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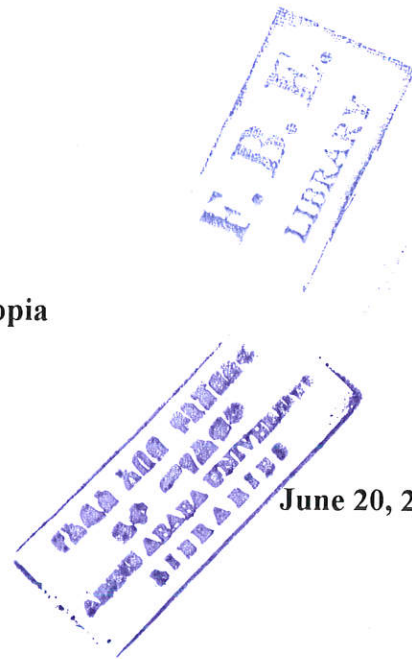
# PROSPECTS AND CHALLENGES OF ESTABLISHING ISLAMIC BANKS IN ETHIOPIA

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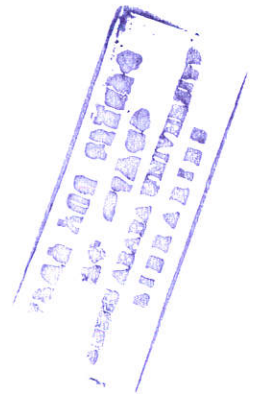


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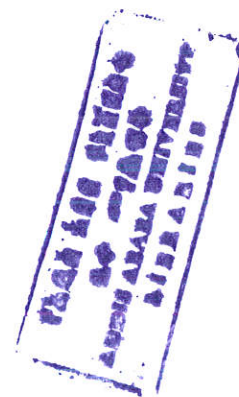




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## Abstract

*The purpose of the study is to identify the prospects and challenges of establishing Islamic banks. Seventy five survey instruments were distributed to assess the views of the Muslim business community's awareness and attitude towards Islamic banking and banking in general. The study also addresses favorable conditions and also challenges in the establishment of Islamic banks. Books and articles from several websites were extensively used in addition to the questionnaires. The study showed that even if there is low awareness level among Muslim community about Islamic banking products, establishment of Islamic banks is highly required by the Muslim business community. The study further showed that there are challenges like lack of professionals in the field of Islamic banks. The study recommends that Islamic banks, which basically works under the scheme of profit and loss sharing, should be established to cater divergent needs of different customers particularly those who do not want to deal with interest. It also recommends high level of support from the government particularly effective legal framework ensuring speedy justice is essential for the success of Islamic banking.*



## Chapter one

### *Introduction*

#### *1.1 Background of the study*

Bank is an organization, usually a corporation, chartered by a state or federal government, which does most or all of the following: receives demand deposits and time deposits, honors instruments drawn on them, and pays interest on them; discounts notes, makes loans, and invests in securities; collects checks, drafts, and notes; certifies depositor's checks; and issues drafts and cashier's checks

Banking is a modern human invention within the financial sector of an economy - as opposed to the real sector of an economy - with specific aims to fulfill three socially beneficial functions: (i) efficient payment system that expedites payments to be made to parties to economic activities; (ii) intermediation function that is to channel savings of households in an economy to the producer units (businesses and government) for reinvestment as capital, a scarce resource of mankind; and (c) other financial transactions, which are a whole range of specialized activities such as mortgage creation, cross-border trade guarantee (letter of credit), securities trading such as in common stocks and others.

The history of banking is closely related to the history of money. As monetary payments became important, people looked for ways to safely store their money. As trade grew, merchants looked for ways of borrowing money to fund expeditions.

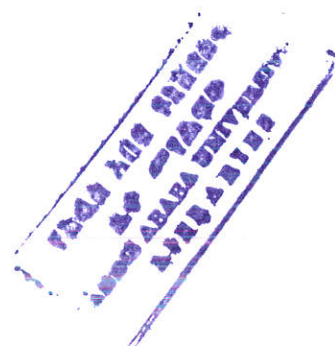
The first banks were probably the religious temples of the ancient world, and were probably established sometime during the 3rd millennium B.C. Banks probably predated



the invention of money. Deposits initially consisted of grain and later other goods including cattle, agricultural implements, and eventually precious metals such as gold, in the form of easy-to-carry compressed plates.

A system of trading in money which involved safeguarding deposits and making funds available for borrowers, banking developed in the middle Ages in response to the growing need for credit in commerce. The lending functions of banks were undertaken in England by money-lenders. Until their expulsion by Edward I in 1291, the most important money-lenders were Jews. They were replaced by Italian merchants who had papal dispensations to lend money at interest. In the 13th century credit was essential to finance commerce and major projects. The most important was the wool trade but other examples included large buildings such as Edward's castles in north Wales. When Italians had their activities in England curtailed in the early 14th century, they were replaced by English merchants and goldsmiths, whose rates of interest were sufficiently low to avoid the usury laws.

In the 19th century, overseas trade and the expanding British Empire reinforced the place of London as a centre of merchant banking. The skills of these specialist bankers attracted business from foreign firms and governments seeking loans. These arrangements made possible the rapid development of railways, heavy engineering, mines, and large commercial developments. Banking has been characterized, largely because of technological innovation, by an increasingly sophisticated provision of banking services and an expansion of consumer credit. The business of safeguarding and lending money is often arranged through machine-readable cards and continuous access by telephone



- Brief overview of banking in Ethiopia

In Ethiopia it was in 1905 after agreement reached between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking. Following the agreement, the first bank called Bank of Abyssinia was inaugurated in Feb. 16, 1906 by the Emperor. The Bank was totally managed by the Egyptian National Bank. By 1931 Bank of Abyssinia was legally replaced by Bank of Ethiopia shortly after Emperor Haile Selassie came to power. The new Bank, Bank of Ethiopia, was a purely Ethiopian institution and was the first indigenous bank in Africa and established by an official decree on August 29, 1931 with capital of £750,000. Bank of Egypt was willing to abandon its concessionary rights in return for a payment of Pound Sterling 40,000 and the transfer of ownership took place very smoothly and the offices and personnel of the Bank of Abyssinia including its manager, Mr. Collier, being retained by the new Bank. Ethiopian government owned 60 percent of the total shares of the Bank and all transactions were subject to scrutiny by its Minister of Finance.

The State Bank of Ethiopia had established 21 branches including a branch in Khartoum, Sudan and a transit office on Djibouti until it ceased to exist by bank proclamation issued on December, 1963. Then the Ethiopian Monetary and Banking law that came into force in 1963 separated the function of commercial and central banking creating National Bank of Ethiopia and commercial Bank of Ethiopia. Moreover it allowed foreign banks to operate in Ethiopia limiting their maximum ownership to be 49 percent while the remaining balance should be owned by Ethiopians.

The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.

Following the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. Organizational setups were taken in order to create stronger institutions by merging those that perform similar functions. Accordingly, the three private owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli Merged in 1976 to form the second largest Bank in Ethiopia called Addis Bank with a capital of Eth. birr 20 million and had a staff of 480 and 34 branches.

The financial sector that the socialist oriented government left behind constituted only 3 banks, each enjoying monopoly in its respective market. The following was the structure of the sector at the end of the era.

- The National Bank of Ethiopia (NBE)
- The Commercial Bank of Ethiopia (CBE)
- Agricultural and Industrial Development Bank (AIDB)



Following the change in the economic policy, financial sector reform also took place. Monetary and Banking Proclamation of 1994 established the National Bank of Ethiopia as a judicial entity, separated from the government and outlined its main functions.

Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank, Awash International Bank was established in 1994 by 486 shareholders and by 1998 the authorized capital of the Bank reached Birr 50.0 million. Dashen Bank was established on September 20, 1995 as a share company with an authorized and subscribed capital of Birr 50.0 million. Bank of Abyssinia, another private bank was founded by 131 shareholders with subscribed and authorized capital of 25.0 million and 50 million, respectively. Wegagen Bank with an authorized capital of Birr 60.0 million started operation in 1997. The fifth private bank, United Bank was established on 10th September 1998 by 335 shareholders and now has four branches. Nib International Bank started operation on May 26, 1999 with an authorized capital of Birr 150.0 million. (Source :NBE website) Anbessa international Bank also started operation in 2007. there are also other banks under formation such as Buna International bank, Access bank, Birhan bank and Zemzem bank

- ***Nature and Significance of Financial Intermediation***

Banks play very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking system. Although banks create no new wealth but their borrowing, lending and related activities facilitate the process of production, distribution, exchange and consumption of wealth

In this way they become very effective partners in the process of economic development. Today, modern banks are very useful for the utilization of the resources of the country. The banks are mobilizing the savings of the people for the investment purposes. The savings are encouraged and saving rate increases. If there would be no banks then a great portion of a capital of the country would remain idle. Which means the country would lose many jobs and huge amount of tax revenue that could be collected from investors.(Siddiqui,1999)

Banking is now an essential part of our economic system. Modern trade and commerce would almost be impossible without the availability of suitable banking services.

Those who save and accumulate some money look for an opportunity for making more money by investing their savings. Those who are doing business are looking for funds they could use. They are willing to bear the cost. In interest based system the cost is, more often than not, in the form of a predetermined rate of interest. In interest-free system it would be a share in the profits accruing on the use of the funds. Whether the system is interest-based or interest-free, if these two kinds of people were to search for one another and make a deal they would have great difficulty. There would have to be a coincidence relating to the size of the funds and the time period for which they are needed and offered. A business man will have to deal with a number of fund owners before he can get the amount of funds required. This would take time. A fund owner would have to approach a number of businessmen before he can find one who accepts his money for the time period it is offered. Also, failing a perfect coincidence in time period for which funds are demanded and supplied it may be difficult to ensure continuous supply and use of funds. Then there are the more difficult matters related to risk. As we note below there are different kinds of risks involved in investing funds for profit, some of them not easy to comprehend. Given

coincidence relating to size and time many projects may not suit a particular fund owner because of their risk profile. Apart from business risks there is also the risk of default, even the fear of outright fraud. Faced with these problems many small individual savers will be looking for some one they know and trust, some one in the neighborhood. All this could cause delay and results in (unintended) hoarding.

Direct finance in which there is a direct deal between fund owner (saver) and fund user (investor) is inefficient. Its inefficiency has rightly been compared to the inefficiency of barter. Also if fund owners have to seek out fund users and fund users have to search for fund owners the net return to the fund owners would be substantially lower than the gross cost of funds to users. Fund owners will subtract search costs together with any risk premiums due to the uncertainty about the fund users trust worthiness. Lower returns on funds will discourage savings. High cost of funds will discourage investment. The overall consequences for the economy will be smaller volume of production, fewer jobs, lower incomes and a weaker economy as compared to what is achievable through financial intermediation. Intermediation is rightly regarded to be welfare enhancing. (Robert, 1983 p.909)

- **Role of Financial Intermediaries**

Financial intermediaries are able to remove the inefficiencies of direct finance in a number of ways. Financial intermediation enables a separation between the decision to save and the decision to invest in real production. Since the latter requires much more information and expertise than available to ordinary savers, their division of labor and specialization increases the wealth of nations. Separation between these two functions and a distancing between management of the financial sector of the economy and that of its real sector has



now become an inalienable feature of the modern economy. The real sector expands when those acting in that sector get command over resources at acceptable terms. Acceptability has several dimensions: time horizon, size of fund, risk, cost, speed and flexibility are some of these dimensions. The relative importance of a dimension differs from business to business. But competition makes entrepreneurs always to seek to improve upon the package they already have. The competitive pressure originates mainly in the hearts and minds of people who are seeking better products at cheaper prices with such other services as make the deal attractive (guaranteed quality, quick delivery, maintenance and repair and continuity in supply etc.)

Involved in this separation is also an institutionalization of the process not known in earlier periods of history. Institutions rather than individual middlemen take over the mobilization of savings and their transfer to users in real economy. The various steps involved in this process of transferring funds from ultimate saver to ultimate user are divided and subdivided into functions through which specialized functionaries reduce costs, improve services and tailor the 'financial product' to the needs and preferences of both parties: fund owners as well as fund users.(Siddiqui, 1999)

- **Islamic banking overview**

Islamic finance is a system that operates in observance of Islamic law or commonly referred to as Shari'ah principles. Although contemporary media sources and academic writers describe Islamic banking in many ways, Islamic banking is in essence the group of financial activities based on a set of Islamic rules governing transactions known as Fiqh al-Muamalat. The basic tenet of the Islamic value proposition is a prohibition on paying and receiving of interest (Riba), and a fundamental belief in the sharing of profit and risk (mudarabah) in the conduct of business

Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic Shari'ah. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Shari'ah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy

Islamic banking is an ethical and equitable mode of financial services that derives its principles from the Shari'ah (Islamic law). The Shari'ah is based on the Quran and the Sunnah of the Prophet Muhammad (PBUH), and it governs all aspects of personal and collective life.

The most distinctive element of Islamic banking is the prohibition of interest, whether "nominal" or "excessive," simple or compound, fixed or floating. Other elements include the emphasis on equitable contracts, the linking of finance to productivity, the desirability of profit sharing, and the prohibition of gambling and certain types of uncertainty. These parameters define the nature and scope of Islamic banking, as interpreted by the Shari'ah scholars that work with Islamic financial institutions

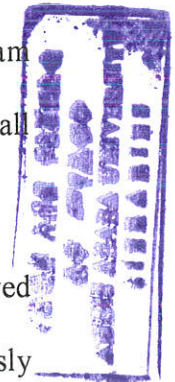
Islam treats wealth as a means and not an end. Islam regards economic well being as a means to peace, freedom from hunger and freedom from fear of, or domination by, any being other than God. Beyond the satisfaction of basic needs, the ultimate objectives of earning and spending money are moral and spiritual. This rules out the seeking of



economic gains at the cost of moral and spiritual values, both at the individual and at the societal level. It is against Islam to hoard money.

The basic principle of Islamic banking is the prohibition of riba (usury, or interest). Islam not only prohibits dealing in interest but also in liquor, pork, gambling, pornography and anything else that Shari'ah (Islamic law) deems haram (unlawful). Islamic banking is an instrument for the development of an Islamic economic order. Some of the salient features of this order include:

- While permitting the individual the right to seek his economic well being, Islam makes a clear distinction between what is halal (lawful) and what is haram (forbidden) in pursuit of such economic activity. In broad terms, Islam forbids all forms of economic activity that are morally or socially injurious.
- While acknowledging the individual's right to ownership of legitimately acquired wealth, Islam makes it obligatory for the individual to spend his wealth judiciously and not to hoard it, keep it idle or to squander it.
- While allowing an individual to retain any surplus wealth, Islam seeks to reduce the margin of the surplus for the well being of the community as a whole, in particular the destitute and deprived sections of society by participation in the process of zakat.
- While making allowance for the ways of human nature and yet not yielding to the consequences of its worst propensities, Islam seeks to prevent the accumulation of wealth in a few hands to the detriment of society as a whole, by its laws of inheritance.



- Viewed as a whole, the economic system envisaged by Islam aims at social justice without inhibiting individual enterprise beyond the point where it becomes not only collectively injurious but also individually self-destructive.

