



ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

*Opportunities and challenges of Islamic
Banking Establishment in Ethiopia*

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A Thesis Submitted to St. Mary's University, School of Graduate Studies in Partial Fulfillment of the Requirements for the Degree of Masters of Business Administration in Accounting and Finance.

June, 2020

Addis Ababa, Ethiopia

St. Mary's University

School Of Graduate Studies

This is to certify that the thesis prepared by Zegeye Belayneh, entitled: *Challenges and Opportunities of Islamic Banking Establishment in Ethiopia* and submitted in partial fulfillment of the requirements for the degree of Master of Accounting and Finance, complies the regulations of the university and meets the accepted standards with respect to originality and quality.

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Acknowledgements

All praises be to the Almighty Allah, The Lord of all that exists for he brought me to the world, sustained me, helped me to fulfill good deeds. He deserves the highest praise and glory.

I would like to express my gratitude to my advisor, **Abraham G. (Asst. Professor)**. For his professional and fatherly advices and guidance which contributed a lot to the fulfillment of this thesis.

I would like to use this opportunity to express my respect and thanks to my spouse, **Miss Refref Seid**, the mother of my children, who stood by my side, sacrificed her precious time, and encouraged me in all my way to attend the University's courses and conducting this study.

I am grateful to **Ustaz AbuYasir AbdulMenan**, a chairman of Sharia Advisory Committee in one of the private banks, for sharing me his knowledge and experience concerning Islamic Banking concepts and helped me a lot in organizing the research paper.

Finally I would like to express my recognition and appreciation to those managers and staffs of the available private banks, founders and shareholders of ZamZam and Hijra bank, for feeding me with necessary information, filling the questionnaires and spending their time in responding my interviews.

Thanks for all!

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Acronyms

NBE - National Bank of Ethiopia

CBE - Commercial Bank of Ethiopia

ISB - Islamic Banking

IFB - Interest Free Banking

Abstract

The significant role of banks in the facilitation of the economic movement and enhancing the wealth growth of a nation is so much clear.

In recent years, the promotional packages of televised advertisements forwarded by banks both CBE and the other private banks draws ones attention interested in the field. The objective of this study is to assess the opportunities and challenges of Islamic Banking Establishment.

To achieve the goal of this research a total of 150 questionnaires were prepared and distributed to bank managers, IFB directors, Bank employees, under - formation bank founders, shareholders of banks, Sharia'ah advisors and businessmen.

128 questionnaires were collected with a response rate of 85.3%. Nevertheless, only 120 questionnaires were found completed and valid for analysis.

The findings of the questionnaire, interviews and documentary results reveals that the equity tied capital business makes up a huge market financial resource is the opportunity. However the current status of Islamic Banking in Ethiopia is very low which does not respond to recent demands of potential customers; and the policies yet to design to run the IFB and full-fledged ISB services.

The lack of linking institutions, constraints in public awareness to ISB are among the major challenges. It is recommended that the public in general should avoid the negative attitude, understand the true sense of ISB along with its economic contribution, stakeholders in IFB and ISB should enhance the way their promotional package and the government should smooth the Islamic financial institutes as Islamic Banking services come up with alternative packages that will enhance the national economic growth.

Key Words: - Full-fledged Islamic Banking Establishment, Opportunities and, Challenges.

CHAPTER ONE

1.1. Introduction

This chapter introduces the research subject briefly and defines the research background comprising the results and problems from preceding studies concerning the subject both at international and national levels. Further, the statement of the problem, the objectives, the significance, scope and limitations and the structure of the research project are discussed.

1.2. Background of the study

The challenges and opportunities of Islamic banking have been studied by different scholars in relation to its rapid growth and has become increasingly significant in financial area in the World. Islamic banking is a banking system that complies with Islamic Law – Shariah. The rules and practices under Interest free banking are in accordance with the primary sources of Shariah Law. The growth of Interest free Banking partly reflects the demand from the Muslim population and non-Muslim clients for Interest free deposit facilities and fund management services which involve Shari’ah compliance. At the same time Islamic financing methods are viewed as challenges on the operation by Ethiopian commercial bankers, many of whom have sought to get involved in this growing industry. In client driven societies there is willingness by those in financial services to listen and learn from the experiences of Islamic banks, which in the longer run may bring a major breakthrough for Islamic banking at the retail level in the country (Usmani, 2015).

In some countries such as Pakistan, Iran and Sudan all banks are operating according to Islamic financial law but in some other countries such as Ethiopia, Bangladesh, Egypt, Indonesia, Jordan and Malaysia Islamic banking services are provided through conventional banking. There is big movement started in the Western countries especially United Kingdom, Australia and United states to open Islamic banking in full-fledged model. According to Islamic law interest is totally prohibited because interest has lot of bad effects on society such as their earning capacity, purchasing power and increases poverty, unequal distribution of wealth and credit crisis in an economy. (Shanmugam, Perumal and Ridzwa, 2004)

The Islamic banking system is one which operates according to the teachings of the Islamic faith. Apart from this feature, the interest-free banking system has other objectives amongst which are the equitable distribution of income and wealth and increased equity participation in the economy (Clifford, 2008). It also prohibited investing in businesses that provide goods or services considered contrary to its principles, *Haraam*, such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, which are contrary to Islamic values (Mohammed 2012).

In Ethiopia more than nine banks have the license to provide Islamic financial services on window basis and according to Sha'riah law. Islamic banking is based on Sha'riah Law which is believed to provide all solutions for financial Problems.

Nowadays, through the intensification and modernization of the financial sector is becoming inevitable in enhancing the development of a country.

Turning a face to the global trends of the Islamic banking as an alternative package in the financial sector and the demand of religious affiliated customers is the main derive to conduct this thesis.

1.3. Statement of the problem

Even if there are various researches on the significant factors of Islamic Banking (Interest free) in developed and emerging market countries are available. Due to its uniqueness to Ethiopia the concept is not yet well researched. Among these studies Mohammed in 2012 has studied the Prospects, Opportunities and Challenges of Islamic Banking in Ethiopia“ in his work discuss the potential challenges as: lack of awareness, regulatory, supervisory and institutional challenges, lack of support, gap in research and development in Islamic studies, lack of qualified human resource as well as unreasonable association with specific religion and the global terrorism but this study was conducted before the practical introduction of the IFB in Ethiopia.. And also Debebe Alemu (2015); who studied the factors affecting customers' use of IFB in Ethiopia and found out that 100% of IFB account holders were all Muslims. Obviously, the failure of banks to estimable serve the Ethiopian Muslim population hinders the development of the Muslim

inhabited areas in particular and the economy of the nation as a whole. This study is about impact assessment on the attitude towards IFB usage which does not address the current problem at hand. On the other hand a research by Akmel Hailu's (2015); study is about "challenges and prospects of Islamic banking for resource mobilization in Ethiopian commercial banks. "The study focuses on challenges and opportunities of IFB only on resource mobilization other challenges and opportunities are not well addressed. And also Teferi's (2015), study is about "Contribution of IFB to economic development and its prospect in Ethiopia". The contribution of the study includes assessing the Muslim population in to the banking (financial system) to the economic development and GDP growth. This study has a gap of taking the realities of other Countries and in Kerima Ali Mohammed's (2016), study which is about "Challenges on Interest Free Banking Services" The study discuss the challenge faced by service providers and users of IFB products and scope of service provided by Ethiopian banking through IFB including whether there is unmet demand of users, awareness of customers and capacity of bank .the study doesn't addressed the opportunities of interest free banking as a new business strategy in Ethiopia.

And also the other (Shaikh, Salman, Ahmed2014), Wondwosen (2018), (IMF (2015). Tsion (2017); their characteristic is quite different from developing countries, (Ahmed,(2010) Differences in culture, corporate governance, interest free, information asymmetry, investors, attitude, and ownership structure are the differences mentioned AT Kearney, 2012) few studies are conducted on the Islamic banking in Ethiopia like Tsion (2017); and Wondwosen (2018); focused on the interest free banking sector. Islamic Banking is not only affected by the factors that associated with the firms rather than the industry, the macroeconomic and legal environment of the country which the firms operate may have also a significant impact so that the banking decision in developing countries may affected by different set of behaviors.

Most of the researches ever conducted locally addressed the Interest Free Banking (IFB) which even the conventional banks are already giving the service in windows and some in isolated branches. The establishments of full-fledged Islamic banks, which offer the owners of capital to share the profits made by the entrepreneur who comes up with investment projects, is an untouched concept for the local financial sector.

Since, Muslims believe that banking with the conventional banks is against their religious belief; large numbers of potential Muslim customers are not banking with the existing conventional banks available in the country.

The idea of Islamic banking is new for the economy, new for the society, and new even for business practitioners. It is necessary to look at the opinions regarding services and products offered under Islamic Banking.

The problem is believed to be so important since the currently running conventional sector is not serving the large part of the citizens who are affiliated to their interest-forbidding religion as researches indicate. Therefore, this study attempts to fill the above research gap by investigating the challenges and opportunity of Islamic banking Establishment from the service provider's view.

Having in mind that Islamic Banking has its part in the Business area globally; the eagerness to know whether the so-called full-fledged Islamic Banking is a feasible alternative package in Ethiopia in the banking arena with all possible challenges is the point that motivated me to conduct this study.

1.4. Research questions

- What is the current status of Islamic banking services in Ethiopia?
- What are the opportunities that Islamic banking establishment has in Ethiopia?
- What are the challenges which the banks and customers could face in delivering and using Islamic banking?

1.5. Objectives of the study

1.5.1. General Objective

The main objective of this study is to assess the opportunities and challenges of Islamic banking establishment in Ethiopia.

1.5.2. Specific Objectives

The specific objectives of the project study are as follows:

- To assess the current status of Islamic banking services in Ethiopia.
- To investigate the opportunities that Islamic banking establishment has in Ethiopia.
- To evaluate the challenges which the banks and customers could face in delivering and using Islamic banking.

1.6. Significance of the study

The establishment of Islamic banking will have too much advantage for Ethiopia. Thus, the study will be conducted by expecting that it will yield valuable and potential outcomes that will benefit too many parties in and outside Ethiopia as well. The study will take into account the following benefits and beneficiaries: Firstly, for bankers and financial institutions, it provides another window to expand their profits and services. Secondly, it will try to show would be benefits and opportunities of Islamic banking to individual and institutional investors of Ethiopia who want to invest in this sector. Thirdly, it helps the NBE policy makers to understand the environment needed for Islamic banking in Ethiopia and it supports them while developing new policy related to Islamic banking. Fourthly, it gives awareness to the Islamic bank officers to be ready to face challenges that will hinder its establishment and progress. It also gives more awareness to the intellectuals as well as the general public regarding the benefits and operation of Islamic banking; and finally, it gives highlights to the government officers who have relations with banking activities regarding its sources of revenues and taxable incomes.

1.7. Scope of the study

The researcher has assessed the rationale behind the prohibition of interest, the needs for Islamic banking, and some of the many opportunities of Islamic banking establishment in Ethiopia. The study focused on the challenges that would be faced by Islamic banking that would be established in Ethiopia up on its establishment process. In addition, the anticipated potential opportunities of Islamic banking in Ethiopia has also been identified and analyzed. In almost all analysis, the researcher took into account as case, two under formation Islamic banks, namely ZamZam and Hijra Bank. It has also dealt with the potential challenges of these banks in Ethiopia if their dreams came true and they come to ground.

1.8. Limitation of the Study

For complete understanding of the subject matter, it would be essential to consider all under formation banks that claim they will apply Sheria Law in their Banking services and those conventional banks that render Interest Free Banking services in Windows and isolated branches. So, the research results, the derived conclusions and recommendations would fill a percentage of gaps of previously conducted studies.

Secondary data could not be attained to satisfactory level and that was because of COVID-19 exacerbation in many offices. This is the other limitation of the study.

1.9. Organization of the paper

The rest section of research paper is organized into five different chapters. Chapter one contains back-ground of the study, statement of the problem, research objectives, significance of the study, limitations and scope of the study. The second chapter summarizes theoretical and empirical literatures on Islamic banking and the related issues. Chapter three is about the methodology of the research; that is the research design, sampling technique, method of data collection, data collection instruments, method of data analysis and so on. The fourth chapter of the paper presents the findings as well as the quantitative and qualitative data analysis. Finally, in chapter Five, the researcher has summarized and concluded the study. Finally, some recommendations are proposed depending on the research finding conclusions.

Chapter Two

Review of Related Literature

In this chapter, the related literature is reviewed and discussed. The literature concerning the opportunities and challenges of Islamic Banking establishment in Ethiopia and elsewhere is presented. The relevant literature is collected from different secondary sources and it includes about the History of Banking in Ethiopia, meaning and categorization of Riba (Interest), Reason behind the Prohibition of Interest, and Islamic banking literature versus practice, empirical evidences on Islamic Banking establishment in Ethiopia is analyzed in the following sections of this chapter.

2.1. History of Banking in Ethiopia

The agreement that was reached in 1905 between Emperor Minilik II and Mr. Gill vary, Representative of the British owned National Bank of Egypt diverse the introduction of modern Banking in Ethiopia. Following the agreement, the first bank called Bank of Abyssinia was established in office in February 16, 1906 by the Emperor (NBE, 2001, p.1).

The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the integration as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million. In the new commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians (NBE, 2008, p.3).

Following the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. Organizational setups were taken in order to create stronger institutions by merging those that perform similar functions. Thus, the three private owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli Merged in 1976 to form the second largest Bank in Ethiopia called Addis Bank with a capital of Eth. Birr 20 million and had a staff of 480 and 34 branches. Before the merger, the foreign participation of these banks was first nationalized in early 1975. Proclamation No. 99 of 1976 brought into existence the Agricultural and Industrial Bank, which was formed in 1970 as a 100 per cent state

ownership, was brought under the umbrella of the National Bank of Ethiopia. Afterwards it was re-established by proclamation No. 158 of 1979 as a public finance agency possessing legal personality and named Agricultural and Industrial Development Bank (AIDB). It was delegated with the financing of the economic development of the agricultural, industrial and other sectors of the national economy extending credits of medium and long-term nature as well as short-term agricultural production loans (NBE, 2001, p.4).

Next the change in the economic policy, financial sector reform also took place. Monetary and Banking Proclamation of 1994 established the National Bank of Ethiopia as a legal entity, separated from the government and draw round its main functions (NBE, 2001, p.4).

