

ADDIS ABABA UNIVERSITY
COLLEGE OF LAW AND GOVERNANCE STUDIES
SCHOOL OF LAW

The Regulation and Supervision of Interest-Free Banking in Ethiopia

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Addis Ababa, Ethiopia

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

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Declaration

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

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March, 2016

Preface and Acknowledgement

Hitherto, the western principles and laws have dominated the life of Muslims in different parts of the world. As part of the Islamic resurgence and revival of Islamic identity, the political freedom of the Muslim world from the western colonizers has opened the road for the actualization of Islam in the political, social and economic stand of the Muslim communities around the globe. The same kind of development has also been reflected in the field of economic transactions and financial dealings of Muslim populations. And due to the rising interest and attention from Muslim scholars of deferent periods, Islamic banking and finance has able develop rapidly during the years following its emergence until the current state of the art.

The development process of the Islamic economic and financial system has passed a lot of hurdles before reaching to present status, mainly owing to the dominance of the conventional financial industry that holds totally opposing values to the Islamic economic system. In the past 40 years, Islamic economics and finance had to encounter with the deeply rooted and widely accepted economic philosophy of capitalism.

The principles of Islamic economics are directly linked to the foundational concept of monotheism (*Tawheed* - oneness of God) of Islam which basically articulates that God has created the universe and man, and made man a vicegerent on earth.¹ Life of man on earth has got grand objectives to achieve through following the guidance of God in every aspect of his life. God has revealed His guidance from the time man has set his foot on earth up to the last nation of Prophet Muhammad. This guidance of God is revealed to human kind through prophets and messengers who are sent for every nation up to the last nation (*Ummah* - the community of Muslim believers) to whom Prophet Muhammad is sent with the speech of God i.e. the Holy Qur'an and the *Sunnah*². These two revelations of God constitute the primary sources for principles and laws governing the life of a Muslim in every sphere of life, not being limited only to spiritual and ritual matters, as in other religions.³

In fact, we see the Qur'an and the *Sunnah* laying down some foundational principles and some specific laws governing relationships in the society while leaving the wide area to be filled through *Ijtihad* (juristic reasoning). The same approach is reflected in Islamic economics and finance. We find only a handful of verses in the Qur'an regarding economic dealings and somewhat explanatory narrations thereof from the *Sunnah*. Hence, the jurists of the Sharia, since its emergence 200 years after the demise of Prophet (PBUH) up until the contemporary scholars, have been able to deduce the Sharia laws of wider perspective in the field of Islamic finance.

¹ Mustafa O. Mohammad and S. Shahwan, "The Objective of Islamic Economic and Islamic Banking in Light of *Maqasid Al-Shariah: A Critical Review*", *Middle-East Journal of Scientific Research* (2013), p. 76

² The term *Sunnah* denotes the prophetic actions, speeches and approvals in the discourse of *Uslul al-Fiqh* (Principles of Islamic Jurisprudence).

³ Taqi Usmani, *Introduction to Islamic Finance* (1998), p. 1, Available at: <http://www.freebooks4all.com/an-introduction-to-islamic-finance-by-mufti-muhammad-taqi-usmani/> (Oct., 2015)

In trying to understand the Sharia from the vantage point of finance and banking, the hierarchical authority of the sources must be kept, meaning that the Qur'an, the *Sunnah*, *Ijmae'* (general consensus of Muslim jurists) and *Qiyas* (analogical reasoning) comprise the first up to the fourth legal sources of the Sharia respectively. The secondary status of the latter two reasoning sources of Sharia i.e. *Ijmae'* and *Qiyas* indicates the evident superiority of Godly revelations over reason, as these sources are susceptible to fall into errors particularly when it is confused with 'human desire and instincts' which would result in destructive decisions in various political, social and economic issues of the society. Therefore, in an attempt to comprehend the principles of Islamic finance and other accepted practices, the necessary precedence to the higher norms and objectives of the Sharia (*Maqasid ash-Sharia*) must be kept.

I hope that this effort of introducing theoretical aspect of Islamic banking together with much emphasis on the regulatory and supervisory framework of interest free banking industry in Ethiopia would enhance the meager level of knowledge of its stakeholders mainly of the policy makers and regulatory authorities at the government level and the general population, and provide a fertile ground for further exposition of the literature and improvement of the regulatory and supervisory practice of interest free banking in Ethiopia.

I thank Allah, the Almighty, for His guidance and making me of interested in this rising contemporary study of the Sharia. I am grateful to my advisor Zekarias Keneaa (Associate Professor at the Law School of AAU) for his constructive suggestions in the course of researching on the topic of the thesis and writing of the report thereof. I also extend my gratitude to those who have kindly supported me through accessing me of the relevant data inputs at their disposal.

I ask Allah (SW) to make this humble effort, in His cause, to be informative and a source of guidance for those policy makers and supervisory authorities; to those who are interested to address further the untouched areas of Islamic Economics and Finance in Ethiopian context and to the public in general in one or another way.

وما توفيقي إلا بالله

Alyu Abate Yimam

Addis Ababa, Ethiopia

Nov, 2015

Table of Contents

❖ Preface and Acknowledgements	II
❖ Acronyms and Abbreviations	VI
Chapter 1: Introduction	
1.1. Background to the study	1
1.2. The Research Problem and Research Questions	2
1.3. The Objectives and Significances of the Study	3
1.4. State of the Literature	4
1.5. Methodology of the Research	5
1.6. Organization of the Study	6
Chapter 2: Introduction to Islamic Economics and Finance: A General Framework for Islamic Banking	
2.1. Introduction to the Economic System of Islam	7
2.2. Introduction to Islamic Finance: The Legal Framework for Interest Free Banking	10
2.2.1. Principles of Islamic Finance	10
2.2.2. Islamic Financing Products as Banking Products	12
Chapter-3: Islamic Banking: Overview of its Standard Modes of Operations	
3.1. Introduction to Islamic Banking	15
3.2. The Difference and Similarity between Islamic Banking and Conventional Banking	16
3.3. Overview of the Standard Modes of Operations of IBs	16
3.3.1. Introducing Islamic Standard-Setting Financial Institutions	17
3.3.2. The Core Standards of Operation	18
Chapter-4: Islamic Banking in Ethiopia: Analysis of the Regulatory and Supervisory Framework	
4.1. Introduction	22
4.2. Nomenclature of the Industry in Ethiopia	23
4.3. The Adoption of Interest-Free Banking in Ethiopia	25
4.4. Major Concerns after Adoption of the Industry	26
4.4.1. Compliance to the Sharia Principles and Standard Practices	26
4.4.2. Awareness Campaigns	27
4.4.3. Setting up Appropriate Dispute Resolution Forums	29
4.4.4. Suitable Regulatory and Institutional Atmosphere	29
4.5. The Regulation of Interest Free Banking Industry in Ethiopia	31
4.6. Supervision of Interest Free Banking in Ethiopia	34
Chapter-5: Conclusions and Recommendations	
5.1. Conclusions	37
5.2. Recommendations on the Regulatory Framework of the Country	38
5.3. Recommendations on the Supervisory Framework of the Country	39
5.4. What is expected from CBs Offering the Service?	40
References	
• Books and Articles	42
• Table of Laws	43
• Internet Sources	43
Annex	
• Directives to Authorize the Business of Interest Free Banking Number SBB/51/2011	

Acronyms and Abbreviations

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

AAU: Addis Ababa University

BCBS: Basel Committee on Banking Supervision

BCPs: Basel Core Principles

CBs: Conventional Banks

CBE: Commercial Bank of Ethiopia.

E.C: Ethiopian Calendar

FDRE: Federal Democratic Republic Of Ethiopia.

IAHs: Investment Account Holders

IBs: Islamic Banks

IFB: Interest-Free Banking

IFSB: Islamic Financial Service Board

IFSI: Islamic Financial Services Industry

NBE: National Bank of Ethiopia

PLS: Profit and Loss Sharing

PSIA: Profit Sharing Investment Accounts

PBUH: Peace Be Upon Him

SSB: (Sharia Supervisory Board)

SW: (*Subhanahu Wata'ala* - the Almighty and the Exalted)

UB: United Bank

Chapter-1

Introduction

1.1. Background

The fall of the Socialist *Derg* Regime marked the end of the command economic system that Ethiopia had experienced for about 16 years, and the market-led economy has put in place instead by the present FDRE government. Following this regime, most of the private business organizations that were nationalized during the Socialist governance are now being privatized, and the formation of private companies including a number of commercial banks competing in the financial market of the country has become the reality.⁴

The conventional banking system has dominated the world economy for hundreds of years. By and large, it has contributed to the growth of the world economy. Needless to say, the commercial banks, with the support of the modern insurance practices, have acted as the catalyst in the transformation of the agrarian economies into modern economies. However, over the last century, the weaknesses of the conventional banking system have been witnessed.⁵

An interest free banking system under the paradigm of Islamic Economics has been presented by the Sharia jurists as alternative to the traditional interest based banking system with the aim of curing the inherent problems of the latter. In fact, any shortcomings of the conventional banking are attributable to its foundational ideology of capitalist economy. Conventional Banks (CBs) that have been in operation for more than four centuries are nothing but the right hand and major instrument of enforcing the capitalist economic worldview of market-led economy. Hence CBs have exacerbated the weakness of capitalism which in general terms include widening of the gap between the rich and poor members of the community, unemployment, monopoly and inflation and economic inefficiency.

Coming to Ethiopia, as part of the new developments seen in financial system and banking sector of the country's market led economy, interest free banking business has come in to picture as a result of the FDRE government's policy decision which, in a nutshell, can be justified in light of the sector's potential of creating a suitable business atmosphere for the sizeable Muslim population of the country. The industry can also play a decisive role in channeling their financing transaction into the modern banking financial circulation at national level through the instrumentality of interest-free banking departments of the conventional commercial banks of the country.

Art. 22 (2) of the Banking Business Proclamation No. 592/2008 has preconceived the aforementioned policy of the government regarding interest-free banking business by authorizing

⁴ Solomon Abay, *Financial Market Development, Policy and Regulation* (2011), p. 1. Available at: <http://dare.uva.nl/document/216843> (Oct., 2015)

⁵ Ibid. p. 4

the National Bank of Ethiopia (herein after the NBE) to regulate the mobilization and utilization of non-interest bearing deposits by conventional banks. Based on this enabling provision of the proclamation, the NBE has enacted a directive for the authorization the conventional banks to undertake an interest free banking business which is titled as “Directives to Authorize the Business of Interest Free Banking No. SBB/ 51/2011” (hereinafter referred to as ‘the Directive’). The Directive requires those banks that wish to get license and carry on an interest free banking service to comply with the principles of Islamic finance and standard modes of operation and fulfill some other procedural requirements.

1.2. The Research Problem and Research Questions

For the country to achieve its goal of development and stability in the financial sector, the financial policies and laws should take the interest of its Muslim community which makes up the sizeable portion the country’s total population. Out of which, the large section apparently wants to do business without indulging in the interest based business deals in the banking transactions as part of their faith. The Muslim community, in fear of involving in interest-based transactions, is keeping its savings in unsafe places or involve in individual financial transactions avoiding the situation where the huge sum of money would get the chance to circulate through the modern banking routes at national level.

There has been a growing demand from the public for interest free banking products as attested to in the preamble of the Directive; and the government also has been recommended to introduce the industry into the financial system of the country in order to attract foreign investors who require such banking structure before investing their capital.⁶ Consequently, the government has adopted an interest free banking business and some regulatory and supervisory frameworks has been devised for the industry. This regulatory and supervisory exercise of the government can generally be characterized, on the one hand, by the recognition given to Sharia law (Islamic finance) and standard modes of operations as a legal and regulatory framework of the industry respectively, and on the other, the application of the default conventional banking regulations and supervisory frameworks on the sector. Even if the normative status of Islamic finance and the operational guidance of standard practices to interest free banking has not been denied by the Directive, the summary application of the conventional banking regulatory framework of the country on interest free banking sector, as well as the existing regulatory and supervisory gaps will pose a risk of Sharia incompatibility which is known as Sharia or reputational risk and might inhibit the effectiveness of Islamic windows.⁷ These regulatory and supervisory gaps in relation to the sector needs to be identified in light of the international operational and oversight standards of IBs and windows; and the necessary regulatory and supervisory redresses has to be

⁶ See: Abudulwasi’ Yusuf, ‘ወላይ አልባ ገንዘብ’ (2003 E.C), pp,108-110

⁷ Inwon Song and Carel Oosthuizen, “Islamic Banking Regulation and Supervision: Survey Results and Challenges”, IMF Working Paper No. 14/220 (2014), pp. 35-36. Accessed from: <https://www.imf.org/external/pubs/ft/wp/2014/wp14220.pdf> (10, Nov. 2015)

made so that a suitable legal atmosphere would be created for the development of interest free banking industry in the country.

Hence, the broad question of what constitutes the theoretical and legal regime of interest free banking which is present in Islamic economics and Islamic finance respectively needs to be explored. More importantly, the international standards of regulation and supervision of Islamic banking as developed by the standard setting institutions of Islamic Financial Services Industry (IFSI) at international level has to be examined so that they can serve as a ground for analyzing the propriety of the existing regulation and oversight structure of interest free banking in Ethiopia in light of compliance with the Sharia and its objectives in the realm of finance and banking.

Those being the general problem on which this study delves on, the specific questions that are addressed by the paper are the following:

1. What are the general economic and financial principles of Islam that serve as a guidepost for interest free banking in general?
2. What are standard regulations that have been developed in relation to Islamic banking by international Islamic standard-setting financial institutions?
3. What does the current stage of interest free banking in Ethiopia look like? To what extent does the regulatory and supervisory practice of interest free banking in the country conform to the rules of Islamic finance, regulatory and supervisory guidelines as identified by the institutional infrastructure of the industry at international level?
4. What reform measures need to be taken by the different stakeholders of the sector so as to harmonize the national standards with the best practice of Islamic banking from different perspectives?