The Islamic financial system employs the concept of participation in the enterprise, utilizing the funds at risk on a profit and loss sharing basis. This by no means implies that investments with financial institutions are necessarily speculative. This can be excluded by careful investment policy, diversification of risk and prudent management by Islamic financial institutions.

Islamic banks are structured to retain a clearly differentiated status between shareholders' capital and clients' deposits in order to ensure correct profit sharing according to Islamic law

In a nutshell, Islamic banking fulfils the same basic intention as conventional banking. However, Islamic banking operates in accordance with an overall set of guiding principles based on common Islamic concepts described in the Holy Qur'an and the Sunnah such as profit sharing (mudarabah), safekeeping (wadiyah), joint venture (musharakah), cost plus (murabahah), leasing (ijarah) and the prohibition of interest (riba).

These concepts representative of Islamic banking are not new. For many centuries, Muslim societies living in nations in all parts of the world have strived to develop ways to assimilate their religious values within the economic and banking activities of the nations in which they live. The process of assimilation follows two distinct paths: a liberal or non-interventionist approach, whereby Islamic values are seen as compatible with modern



secular institutions and law within certain limits, or a conservative traditionalist approach, where the expressed goal is to produce a true Islamic society and subsequent monetary system. In today's global economy, the vast majority of Muslims fall within a gradient of tolerance between these two paths.

The first modern experiment with Islamic banking was undertaken in Egypt in 1960s. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967 (Ready 1981), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi 1988). Thus, they functioned essentially as saving- investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shari'ah (Islamic law) (Mohammed, 1988).

The Islamic banking industry today stands at several hundred billion dollars (estimates vary), and consists of more than 400 financial institutions in and outside the Muslim world. It is the product of the collective effort of bankers, economists, and Islamic legal scholars over the past several decades to develop financial solutions that meet the religious requirements of Muslims.

It is a young industry and a growth industry, and continues to evolve and expand both financially and geographically. It is indigenous and community-focused: it caters to devout Muslims in indigenous Muslim societies as well as in Muslim minorities of non-Muslim



countries. Furthermore, it is an inclusive paradigm: non-Muslim individuals and communities that seek ethical financial solutions have also been attracted to Islamic banking.

Since its emergence in mid 1960s, Islamic banking has spread to a large number of Muslim countries, including the GCC and the Arab world at large, South and Southeast Asia, and even Muslim communities in the West. e.g., the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Sudan (1977), the Faisal Islamic Bank of Egypt (1977), and the Bahrain Islamic Bank (1979), to mention a few. Bahrain is considered a hub for Islamic banking, with significant activity also taking place in Kuala Lumpur and London. Islamic financial institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, and financial service companies. They follow different banking models: private institutions in a conventional economy (as in the GCC and the West), attempts at national Islamic banking systems (as in Sudan, Iran and Pakistan), and dual banking models (as in Malaysia). They also take different forms: wholly Islamic institutions, Islamic subsidiaries of conventional banking groups, and Islamic banking windows within conventional banks.

This is an industry that is still evolving, developing and growing. It has gone from commercial banking to syndicated transactions and equities, and more recently, into debt issuance and structured products. Its sophistication and product offering have developed along with this change. At an earlier stage, industry growth was in part a reflection of economic growth in the Islamic world, fuelled primarily by oil wealth. This created a growing middle-wealth segment and hence made banking a necessary service to the larger

segment of the population. In the past several years, increased awareness about Islamic banking has led to conversion from conventional banking and continued high growth (15-20% in key markets).

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra 1982), it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in the Islamic order.

There have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that riba refers to usury practiced by petty money-lenders and not to interest charged by modern banks and that no riba is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between riba and interest. (Mohammed, 1988)



## 1.2 *Statement of the problem*

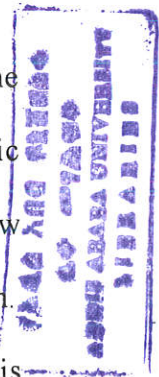
Ethiopia has population of more than 80 million and 45 to 50 % of the population being Muslims (almanac, 2004). This significant segment of the population were marginalized by past regimes and denied various rights practiced by every citizen. After change of government in 1991 Muslims are relatively enjoying equal rights with other religious group members.

The existing financial system works under basic framework of using interest as a cost of borrowing and on a collateral base for investment loans and consumption loans. The level of transaction cost of borrowing i.e. interest cost, collateral requirement in addition to other cost discourages this income group from participating in production activities through bank loans.

Majority of the population are marginalized because of costly policy requirements of the conventional banking system. Majority of Muslims do not deal with interest. Islamic doctrine prohibits interest in all its forms as a result most Muslims are unable to borrow and invest in productive activities because of absence of Shari'ah adhering banking system.

Nowadays the role of banking has dramatically increased. Now the country's economy is growing and competition is becoming more stiff and stiff. In such scenario, any business needs finance very badly. Obviously, the main sources of finance are banks. As peoples income increases the propensity to save increases. Banks are indispensable in their interface between investors and depositors.

Conventional banks are not entertaining the divergent needs of largest segment of the population. Islam bans all sorts of riba (interest) in all its forms whether in consumption loans or productive ones. The Islamic ban on interest does not mean that capital is costless



in an Islamic system. Islam recognizes capital as factor of production but it does not allow the factor to make prior or pre determined claim on the productive surplus in the form of interest. This obviously poses the questions to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit sharing can be a viable alternative (kahf 1982). In Islam, the owner of the capital can legitimately share the profit made by the entrepreneur.

Country's economic growth and prosperity depends on its people efforts and contributions. To harness development activities and enhance productivity it is imperative to have participatory and enabling policies for majority of its population. Eliminating or at least minimizing obstacles or bottlenecks of development is what is expected of all stakeholders and particularly on government or its various branches.

In our country's context where majority of Muslims are involved in business activities, solving the banking problems has paramount and tremendous impact for the prosperity of the people and the nation at large.

This paper tries to show possibility of establishing Islamic Banks and tries to get answers for the following questions:-

- Is it possible and feasible to establish Islamic banks in Ethiopia?
- What are favorable conditions to establish Islamic banks?
- What are challenges that can come on the way of Islamic banks?
- How Muslim community perceives Islamic and conventional banks?

### ***1.3 Objectives of the study***

General objective:-

The main purpose of this study is to assess possibility of establishing Islamic banks in Ethiopia and detect potential challenges and also favorable conditions.

Specific objectives:-

1. To see how Muslim community perceives current conventional banking system
2. To pin point favorable opportunities that encourages Islamic Banking practices in Ethiopia
3. To identify major obstacles or challenges that might hinder establishment of Islamic banks in Ethiopia
4. To draw attention of the investors and the government to invest and facilitate good and enabling environment for Islamic banking through its legislation and executive wings.

### ***1.4 Limitations of the study.***

The main constraint is shortage of time and lack of sufficient and relevant domestic works in the area. Particularly there are very few domestic papers in the topic. So, many references are taken from external sources. Due to the above mentioned constraints the sample size is very few. This may make the generalization of finding very difficult.

### **1.5 Significance of the study**

This paper tries to provide an alternative insight to conventional interest banking and that Islamic banking is not dream but reality practiced in many Muslim as well as non Muslim countries .

It will also pave the way for more investigation and studies about alternative banking system in the country.

### **1.6 Delimitations**

The paper does not cover the wide scope of Islamic economics nor does investigate the whole operation of conventional banks. It does not also cover Islamic insurance which is very close subject to Islamic banking. It just focuses on Islamic banking.

### **1.7 Methodology of the study**

#### **1.7.1 Research Design**

The purpose of this study is to examine the awareness of Muslim business persons of Islamic banking. A sample of 75 Muslim merchants was surveyed utilizing a short questionnaire containing specific questions. The study was conducted in merkato area of Addis where most Muslim merchants are available. The sample size of 75 medium and high income group Muslim merchants was taken. This was because the researcher assumed that mostly potential users of banking service in our country are those with medium to high income groups. The sampling method was systematic random sampling. Reliable and relevant information was obtained from the respondents.

### **1.7.2 Data Collection**

The methodology includes questionnaires and secondary data like books relevant internet sources, and previous works on the topic under study. The questionnaires were presented in two languages i.e. English and Amharic for convenience of respondents. The researcher used primary, secondary and tertiary data like encyclopedia, dictionaries etc, which are mainly used in literature review part of the study. Since Islamic banking is new for Ethiopia, the researcher mainly used external references.

### **1.7.3 Data Analysis**

The data collected through records review, questionnaires were analyzed and interpreted by using graphs, tables, percentages, and other appropriate method.

### **1.8 Organization of the paper**

The paper is organized in to 5 chapters. The first chapter deals with the introduction of issues pertinent to banking industry in general and Islamic banking in particular .The second chapter includes literatures in the field. The third chapter goes deep in to nuts and bolts of Islamic banking. The fourth chapter contains analyses of data and summary. Finally the fifth chapter provides conclusions and recommendations



## Chapter Two

### Review of related Literature

#### 2.1 Overview of Islamic Banking

The Encyclopedia Britannica defines a bank as "... an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits and make loans and derive a profit from the difference in the interest rates paid." Islamic bank will fit this description only just even if one replaces 'interest rates paid' with 'profit-shares and fees'.

Islamic banking generally referred to as interest free banking has been gaining popularity in the recent past. The main pillar of Islamic finance is prohibition of interest. Unlike conventional banking where interest is an integral part of the banking system, Islamic banking avoids interest in all bank transactions [Samad and Hassan (1999)]. Then what is the difference between a conventional bank and this new form of banking under widespread public discussion today? A bank is an institution because, similar to any other societal-sanctioned institutions such as an insurance company, a bank is heavily regulated by a set of laws.

The same is also true of the Islamic banks. In addition to the normal banking laws and prudential laws, an Islamic bank is supervised by a Shari'ah Board to enforce the application of fair-dealing and avoidance of a number of prohibited financial transactions.

Islamic bank can also be defined as "... an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits and make loans and derive a profit from the difference in the profits-shares and fee incomes that are consistent with the Shari'ah common law principles governing such a bank." Defined this way, it is a

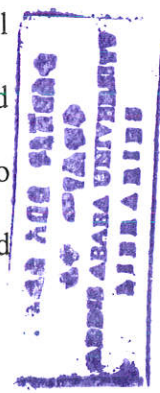


modern institution fulfilling the three conventional functions and a fourth ethical function mandated as compliance with a set of socio-ethical principles. Underlying the entire tenet of the financial transactions of this form of banking are two requirements: a reward in a money-based transaction must be the result of profit-shares from sharing in the risk of the outlay and not pre-agreed and fixed reward regardless of the consequence of investment; and that any financial transaction that is doubtful of ensuring long-term societal well-being is considered disallowed.

A significant trend in global finance over the last 15 years has been the rapid growth of Islamic banking and finance (IBF). There are now over 400 Islamic banks and financial institutions worldwide, with estimated assets of more than \$300 billion, and there may be a further \$1.1 trillion in Islamic global funds (Henry and Wilson 2004; Sandhu 2005; Ibrahim 2006). According to the Institute of Islamic Banking and Insurance, there are more than 400 Islamic Financial Institutions in the world. These institutions are working in the following countries: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, The Netherlands, Niger, Nigeria , Oman, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad and Tobago, United Arab Emirates, United Kingdom, United States, Yemen. Countries such as Bahrain, Brunei, Iran, Malaysia, Pakistan, Saudi Arabia and Sudan have 'Islamicized' their banking systems to one degree or another, and 'interest-based' banks throughout Muslim-dominated

countries are now considering converting to Islamic banks in order to expand their client base. Once restricted to Muslim-dominated countries, almost 25 per cent of Islamic financial institutions now operate in countries that do not have Muslim majorities and interest-based banks have opened up 'Islamic windows' to attract the growing number of Muslims living in Europe and North America.

The global, or at least international, character of IBF is further visible in the creation of the Dow Jones Islamic Market Index in 1999, and of the Dow Jones Citigroup *Sukuk* (Islamic Bond) Index in Kuala Lumpur in 2003 (Anonymous 2006a). Participants in the *Sukuk* Index are indicative of the institutional and geographic diversity of IBF, with countries such as Bahrain, Malaysia, Pakistan and Qatar, companies such as Emirates Airlines, supranational institutions such as the Islamic Development Bank, and non-Muslim political entities such as the German state of Saxony-Anhalt all becoming involved in this bond market (Khalid 2005; Chiu and Neuberger 2006). In sum, IBF has gathered momentum to become a considerable feature of the financial landscape in both Muslim-dominated and 'Western' countries in the twenty-first century



The most basic starting point, however, is to note that IBF is rooted in the rules and norms of Islam, and in particular *Shari'ah* law, which emerges out of the *Qur'an*, and the prophet Mohammed through the *Sunnah*. The *Sunnah* (or an explanation of the *Qur'an* condensed into ways of acting) is derived from the *Hadith* – that is the tradition or story of the Prophet. From *Shari'ah* law there are two broad concerns that structure the practices of IBF and provide some points of contrast with Western finance. First is the prohibition of *riba* (increase) as it is viewed as exploitative and unfair. The prohibition of *riba* does not mean that money may not be lent under Islamic law, but merely rules out what might be

considered unearned profit. The provider of capital is not permitted to fix a predetermined rate of interest, but should be allowed an adequate return by having a financial stake in the project to be undertaken. That is, money is not considered a commodity in Islamic economics, but rather a bearer of risk. A second suite of concerns affecting IBF is the prohibition of excessive risk or uncertainty (*gharar*); Islamic institutions shun investments into gambling, but also certain kinds of businesses, especially those involved with pork-related products, alcohol, prostitution and other forms of entertainment deemed unacceptable. More generally, Islamic law frowns on speculation and stresses the 'asset-based' qualities of IBF practices. A key aspiration in IBF – in sharp contrast to interest-based finance – is a close coupling of the financial and the 'real' economy. Financiers are encouraged to invest in promising projects, to share profits and losses with entrepreneurs and, in so doing, promote development. Money is to be tied to real (material) assets to make them grow; it cannot be used as a commodity in and of itself or used as collateral.

If it is not clear whether a particular financial practice is acceptable based on a ruling from the *Qur'an* or from the *Hadith* and the *Sunnah*, then authority is given to Islamic scholars to invoke *Ijtihad* (which literally means 'effort', but is essentially the interpretation of *Qur'an* texts). The concept of *ijtihad* is vital to the contemporary practice of IBF, especially as it develops in non-Islamic banking and financial systems. Islamic scholars meet communally to arrive at decisions and issue a *fatwa* (opinion) and these become part of Islamic jurisprudence. In practice, this means that Islamic banks or financial institutions are regulated by *Shari'ah* boards, comprising one or more Islamic scholars, which offer a *fatwa* or statement of guidance interpreting Islamic law. When all Islamic scholars of a particular time period agree on an interpretation, this is referred to as *ijma* (consensus).

