displaced commercial risk (DCR), which entails the IBs and their shareholders foregoing part of their profits to attract or retain investors.²²⁶

As stated under CPIFR 26 a supervisory authority has a role of regulating and supervising whether IB have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate rate of return (ROR) risk in the banking book on a timely basis. Thus, IBs are expected to have systems and capacity in place to mitigate and manage the ROR risks and any resultant DCR in the banking book on a timely basis considering IBs’ risk appetite, risk profile, IAHS’ behavioral and maturity profiles and market and macroeconomic conditions.

Another type of unique risk is equity investment risk.” It is a risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing.”²²⁷ IBs are exposed to equity investment risk in PLS investments. The delays in investments and variation in cash flow patterns and possible difficulties in executing a successful exit strategy may pose challenges. The capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to capital impairment risk in the event of losses.

As clearly mentioned under CPIFR 24, IBs are required to have adequate policies and procedures, appropriate strategies, risk management, and reporting processes for equity investment risk management. The supervisory authority should, therefore, ensure that the IBs have in place appropriate and consistent valuation methodologies; define and establish the exit strategies in respect of their equity investment activities; and have sufficient capital when

²²³ Ibid

²²⁴ Ibid.

²²⁵ World bank (2018), Cited above at note 74, PP.8-9

²²⁶ Ibid.

²²⁷ Song and Oosthuizen (2014), cited above at note 63, p.27

engaging in equity investment activities, and that rules or guidelines are in place for measuring, managing, and reporting the risk exposures when dealing with non-performing equity investments.

However, the NBE as a supervisory authority did not issue directive, standard or guideline for the management of rate of return risk and equity investment risk.²²⁸The banks which are providing the service, through Islamic Windows and dedicated branches did not develop such systems and capacity in place to mitigate and manage the ROR risk and equity investment risks.²²⁹ This may expose the banks to ROR and equity investment risks when they start providing PLS financial services. Therefore, on the specific types of risks, the country has to set its own guidelines according to the type and nature of risks associated with its financial industry by taking in to account CPIFR 26, CPIFR 24 and their essential criteria. The effectiveness of these guidelines in critical situations is also a major concern among industry practitioners.

4.3.4. Sharia-Compliant Liquidity Management Regulation

The BCBS defined liquidity as “the ability of a bank to fund increases in assets and meet obligations as they become due, without incurring unacceptable losses.”²³⁰“Liquidity is an essential element in the macro economy and the absence of this element exposes banks to liquidity risk, therefore, establishing a comprehensive regulatory framework to minimize the exposure to liquidity risk in banking industry is crucial.”²³¹ Since Islamic banks operate on Sharia principles, only Sharia-compliant liquidity instruments from a Sharia-compliant institution are allowed to be traded. Treasury Bills, government loans are available for CBs; however, this does not work for IBs

In this regard the NBE did not issue directive, standard or guidelines which accommodate the sharia compliant liquidity management issues for IBs.²³²IFB are facing a lack of liquid assets options that they can hold.²³³ They may not be able to opt for Lender of the Last Resort from the

²²⁸ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

²²⁹ Interviews Conduct with Directors and Manager, Cited above at note 193.

²³⁰ BCBS, via <http://www.bis.org/index.htm> accessed on 10 March,2020

²³¹ Zolkapli Nuramarina , (2017) , Cited above at note 131,PP.193

²³² An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

²³³ Interviews Conduct with Directors and Manager, Cited above at note 193.

NBE for liquid injection. This is because, the funds of the Lender of Last Resort scheme may be invested in an interest-based transaction, and IBs may be charged an interest rate by the Bank. Liquidity instrument and institutions such as Sukuk and Islamic Inter-Bank Money Market are not available in Ethiopia. This is the regulatory and institutional challenge that IFBs are facing.