1.3. Objectives and Significances of the Study

The CBs that are going to be involved in the business of interest-free banking service on the basis of the Directive have to mobilize or advance funds in a manner consistent with Islamic finance principles and mode of operation.⁸ This is a very broad guideline which falls short of providing even some of the basic principles of interest-free banking business and its standard practices except one of the cornerstone principles of Islamic finance i.e. the avoidance of paying and receiving interest and a very few modes of operation like segregation of funds of interest-free banking business from all other banking businesses.⁹

⁸ See: Article 2 (2.2) of Directives to Authorize the Business of Interest Free Banking Directives Number SBB/51/2011. Accessible at: <http://www.nbe.gov.et/>

⁹ Ibid., Article 4 (4.2)

The lack of detail regulation encompassing the principles of Islamic finance and modes of operation assumes the fact that both the supervising authority of the banking business in the country i.e. the NBE and the banks intending to involve or that are already authorized to offer the service has to equip themselves with the expertise of Islamic finance to bring the system in to reality. Therefore it is the objective of this thesis to introduce these principles of Islamic financing and the *Fiqh* (Sharia law) rules governing the financing products and services that are identified to be Sharia-compliant by the classical and contemporary jurists of the Sharia.

The Islamic banking industry is being internationalized through the convergence of Islamic banking regulations and modes of operations by the instrumentality of the standards setting institutions of the IFSI. The Islamic Financial Service Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAIFOI) are worth mentioning in this regard. The study, besides introducing these organs, draws major lessons from standards of operations for Islamic banking so that these would serve as a parameter to appraise the regulatory and supervisory regimes of interest free banking in Ethiopia.

After discussing the real practice on the ground from the perspective of the international regulatory and supervisory standards and best practices of Islamic banking, the study has the objective of finding the status quo, and identifying the shortcomings in the regulation and supervision of interest free banking business in the country; and it also suggests the improvements and measures that must be taken by various stakeholders mainly the NBE and the licensed CBs offering the service.

1.4. State of the Literature

The literature of Islamic Economics and finance can generally be classified in to two. The first category consists of that part of the literature focusing on the general theorization of Islamic Economics and Finance. The scholars in the field start to discuss the economic foundations of the Sharia in light of its Goals and Objectives (*Maqasid ash-Sharia*) through the different principles which would in turn serve as guiding posts for different branches of Islamic economics including Islamic finance and banking.¹⁰

Secondly, the most developed branch of Islamic economics, among others, is Islamic finance and Islamic banking. We find even a large number of writings on Islamic banking being analyzed in light of the wider principles of Islamic finance. The major themes of the literature are on how to offer the Sharia-compliant financing techniques through CBs or their subsidiaries or full-fledged IBs. The literature also gives emphasis on the globally accepted modes of interest-free banking operations as developed by the specialized institutions in charge of developing Islamic banking standards around the world.

¹⁰ Mohammad and Shahwan, cited above at note 1, pp. 76-77

There is a fairly large amount of literature on Islamic finance and banking that has been written by the classical and contemporary jurists of the Sharia. The discussion of Islamic finance which provides legal framework for interest-free banking is also part of the classical legal literature of the Sharia. But the intellectual venture of correlating Islamic finance with the modern financial market and banking structure is a recent phenomenon that didn't last for more than four decades.¹¹

When it comes to the Ethiopian experience, unlike the wealth of literature in respect of the theoretical, the legal, regulatory and enforcement regime of Islamic banking business outside of Ethiopia, there is only a single research paper that I know of which is written on the subject by a certain graduate of the Law School of Addis Ababa University named Abdulwasi' Yusuf.¹² This study is a kind of policy research that tried to pressurize the FDRE government to introduce interest-free banking business into the country's financial system so that the financial transactions of the Muslim population of the country would be channeled into its modern banking system; and to attract the international investors around the world especially those from the Gulf countries who need an interest free banking facilities to run their investment portfolios. It also tries to point out some prior legal amendments that should be made before introducing the industry.¹³ The thesis, being the first to research and bring the idea into attention, has brought up several points, though much has left untouched or not adequately addressed. To mention some, the research doesn't provide a general Sharia framework of interest-free banking which is present in the field of Islamic economics and finance; and a detail exposition of the *Fiqh* rules about financing products and services which is of course at the center of the business. The research also doesn't address the standards of regulations developed at the international level and concerned standard setting institutions of Islamic financial institutions.

Much later on, the NBE has come up with a Directive that makes interest-free banking a reality in the financial system of Ethiopia. After the policy change, however, not a single research or at least a manual has been prepared by the NBE or the respective CBs that have launched the service except some very brief pamphlets meant to reach the public about the banking products and services of interest free windows. Furthermore, the concerns or the issues that need to be investigated before and after the introduction of the sector into the financial market of one's country are obviously different. The fact that the FDRE government has taken a positive policy decision towards introducing interest-free banking business must bring about a new perspective of analyzing the subject matter. Hence, this study is following this path of post-adoption analysis of the industry; and tries to examine the adoption from the fresh light of explaining the principles of Islamic financing including the introductory investigation of the inclusive disciplines of Islamic Economics and Finance. The task of compatibility investigation will also be made by

¹¹ M. Kabir Hassan and Mervyn K. Lewis, *Islamic Banking: An Introduction and Overview*, Handbook of Islamic Banking (2007), p. 1; see also, Taqi Usami, *Introduction to Islamic Finance* (1998), p. 7

¹² The Thesis has been translated by the original writer into Amharic with the title: 'ወላድ አልባ ባንክ' (Interest-Free Banking) in 2003 E.C, and printed by Dire Printing SC.

¹³ Abdulwasi' Yusuf, 'ወላድ አልባ ባንክ' (2003 E.C), Dire printing SC, pp,101-122

trying to analyze the law of the Sharia and international Islamic banking standards together with the country's emerging practice of interest-free banking from various vantage points of regulation and supervision.

1.5. Methodology of the Research

The Methodology Employed is qualitative focusing on the legal policies and regulatory and enforcement issues of interest free banking in Ethiopia in that both the theoretical and legal frameworks of the interest-free banking and the efforts being made to regulate and supervise the industry are explored. There is good number of downloadable and online resources that can provide a sufficient explanation on the theoretical foundation and legal analysis of Islamic finance and banking as well as the regulatory standards of the international standard setting institutions of the industry. The major problem in this regard is to identify the authentic works in the field which are based on the authorities of Islam which might be difficult for a common reader to do the same without making deep investigation of the authentic works and the authors thereof in the discourse of Islamic finance and banking. So, this study has substantially used the few reliable textual works in the effort to summarize the ideologies, principles, legal rules and best practices of Islamic banking.

For realistic evaluation of the interest free banking services in Ethiopia, the necessary data has been collected from the different stakeholders of the industry. The one which is at the center of the planned data collection is that part of the executive organ of the Ethiopian government which is entrusted with the task of regulating and supervising the financial institutions i.e. the National Bank of Ethiopia (NBE). The interest-free banking practices of the Islamic windows and other related activities of the CBs in the country are also used as data input relevant for the exposition of the topic of the research.

In the process of collecting data from the aforementioned sources, interviews or questionnaires will be used as a means of data collection as the case may be. The documents at the banks' disposal that are related to their Islamic banking operation will also be consulted with a view to find any relevant data that will help explain the specific questions of this thesis.

1.6. Organization of the Study

The earlier introduction being the first, the second chapter of the research discusses the foundational notions of interest free banking existent in the rising paradigms of Islamic Economics and Islamic Finance. It takes some comparative analysis of Islamic ideology with other major world systems with respect to the economic problems of man. It also touches upon the principles of Islamic finance and the *Fiqh* rules for the financing modes as discussed in the classical and contemporary legal literature of the Sharia. The third chapter inquires into the main standards of operation developed for the industry by the contemporary jurists of the Sharia and the host of standard-setting international Islamic financial institutions. The third chapter of the paper delves into the realistic evaluation of the country's interest-free banking sector. The policy

of introducing and integrating Islamic banking into the country's financial system of the country; the compatibility of the regulatory and enforcement measures with the Sharia and the standard practices of the industry and other related issues will be discussed. The last chapter summarizes the study and draws conclusions. The measures that need to be taken by the concerned government organs and other stakeholders of the industry are also indicated.

Chapter-2

Introduction to Islamic Economics and Finance: A General Framework for Islamic Banking

2.1. Introduction to the Economic System of Islam

The science of Islamic finance and Islamic banking is a sub branch of Islamic Economics which is systemic in the sense that it is an order within the overall order of Islam.¹⁴ In other words, Islamic Economics provides a general theoretical framework for Islamic finance and banking, whereas Islamic finance is a legal framework of Islamic banking as will be discussed later in this chapter. That is to mean that Islamic Economics is one among other sciences of Islam that provides a general norms and objectives for the everyday financial and business activities of Muslims. Going back to the general economic principles, though it seems a little bit broader from the topic of the thesis, but it is vital as it is not possible to understand and comply with the principles of Islamic finance, or interest-free banking for that matter, without comprehending the foundational norms of Islamic Economics.¹⁵ So let's look at some of the basic principles of Islamic Economics in a comparative manner of analyzing the same economic framework with other major economic orders of the world.

As Islam regulates all aspects of life, and a Muslim cannot compartmentalize his life in to secular and spiritual life if he wishes to submit to Islam. This is because Islam has an astonishing broadness of laws that regulates every sphere of life. We find the same governing claim of Islam for economic activities and financial matters.¹⁶ Any business activity which is claimed to be in conformity with the Sharia has to meet the conditions underlined for the legality thereof including the banking business.

Economic activities in Islam are something encouraged and sometimes even obligatory upon man. Benefiting from the wealth of the world is the benevolence that God has bestowed up on humans beings. The difference in the point of view of Islam towards wealth with other economic systems like capitalism and socialism is that economic prosperity is not the be-all and end-all of human life. The Islamic outlook of this life (*Dunya*) is as a means to another grand objective of life i.e. sublimity of character and conduct, and success in the next life.¹⁷

In Islam, the wealth of the world and the real right of property over wealth rests upon God and humans are mere agents holding the secondary right of property over wealth meaning that man is

¹⁴ Mehmet Asutay, "A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System", *Kyoto Bulletin of Islamic Area Studies* (2007), p. 3. Accessed on 15, Nov, 2015, from: http://www.asafas.kyoto-u.ac.jp/kias/1st_period/contents/pdf/kb1_2/04asutay.pdf

¹⁵ Ibid.

¹⁶ Latifa M. Algaoud and Mervyn K. Lewis, *Islamic Critique of Conventional Financing*, Handbook of Islamic Banking (2007), p. 38

¹⁷ Muhammad Usmani, *Meezan Bank's Guide to Islamic Banking* (2002), p.13. Accessed from: https://www.meezanbank.com/docs/MBL_G2IB.pdf (10, Nov, 2015)

subject to the law that God has communicated regarding the exploitation and administration of the wealth of this world.¹⁸

The Holy Quran is clear on the point that the real owner of wealth is the Creator and man is the enjoyer, and the latter derives its secondary right of property as per the laws of the Sharia. The fact that Quran has recognized the right of property of man with limitation next to the original belongingness of wealth to Allah has cut the roots of capitalism which is built on the unconditional and absolute right of private property, which enables man to use his wealth in a manner he likes. In fact Islam, like the Capitalist economy, also believes in the concept of private property, the motive of profit and operation of market forces in the market economy. The difference lies in the fact that the unlimited tendency of making profit as an ultimate purpose of the market is not acceptable in Islamic economics.

According to secular capitalism and its version of the materialist economics, however, livelihood and economic development of man are the fundamental problem and the ultimate end of human life¹⁹. It gives unbridled power of decision in favor of profit making purpose, and the control of divine regulation is totally ruled out in this world-dominating ideology of economy, though some countries like the US seem to have officially accepted the concept of God as it is affirmed on the face of the US dollar.²⁰

On the other hand, Islam, by holding this notion of limited private property, has also disapproved the position of Socialism in that individuals are devoid of the right of private ownership of property, and wealth is collectively owned and administered by the state; but Islam cuts this foundation of Socialism by guaranteeing persons with private ownership as a favor from Allah. The same verses of the Qur'an mentioned above may also be cited here to underpin the position. One can notice at this juncture that Islam remarkably sticks to its firm stand of the Qur'anic principle of *Wasattiya* (Middle Position),²¹ as it does in relation to other issues, that it strikes the middle position of the two extremes of Capitalism and Socialism i.e. the absolute and unconditional right to property of Capitalism and the total denial of private property of Socialism respectively.

As far as the purpose of life is concerned, both Capitalism and Socialism share the same position of tackling economic problem of man and ensure a prosperous life;²² whereas Islam has an economic system operating within the purview of the purpose of life identified in study of Objectives of the Sharia (*Maqasid ash-Sharia*) under the jurisprudence of the Sharia. It is said that the objectives of the Islamic Economic System and Finance can be analyzed from the two

¹⁸ See: the Noble Qur'an 24:33 & 28:77

¹⁹ Usmani (2002), cited above at note 17, pp.13-14

²⁰ Taqi (1998), cited above at note 2, p. 11.

²¹ See: Mohammad Hashim Kamali, "The Middle Grounds of Islamic Civilization: The Qur'anic Principle of *Wasatiyyah*." Accessible at: www.hashimkamali.com

²² Usmani (2002), cited above at note 17, pp. 13-14

perspectives. One is the philosophical objective attached to the science of *Tawhid*,²³ which requires human beings to acknowledge the existence, lordship and unity of Almighty God. Thus the philosophical goal of Islamic economics and finance is attached to the general objectives of the religion of Islam. Consequently, the regulation of the economic activity of man must not defeat the purpose that Islam has attached to life, and divine regulation should take precedence over any other ideologies and economic justifications.

The other objective of Islamic economics is seen from operational vantage point in the sense that the objectives are spelt out in relation to the efficiency of economic activities only. Hence the goal of Islamic economics and finance in this regard is similar to that which is articulated in Capitalism and Socialism i.e. elimination of poverty and economic development. Therefore, the primary materialist objective of life as put in other ideologies takes secondary status in Islamic Economics.²⁴ But as far as distribution of wealth is concerned, Islam and Capitalism have a similar formulation of factors of production with a small difference whereas Socialism holds a position at odds with both Islam and Capitalism.