However, such decisions through *ijma* cannot be inconsistent with the *Qur'an* or the *Sunnah*. As Al-Omar and Abdel-Haq argue, 'human reason has considerable sovereignty within the law; it has no sovereignty over the law' (1996, 2). Nevertheless, Islamic scholars can also rely on *qiyas* (reasoning by analogy) to use the rulings of one event and apply them to another, so long as one can grasp an underlying principle within both events. Together, *ijma* and *qiyas* constitute two other sources of law that are independent from the *Sunnah* and the *Hadith* and three adaptive mechanisms – departures from tradition because of local custom (*'urf*), public interest (*maslaha*) or necessity (*darura*) can also be invoked. Thus, Islamic scholars have invoked *darura* to permit Muslims' use of conventional insurance to purchase a home in the United States because of the unavailability of *takaful* (*Shari'ah*-compliant insurance involving mutual risk) (Thomas 2001).

## **2.2 Rationales for the critique of Riba**

### **2.2.1 Usury in Judaism**

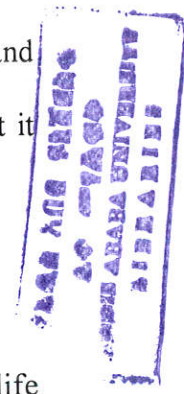
Criticism of usury in Judaism has its roots in several Biblical passages in which the taking of interest is either forbidden, discouraged or scorned. The Hebrew word for interest is *neshekh*, literally meaning "a bite" and is believed to refer to the exaction of interest from the point of view of the debtor. In the associated Exodus and Leviticus texts, the word almost certainly applies only to lending to the poor and destitute, while in Deuteronomy, the prohibition is extended to include all money lending, excluding only business dealings with foreigners. .Despite the prohibition on taking interest, there is considerable evidence to suggest that this rule was not widely observed in biblical times. (The Jewish Encyclopedia, 1912).

### 2.2.2 Usury in Christianity

Despite its Judaic roots, the critique of usury was most fervently taken up as a cause by the institutions of the Christian Church where the debate prevailed with great intensity for well over a thousand years. The Old Testament decrees were resurrected and a New Testament reference to usury added to fuel the case. Building on the authority of these texts, the Roman Catholic Church had by the fourth century AD prohibited the taking of interest by the clergy; a rule which they extended in the fifth century to the laity. In the eighth century under Charlemagne, they pressed further and declared usury to be a general criminal offence. This anti-usury movement continued to gain momentum during the early Middle Ages and perhaps reached its zenith in 1311 when Pope Clement V made the ban on usury absolute and declared all secular legislation in its favor, null and void (Birnie, 1952). Increasingly thereafter, and despite numerous subsequent prohibitions by Popes and civil legislators, loopholes in the law and contradictions in the Church's arguments were found and along with the growing tide of commercialization, the pro-usury counter-movement began to grow. The rise of Protestantism and its pro-capitalism influence is also associated with this change (McGrath, 1990), but it should be noted that both Luther and Calvin expressed some reservations about the practice of usury despite their belief that it could not be universally condemned.

### 2.2.3 Usury in Islam

The criticism of usury in Islam was well established during the Prophet Mohammed's life and reinforced by several of his teachings in the *Holy Quran* dating back to around 600 AD. The original word used for usury in this text was *riba* which literally means "excess or addition". This was accepted to refer directly to interest on loans so that, according to



Islamic economists Choudhury and Malik (1992), by the time of Caliph Umar, the prohibition of interest was a well established working principle integrated into the Islamic economic system

#### **2.2.4 Usury in Modern Reformist Thinking**

Adam Smith, “Father of the Free-market Capitalism” and general advocacy of laissez-fair economics, came out strongly in support of controlling usury (Jadlow, 1977; Levy, 1987). While he opposed a complete prohibition of interest, he was in favor of the imposition of an interest rate ceiling. This, he felt, would ensure that low-risk borrowers who were likely to undertake socially beneficial investments were not deprived of funds as a result of “the greater part of the money which was to be lent [being] lent to prodigals and projectors [investors in risky, speculative ventures], who alone would be willing to give [an unregulated] high interest rate” (Smith, 1937: 339).

The great twentieth century economist John Maynard Keynes held a similar position believing that “the disquisitions of the schoolmen [on usury] were directed towards elucidation of a formula which should allow the schedule of the marginal efficiency to be high, whilst using rule and custom and the moral law to keep down the rate of interest, so that a wise Government is concerned to curb it by statute and custom and even by invoking the sanctions of the Moral Law” (1936: 351-3).

#### **✓ Usury as Unearned Income**

The Church's simplest and perhaps earliest objection to usury was on the basis that it constituted unearned income, an idea which stemmed from its general doctrine of Just Price. The Lateran Council of 1515 clearly expressed such a view of the Church: “This is the proper interpretation of usury when gain is sought to be acquired from the use of a

thing, not in itself fruitful (such as a flock or a field) without labour, expense or risk on the part of the lender.” Birnie reinforces this point by noting that “to live without labour was denounced as unnatural, and so Dante put usurers in the same circle of hell as the inhabitants of Sodom and other practices of unnatural vice” (1952: 4).

This is also the rationale Ahmad uses to explain why in Islam God (al-Qur'an, II: 275-276) “permits trade yet forbids usury”: “The difference is that profits are the result of initiative, enterprise and efficiency. They result after a definite value-creating process. Not so with interest”; also “interest is fixed, profit fluctuates. In the case of interest you know your return and can be sure of it. In the case of profit, you have to work to ensure it” (1958: 25). Perhaps Aristotle had similar sentiments in mind when he argued that “a piece of money cannot beget another”.

There is an important psycho-political dimension to this argument. Keynes' biographer, Skidelsky, intriguingly comments that “Keynes's sense that, at some level too deep to be captured by mathematics, ‘love of money’ as an end, not a means, is at the root of the world's economic problem” (1992: 454). Hence, at a fundamental level of analysis, the so-called evils of usury must be understood as being connected with money being a social psychological construct legitimized by the power dynamics of a given political economy which may or may not be democratically and consciously legitimized. It invited questioning of the very psycho-spiritual power dynamics that constitute the deep roots of human relationship in economy, and which have always caused matters of political economy to be central to prophetic witness.

Usury is what marks the distinction between money being simply a socially contracted abstract mechanism to lubricate between supply and demand, and money as an end in itself.

As an end in itself, as a social commodity legitimized through usury to tax other economic activity, the honest process of living by the sweat of one's brow is short-circuited. The true dignity and full reward of ordinary labour is compromised. Money thus becomes self-perpetuating power in itself rather than just a mediating agent of power. And it is the relentlessness of compound interest in the face of adversity that sets the potential cruelty of usury apart from equity-based return on investment. It was in recognition of the need to have corrective feedback mechanisms that Islam not only rejects usury, but also imposes Zakat or wealth tax. And more radical still, the Old Testament proposes a complete economic readjustment through the "Jubilee" process every fifty years (Leviticus 25), though there is no evidence that such whole scale redistribution of wealth in all forms was ever actually carried out.

#### ✓ **Usury as Double Billing**

A slightly more obscure rationale was employed by the Church later in the middle Ages in order to strengthen its anti-usury doctrine. Drawing on some of the concepts of Civil Law, it argued that money was a consumable good (*fungible*), for which the ownership passed from lender to borrower in the course of the loan transaction, with the fair price of 'sale' therefore being the exact amount of the money advanced. Hence to ask for more in the form of interest was illegal and immoral, "like selling a loaf of bread and then charging in addition for the use of it" (Birnie, 1952: 6).

#### ✓ **Usury as Exploitation of the Needy**

The condemnation of usury in the form of charging for loans to the poor and destitute is a recurring theme in several traditions. This is clearly the contextual meaning of the Judaic biblical passages in Exodus and Leviticus (Encyclopedia Judaica, 1971) and Ruston

suggests that “the original target of the medieval usury laws was the medieval equivalent of the ‘loan shark’ [but that] the medieval theory was unsatisfactory because it could not distinguish the helpful loan from the oppressive” (1993: 173).

✓ **Usury as a Mechanism of Inequitable Redistribution of Wealth**

The observation that usury acts as a mechanism by which, 'the rich get richer and the poor get poorer' is common to several traditions. Islam rejects financial interest on the basis that it contradicts the Principle of Distributive Equity which its political economy strives to enshrine: “Interest in any amount acts in transferring wealth from the assetless section of the population” (Choudhury and Malik, 1992: 51). Coming from a totally different perspective as a self declared ‘individualist’, Birnie reaches a similar conclusion: “Interest, by making capital a quasi-monopoly, effectually prevents the establishment of a true competitive system” (1958: 1). Kennedy (1992) provides some excellent empirical evidence of this phenomenon which relates to Germany in 1982. She shows that, while the poorest 2.5 million households paid out (net) DM 1.8 billion in interest, the richest 2.5 million households received (net) DM 34.2 billion. The psychological effect of this on the relatively poor can be seen to be magnified when merely quantitative evaluation of transfers from poor to rich is superseded by consideration of the qualitative cost of such a wealth transfer. For the relatively rich, the utility gain provided by usury is marginal to the already substantial utility of the principal sum. The principle of the diminishing marginal utility of wealth therefore applies to each incremental unit of wealth procured by interest earnings. The poor, however, experience the converse of this. For them, the loss in utility incurred by having to pay interest is qualitatively much greater than the gain to the rich.

Each unit of interest paid incurs increasing marginal utility loss. Permitting usury to operate in an economy therefore reduces overall utility in the economy. This must count as one of the strongest arguments against usury.

#### ✓ **Usury as Discounting the Future**

Because compound interest results in an appreciation in invested monetary capital, it is presumed rational for people to prefer having a specified amount of currency now than the same amount some time in the future. This simple and rarely questioned logic has several disastrous implications. For instance, Pearce and Turner (1990) note that discounting affects the rate at which we use up natural resources - the higher the discount rate (derived partly from the interest rate), the faster the resources are likely to be depleted. Daly and Cobb (1990) take this observation to its logical conclusion and show that discounting can lead to the “economically rational” extinction of a species, simply if the prevailing interest rate happens to be greater than the reproduction rate of the exploited species.

#### ✓ **Usury as an Agent of Economic Instability**

Gesell's (1904) main objection to interest is that it is an endemic factor in the instability of interest-based economies, i.e. the cycles of boom and bust, recession and recovery. Similarly, Ahmad, arguing from an Islamic perspective, claims “the greatest problem in the capitalist economy is that of the crises [and] interest plays a peculiar part in bringing about the crises” (1958: 36). Even Keynes, the campaigner for interest-based monetary policy, admits the fact that “the rate of interest is not self-adjusting at the level best suited to the social advantage but constantly tends to rise too high” (1936: 350).

### *2.3 Rationales for the banning of the interest in Islam*

While the banning of interest is rooted in the Islamic theology, proponents of Islamic finance provide economic rationales to support the ban of interest. Some of these rationales are described by the international association of Islamic banks (1995. Pp. 3-4).

- ✓ First, in an Islamic profit sharing contract, the return on capital will depend on productivity, and the allocation of funds will be primarily based on the soundness of the project. This will improve the capital allocation efficiency.
- ✓ Second the Islamic profit sharing system will ensure more equitable distribution of wealth and the creation of additional wealth to its owners. This system would no doubt reduce the unjust distribution of wealth under the interest system.
- ✓ Third, the profit sharing regime may increase the volume of investments and hence create more jobs. The interest regime would make feasible and acceptable only those projects whose expected returns are higher than the cost of debt, and therefore filter out projects which are otherwise acceptable under the Islamic profit sharing system.
- ✓ Fourth, the Islamic finance system will reduce the size of speculation in financial markets, but still allow for a secondary market for trading stocks and investment certificates based on profit sharing principles. This will bring sanity back to the financial market and promote liquidity to equity holders.
- ✓ Fifth, under the profit sharing system, the supply of money is no allowed to overstep the supply of goods and would thus curb inflationary pressures in the economy.

Some Islamic bankers argue that Islamic finance may even have a role to play underpinning the stability of the international economy (Dudley 1998). Under the Islamic financing system, investments or finance is targeted to the specific needs of Financiers or investors will need to satisfy themselves as to the reliability of a project, their lease rentals or the return promised in any financing deal. The investors and financiers have to exercise due diligence and careful monitoring of their investments. There is not much room for raising a variety of unsecured debts that are not targeted to the specific needs of borrowers. Conventional western financing, on the other hand, lacks a corrective mechanism to stop excessive borrowing beyond individual companies' means. In good times, raising funds is easy. While in the bad times the cost of raising fund is high; therefore, the risk to the financing institution is increased. The amount of borrowing under the conventional system is several times more than it would be under an Islamic system, and so are the risks inherited from these excessive borrowings.

The prohibition of Riba is based on the arguments of social justice and equality. Elimination of interest in Islamic Banking does not mean zero-return on capital; rather Islam forbids a fixed predetermined return for a certain factor of production [Ahmad (1994)]. The main idea is that there should not be any predetermined benefit attached to the capital. Islam permits profit sharing, though profit sharing ratio is predetermined, the ratio of return is not predetermined. Highlighting Islamic Banking principles Khan (1986) in IMF staff paper states that the Islamic model of banking based on principles of participation bears a striking resemblance to proposals made in the literature for reforms of banking systems in many countries. The Islamic System may well prove to be better suited

to adjusting to shocks that result in banking crises and disruption on payment mechanism of the country [see for details Khan (1986), p. 19].

Scharf (1983), while propagating the case of Islamic Banking states that Islamic banks could make a useful contribution to economic growth and development particularly in a situation of recession, stagnation and low-growth-level because the core of their operations is oriented towards productive investment. It is further that Islamic system based on the principles of Shari'ah is not only feasible but also profitable. The purpose of Islamic banking is to develop a financial system the very basics of which revolve around justice and morality [Ayub (2002)].

In order to understand how the Islamic system differentiates between profit and interest, one has to look at the differences in economic ideology. In capitalist theory, capital and entrepreneurs are treated as two separate factors of production where the former gets interest and the latter is entitled to profit. It is assumed that interest is a fixed return for providing capital, and profit can only be earned after distributing the fixed return to land, labour and capital (in the form of rent, wage and interest). In contrast, the Islamic economic system does not consider capital and entrepreneurs as separate factors of production. It believes that every person who contributes capital in the form of money to a business venture assumes the risk of loss and therefore is entitled to a proportional share in the actual profit. The system is protective of the entrepreneur, who in a capitalist economy would have to make fixed interest repayments even when the venture is making a loss. Capital has an intrinsic element of entrepreneurship, so far as the risk of the business is concerned and therefore, instead of a fixed return as interest, it derives profit. The more the

profit of the business, the higher the return on capital. With no fixed interest repayments, the profit would be higher. In this way the profits generated by the commercial activities in the society are equally distributed among those who have contributed capital to the enterprise.



## Chapter Three

### 3.1 Historical development of Islamic Banking

It seems that the history of interest-free banking could be divided into two parts. First, when it still remained an idea; second, when it became a reality -- by private initiative in some countries and by law in others. The last decade has seen a marked decline in the establishment of new Islamic banks and the established banks seem to have failed to live up to the expectations. The literature of the period begins with evaluations and ends with attempts at finding ways and means of correcting and overcoming the problems encountered by the existing banks.

#### 3.1.2 Interest-free banking as an idea

Interest-free banking seems to be of very recent origin. The earliest references to the reorganization of banking on the basis of profit sharing rather than interest are found in Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952) in the late forties, followed by a more elaborate exposition by Mawdudi in 1950 (1961).<sup>2</sup> Muhammad Hamidullah's 1944, 1955, 1957 and 1962 writings too should be included in this category. They have all recognized the need for commercial banks and the evil of interest in that enterprise, and have proposed a banking system based on the concept of *Mudarabah* - profit and loss sharing.