Monetary and Banking proclamation No. 83/1994 and the Licensing and supervision of Banking Business No. 84/1994 laid down the legal basis for investment in the banking sector. As a result shortly after the proclamation the first privet bank, Awash International Bank was established in 1994 by 486 shareholders and by 1998 the authorized capital of the bank reached Birr 50.0 million. Dashen Bank was established on September 20, 1995 as a share company with an authorized and subscribed capital of Birr 50.0 million. Bank of Abyssinia, another privet banks was founded by 131 shareholders with subscribed and authorized capital of 25.0 million and 50 million, respectively. Wegagan Bank with an authorized capital of birr 60.0 million started operation in 1997. The fifth private bank, United Bank was established on 10th September 1998 by 335 shareholders (NBE, 2001, p.4).

2.2. Islamic Banking

Many scholars“ gives various meaning to this term Islamic banking. It refers to a system of banking or banking activity that is regular with the principles of Islamic law (Sharia) and its practical application through the development of Islamic economics.

This Islamic law (Sharia) prohibits the payment of fees for the renting of money (Riba, usury) for precise terms, as well as investing in businesses that provide goods or services considered opposite to its principles (Haraam or forbidden). While these principles were used as the basis for a successful economy in

earlier times, it is only in the late 20th century that a number of Islamic banks were formed to apply these principles to private or semi-private commercial institutions within the Muslim community (Martin C. & Heiko Hesse, 2008.).⁵

According to Yahiya Abdul-Rahman, (2010),⁶ Islamic banking defined as conventional banking minus the word „interest“ with a new contract that does not include the word „interest“ and that is structured in a convoluted version of buy/sell, in which the seller changes ownership to the bank and then the bank sells it to the eventual buyer. Islamic banking according to Sandrara rajan, (2011) consists of mobilizing funds through noninterest bearing deposits and through investment deposits based on “profit-sharing and loss-bearing” contracts and channeling these funds to finance permissible (under the Shari‘ah law) investments activities, using various forms of Islamic finance contracts. Islamic banking as described according to Yahia Abdul-Rahman, (2010) it is a brand of banking that is socially responsible and is community-based in both spirit and intent. This brand of banking is the manifestation of Judeo-Christian-Islamic values.

In addition to this Islamic banking does not discriminate, because discrimination in service and financing and in dealing with others is a major sin in all Abraham faiths.

Islamic banking is a system of banking that mobilizes saving on the basis of profit and loss sharing that is considered to be fairer and more conducive to measurement and development. Owing to the growing demand by the Muslim population in Western countries and also to the increasing interest of Islamic investors to diversify geographically their portfolios, conventional banks are increasingly becoming interested in entering the market of Islamic financial products. (Hassen and Lewis, 2007)

2.3. Overview of Riba (Interest)

The word riba has been in the Holy Qur'an on numerous occasions. So it is necessary to know what it means or what it really stands for. Riba has been take out from Raba. It means addition or increase (Maudoodi, 1987, p.84).

Hence, riba exactly means to increase, to grow to rise, to add. It is, however, not every increase or growth which has been prohibited by Islam. In the Shari'ah, riba technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a

condition for the loan or for an extension in its maturity. In this sense riba has the same meaning as interest in accordance with the consent of all the lawyer without any exception. So the holy Qur'an and the Hadith⁴ do not make any such distinction between usury and interest. Interest and usury both are taken as synonymous for the Arabic Word riba (Harran, 1993, p.6).

Muslim lawyer have classified riba in two type: 1) riba al-nasi'ah, and 2) riba al-fadl.

Riba al-nasi'ah: The term nasi'ah means to delay or to wait and it refers to the time period that is allowed for the borrower to repay the loan in return for the addition of the premium.

Hence it refers to the interest on loans. The prohibition of riba al nasi'ah in essence implies that the fixing in advance of a positive return on loans as a reward for waiting is not permitted by the Shari'ah (Capra, 1992, p.35).

Riba al-fadl is the excess over and above the loan paid in kind. It lies in the payment of an addition by the debtor to the creditor in exchange of commodities of the same kind. The following tradition of the prophet Muhammad is cited as evidence. It is related that Abu Said al-Khurdi said "the prophet Muhammad has said that gold in return for gold in return for gold, silver for silver, barley for barely, wheat for wheat, and salt for salt can be traded if and only if they are in the same quantity and that is should be hand to hand. If someone offer more or receive, then he is engaged in riba and accordingly has committed a sin" (Al- Harran, 1993, p.18).

Towards, riba al-nasi'ah and riba al-fadl are both covered by the poetry, "Allah has allowed trade and prohibited riba" Qura'n (2:275), while riba-al nasi'ah relates to loans and riba al- fadl relates to trade. Even though trade is allowed in principle it does not mean that everything in trade is allowed.

2.4 .Prohibition of Interest

Many Muslim scholars and some western thoughts believe and still considering that just in-terest free banking is as an Islamic banking. Actually interest is fully prohibited in Islam that is proved in Qur'an and sunnah. "the interest that you give in order to increase the wealth of the people, does not increase in the sight of God; and the zakat that you pay in order to win God's approval, its payers do indeed increase their wealth. It is concluded from above statements that in Islamic there is no room for interest. Interest is totally prohibited in Islam. In interest-based economy the

depositors want to get more interest and want to increase their wealth through interest. They are not taken part in investment activity it leads to collapse and credit crunch. On other hand the banks charge high rate of interest on loan, it creates the difficulties for poor people of the society and leads to maximize the wealth of industrialists and giants. (Shafi and Usmani, 1997)

2.5. Progression and Historical Development of IFB

The basis of Islamic banks as major players in the financial field was in the early 1970's. But the rules and regulations governing the Islamic banking system has been present in the world for more than centuries (Siddiqi, 198p, p.219).

It seems that the history of interest-free banking could be divided into two parts. First, when it still remained an idea; second, when it became a reality -- by private initiative in some countries and by law in others. We will discuss the two periods separately (Siddiqi, 1980, pp.219-20).

2.6 .Interest-free Banking as a thought

Interest-free banking look like to be of very recent origin. The earliest references to the reorganization of banking on the basis of profit sharing rather than interest are found in Anwar Qureshi (1946),⁸ Naiem Siddiqi (1948)⁹ and Muhmud Ahmad (1952) in the late forties, followed by a more elaborate description by Muhammad Hamidullah's 1944, 1955, 1957 and 19629 writings too should be included in this category. They have all recognized the need for commercial banks and the immorality of interest in that enterprise, and loss sharing. In the next two decades interest-free banking paying attention, partly because of the political interest it created in Pakistan and partly because of the emergence of young Muslim economists. Workings specifically devoted to this subject began to appear in this period. The first such work is that of Muhammad Uzair (1955). Another set of works emerged in the late sixties and early seventies. Nejatullah Siddiqi (1969),¹⁰ were the main contributors (Siddiqi,1980,p.220).¹¹

2.7. The future of Interest-Free Banks

The primary private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and the Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House (Rad, 1991, pp 13-14).

In the ten years since the establishment of the first private commercial bank in Dubai, more than 50 interest-free banks have come into being. Though nearly all of them are in Muslim countries, there are some in Western Europe as well in Switzerland, Denmark, Luxembourg, and the UK. Many banks were established in 1983 and 1984. The numbers have declined considerably in the following years (Ausaf, 1994, p.373).

2.8. Objectives of Interest-free banking System

In the early nineteen eighties Ataul (1982); stated the following eight objectives of Islamic banking.

1. The reason why interest is forbidden is to create opportunities for the investor or capital owners to apply their own physical and mental capabilities in multiplying their wealth.

2. It is stated in the Quran that the poorer section of the community has got the right on the wealth of those who have got excess over their own need.

So, it is not a question of asking the poor borrower to pay excess over that lent out rather than helping them in their suffering.

2. The reason behind forbidding interest is to help situate an explorations free society. There is no refuse the fact that interest is one of the most important and powerful mechanisms by which more fortunate use the less fortunate.

4. To help an economy to achieve maximum growth;

5. Payment or acceptance of interest should be understood in the light of all other inestimable embargo of Islam. To avoid doing from paying or accepting interest is as important as the payment of Zakat to enjoy clean wealth.

6. The purpose behind the profit-sharing system as opposed to fixed interest is to discourage the make use of leading to income concentration. If business partner knows that he will have to share with his absentee partner any amount of profit on fifty-fifty basis, he will be less passionate to maximize his profit through illegal or more risky methods.

7. By eliminate interest; distributive justice is taken care of under Islamic economic system better than any other existing economic systems. Under the present system it is found that in

institutional sources of credits the substantial amount of total deposits comes from the lower and middle income classes. But the investors from the said two income groups have limited access as well as opportunity to provide extra fund required to start any enterprise. They are constrained to supply required security to get loans from the banks.

8. The closing down of interest will help an economy to get rid of the most disastrous effect of business fluctuation resulting either from over or under production (Ataul, 1982, pp.73-82).

2.9 .Classification of Islamic Banking

As in the nineteen nineties Manzoor, (1999) write that Islamic banking system can be grouped into three categories, each representing a different model.

1. In the private sector, there are banks, financial institutions, investment companies, leasing companies and mutual funds trying to operate without interest. They are mostly owned by entrepreneurs and private investors; however some governments and international financial institutions provide some financial support. In some countries, special laws have been introduced to help interest-free banks to function effectively.

2. At least three countries have tried to develop a state sponsored process for the taking away of interest from the entire banking system. Pakistan, Sudan and Iran have converted their financial systems according to the Shari'ah. All the financial institutions in these countries are conducting their transactions on an interest-free basis. Instead of establishing interest free banks in the private sector, the idea was to first establish 'interest-free counters' within the system. Then expand the interest-free system to the whole banking sector, so as to operate on new principles under the protection of state policy and central bank guidelines. The aim is not just one or two Islamic banks but to change the entire financial and banking system and eventually the whole economy so as to conform to Islamic way.

3. The mixture of the two, for example Malaysia. They have established under the country's law a totally interest-free Islamic bank with a distinct law and identity. They also have conventional banks, which can have interest-free system within them. So far 52 conventional banks have opened such system (Manzoor, 1999).

2.10 .Characteristics of Islamic Banking

The foremost characteristic of the Islamic system of banking involves five major elements.

1. Islamic finance involves a system of equity sharing and stake-taking. It works by the principle of a variable return depending on the actual productivity and how well the project performs.
2. A very crucial point relates to the whole vision of an Islamic economy. Islamic banking plays a major part in that vision, which is to an extent a revolutionary change as it calls for new approach to the economy (Chapra, 2000).
3. In the Islamic way ethics will play a key role. The ethical and social dimensions will be crucial to all economic activities, there will exist framework of 'Halal'(permissible) and 'Haram' (prohibited) within which all economic activity, private and public, has to take place. The ethical issue will operate at different levels and therefore morals will play effect the principles of the entrepreneur and the firm, the +-society, the legal framework and the supervisory of the state. This means activities which would be treated in the capitalist system as productive because it has some demand (e.g. pornography, gambling, prostitution, the promotion of alcohol, etc), however in the Islamic system will be prohibited (Chapra,2000).
4. Islamic Banking is entrepreneurial driven. It is directed not just towards financial expansion but also towards physical expansion of economic production and services (Usmani, 2002).
5. The Islamic system is non-inflationary; this is a very important and fundamental aspects of Islamic banking. The linkage between financial expansion, money supply and the physical expansion of the economy is a result of the financial and banking dynamic of the current time, whereas the Islamic banking and finance restores the balance between these three variables. Stability in the value of money is a primary goal of an Islamic economy (Khurshid, 2000).

2.11. Operations of Islamic Banking

2.11.1. Deposit Accounts

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

The opening of an account in an Islamic bank represents something different than the ordinary debtor-creditor relationship as it is in the conventional banking system. In Islamic banks it is

seen as a partner relationship. The whole Islamic banking system is built on a partnership basis in which the depositors, investors and borrowers participate (Zineldin, 1990). The main source of the bank's funds consists of the accounts available to the customers. All literature discusses the same three accounts while Al-Omar adds a fourth specific account; Special investment accounts. The main accounts are the following (Zineldin, 1990; Akacem et.al., 2002; Al-Omar et.al., 1996):

1. Demand Deposit Account (Current or Checking Accounts)
2. Saving Accounts
3. Investment Accounts
4. Special

2.11.2. Checking or Demand Deposit Accounts

Banking regulation should specify the main categories of each type of deposits and accounts, leveling the door open for innovation through the design of new ones within the main categories. In this context, any interest-free banking system would include current accounts, savings accounts and investment accounts. Current accounts are not allowed to any returns, but their principle is guaranteed and they are subject to the legal reserve regulations. As small return is paid in respect of savings accounts, which is adequate with their invested balances. This modest return is certified to the normally high cost of investing the balances of these accounts that could fluctuate from one period to another (Gafoor, 1995).

Zineldin (1990) and Wards (2000) have both shown that in the Demand deposit account, the deposits can be withdrawn on demand without any conditions and restrictions. The main motive for customers to open an account of this kind is to keep excess liquidity available on demand, and not to earn any profit or income. Naturally, the bank does not pay any interest on these deposits.

The bank provides the clients with checkbooks and other usual services connected with current accounts. Some of the Islamic banks charge a service fee for providing such as service (Zineldin, 1990; Saeed, 1996; Al-Omar et.al., 1996). The nominal value of the deposits would be guaranteed and can therefore be seen as a completely safe financial asset, which would satisfy

the demands of risk adverse customers. There are restrictions imposed on how the capital can be used. It cannot be used for risky venture and will not be invested for making loans or investment and other securities. They can be used to make very short- term loans to parties who run out of liquidity. If the bank intends to use these funds while they remain with the bank it must ask for their clients' permission. The profit, that the bank generates while using these funds, belongs to the bank (Al-Omar et.al., 1996; Zineldin, 1990; Akacem et. al., 2002).

2.11.3. Saving Accounts

Customers who want to save some funds and to earn some income mostly use the savings accounts. The motive is precautionary. The funds can be withdrawn at any time and are usually used in short range investment projects and ventures. The bank or the government guarantees the nominal value of the deposits. Some profit rate is usually paid to the depositor. However, any positive rate of return is not guaranteed. The depositor will not receive any premium if the bank incurs a loss on its investment projects (Zineldin, 1990). Some banks consider this sort of account to be in the category of investment accounts rather than saving accounts (Al-Omar, et. al., 1996).