Thus, the NBE can complement the lack of regulatory accommodation by adopting IFSB standards IFSB-12 Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services and CPIFR 27.²³⁴ Furthermore, it can be suggested that the Malaysian practice of Islamic Inter-Bank Money Market and deposit insurance could be taken as exemplary for Ethiopia to assist liquidity management for IBs. By realizing the needs to manage short term funding requirement for IB, BNM established Islamic Interbank Money Market on January 3, 1994 and sharia-compliant deposit insurance.²³⁵ To facilitate the operation of IIMM BNM also issued number of guidelines on operations and instruments in money market.²³⁶

4.4. Supervisory Framework of Islamic Banking in Ethiopia

Ethiopia has single Supervisory authority the NBE for the entire financial sectors. Both Islamic banks and Conventional banks are supervised by a single banking Supervision department under the authority.²³⁷ The department applies offsite CAMELS rating framework and onsite risk based supervision method for both IBs and CBs.²³⁸ IBs are subjected to CBs Information disclosure standards and reporting requirements.²³⁹ Regarding offsite monitoring, general offsite supervision guidelines or manuals which apply to CBs are applicable to IBs. Onsite supervision of Sharia compliance is performed by the same examiners, conventional risk management standards and IFRS accounting standard are applicable for IBs.²⁴⁰ At a general level, supervisory authority apply the same generic supervisory framework to IBs and CBs, as well as the same approaches, systems, methodologies, processes, and procedures. IBs involve in PLS financing

²³⁴ IFSB, (April 2015), Cited above at note 65, PP.54-56

²³⁵ Asad Khan, (2016), cite above at note 115, PP.107

²³⁶ Ibid

²³⁷ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185.

²³⁸ Ibid.

²³⁹ Ibid.

²⁴⁰ Ibid.

and their debt financing is asset based it is different from conventional debt financing. Hence, their supervision should take into account their specific financing nature and sharia compliance issues. However, there is no such methodology in place in the authority. Lack of effective supervisory framework is one of the weaknesses of the prevailing system and deserves serious attention. Therefore, some of the drawbacks and challenges of IB supervision will be discussed in the next sub-sections.

4.4.1. Lack of Institutional Framework

Banking Business amendment Proclamation No.1159/2019 as well as the 1st Replacement Directive did not set separate supervisory department or authority for IBs. The regulatory accommodation of IB has to create the desired level-playing field between Islamic and conventional banks. Substantive equality requires the law to accommodate the differences of both banking sectors by giving recognition to the basic differences of both banking sectors. Substantive equality should recognize the Sharia-compliant aspect of Islamic finance and its transactional nature, the risk exposures, and the contractual relationships between the parties.

However, in Ethiopia IBs are supervised by conventional bank supervision unity and stuffs. There is no dedicated professional supervisor for IBs to conduct onsite/offsite examinations.²⁴¹ Since IBs have special characteristics, the conduct of banking supervision needs to be undertaken in a manner that addresses these characteristics. The supervision work should be knowledge based. Supervisor need to have an understanding of Islamic banking and financial products, contracts, transactions, risks specific to Islamic banks and sharia compliance issues. The supervision department has no compilation of sharia rulings rendered by SSB of IFBs, the audited data that show total asset and growth rate of IFBs²⁴² let alone the ability to supervise the Sharia compliance issue and do the harmonization works. Hence, lack of a proper institutional set-up and absence of professional examiners is the serious challenge for IBs in Ethiopia. Therefore, since the Banking Business amendment Proclamation mandate the NBE with the power of issuing additional directives for IFBs establishing dedicated department set-up is suggested.

²⁴¹ An interview conducted with Ms. Frehiwot Kiros, Cited above at note 185

²⁴² Ibid.

4.4.2. Absence of dedicated manuals and guidelines

The NBE did not set dedicated offsite and onsite manuals/guidelines designed for IBs. The information disclosure guidelines did not incorporate unique nature Islamic banking disclosure which requires detail information pertaining to different types of risks, IAHs, off-balance sheet activities and Sharia governance. On the other hand onsite examiners are not well trained and well versed in Sharia Laws. Without having well-equipped Supervisory framework ensuring sharia compliance, transparency and soundness of the financial system will be difficult task. Thus, it can be recommended that the Malaysian experience of setting offsite and onsite manuals/guidelines for IB could be an example for the Ethiopia supervisory framework. For offsite supervision BNM set detail guidelines in Capital Adequacy framework for Islamic Banks (CAFIB)-Disclosure Requirements Pillar-III.²⁴³ Further to give a sound framework on financial reporting issued Guidelines on Financial Reporting for Licensed Islamic Banks.²⁴⁴ Supplementary onsite examination manuals for Islamic banks are used on top of those for CBs, and dedicated supervisors for Islamic banks conduct onsite examinations in the areas of credit, market and operational risks.²⁴⁵

Therefore, the NBE has to prepare dedicated offsite and onsite manuals/guidelines by adopting Malaysian experience, IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services, IFSB-16: Revised Guidance on Key Elements In The Supervisory Review Process of Institutions Offering Islamic Financial Services and IFSB-17: CPIFR issued by IFSB which is in compliance with the BCPs.