In the next two decades interest-free banking attracted more attention, partly because of the political interest it created in Pakistan and partly because of the emergence of young Muslim economists. Works specifically devoted to this subject began to appear in this period. The first such work is that of Muhammad Uzair (1955). Another set of works



emerged in the late sixties and early seventies. Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974) were the main contributors. (Siddiqi (1980), pp.219-20)

Early seventies saw the institutional involvement. Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, First International Conference on Islamic Economics in Mecca in 1976, International Economic Conference in London in 1977 were the result of such involvement. The involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process.

### **3.1.3 The coming into being of interest-free banks**

The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and the Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House.

However, small scale limited scope interest-free banks have been tried before. One in Malaysia in the mid-forties and another in Pakistan in the late-fifties. Neither survived. In 1962 the Malaysian government set up the "Pilgrim's Management Fund" to help prospective pilgrims to save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially and then closed down for various reasons. However this experiment led to the creation of the Nasser Social Bank in 1972.

### 3.2 Islamic rule on financing

The rules regarding Islamic finance are quite simple and can be summed up as follows:

- 1) **Any predetermined payment over and above the actual amount of principal is prohibited.**

Islam allows only one kind of loan and that is qard-el-hassan (literally good loan) whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the qard (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall." The principle derived from the quotation emphasizes that associated or indirect benefits are prohibited.

- 2) **The lender must share in the profits or losses arising out of the enterprise for which the money was lent.**

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the Shari'ah, or Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay

back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high risk investments provide a stimulus to the economy and encourage entrepreneurs to maximize their efforts.

### **3) Making money from money is not acceptable in Islam.**

Money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital. And as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so



that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

**4) Gharar (Uncertainty, Risk or Speculation) is also prohibited.**

Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials. A number of transactions are treated as exceptions to the principle of gharar: sales with advanced payment (bai' bithaman ajil); contract to manufacture (Istisnaa); and hire contract (Ijara). However, there are legal requirements for the conclusion of these contracts to be organized in a way which minimizes risk.

**5) Investments should only support practices or products that are not forbidden -or even discouraged- by Islam. Trade in alcohol, for example would not be financed by an**

Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest

### **3.2 Accounts in Islamic banks**

The opening of an account in an Islamic bank represents something different than the ordinary debtor-creditor relationship as it is in the western banking system. In Islamic banks it is seen as partner relationship. The whole Islamic banking system is built on a partnership basis in which the depositors, investors and borrowers participate. (Zineldin)

The main source of the bank's funds consists of accounts available to the customers. There are four main accounts are the following (Alkacem et.al.2002).

- demand deposit accounts (current or checking account)
- savings accounts
- investment account
- special investment accounts



#### **3.2.1 Current, checking or demand deposit account**

Demand deposits can be withdrawn on demand without any conditions. The main motive of for customers to open an account of this kind is to keep excess liquidity available on demand, and no to earn any profit or income. Naturally, the bank does not pay any interest on these deposits. (Zineldin, 1990; warde, 2000).

The nominal value of the deposits would be guaranteed and can therefore be seen as a completely safe financial asset, which would satisfy the demands of risk-averse customers. There are restrictions imposed on how the capital can be used. They can be used to make very short term loans to parties who run out of liquidity. If the bank intends to use these funds while they remain with the bank it must ask for their clients' permission. The profit that the bank generates while using these funds belong to the bank (Alkacem et. al., 2002)

### **3.2.2 Saving accounts**

The funds can be withdrawn at any time and are usually used in short range investment projects and ventures. The bank guarantees the nominal value of the deposits. Some profit rate is usually paid to the depositor. However, any positive rate of return is not guaranteed. The depositor will not receive any premium if the bank incurs a loss on its investment projects. (Zineldin, 1990).

### **3.2.3 General investment account –mudarabah accounts**

General investment accounts are also called profit and loss sharing deposits. The most important source of funds and earning activity for Islamic banks is the investment accounts. The motive is to earn a profit rather than holding funds for precautionary or transaction reasons. an investment account offer a higher portion of the rate of return than the ordinary deposit account in return for a higher risk from investment operations (Alkacem et. al,2002)

The only guarantee that the holder of an investment account receives is the profit and loss ratio, how profit and losses are to be shared between the bank and the depositor. This ratio is agreed up on in advance and cannot be changed during the life of the contract

The holder of the account can be entitled to share in the profit of a single project or a general share in all activities excluding earnings from banking and other services. Deposit holders normally have no saying in the management of the bank and in most cases do not participate in the management of investing the funds the funds are invested in economic projects or sectors that follow Shari'ah principles. The nominal value of the capital is not guaranteed and the bank pays no interest on the capital. The depositors receive shares in the profit made by the bank. Even losses are shared between the bank and the depositors, but according to Omar the client bears all the losses if the investments are not profitable (Zineldin, 1990)

#### **3.2.4 Special investment accounts**

The banks may offer special investment accounts in addition to the general investment. These are often offered selectively to wealthy individuals or corporate clients. These accounts also follow the principles of mudarabah. The difference is that the modes of investment of the funds and the distribution of profits are negotiated individually (Al Omar, 1996)

#### **3.2.5 Mudarabah capital trust financing**

The contract or the arrangement of mudarabah is actually an arrangement to provide an Islamic solution to the economic dilemma of how the supplier of capital or monetary assets and the entrepreneur who uses the investable fund, according to his abilities and thus experience and expertise, can be brought together on common ground.

The entrepreneur manages the investment venture, but the bank can choose to take practical part in the running of the project. The bank also has the right to follow up the operating business through audit and advise the partner with important information. (Zineldin, 1990)

The holder of a mudarabah certificates is entitled to share in the profits of the investment activities being undertaken by the company. Risk capital for company can be provided by banks in the form of direct equity, or through loans with equity features. Agreements can be made between the two parties concerning for how long a period of time the capital can be used and if it is only intended for a specific project. Once the project or the time period has ended the entrepreneur returns the money to the investor. Besides that, the investor also receives his pre-agreed share profit. The entrepreneur keeps what remains of the profit for himself as a compensation for his work and expertise. Should the venture be unsuccessful, the capital provider alone must bear the financial losses. The liability of the investor is limited to the amount of the capital he has paid. The he entrepreneur loses his reward for the time and effort spent, but he does not have to bear any financial loss under the condition that has not been negligent. The risk of total loss, through mismanagement or negligence, is forbidden the entrepreneur is obliged to repay the original sum of capital to the owner in case the entrepreneur is or has been negligent (zineldin, 1990)

This pre-agreed profit sharing ratio should not be mixed up with the return on money-lending, interest, which is prohibited the interest is pre-determined while profit is not.

The depositor or the investor can not require guarantee against the risk that the investment is lost in art or totally. This happens; such an investment does not qualify as a trust financing. Mudarabah is and must be a combination of business activity and commercial risk taken by the capitalist (zineldin, 1990)

General rules related to the legitimate mudarabah: There are some transactions and activities that the working partner is not allowed to perform unless he obtains a clear approval or permission from the capital owner. Examples of such activities are as follows:



- a. to establish a new company or a new mudarabah with others ;
- b. to deposit the capital of the mudarabah with others ;
- c. to mix the capital of the mudarabah with his own money before he starts the activity ;
- d. to sell or trade with others on deferred or installment basis ; and
- e. To travel with the capital to other places.

If working partner makes any of the above activities without obtaining the permission of the capital owner, then he will be liable for any losses that may inflict capital.

### 3.2.6 Musharakah equity financing

Musharakah financing contract means that a capital owner finances investments in other party's business. The capital is provided on the condition that the capital owner shares the profit from the business (al omar.et.al, 1996)

The profit sharing joint venture is usually designed for limited production or commercial activities of long duration, whereby the bank and the customer contribute capital assets as well as technical and managerial expertise in varying proportion, for a specific project.

These profit sharing arrangements may be applied either to the whole enterprise, where each partner takes an equity position, or to a particular line of activity within the enterprise; that is, they can have either whole-firm or project-specific orientations. Zineldin, 1990

The profit sharing ratio is predetermined and fixed and known to all concerned. The capital owner and entrepreneur agree upon the ratio and it may be different from the ratio in which the two parties have invested in the total capital of the project. The reason is that the two parties may share the work of managing the project in any amount mutually agreed upon. The losses are shared according to the exact proportion of capital contribution ratio without any modification. (al omar et.al. 1996).



Table 1, Comparison between mudarabah and Musharakah

Type of financing	Capital supplied by	Profit shared	Losses shared
Mudarabah	Bank/investor	According to agreed upon ratio	No, capital provider alone bears losses.
Musharakah	Bank and client	According to agreed upon ratio	Exactly according to capital contribution



### 3.2.7 Murabahah cost-plus profit/mark up

Murabahah is short term financing. It takes a leading role as an Islamic financial instrument.

By using the Murabahah Islamic banks can enter in to trade cycle. The banks can enter as buyers of raw materials, goods, equipment or any other assets. The merchandise will later be sold to client at cost plus a negotiated profit margin on the basis of deferred payments. Both parties must know the original price and the profit rate. The price of the commodities is agreed upon between the bank and the client at the time of sale and cannot any charges if payments are not made on time. The rate of profit should not be tied to the length of the period over which the financing is to be provided. The mark up is not a compensation for tie or deferred payment. The mark up is for the service that the finance-owner provides. These services include seeking out, locating and purchasing the required goods at the best price. This service is recognized and can be paid for since its value is pre-determinable. (Al Omar et.al, 2002)

When a client wishes to use this method he requests the bank to buy a certain asset at a specific price. The client promises to buy it from the bank at set time and at the higher price. The agreement of the bank to buy or purchase itself does not oblige the client to buy the asset, all according to Shari'ah.(al Omar et.al,1996)

Other mark up schemes

There are variations of mark up - Murabahah

### **3.2.8 Lease-based Principle or Ijarah :**

An individual short of funds may approach another with a surplus (the other party or financier) to fund the purchase of a productive asset and renting that to him on rent-payment basis.

The following conditions must be met to adhere to Islamic law (Shari'ah)

- The services that the asset is supposed to provide and for which it is being rented should be definitely known to both parties
- The asset remains in the ownership of the lessor who is responsible for its maintenance so that it continues to give service for which it was rented
- The leasing contract is terminated as soon as the asset ceases to give service.

The price of the asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be predetermined only at the time of expiry of the contract

If the title of the asset is fully transferred to the user at the end of the period, i.e., lessee become the owner of the asset, then it will be called Hire Purchase or Ijarah wa Iqtanah.

### **3.2.9 Advance Purchase Principle :Bai-Salam :**

The term Bai-Salam means advance payment or forward buying. The salam contract is the sale of a good to be delivered to the purchaser at a future date, which is set at the time of the contract. This is a trade transaction contract and not a loan contract. This type of financing is most often used when a manufacturer needs capital to manufacture a final product for the buyer. In return for paying in advance, the buyer receives a more favorable price (i.e. splits the profit margin with the manufacturer).

### **3.2.10 Istisnaa (Progressive Financing) :**

It is a contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job. An example would be for the purchase of a house to be constructed, payments are made to the developer or builder according to the stage of work completed. Istisnaa contract opens the way to a number of new possibilities of business contracts including some forms of futures contract trading of processed commodities, as it permits deferring of both ends of the contract: delivery as well as payment.

## **3.3 Performance of Islamic Banks**

A number of empirical studies revealed the profitable business of Islamic banks in different countries. The performance of the Islamic banks has been judged by using different key ratios like profitability ratios, liquidity ratios, risk and solvency ratios [see Sarker (1999); Samad and Hassan (1999)]. For example, Iqbal (2001) made trend analysis to depict the overall performance of the Islamic banks as compared to the conventional banks.

According to him, Islamic banks in general are fairly stable, profitable and well capitalized.

Their profitability ratios compare favorably with international standards in banking.

Table 2. FINANCIAL POSITION OF THE TOP 20 ISLAMIC BANKING INSTITUTIONS AT YEAR-END 1996 (in \$ millions)

Region	Rank by Assets	Capital	Total Assets	Total Deposits	Net Profit	Capital to Asset in %	Net Profit as % of Total Assets
Bank Melli Iran	1	656	19,297	18,617	53	3.4	0.2
Iraqi Islamic Bank for Develop. & Invest	2	402	9,900	10,900	NA	4.0	NA
Halib bank of Pakistan	3	72	9,827	5,684	21	0.7	0.2
National Bank of Pakistan	4	73	9,348	6,081	90	0.8	1.0
Al-rajhi Bkg & Invest. Corp.-Saudi Arabia	5	400	8,608	6,051	322	4.6	3.7
Bank Tejarat, Iran	6	326	8,544	6,978	23	3.8	0.3
Bank Sedarat, Iran	7	542	7,055	466	0.5	7.7	--
Bank Mellat, Iran	8	346	6,535	4,967	NA	5.3	NA
United Bank, Pakistan	9	49	5,088	3,704	9	1.0	0.2
Kuwait Finance House	10	169	4,732	3,767	271	3.6	5.7
Muslim Comm. Bank Pakistan	11	45	4,071	2,816	3	1.1	--
Agricult. Bank of Iran	12	233	3,024	1,001	11	7.7	0.4
Allied Bank of Pakistan	13	20	2,558	1,493	4	0.8	0.2
Islamic Int'l Bank for Invest. & Develop, Egypt	14	134	2,358	1,494	34	5.7	1.4
Agricult. Develop. Bank of Pakistan	15	104	1,982	81	6	5.2	0.3
Dubai Islamic Bank, UAE	16	136	1,935	1,754	16	7.0	0.8
Faisal Islamic Bank of Egypt	17	100	1,900	1,508	85	5.3	4.5
Lambaga Tabung Haji, Malaysia	18	NA	1,877	1,817	145	NA	7.7
Bank of Industry & Mine, Iran	19	729	1,778	147	88	41.0	4.9
Bank Islam Malaysia Berhad	20	53	1,442	1,278	15	3.7	1.0

NA = not available

-- = insignificant percentage.

SOURCE: International Association of Islamic Banks, Jeddah, Saudi Arabia, quoted by Timewell (1998)

The data on Table 2 were taken in 1996 which is 12 years back. Islamic banks at that time were few in number and very limited types of products were provided. The data in the table particularly the percentage of profits to total asset were unsatisfactory. But now this figure has changed as many authors have indicated mostly individual banks performance in different countries.