2.11.4. General Investment Accounts- Mudaraba Accounts

General investment accounts are also, known as Profit- and- Loss Sharing Deposits. The most important source of funds and earning activity for Islamic banks is the investment accounts. The motive is to earn a profit rather than holding funds for preventive or transaction reasons. An investment account offers a higher portion of the rate of return than the ordinary deposit account in return for a higher risk from investment operations (Akacem, et al., 2002; Zineldin, 1990).

The only warranty that the holder of an investment account receives is the profit and loss ratio, how profit and losses are to be shared between the bank and depositor. This ratio is agreed upon in advance and cannot be changed during the life of the contract (Akacem et. al. 2002).

2.11.5. Special Investment Accounts

In addition to the general investment accounts, banks may also offer special investment accounts. These are often offered selective to wealthy individuals or corporate clients. These accounts also

follow the principles of Mudaraba. The difference is that the modes of investment of the funds and the distribution of profits may consult individually (Al-Omar, et. all., 1996).

2.12 Islamic Banks and their Interest Free manner of Financing Activities

The initial success full application of Islamic finance was take on in 1963 by Egypt's MIT Ghamr Saving Banks, which earned its income from profit-sharing investments rather than from interest (Lewis & Algaoud, 2001, p.5). In order to compete with conventional modes of financing (interest- based financial instruments). Islamic financial institutions developed products that would fulfill the Shari'ah obligation and provide the same values as conventional bank products. The core Islamic financial products include profit-and-loss sharing (Mudaraba and Musharaka), cost plus mark-up, and leasing.

2.12.1. Musharaka-Equity/ Participating Financing

The accurate meaning of the word Musharaka is sharing. Under Islamic law, Musharaka refers to a joint partnership where two or more persons combine either their capital or labor, forming a business in which all partners share the profit according to a specific ratio, while the loss is shared according to the ratio of the contribution (Usmani, 2002, p.87). It is based on a mutual contract, and, therefore, it needs to have the following features to enable it to be valid: Parties should be capable of entering into a contract (that is, they should be of legal age). The contract must take place with the free agreement of the parties (without any force).

In Musharaka, every partner has a right to take part in the management, and to work for it (Gafoor, 1996). However, partners may agree upon a condition where the management is carried out by one of them, and no other partner works for the Musharaka. In such a case the "sleeping" (silent) partner shall be entitled to the profit only to the extent of this investment, and the ratio of profit allocated to him should not exceed the relative size of his investment in the business(Usmani,2002,p.92).¹² However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business, and work done by any of them in the normal course of business shall be deemed as being authorized by all partners.

2.12.2. Mudarabah (Trust Financing)

Is a contract, in this contract it is the responsibility of the bank provides all the capital, the artner contributes commercial efforts, professional skills and experiences. Finally, the bank receives a predetermined proportion of the profits. In the case of a loss, the bank bears all the financial loss whilst the manufacturer goes unrewarded (Rob, 1992). It is concluded that this system encourage the individual to participate in financial activity and prove himself as an active part of society (Kettell, B. 2011).¹³

Commodity ‘Murabahah’¹⁴

Commodity „ Murabahah“ is a trade–related transaction. The main structure of this transaction will be based on the actual trading of steel in London Stock Exchange through a nominated broker. The trade entails a spot purchase of „ Shariah“ compliant commodities for immediate delivery and forward sale on deferred payment term (cost plus basis). Up Financing Murabaha, or markup purchase, is short term financing. Murabaha is a cost-plus sale type of arrangement, where a bank purchases an asset on behalf of a customer while the understanding that the customer will repurchase the asset back from the bank. The bank's price to the customer includes a stated profit known to both parties, and the payments are amortized across a payment period, similar to a secured loan (Silva, 2006).

Other Mark-up Schemes

There are a number of variations on the basic idea of Murabaha. They are as follows (Wards, 2000):-

- i. Bai Muajjal(Credit sale or Sale on a deferred- payment basis)
- ii. Bai Al-Salam(Advance payment or Forward buying)
- iii. Bai Istisna(Commissioned manufacture)

i. Bai Muajjal- Credit sale/ Sale on Differed Payment Basis

Accurately bai muajjal means a credit sale. Technically, it is financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal.

It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date in installments. It has to expressly

mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price. The Bai Muajjal financing technique is based on mark-up in price and is also known as Murabaha. This transaction is a sale and not a loan. The goods are delivered immediately. The price must be agreed upon at the time of the bargain and it is paid at a given time in the future. The price includes the cost plus a margin of profit to cover administrative costs and it cannot be changed even if the payment is not made at the due date. The creditworthiness of the purchaser is the only guarantee of timely payment (Al-Omar et. al., 1996; Wards, 2000).

ii. Bai Al-Salam-Advance Payment/Forward Buying

Bai Al-Salam is a trade transaction. The financier agrees to purchase a commodity must be specified as well as the agent time and place of delivery. The agreed price is paid in full in cash at the time of the contract

The commodity will be delivered to the purchaser at a future date. Risk therefore generally stays with the seller until the time of delivery. The purchaser in the Salam sale has the right to inspect the goods. He may reject the goods on sight if they do not agree with their description as specified at the time of contracting.

This method is not widely used yet, but according to Warde it has great potential in certain areas, such as agricultural products (Al-Omar,et al.,1996; Wards,2000).

iii. Bai-Istisna- Commissioned Manufacture

Bai- Istisna is a new concept in modern Islamic finance and it is an agreement for processed goods and commodities. It offers a number of future structuring possibilities for financing and trading. This agreement allows cash payment in advance and future delivery as well as future payment and future delivery. These choices give the lender some flexibility. He can pre-sell to his client for future delivery on a cash-on-delivery basis and then negotiate the purchase (Warde, 2000; Al-Omar,et al.,1996).

Ijara-Lease Financing

Leasing refers to a contract of land or other asset leased at a fixed rent payable in cash, a mode of financing which is also adopted by Islamic banks. It is an arrangement under which Islamic

banks lease equipment, buildings and other facilities to a client against an agreed rental lease. The lessee in general also has an option to purchase the leased asset. Ijara is a contractual agreement comparable to a sale/lease back, where the bank buys and then immediately leases an asset to a customer for a fee. The duration of the lease and the fee is set in advance, and are in many terms comparable to the terms that may be applied to the loan (Silva, 2006).

Ijara wal Iqtina:- Hire Purchase

It is a contract where an Islamic bank finances equipment, building or other facilities for a client against a rental agreement. There is an independent undertaking by the bank or the client so that at the end of the lease period, the ownership of the asset is transferred to the lessee. The undertaking or the promise does not have to become an integral part of the lease contract in order to make it conditional. The rental as well as the purchase price is fixed in such a manner that the bank receives back its cost price along with some profit, which is usually determined in advance (Sarah, 1988, p.24).

Istisna' is a contractual agreement for manufacturing goods and commodities, allowing cash payment to be made in advance with a set date for future delivery, or a future payment and delivery. A manufacturer or builder agrees to produce good or building at a given price on a given date in the future. Price can be paid in installments, or as agreed between the parties. Istisna' can be used for providing the construction of houses, plants, projects, and buildings of bridges, roads and highways (Sarah, 1988, p.23).

Sukuk (Islamic Tradable Bonds)

Sukuk in general may be understood as a Shari'ah compliant 'Bond'. In its simplest form Sukuk represents ownership of an asset. The claim embodied in Sukuk is not simply a claim to cash flow but an ownership claim. This also differentiates Sukuk from conventional bonds as the latter proceed over interest bearing securities, whereas Sukuk are basically investment certificates consisting of ownership claims in a pool of assets. Sukuk (plural of word sack) were extensively used by Muslims in the middle Ages as papers representing financial obligations originating from trade or other commercial activities. However, the present structure of Sukuk are different from the Sukuk originally used and are akin to the conventional concept of securitization, a process in which ownership of the underlying assets is transferred to a large

number of investors through certificates representing proportionate value of the relevant assets(Sharqi,2007).

2.13. Sources and Uses of Funds of Islamic Banking

2.13.1. Sources of Funds

Moreover its shareholders (own) capital and equity, the main source of funds if Islamic banks would be two forms of deposits transaction deposits and investment deposits. Mohasin & Abbas (1986) in their book said that transaction deposits are directly related to transaction and payments, and can be regarded as equivalent to demand deposits in a conventional banking system. Even if a bank would warranty the nominal value of the deposit, it would pay no return on this type of liability. Generally speaking, funds mobilized through this source cannot be used for profitable investment by banks. As such, banks would most likely have to impose a service charge on deposit holders to cover the cost of administering this type of account. Investment deposits constitute the principal source of funds for banks and they more closely resemble shares in a firm, rather than time and saving deposits of the customary sort. The bank offering investment deposits would provide no guarantee on their nominal value, and would not pay a fixed rate of return. Depositors, instead, would be treated as if they were shareholders and therefore entitled to a share of the profits or losses made by the bank. The only contractual agreement between the depositor and the bank is the proportion in which profits and losses are to be distributed. The profit-or- loss- sharing ratio has to be agreed in advance of the transaction between the bank and the depositors, and cannot be changed during the life of the contract, except by mutual consent (Mohsin & Abbas, 1986).

2.13.2. Uses of Funds

Unlike conventional banks that have a relatively simple financing mechanism, Islamic banks are facing a complicated task in allocating their resources. There are many factors that differentiate Islamic banks and conventional banks. First, Islamic banks are not guided by a profit hunting motive. Their utmost objective is for the betterment of the whole community and other its overall business philosophy is based on justice and equity. Second, the status of Islamic banks in relation to their customers is that of partner, investor, and trader, whereas, for conventional banks the relationship is more of creditor-debtor. Third, for many conventional banks, their lending policy

normally is that the loan wanted to a customer is for the additional capital and not as initial capital (with the exception of venture capital institutions). Islamic banks however will participate in either new or existing projects as long as the proposed venture is viable and profitable. Another factor that makes Islamic banks differ from the conventional banks is in terms of their lending criteria. Normally, conventional banks will use the interest rate as a cut-off point in making loan decisions. No loan will be approved if the rate of return of the borrower's business is below the interest rate on loan. Contrary to this practice, Islamic banks will participate many project as long as the selected project generates profit (Sudin, 1996).

Non-commodity trading is strictly prohibited by Shari'ah considers money as a non-commodity item (Siddiqi, 1986) granting loans to customers for profit is therefore, unlawful. In the most case the funds will be used through equity participation or partnership. Principal of Mudaraba, Musharaka, and Murabaha are commonly used by the Islamic banks in helping their commercial customers. Principle of Iira and principle of Ijara-Wa-Iktina are for the leasing facility, whereas, principles of Bai Mua'ajal and Qard-e-Hassan are for ordinary customers who need financial assistance in buying houses durable goods, and other personal needs. Other banking services such as letters of guarantee, letters of credit, remittance services, travelers' checks, and safe-deposit boxes are considered as fee-base services principle of Wakalah and principle of Kafalah are normally used by the Islamic banks when rendering these services (Sudan, 1996).

2.14. The Role of Central Bank on Interest-Free Banks

Under an Islamic system, operations are without a doubt more varied and complex than in a traditional banking system. In terms of profit sharing activities, the criterion of creditworthiness of the borrower that underlines the conventional banking system has to be changed to place more emphasis on the viability and profitability of projects. In addition to a term structure of rates of return, there has to be a structure of returns from different economic activities that banks have to consider. Project evaluation and appraisal, determination of profit sharing ratios, and the establishment of a procedural framework for the processing, monitoring, supervision, and auditing of various projects create new demands on commercial banks (Iran, 2002).

The monetary authorities operating in an Islamic framework continue to have the power to regulate banking and financial operations in the economy, both to allocate resources in

conformity with the priorities of the society, and to direct monetary policy toward specific goals. To achieve its policy objectives, the central bank has control over the supply of “high powered” money (that is, currency plus deposit liabilities of the central bank to commercial banks), the reserve ratios on different types of liabilities, and the maximum amounts of assets that banks can allocate to their profit-sharing activities. A further control is available to the central bank through its purchase of equity shares of bank and other financial intermediaries. Through performance of its regulatory, supervisory, and control functions, as well as its leader-of-last-resort role, the central bank, can continue to exercise substantial influence on the financial system. Moreover, opportunities may exist for direct investing in the real sector on a profit-sharing basis as well as taking equity positions in joint ventures along with other banks. The ability to buy and sell securities representing real assets in the financial market, that is, open market operations, would still be permitted as long as these securities do not have par value features and a non- zero coupon rate (Mohsin & Abbas, 1986).

Furthermore the suggestion has been made that the central bank could regulate profit-sharing ratios between the banks and borrower on the one hand, and the banks and depositors on the other. Variation in these ratios would alter the rates of return and could have the same impact as changes in interest rates on the overall flows of financial resources (Iran, 2002).

2.15. Some Distinguishing Features of Islamic Banking over Conventional Banks

While Islamic banks perform mostly the same function as the conventional banks, they have their distinguishing features. Some of these are given below (Iqbal, et al., 1998, p.15).

2.15.1. Risk sharing

The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) on the one hand and both the financial intermediary (the bank) and the user of funds (entrepreneur) on the other hand. By contrast, under conventional banking, the investor is assured of a predetermined rate of interest. Since the nature of this world is uncertain, the results of any project are not known with certainty ex-ante, therefore, there is always some risk involved. In conventional banking, all this risk is borne in principle by the entrepreneur. Whether the projects succeeds and produce a profit or fails and results in a loss, the owner of capital gets away with a predetermined return (Iqbal, et al, 1998, pp.15-16).

2.16. Review of empirical studies

2.16.1. Empirical Literature Studies in developed and emerging market countries

There are many studies carry out relating to challenges and opportunities of Islamic banking.

The Islamic finance and banking literature shows that many scholars have undertaken the subject matter of the Islamic finance challenges and opportunities.

Al Maraj (2008); “Governor of the Central Bank of Bahrain discusses the need for Islamic banks to differentiate activities, and he could identify the challenges that faces Islamic Finance as that investment banks are project-driven and do not have a steady source of revenue to tide them over any declines in economic activity, the multiplicity of Shari’a boards and judgments, Shari’a compliance and how to provide a satisfactory framework to assure investors and other stakeholders, accounting standards.