4.5. Teaching, Training, Research and Development

Teaching, training and researches are the cornerstones for the development of any industry. Despite this fact there is no institution or universities which offer Islamic finance courses in Ethiopia. As I understood from the response of interviews the managers, officers and accountants

²⁴³ Asad Khan, (2016), Cited above at note 115, PP.87

²⁴⁴ Ibid.

²⁴⁵ Song and Oosthuizen (2014), Cited above at note 63, p.23

of Islamic banks as well as the supervisors and examiners of NBE are not very well trained in the Islamic modes of finance. Unfortunately, very little effort has been made to meet these requirements. But, the future of Islamic banking and finance crucially depends on teaching, training and research in the desired specialization. UK has been ranked as the global leader in Islamic finance education with more than 60 institutions offering Islamic finance courses and 22 universities offering degree programs specializing in Islamic finance.²⁴⁶ Malaysia has 50 course providers and 18 universities offering degree programs.²⁴⁷ Malaysia is leading in terms of research published on Islamic finance in the last three years, with 169 research papers, of which 101 were peer reviewed.²⁴⁸ The UK followed with 111 research papers, of which 56 were peer reviewed.²⁴⁹ Hence, it is recommended that Ethiopia has to learn a lot from UK and Malaysian experiences in order to begin offering Islamic finance courses and develop the industry. The efforts in this area need to be enhanced to several times of current level.

²⁴⁶ Ahmed Belouafi and Abdelkader Chachi, (2014), Cited above at note 147, PP.56-57

²⁴⁷ Ibid.

²⁴⁸ Ibid.

²⁴⁹ Ibid.

Chapter-Five

5. Conclusion and Recommendations

5.1. Conclusion

The dynamics in the financial markets require the regulatory frameworks governing the banking and financial services institutions, nationally and internationally to be able to accommodate the existing and the future financial markets. The banking regulation should not remain static, so as to become outdated and ill-equipped. Hence, there is a constant burden on the regulators to provide the appropriate regulation in meeting the needs of a complex, diverse and competitive financial system.

As a result, banking and financial regulators have become more receptive to the specific risks attached to Islamic banks in terms of their products and institutional operations as well as their impact on the stability and resilience of the financial system. The international agreements such as the BCPs which aim to provide level-playing field regulations for all banks, in fact, do not consider the nature of the Islamic banking sector, hence IFSB standards, Guidelines and core principles were established to compliment the lack of level playing field regulations in Basel Accords.

The Ethiopian government in response to increasingly strong public demand for Islamic banking products gave legal recognition to IFB as of 2008G.C. Article 22(2) of Banking Business proclamation No 592/2008 authorizes the NBE to issue directive to regulate banking businesses related to non-interest-bearing deposit mobilization and fund utilization. In 2011, the NBE issued a directive to authorize the business of IFB (SSB/51/2011). This directive allow the Provision of IFB service at window level in accordance with the principles of Islamic finance by following the same regulation as the other banks except on the interest rate, which does not apply. Then the NBE issued 1st Replacement Directive to License and Authorize Interest Free Banking Business No SBB/72/2019 which repealed and replaced the first directive. The replacement directive as well as article 59 (1) of Banking Business amendment Proclamation No.1159/2019 permit the establishment of fully-fledged IBs. In the replacement directive as well IBs are still fall under the conventional regulatory setup.

Currently, eleven CBs received licenses for IFB windows from the NBE and are providing service through Islamic windows and dedicated branches. Six fully-fledged IBs are under formation. Due to the inexistence of relevant legislation, each bank has adopted their own methodology, models and benchmarks for launching IFB products with little coherence or commonality in the market.

This study critically analyzed the regulatory and supervisory frameworks that govern Islamic banks in the Ethiopian dual banking system. It examines the existing regulatory and supervisory frameworks in light of harmonized international standards, core principles and guidelines set by IFSB as well as the Malaysian's and UK's experiences. The research study identified major regulatory and supervisory gaps, loopholes and challenges as discussed in detail in the body of the research paper.

Addressing some of these challenges is crucial for improving the efficiency of Islamic banking activities in the country. Appropriate broader policy framework and objectives which enhance the industry's development are not set by the legislator as well as the regulator.

