



**ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE
STUDIES**

**CHALLENGES AND PROSPECTS OF FULL FLEDGED ISLAMIC
BANKS IN ETHIOPIA**

**A THESIS SUBMITTED TO ST. MARY UNIVERSITY SCHOOL OF
GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS
ADMINISTRATION IN ACCOUNTING AND FINANCE**

BY: ABEL GIRMA

**ADVISOR: MOHAMMED SEID (ASS/T
PROFESSOR)**

DECEMBER 2020. ADDIS ABABA ETHIOPIA

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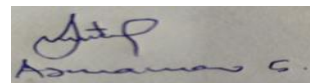
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DECLARATION

I Abel Girma declare this thesis "Challenges And Prospects of Full Fledged Islamic Banks in Ethiopia" as my own Work and prepared under the guidelines of Mohammed Seid (Ass/t professor) and all sourced materials used for accomplishment of this thesis have been acknowledged. This thesis work has not been submitted in part or in full for any degree or examination at any other institution.

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TABLE OF CONTENTS

ACKNOWLEDGMENTS	VI
ABSTRACT.....	IX
KEY WORDS.....	X
CHAPTER ONE.....	1
INTRODUCTION.....	1
1.1 Background of the study.....	1
1.2 Statement of the problem.....	2
1.3 Objective of the study.....	3
1.3.1 General objectives.....	3
1.3.2 Specific objectives.....	3
1.4 Research questions.....	3
1.5 Significance of the study.....	3
1.6 Scope of the study.....	4
CHAPTER TWO.....	5
LITERATURE REVIEW.....	5
2.1 Theoretical review.....	5
2.2 Empirical evidence.....	14
2.3 Research gap.....	16
CHAPTER THREE.....	17
RESEARCH METHEDOLOGY.....	17
3.1 Study design.....	17

3.2 Study population.....	17
3.3 Methods and tools of data collection.....	17
3.4 Plan of data analysis.....	17
CHAPTER FOUR.....	18
DATA PRESENTATION AND ANALYSIS.....	18
4.1 Introduction.....	18
4.2 Data presentation.....	18
4.2.1 Challenges.....	18
4.2.2 prospects.....	23
4.2.3 Intensity of challenges.....	26
CHAPTER FIVE.....	29
SUMMERY, CONCLUSION AND RECOMMENDATION.....	29
5.1 Introduction.....	29
5.2 Summery of findings.....	30
5.3 Conclusion.....	31
5.4 Recommendations.....	31
REFERENCES.....	32
APPENDIX.....	35

ABSTRACT

This study aimed at figuring out the challenges and prospects of full fledged Islamic banks in Ethiopia. In order to accomplish the research purpose, a mixed approach was used. Both primary and secondary data were used in order to grasp the whole picture and get the possible closest result that the research process can provide. as a secondary source, of data, the holly Qur'an, unpublished study reports and IMF's finance manual were used. As a primary data source, a questionnaire was used and the appointed project managers from the newly establishing Islamic banks which are Zemzem Bank, Hijra Bank, Zad bank, Ramis Bank and Shebele bank filled up the questionnaire. The primary data was analyzed by a statistical software called SPSS 25 and presented as a descriptive analysis result. The questionnaire contains a three part investigative questions which aimed at figuring out the challenges, prospects and intensity of the challenges in Islamic banks. The result of the paper Indicates that there is a good market potential and positive prospect for full fledged Islamic banks in Ethiopia. But as the result indicates, there are serious challenges that need attention and hard work. The main challenge turned out to be the current regulatory challenge in Ethiopia and lack of adequate public awareness about Islamic banking. After those results and conclusions the researcher recommends that there shall be efforts including future studies on how to improve banking regulation in a way that will greatly consider Islamic banks by the government and also there shall be a huge effort to create awareness about Islamic banking among the Islamic and general population in order to experience the positive and promising prospect that full fledged Islamic banks possess.

KEY WORDS

Amanah: Trust, with associated meanings of responsibility, truthfulness and sincerity. As an important secondary meaning, the term also identifies a contract where one party keeps another's funds. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. Now a days HSBC has maintained Amanah bank accounts.

FFIB: Full fledged Islamic banks

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.

Murabaha: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity from a third party and resells it at a prearranged higher price to the capital user. By paying this higher price over installments, the capital user has successfully obtained credit without paying interest.

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.

Quran: The Holy book of Muslims revealed on prophet Muhammad.

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 Islam.

Sha'riah: Islamic law as revealed in the Quran and through the example of Prophet Muhammad. A Shariah compliant product meets the requirements of Islamic law. A Shariah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of shariah compliant products.

Shariah 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. While some Islamic banks consult individual Sha'riah advisor, most establish a committee of Shariah advisors.