Looking at the ideologies from the perspective of distribution of wealth, Capitalism recognizes all the four postulates of factors of production i.e. capital, land, labor and entrepreneurship. It means wealth is produced by the cooperation of these factors and it will be distributed among those who participate in one of these factors of production.²⁵ The Islamic point view of distribution of wealth is that there are generally two kinds of people who have the right to wealth in Islam. Firstly, those who are directly involved in producing wealth through one of the factors of production as put in slightly different manner. Secondly, those who are given the right to share some wealth from the direct participants even though they themselves do not take part in the production process.²⁶ In the first category, Islam believes that the factors of production are three confirming the first three factors as put by Capitalist economy excluding entrepreneurship which has a reward of profit. In Islamic economics, entrepreneurship is considered to be part of labor which is defined as an exertion whether of bodily organs or of intellect. It also includes organization and planning.²⁷

The definition given to Capital and Land is also different as compared to what has been provided under capitalism. Capital in Islamic Economy is defined narrowly as those things which cannot be used in the production process without being wholly consumed, or which cannot be leased hence it excludes machinery; whereas in Capitalism, it is defined expansively as: “the produced means of production” which, in addition to money and foodstuff, includes machineries.²⁸ In

²³ It is the most accredited science of Islam that advocates for the unity of God and enunciates the main purpose for the existence of human being i.e. to believe in God’s unity and abide by the laws of Islam (Sharia) including the rules on economics and finance.

²⁴ Mohammad and S. Shahwan (2013), cited above at note 1, pp. 76-77

²⁵ Usmani (2002), cited above at note 17, p. 20

²⁶ Ibid.

²⁷ Ibid. p. 21

²⁸ Ibid. p. 19

contrast to the narrow definitional approach followed towards land, it is given a broader meaning under the Sharia unlike its capitalist counterpart.²⁹ Consequently, land does not mean: “natural resources” rather it refers to things which could not be wholly consumed during the process of production. It is to be noted that land is defined under capitalism as a means of production that does not went through any process of production (natural resources).³⁰

The wealth produced from the combined interaction of these three factors would go to capital in the form of profit, not interest; the other shares would be distributed in to land and labor in the form of rent and wages respectively.

Socialism holds a totally odd position with respect to distribution of wealth in light of that which Islam and Capitalism stands on. Socialism rejects all factors of production except labor.³¹ As discussed above, the concept of private property is not acceptable under the socialist economy; and thus, land and capital are exclusively owned by the state. So the issue of interest will not arise. The entrepreneur is also the government itself making interest again out of agenda. Labor remains to be the only proper source of income for individuals in the form of wages.³² This creates a worst situation of concentration of wealth in the hands of a single big Capitalist – the State - which results in arbitrary administration.³³ Moreover, since individuals are not allowed to own the fruit of their labor, they may lack the incentive to work which would possibly lead the state to use force to get their labor, which again will have an evil effect of loss of liberty and inefficiency of work.³⁴

But Islam, unlike Socialism, guarantees persons with the right to private ownership; and it does not distribute wealth only through wages but also in the form of profit and rent. Hence it avoids the evils of Socialism. It also, unlike Capitalism, rejects interest as a mode of distribution of wealth, and further introduces the rightful persons to wealth at secondary level through the system of *Zakat* (alms giving)³⁵. Thus, it eradicates the possible concentration of wealth in the hands of few people, which is the inherent problem of Capitalism.

In conclusion, to remedy wealth accumulation, Socialism has opted for the extreme measure of elimination of the concept of private property which in itself has got its evil consequences of depriving the natural right of individual ownership and control over ones labor. As a response to this deficiency of socialism, Capitalism has come up with the unlimited right of private property and market mechanism with the evil result of capital accumulation in the hand of few wealthy persons, monopoly and unemployment. Most, if not all, of these problems are attributable to interest constituting the backbone of the conventional financial system and the reward of few

²⁹ Ibid. p. 21

³⁰ Ibid., pp. 19-24

³¹ Ibid., p. 20

³² Ibid.

³³ Ibid., p. 22

³⁴ Ibid.

³⁵ *Zakat* is one of the five pillars of Islam, and it is a yearly obligation upon a Muslim owning a property above a certain *Nisab* (minimum amount) level.

industrialists. Islamic economics, by denying interest as a return of capital and inculcating the idea of profit and loss sharing in the realm of finance and banking has followed the middle path of the two economic systems. Beside its indictment of interest, it has made the larger part of wealth like fire, water, earth, un-owned and uncultivated lands etc under the common trust. Hence, everyone is entitled to use and benefit from this part of the wealth, and only the remaining part would be open for private ownership through any one of the three factors of productions. This minimizes the possibility of concentration of wealth on few capitalists.

2.2. Introduction to Islamic Finance: Legal Framework for Interest Free Banking

2.2.1. Principles of Islamic Finance

a) Interest (*Riba*) is prohibited in all transactions

Riba literally means excess or increase³⁶. Both the payment and receiving of interest is explicitly prohibited by the Holy Qur'an and the *Ahadith*³⁷ of the Prophet.³⁸ Taking interest is treated as unjustified enrichment of appropriating the property of others for one's own use. So these verses of the Qur'an justified the ban of interest from justice and fairness perspective with the conclusion that it creates unjust outcome in the society.³⁹

Interest includes both what is referred to as usury and interest.⁴⁰ In the first phase of development of Islamic Economics and Finance, some western authors held 'usury' for exorbitant interest, trying to justify the bank interest as Sharia-compliant. Some Sharia scholars also were very much apologetic in trying to narrow down the gap between the principles of Islamic finance and the dominating trend of Capitalism. They have tried to differentiate usury and interest with the aim of allowing Muslims to benefit from the conventional banking service. The contemporary Islamic Economists, however, have reached to a general agreement that both usury and interest constitute the prohibited *Riba* in light of 2:279 of the Qur'an which does not differentiate the legality of *Riba* on the basis of its amount.⁴¹

³⁶ Latifa and Mervyn (2007), cited above at note 16, p. 38

³⁷ The word *Ahadith* (singular *Hadith*) refers to the sayings, deeds and silent approvals of the Prophet in the study of Islamic Sciences.

³⁸ There are four verses in the Qur'an that clearly put a ban on interest. These are: 4:161, 2:275, 2:276 and 2:278

³⁹ Latifa and Mervyn (2007), cited above at note 16, p. 42

⁴⁰ *Ibid.*, pp. 42-43

⁴¹ *Ibid.* p. 43

This differentiation of terminology seems to have appeared to justify lower rates of interest as interest above certain is prohibited and even criminalized as specified by different countries differently. The same trend has been followed by Ethiopia as indicated in the Criminal Code of the Federal Democratic Republic of Ethiopia (2004). The code under Article 712 criminalizes the collection of interest beyond the official rate of interest as Usury. As other jurisdictions, Ethiopia has also followed two extreme positions regarding interest. Firstly, an interest up to the maximum rate specified by the NBE is not only allowed but also serves as a foundation for the financial system of the country. Secondly, any contract of loan that sets the rate of interest higher from the official rate would constitute a crime for reasons of material exploitation and moral intimidation as understood from the same usury of provision of the criminal code. It would be difficult for the person of reason to understand such a double policy on the same matter taking it as a backbone of the banking and financial sector and as the same time recognizing it as harmful and

b) Profit and Loss Sharing (PLS)

As a substitute to interest as a reward of capital, Islamic finance has provided Profit and Loss Sharing (PLS) instead. Thus, anyone who provides the fund would become an investor instead of being a creditor unlike in the interest-based financial system.⁴² Islamic finance and banking have come in to picture to realize this economic philosophy of Islam. Islamic Economics aims at achieving distributive justice mainly by avoiding interest. In the realm of conventional finance, once the banks have mobilized the saving of the common people, only those with the greatest collateral i.e. the few rich members of the public will have a greater access to this large portion of the banks'/publics' money, and then these few entrepreneurs would invest it on huge business projects through which they again would be able to amass huge profit. The only benefit that the saving unit of the society may obtain is a small fraction of interest collected from the entrepreneurs, whereas the large share would go to the equity holders of the banks'. The industrialists even would add the interest they will pay to the depositors into the price of the goods and services supplied to the public. Therefore, the entrepreneurs pay nothing to the depositing public in actual terms, while at the same time exploiting the public resources by their mere access to the paper money collected by the banks. The capitalist economy, thus, through the instrumentality of the conventional banking, has been able to serve few capitalists only, not the common people. As said in the foregoing sections, Islamic economics does not entitle the owner of the capital (money) for any interest rather capital is rewarded in the form of profit, while it also takes the risk of loss simultaneously. The other two factors of productions of land and labor are rewarded by rent and wages respectively.

c) *Gharar* (Unreasonable Uncertainty) is prohibited

Though business transactions are generally plagued by a certain level of uncertainty, the excessive one is not welcome under Islamic finance. Hence, contracts forming the basis of business transactions and Islamic banking services should be known to a large extent about their consequence. Commercial contracts whose objects are not specified may end up in creating disputes between parties in the contract.⁴³ For instance, the conventional banks offering the Islamic banking window service have to provide deposit products to the saving unit of the public with a certainty that the money is going to be invested to a *Halal* (Permitted) projects and get an approximately certain return for depositors.

immoral with no middle position. Irrespective of the rate used as a dividing line between the legal interest and the illegal usury, the underlying notion of interest is its evil nature and bad consequence on the social and economic stand of the society.

⁴² Abbas Mirakhor and Iqbal Zaidi, "Profit-And-Loss Sharing Contracts in Islamic Finance", in M. Kabir Hassan and Mervyn K. Lewis (ed.), *Handbook of Islamic Banking* (2007), pp. 1-3. Accessed on 15, Nov, 2015, from: <http://www.kantakji.com/media/2129/b029.pdf>

⁴³ Latifa and Mervyn (2007), cited above at note 16, p. 43.

d) Prohibited transactions

Some business dealings are explicitly forbidden (*Haram*) for any individual or interest-free banks to engage in even if the very financing mode is in and of itself conforms to the laws of Islamic finance. In other words though the method of financing is free from interest or any other prohibited element, the fact that it finances a project which involves an illegal element as per the Sharia gives it a prohibited status. This is what is called as *haram li-gayrihi* (prohibited for other reasons) as opposed to *haram li-thatih* (prohibited itself) in the discourse of Islamic Jurisprudence (*Usul al-Fiqh*).⁴⁴ Investing in or financing any business activity that involves alcohol, pork, gambling (*Qimar*) or Maysir (Unearned income) or interest bearing projects is not allowed. Some also consider the investment for the production and marketing of luxury goods *Haram (Israf wa Taraf)* in the situation where the Muslim society is suffering from the lack of basic goods like food, clothing, shelter, health etc.⁴⁵

2.2.2. Islamic Financing Products as Banking Products

If there is any need to operate banking activities along Islamic lines, an Islamic bank or subsidiary thereof or an interest free window service has to restrict itself to offer those banking services that are identified by the scholars of the field as Sharia-compatible. Based on the objectives of Islamic economics and principles of Islamic finance, the classical legal schools of the Sharia have identified various Sharia-compliant financing products. These financing techniques are now adapted to an Islamic financial institutions particularly to Islamic banks and windows.⁴⁶ Thus, Islamic banks around the world are delivering the same financing modes as banking products even without changing their nomenclature as in the classical *Fiqh* literature. Hence it should be clear that these techniques of finance engineered to be in line with the principles of Islamic finance are meant to be utilized in the broader context of financial dealings among individuals, groups and institutions. Therefore, those financial modes can be used beyond the institutional framework of banking in the day to day business dealings of the society.

Without prejudice to the other principles of Islamic finance, the rule of Profit and Loss Sharing (PLS) is used as a parameter to classify the existing financing mechanisms in to ideal and non-ideal modes of finance. The scholars employ diverse terminologies to refer to these two modes based on their respective common feature like PLS and mark-up (sale based), variable and fixed return, core modes and marginal modes, all representing the same category of ideal and non-ideal modes respectively. Basing their research on this foundational idea of PLS, the jurists have introduced the instruments of *Musharakah* (Full partnership) and *Mudarabah* (trust-financing) as the most important and ideal techniques of finance.⁴⁷

⁴⁴Muhammad Hashim Kamali, *Principles of Islamic Jurisprudence* (1991), p. 286. Accessible at: www.hashimkamali.com

⁴⁵Latifa and Mervyn (2007), cited above at note 16, p. 39.

⁴⁶ Abbas and Iqbal (2007), cited above at note 42, p. 49

⁴⁷Taqi (1998), cited above at note 20, pp. 36-37

Musharakah refers to joint venture or partnership of parties over a certain business. It is the most ideal mode of Islamic finance where the parties in the *Musharakah* contract share the profit or loss result of their business venture.⁴⁸

Mudarabah (trust-financing) is a special kind of partnership whose investment comes from one of the partners only with no consequential right to manage or work for the partnership; whereas the one who has a viable business plan would run the business solely without any investment on his part. The natural consequence of which is that it is only the *Rabb al-Mal* (the investing partner) who fully owns the business of the partnership, and hence any loss incurred by the partnership is fully assumed by the *Rabb al-Mal* (the investor) only. Whereas the other partner (*Mudarib*) will lose his effort and time. This rule is subject to an exception i.e. if the loss suffered by the business is due to the negligence or dishonesty of the *Mudarib*, he will be liable for the loss suffered. As for the profit accrued to the enterprise, both will share it as per the rate specified in their *Mudarabah* contract.⁴⁹

Qard al-Hassan or *Amanah* (Benevolent loan), as a financing product, has also a strong potential of achieving the economic objectives of the Sharia. Thus, it can be considered as an ideal mechanism. In other words, every financial mode that is identified to be Sharia-compliant is not based only on PLS basis because there are some economic sectors that cannot be accommodated by the application of PLS modes of finance. Consequently, the Sharia jurists, in order to respond to such modern financial needs, have also come up with other Islamic financing techniques which are not necessarily the extension of the PLS principle. These are: *Murabahah* (Cost-Plus Sale), *Ijarah* (leasing), *Salam* (Advance payment) and *Istisna'* (Manufacturing contract).⁵⁰

Murabahah (cost-plus sale) refers to a sale arrangement made between the bank and the client/buyer on the terms that the bank buys a certain commodity upon the request of the customer, and the latter agrees to buy the property bought by the financier/bank on cost-plus profit basis.⁵¹ When *Ijarah* (leasing) is utilized as a mode of finance, it is called as a financial lease as opposed to the operating lease.⁵²

Salam is a kind of sale where the buyer/financier agrees to buy a certain commodity with cash price while the supply of the commodity agreed to be differed and to be delivered at specified future date.⁵³ *Isisna* is also a type of sale contract where the purchaser orders the seller to manufacture a certain product to be delivered on the future specified date.⁵⁴

⁴⁸ Ibid., pp. 17-18

⁴⁹ Ibid., pp. 31-33

⁵⁰ Ibid., pp. 72-73

⁵¹ Ibid., pp. 65-66

⁵² Ibid., pp. 113-115

⁵³ Ibid., pp. 128-129

⁵⁴ Ibid., pp. 135-138

It should be noted that every instrument of finance under Islamic financial system, irrespective of its type, has its own set of rules and conditions as developed in the classical Fiqh literature and the current addition of rules in line with the development of the business environment and interest free banking industry. The non compliance of these Sharia rules and requirements would mix it with the conventional interest-based financial system. The detail discussion of this legal (Sharia) regime of interest-free banking is not within the scope of the topic of this thesis, the writer suggests the reader to refer only to the most authentic texts prepared by reliable scholars in the field.⁵⁵

⁵⁵An introductory discussion of the specific Sharia rules regarding each financing products can be found in the Sharia commentary texts of Islamic finance that discusses the latter in the context of Islamic banking and windows. Among the many, the one written by the Mufti Muhammad Taqi Usmani entitled “Introduction to Islamic Finance” is a good work. See: supra note 13 for its details to access the material.