While Sharia compliance is a core element in Islamic banking the directive did not put it as a regulatory objective rather it left the matter to the banks. Sharia governance frameworks are not set in place. The directive did not set the requirement of establishing SSB at the institutional level for IBs. The NBE as a regulator does not have SAC or single advisor at a central bank level.

Absence of separate and comprehensive legislation that covers all areas for the Islamic banking activities in Ethiopia are creating difficulties in a number of ways. The directive did not define and segregate customer's deposits into Islamic deposits and investment deposits. As a result there is no policy, standards or guidelines to determine the treatment of IAH. The assets financed by the funds of the UIAH are not excluded from the denominator of the standard capital adequacy formula. Similar CAR applies for both IBs and CBs. The NBE as a supervisory authority did not issue a directive, standard or guideline to manage risks specific to IBs. Sharia-compliant liquidity management frameworks and institutions are not available in the country. Lack of an effective supervisory framework such as the absence of dedicated supervision units and staffs as well as separate manuals/guidelines are also among the challenges.

In general the findings of the study revealed that yet the country did not develop the regulatory, supervisory and institutional framework that enable Islamic banking to operate on a level

playing. Therefore, the paper opted to introduce appropriate policy, regulatory and supervisory framework for the industry. Having this in mind, it strictly focuses on proposal for Ethiopia in the next section.

5.2.Recommendations

By critically analyzing the regulatory framework of the country the following are recommendations on the policy, legal, regulatory and supervisory framework which need serious attention.

5.2.1. Policy Recommendations

Comprehensive and supportive government policy frame work is crucial for the development of Islamic banking and financial industry. The Ethiopian Government has not yet issued an official policy document for the industry. As inferred from declarative and derivative sources, the preamble of directives issued by NBE financial and social inclusions of Muslim population is the only policy justification set for the accommodation of the industry. The experience of countries like UK revealed that the constant support for development of the industry from regulators and governments side were predominantly due to economic rational rather than religious motivation. Hence, it is advisable to broaden the policy objective in a way that incorporates political economic justifications. Moreover, the regulatory approach has to be principle-based regulation rather than ruled-based. Based on these, the specific measures that the government needs to take may include the following;

- ✚ The Ethiopian government has to issue a comprehensive policy document which incorporate strategies that enable the Islamic banks and financial institutions to compute at regional and global level.
- ✚ The government should create a level-playing field which enables Islamic banks to operate and compute in parallel with their conventional counterparts. Such as creation of a dual regulatory framework, amendment of laws that hamper the development of the industry and fulfilling essential infrastructures for the industry.
- ✚ The government has to work in collaboration with the international standard setting bodies such as IFSB and AAOIFI as well as financial institution such as Islamic Development Bank in order to get technical and financial assistance which enhance the development of the

industry. Moreover, selectively adopting the standards, core principles, guidelines and technical notes which are already adjusted in compliance with BCPs create harmonization of regulatory and institutional frame work.

- ✚ The government has to incorporate Islamic banking and finance courses in to the educational curriculum of the country and begin offering degree programs specializing in Islamic finance at university level to enhance the development of the industry as UK and Malaysia did.

5.2.2. Recommendations on Legal and Regulatory Framework

Banking Business amendment Proclamation No.1159/2019 only provide a provision that give legal recognition for the establishment full-fledged IB. The 1stReplacement Directive (SBB/72/2019) has scanty provisions that did not fully address the specificity of the Islamic financial contracts and the peculiarities of Islamic banks as discussed in previous chapter. Therefore, the enactment of comprehensive separate proclamation which specifically dedicated for the regulation of Islamic banking and finance is essential for the development of the industry. Thus, the proclamation that will be enacted or the directive to be issued by the National Bank needs to address the following regulatory gaps and challenges;

- ✚ It is desirable that the NBE has to amend 2nd Replacement Directive No SBB/65/2017 which set a cap, that a bank's aggregate equity investment in all non-banking business, including insurance companies shall not exceed 10% of its net worth. Since it hamper the PLS financing (Mudaraba and Musharaka) of IBs. The cap should be waived.
- ✚ Regarding sharia governance and Sharia board ;
 - Setting the Sharia compliance as one of the regulatory objectives in the laws that govern Islamic banking and finance.
 - The legislature or the NBE has to set mandatory requirement of setting-up Sharia board (SSB) at the institutional level for full-fledged IB, dedicated branches and Islamic windows to determine the Sharia compatibility of their products and transactions.
 - In addition, it necessary to prepare guidelines/manuals that clearly demonstrate the role of SSB in IBs, their mandate, reporting line, responsibility, acceptable "fit and proper" criteria, composition, well-defined operating procedures, assessment of the effectiveness of the members to create harmonization at country level.