The Jordanian case shows that competition and also political instability affects banking performance as shown below

**Table 3 : Profitability and Performance for Jordan Islamic Bank for Finance and Investment**

profitability and performance	2000	2001	2002	2003
Return On Assets (ROA) %	0.33	0.14	0.26	0.33
Return On Equity (ROE) %	3.95	1.88	3.68	5.62
Net Interest and Commissions Income/Operational Income%	88.41	86.31	90.37	87.44
Credit Interest / Credit Facilities, Net %	11.89	10.75	10.15	10.09
Net Income / Total Revenues %	6.38	3.18	5.89	7.95
Total Revenues / Total Assets %	5.12	4.50	4.37	4.13
(Provision for Credit Facilities + Interest in Suspense) / Credit Facilities%	9.95	10.65	11.01	6.86
Net income/total liabilities	0.36	0.16	0.28	0.35

**Table 4: Profitability and Performance for Islamic international Arab bank PLC**

Profitability and performance	2000	2001	2002	2003
Return On Assets (ROA) %	1.59	1.14	0.58	0.52
Return On Equity (ROE) %	6.94	6.33	3.88	4.08
Net Interest and Commissions Income/Operational Income%	33.43	44.21	62.50	60.20
Credit Interest / Credit Facilities, Net %	8.95	6.68	6.39	5.66
Net Income / Total Revenues %	32.03	26.75	18.66	19.30
Total Revenues / Total Assets %	4.97	4.25	3.11	2.68
(Provision for Credit Facilities + Interest in Suspense) / Credit Facilities%	1.43	1.48	1.40	1.51
Net Income/Total Liabilities	2.06	1.39	0.68	0.59

Source: Economics Working Paper Series 2006 University of Wollongong

Table 3 and Table 4 show that both measures of performance ROA and ROE have a positive sign in both banks. Both measures of performance are higher in Islamic International Arab Bank in all years compared with the Islamic Bank for Finance and investment. The ROA in



2000 is 0.33% in Jordan Islamic Bank for Finance and Investment compared with 1.59% in Islamic International Arab Bank. (Saleh and Zeitun,2006)

Alam (2000) undertook a case study to examine the contribution of Islamic Bank Bangladesh Limited (IBBL) towards small and rural sector. The study revealed that IBBL succeeded in attracting both deposits and investment positions since it started its activities. For instance, the deposit figure rose to Taka 10,418 million in March 1995 from Taka 144.20 million as on March 1983, registering an increase of Taka 10,273 million. It was observed from the response of few small-scale industrialists that the remarkable advantages they get from the bank are easy formalities of obtaining loan and quick action in processing loan activities.

Samad and Hassan (1999) evaluated the performance of Islamic bank in Malaysia in terms of its profitability, liquidity, risk and solvency. Financial ratios were applied to measure these performances. A comparison between the Islamic bank and eight other conventional banks was also made. The study revealed that Islamic bank made significant progress on return on assets and return on equity during 1984-1997. The comparison of Islamic bank and the group of eight conventional banks revealed that there was no difference in economic participation between them.

Sarker (1999) used "Banking Efficiency Model" to judge the performance of Islamic banking in Bangladesh. He concluded that Islamic banks could operate with certain level of efficiency even within the presence of conventional banking.

Halim, Hamid and Nordin (2001) conducted a study on the Malaysian Islamic Bank in perspective of Islamic banking education. They showed that the shareholder's funds of the Islamic bank and then interest-free banking fund amounted to RM 1.3 billion, while profit before taxation and zakat amounted to RM 153 million in 1997. Total financing of Islamic bank registered 39.6 percent increase in the second half of 1997.

Since the inception of Profit and Loss Sharing (PLS) mode in Pakistani banking sector, the volume of total deposits did not decline. Total PLS deposits of all scheduled banks increased from Rs 370,281 million to 1,005,738 in 1992 and 2001 respectively thus registering on average a growth rate of 4 percent per annum.

In the light of the above-mentioned studies it could be argued that there is no question of the profitability, viability or efficiency of the Islamic banking system. Islamic banks are equally as profitable as any of the conventional banks. The basic issue is the implementation of the Islamic banking in its true spirit.

Table

### ***3.4 Advantages of Islamic Banking and Finance***

Justice and fairness to all concerned was the main feature of a model of financial intermediation whose core was profit-sharing. Interest was essentially unfair because our environment does not guarantee positive returns to business enterprise financed with borrowed money capital. Current practice penalizes entrepreneurship by obliging it to return the principal even when part of it is lost due to circumstances beyond the

entrepreneur's control. Justice requires that money capital seeking profit share the risk attached to profit making. A just system of financial intermediation would contribute to a more equitable distribution of income and wealth.

Islamic finance will foster greater stability as it synchronizes payment obligations of the entrepreneur with his or her revenues. This is possible only when the obligation to pay back the funds acquired from the financier and pay a profit is related to realization of profits in the project in which the funds are invested, as it is in the profit-sharing model. Contrary to this, in the debt-financing model the payment obligations of the entrepreneur are dated as well as fixed in amount. The same is the case with the financial intermediaries; their commitment to the depositors in time and saving accounts is to pay back the sum deposited with interest added. When a project fails and businessman defaults, the financial intermediary must also default with ripple effects destabilizing the whole system. The debt based financial system of capitalism is inherently prone to recurrent crises. This malaise of the capitalist financial system is well discussed by Hyman P. Minsky in his book, *Stabilizing an Unstable Economy* (New Haven and London, Yale University Press, 1986.)

The linking of depositors' entitlements to the actual profitability of the projects in which their monies are invested through the services of the financial intermediary, the bank, would almost eliminate the risk of runs on the bank insofar as the investment accounts are concerned. A report or rumor that the bank investments are not doing well will not prompt a rush of withdrawals from investment accounts as depositors could get only what is actually salvageable. Waiting till the situation improves would be a more rational option.

Islamic finance is more efficient as it allocates invest able fund on the basis of expected value productivity of projects rather than on the criterion of creditworthiness of those who own the projects, as is the case in debt based finance. There is no guaranty that the most promising projects seeking finance will come from the wealthiest.

Last but not the least, Islamic finance will be less prone to inflation and less vulnerable to gambling-like speculation, both of these being currently fueled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money substitutes while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.

It is true that these advantages belong to a system whose core is profit- sharing. But even *murabahah* (cost plus or mark up) financing keeps the system far less vulnerable to inflation and gambling-like speculation than the conventional debt based arrangements. *Murabahah* is firmly linked with exchange of real goods and services. It is a price, to be paid later. It is essentially different from money given as a loan which may or may not be linked to production or exchange of real goods and services. An Islamic system of finance in which profit-sharing and mark up financing both exist side by side would still retain the advantages noted above. (Siddiqi 2001)



### ***3.5 Islamic Vs Conventional Banking Similarities & Differences***

Unlike Western banking institutions the interest-free Islamic banks are endowed with certain inherent features which make them quite distinct. For instance, operate as they do largely on the basis of profit and loss sharing, the majority of their clients are not savers but holders of profit and loss accounts. In this way not only are the holders of PLS accounts enabled to get a much larger share of the investment-return, but are also psychologically converted from traditional savers into investors.

It may be mentioned here that unlike a traditional saver who generally saves to finance some expenditure in future, an investor generally thinks of not meeting a particular expenditure in future, but much more in terms of building reproductive assets and services for the purpose of future command over resources in a dynamic sense. The Islamic banks operating to fulfill the latter function contribute towards acceleration of investment activity along with the realization of other concomitant goals of better income distribution, higher efficiency of capital and lesser attraction for demonstrative expenditure

Mohammed A.Elhari (2000) has tried to show similarities and differences between Islamic and conventional banking

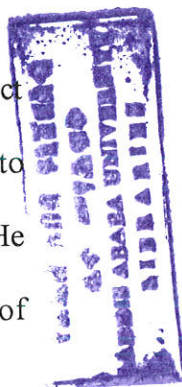
1. They are both financial intermediations. A financial intermediary is the institution that acts as a middleman between cash surplus units (savers) and deficit spending units (users of fund). It is quite obvious that the main function of conventional banks is financial intermediation. However, there are those who would like to think that there is no such thing in the Islamic economic system as financial intermediation and that an Islamic bank can only be "sufficiently" Islamic if it can operate like a trader, one who buys and sells goods and commodities.

The financial intermediary in conventional banking is a “borrower-lender” institution. Since such institution will not survive unless it at least covers expenses, then an income must be generated from such arrangement. This is where interest appears. An Islamic bank, on the other hand, is based on a multi-tier Mudarabah. A Mudarabah is a partnership in profit where capital and management may joint together to create value. The income accruing to the Islamic financial intermediary is coming out of profit not from interest. The root of such a conception is the fact that Shari'ah doesn't distinguish between a sellers being a trader or a final intermediary, unlike positive law where civil law is different from commercial law. In Shari'ah all people stand against one legal code.

A case in mind is Murabahah. There are those who say if an Islamic bank does Murabahah any other form but the traders' way of doing things it will not be permissible from Shari'ah point of view, and an Islamic bank would be in their view a “dubious” conventional bank. They say: since it is never the intention of the bank, to own there assets and hold on to them then, such bank is not sufficiently Islamic.

According to this viewpoint, an Islamic bank must have huge warehouses and elegant stores full of goodies for sale. This is not valid and those who think so miss two important points:

Intention is of no consequence on the permissibility or otherwise of any exchange contract in Shari'ah. In an authentic Hadith, the Prophet (PBUH) showed one companion how to substitute a usurious transaction by another non usurious to reach the same purpose, He (PBUH) didn't object to the intention nor that he nullified the contract on the basis of intention. Rather he corrected the form of contract.



If the anatomy of the contract is in line with Shari'ah requirements, then the transaction is acceptable. Hence, if bank actually buys and then sells, with ownership passing from seller to buyer and that the subject of contract is a good or commodity then the transaction is correct. In conventional banking the subject of contract is money hence any increase is usurious.

2. The way conventional banks render financial intermediation is very simple. They borrow money and lend money. Both assets and liabilities are one form of lending. Islamic banking functions in a rather "elaborate" (not perplexing) way. They have to continuously innovate to satisfy the needs of their clients. It is because of this we see Murabahah, Musharakah, Mudarabah, Istisna, and Salam to name just a few Islamic modes of finance. This makes the job of an Islamic banker "not all roses", but certainly a more interesting one.

3. A conventional banker is a risk manager. He is concerned with all kind of credit, market, interest rate, legal and other risk factors. An Islamic banker should be just as concerned. However, there is one added risk for the Islamic banker, this is what we may call "Shari'ah disobservance risk". Risk analysis refers to the forces that may cause the outcome of investment to be sub optimal. Certainly an Islamic investor earning non-permissible income is an outcome that is most undesirable, and it may cause the value of his investment to be reduced.

4. Contrary to popular opinion, being concerned about time value of money is a similarity not a difference between Islamic and conventional banking. There is no basis for

the current thinking that Shari'ah doesn't allow the attachment of monetary value to time in the contracts exchange. The contract of Salam and differed-payment sales flies in the face of this argument. It is only in loans that Shari'ah requires that no time value of money is considered (but replaced by great rewards in the hereafter).

5. A major difference, however, remains in the handling of delinquency and default. When a borrower delays payment of debt, interest will accrue on his delayed portion. Unless, such borrower defaults and become incapable of paying back his debt, such interest will compensate the conventional bank for lost business. This can't be done in Islamic banking as this is considered usurious.

Clearly, this is a disadvantage from two aspects: Firstly, an Islamic bank will not have the opportunity in a Murabahah transaction for example, to be compensated for lost profit. But more importantly, it increases significantly, the Murabahah risks. Since bank clients are rational people who will seize an opportunity when they see one, they will always delay payment. One major Ijtihad of contemporary Shari'ah scholars is to allow the Islamic bank to impose penalties. Rather than accrue such penalties as income, and hence become usurious, they are disposed off to charity. This way the pressure will mount on the debtor to pay in time, without falling into Shari'ah impressibility.



Figure 1. Basic Difference between Islamic and Conventional Modes of Finance

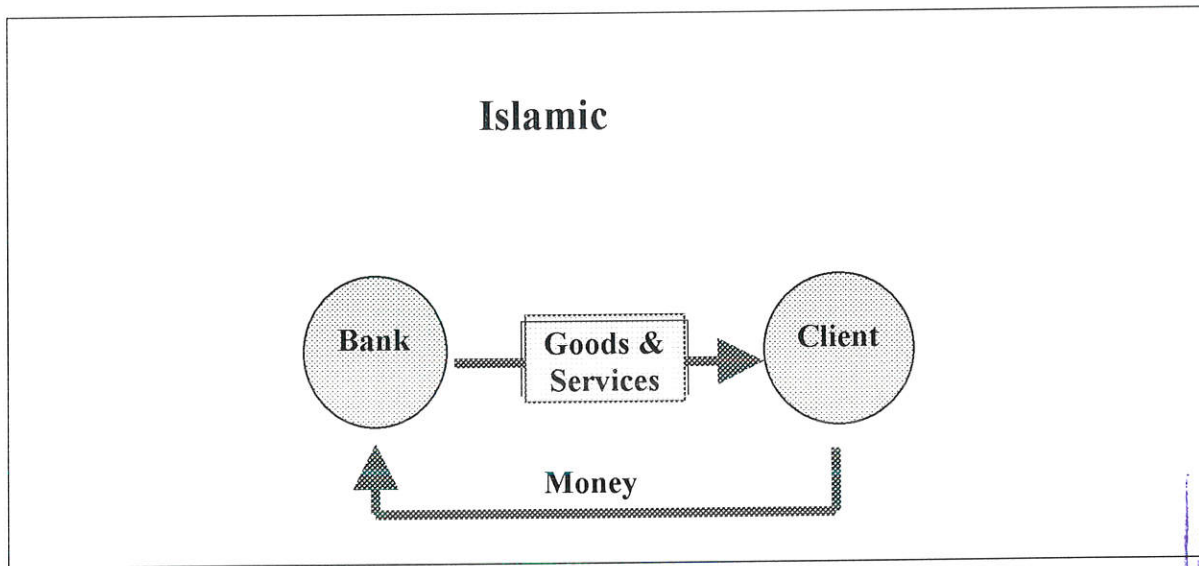
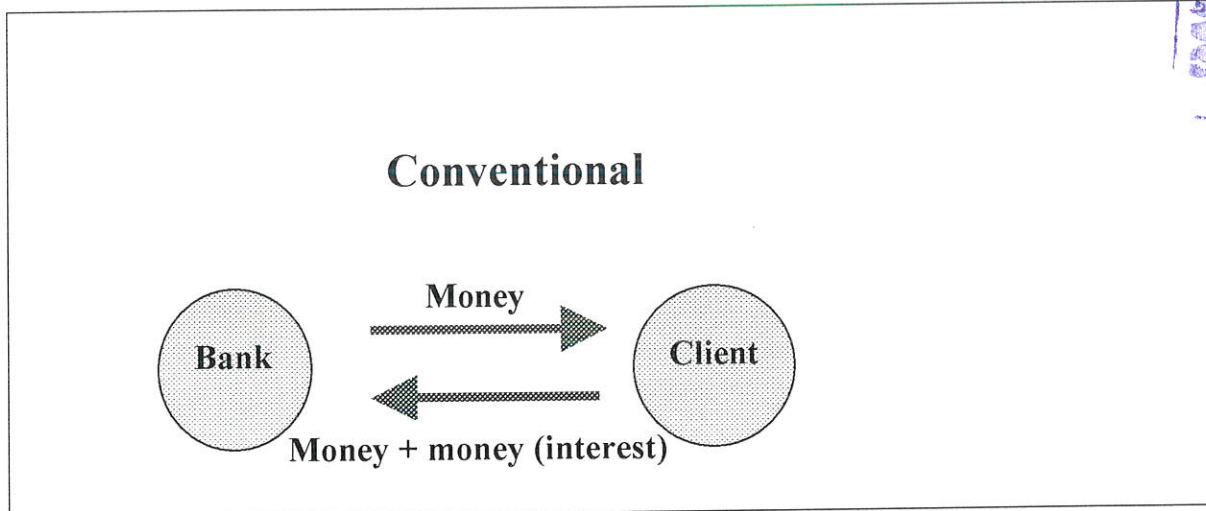


Figure 2.b)



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Table 5: A Simple Classification of Islamic Banking Using Financial Statements

Financial Statement items	CONVENTIONAL BANK	ISLAMIC BANK
<b>Panel A: Performance of a bank</b>		
<b>Profit &amp; Loss</b>	Net <i>interest</i> income Financial services income Capital gains Less -Operating expenses -Amortization of goodwill -Charge for doubtful loans = Gross Profits - Income taxes = Net Profits	Net income ( <i>profit shares</i> ) <sup>a</sup> Financial services income <sup>a</sup> Capital gains Less -Operating expenses -Amortization of goodwill -Charge for doubtful loans = Gross Profits <sup>a</sup> - Income taxes = Net Profits <sup>a</sup>
<b>Panel B: Financial Position of a Bank</b>		
<b>Balance Sheet</b>		
Assets:	Loans and Advances (after provisions for NPL) Fixed assets Total Assets Total Risk-weighted Assets <sup>c</sup>	Loans & Advances <sup>b</sup> (after provisions for NPL) Fixed assets Total Assets Total Risk-weighted Assets <sup>c</sup>
≡ Liabilities and	Deposits & other borrowing Bonds, notes & subor debt Floating Rate Notes Ordinary Shares	Deposits & other borrowing Bonds, notes & subor debt <sup>b</sup> Floating Rate Notes <sup>b</sup> Ordinary shares ( <i>musharakah</i> )
Shareholder capital	Equity instruments Total Equity	Equity instruments Total Equity ( <i>musharakah</i> )

Source: Monash Business Review Volume 3 Issue 1 – April 2007 5

<sup>a</sup> Income earned by an Islamic bank is from profit-shares, services fee and the excess over all expenses.