Wilson (2000); examines the growth of Islamic finance in United Kingdom. He invented that the Islamic finance partly reflects demand from Muslim resident and non-resident clients for Islamic deposit facilities and fund management services which involve Shari’ah compliance.

The study is concentrated on the Islamic financing methods as a challenge and opportunity by Western bankers.

The results of the study indicate that there are many challenges and opportunities faced by Islamic Banks in United Kingdom to increase their economic growth.

SunGard (2008), discusses the Islamic Banking and Finance growth and challenges ahead. It provides a long list of challenges such as competition, Demand for more expertise on Islamic finance, the immediate need for short-term money market investments and tools for liquidity management, Limited Islamic secondary markets, and various Sharia'h interpretations, Small number of participants and Slow or stagnant development of Islamic financial instruments.

Nur Aqilah Zainordin.(2016)¹⁶; conducts a questionnaire to investigate the challenges facing the Establishment and development of Islamic banking in Kenya. His findings consider the Legal

Support as most challenge as Islamic law offers its own framework for execution of commercial and financial contracts and transactions.

Iqbal, Ahmad and Khan (2009); supported that legal challenges affected the development of Islamic banking and financial institutions as Islamic banking is lack of effective supervisory framework. It caused the prevailing system inefficiency and hence it justifies a serious attention. Legal challenges also exist when Ahmad Ibrahim (2004), found that commercial banking and company laws do not appropriate for the implementation of Islamic banking and financial contracts.

Haidi and Malik (2006); supported the statement of “Misunderstanding of Islamic financial concept.” They stated that the first impression of Islamic banking is the fixed rate concept of a “halal” loan serves as the substitution for conventional loan.

Karbhari, Naser, and Shahin (2004); claimed that the difference Islamic cultures and societies within different country causing the interpretation of Shariah principles goes inconsistent among each of the Muslim schools. The inconformity towards the Shariah views and different methodologies make the concept of Islamic financial institutions become unclear.

The study of John Wiley and Sons (2011)¹⁷; proved this challenge. He found that Islamic financial intermediaries expose themselves to liquidity problem due to the lack of developed money market and the shortage of short term investment securities such as treasury bills and marketable securities which offer limited capital risk with optimum returns.

The discussion of Islamic banking and finance has a long history in the world but it is not the same in Ethiopia because the phenomenon of Islamic banking and finance is a new concept. And there have been very few studies conducted regarding operational challenges of interest free banking and its opportunities. The first empirical study of major challenges and opportunities of Islamic banking was conducted by Ayazul Haq (1997); he piloted his study on Pakistan companies From his study he established that the objective was pursue the principles of Islamic Shariah.

Ahmed,(2010)¹⁸; Conducted a study to identify economic merits of Islamic banking by pointing out that credit expansion through Islamic banking is linked to the growth of the real economy by

allowing credit primarily for the purchase of real goods and services. Tukamuhabwa (2011); on their study concluded that the best way to enhance the performance of analyzing the competitive forces. For the purpose of this study, I defined the competitive challenges and opportunities of the Islamic banks to enhance their performance. A.T .Kearney, 2012), discusses the future of Islamic banking and identifies the challenges of Islamic banking as the small size as many Islamic banks are smaller than their competitor. This paper aims to review the recent empirical literature on Islamic banking and present other directions for future studies. The survey did not cover the entire empirical research in the area but rather explores most of the literature published in the high impact journals. This paper differs from previous survey studies which focuses on specific issues of Islamic finance and banking such as financial stability (Odeduntan & Adewale 2015; Belouafi et al. 2015); rate of return risk (Zainol & Kassim 2012); its role in the new world order (Moisseron et al. 2015); bank growth nexus (El-Galfy and Khiyar (2012); selection criteria (Nawi et al. 2013; Mahfooz & Ahmed 2014); interest rate (Bellalah & Ellouz 2004); review of theory and practice (Ahmed 1989; Tahir 2007; Shaikh 1997; Siddiqi 2006; Siddiqi 1978; Ariff 1988); comparative assessment with conventional banks (Zaher & Hassan 2001); Malaysian context (Musaeva et al. 2014); empirical studies (Abedifar et al. 2015; Alam & Rizvi 2017); equities (Masih et al. 2016) ; and sustainability (Aliyu et al. 2016). However, not all of these studies were able to combine the thematic and sub-themes that diverse from theoretical to practical issues with consideration to societal impact through maqasid sharia, financial inclusion, and disclosure despite their vital role in the Islamic financial system. Therefore, this present study intends to fill this gap through linking recent studies with prior ones for critical assessments and suggestions for future research.

This paper also aims to provide a link between the earlier and the subsequent empirical studies of Islamic financial literature to determine possible consistency or deviance within the contextual findings. Thus, this will provide additional implications to theory, practice, and future research. The paramount goal of this paper is to contribute to providing balanced thought that will highlight the gap between theory and practice and henceforth strengthen the system to support not only the industrial sector but also societal well-being in general.

2.16.2. Empirical Literature in Africa

Aliyu (2012), Islamic banking in Nigeria like in most countries the world is evolving although with vary degrees of successes. The issue challenges and opportunities surrounding its evolution in Nigeria are however, unique. The findings indicated that there is a positive the government to hasten its bid to become the hub of Islamic finance of Africa and this can only be actualized when it sets enabling environment for trading of Islamic capital market instruments –sukuk and other halal (permissible) investments.

(Daud dahir hassan, 2018)¹⁹; Explained the opportunities and challenges of Islamic banking in Somalia, most of the developments of Islamic finance have taken place in the last four years and limited, simple, uncomplicated and relatively uncompetitive Sharia compliant products that compared unfavorable to their conventional equivalents are offered by few commercial banks. Empirical studies on the Islamic banking depression performance are inadequate to predict the future activities of the institution.

Despite the proposed mathematical modeling of Bedoui and Mansour (2014); and the subsequent application

Asutay and Harningtyas (2015), some of the indicators to maqasid framework are not disclosed by most of the Islamic banks' reports (Antonio et al. 2012). As a result, Aliyu et al. (2016); suggest for standardizing a unified content to Islamic banks reporting, which will capture both financial and non-financial information that are related to the maqasid framework. In this regard, revisiting the existing index for assessing the maqasid to a financial institution is necessary since some of the concise indicators exhibited in Bedoui and Mansour (2014), are invariably beyond the strong ability of the institution to achieve them. However, the maqasid index developed by Mohammed, Razak, and Taib (2008); is closer to the content of the financial reporting, but some elements used in constructing the index are not frequently available in the banks' reports. Therefore, formulating maqasid index that considers the theoretical underpinning coupled with available reporting indicators will pave the way to account for the all relevant components of Maqasid (Amir 2014).

2.16.3. Empirical Literature in Ethiopian Context

Based on the Economist Intelligence entity report (2015), Africa is the world's largest untouched growth market for "Islamic" commerce, across Islamic finance (banking, insurance, bonds and

20 capital markets) and halal (sharia-compliant goods and services). Islam is a dominant religion on the continent, along with Christianity, from those 67% of Muslims in Sub-Saharan Africa. A part of sub-Saharan country Ethiopia also has potential customer for IFB. Based on the 2007 national census report the Muslim population comprises 33.9% of the total population (www.csa.gov.et accessed on 12/02/2016) in Ethiopia.

Therefore, the country has assure for the growth of Islamic banking. Beyond satisfying the need of Ethiopian customers Islamic banking will also create for Ethiopian government to gain diplomatic advantages to make financial dealings with Muslim dominated nations (Usmani, 2002). It is known that Ethiopia is acquiring awareness for forging investors As Mohammed (2012), introduction of Islamic banking for Ethiopian government will certainly create diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from the gulf countries. The development of Islamic banking start after 2008 when commercial bank of Ethiopia (CBE) start to implement Special Non-interest Savings Accounts (i.e. Special Demand Deposit), but there was no Sharia-compliant transactions up to 2013. Even though, National Bank of Ethiopia (NBE) issued a directive to banks allowing them to provide interest-free banking (Islamic banking) service using a separate window along with their other banking services, the system was started to implement only in 2013 by few commercial banks like Oromia international bank S.C, Commercial Bank of Ethiopia and united bank S.C. NBE enact 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” in 2011. 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 fulfil some other procedural requirements. This show in the context of Ethiopia, IFB is the recent phenomena. To the knowledge of the researcher, there appears to be very limited work on the challenges and prospect of interest free 21 banking in Ethiopia. These studies include the recent studies of (Kerima Ali, 2016) and (Abraham, 2017). Those studies examined the challenges on interest free banking services with particular reference to Commercial Bank of Ethiopia and determinate of customers’ intention to use interest free banking products and factors affecting employees product knowledge respectively. A study done by Mohammed, 2012 on the “Islamic Banking:

Prospects, Opportunities and Challenges in Ethiopia” identified that the main challenges are lack of awareness, regulatory and supervisory challenges, institutional challenges, lack of support and institution, gap in research and development in Islamic studies, lack of qualified human resource as well as wrongful association with specific religion and the global terrorism.

Akmel (2015), study examine the challenges and prospects of Islamic banking service for resource mobilization in Ethiopian commercial banks through conducting questionnaire and Semi-structured interview for the selected three banks staff using stratified sampling. The result show that awareness, manpower, legal framework, societal belief, resource requirements as some of the challenges while economic growth, attraction of investors, and fostering investment are the likely prospects of the banks. The researcher recommended that banks need to create awareness for public acceptance and training of staffs, employ good marketing techniques, governing body need to establish clear set of legal framework, and compliance with Sharia issues should be adhered.

Debebe (2015), study asses the willingness of the Ethiopian customers to use interest free banking and the factors that may influence their decision and the results showed that perceived relative advantage, perceived compatibility, customers’ level of awareness and subjective norm have a significant positive impact on the attitude towards interest free banking in commercial bank of Ethiopia.

Kerima (2016), conduct study in challenges on Interest free banking services in Ethiopia with particular reference to the commercial bank of Ethiopia and this research has found out that the challenges to IFB services as: lack of commitment of the bank, lack of Shariah advisor, lack of supportive regulatory directives , Problem related to Ethiopian Commodity Exchange (ECX) law, lack of capacity to deliver IFB product at full rage, lack of awareness of customer about IFB 22 products, lack of trust and confidence of customers, inadequate marketing and promotion, double taxation, nature of IFB products, unavailability of IFB products in all of its branches and the IFB being delivered in a Window model. The recent study by Abraham (2017) on determinate of customers’ intention to use interest free banking products and factors affecting employees’ product knowledge in the context of commercial bank of Ethiopia and the result show that except knowledge, all the other variables: attitude, social influence, perceived financial cost and religious belief have significant effect on IFB use intention. From the population of

Africa continent, Islam is a dominant religion along with Christianity, from those 67% of Muslims in Sub-Saharan Africa. As Ethiopia is part of in Sub-Saharan countries, there will be huge opportunity for the development of interest free banking. Due to interest free banking is the a contemporary phenomenon in the Ethiopian banking sector the main challenges and prospect of interest free banking is not yet studied. The main reasons for this study is to identify the main challenges that banks face in implementing interest free banking and will helps for the banking sector to move in the solution for this challenges. Even though, different studies mainly focused on the challenges bank face on implementing. The general objective of this study is to assess the prospects and challenges facing Islamic banking in Ethiopia. The study tries to assess the potentiality, prospects and challenges that IFSIs face in the Ethiopian financial services industry.

Wondwosen (2018), this study was to identify the main operational challenges of interest free banking and its opportunities in the case of five selected commercial banks in Ethiopia that have been operate over the period of 2013- , 2018. The finding showed that Supervision of Islamic banks is equally important. At present, lack of effective prudential regulation is one of the weaknesses of the Islamic institutions. Hence, Shariah Supervisory Board has to making an effective supervision framework to manage all the financial institutions in Ethiopia.

Tsion (2017), conducted a study on Challenges and opportunities of interest free banking in Ethiopia on the selected five convectional Banks. The author have used three independent variable, interest free banking law; system, and service of the firm and challenge and opportunity as dependent variable.

2.16.4. Summary and Gap in the Existing Literature

It becomes especially useful to examine operational challenges and opportunities of Islamic Banking in Ethiopia since different outcomes are expected to conclude in this area. Although various survey studies have been conducted to assess the challenges and opportunities of Islamic Banking, most of the studies have been carried out on the overall opportunities and challenges and its competitiveness with that of conventional banks. Even though IFB seems to be familiar and highly demanded, there is a lack of empirical study that examines the operational challenges and its opportunities in Ethiopia particularly. Therefore, this study makes an attempt to bridge

this gap and elaborate the operational challenges and opportunities of Islamic banking establishment in Ethiopia.

Summary of Ethiopian empirical findings

Author and Date Title and case Study Methodology Variables considered Research gaps in this thesis Mohammed (2012) Islamic Banking: Prospects, opportunities and Challenges in Ethiopia qualitative and quantitative data were used different Islamic banking products and services.to investigate banking services lack of awareness and misconceptions,

lack of qualified human resource for Shari'ah compliance, Wondwosen (2018) Operational challenges and opportunities of interest free banking in Ethiopia .The questionnaire can be used for descriptive or explanatory study regulatory system on IFB operation limited market and products lack of sharia experts and man power on IFB evaluating the operational challenges of IFBs and its opportunities in the selected conventional banks those started IFBs in window bases.

Tsion (2017) Challenges and opportunities of interest free banking in Ethiopia quantitative data analysis techniques Interest free banking services and products in selected Ethiopian commercial banks the idea of interest free banking is still new for the economy, new for the society, products offered under Interest free banking by Ethiopian commercial banks

Akimel (2015)Challenges and prospects of Islamic banking for resource mobilization in Ethiopian commercial banks used both qualitative and quantitative data analysis techniques Islamic banking service in resource mobilization efforts of the banks. Growth prospects of Islamic banking service Assessing challenges and prospects of Islamic banking service in resource mobilization efforts of Ethiopian commercial banks.

Conclusion

From the ever discussed literature review, a reader can observe that the studies conducted both at international and national levels do not address the opportunities and possible challenges of Islamic Banking establishment in Ethiopia to the necessary level. Hence, further studies should be conducted so that a stakeholder in the field can make use of the subsequent conclusions and recommendations therein.