Chapter-3

Islamic Banking: Overview of its Standard Modes of Operations

3.1. Introduction to Islamic Banking

It is an open truth that Muslim communities around the world, long after their independence from western powers, are still under the rules of secular democracy which only has allowed them to practice the spiritual (worship), educational, and in some countries, personal and family laws of the Sharia⁵⁶, while other aspects of the Sharia including the economic and financial relation of Muslims is still far away from the divine guidance. That being the long lasted status quo, the rise of Islamic banks has brought about some light for the actualization of the economic teachings of the Sharia in the life of Muslims and even for those countries that haven't got the chance to avoid interest in their day to day life for whatever reasons they might have.

Interest-free banking refers to a system of banking or banking activity that is consistent with Islamic law (Sharia) principles and guided by the general guidelines and objectives of Islamic economics.⁵⁷

The fact that Islamic banks have been able to penetrate the various countries' financial system, it has been able to move the wheel of the socio-economic framework of the Sharia which has long been stopped due to the fall of the Muslim *Ummah* under the western colonial rules and later under the secular lines of governance which is far from realizing the long lasted wish of the *Ummah* (Muslim communities) to be guided by the socio-economic teachings of the Sharia.⁵⁸

Interest-free banks can contribute to the general advantages that the conventional banking system offers for the betterment of the economy by mobilizing deposits from the general mass and channeling the same to persons who need it for investment. The Saving Deficit Unit (SDU) of the society will invest the funds they borrowed for different purposes like for the expansion of their businesses and production thereby adding its share to the Gross Domestic Product (GDP).

⁵⁶ The Ethiopian FDRE constitution (1995) can be taken as one of the examples, among many others, that gave permission for the application of the Sharia as far as personal and family matters are concerned as provided under Article 34(5) of the same constitution. In the enforcement of constitution, the legislative organ of the country i.e. the House of Peoples and Representatives (HPR) has enacted the Sharia Court Consolidation Proclamation No. 188/1999 at the Federal level, and the Council of States of most of the regional governments, which is the legislative organ at state level, has also followed the same lines of enforcing the FDRE constitution through establishment of the Sharia Courts with the jurisdiction of entertaining family matters among their respective Muslim communities. This could be taken as the first big step on the part of the Ethiopian government in creating the opportunity for the Ethiopian Muslim population to realize the Sharia rules in their lives, even though it is only limited to personal matters. The authorization of conventional banks to operate Interest free banking in line with the principles of Islamic finance can also be taken as the second significant policy direction of the government in the effort to actualize the dream of the Ethiopian Muslim community to follow the Sharia and mobilize the same through the financial system of the country contributing thereby to the growing economy of the nation.

⁵⁷ Taqi (1998), cited above at note 20, p.164.

⁵⁸ Ibid., pp. 161-163

Furthermore the existence of network of interest-free banking window services within the conventional banking system makes the payment system easy and efficient.⁵⁹

3.2. The Differences and Similarities between Islamic Banking and Conventional Banking

Both interest-free banks and conventional banks share the same purpose of making profit. The difference lies on how they achieve this same goal. Islamic banks are meant to achieve the purpose of profit making in conformity with Islamic principles and rules governing business dealings.

The difference between conventional and Islamic banking can be explained in terms of their foundational difference between capitalism and Islamic economics respectively. It can easily be pointed out that both banking systems differ in their stand point towards interest/usury, speculation, ethical standards of different types of business transactions and other points.

Besides these, the two systems also differ in the number of products they are offering to their customers. The most authoritative scholar in the field of Islamic finance by the name Dr. Hussien Hamid Hassan said regarding the difference between Islamic and conventional banking that Conventional Banks have been able to offer a single banking product only i.e. loan with interest in its asset aside in their 400 plus years of development, whereas Islamic banking has a number of alternative banking services of *Mudarabah, Musharakah, Ijarah, Murabaha* etc.⁶⁰

We can also discern the two from the vantage points of their modes of operation. There are some unique banking standards developed by international standard-setting organizations in the field of Islamic banking that are applicable only to Islamic banking practice. Hence, these points are also worthy to be mentioned as the major points of difference between the two banking systems. These standards include segregation of funds, different accounting standards etc. We shall briefly loot at these standards in the forthcoming sections.

3.3. Overview of the Standard Modes of Operations of IBs

By standard modes of operations, it refers to the regulatory frameworks enacted or adopted by standard-setting organizations of IFSI mainly IBs. In other words, the terms ‘standards of operations’ or ‘regulatory frameworks’ of IFSI do not include what is used to be separately discussed in the literature under the topic of Islamic finance which is a general legal regime consisting of higher order laws of the Sharia set for the regulation of IFSI including IBs and windows. As far as Islamic banks are concerned, the banking transactions that are based on different types of contracts are completely regulated by the laws of the Sharia. The *Fiqh* rules of

⁵⁹ Muhammad Obaidullah, *Islamic Financial Services* (2005), p. 39. Available at: <http://www.iefpedia.com/english/wp-content/uploads/2009/09/ISLAMIC-FINANCIAL-SERVICES.pdf> (Oct, 2015)

⁶⁰ Dr. Hussein Hamid Hassan, presentation on the topic of “Islamic Economics - The Solution for World Crisis”, Dubai International Peace Convention (2010). Accessed from: <https://www.youtube.com/watch?v=Qh3me1gKQkA> (Oct, 2015)

the Quran and the *Sunnah*, and the *Fatwas* (legal verdicts) of the Sharia jurists on the compatibility of any financial transaction undertaken by an Islamic bank with the Sharia constitutes the legal regime of Islamic banking. Regarding the regulatory regime of Islamic banks as an institution, this issue has not been the subject of legal discussion in the classical legal literature of the Sharia. The idea of offering the various Islamic financial modes through an institution called bank or other Islamic financial institutions for that matter is a recent *Fiqh* development that has been worked out since four decades ago when an Islamic banking got its inception.⁶¹

The methodology of issuing *Fatwas* (legal verdicts) on the various aspects of banking operations must be based on the legal methodology of deducting law from the higher sources of the Sharia (*Ijtihad* or *Istinbat*) as sufficiently studied under the classical Islamic science of *Usul al-Fiqh* (Principles of Islamic Jurisprudence).⁶² It is based on this legal science of Islam that a number of international Islamic financial institutions are providing standards of operations or regulations for Islamic financial institutions including IBs and windows.

The standards developed by these specialized agencies, introduced herein below, need to be adopted and implemented by the national regulatory organs and Islamic financial institutions all over the world for cross-border harmonization of standards of the sector.

3.3.1. Introducing Islamic Standard-Setting Financial Institutions

The Islamic financial industry has been looking for some guidelines or references developed by the institutions of the conventional banking system in the areas where the Sharia does not provide specific directives. But since the institutional regime of the conventional financial system is particularly geared towards its interest-based features, it does not suit the peculiarities of interest free banking. Therefore, the Islamic banking industry, since its inception, has suffered lack of institutional support for a long period as the conventional one did not address the unique concerns of Islamic finance. Fortunately, after 30 years of evolution, the Islamic Financial Service Industry has able to secure the help of a number of standard-setting Islamic financial institutions.⁶³

It was suggested before the establishment of such international standard-setting agencies like Islamic Financial Service Board (IFSB) and Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) that the regulation of Islamic banks should take the benefit of referring to the standards and best practices developed by Basle Committee on Banking Supervision (BCBS).⁶⁴ But for now the Islamic financial industry has evolved to the point where some specialized agencies have emerged to take care of identifying and harmonizing the

⁶¹ Taqi (1998), cited above at note 20, pp. 162-163

⁶² *Ibid.*, p.163

⁶³ Munawar Iqbal, "International Islamic Financial Institutions" in M. Kabir Hassan and Mervyn K. Lewis (ed.), *Handbook of Islamic Banking* (2007), p. 361

⁶⁴ *Ibid.*

principles of Islamic banking at global level. Had these institutions not been established, it would have been necessary to adapt the standards of the Basle Committee in such a way that it conforms to the norms of Islamic finance and to the peculiarities of Islamic banking as the Committee has developed the standards only for the conventional banking system. Therefore, the necessity of adaptation is now removed through the process of actualizing Islamic finance principles by the instrumentality of these standard setting institutions as IFSB and AAOIFI. The next part will briefly introduce the major standard-setters and their respective objectives and missions.

a. Islamic Financial Service Board (IFSB)

The Islamic Financial Service Board (IFSB) is established in 2002; and it is the Islamic counterpart of conventional institutions such as Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commission (IOSC) and the International Association of Insurance Supervisors (IAIS). It is serving as a standard-setting body in the sphere of regulation and supervision of the Islamic financial services which is broadly defined to include the banking, the capital market and insurance sectors. Thus, IFSB introduces new or adapts the existing international standards consistent with the Sharia. In 2015, the membership of the Board has been raised to 188 different entities comprising of 61 National regulatory and supervisory authorities, eight international inter-governmental organizations and 119 market players.⁶⁵ The Board has issued a number of guiding standards in the areas of Risk Management, Capital Adequacy, Corporate Governance and others since its inception.⁶⁶

The IFSB also undertakes activities like organizing international conferences, seminars, workshops, trainings hosted by different countries with the aim of promoting awareness of Islamic Financial Service Industry (IFSI).⁶⁷

b. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

AAOIFI is a non-profit organization established to develop Islamic accounting and auditing thoughts for Islamic financial institutions. It is a non-profit corporate body established with the objective of laying down a uniform set of standards in respect of auditing and accounting operations of Islamic financial institutions including IBs and windows. It has a membership of supervisory authorities from 40 countries, Islamic financial institutions and other participants from the industry counting up to 200 so far. The organization has issued various standards on accounting and auditing aspect, and code of ethics in accordance with the Sharia.⁶⁸

AAOIFI also reviews the accounting and auditing standards of Islamic Financial Institutions as per the Sharia and the specific environment in which they are operating so that they can enhance

⁶⁵ Cited from: <http://www.ifsb.org/background.php> (14, Oct, 2015)

⁶⁶ Ibid.

⁶⁷ Ibid. for more details see: www.ifsb.org

⁶⁸ Cited from: <http://www.aoofi.com/en/about-aoofi/about-aoofi.html> (14, Oct. 2015)

the confidence of the customers of the Islamic financial institutions. The review of financial statements of Islamic financial institutions following the auditing and accounting standards of AAOIFI provides credible information to shareholders, depositors, investors and regulators. Similar to the IFSB, AAOIFI also involves in awareness creation campaigns and promotion of the standards it has issued through trainings, seminars, research and publications.⁶⁹

3.3.2. The Core Standards of Operation

a) Segregation of Funds

One of the well settled standards of Islamic banking business offered as a window service under the conventional banking is segregation of funds. This means offering the funds intended to be utilized for Sharia compatible products should not be commingled with the funds of the conventional bank. The reason is obviously the funds of the latter may be used to finance activities that may involve *Riba* (interest), *Gharar* (contractual uncertainty) or *Haram* (prohibited) investment ventures.⁷⁰

b) Sharia Supervisory Board (SSB)

It is a standard and required practice among Islamic financial institutions including Islamic banks as well as the concerned government organs entrusted with the function of supervising and controlling the activities of IBs and windows to establish their own Sharia Advisory Council or Board consisting of expert members in the field of Islamic financial law. This Council will have a major function of ensuring the Sharia-compatibility of the banking operations of the banking institution. A SSB should also be set up within the supervisory authority for the same reason of ensuring the issuance and enforcement of regulations in accordance with the Sharia and standards of the industry developed at international level.⁷¹

The IBs or the CBs offering Islamic window services need to have their own consultative body of experts that will design and follow up the activities of the banks' operations in light of the governing Islamic finance principles and best practices. Looking at the matter from the human resource perspective, the conventional banks that are interested in opening an interest-free counter need to hire expert employees and give a regular training on modes of operation of interest-free banking to its existing staff.⁷²

⁶⁹ Ibid. for more details see: www.aaofi.com

⁷⁰ Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems", IMF Working Paper (2007), p. 5. Available at: <https://www.imf.org/external/pubs/ft/wp/2007/wp07175.pdf> (14, Oct. 2015)

⁷¹ Alejandro López Mejía et.al., "Regulation and Supervision of Islamic Banks", IMF Working Paper No. 14/219 (2014), pp. 14-15. Retrieved from: <https://www.imf.org/external/pubs/ft/wp/2014/wp14219.pdf> (Oct. 2015)

⁷² Ibid.