- The NBE has to set Sharia Advisory Council (SAC) at the Central bank level which has the role of legislator, supervisor and advisor on sharia matters. The rulings of the SAC shall prevail over any contradictory ruling by a Sharia board or committee in Ethiopia. This will harmonize the Sharia application on all aspects of IFSIs.
- ✚ The NBE did not issue directives, standards or guidelines to determine treatment of IAH. The assets financed by the funds of the UIAH are not excluded from the denominator of the standard capital adequacy formula, there is no separate regulatory treatment, governance, disclosures, and associated risk-absorbency features such as PER, IRR etc. However, when the full-fledged banks began their operation and provide the PLS services it will become a serious challenge. Therefore, it is advisable for the NBE to issue the directives, standards or guidelines to determine treatment of IAH by taking into account CPIFR 14 and its essential criteria as well as Malaysian experience of segregation of deposit and issuance of Investment Account Policy Document 2014.
- ✚ The 1st Replacement Directive does not provide separate capital adequacy requirements for Islamic bank, window and dedicated branch which are different from the conventional banks. When we take Malaysian experience it adhere to CAR contain prescriptions that are often based on IFSB prudential standards and guiding principles on needed adjustments to the BCBS capital framework to cater for certain Islamic banking features. IFSB issued CPIFR 18 by making amendments to BCP-16 in a way applicable for Islamic banks. Hence, it is recommendable for the NBE to take into account and align its regulation with CPIFR 18 issued by the IFSB for assessment of CAR for Islamic banking.
- ✚ Islamic banks are exposed to additional risks which are unique to Islamic finance such as rate of return (ROR) risk and equity investment risk. The NBE as a supervisory authority did not issue directive, standard or guideline for the management of rate of return risk and equity investment risk. The banks which are providing the service, through Islamic Windows and dedicated branches did not develop such systems and capacity in place to mitigate and manage the ROR risk and equity investment risks. This may expose the banks to ROR and equity investment risks when they start providing PLS financial services. Thus, on the specific types of risks, the country has to set its own guidelines according to the type and nature of risks associated with its financial industry by taking in to account CPIFR 26, CPIFR 24 and their essential criteria.

✚ The NBE did not issue directive, standard or guidelines which accommodate the sharia compliant liquidity management issues for IBs. IFB are facing a lack of liquid assets options that they can hold. They may not be able to opt for Lender of the Last Resort from the NBE for liquid injection. This is because, the funds of the Lender of Last Resort scheme may be invested in an interest-based transaction, and Islamic banks may be charged an interest rate by the Bank. Liquidity instrument and institutions such as Sukuk and Islamic Inter-Bank Money Market (IIBMM) are not available in Ethiopia.

Therefore, NBE can complement the lack of regulatory accommodation by adopting IFSB standards IFSB-12 Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services and CPIFR 27. Furthermore, it can be suggested that the Malaysian practice of Islamic Inter-Bank Money Market and deposit insurance could be taken as an experience for Ethiopia to assist liquidity management for IBs.

5.2.3. Recommendations on Supervisory Framework

Supervision of Islamic banks is as important as that of the conventional banks. At present, lack of effective supervisory framework is one of the weaknesses of the prevailing system and deserves serious attention as discussed in the previous chapter. The NBE as supervisory authority has the obligation to create a level-playing field for IBs which enable them to compete with CBs. Having this in mind the following supervisory challenges has to be addressed;

✚ In Ethiopia IBs are supervised by conventional bank supervision unity and stuffs. There is no dedicated professional supervisor for IBs to conduct onsite/offsite examinations. Since IBs have their own the specificity, the conduct of banking supervision needs to be undertaken in a manner that addresses these characteristics. Thus, the NBE has to issue additional directive to constitute dedicated department set-up for IBs supervision.

✚ The NBE did not prepare dedicated offsite and onsite manuals/guidelines designed for IBs. Without having well-equipped Supervisory framework ensuring sharia compliance, transparency and soundness of the financial system will be difficult task. Therefore, it can be recommended that the NBE has to set dedicated offsite and onsite manuals/guidelines by adopting Malaysian experience and standards set by IFSB.

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