Chapter Three

Research Methodology

3.1. Research Design

In this research a Descriptive research design is implemented. This is because the research nature used both elements of qualitative and quantitative nature of survey.

According to Kothari, (2004), 20 a research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. In fact, research design is the conceptual structure within which research is conducted; it constitutes the blueprint for the collection, measurement and analysis of data.

3.2. Research Approach

According to Creswell, (2009) there are three type of research approach, these are – Qualitative, Quantitative and Mixed Approach.

Kothari, (2004) also defined, quantitative approach involves the age group of data in quantitative form which can be subjected to careful quantitative analysis and it sub-classified into inferential, experimental and simulation approaches to research. The purpose of inferential approach to research is to form a data base from which to infer characteristics or relationships of population. This frequently means survey research is a sample of population is studied, and it is then inferred that the population has the same characteristics; also the research is based on set of specific observation to reach on a general conclusion. In making predictions and creating generalization, the research bases on the observations available.

While, qualitative approach to research is fretful with subjective evaluation of attitudes, opinions and behavior; and it generates results either in non-quantitative form or in the form which are not subject matter to careful quantitative analysis through focus group interviews, projective techniques and depth interviews.

As Dawson (2003) defined qualitative research investigate manner, behavior and experience through such methods as interview or focus groups but quantitative research make statistics

through the use of large scale survey research, use methods such as questioners or structured interviews. According to Creswell (2009, 4) definition “Mixed approach research is an approach to analysis that merge or associates both qualitative and quantitative forms.” keep in view of the purpose of this study the researcher adopt Mixed approach consisting both interview and questioners techniques for data collection.

3.3 Data Type and Source

In conducting this research, both primary and secondary data is used. The primary data is collected from private bank managers, officers, staffs and managers and officers of two banks under formation particularly Zamzam and Hijra bank as well, and those founders and shareholders of the mentioned banks. Bank Directors of some banks working under IFB is also included in collecting primary sources.

Formal directives on Islamic-law compliant finance were issued by the National Bank of Ethiopia in 2011 G.C and accordingly conventional banks were allowed to render the Sheria – compliant Interest Free Banking services at window level.

On May 22, 2019 G.C, the Ethiopian Prime Minister, Dr. Abiy Ahmed who attended the massive Grand Iftar evening organized by Ethiopian Islamic Affairs Supreme Council at Millennium Hall, announced that the Ethiopian government will allow Interest Free Banking in the country. Eventually, four Islamic banks, namely: ZamZam, Hijra, Nejashi and Zad banks were formed.

Among the four mentioned, only Zamzam and Hijra banks were able to fulfill the necessary preconditions and procedures and finally got the license from the NBE to come to the ground.

In addition to this, the previously window level interest free serving conventional banks were allowed to widen the Sheria-compliant banking services to isolated branch level.

This is what made the researcher to use the term “**Islamic Banking**” in the questionnaire and in the subsequent data analysis part of the thesis.

A questionnaire is a list of carefully arrangement questions with a view to investigate a reliable response from a chosen sample (Hussey and Hussey 1997). A questionnaire consists of a number of questions in print or nature in a definite order on a form of close-ended questions is used to collect the primary data for the study from chosen samples in order to take the opinions on challenges and opportunities of Islamic banking Establishment. Structure interview also set to interviewee of interest free banking head department official and for line managers in order to achieve the objective of the research.

Secondary source are those which are made available or have been collected for other research purpose (Adams, Khan, Reside, and white, 2007).

The secondary data is collected to describe and realize the conceptual feature of challenges and opportunities of Islamic banking and their applicability, through booklets, brochures and magazines printed by those banks and other banks that are already working in IFB in windows and branch level for similar objectives. The Directives issued by the NBE to address IFB is also taken to consideration for its great contribution to this sector.

3.4. Collection method and Technique

The researcher accepted and modified questionnaires used by Mohammed (2012). The questionnaire contained structured questions using five method to evaluate (Strongly disagree, Disagree Neutral, Agree, and Strongly agree).

The primary data is collected through interviews and questionnaires that were addressed targeted groups among the officers and managers of the mentioned organizations.

During the interview as well as in the questionnaire, both open ended and close ended questions is used. As to the secondary data, targeted offices particularly customer service and public relation offices are visited to collect related information from printed sources and researches conducted by other individuals.

The questionnaire has four parts, part one is about respondents' demographic profile. Moreover, part two anticipated and measured and opportunity of Islamic banking establishment.

In part three the researcher has used close-ended questionnaire by considering the demand of interest free banking service to customers or employees and part four assess the challenges of Islamic banking.

To collect the data the researcher involved in the collection of the questionnaire in order to make the respondents feel comfortable about their response they gave and give support to facilitate while they are filling the questionnaire. Before distributing the questionnaire permission is obtained from every respondent.

The other method used to collect primary data from those organizations is interview. Interview method of data collection gives an opportunity to clarify any issues raised by the respondent or ask questioning or follow-up questions. However, interviews are time consuming and resource-severe. The researcher conducted interview through a face to face contact with the respective bank officials and professionals to obtain supportive data.

3.5. Population

3.5.1. Target Population

Target population is defined as the entire group a researcher is interested in. According to Zikmund (2003), the definition of population was identifiable total set of elements of interest being investigated by a researcher.

The target population consisted of two groups; managers, officers and employees in one hand and the shareholders and stakeholders of the banks under formation and professionals in the other hand.

3.5.2. Sampling Technique and Sample size

As for the shareholders of the mentioned banks, stratified sampling technique is applied. But for the managers and officers, convenience sampling is applied because of their particular characteristics that common people do not own and which is one of the non-probability sampling methods which is convenient, quick and less expensive. The most common types of non-probability sample which is called a convenience sample had been approached. Not because of such samples are essentially easy to employ, it is because researchers are able to use whatsoever

persons are accessible instead of choosing from the whole population. Those respondents in our research are those who are banking authorities and they are willing to give cooperative.

To achieve the goal of this research a total of 150 questionnaires were prepared and distributed over respondents. The respondents consist of bank managers, IFB directors, Bank employees, and Under-formation bank founders, shareholders of banks, Sharia'ah advisors and businessmen.

Further, the researcher has enlarged the data collection interviewing five professionals that have got a direct touch to Islamic Banking.

3.6. Data Analysis

The collected data is sorted and screened for any errors and then tallied to prepare tables for making analysis. Besides, the study attempted to analyze the various issues that evolve around opportunities and challenges of Islamic banking establishment in Ethiopia, (being the two mentioned banks under consideration) such as misconceptions, awareness, legal and regulatory frame work, etc. The primary data is analyzed using the applicable statistical tools after all the necessary primary and secondary data are gathered and edited for any errors as well as omissions. The data is presented in a useful and organized manner suitable for analysis. Descriptive statistics mainly of percentiles of the distributions of participants' response is used. The researcher performed quantitative and qualitative analysis from responses collected on the research questions. The results is shown using tabular and charted figures in order to convey the intended meaning and be convenient for interpreting the findings of the research.

Qualitative data which is interview have been collected by taking written notes during the interview and video and sound recordings of what is said provided the raw materials for the report. The analysis summarized and presented by interpreting the information provided by the informant and relating it to the main objectives of the study using narrative approach. On the other hand, qualitative analysis is also used to triangulate some of the response obtained through close ended questions.

CHAPTER FOUR

4. DATA PRESENTATION AND ANALYSIS

In this section the findings of the study on Opportunities and Challenges of Islamic Banking Establishment in Ethiopia attain through the data collection instruments; questionnaires and interviews will be discussed.

The data collected from participants about current status of Islamic Banking in Ethiopia, its establishment opportunities, the challenges it could face, the public awareness about it, the demand for its products, and the legal and regulatory Framework that rule Islamic Banking is analyzed in the following section of this chapter.

Out of 150 distributed questionnaires, 128 questionnaires were collected with a response rate of 85.3%. Nevertheless, only 120 questionnaires were found valid for complete responses. Hence, the research paper is done on this number of respondents.

Further, the researcher has enlarged the data collection interviewing five professionals that have got a direct touch to Islamic Banking.

The finding of the interviews is presented in an aggregate form in separate part next to the findings extracted from the questionnaires.

The following is the presentation of the findings of the questionnaire starting with the demographic profile of the sampled respondents among the target population.

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4.1. Background of Respondents

Table-4.1: Summary of Demographic profiles of Respondents

Variable	No. of respondents	%age value of respondents
Gender		
Male	102	85%
Female	18	15%
Total	120	100%
Age		
18-30yrs	12	10%
31-40	82	68.3%
41-50	26	21.7%
Above 50	0	-
Total	120	100%
Educational qualification		
High school	0	-
Diploma	17	14.2%
1 st degree	91	75.8%
2 nd degree	10	8.3%
PHD and above	2	1.7%
Total	120	100%
Profession		
Student	0	-
Govt. employee	13	10.8%
Private employee	76	63.3%

Self-business	31	25.8%
Total	120	100%
Job experience		
Up to 5 yrs	50	41.7%
6-10 yrs	39	32.5%
11-15 yrs	9	7.5%
16 yrs& above	2	1.7%
Total	120	100%
Exposure to IFB		
Up to1 yr	31	25,8%
1-2 yr	33	27.5%
2-3yr	48	40%
3 and above	8	6.7%
Total	120	100%
Religion		
Muslim	55	45.8%
Orthodox Christian	28	23.3%
Protestant	26	21.7%
Other	11	9.2%
Total	120	100%

Questionnaire results 2020

Presentation

As table (4.1) Shows, from the total sample of 120 respondents, 102 (85%) of the respondents here male and 18 (14.5%) of them were Female.

Table (4.1) also indicates the age characteristics of the respondents. According to the data shown in the table (4.1), 12 (10%) of the respondents drop in the age category between 18-30Yrs, 82

(68.3%) of them are in the age category between 31- 40Yrs, 26 (21.7%) of them are in between 41 50Yrs.

Table (1.4) With regard to the educational background of the 120 respondents, 91 (75.8%) have Bachelor degree, 17 (14.2%) of them have diploma, 10 (8.3%) were 2nd Degree while 2 (1.7%) respondents are PHD holders.

Table (4.1) also shows the professional distribution of respondents. According to table (4.1), 13 (10.8 %) of the respondents where Govt. employees, 76 (63.3%) of them where Private employees, 31 (25.8%) where Self-business.

Table (4.1) is show about job experience, as this table show, respondents 50 (41.7%) of them are up to five years, 39 (32.5%) were 6-10 years, 9(7.5%) were 11-15 years while the rest 2 (1.7%) were above 16 years.

Regarding to the job exposure to IFB , as show in the table (4.1) the largest number of respondents 48 (40%) were 2-3 years ,33 (27.5%) were 1-2 years, 31 (25.8%) up to 1 years and 8 (6.7%) were three and above years.

Thus data obtained from all them would be fair enough to draw reasonable conclusion.

Finally, 55 (45.8%) of the respondents where Muslims, 28 (23.3%) of them were Orthodox Christians 26 (21.7%) of them where Protestants while 11(9.2%) were other.

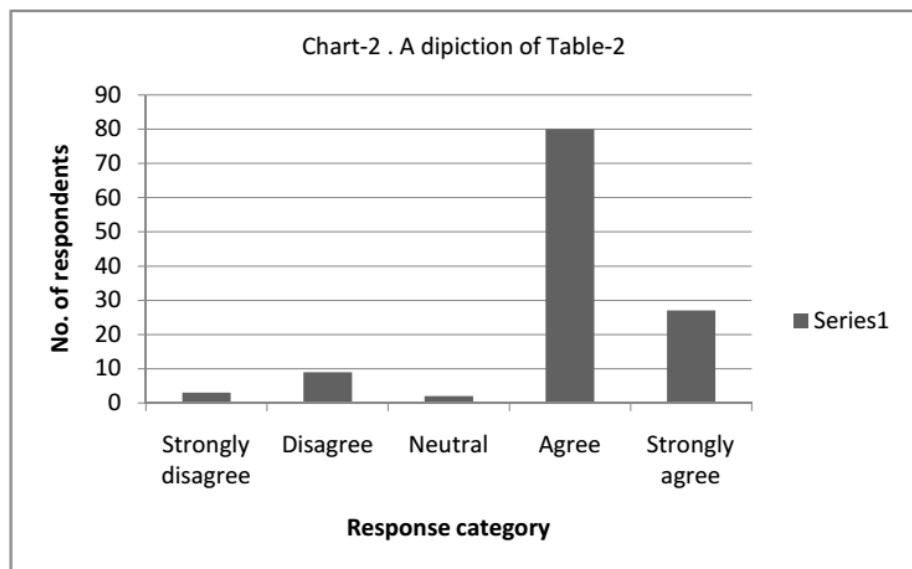
4.2. Current status of Islamic Banking

Table 2

Statement	Response category	Frequency	Response Percentage
The current global trends in Financial Services will have positive expression on the future of Islamic banking establishment in Ethiopia.	Strongly disagree	3	2.5%
	Disagree	9	7.6%
	Neutral	2	1.7%
	Agree	80	67%
	Strongly agree	26	21.7%
Group Total		120	100%

Sources : Questionnaire results,2020

The current global trends in Financial Services will have positive expression on the future of Islamic banking establishment in Ethiopia



In the era of globalization, what happens at one edge of the world affects the other part directly or indirectly. Hence, asking about the global trend financial services comes to be necessary.

According to the data collected, a total of 9 % (2.5%, 7.6%) of the respondents disagree with the idea that the global financial service trend has a positive expression on Islamic banking establishment in Ethiopia. However about 89 % (67%, 22.7%) agree with the idea. Hence, depending on the finding we can conclude that the current global trends in Financial Services will have positive expression on the future of Islamic banking establishment in Ethiopia.

This conclusion agrees with the findings of the interviews concerning the issue.