<sup>b</sup> Can be any or all of: profit shares (*mudarabah*); cost plus services (*murabahah*); joint-venture (*musharakah*); safekeeping (*wadiah*); and leasing of assets (*ijarah*).

<sup>c</sup> This refers to the requirement of both conventional and Islamic banks to risk-weight the assets as per Basel I or II accord. These accords at the Bank for International Settlements (BIS) in Basel Switzerland requires that the value of assets are adjusted downwards by a



system of risk evaluation of the assets so that the adjusted figures could then be compared as assets adjusted to account for risk.

A conventional bank reports net income on loans net of interest paid to the depositors and loan capital providers. An Islamic bank does not accept or pay interest but reports net income from profit-shares agreements (see footnotes "a" and "b" to the Table for the Islamic bank terms used) and fee incomes from sale-like or lease-like or banking services fees. Profit share income may be from different forms of lending (more correctly financing) activities such as

profit shares (*mudarabah*) or joint-venture (*musharakah*) or some specialized form of financing not described here. Or it may be from services fees for safekeeping (*wadiah*), cost plus services (*murabahah*), and leasing of assets (*ijarah*).

Continuing the other items in the Panel A, all items are similar, but for the exception we have noted that the entire report is conditional on income reporting that (i) avoids interest, (ii) financing activities that are not in the long-term interest of society (no funds for liquor production for consumption, no gambling, etc.) and (iii) prohibitions of financial products with extreme information asymmetry bordering near gambling, hence dangerously risky as an investment. Looking at the balance sheet in Panel B, the Islamic bank would have the same type of entries (the actual items will have some technical terms equivalent to them). Deposits and other borrowings would mean that these borrowings are consistent with the three principles discussed earlier: for example a bank may hold a bond, and but it is called a *Sukuk* bond as it is issued with no pre-agreed interest coupons as is the case in conventional bonds that offers a pre-agreed interest payment. There are finer points to consider here. The issuer of *Sukuk* (say a central bank) has some real assets, which provides

periodic rental incomes, which income is then used to provide returns to the investor in a *Sukuk* bond. Similarly, the equity may be referred to as the *musharakah* fund but it means exactly the same as equity.

The identical nature of the column entries to explain the terms in Table 1 for the conventional and the Islamic banks may convince once again that the latter is a newer form of banking. As such it is yet another specialized bank offering newer products in the same way as investment banking started to offer opportunities for securitization of assets some decades ago. Newer forms of banking fulfill the demand by clients who would not otherwise participate in the banking activities of a typical conventional bank. Islamic banks provide for their clients secular satisfaction that their financial activities is carried out in a manner that is socio-ethically consistent with their beliefs of avoidance of interest (*riba*), pro-societal financing (non-*haram*) and avoidance of extreme risk (*gharar*). The nature of profits therefore takes a different form from than the pre-agreed, pre-fixed, non-risk-shared rewards that has been promoted by the financial institutions for four centuries.

### **3.6 Requisites of Islamic Banking**

Islamic banking can be practiced more effectively in an environment, which conforms to the tenets of Islam. Thus there are some essential requirements for a successful Islamic banking, such as:

- i) Supportive Legal Framework and Swift Judicial System: An effective legal framework ensuring speedy justice is essential for a good society, it is more so for the success of

Islamic banking, because its investment risk is more than that of a conventional interest-based bank as its dealings are on profit and loss basis.

- ii) **Disciplined Entrepreneurship:** It would minimize cases of malfeasance and mismanagement. Besides, a banker must extend from being merely a financier to a role-player in business. Although a Murabahah transaction in Islamic banking does provide an opportunity to a banker to share in business, the Islamic banks generally limit themselves to being inactive partners for their credit risk only. The real entrepreneurial role of an Islamic bank needs, therefore, to be increased.
- iii) **Conceptual Change from Credit Risk to Overall Risk Management:** While it is difficult to predict, with any degree of certainty, the operating results of an enterprise and the magnitudes of profit and loss, all the same, it seems unjust if the party providing the capital is guaranteed a fixed and predetermined rate of return, and the other party undertaking the enterprise is made to bear the uncertainty alone. Under the circumstances, an Islamic banker has not only to focus on credit risk but also to view all the business risks of the enterprises in which he has invested the bank money.
- iv) **Strong Ethical Values:** The Islamic economic system offers a balance between the two extremes of public or social and private or individual ownership of property. The success of Islamic banking in a society is related to the extent of acceptability of the doctrine of trusteeship and transformation of the self-interested and profit-oriented behavior of people into an altruistic and value-oriented behavior.
- v) **Supreme Shari'ah Council:** The function of Shari'ah Council in maintaining Islamic banking activities in a country within the orbit of Islamic injunctions is dependent on its legal status and the extent of implementation of its opinion.

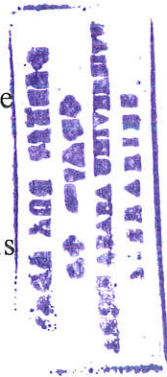
The opinions of Shari'ah Councils of different countries may not necessarily be uniform. There is, therefore, a need for a Supreme Shari'ah Council representing Muslim community all over the world to decide about various issues confronted by Islamic banks. A beginning has been made in this direction by establishing the Council of the Islamic Fiqh Academy at Jeddah, Saudi Arabia under the auspices of the Organization of Islamic Conference (OIC) but its role has to be augmented.

vi) Uniform Accounting Standards: there is need for harmonization of financial reporting of Islamic banks in respect, particularly, of the following;

- a) The significant accounting policies on which the statements are based should be fully and clearly declared,
- b) The methods of translating foreign currency transactions would be appropriately disclosed,
- c) Appropriate and sufficient disclosures regarding the quality of banks assets is of much concern to the depositors,
- d) Additional disclosure of the nature of the financial contingencies and commitments (Non Funded Liabilities) of the banks in their financial statements.

vii) Committed Management: If the management of a bank is determined to step into the business of Islamic banking, it can easily evolve a strategy for the same, formulate a plan for a specific time - frame and implement it accordingly.

viii) Progressive and Modern outlook: In order to ensure successful management in Islamic banks, There is need to apply all the available modern tools of managing corporate



business, including management of human assets, offices, information resources, marketing etc.

- ix) Body to Evaluate Islamic Financial Institutions: In order to ensure quality and standard in management of Islamic financial institutions and to build confidence of the general public in Islamic banking, there is need to establish some professional body responsible to define professional standards and ethics and other aspects of Islamic financial institutions. It may also certify the level of financial health of such institutions. (Hussein 1994 pp 7-13)

### **3.7 Sustainability of Islamic finance**

Prospects for sustainability of Islamic finance appear promising, but there are associated challenges which need to be concurrently addressed while one exploits and maximizes the opportunities created by this discipline.

First, the sustainability of Islamic finance stems from recognition that Islamic economic and financial architecture has a lot of appeal and depth going beyond Muslim countries. While initially conceived to be solely anchored on Riba free interest rate regime, there is now appreciation that advocacy to move to Islamic business and finance structure – whether on religious or social grounds – is not a “slogan” or mere religious pronouncement or condemnation of Riba but is supported by a complete and deep Islamic ideology. When studied carefully, it has its logic and basis in a comprehensive Islamic economic system which deals with allocation of resources, production and exchange of goods and services and distribution of wealth – all too familiar debates in conventional economic textbooks.

Second, the confidence in sustainability of Islamic economic system emerges from the better understanding that this economic system is a well conceptualized, consistent and



integrated framework. More interestingly, it is accompanied by a rich and an elaborate set of tenets which, among others, recognize the right to property supported by elaborate obligations for stakeholders, principles and rules of conduct, a contract system and institutional framework and procedures for enforcement of rules which all together lay the foundation for Islamic business and financial architecture. It is this substantive Islamic ideological and legal framework, governed by Shari'ah injunctions and principles that have translated into defining the public and private economic and social affairs that eventually help frame the business and financial relations. The core of these relationships is backed by solid principles of contracts, rights and obligations of parties to the contractual arrangements.

Third, the sustainability of this system is reinforced by the business and financial relations that are guided by the logically defined emphasis on the preferred modes of transaction which advocates profit sharing and as such relies on "ex-post" variability rather "than ex ante" fixity in returns and consequently has built in risk sharing as a central element of transactions. Relevance of contracts is at the core of Islamic transactions which define the rules of game for sale and purchase/trade/exchange of goods and services. Financing contracts are than structured around the nature of transaction which could be either in the form of trade financing; asset based financing or different forms of partnerships. Under Islamic finance preference is given to trading of physical assets as well as trading of rights.

Fourth, the confidence in sustainability emerges from the framework of enforcement implicit in Islamic system. The main driver of enforcement of contracts and rules-compliance in Islamic system is ideology and faith which is in turn influenced by Islam's emphasis on establishing an equitable, ethical, just, and fair socio-economic system. It is

this feature which shapes up Islamic finance and also distinguishes it from the conventional finance. Although one can argue that sustainability of interest in Islamic Finance is tied solely to the response of Muslim population to their religious values and beliefs, but it has to be recognized that attraction in this discipline is now widely emerging as there is better understanding of Islamic economics and finance and mechanisms are being found to juxtapose the knowledge of conventional economics and financial

### **3.7.1 Challenges forwarded from critics and responses**

Mirakhor (1988) has summarized the challenge came from western analysts who suggested the folly of adopting such a system and their arguments in six propositions:

- that zero interest meant infinite demand for loanable funds and zero supply;
- such a system would be incapable of equilibrating demand for and supply of loanable funds;
- with zero interest rate there would be no savings;
- this meant no investment and no growth;
- in this system, there could be no monetary policy since no instruments of liquidity management could exist without a fixed predetermined rate of interest; and, finally,
- This all meant that in countries adopting such a system there would be one way capital flight.

By 1988, this challenge was met when research, using modern analytic financial and economic theory, showed that:

- A modern financial system can be designed without the need for an ex ante determined positive nominal fixed interest rate. [In fact, it had been shown by western researchers that there was no satisfactory theory that could explain the existence of a positive nominal ex ante interest rate];
- Moreover, it was shown that not assuming a nominal fixed ex ante positive interest rate, i.e., no debt contract, did not necessarily mean that there would have to be zero return to capital;
- The basic proposition of Islamic finance was that the return to capital would be determined ex post, and that the magnitude of return to capital was determined on the basis of the return to the economic activity in which the funds were employed;
- It was that expected return which determined investment;
- It was also the expected rate of return, and income, which determined savings. Therefore, there is no justification for assuming that in such a system there would be no savings and investment;
- It was shown that in such a system there would be positive growth;
- That monetary policy in such a system would function as in the conventional system, its efficiency depending on the availability of instruments which could be designed to manage liquidity;
- Finally, it was shown that, in an open-economy macroeconomic model without an ex ante fixed interest, but with returns to investment determined ex post, there was no justification to assume that there would be a one-way capital flight.

Therefore, the system which prohibited a fixed ex ante interest rate and allowed the rate of return to capital to be determined ex post, based on the returns to the economic activity in which the funds were employed, was theoretically viable.

In the process of demonstrating the analytic viability of such a system, research also clearly differentiated it from the conventional system. In the conventional system, based on debt contracts, risks and rewards were shared asymmetrically with the debtor carrying the greatest part of the risk, and with governments enforcing the contract. Such a system had a built-in incentive structure that promoted moral hazard and asymmetric information requiring close monitoring whose costs could be managed if monitoring could be delegated to an institution which could act on behalf of the collectivity of depositor/investor; hence the reason for existence of banking institutions.

Based on what was known then and in the absence of an analytic framework recognizable by modern economic and financial theory, most western observers and commentators began to refer to Islamic banking and financial system as a "zero-interest" system, by which they meant "no return to capital". I recall when the Islamic Revolution of Iran succeeded and its leaders and economists declared they wished to eliminate Riba from their economic system, western media, including the BBC and the Wall Street Journal, commented on the impossibility of such a system referring to the thinking behind it as "voodoo economics".

### 3.8 TYPES OF ISLAMIC BANKS

The Islamic financial institutions did not start to develop until in the mid 1970s. According to Archer, three main reasons caused the late development. First, political independence was achieved in those nations during 1950s and 1960s. Second, awareness of an Islamic identity was rising. Thirdly the wealth grew in the Middle Eastern countries, due to their oil production which caused a great need for financial intermediation. Conventional financial institutions mainly outside the Middle East and Islamic countries handled the investments of the so called petro-dollars. (Archer et.al.2002)

Different categories of Islamic banks

There are five categories of Islamic banks (Al-Omar et al 1996 p22)

- The Islamic development bank
- The banks which operate in countries where the whole banking system is overseen in some way by religious bodies (like in Pakistan)
- The banks which operate in Muslim countries and which co exist with interest based banks (for example in Jordan, Egypt, Malaysia)
- Islamic banks in non-Muslim countries whose monetary authorities do not recognize their Islamic character (like the al Baraka international bank in London and the Islamic bank in Durban, south Africa)
- Islamic banks which exist in non-Muslim countries whose monetary authorities do not recognize their Islamic character (for instance the Faisal International bank (FIB) based in Copenhagen, Denmark registered under the Danish Banking supervisory Board)



## Chapter Four

### 4.1 Analysis of data and Discussion

Respondents profile shows us that almost half of them are bachelor degree holders and less than 20% are under 12 grades. 90% of respondents were male and only 10% were females as shown in the table 7 below. when we see the distribution of ownership and management owner managers are more than 60% follows owners and only as few as 10% are employed managers.