Since the emergence of Islamic banks has necessitated the oversight of their services by the Sharia Boards, the latter becomes the reason for the movement of the wheel of Islamic economic system and its jurisprudence (*Fiqh*) as far as finance and banking matters are concerned. This is because the board will inevitably present relevant *Fiqh* queries to the Muslim jurists regarding the legality of banking operations in light of the Sharia which in turn will create an opportunity for Muslim *Fiqh* scholars to make *Ijtihad* or *Istinbat*⁷³ for various financial and banking issues. It has also created the chance for the jurists to get to know about the present business reality and provide some broader analysis, beyond the queries presented, on the various market situations in light of the Sharia which again will enable the latter to cater for the new developments in the financial and banking dealings of Muslims around the world.⁷⁴

c) Protection of Investment Account Holders (IAHs) and other Depositors

One of the unique regulatory concerns stems from the fact that Islamic banking is essentially in the nature of Profit and Loss Sharing (PLS); thus, investment depositors do not have a voting right in the banks strategies and preference of investment areas.⁷⁵ Since the bank is able to pass the substantial amount of investment losses onto the depositors, it can freely invest the fund even in the areas whose feasibility and profitability is not well studied. But it is obvious that in the conventional banking system, irrespective of the fact that the bank has sustained a loss, it has to pay its depositors the fixed amount of interest as specified in the terms of the contract which is not the case with respect to interest-free banking. In fact, it is to be noted that the amount of the losses to be transferred to the depositors could be taken as a good point of competition among IBs/windows, and as a matter of fact, full-ledged Islamic banks or window services have an investment risk reserve to protect the depositors from loss and to avoid the risk of withdrawal of the fund by the depositors. Therefore, the market itself has a strong potential of controlling such a risk. In spite of this fact, the authorities need to regulate in order to protect the interest of IAHs as there are cases where the market fails.

In the PLS facilities particularly in the *Mudarabah* contract where bank has no control over the management of the investment project of the agent entrepreneur, the capital losses that might have resulted due to the mismanagement of the entrepreneur are borne by the bank, while the loss of the entrepreneur is limited to its time and effort.⁷⁶ The loss, thus, incurred is going to be shared by the investment account holder. This risky situation is further worsened by the optional nature of collateral or other guarantees that the bank may require. Therefore to safeguard the depositor from loss and realize profits, the regulatory framework of a country where IBs/windows are present should impose strict requirements necessary to be fulfilled for the bank to extend the finance on PLS basis.⁷⁷

⁷³ *Ijtihad* or *Istinbat* means Logical deduction of specific laws from the general principles of the Sharia.

⁷⁴ Taqi (1998), cited above at note 20, pp. 162-163

⁷⁵ Sole (2007), cited above at note 70, p. 15

⁷⁶ Taqi, cited above at note 20, p. 31

⁷⁷ Solé (2007), cited above at note 70, pp. 15-16.

The fact that the bank uses the funds in current accounts to finance PLS undertakings, though it seems normal for investment account holders, poses another unique regulatory concern of protecting the interest of demand account holders. The bank has an obligation to provide any amount of money requested by the demand deposit holder, and the bank cannot advance a defense of loss for its incapability. Any possible failure on the part of the bank due to free use of the funds in the demand accounts triggers a regulatory concern. One of the best responses to this problem of liquidity is that the banks are required to comply with 100 percent reserve requirement ratio meant for demand deposits.⁷⁸ The bank can use the money in the current account to finance investment projects on PLS basis even without requiring the client to furnish collateral. This adds fuel to liquidity risk of the bank. Thus, such risks of loss and liquidity need to be addressed by the regulatory and supervisory regimes of a country in relation to interest free banking.

d) Supervision of Islamic Banking Business

It is generally believed that the supervisory authorities that are in charge of regulating the financial system of any country and the actors therein can play a very significant role in creating a suitable environment for the effective operation and efficiency of the financial institutions including IBs. It is clear that fixing of interest rates by the Central Banks will not constitute a point of regulatory concern in relation to IBs or windows. This does not mean that there are no other concerns that the National Bank has to take a concern of serious supervision over IBs. Besides the regulatory framework applicable to both the IBs and CBs, the unique regulatory regimes of IBs and windows pose an additional supervisory commitment on the part of the authorities. To address these unique supervisory concerns, the authorities need to equip themselves with the necessary resources and expertise. The establishment of separate supervision team, adoption of standard examination procedures and information disclosure requirements are some among others that are suggested to be adopted by the standard setting institutions of the IFSI.⁷⁹

The relevant regulatory and supervisory standards of the Islamic banking industry shall be analyzed in relation to the comparable directives and enforcement practices of the NBE to the interest free banking sector of Ethiopia in the next chapter.

Regulatory Considerations arising from the risk-sharing nature of investment deposits are referred to as Moral Hazard Considerations in the literature. See: Sole (2007), pp. 15-16) for details.

⁷⁸ Song and Oosthuizen (2014), cited above at note 7, p. 19.

⁷⁹ Alejandro López et.al.(2014), cited above at note 71, p. 19

Chapter-4

Islamic Banking in Ethiopia: Analysis of the Regulatory and Supervisory Framework

4.1. Introduction

Islamic banking is present in all jurisdictions where Muslims are the majority (Muslim countries). In few countries however, Islamic banking is the only form of banking which is allowed. But in most jurisdictions, Islamic banking is being practiced alongside the conventional banking, while the latter is still the dominant one; but the growth rate of Islamic banking in these countries is faster than conventional banking.⁸⁰ Same trend is in Ethiopia where the development of interest-free banking is found to be faster than the traditional conventional banking system of the country, and the window services are profitable as affirmed by the IFB Finance Manager of CBE.⁸¹ Generally speaking, the Interest-free banking industry is a relatively recent development as compared to the conventional banking system. While conventional banking has been developing for the last 300 plus years, Islamic banking has lasted only for four decades.⁸² According to the IFSB, Islamic Financial Services Stability Report (2014), the industry is playing a large role in many Muslim countries and it is even systemic in many jurisdictions including Iran, Sudan, Saudi Arabia, Kuwait and Qatar. According to the same report, the total asset of Islamic banks and Islamic windows at end- June, 2013 exceeds 1.5 trillion US \$ out of the USD 1.87 trillion total assets of the IFSI.⁸³

Coming to the reality of IB in Ethiopia, part of the Muslim population of the country have been depositing their money in the conventional banks in the Current (demand) accounts bearing no interest. The reason behind this common practice is to stay away from involving in interest generating banking services. This being the intention of the population, however, the mobilized fund from the non-interest bearing deposits of the conventional banks will inevitably be used to finance consumers or entrepreneurs in return for interest. Hence, the very caution of the depositors not receive interest will be defeated in so far as the money is utilized to fund transactions which are prohibited (*Haram*) including interest bearing loans. Financing an interest bearing activity is forbidden as much as receiving interest as per the Sharia.

After the business of interest free banking was allowed, the conventional banks that has got permission to offer interest-free banking services, by now, are mobilizing funds from the general public largely from the unbanked Muslim population of the country and from those who already have a deposit account from the conventional banks but decided to change the same to an interest-free deposit account based on *Mudarabah* contract with the parent bank. Some are not yet ready to offer interest-free banking services to the needing customers. This is mainly, as most

⁸⁰ Song and Oosthuizen (2014), cited above at note 7, p.8

⁸¹ Mesfin Zegeye, Interest-Free Banking Offers Opportunities, Face Limitations: Workshop, *Addis Business* (Sept, 2015), p. 1 and 8

⁸² Waqar Anwar, *Economics in Islam* (2012), Markazi Maktaba Islamic Publications, p.124

⁸³ Islamic Financial Services Industry Stability Report (May, 2015), p.9, Retrieved on Oct., 2015 from: www.ifsb.org

of the authorized commercial banks have justified, aimed at ensuring their liquidity and the risks thereof before starting to utilize the money collected until it reaches to a certain minimum.

It might be difficult at this juncture to tell about the dominant banking product in the emerging interest free banking practice of Ethiopia. This is because almost all of the banks that are authorized to offer interest free banking service are yet mobilizing funds from the general public before they start giving the services to their customers.⁸⁴ Due to the small amount of fund that the banks have managed to solicit, they, still, do not start offering the various Islamic banking products. Therefore, the banking product that will take the lions share will be something to be known in the future.

4.2. Nomenclature of the Industry in Ethiopia

Concerning the propriety of naming Islamic Banks as interest-free banks, a certain researcher by the name Abdulwasi' Yusuf has expressed his opinion saying that calling interest free banks as "Islamic bank" is not proper because using the word "Islamic" would result in discouraging the non-Muslims from participating in the system. He further underpinned his position that those countries that have integrated Islamic finance into their conventional system have named their banks following the Sharia as "Islamic banks" for their own reasons. But looking at the matter from the vantage point of attracting customers besides Muslims, since the word 'Islam' has unfortunately got bad connotations among the non-Muslims, attaching this name to the interest-free banking industry will have a negative effect of excluding the non-Muslims owing to their misconceptions towards Islam.⁸⁵

My position on the issue at hand, however, is different from that of Abdulwasi'. In the first place, the reason behind the naming of interest-free banks as 'Islamic' in other jurisdictions is not something mystery as he has jumped without trying to look for its rationale. I say that it is for a simple reason that the industry has got its foundation from the principle of Islamic economics and finance, and that the banking products and services engineered by the Sharia jurists are totally in compliance with the principles outlined in norm-setting sources of the religion. Trying to look the issue from the ground realities of Ethiopia, it is better to start from the legislative framework on the financial system of the country. Surprisingly, we find only one directive of the National Bank of Ethiopia that single-handedly governs the emerging industry of interest-free banking business.⁸⁶ The Directive clearly states under Article 2(2.2) that interest-free banking business is a business that is "undertaken in a manner consistent with 'Islamic' finance principles and mode of operation". Hence, it is to be noted that the regulatory body i.e. the NBE here mentions the word "Islamic", as there is, indeed, no other option. As far as the motives and grounds for the adoption of interest-free banking is to integrate Islamic finance principles into

⁸⁴ Interview with Tesefaye Dibabu, Accounts and Operation Manager of Interest Free Window Service at CBE, (15-Sep.2015)

⁸⁵ Abdulwasi' (2003 E.C), cited above at note 13, p, 125

⁸⁶ The NBE Directives to Authorize the Business of Interest Free Banking No. SBB/ 51/2011

the financial system of the country for economic and other policy reasons including satisfying the needs of Muslims, which constitutes a significant portion of the population of the country.

What is not proper is not to mention interest-free banking as ‘Islamic banking’ rather to feel apologetic and confirm what some Muslims themselves, let alone non-Muslims, have tried to attribute the attitudes and acts of the black sheep present in any community to the image of Islam. The proper course of action from the stakeholders including the Muslim jurists and the government itself is to ignore, if not clear up, this misconceptions about Islam and develop a firm ground for development of interest-free banking, so that the country would get the benefit that other countries are obtaining from the sector, and serve and enhance the involvement of the large Muslim population of the country in the financial system of the latter. We find countries in Europe and America with meager Muslim population naming their interest-free banking industry with the name ‘Islamic’⁸⁷, thus it would be strange if the non-Muslims of Ethiopia, who have co-existed peacefully with the Muslims of the country for centuries, would run away from the word “Islamic” if it is attached to the non-interest based banking sector of the country. Even if we accept the unfounded and improbable possibility that the researcher is cautioning, it is illogical to deliberately avoid the word ‘Islamic’ for the simple reason of some unrelated misconceptions, while the industry as a whole is based on Islamic finance.

Another justification advanced by the aforementioned researcher is that all of the banking practices may not be Islamic and as such naming the services as ‘Islamic’ is not proper. But, as far as the banks respect the prescriptions and proscriptions of the Sharia, any banking product offered in compliance with the principles of Islamic banking is Islamic as it does not contravene with the rules of the Sharia.

Regarding the possibility where the banks may act against the principles of Islamic finance, the same author has expressed his concern that the fault of the bank might be attributed to the principles of Islamic finance. This, however, is not a strong reason not to name interest free banks as Islamic banks because it is the bank that ought to abide by the Sharia, and any violation of Sharia and the consequence thereof is to be attributed to the bank, and not to the Sharia. Therefore, the possibility of violation of can in no way be a good reason not to name interest free banking as Islamic banking.

When we analyze the use of “interest-free” as a technical term, it seems correct, on the one hand, as it may magnify the major guiding principle of Islamic finance for banking i.e. the prohibition of interest. The same idea is illustrated in the above mentioned provision of the Directive where it defines interest free banking business as:⁸⁸

⁸⁷ For example: Islamic Bank of Britain

⁸⁸ Emphasis mine

A banking business in which mobilizing or advancing funds is undertaken in a manner consistent with Islamic finance principles and mode of operation **that avoids receiving or paying interest.**

This provision outlines the basic principle of Islamic finance, among others, which is the avoidance of interest in any of the dealings of interest-free banking window services. But this does not mean that other principles are not available. To mention some, the prohibition of *Gharar* (excessive uncertainty) and prohibition of some transactions like dealing pork and alcohol etc. In light of the presence of many principles of Islamic finance and modes of operations in addition to the prohibition of interest, naming a banking business which is based on these principles as whole as “interest-free banking” is not correct because it sends a wrong connotation that the difference of such banking system with the conventional one is a mere absence of interest. In other words, being an interest-free is a feature of Islamic Banking, not its name.

Therefore, based on the unreasonable and unrealistic nature of the fear of discourage and exclusion of non-Muslim customers from interest-free banking service and the narrow meaning of the terminology, it would be preferable to use the term “Islamic Banking” to refer to nothing but to Islamic banking as developed in the literature.

That being said, the researcher took the freedom to use both interest free banking and Islamic banking alternatively in this paper for the sake of easy understanding at least for the moment.

4.3. The Adoption of Interest-Free Banking in Ethiopia

Various jurisdictions have adopted Islamic banking based on different policy motivations. Some like UK have allowed Islamic banking with the aim of promoting and contributing for the development of their financial system. In other words, the positive economic and financial role of the industry underlies their policy decision. While others such as Tanzania, Kenya and South Africa have recognized Islamic banking so as to respond to the needs of their Muslim community for the Sharia-compliant banking structure.⁸⁹

When it comes to Ethiopia, the initiative to recognize interest free banking arises from the fact that the Muslim population of the country has been demanding interest free banking products for several years. This policy justification of the government is explicitly provided in the very first line of the preamble of the NBE Directive where it states that the strong public demand for the industry constitutes the policy motivation for the authorization of conventional banks of the country to offer the services.⁹⁰ The adoption of an interest free banking can further be justified in terms of creating a strong economic relationship with Islamic jurisdictions; it is one of the country’s foreign economic policy to have such a strong financial and trade service with Muslim

⁸⁹ Song and Oosthuizen (2014), cited above at note 7, p.7

⁹⁰ See: the preamble of the NBE Directives to Authorize the Business of Interest Free Banking Directives Number SBB/51/2011

Countries. Therefore, the introduction of sector into the country's financial system has a strong potential of attracting international investors who need Islamic financial infrastructure for their investment.