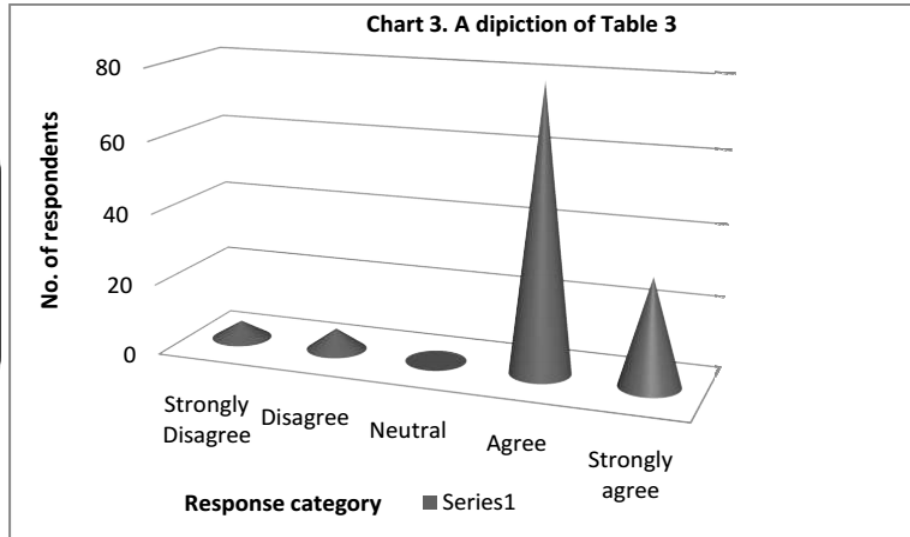
4.3. Opportunities of Islamic Banking Establishment in Ethiopia

N.B. Percentage values are approached to the nearest decimal.

Table (3)

Statement	Response category	Frequency	Response Percentage
Islamic banking system is helpful for growth of Ethiopian economy.	Strongly disagree	5	4.2%
	Disagree	6	5%
	Neutral	-	
	Agree	79	65.8%
	Strongly agree	30	25%
Group Total		120	100%

Islamic banking system is helpful for growth of Ethiopian economy



Questionnaire results,2020

Islamic Banking is an alternative package in the banking market disregarding its amount of contribution. Therefore, coming up with this notion in the questionnaire is inevitable.

According to table 3 and the corresponding chart, we can understand that the collective number of respondents (90.8%) that agree on the raised issue, exceed in high number than those who disagree (9.2%) and are neutral to the idea. Hence, can we conclude that Islamic banking system is helpful for the growth of Ethiopian economy.

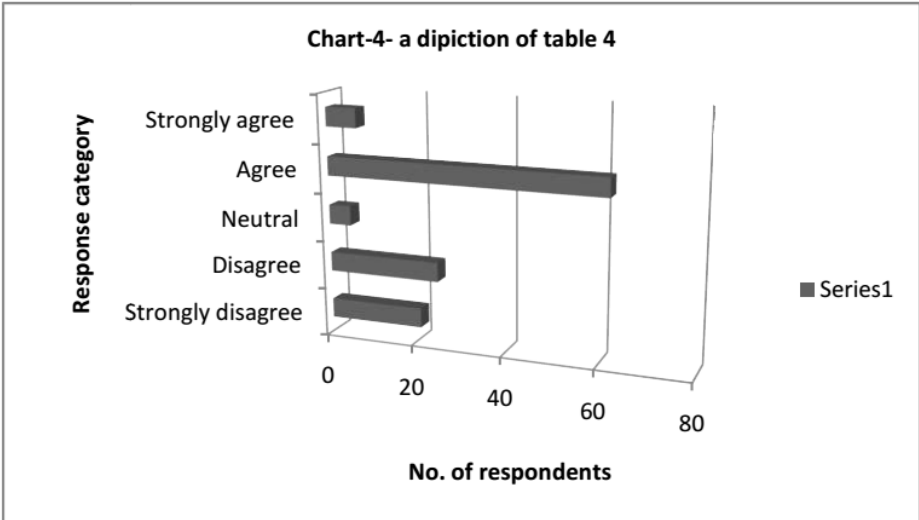
When this conclusion is judged against the data obtained through the interviews of the professionals, the researcher has got the interview result favoring the questionnaire's outcome.

Table (4)

Statement	Response category	Frequency	Response Percentage
Islamic banking is a flexible financial system and easy to adopt.	Strongly disagree	21	17.5%
	Disagree	25	20.8%
	Neutral	5	4.7%
	Agree	62	51.7%

	Strongly agree	7	5.8%
Group Total		120	100%

Islamic banking is a flexible financial system and easy to adopt.



Questionnaire results,2020

The flexibility, clarity and adoption simplicity as well are important perspectives for the understanding of a newly introduced substance.

From the data portrayed in Table-4 and corresponding chart, we can observe that the number of respondents who disagree and are neutral to the raised issue (abt.43%) is significant portion to be considered. This portion of the respondents is not taking the Islamic Banking clear for understanding and adoption.

When we take the demographic profile of the respondents in Table-1 of this section under exposure to IFB, we come to understand that the total number of respondents with longer exposure exceeds much from those with shorter exposure.

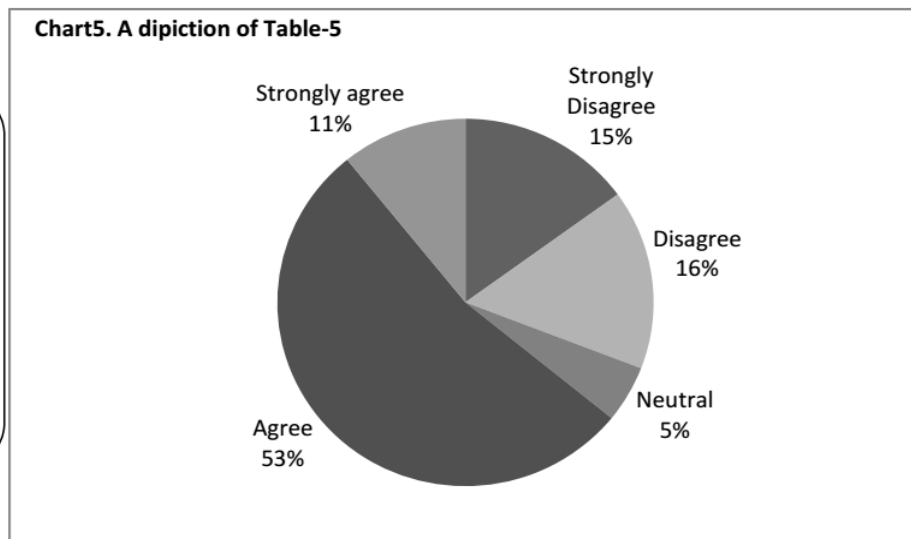
Therefore, the researcher understands that those who get on related job experience and have the information about ISB can adopt the new substance easily.

Table (5)

Statement	Response category	Frequency	Response Percentage
The offering of Islamic banking products (Saving and Loan Service) will improve the tendency for business expansion and investment.	Strongly disagree	18	15%
	Disagree	19	15.8%
	Neutral	6	5%
	Agree	64	53.3%
	Strongly agree	13	10.8%
Group Total		120	100%

Chart5. A dipiction of Table-5

The offering of Islamic banking products (Saving and Loan Service) will improve the tendency for business expansion and investment.



Questionnaire results,2020

Reclining a sight on the conventional banking system, it is believed that the deposits of potential customers within banks and the bank finance provided to customers play great role to the business expansion of both parties.

According to the data obtained from table-5 and the subsequent chart, the part of respondents that agree on the idea (64%) surpasses the other parties that disagree on the raised issue (31%).

Hence, the researcher understands that the offering of Islamic banking products (Saving and Loan Service) improve the tendency for business expansion and investment.

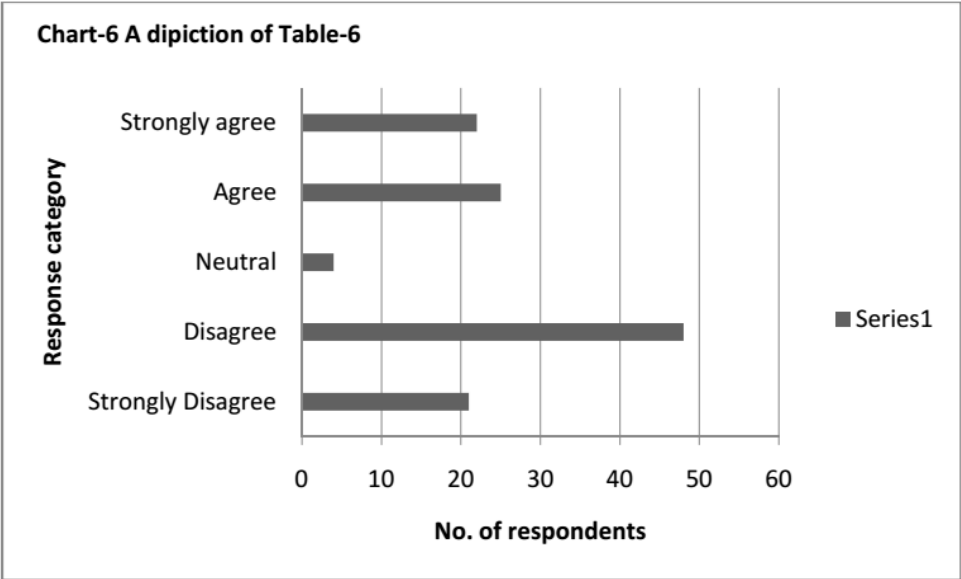
This indicates that ISB services are not quite unique from the conventional ones. Rather there is a wide shared room between the two in many product packages.

However, the portion of respondents who disagree with the idea (31%) is not immaterial. This means that they make up significant fraction in the large population. This could be either from lack of deep knowledge of business world in general and to the ISB in particular.

Public awareness about Islamic Banking Table (6)

Statement	Response category	Frequency	Response Percentage
I have a clear idea on how Islamic banking products work.	Strongly disagree	21	17.5%
	Disagree	48	40%
	Neutral	4	3.3%
	Agree	25	20.8%
	Strongly agree	22	18.3%
Group Total		120	100%

I have a clear idea on how Islamic banking products work.



Questionnaire results,2020

The data obtained from Table-6 and the corresponding chart shows that the collective number of respondents that disagree with the clarity of ISB operation (57%) surpass those who agree with its clarity (39%).

From this the researcher understands that much of the respondents do not have clear idea. Even those who responded that they have clear idea should be related to other factors. That factor could be their exposure to IFB as we can see their proportion from the demographic profile in Table-1 under “exposure to IFB”; keeping in mind “not all of them”.

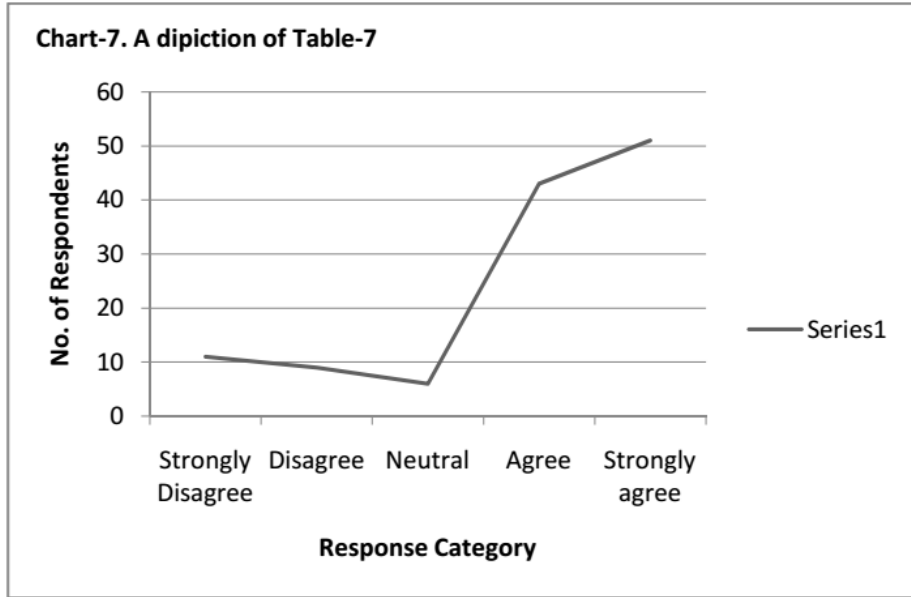
Still, the former group that disagrees with the clarity of the idea is a literate group. Looking at the demographic profile of respondents in Table-1 of this section, we can see that those who hold Diploma, 1st and 2nd degree constitute almost 98% of the sample group. If this is for those who have educational background, the laymen among the mass population resemble to hardly have the clear idea on how Islamic banking products work.

4.4. Challenges of Islamic Banking

Table (7)

Statement	Response category	Frequency	Response Percentage
Ethiopia is facing difficulties in developing Islamic banking because the awareness of Islamic financial industries by the public is still weak.	Strongly disagree	11	9.2%
	Disagree	9	7.5%
	Neutral	6	5%
	Agree	43	35.8%
	Strongly agree	51	42.5%
Group Total		120	100%

Ethiopia is facing difficulties in developing Islamic banking because the awareness of Islamic financial industries by the public is still weak.



Questionnaire results,2020

As a reader can observe from Table-7 and the subsequent chart, in the same manner of the previous finding, those respondents that agree with the statement that states “Ethiopia is facing difficulties in developing Islamic banking because the awareness of Islamic financial industries

by the public is still weak” is larger in proportion. They make up a total of about 78% of the sample group.

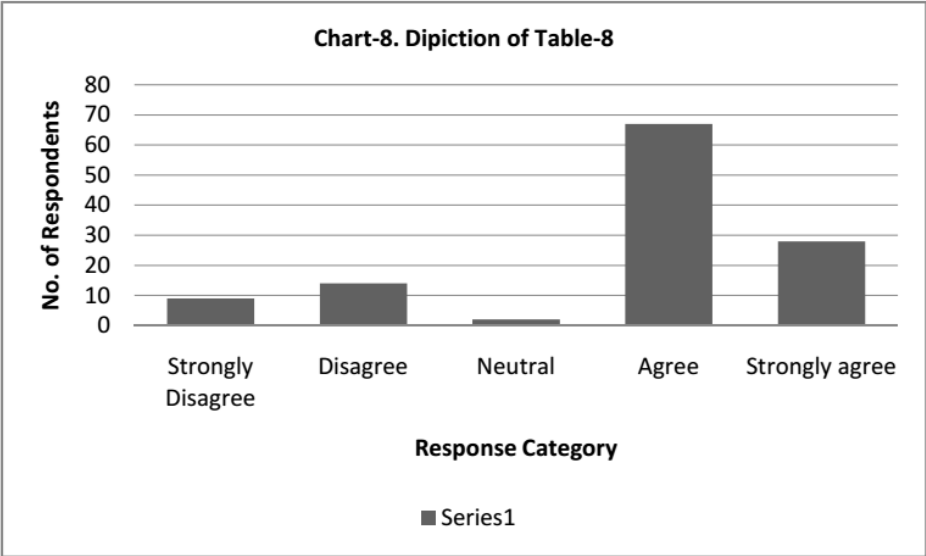
The respondents are speaking in behalf of the public. Most of those respondents are working in business institutions as we can see from the demographic profile of respondents in Table-1 of this section under “Profession”. They constitute about 74%. They know those customers among the mass public as they are rendering the service.