Respondent companies legal status reveal that sole proprietors come first following PLC and Incorporated with 60%, 35% and 5% respectively.

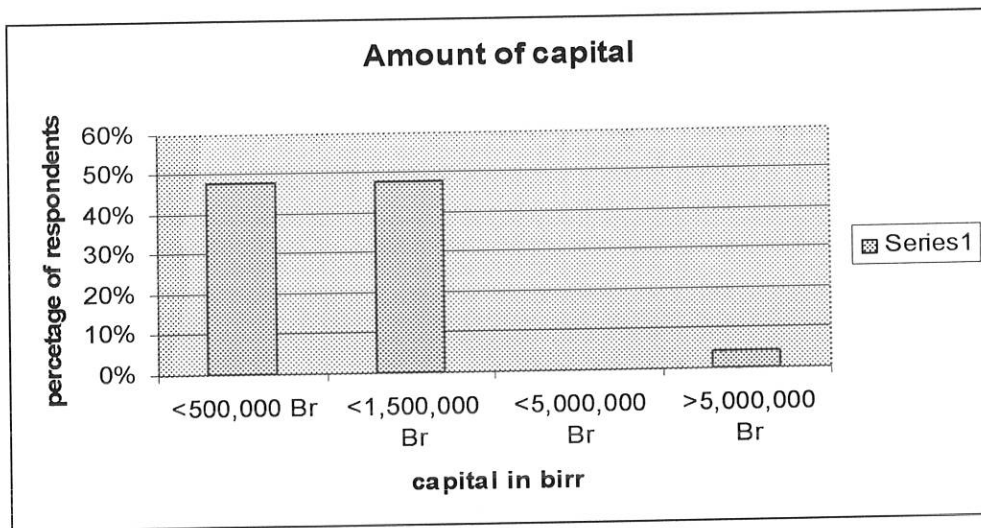
Table 7. Education level and legal status of respondents.

Education level	Below 12 <sup>th</sup> grade	Diploma	Degree
%of respondents	20%	30%	50%
Legal status of respondent's	Sole proprietor	PLC	Incorporated
%of respondents	60%	35%	5%



The distribution of capital invested as fig. 2 below shows that among respondents whose capital amount exceeding 5 million birr and above accounts only to 4%.while respondents who invested below 1.5 million accounts for the rest of balance i.e. 48% of respondents are with in the range of 1.5 million to 500,000 and the remaining 48% lie below 500,000 birr.

Fig.2 amount of capital invested



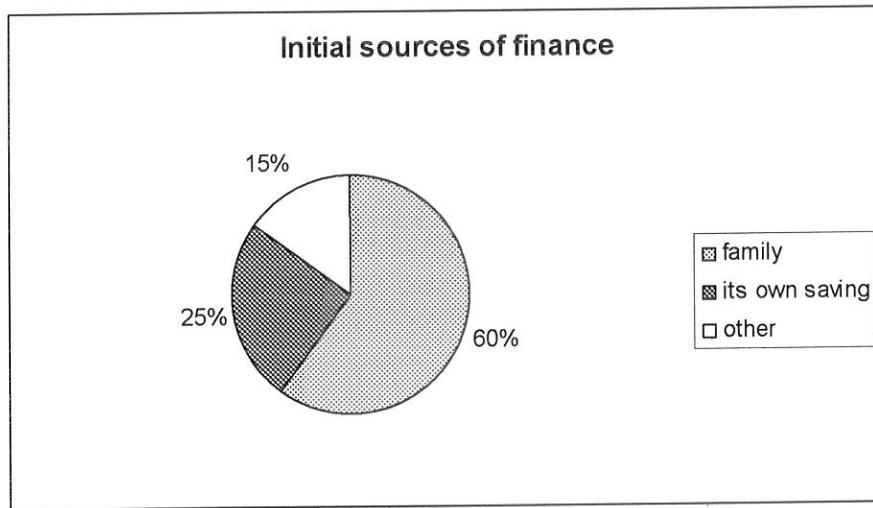
Most of the respondents have been in business for more than 5 years.

After having description about the profile of the respondents, let us see other important issues about financing and other bank related services.

The questions addressed to the respondents and their answers are summarized below.

The response for the question, “what was your source of finance when you started business?” as can be clearly seen from the fig.3 below, most of the respondents 60% said that their source of finance were their families.25% said that the source was their own effort and saving. The remaining 15% from various sources like share holders contribution in case of incorporated. There is no single respondent who started its business through bank loans.

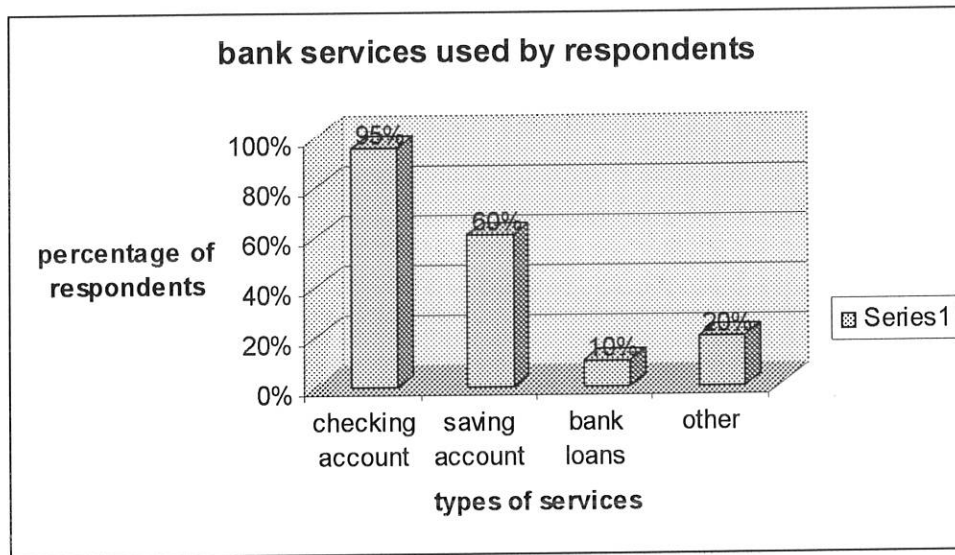
Figure 3. Initial sources of finance



This probably shows that in Ethiopia banks are not supporting at the start of business for new entrants with financial problem. Another issue which will be discussed later is Muslims avoid dealing with interest. For this reason they opt to other sources of funds mainly to their family, if available.

As it can be seen from fig.4 below 95% percent of the respondents have used bank services one way or another. Most of them used bank services like checking account (95%), saving account (60%) bank loans 10% and almost all money transfer services from the existing banks.

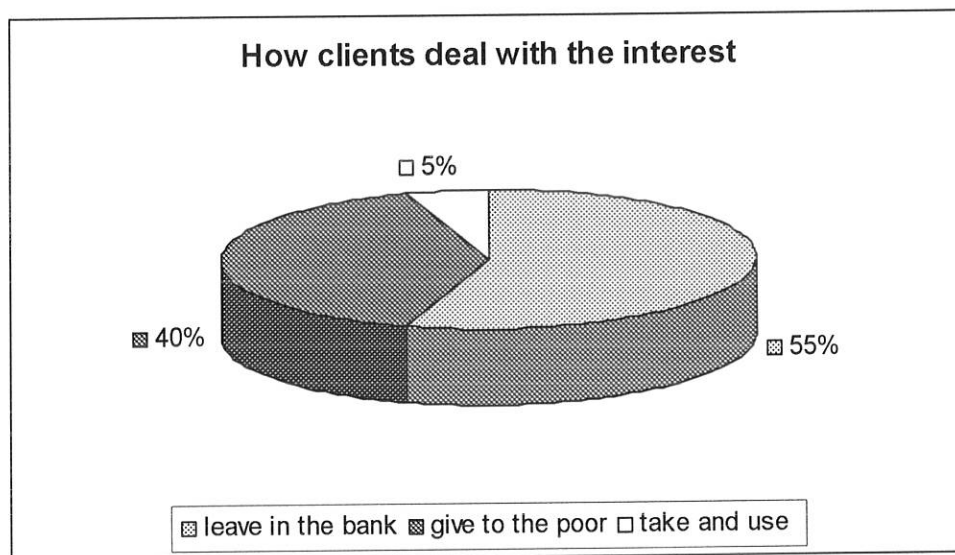
Figure 4. Banking services used by respondents



This indicates that business is closely interrelated with finance institutions.

Asked how they deal with the interest accruing from their saving accounts, as shown in figure 5, 55% of the respondents who have saving accounts said that they leave it in the bank the other significant minority 40% said that they take it away and give it to the poor. Only 5% of the respondents said that they take the interest and use it.15% of the respondents hold interest free saving accounts in the bank. From this figures we can see that most Muslims do not have halal alternative. Further more they are not getting return on their savings just because of absence of Shari'ah adhering banking system

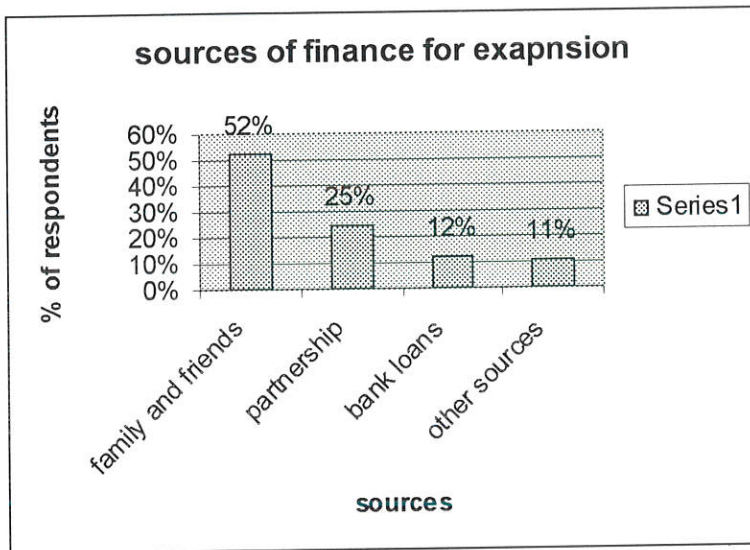
**Figure 5. How respondents deal with the interest.**



Interest income is not acceptable by most Muslims.

More than half of the respondents opt to seek finance for their business expansion from families and friends while 25% respondents have preference for partnership with others to fill the gap for their financial need at the time of business expansion. 12% of respondents said that they will use bank loan for the expansion purpose. The remaining 11% said they will finance their business through traditional institution like 'Equb' and other mechanisms.

Figure 6 sources of finance for expansion



The response about the interest rate shows that most of the respondents do not believe that the interest rate is fair. With reference to table 6, this accounts for 56% of the respondents. 40 % of the respondents said that the interest rate is fair. The remaining respondents said that it is difficult to say fair or not because they do not know the prevailing interest rate in the conventional banks.

**Table 8. Respondents' perception of interest rate**

Fairness of interest rate	Unfair	Fair	Do not know
% of respondents	56%	40%	4%
About bank service	Satisfied	Unsatisfied	No response
% of respondents	58%	33%	9%

Table 8 shows that 58% of respondents described the bank services as unsatisfactory. Their response for the causes of dissatisfaction of customers includes:-

High service charge, inefficient service, lack of Shari'ah adhering banking products, backward and time consuming processes especially in government owned banks and also lack of latest banking technologies applied in other developed countries. 33% of respondent are satisfied with the banks' services.

The awareness level of the Muslim business community concerning Islamic banks indicates that most of them do not know how Islamic banks operate and also the range of products provided by such Shari'ah compliant banking system. According to the table 9 below, 50% of the respondents do not know about Islamic banking except that it is interest free. 20% of respondents do not know at all about Islamic banking.

30 % of respondents stated that Islamic banking is all about risk and profit sharing and also does not involve interest . They have also said that Islamic banking is fair and practical.

**Table 9, Respondents knowledge of Islamic banking**

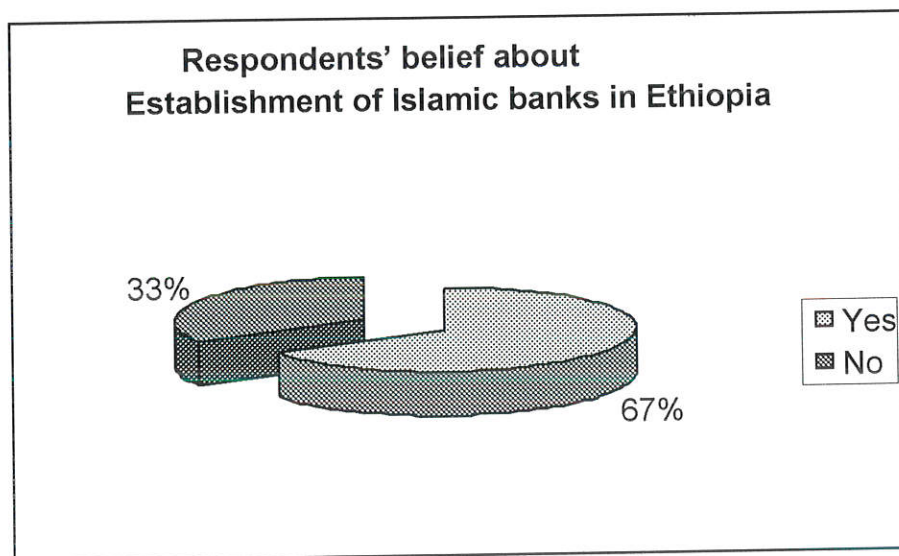
Knowledge about Islamic banking	Islamic banking is just interest free banking	Islamic banking is interest free and also PLS system	Do not know
%of respondents	50%	30%	20%

From the fig. 7 we can observe that more than 67% of the respondents have beliefs that Islamic banking can be established in Ethiopia. The remaining 33% of the respondents see that it is not possible to establish Islamic banks .Ascribing the hindrances to various reasons. As mentioned earlier, most respondents see the possibility of this institution but the minority of the respondents attributed the obstacle to government policy, lack of

awareness of Muslim community and lack of initiative from Muslim investors and scholars. Among the factors they have stressed are lack of initiation and lower awareness level of Muslim communities about Shari'ah compliant banking.

One grave concern addressed by the respondent is that lack of professionals in the Islamic banking sector.

Figure 7. Respondents belief about establishment of Islamic banks in Ethiopia



All respondents have said that if Islamic bank is established, financial problems Muslim businesses encounter can be solved. Here we can say that there is great need and aspiration about Islamic banks among Muslim merchants. As they unanimously responded positively about Islamic banks potential to tackle financial difficulties and problems.

The other important input to substantiate the above statements is the response given for the question “what would be you role if Islamic banking is established” .all of the respondents are interested to be a customer of Islamic banking. not only that 60% of the respondents said that they will encourage others to use Islamic banks services.50% percent of the respondents said that they will purchase shares of Islamic banking in addition to using

services. Should the respondents materialize their words, there is big opportunity for Islamic bankers.