Furthermore, there is also a variant practices across jurisdictions with respect to the level of institutional adoption of the sector. Theoretically, three broad stages have been identified that a country might pass through in the process of introducing an Islamic banking into a conventional banking system. These are Islamic windows followed by full-ledged Islamic Banks and then the introduction of non-bank Islamic Financial Services Industry (IFSI).⁹¹

Most has directly allowed the service to be offered either by stand-alone Islamic banks or through a window service in the conventional bank structure (e.g. Malaysia and Saudi Arabia)⁹²; while others like Ethiopia have permitted the service to be offered only by the conventional banks through their interest free unit or window. In the other end of the spectrum, however, there are also some jurisdictions that have prohibited the delivery of Islamic banking products by Islamic windows (e.g. Kuwait, Jordan and Iraq).⁹³ This variation of approaches regarding the type of institution that will conduct Islamic banking could be justified differently according to the level of development of a country's financial system, the demand and awareness of the general public towards the products and services of Islamic banking industry and other relevant factors. Hence there are no rigid stages of introduction of Islamic banking into an already operating conventional banking system.⁹⁴

To say more on the window choice of the Ethiopian government, it can be justified on the basis of the smallness of the demand and scanty level of awareness and inexperience about the sector from the customers, practitioners and supervisor's perspective. Therefore, it is proper to start from the window service and move on its way towards a full-fledged Islamic banking and other Islamic financial services. The level of awareness of the Ethiopian Muslims regarding the modern Islamic banking framework and the products/services offered by Islamic banks as distinguished from the ordinary banking is very low. Hence, the policy preference taken by the government is appropriate, according to the researcher, taking the above mentioned factors into consideration.

In fact, there are also some noted disadvantages of Islamic windows by supervisory authorities of some jurisdictions that have prohibited the conduct of Islamic windows. These are firstly reputational risks in the sense that the commingling of assets and liabilities of the window service with the conventional bank. The users of the service might lose confidence about the Sharia compatibility of the products offered by the window due to the fear of mix of funds or

⁹¹ See: Sole (2007), cited above at note 70, p. 7-13, for detail explanation of the three phases of adoption.

⁹² Song and Oosthuizen (2014), cited above at note 7, p.9

⁹³ Ibid.

⁹⁴ Sole (2007), cited above at note 70, p. 3

transactions. This may create a doubt in the mind of the depositors and they may withdraw their money from the window which is referred to as withdrawal risk.⁹⁵

The other demerit of window service is in relation to the corporate governance structure of the conventional bank which might not take the inherent risks and unique demands of the Islamic window into consideration. It is pointed out that even the SSB and internal oversight committee for the protection of IAHs of Islamic windows are made to be accountable to the Board of Directors of the CB in some jurisdictions. This governance process has the potential to pose the risk of not catering for the needs/risks of the window. E.g. the Board might be loose in enforcing the fund segregation requirements. Moreover, proper financial statement might not be prepared properly which could hinder the effective oversight of their financial activities by the regulatory authority and deny the access of basic data about the operation and performance of the window to the various stakeholders.⁹⁶

4.4. Major Concerns after Adoption of the Industry

In the process of introducing Islamic banks in to a conventional financial structure, there are some areas that practitioners/conventional banks and the supervising authorities need to work on as identified by Juan Sole⁹⁷. These and other related areas are discussed in the following sections.

4.4.1. Compliance with the Sharia Principles and Standard Practices

To effectively embody Islamic banking in a country's financial system, the practitioners and supervisors should be acquainted with the principles of Islamic finance and the various *Fatwas* (legal verdicts) issued by Muslim jurists on the various legal issues of Islamic finance and banking from time to time. The establishment of Sharia boards both in the IBs or CBs offering interest free window services as well as in the supervisory authority is essential in the effort to comply with the legal framework of interest free banking.⁹⁸

The contribution of the Islamic Fiqh Academy based in Jeddah, Saudi Arabia, under the auspices of the Organization of Islamic Conference (OIC), is also worth mentioning at this juncture as it has been able to get the honor of the contemporary jurists for its resolution on various *Fiqh* issues with respect to Islamic finance and banking.⁹⁹

Concerning the mode of operation of Islamic banks, the national regulatory organs should take the necessary steps to harmonize their regulatory regimes and decisions with the standards of the

⁹⁵ Alejandro López *et.al.*(2014), cited above at note 71, pp. 28-29

⁹⁶ *Ibid.*

⁹⁷ See: Sole (2007), cited above at note 70, pp. 7-13

⁹⁸ *Ibid.*, p. 5

⁹⁹ *Ibid.*

international Islamic financial institutions mainly the IFSB and AAOIFI as introduced in the preceding chapter.¹⁰⁰

Moreover, the accounting and auditing methods of the conventional banking shall not be used for the banking products of the Islamic window services. The financial institutions and supervisors are advised to adhere to the accounting and auditing standards of the AAOIFI which are practically tested for their merits and Sharia conformity rather than following what their respective Sharia experts have come up with. This pursuit of international consistency will help supervising authorities to easily regulate cross border financial transactions. The harmonization of the different countries' accounting and auditing standards will attract international investors who, in this case, can be able to use the same banking products across different jurisdictions with no uncertainty of the governing standards. Therefore, in the presence of the standards developed by these multilateral bodies, the use of one's own standard as developed by the respective Sharia boards of the supervisory authorities will discourage international investors who want to use Sharia-compatible products across jurisdictions. It will also inhibit the integration of Islamic financial institutions and the development of Islamic banking industry both at national and international level.¹⁰¹

Even countries like Ethiopia that are not members to these multilateral arrangements have a very good role model of regulation to emulate in these institutions and easily integrate in to the Islamic financial system being developed at international level.

4.4.2. Awareness Campaigns

When an interest free banking system is introduced into a conventional financial system, it is natural that the stakeholders of the industry would not be familiar with the sector's legal, regularity and supervisory framework as well as the products and services thereof. Hence, to address such issue, both the regulatory authorities as well as those licensed conventional banks should embark on awareness creation campaigns among the depositing public and investors.¹⁰² Issuing a prospectus or pamphlets, as some of the Commercial Banks in Ethiopia are doing, could be mentioned as one way of making the sector public. But the central banks including the NBE need to indulge in public communication about the newly introduced interest free banking products, their nature and the risks involved therein.

It is responded that the NBE does not/ need not involve in promotion and awareness creation campaigns of interest free banking business. The same position is also taken towards the conventional banking sector.¹⁰³ But the point that should be noted here is that one of the

¹⁰⁰ Ibid.

¹⁰¹ Ibid. p. 6

¹⁰² Sole (2007), cited above at note 70, p. 6-7

¹⁰³ Interview with an anonymous Examiner in the Banking Supervision Department of the NBE (Oct., 21, 2015)

I would like to say some words on the research environment and accessibility of data in some governmental institutions like the NBE in Ethiopia. The interviewee referred to above is one of the higher of officials of the NBE

functions of the NBE is to create a favorable condition for the expansion of banking and other financial services in the country as articulated in its establishment Proclamation.¹⁰⁴ It is also provided more generically under Article 4 of the same Proclamation that the purpose for the establishment of NBE includes fostering a healthy financial system and performing other related activities that are favorable for the economic development of the country.¹⁰⁵ These provisions necessarily anticipate the scenario where the NBE involve in awareness creation activities in order to channel monetary transactions of the general public through the modern banking systems of the country, as this largely contributes to the systemic development and stability of the country's financial system. Therefore, while the function of promotion and public awareness remain the task of NBE for the conventional banking, double role of promotion of the business of interest free banking business in particular is expected as the latter is a newly emerging one with little awareness on the part the Muslim population of the country which is, of course, the main potential user of the system among other possible customers in general. The fact that the bank supervisory authorities involve in promotion activities is also supported by the international practice and state of the art.¹⁰⁶

In general, in the process of introducing interest free banking into a conventional banking structure, the deep understanding of the principles of Islamic finance and standards of operation as developed by international standard setting organizations both by the central banks and the financial practitioners should be the first big step. Furthermore, these institutions are expected to attract the large Muslim population in Ethiopia and foreign investors who need the Islamic financial infrastructure for their investment by creating free and easily accessible information about the industry in the country's context, so that it can be seen as a well regulated and transparent system before the eye of its potential customers. In the absence of such measures, however, the sector will not advance ahead from its nascent stage and satisfy the internal demand and benefit from the industry for the financial and economic development of the country.

4.4.3. Setting up Appropriate Dispute Resolution Forums

leading the supervisory team of the Authority. Unfortunately, he is not willing to be quoted unless some bureaucratic requirements have passed through just to give an interview to a researcher who has adduced a letter of support from Addis Ababa University. The dominating trend on the part of the government institutions regarding the accessibility of data on their internal working procedures and working environment is very limited, and their staff is cooperative to those who prove themselves to be a researcher on the areas related to the mandate of that particular government organ. The same atmosphere is reflected in the NBE wherein, in order to make a simple interview with one of the officers or employees of the institution, the researcher should get the signature of at least three different officials of the Authority. This bureaucracy is obviously not appropriate as the matter is all about Research and Development (R&D), not to get a banking license, for which every governmental and non-governmental institutions should create a cooperative environment and free access of information about their powers and functions. What really paradoxical with respect to the NBE is that the Supervision Department has organized some quantitative data to be delivered to anyone who requests for the same without the need to go through the set procedures for the one who require to conduct an interview. The rationale behind these different viewpoints regarding data collection methodologies is not clear.

¹⁰⁴ The National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008, Art.5(8)

¹⁰⁵ Ibid., Art. 4

¹⁰⁶ Sole (2007), cited above at note 70, pp. 6-7

Legal and institutional framework of a country need to be put in place in order to create a suitable atmosphere for the effective resolution of disputes arising from interest-free window banking transactions. One of the areas that need attention is to assign a particular forum for the resolution of disputes that may arise in the day to day transactions of interest-free windows with their clients. Cases arising from interest-free banking transactions are being entertained by the ordinary Federal Courts and the relevant courts of regional states. But the present court structure is not suitable to accommodate the industry's needs for obvious reason of lack of Sharia expertise in the person of the federal or regional court judges.

The previous adoption and operation of Sharia courts in Ethiopia seem to have laid down a suitable ground for the development of the industry from the point of view effective dispute resolution. So, these Sharia courts established both at the federal and regional level seem to be proper forums for the purpose in question.¹⁰⁷ Nevertheless, even the judges in the Sharia courts lack the knowledge and experience of Islamic banking and its best practices as they didn't have the exposure of studying the *Fiqh* rules in this regard and entertaining practical cases and even for the coming years. The same scenario will continue until the Sharia courts are expressly given the material jurisdiction over cases relating to interest-free banking business and thereby equip themselves with the relevant Sharia rules and best practices of the sector. Thus, the Federal Government can easily expand the jurisdiction of Sharia courts to include interest free banking transactions. Of course, a short-term training and continual training and experience sharing forums for the Sharia court judges must also be taken in to consideration before and after expanding the court's jurisdiction.

4.4.4. Suitable Regulatory and Institutional Atmosphere

It is one of the duties of the NBE that it has to create a favorable environment for the expansion of financial institutions including banks which now upon the issuance of the directives on interest-free banking have incorporated Islamic windows.¹⁰⁸ The NBE not only have an obligation to create a level field of competition for both types of banks in the country but also has the duty to undertake such steps which are considered to be suitable for the development of the interest free banking sector in the country. In general, the legal and institutional constraints for the effective operation of Islamic banking must be avoided.

But one of the key the legal challenges for the operation of interest-free windows in the country is what is provided in the Directive under Art.7/7.2 which strictly prohibits the direct engagement of interest free windows in non-banking businesses such as agriculture, industry, and commerce, and restricts the equity participation of the same in real estate and securities as well as other limitations as provided under Arts.1-8 of NBE Directive No. SBB/12/1996 (Limitation on Investment of Banks). This Directive poses a danger on the effectiveness and profitability of interest-free banking business because it severely hampers the investment

¹⁰⁷ See: Supra note 52 for more information on the issue under discussion

¹⁰⁸ See: the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008", Article 5/8.

activities of interest-free banking business. As it is discussed, in the previous sections, interest-free banks do not perform the typical commercial banking service of collecting funds from the saving public and lending it to those who need it most for their own purpose in return for interest. So, the main source of profit for conventional banks is interest; whereas the profit of the interest-free banking business comes from a profit obtained from different investment activities directly or indirectly. For example: the bank may take the status of *Rabb al-Mal* (the owner of the fund) in the *Mudarabah* contract with another entrepreneur (*Mudarib*) in which case the field of investment could be in varieties of options like in agriculture, manufacturing etc. But if such a restriction is imposed on the interest-free banks, it would really be a huge obstacle to exploit the opportunities through the ideal instrument of *Mudarabah*. Taking the no-interest features and profit-loss sharing characters of such banks, the requirement provided under Article 7(7.2) of the NBE Directive should not have been decreed. The same challenge of restriction on the investment choice of interest free banking has been forecasted, and suggested to be inapplicable to the sector in particular if the government is going to adopt the industry.¹⁰⁹ Nonetheless, the predicted challenge has become the reality by the Directive under discussion.

But what is clear from the day-to-day operation of interest free windows in this regard is that they do not even know the presence of this bottle-neck provision of the Directive. They thought that they are free to engage in any business particularly through *Musharakah* and *Mudarabah* and, they didn't even know the application of the investment limitation regulation of conventional banking to the window services.¹¹⁰ This denotes the fact that the legal awareness of even the high level officials, let alone the ordinary staff, of interest free banking windows of conventional banks is very weak.