Unless ISB industry is understood well and the awareness towards it is enhanced, yes its development in the country could not be as such easy.

Table (8)

Statement	Response category	Frequency	Response Percentage
There is Lack of suitable banking policies for Islamic banking.	Strongly disagree	9	7.5%
	Disagree	14	11.7%
	Neutral	2	1.7%
	Agree	67	55.8%
	Strongly agree	28	23.3%
Group Total		120	100%

There is Lack of suitable banking policies for Islamic banking.



Questionnaire results,2020

Up to date it is obvious that the NBE is judging the CBE and the private conventional banks through its policies. As to the IFB and ISB, because of its recent introduction, it is expected that policies may not be designed accordingly. Anyways, the researcher saw the inclusion importance of this statement in the prepared questionnaire.

According to Table-8 above and the following chart, we can see that about 79% of the respondents agree with the idea that there is Lack of suitable banking policies for Islamic banking in the country.

As noticed in the survey, these responses of the respondents go in line with the interview findings of the researcher as indicated at next to the questionnaire findings.

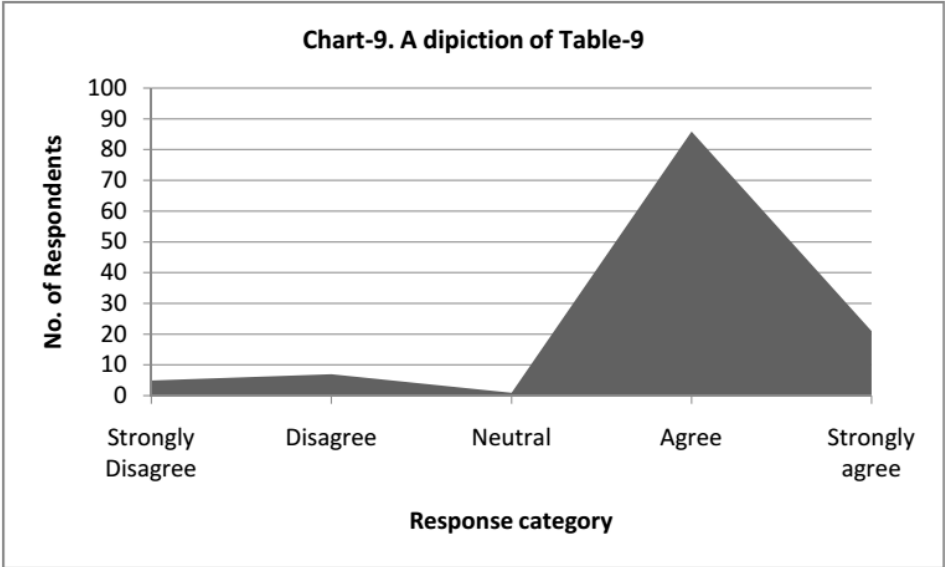
Hence, the researcher comprehends that the policies yet designed are not perfect fits to respond to smooth moves of IFB and full-fledged ISB services.

Table (9)

Statement	Response category	Frequency	Response Percentage
There is a lack of supportive and linking	Strongly	5	4.2%

institutions such as Shar'iah boards and consultancies for successful practice of Islamic Banking and Finance.	disagree		
	Disagree	7	5.8%
	Neutral	1	0.8%
	Agree	86	71.7%
	Strongly agree	21	17.5%
Group Total		120	100%

There is a lack of supportive and linking institutions such as Shar'iah boards and consultancies for successful practice of Islamic Banking and Finance.



Questionnaire results,2020

Beginning from the name ISB, it enlightens that it has direct relation with Sheri'ah laws that govern associated market values. To help and smoothen the practice of ISB, the availability of Sheri'ah board and consultants in the field is critical. Consequently, raising such a question at this point is believed to be necessary.

From Table-9 above and the corresponding chart, a reader can understand that, most of the respondents (97%) agree with the idea that there is a lack of the previously mentioned vital part. Those that respond the other way are almost insignificant (3%).

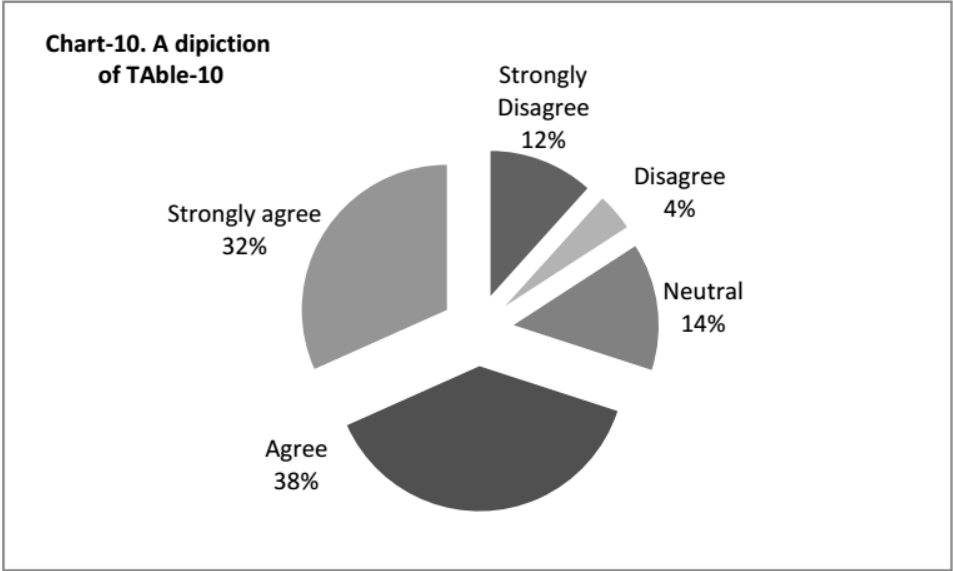
Therefore, the researcher realizes that there is lack of supportive and linking institutions, such as Shar'iah boards and consultancies for successful practice of Islamic Banking and Finance.

No doubt that the availing of such a problem and the availability of the needed party will contribute to the successful practices of ISB services and finance.

Table (10)

Statement	Response category	Frequency	Response Percentage
There is gap in research and development in Islamic studies in general and Islamic finance and economics in particular.	Strongly disagree	14	12%
	Disagree	5	4%
	Neutral	17	14%
	Agree	46	38%
	Strongly agree	38	32%
Group Total		120	100%

There is gap in research and development in Islamic studies in general and Islamic finance and economics in particular.



Questionnaire results,2020

Widening the sight coverage to the global trend concerning the field may not indicate the research gaps. As in the problem statement of the researcher, the focus is described to be

shortened to the national level. Here, the researcher raised the question to test whether researches ever conducted in ISB at national level are enough to make stakeholders grasp the field.

The data in Table-10 above and the related chart illustrates that, about 70% of the respondents agree that there is gap in research and development in Islamic studies in general and Islamic finance and economics in particular.

Depending on the data obtained the researcher realizes that deep and wider researches addressing the problem are not ever conducted to the needed level.

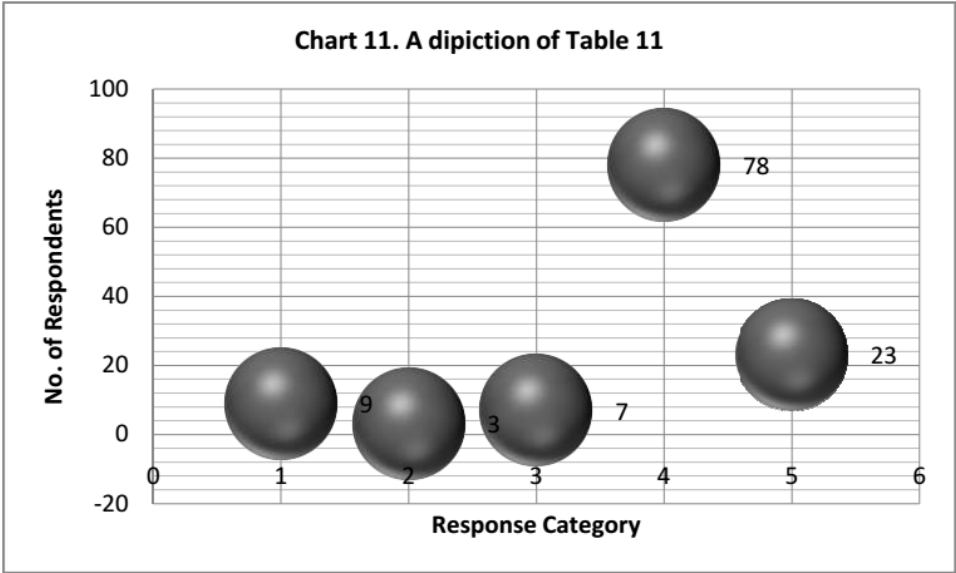
According to the interview survey, the researcher has also confirmed that the bank founders and the shareholders repeatedly mention the global trend to attach it to the national environment.

4.5 Demands for Islamic Banking Products

Table (11)

Statement	Response category	Frequency	Response Percentage
There is a need for Islamic banking in Ethiopia so that it will improve the financial services scarcity of the Muslim community.	Strongly disagree	9	7.5%
	Disagree	3	2.5%
	Neutral	7	5.8%
	Agree	78	65%
	Strongly agree	23	19.2%
Group Total		120	100%

There is a need for Islamic banking in Ethiopia so that it will improve the financial services scarcity of the Muslim community



Questionnaire results,2020

From the official Ethiopian population statistics, we can realize that the Muslim community constitutes significant proportion in the country. The economical lugging of this portion of the nation certainly affects the cumulative economy of the country. The researcher included this statement in the questionnaire because of its expected importance.

As referred in Table-11 above and the subsequent chart, about 84% of the respondents (the 4th and 5th vertical line in the chart) agree that there is a need for Islamic banking in Ethiopia so that it will improve the financial services scarcity of the Muslim community.

When we look at the demographic profile of the respondents sampled, we get Muslim respondents with the largest number mentioned over there. This leads the researcher to conclude that the part which kept itself apart from interest based banks knows the subject matter more.

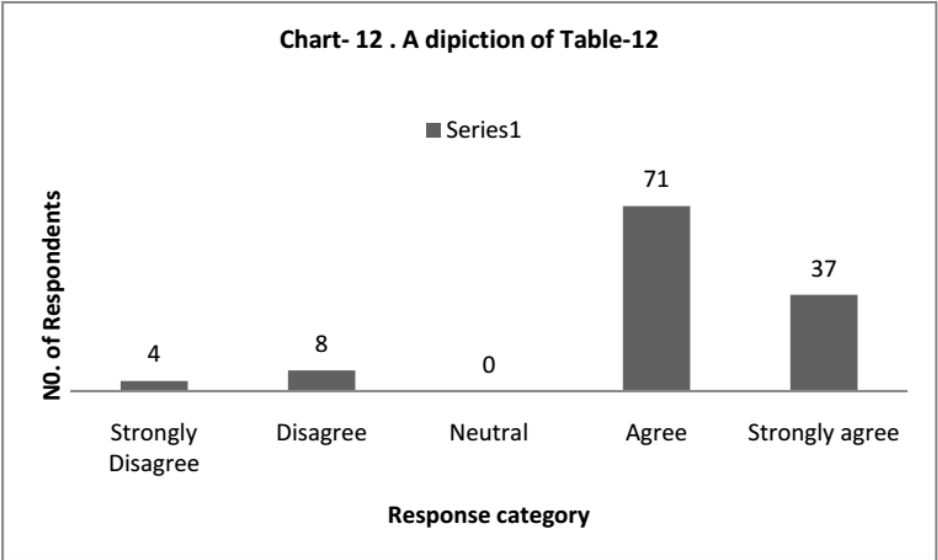
4.6 Legal and Regulatory Framework for Islamic Banking

Table (12)

Statement	Response category	Frequency	Response Percentage
Lack of effective and wise regulation is one of	Strongly	4	3.3%

the constraints of the Islamic banking industry in Ethiopia	disagree		
	Disagree	8	6.7%
	Neutral	-	-
	Agree	71	59.2%
	Strongly agree	37	30.8%
Group Total		120	100%

Lack of effective and wise regulation is one of the constraints of the Islamic banking industry in Ethiopia



Questionnaire results,2020

It is natural that disputes occur among dealing parties in business and social issues. The conflict resolution can't be limited to individuals and it leads to the importance of higher level interference some times. When agreements are breached, the intervention of legal entities comes quite important. Hence, the researcher raised the regulatory and legal issue over here.

From Table-12, and the depicting chart, we can see that about 90% of the respondents agree on the subject matter here. Those who responded opposing the idea do not weigh the balance.

Hence, the researcher understands that the statement that describes: “Lack of effective and wise regulation is one of the constraints of the Islamic banking industry in Ethiopia”, is a point that deserves special consideration.

Discussion of Interview data

The following is presentation of the interviewed professionals' **aggregate** responses concerning the Islamic Bank Establishment in Ethiopia

1. Current Status of Islamic Banking

The introduction of Interest Free Banking which is identical with the Islamic Banking is still in the infant stage at national level. But it has got high potential. Over 50 Billion Birr is collected under IFB nationwide. This probably has made the Ethiopian government to enhance the sector from window services to full-fledged level.

From among nine internationally applied products of Islamic banking, three to four products are being given by window level IFB services. Though *Murabaha*(Cost-plus) financing takes the highest portion of the products, related products like *Qard*(Loan), *Mudharabah*(*Profit-Loss Sharing*), *Kafalah* (Guaranty/Warranty) services are also being rendered. Though it is not touched well, the feasibility of Islamic Banking Products is portrayed through those conventional banks that work on IFB at window level.