Most recommendation provided by the respondents, favors establishment of Islamic interest free banks. Their response includes the following

Necessity of Islamic banking as most Muslims want to adhere to their religious code at the same time they want to participate in various development efforts that are undergoing in the country. Most of the respondents mentioned that the major obstacle to further their efforts in the investment is lack of Shari'ah adhering financial intermediation.

They have listed many advantages of interest free banking such as describing it as fair, practical and societal oriented. Particularly inability to repay the loan caused many of the investors out of market. Failure to repay the loan, according to the respondents, is attributed to the higher interest rates which the conventional banks charge their customers. According to the respondents this fear will successfully eliminated as there will be profit and loss sharing mechanism in Islamic banking institutions. The respondents main concern is that Muslims who want Shari'ah compliant financial services are not provided the service to date.



## 4.2 Summary

Islamic banking may have fertile ground as most of the respondents are keen to use its products and also to buy shares of the bank if established.

Most of the respondents are not satisfied with the conventional banks as they do not provide shar'iah compliant banking services. Merchants lack confidence to deal with the banks for the fear of bankruptcy. I.e. when firms go bankrupt banks confiscate the collateral and leave the investor or merchants in a miserable condition.

More than 95% of respondents do not accept interests as Islamic law strictly prohibits. This fact is very important for potential investors in the banking area and also government policy makers so as to devise mechanism which is acceptable and viable both for investors, bankers and government as well.

The comments forwarded from the respondents are very comprehensive and convincing. As shown chapter 2 and chapter 3, there is definitely special character and role for Islamic banks to exhibit and play under conducive policy environment. Particularly Islamic banks are mostly inclined to investment and development activities which are very crucial and essential for developing nations like ours.

Awareness level of Muslim community is not as such encouraging which requires highly concerted effort to educate the mass and promote Islamic banking is well established in many countries as we have seen from previous parts of the paper, but locally the community is not aware of it. This may pose challenge but can be solved with aggressive promotion and also integrating it with formal finance courses.

Lack of professionals in the area is also one impeding bottleneck which needs to be addressed with priority. As indicated by the respondents this problem can be solved with short training at the operational level.



## Chapter Five

### 5.1 Conclusions

From the discussions we have seen so far, there is compelling need for the establishment of Islamic banks. Islamic banks can cater to the diversified needs of customers. It is important for institutions to understand the dynamics of customer segmentation build customer relationships and address requirements and preferences of specific segments of the market. Banks must be able to deliver personalized and customized financial solutions for various segments of customers. Particularly, banks need to consider at least opening Islamic windows if not full fledged Islamic bank services

Islamic banking, which is practiced in more than 400 institutions with more than 60 countries worldwide, is worth considering for the development of efforts undertaken by different role players as it is proven to be a viable financial intermediation channel in supporting economic growth

It is also important that financial institutions invest in new products to meet Islamic customer needs and demands

Among the impeding obstacles that may hinder quick establishment and operations of Islamic banks are: lack of awareness among about Islamic banking products ,lack of highly skilled Islamic banking professionals, at introduction level with Islamic banking expertise and so a solution could not be found immediately to the issues that may arise, policy problems if the government is not willing to show green light for such institutions, lack of education centers for Islamic banking and financial products ,operations and the like .

Despite the fact that there are challenges as mentioned earlier, Islamic bank can be established in Ethiopia for a number of reasons. From the analysis part we have seen that all of the respondents have said that they will become customers of Islamic banks if they are established. Further more, significant percent of the respondents said that they will buy the shares of Islamic banks upon establishment. This can be simply translated as there is great demand for Islamic bank products, there are ample numbers of investors who are willing to invest in Islamic banking industry if all favorable and conducive environment is created. The fact that most Muslim customers do not take interest from saving is also evident that if they are provided with halal alternative investment they will use the opportunity since Islam do not prohibit profit seeking.

There is positive attitude towards Islamic banking even if the awareness about its various products is minimal. This positivism may have arisen due to avoiding of interest, and profit and risk sharing characteristics of the banking.

The survey indicated that most of the respondents are not well acquainted with Islamic banking products or services, so there is great need to develop an effective communication plan that goes beyond just marketing and advertisement to ensure the populace is aware of how Islamic banking products operate. And also policy makers need to understand pros and cons of Islamic banking.

Islamic banking provides significant untapped business potential for investors.

As many authors in the field of Islamic economics stated, Islamic banking is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. This feature of the institution has tremendous contribution for the development of new ventures which may not have large assets for collateral. This character of the bank also encourages creativity and innovation since criterion for the selection of the projects is not the size of collateral but the viability and profitability of the project proposal.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

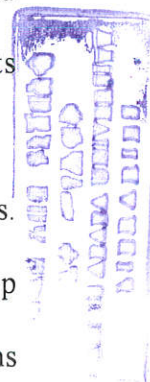


## 5.2 Recommendations

- ✓ Islamic bank, which basically works under the scheme of profit and loss sharing, should be established to cater divergent needs of different customers particularly those who do not want to deal with interest.
- ✓ Government offices with the mandate of devising regulation and policy makers should facilitate possibilities for all financial institutions to create Islamic windows and/or which undertake equity financing subject to strict compliance with the *Shari'ah* rules.
- ✓ Government should give more action oriented concern for this agenda besides economic feasibility as it represents the interest of significant segment of the population. Government's role, as it claims, is to bring about equitable and balanced development for various segments of the population, the interests of Muslim population needs to be addressed appropriately.
- ✓ Much effort is required to create better product awareness and overall acceptance of Islamic banking which would benefit the Islamic banks, investors and the society at large.
- ✓ To solve the problems related with lack of adequate and competent professional and skilled persons in the field of Islamic finance, those with finance background should be developed by providing them adequate and progressive training in the field of Islamic finance locally and also abroad through partnership with foreign universities, Islamic finance training institutions and Islamic development bank.
- ✓ There must be either independent institution with the responsibility of

- teaching Islamic banking and finance system
- conducting research activities in the area
- propagating it to the public by producing research articles and
- providing consultancy services for the Islamic banks and potential investors seeking to work with Islamic financial institutions
- or Islamic finance departments should be established .or it can also be incorporated as a course in the finance departments of private and public higher educational institutions.

- ✓ Much more Research activities covering wider section of the population and issues should be conducted to prove viability of the Islamic banking, its benefits and limitations in the present context
- ✓ One of the requirements of Islamic banking is Shari'ah boards/advisors. Although we may not have experienced domestic scholars we can develop existing scholars capability by providing them short training programs abroad particularly in those country who have accumulated rich experience in the field .not only their knowledge and capability but also government body's support and authorizations is essential for their special contribution.
- ✓ Should the government deregulate the banking sector further allowing foreign banks to operate, it will be an opportunity for many border crossing Islamic banks to exploit the untapped opportunities in the country. This may help knowledge transfer to Ethiopian bankers, professionals and investors as well.



- ✓ Islamic banking needs high level of support from the government particularly effective legal framework ensuring speedy justice is essential the success of Islamic banking, because its investment risk is more than that of a conventional interest-based bank as its dealings are on profit and loss basis.
  
- ✓ Management and operation of Islamic banks need high level of business skills, integrity, commitment and high level of ethical values in general. such qualities can be attained by having training institutions which can address and foster both spiritual and professional characteristics of individuals. All stakeholders in the Islamic banking and finance should strive to have such institutions for effective and smooth functioning of Islamic banks.
  
- ✓ Islamic scholars should lead the effort to establish Islamic banking institutions by providing or conducting research and developing proposals for the development of institutions by presenting nuts and bolts of Islamic banking products and operation. They should also champion the awareness creation programs among the Muslim community and the non Muslim communities as well.
  
- ✓ The last but not the least which needs to be clear is that Islamic banks are not meant to serve Muslims only. any person can use Islamic bank products

provided that it conducts businesses which are Shari'ah compliant or businesses which are not deemed haram (unlawful) such as alcohols, pork, gambling and the likes. Promotion of Islamic banking should also reach all potential users beyond the Muslim community.



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## Appendix 1

### Glossary

Definitions of the most commonly used terms in Islamic banking.

**Shari'ah:** Islamic law derived from three sources: the Quran; the Hadith (sayings of the Prophet Muhammad (PBUH)); and the Sunnah (practice and traditions of the Prophet Muhammad (PBUH).)

**Halal:** That which is permissible. The concept of halal has spiritual overtones. In Islam there are activities, professions, contracts and transactions, which are explicitly prohibited by the Qur'an or the Sunnah. Barring them, all other activities, professions, contracts, and transactions etc. are halal.

**Haram:** Unlawful; Transactions which are not permissible under Islamic law.

**Amanah:** Trust, with associated meanings of trustworthiness, faithfulness and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another's funds or property in trust. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. By extension, the term can also be used to describe different financial or commercial activities such as deposit taking, custody or goods on consignment.

**Arbun:** Earnest money/Down payment; a non-refundable deposit paid by the client (buyer) to the seller upon concluding a contract of sale, with the provision that the contract will be completed during the prescribed period.

**Fiqh al-Muamalat :** a set of Islamic rules governing transactions

**Gharar:** Uncertainty. One of three fundamental prohibitions in Islamic finance (the other two being riba and maysir). Gharar is a sophisticated concept that covers certain types of uncertainty or contingency in a contract. The prohibition on gharar is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.

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

**Ijara:** An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer. Ijarah wa iqtinah extends the concept of ijarah to a hire and purchase agreement.

**Maysir:** Gambling. One of three fundamental prohibitions in Islamic finance (the other two being riba and gharar). The prohibition on maysir is often used as the grounds for criticism of conventional financial practices such as speculation, conventional insurance and derivatives.

**Mudarabah:** A Mudarabah is an Investment partnership, whereby the investor (the Rab ul Mal) provides capital to another party/entrepreneur (the Mudarib) in order to undertake a business/investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The mudarib loses its share of the expected income.

**Mudarib:** The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investor's funds in a project or portfolio in exchange for a share of the profits. For example, a mudarabah is essentially similar to a diversified pool of assets held in a Discretionary Asset Management Portfolio.

**Murabaha:** Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over installments, the capital user has effectively obtained credit without paying interest.

**Musharakah:** Profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner. In a Musharakah, all partners to a business undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

**Riba:** Interest. The legal notion extends beyond just interest, but in simple terms riba covers any return of money on money - whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in the Islamic tradition.

**Shari'ah:** Islamic law as revealed in the Qur'an and through the example of Prophet Muhammad (PBUH). A Shari'ah compliant product meets the requirements of Islamic law. A Shari'ah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Shari'ah compliant products.

**Shari'ah advisor:** An independent professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the Shari'ah, or Islamic law. While some Islamic banks consult individual Shari'ah advisors, most establish a committee of Shari'ah advisors (often know as a Shari'ah board or Shari'ah committee).

**Shari'ah compliant:** An act or activity that complies with the requirements of the Shari'ah, or Islamic law. The term is often used in the Islamic banking industry as a synonym for "Islamic"—for example, Shari'ah compliant financing or Shari'ah compliant investment.

**Sukuk:** Similar characteristics to that of a conventional bond with the difference being that they are asset backed; a Sukuk represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the Sukuk.

**Ijtihad:** A technical term of Islamic law that describes the process of making a legal decision by independent interpretation of the legal sources, the Qur'an and the Sunnah.

**Istisna'a**:- is a sales transaction where a commodity is sold before it comes into existence. For example this mode of financing may be used for home financing where the client owns land and seeks financing for the construction of a house, the financier can provide him with a constructed house on a specified piece of land. The price must be fixed with the consent of all parties involved. All other necessary specifications of the commodity must also be fully settled. The payment of an Istisna'a may be made in advance or installments or in a lump sum at the end of the period.

**Salam**:- is a sales transaction where a commodity, usually horticultural or agricultural goods, is sold before it comes into existence. The price of the commodity must be paid in advance to make the transaction valid.

## Appendix II

ADDIS ABABA UNIVERSITY  
FACULTY OF BUSINESS AND ECONOMICS  
DEPARTMENT OF MANAGEMENT  
MBA Program  
Dear Respondents.

The purpose of this questionnaire is to collect information from Muslim businesses for a research purpose. So, be sure that there is nothing behind the study and all your responses will be kept secret (confidential). Hence you are kindly requested to fill the questionnaire given below. I thank you in advance for your cooperation.

1. Level of education.  
Below 12  Diploma  B.A degree  other
2. Positions:- owner  manager  owner & manger
3. Sex Male  Female
4. legal personality of the business firm  
a) Sole proprietorship                      b) partnership  
c) PLC    d) incorporated    Other, specify \_\_\_\_\_
5. invested amount of capital  
a) Less than 500,000    b) less than 1,500,000  
c) less than 3000,000    d) less than 5000000    e) Above 5,000,001
6. How long you have been in business?  
\_\_\_\_\_
7. What was your source of funds when you started your business?  
a) From family                       b) credit from friends   
c) Credit from banks                       d) from others sources \_\_\_\_\_
8. Have you ever used banks' services?  
Yes                       no
9. If yes what type of services



- a) Saving       b) Money transfer
- c) Loan       d) all  Other specify \_\_\_\_\_

10. If you have saving accounts how do you do with the interest?

- a) I leave it in the bank      b) I take and use it
- c) I give it away for poor      d) other, specify \_\_\_\_\_

11. If your answer for the q# 7 is no? why

- a) For religious reason       b) lack of knowledge about bank services

Other specify \_\_\_\_\_

12. If for religious reason what will be the solution for this?

\_\_\_\_\_

13. How many times you have taken credit services and from which source?

\_\_\_\_\_

14. If you need to expand your business what would be your sources of finance

- a) Bank loans       b) partnership with others
- c) loan from family and friends       d) from other sources, specify \_\_\_\_\_

15. Do you think that current interest rates charged by commercial banks are fair?

- Yes       no

16. If no what do you think about other alternatives?

\_\_\_\_\_

17. are you satisfied with the services of conventional banks

- Yes       No

18. If no, what are the causes of dissatisfaction?

\_\_\_\_\_

19. What do you know about Islamic banking?

\_\_\_\_\_

20. Do you think that Islamic banks can be established in Ethiopia

- Yes       No

21. If no, what do you think are the reasons that hinder its establishments?

- a) Government policy & regulation       b) Lack of awareness by Muslim society
- c) Lack of initiative by Muslim intellectuals and investors

Other specify \_\_\_\_\_

22. Do you think that Islamic banking will solve your problems? How?

Yes  No

\_\_\_\_\_

23. What would be your role if Islamic bank is established in Ethiopia?

I will own shares  I will be customer

I will encourage others to invest and use Islamic banking services

Other specify \_\_\_\_\_

24. What is your comment on banking in general and Islamic banking in particular?

\_\_\_\_\_



**DECLARATION BY THE CANDIDATE**

The MBA project on "Prospects and challenges of establishing Islamic banks in Ethiopia" is my original work. It has not been presented for a degree in any university and that all sources of material used have been duly acknowledged.

Addis Ababa

20 June 2008

Mahdi Jemal

Dr. Ulanganathan

Advisor