Furthermore, it is responded that the NBE does not have any link with any international financial standard setting institutions in neither of its conventional or interest free regulatory and supervisory mandates.¹¹¹ As briefly explained above, the forerunner standard-setters of IFSI are the IFSB and the AAOIFI. These institutions have taken the initiative to develop the regulatory standards and best practices of Islamic banking; and the publication and dissemination thereof. The NBE, though, has adopted a handful of the best regulatory and supervisory standards identified by these international organs, the interviewee explained the reason behind this policy saying that the NBE does not find it necessary to have a cooperative relationship with these institutions for the industry is in its nascent stage posing a minimal need to engage in such relationships. I find this policy direction of the NBE not encouraging for the future development and potential of the industry for the resilience and stability of the country's financial system and economy because the relevancy and collaboration of the standard-setting institutions are not

¹⁰⁹ Abdulwasi' (2003 E.C), cited above at note 13, pp. 105-106.

The thesis is written before the introduction of the Islamic Banking into the country's financial system and made available for the public in Amharic.

¹¹⁰ Interview with Tesefaye Dibabu, cited above at note 84, Accounts and Operation Manager of Interest-Free Window Service at CBE, (15-Sep.2015)

¹¹¹ Interview with the anonymous examiner, cited above at note 103.

limited to the stage where the sector has reached to a developed state. Hence, the NBE has to take a good looking at these standards and best regulatory practices identified at international level and try to develop the country's emerging interest-free banking industry to the level of attracting the local customer and international investors who are aspiring to make use of the Islamic banks in Ethiopia as facilitators and business partners without infringing the rules of the Sharia.

Besides, the best practices that these institutions are introducing is such that they provide a technical assistance and human resource development to member authorities so as to enhance their potential of supervision and ability to provide a suitable environment for the development of the sector across countries. Furthermore, establishing a cooperative framework between supervisory authorities and standard-setters would help harmonize the regulatory and supervisory regimes of the former which would create conducive atmosphere for the cross-border development of the Islamic financial system in general and interest free banking in particular. Ethiopia, for example, can better attract foreign investment from mainly Islamic Jurisdictions by its strong attachment to the IFSB and AAOIFI as an institution and to their respective standards. Therefore, it is recommendable for the NBE to establish this relationship so that the emerging interest free banking industry of the country would better be supported towards its development.

4.5. The Regulation of Interest Free Banking Industry in Ethiopia

Survey results indicate that those countries that have adopted Islamic banking have followed variant approaches in integrating Islamic Banking into their banking regulatory framework. The first approach is the application of the Basel Committee on Banking Supervision (BCBS) regulatory and supervisory framework on all banks including IBs as a default paradigm. This approach is taken by most countries where IB is present including Kenya, Saudi Arabia, South Africa and the UK. Secondly, the application of the default BCBS framework on IBs is complemented by the guidelines of Islamic Financial Service Board (IFSB) so as to ensure conformity with the Sharia. In these jurisdictions, a form of reference is made to the IFSB guidelines without issuing a separate regulations applying to IBs and windows. Many countries have also adopted this approach next to the first (E.g. Jordan, Kazakhstan, Qatar, and Turkey). In third approach, a few countries like Bahrain, Iraq and Kuwait have issued a separate regulatory framework for IBs and CBs. The last one is a mixed approach that applies an integrated regulation for the areas common to both Islamic and conventional of banks with a separate guideline to IBs. This approach is practiced by Indonesia, Malaysia and others.¹¹²

The bottom line of these variant approaches is, although the legal framework of Islamic banking is totally subject to the principles and *Fiqh* rule of Islamic finance, its regulatory framework has a lot to share from the BCBS conventional regulatory regime. It should be noted, however, that the new industry requires some regulatory changes to be made in the existing Basel framework in order to meet the unique needs of Islamic banking and its inherent risks.

¹¹² Song and Oosthuizen (2014), cited above at note 7, p.13

Coming to the regulatory regime of Ethiopia, while the Basel framework is generally adopted for all of the banks, no separate regulatory regime has been laid down for interest-free windows.¹¹³ The Directive of the NBE on interest free banking states under Art. 7/1 that conventional banks who are licensed to conduct interest free banking are required to comply *mutatis mutandis* with all the regulatory and supervisory requirements excepts those directives related to interest. This makes clear that the conventional banking regulations of the NBE are applicable on interest free banking business to the extent that such regulations are relevant and applicable to the latter. But the Directive has also made reference to the modes of operations of the industry in Art. 2/2.2, implying that the standard guidelines that are meant to apply particularly to the sector, as identified by the international standard-setters of IFSI, would constitute the regulatory framework for the window service in addition to the aforementioned conventional directives of the NBE. Therefore, the cumulative reading of the above two provisions of the Directive indicate that the country has a adopted single regulatory framework for both the conventional banks and the Islamic windows with a reference made to the complementary guidelines of standard-setters of the IFSI so that the window service would cater for the reputational risks of non-compliance with the Sharia. Thus the regulatory approach of Ethiopia to the Islamic banking business is similar to those countries that have adopted the second approach of regulation as discussed earlier.

Moreover, the type of authority that takes the legislative initiative of introducing Islamic banking into one's financial system varies across jurisdictions. Many jurisdictions have passed a legislation adopting IB at national assembly level i.e. the matter is taken up by the legislative organ of the concerned country. These states include Sudan, Iran, Indonesia, and Kuwait.¹¹⁴ Whereas others like Bahrain and Afghanistan delegate the power of legislation to the bank regulatory authority. Ethiopia, being placed in the second groups of states, has the NBE which is delegated by the legislative body to issue directives for the implementation of proclamations and regulations concerning financial matters enacted by the Parliament and the Council of Ministers respectively.¹¹⁵ That said in general, the Banking Proclamation No. 592/2008 has specifically mandated the NBE with the power to issue directives to regulate interest free banking business which is stated in a different manner as “a banking business related to the non-interest bearing deposit mobilization and fund utilization.”¹¹⁶ The same idea is also reiterated in the preamble of the Directive that it is issued in accordance with the aforementioned provision of the Banking Business Proclamation.¹¹⁷

¹¹³ Alejandro López *et.al.*(2014), cited above at note 71, p. 18.

¹¹⁴ Song and Oosthuizen (2014), cited above at note 7, p.8

¹¹⁵ *Ibid.*

¹¹⁶ Banking Business Proclamation No. 592/2008, Article: 22/2

¹¹⁷ See: the preamble of the NBE Directives to Authorize the Business of Interest Free Banking No. SBB/ 51/2011

In Islamic Jurisdictions¹¹⁸, Sharia compliance is explicitly required from any applicant who wishes to get license to establish an IB or launch Islamic window. Secular states, however, do not put Sharia compliance as an explicit precondition for licensing IB, but it is made implicit in their licensing and supervisory activities of the relevant authorities. All of the licensing requirements that are unique to IBs as different from the conventional licensing requirements such as the corporate governance structures of SSB and the periodic Sharia review processes, the internal committee set up for the protection of the interest of IAHs, the reporting requirements and all others unique to IBs/windows ensure the compliance of the Sharia, albeit indirectly.¹¹⁹

Ethiopia, being a non-Sharia law jurisdiction where secular laws are applied except in some negligible areas, has followed similar licensing approach to those secular states as reflected in the Directive where mention is made as to the fact that interest free banking is undertaken in accordance with the principles of Islamic finance; but such is not provided in the list of preconditions specified under Art. 4/4.2 of the Directive. But looking through the items in the list, the requirements to submit documents specifying the applicant's accounting policies and profit and loss sharing mechanisms (Art. 4/4.2/f); methods of segregating the funds of interest free banking business from all other businesses (Art. 4/4.2/j); availability of adequate capacity and facilities to run interest free banking business (Art. 4/4.2/e) which is a generic requirement which, *inter alia*, may require the applicant to show its capacity in terms of having the necessary trained staff and technological support meant in particular for interest-free banking business; and other requirements in the list have the effect of indirectly ensuring the conformity of the Sharia, even if such is not explicitly put as a precondition to obtain authorization. Also, other supervisory requirements of the Directive to be implemented after getting license like the obligation to maintain accounts and financial statements in respect of interest free banking transactions (Art. 6 of the Directive) will make sure the compliance of the Sharia as well.

Furthermore, the Directive does not provide separate capital requirements for interest free window as different from the conventional banking system. Thus, the country, just like most of other jurisdictions like Kazakhstan, UAE, UK etc. who are striving to adhere to the BCBS Basel I, II and III, is applying the default Basel capital framework to all banks. There are, however, some divergent comparable IFSB capital standards that are meant to cater for the special features of IBs and windows¹²⁰; hence it is advisable if authorities including NBE take these special guidelines into account and align their regulation with the IFSB capital adequacy requirements, in addition to the BCBS models.¹²¹

With respect to liquidity, the rules of BCBS and the IFSB can be applied to Islamic banks and windows as there is no specific prescription or proscription of the Sharia with respect to the

¹¹⁸ The term 'Islamic Jurisdictions' is used to refer to those countries who have accepted the Sharia as a fundamental law or part of the law of the land.

¹¹⁹ Song and Oosthuizen (2014), cited above at note 7, p.14

¹²⁰ IFSB has issued the first capital adequacy standard, in December 2006, and this and all other guidelines of IFSB are accessible from the homepage of IFSB (www.ifsb.org).

¹²¹ Song and Oosthuizen (2014), cited above at note 7, p.18-20

demand (current) and saving accounts administered by Islamic banks/windows. Therefore, the BCBS and IFSB liquidity rules may be applied to safeguard the interest of depositors through these accounts i.e. *Maslahah* (public benefits) taking the nature of these contracts underlying the demand and saving deposits.

One of the best practices in relation to the governance of IBs and windows is the establishment of the Sharia Supervisory Board (SSB) as part of their corporate structure. Majority of the countries require their IBs and windows to have a Sharia board, and the same also has been recommended by IFSB.¹²² As to the role of the SSB and its accountability, it is given an advisory role in most of the jurisdictions,¹²³ and it is accountable to the Board of the Directors of the IB or the conventional bank in case of Islamic windows. That being the practice in majority of the countries, there are also divergent practices across jurisdictions concerning the role and status of the Sharia board. Some make it a subsidiary organ of the general assembly of shareholders; while in others, it is an independent organ having a compulsory opinion.¹²⁴

The Ethiopian practice in this regard is that the Directive of the NBE does not require the setting up of Sharia board for interest free windows of the conventional banks. This, in fact, is in alignment with the practice of a very few countries like Kenya, Tunisia and Turkey.¹²⁵ But it is identified as one of the risky experiences in the conduct of Islamic banking as the supervisory authority might not be effective in examining every products and services of the IBs or windows in light of the Sharia and regulatory frameworks of the industry, hence the latter might face a very high reputational or Sharia risk in the eye of customers. Therefore, this could be taken as one of the gaps in the regulation of interest free banking in Ethiopia.

Despite the above regulatory gap, the conventional banks that have launched an interest free window service are trying their level best to constitute a SSB at the central level. They, at least have in their short-term plan the commendable task of setting up a Sharia Board that will guide and supervise the operation of their interest free counters across their subsidiaries in the country, though they couldn't find qualified human resource in the field qualifying to be the members of the Board.¹²⁶ The Customers' Account Manager of Interest-Free Window Service at CBE explained the inability of the market in the country to provide Sharia experts in the field of Islamic finance and banking, which is the major factor behind the non-formation of SSB at the CBE. The same scenario is reiterated by other commercial banks offering Islamic window service.¹²⁷

From the supervisory authorities' perspective, the set up of Sharia Board as part of their internal structure is also becoming the practice of several jurisdictions so that the regulatory and

¹²² Ibid., p.17

¹²³ Despite being advisory, the opinions of Sharia Boards are highly respected.

¹²⁴ Song and Oosthuizen (2014), cited above at note 7, p.17

¹²⁵ Ibid.

¹²⁶ Interview with Tesefaye Dibabu, cited above at note 84,

¹²⁷ Ibid.

supervisory activities of the authorities could be guided by expert members of board having the requisite expertise. Similar to heterogeneity of practice with respect Sharia boards of individual banks; the same variety has also been reflected among jurisdictions who have established Sharia boards in their central banks. But the one that represents the majority experience is that Sharia boards have an advisory role in the drafting or amendment of the regulations regarding IBs windows and the enforcement of the same.¹²⁸

In the case of the Ethiopia, the Proclamation that established the NBE as a central bank of the country was enacted before the subject matter of interest free banking has got the policy attention of the FDRE government. Therefore, one can't have the expectation of finding the Sharia board structure in the establishment Proclamation of the NBE. The Directive introducing interest free banking into the country also has no provision to the effect of incorporating Sharia board into the NBE structure. In practice also, the NBE did not constitute a Sharia Board at the central level that would advise the authority on the future policy directions, regulatory and supervisory reforms concerning interest free banking business in the country.¹²⁹

4.6. Supervision of Interest Free Banking in Ethiopia

There are two models of supervisions present across countries where both IBs and CBs are operating. The first is where the supervision is undertaken by a single supervisory authority practiced in counties like Saudi Arabia, Kenya, Tunisia, and the UK.¹³⁰ The second model refers to the supervision by a separate units or departments of a supervisory authority. Indonesia, Pakistan, Bahrain etc. have an independent supervisory unit on Islamic banking within their central banks.¹³¹

Ethiopia follows the first model of supervision where the NBE supervises both the Islamic windows and CBs. The Directive does not provide for a separate unit in the NBE meant for the supervision of interest free banking only.¹³² The mandate of the NBE to supervise an interest free window is being exercised by the single oversight department that is meant for both the conventional and Islamic window of the conventional commercial banks of in the country. The main problem that might ensue by having a unified a supervision unit for both types of banking systems is the high possibility of not implementing an effective surveillance that cater for the unique risks and Sharia compatibility requirements of interest free banking. Though there is a positive claim of the NBE on the adequate knowledge and experience of its examiners in the supervisory department, the fact of the matter can easily be deduced from the responses obtained from an interview with the high ranking examiner of the department that even the fundamentals of Islamic finance and standards of supervision are not well understood. The same hypothesis can further be underpinned from the fact that while the department has an audited quantitative

¹²⁸ Song and Oosthuizen (2014), cited above at note 7, p.17

¹²⁹ Interview with the anonymous examiner, cited above at note 84.

¹³⁰ Alejnadiro *et.al.*(2014), cited above at note 71, p.20

¹³¹ Ibid.