2. Opportunities of Islamic Banking Establishment in Ethiopia

Islamic Banking services represent untapped market even if the target population is high. This is one opportunity. **ISB** services come up with alternative banking packages which will make conventional bank customers shift to this direction. The availability of Islamic Banks will also attract foreign investors interested in the field.

The marginalized people that hated interest and depended upon their own equity with full capacity and ignore wealth maximization or capital growth from interest based finance will set up a huge market size if they get permissive environment that agrees with their religious doctrine. Then, they will shift to equity-debt based wealth maximization which in turn makes up opportunity for Islamic Banking establishment.

3. Challenges of Islamic Banking

The lack of well-trained man power with Islamic Banking and lack of business oriented shari'ah scholars that combine Islamic knowledge with modern marketing concepts is another challenge.

The unavailability of capital markets like selling bonds and asset based cash resources for IFB is creates resource constraint which another challenge. Bank related businesses like insurance which is named *Takaful* in Islamic Banking is not yet worked on it.

Even if Islamic Banking is a business model where people are to be served disregarding their religion, currently non-Muslim communities look to the business through dark glasses. The negative influence of such societal belief is one of the challenges for ISB establishment.

4. Public awareness about Islamic Banking

The global trend shows that awareness of the Islamic Banking and the will of potential customers to use the products is directly proportional. When we come to our country, this is an untapped business area where people hardly have the idea. Most people come to banks for deposits (safe keeping) and in looking for loans. The different packages of ISB products which are even introduced by conventional banks at window level are not comprehended by the mass.

The terminologies of the products are strange for many. Except for bank managers, and those working on the field, even front-line staffs do not understand the products well.

5. Demand for Islamic Banking Products

There is high demand from customer side to get Islamic Banking services. Customers are demanding to invest in *Mudaraba* Financing and investment type that allows to share profit and loss with the investing and financing party which they did not get from their deposits that avails nothing beyond safe keeping of their money.

More demands can be enhanced if banks work hard on the field and show their success histories to potential customers.

Islamic Banking does not make profit it's solely aim to be achieved. Its business ethics to ease repayments in bankruptcy cases, the social guaranties, the relative less risk side of it

has made founders and shareholders courageous in establishing the under formation Islamic Banks.

6. Legal and Regulatory Framework for Islamic Banking

The legal and regulatory frameworks is not yet designed for Islamic Banking to date. This is believed to be one of the deterring factors for Islamic banks to work in. Unless government policies related to trade, taxation, and investment limitations are not designed accordingly it will be a big test.

Banks were not allowed to indulge in direct investment. They were allowed to finance a business. Unlike conventional Banking, Islamic Banking gives wide room for investment. So, the government policies designed for conventional banks will be a direct challenge to go through unless adjusted accordingly.

CHAPTER FIVE

5. CONCLUSIONS AND RECOMMENDATIONS

5.1. CONCLUSIONS

- The current status of Islamic Banking in Ethiopia both at awareness and application level is very low which does not respond to recent demands of potential customers.
- There is lack of supportive and linking institutions, such as Shar'iah boards and consultancies for successful practice of Islamic Banking and Finance.
- The current global trends in Financial Services will have positive expression on the future of Islamic banking establishment in Ethiopia.
- The current global trends in financial services and the introduction of Islamic Banking products through existing conventional banks will make the penetration of full- fledged Islamic banks in the market easier.
- Islamic banking system is helpful for the growth of Ethiopian economy.
- The establishment of Islamic banking in Ethiopia will play a critical role in economic growth of the country as it paves a way to unserved parties because of their religious affiliation that made them hate the divinely prohibited Interest.
- As the NBE has accepted the international standards of the Shari'ah compliant Islamic Finance and has issued the directives for that to CBE and the other private banks to work on that; the establishment of full-fledged Islamic Banking is possible from government side.
- The policies yet designed are not perfect fits to respond to smooth moves of IFB and full-fledged ISB services.
- The awareness of people in Ethiopia concerning the Islamic Banking concept is very low and eventually it has made their participation in Interest Free Banking services below expectations.

- The lack of well-trained man power that responds to the market demand of Islamic finance has made it difficult to run the operation smoothly. This is for IFB services at window level which applies the same to full-fledged Islamic Banking.
- Most of the scholars that advice on Sheri'ah Compliance requirements have general knowledge about the Sheri'ah Law; they are not business oriented. This has become hindrance on co-understanding between them and bank professionals.
- The legal and the regulatory frameworks of the NBE that rule banking services are designed for conventional banks; they hardly address the Islamic Banking services and products. This will become one of the operational challenges if Islamic Banks are established and come to the arena of banking market.
- The competitive environment of the existing banks that work on Interest Free Banking, their financial power and their excelling experience advantage will be another challenge for the persistence of the newly coming Islamic Banks.

5.2. RECOMMENDATIONS

Based on the findings of the study, the following recommendations are forwarded.

- Islamic Banking Services come up with alternative packages that will enhance the national economic growth. Hence, the society ought to understand this, avoid their negative attitudes and should take it as a business model disregarding religion.
- The legal and regulatory framework designed by the NBE to date is a competitive advantage of the conventional banks. So, the under formation Islamic Banks should work hard hand to hand with the national economic institutions to show the global trend of Islamic Banking services, their feasibility, until they get government's concern to smooth the guiding legal and regulatory environment.
- Potential customers among the community that depend on their equity and avoid debt in fear of interest should be identified well, addressed through well-organized promotional packages to create awareness regarding ISB services until they become willing to change their mind to equity-debt proportioned investment that constitutes both their tied capitals and bank finance.
- There is a trained human resource constraint regarding ISB services. Hence, Islamic Banks that will come to the banking market should take from the mass market accountants and front-liners, train them well in short technology aided training packages till they avail the problem.
- As the Islamic Banking package is untapped and wide sector that can contribute much to the national economic growth, both Islamic and Conventional banks through their IFB services should work on it to make use of this overlooked opportunity.

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Appendix A

Glossary of Interest Free Banking

(Source: Existing literatures on Islamic Banking and Internet)

Allah: The Creator, an Administrative of the Universe; God

Prophet: Hazrat Muhammad Mustafa (PBUH)

Quran: The Holy book of Muslims revealed on Hazrat Muhammad Mustafa (PBUH)

Surah: Chapters of Quran; there are 540 Sura in Quran.

Islamic banking: Financial services that meet the requirements of the Sha`riah (Islamic law)

Sha`riah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Sha`riah compliant product meets the requirements of Islamic law.

Sha`riah advisor: An independent professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the sha`riah, or Islamic law.

Sunnah: way of life of Prophet Hazrat Muhammad Mustafa (PBUH); They said about anything, they act anything is called as Sunnah.

Sha`riah Compliant: An act or activity that complies with the requirements of sha`riah or Isla

Zakat: Zakat is one of the five pillars of Islam. It is obligatory for Muslims to pay their wealth to specified categories in society when their annual wealth exceeds a minimum level

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

Halal: Any activity or transaction that is according to law and also permitted in Islam is known as halal.

Haram: Any business or contract that is unlawful and also prohibited in Islam is known as haram.

Maysir: (Gambling) one of three fundamental prohibitions in Islamic finance.

Amanah: Trust, with associated meanings of responsibility, truthfulness and sincerity.

Arbun: Down payment; a non-refundable deposit paid by the buyer to the seller upon finishing a contract of sale, with the condition that the contract will be completed during the prearranged period.

Bai-mua'jjal (deferred payment sale) is a deferred payment sale contract which is traded Without additional costs.

Gharar: (Uncertainty) is a sophisticated concept that covers certain types of insecurity or Contingency in an agreement.

Ijara: Ijara is a kind of lease; it allows the bank to earn profits by charging rentals on the assets leased to the customer. Ijara wa Iqtinah extends the concept to a hire purchase agreement.

Mudaraba: is an investment partnership, whereby the investor (the Rub ul Mal) provides capital to another party (the Mudarib) in order to undertake an investment activity.

Mudarib: The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investors' funds in a project or portfolio in exchange for a share of the profits.

Murabaha: Purchase and resale. Instead of lending out money, the capital provider purchases the desire commodity from a third party and resells it at a prearranged higher price to the capital user.

Musharaka: profit and loss sharing. It is a partnership where profits are shared as per as agreed ratio whereas the losses are shared in proportion to the investment of each partner.

Qard: A Qard is a loan, free of interest. Bank use this arrangement for current accounts hold ers. In essence, it means that Current Account is a loan to the bank, which is used by the bank for investment and other purposes.

Sukuk: Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond.

Takaful: Islamic insurance. **Tawarruq:** Reverse Murabaha. As used in personal financing, a customer with an actual need buys something on credit from bank on a deferred payment basis and then instantly resells it for cash to a third party. In this way, the customer can take cash without taking an interest-based loan.

Appendix B

Data Collection Instruments

Survey Questionnaire

St. Mary's University

School of Graduate Studies

MBA Program in Accounting and Finance

Researcher: Zegeye Belayneh

Contact Address: +251-9 12-00-54-52

Email: zegeyeabuhuda2004@gmail.com

Dear Respondents, This questionnaire is designed to collect data for evaluating “**The Challenges and Opportunities of Islamic Banking Establishment in Ethiopia**”.

Purpose: This questionnaire is needed to conduct a research necessary for the partial fulfillment of the requirement of MBA program at school of graduate studies in St. Mary's university. The result of this study is intended to serve academic purpose only. I would like to remind you that genuine response is highly valuable and has great contribution for the quality of the research. Your response will have a crucial role in providing valuable input for the study.

Attention

- No need to write your name
- Kindly respond to all questions

Thank you in advance for your cooperation

Part one: Background Information

Dear respondents, please label a characteristic that responds to your background data by using “√” mark.

1. Age distribution of the respondent

18-30 Yrs 31-40 Yrs 41-50 Yrs 51-60 61 Yrs and above

2. Gender: Male Female

3. Profession:

Student Govt. employee Private employee Self business

4. Educational Qualifications:

High School Diploma First Degree Second Degree Ph.D. and above

5. Current Job Position in the bank: _____

6. Banking Experience in number of years:

Up to 5 years 6-10years 11-15 years 16 years above7.

7. Exposure to Interest-free banking?

Up to 1 1-2 year 2-3 year 3-above

8. Religion

Muslim Orthodox Christian Protestant Other

1. Opportunities of Islamic banking in Ethiopia

NO	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
1	The current global trends in Financial Services will have positive expression on the future of Islamic banking establishment in Ethiopia.					
2	Islamic banking system is helpful for growth of Ethiopian economy.					
3	The offering of Islamic banking products (Saving and Loan Service) will improve the tendency for business expansion and investment.					
4	Islamic banking is a flexible financial system and easy to adopt.					

2. Challenges of Islamic Banking

Item	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
5	There is Lack of suitable banking policies for Islamic banking				
6	There is a lack of supportive and linking institutions such as Shar'iah boards and consultancies for successful practice of Islamic Banking and Finance				
7	There is a gap in research and development in Islamic studies in general and Islamic finance and economics in particular				

3. Demands for Islamic banking products

	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
8	There is a need for Islamic banking in Ethiopia so that it will improve the financial services scarcity of the Muslim Muslim community.					

3. Awareness items

	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
9	I have a clear idea on how Islamic banking products work					
10	Ethiopia is facing difficulties in developing Islamic banking because the awareness of Islamic financial industries by public is still weak.					

4. Legal and Regulatory frame work

	Items	Strongly disagree 1	Disagree 2	Neutral 3	Agree 4	Strongly Agree 5
11	Lack of effective wise regulation is one of the weaknesses of the Islamic banking industry in Ethiopia.					

1. If you have any other opinion regarding the opportunities and challenges of Islamic banking establishment.

Thank you for spending your time

Appendix C

Interview Questions

1. What do you think about the current status of Islamic Banking services in Ethiopia?

2. Do customers request/demand for Islamic Banking products that banks are currently not providing?

3. As a forming party of your Islamic Banking, what made you have the courage to involve in this form of Banking Business?

4. What challenges do you think Islamic Banks would face in delivering their products?

5. As banks are for all, disregarding religious affiliation, do you believe non-Muslims would adopt Islamic Banking services?

6. As the Islamic banks run in accordance of Shari'a Law are there non-Muslims who got interested in the establishment of your Islamic bank and have bought shares? Do they weigh significant number?

7. As shareholder of ZamZam/Hijra Bank, what made you interested in buying the share? -----

የኢንተርቪው ጥያቄዎች

1. በኢትዮጵያ ውስጥ የኢስላሚዊ ባንኪንግ አገልግሎት ያለበት ተጨባጭ ሁኔታ ምን ይመስሎታል ?

2. ባንኮች በአሁኑ ሰዓት የማይሰጡትን የኢስላሚዊ ባንኪንግ አገልግሎትን ደንበኞች ይፈልጋሉን/ይጠይቃሉን ?

3. እንደ ኢስላሚዊ ባንኪንግ መስራቾነትዎ በዚህ ዓይነት የባንክ ቢዝነስ ውስጥ እንዲሳተፉ ያበረታታዎት ነገር ምንድን ነው ?

4. ኢስላሚዊ ባንኮች ተመስርተው አገልግሎት መስጠት ቢጀምሩ በባንኪንግ አገልግሎቶች ውስጥ ሊገጥሟቸው የሚችሉ ተግዳሮቶች ምን ሊሆኑ ይችላሉ ?

5. ባንኮች ኃይማኖትን ሳይለዩ የሁሉም እንደመሆናቸው መጠን ሙስሊም ያልሆኑ ዜጎች የኢስላሚዊ ባንኪንግ አገልግሎቶችን ይለመዳሉ ብለው ያስባሉ ?

6. ኢስላሚዊ ባንኮች በሽሪዓ ሕግ መሰረት የሚከናወኑ ከመሆናቸው አንጻር በምስረታ ላይ ባለው ባንኮች ሁ አክሲዮን የገዙ ሙስሊም ያልሆኑ ዜጎች አሉን ? ከሆነም ቁጥራቸው ሚዛን የሚደፉ ነውን ?

7. የዘምዘም ወይም የሂጅራ ባንክ ባለ አክሲዮን እንደመሆኖ የዚህን ባንክ አክሲዮን እንዲገዙ ያነሳሳዎት ነገር ምንድን ነው ?