¹³² Ibid.

data about the conventional banks whereas the data about the conduct of the interest free window of the various conventional banks of the country is not yet audited and organized.¹³³ This reality in itself shows the fact that the industry has been given a corner status in the supervisory practice of the NBE oversight department. The bottom-line point would be that the setup of a separate team of supervision for interest free banking within the NBE is a recommended practice even by the international standard-setters of the industry.

The default supervisory framework applied by jurisdictions to both types of banks is the Basel supervision model of Basel Core Principles (BCPs). Even if this system is generally appropriate for IBs/windows, it needs to be adapted in order to cater for the special risks associated to IBs particularly Sharia compliance and protection of IAHs. A more stringent supervision of the Sharia compliance is needed in countries where only Islamic windows are allowed to operate because the risk of the Sharia incompatibility is highly probable when Islamic banking is offered by a conventional bank.¹³⁴ The IFSB, in this regard, has issued a guideline for risk management¹³⁵ which will help identify and address the unique risks of the industry and serve as a spring board to consult the BCPs for other risk management issues which are common to both the Islamic and conventional banking systems.

The typical off-site and onsite supervisions on CBs should also be implemented on IBs and windows. As part of the off-site supervisory activities, the reporting duty of IBs is expected to take differing features of Islamic banking in to consideration as compared to CBs. Hence the Sharia law jurisdictions require IBs/windows to submit additional information relating to Islamic banking transactions and products besides the one which is required from the conventional banking system. If the authorities are to effectively undertake the off-site supervision, enhanced transparency and disclosure requirements must be complied by IBs and windows. Such disclosure would help the central authority to promote good business practice, protect the various stakeholders and take enforcement measures in the case of non-compliance. The supervisory authorities require both types of bank to provide sufficient information on their banking practice in order to examine the conformity of their activities with banking regulations.¹³⁶

The same accommodation of IBs has to be conducted in the on-site supervision of the industry by the mandated authority. These on-site inspectors should be well trained in the field so that they can inspect the compliance of the products and services offered by IBs with the Sharia like for example to verify the fact that the financial transactions actually involve real assets, not just mere monetary or commercial paper dealings.¹³⁷ If the authority, in its on-site inspections of Islamic windows, finds a discrepancy between what the bank reports and what the bank is actually practicing, it should take corrective measures. It is reported that most of the overseeing

¹³³ Interview with the Anonymous Examiner, cited above at note 84

¹³⁴ Alejnadiro *et.al.*(2014), cited above at note 71, p.21

¹³⁵ Guiding Principles of Risk Management for Institutions (other than insurance institutions) offering only Islamic Financial services (IFSB-1)

¹³⁶ Song and Oosthuizen (2014), cited above at note 7, pp. 22-23

¹³⁷ Ibid.

authorities of Muslim countries spent up to 80 percent of their resources for on-site examination IBs. They have well-qualified on-site examiners in the field. In this respect, international Islamic financial institutions including the IFSB provide technical assistance to national supervisory authorities; therefore, the latter are advised to benefit from the available assistance scheme of such international organs.¹³⁸

The practice of the NBE in this regard is that, since the inspection, either on-site or off-site, is being undertaken by the same supervising department whose examiners have no special training and experience in the standards of supervision of interest free banking, the unique risks of window operation that could be addressed by standard supervisory precedents might not be averted until the necessary standard supervisory arrangements are made.

¹³⁸ Ibid., p. 23

Chapter-5

Conclusion and Recommendations

5.1. Conclusion

The discussion of some of the basic notions of Islamic economics and Islamic finance can generally be justified on the basis of the fact that these disciplines provide the theoretical and legal regime of interest free banking respectively. Both the legal and regulatory and the institutional framework of Islamic banking has been adopted and integrated into the financial systems of many jurisdictions across the world at different levels. The effectiveness and the positive contribution of the system have been proven since its emergence four decades ago.

The same framework has been able to attract the policy attention of the Ethiopian financial system primarily with the rationale of responding to the long felt need of Islamic banking products by the Muslim population of the country which constitutes the largest fraction of the country's total population next to the Christians. The benefit or the potential that the interest free banking system holds in light of the overall financial and economic system of the country must also be noted as witnessed in the Islamic and other secular jurisdictions where IBs are present.

The NBE has reflected the government's policy of adopting Islamic banking and responding to the need thereto by issuing the Directive that mainly enlists the precondition for the authorization of CBs to offer interest-free banking services. Based upon the enabling Directive of the NBE, a number of conventional banks of the country including the CBE, the UB and the Oromia International Bank and others have got the license and started offering the products to the public.

That being the *status quo* of interest free banking sector in Ethiopia, the Islamic banking industry is being harmonized by its institutional framework at international level which, among others, holds the IFSB and the AAOIFI. These institutions took the initiative to identify the best practices of the industry as it is practiced by jurisdictions where IB is present, and they have also adopted the default BCBS framework to Islamic banking in a manner which is compatible with the Sharia principles of finance and economics.

As Ethiopia has adopted interest-free banking, and it is being regulated and supervised, the same endeavor can be examined in light of the international regulations as developed by the standard-setting organizations of the industry. This very point has become the focal point of this paper, thus the regulation and supervision of interest free banking in Ethiopia, as it is now, has been examined in light of the standards of regulation and supervision prepared by the institutional infrastructure of the IFSI. It should generally be noted that the default regulatory and supervisory framework of the Basel Committee on Banking Supervision (BCBS) is also relevant for interest free banking. One might wonder why to deviate from the default framework. The answer, in nutshell, to comply with the Sharia rules (the legal framework), minimize the risks associated with the application of the Sharia and the protection of depositors. Therefore, taking the unique

features and risks associated with the industry, the standard-setters of the industry have adopted the Basel standards and issued new standards where necessary.

Taking this approach for the analysis of the topic of the thesis, regulatory loopholes and bottleneck requirements of the Directive of the NBE, and the supervisory deficiencies and weaknesses of interest-free banking industry are discussed in the body of the paper; and the possible solutions to these regulatory and supervisory gaps are suggested in the forthcoming sections.

5.2. Recommendations on the Regulatory Framework of the Country

In the endeavor to regulate interest-free banking has, the NBE has, thus far, come up with only one directive that has several gaps in the regulation of the industry. Thus, the NBE should develop a comprehensive regulatory framework for the currently operating Islamic windows under the licensed conventional banks of the country. In fact, it is not necessary to duplicate the default banking regulation of the country which is largely based on the Basel framework to the extent that it is the same with what is in the standards of the IFSB and AAOIFI in terms of its content and application. But as far as the unique characteristics of interest free windows are concerned, a separate and detail standards has been identified by these organs. Therefore, the NBE has to enact a detailed directive covering the unique regulatory needs of interest free banking conforming to the standards of the IFSB and the AAOIFI. That said in general, the specific regulatory measures that the NBE need to take may include the following;

- ❖ One of the gaps in the regulation of the industry in the country is that the Directive governing interest free banking does not require the CBs offering Islamic banking the obligation to establish a Sharia Board which is essential for the effective governance and risk avoidance of the windows' operation. It is made clear that setting up of a Sharia supervisory board plays a vital role in minimizing the reputational risk of Sharia non-compliance in general, and it has also the positive role of ensuring the follow-up of the windows up to the standard of operations and protecting the interest of IAHs and depositors in general.
- ❖ The Directive also lacks in the necessary provisions regulating the risks associated only with interest-free banking, though the other risks shared by both the CBs and windows are made to be regulated by the already existing default regulatory directives of the NBE. As stated earlier, risks related to the PLS nature of interest free banking such as capital risks or risk of loss of the IAHs due to bad investment decisions and the resultant transfer of the same risk to the IAHs is left untouched in the Directive.¹³⁹

¹³⁹ It is supposed that the market of interest free banking has a potential of protecting the IAHs from sharing losses out of the investments of the bank because the latter might lose its customers if it transfers loss to the capital of their deposits. But in a country like Ethiopia where the development of interest-free banking is in its infant stage, competition of IBs/windows or the market of interest free banking may not protect the interest of IAHs. Rather, the whole responsibility of ensuring the investment options of the bank in light of the depositors' interest will fall on the supervising authority which is the NBE in our case. The NBE, therefore, besides the Directive for the authorization of interest-free banking window services, has to come up with a detail directive regulating the investment practice of the conventional banks offering interest free banking service so as to protect the depositors of the same.

- ❖ The Directive can also be critiqued in terms of laying down a non-suitable regulatory environment for the development of the industry. It has been discussed that Art. 7(2) of the Directive prohibit interest free windows from indulging in the direct investment of trade, commerce and agriculture, and it also limits the equity participation of Islamic windows in real estate and securities. As interest free windows do not involve in the payment or receipt of interest, the major source of profit constitutes the return from direct investments with or without partnerships. Thus, the restriction would seriously hamper the banks' capacity to pay profits to its depositors and to secure enough amount of profit for its shareholders which is the prime reason for its survival. Therefore, the application of this investment limitation in the directive of the NBE on interest free windows has to be lifted as the limitations do not suit the business of interest free banking.

5.3. Recommendations on the Supervisory Framework of the Country

As a general policy guideline, the NBE is mandated to play a significant developmental role in creating conducive environment for Islamic banking as introduced into the conventional system. This is not to say that regulatory or supervisory advantages should be given to interest-free banking services but a level playing ground should be laid for both systems meaning that the NBE should strive to create awareness about interest-free banking and its products; and avoid any possible regulatory or oversight discrimination in terms of protecting customers and fostering the environment for the banks to be able to offer a suitable response to customers' demands for Islamic banking products. In particular, the following supervisory flaws need to be addressed;

- ❖ The NBE has to constitute a Sharia Board that will assist the regulatory and supervisory activities of the authority on interest free banking sector of the country. The significant position of the SSB in terms of creating confidence of customers and attracting foreign investment has been noted from the advice of standard setting institutions and standard practice of numerous jurisdictions practicing Islamic banking.
- ❖ A separate supervisory team for interest-free banking business must be constituted within the supervisory structure of the NBE
 - This enables the NBE to cater for the unique supervisory needs or risks of the industry as opposed to the ordinary oversight requirements common to both the CBs and Islamic windows.
 - Having a separate supervisory team also lays a good ground for developing a separate and specialized team of examiners that will have better capabilities in terms of Sharia expertise and standards of supervision for interest free banking.
 - The present banking supervision department of the NBE working both on the conventional and interest-free banking must get regular trainings and workshops

about the international supervisory standards of interest free banking, so that their oversight activity would accommodate the unique supervisory needs of the sector.

- ❖ The NBE has to involve in awareness creation campaigns and public communication about the interest free banking products and their risks, so that it can achieve its purpose of attracting the saving of the large segment of the country's Muslim population towards the strengthening the country's financial system and economy.
- ❖ The position of NBE, as it is now, with regard to establishing a strong affiliation with the standard-setters of IFSI at international level is not acceptable. Any financial system wherein Islamic banking is present is advised to have a connection with these institutions irrespective of the level of development of the industry in the country, because these institutions are even better committed to extend a variety of assistance packages to those member jurisdictions where the industry is at nascent stage of growth.
- ❖ The non-availability of qualified experts and workforce account for the non establishment of Sharia Boards at the CBs offering the Islamic banking service in Ethiopia. The problem can be minimized in short-term by delivering regular trainings and seminars for the existing personnel of the CBs that have interest-free banking counters.
 - The long term solution for the problem at hand would be to inculcate the subject of Islamic finance and banking in the higher educational curriculum of the country. To avert the problem at hand in the long term, the higher educational curriculum of the country should accommodate the growing need of the sector for trained human power so that the scarcity facing the sector could be remedied in the long-term. Thus, Islamic finance and banking should make up part of the studies of various disciplines in its multi-disciplinary (cross-curricular) nature. It should be noted that the sector's need for expertise is shared by its supervision, dispute resolution, and bankers (CBs).¹⁴⁰
- ❖ Appropriate and capable dispute resolution forums must be assigned and developed in their capacity. The present ordinary court judgship entertaining disputes arising from interest-free windows transactions needs be acquainted with the laws of Islamic finance and banking regulations and standards in order to resolve such cases effectively. In long run, the idea of broadening the jurisdictions of Sharia courts of the country to include financial transactions in the context of interest-free banking have to be considered, and the necessary building of the capacity these courts need to be sought about now on.

¹⁴⁰ The inclusion of Islamic law as a course in the legal curriculum of the universities is a good precedent that such academic institutions could follow in the process of incorporating Islamic finance as an independent discipline. But since efforts requires the government's time and resources, temporary measures corresponding to the recent opening of interest free window services need to be taken by the concerned government organs.

In general, the regulatory loopholes and supervisory weakness of the interest-free banking industry of the country seems to have stemmed from handling both the conventional and interest-free banking businesses in the same manner. In so far as these two systems are different in terms of their philosophical foundations and modes of operation, differential treatments should have been accorded to them for the sake of equality and creating a level playing field for both banking sectors.

5.4. What is expected from CBs Offering the Service?

The banks that got authorization to offer interest-free banking service or those who are planning to get authorization are also expected to play a better role. These include:

- ❖ The general public in Ethiopia does not have even a basic level of awareness about interest-free banks and its services. Most feel strange when they hear about the bank without interest. Even those members of the community who are not willing to work with the conventional bank do not feel safe when they think about the bank's effectiveness and profitability. Therefore, the banks that are giving interest and the government should engage in awareness creation campaigns. The Commercial Bank of Ethiopia (CBE), the United Bank and other conventional banks that got authorization to operate interest-free banking business are trying to introduce the service to the general public and their customers through TV advertisement, Pamphlets and Posters. Though awareness creation activities bear high costs, since the industry is operating for the first time, awareness creation should be conducted at large scale at any cost as it is a condition for their success.
- ❖ They should create a public confidence by adhering to the accounting and other operational standards of the leading international organs of the industry
- ❖ Regular training programs, Seminars, workshops on Islamic finance, and standards and procedures of Islamic banking must be organized for the officials and employees on the interest free counters of the commercial banks.
- ❖ Commercial Banks that have launched the window service have to prepare a comprehensive blueprint on interest free banking concepts and procedures which would serve as a guide to the management and staff of the windows. The guidelines of foreign Islamic banks and windows could provide a material source of knowledge and precedent in the preparation of the blueprint for interest free banking windows of the country. Meezan Bank's Guide to Islamic Banking can be one example.¹⁴¹

¹⁴¹ See: Usmani (2002), cited above at note 12.

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