Sha'riah Compliant: An act or activity that complies with the requirements of sha'riah or Islamic law.

Takaful: Islamic insurance. Planned as charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of traditional insurance (i.e., interest and gambling) that are challenging for Muslims.

CHAPTER ONE: INTRODUCTION

1.1 BACKGROUND OF THE STUDY

It is becoming clear that because of the preference of the Muslim community which has a substantial population number in Ethiopia, it was necessary to adopt an alternative modern and fully fledged interest free financial service for customers who do not wish to use the conventional Islamic banking window who could not offer a variety of sharia abiding services. Full fledged Islamic banks are the ones that operate by abiding the shariah principles. they work according to the teachings of Islamic dogma. one of the prominent feature of the Islamic bank is that it is interest free. It does its work as a financial institution, for savers and investors by providing banking services on the platform of legitimate contracts . The bank tries to balance between economic and social return, by setting an objective of the equitable distribution of income and wealth and increased equity participation in the economy (Ofum 2014).

The start of interest free or Islamic bank generally goes back to the days of Islamic empire formation. which was followed by the buildup of internal and external trades that needed Islamic financial tools of the Islamic banks such us deposits, transfers of money, checks, bills of exchange and so on to keep up with the trade and economic developments.

Gradually though Islamic banking system became weak in Islamic countries because of the debilitation of the Islamic empire. but Europeans adopted this Islamic financial practices and made them evolve till the modern era. Then after, this practices were replaced by the western banking style (Asyraf 2007).

The start of Muslim financial system was before 1400 years. certain kinds of banking models were there in the 1st century of Islam (AD 600) that look like the modern banking transactions. Islamic banking in its modern form has had three developmental stages.

The first developmental stage was from 1972- 1975. Islamic banking in this stage was linked with oil revenues and liquidity. The establishment of Dubai Islamic bank was on this time.

The second developmental stage begins at 1976 till 1980s. during this time Muslim financial system grew from the gulf countries to Malaysia and west ward to UK. numerous of local and multinational institutions had been formed. like Islamic banking associations and advisory bodies in order to grow their activities.

the last stage is starting from 1983 to present when the banking system come to maturity phase. Arab nations were challenged by economic hardships. like slowdowns in oil revenues in the start

of 1980s, the fact that US dollar got the relative power, high interest rates in the a U.S, The countries of OPEC start to face capital outflow.

Islamic interest free system is spreading in the whole world. according to the AME info 2005, there are now more than 250 institutions of such kind and client money valued at over 400 billion USD (Munwar and Philip 2016).

FULL FLEDGED ISLAMIC BANKING IN ETHIOPIA

Full fledged Islamic banking in Ethiopia is a very new experience. Enactment of the nation's first interest free banking directive by the national bank of Ethiopia was passed in 2011. The directive that authorized the business of Islamic banking in Ethiopia was highly suppressed with controversy back when it was enacted.

Around the time of the enactment of the directive, was the emergence of the first bank in Ethiopia that wants to practice interest free banking which was in consistent with the Islamic principles, which was called Zemzem bank. but the whole thing was short lived. soon the national bank directive was reversed and the first interest free bank in Ethiopia in a full fledged manner was no longer executable. The directive authorizes Islamic banking in the setup of a conventional banking system and not a full fledged interest free bank.

After six years, Zemzem bank returned with two more potential full fledged Islamic banks named Zad and Hijra. The three have officially started selling shares (Suadiq 2020).

1.2. STATEMENT OF THE PROBLEM

The emergence of Islamic financial system is important since Islam by its nature is a religious frame work that encompasses all aspects of all aspects of the life of the observant. this is where financial instruments that are completely consistent with the Islamic belief and principles become a necessity. Islam prohibits on moral grounds activities related to gambling involving money and non monetary assets. hence it argues that Islamic finance is generally governed by three principles. equity, participation and ownership (IMF Islamic finance paper 2015).

The new entrants of full fledged Islamic banking, may face a host of challenges to make it in the business. They may have to navigate through the various legal and regulatory restrictions placed on their way.

Since full fledged Islamic banks are very new to Ethiopia, there is no research paper done on these particular financial institutions. The purpose of this paper will be to fill in this gap.

1.3. OBJECTIVE OF THE STUDY

1.3.1 GENERAL OBJECTIVE

The objective of this study is to determine the challenges they may face in the new environment, as well as give a prospective assessment on the prospects of these interest free banks.

1.3.2. SPECIFIC OBJECTIVE

- To figure out the regulatory convenience to pursue Interest free banking system.
- To show the ideas of philosophies through which Islamic banks operates that help to be the basement of Islamic banking services.
- To examine the prospects of the survivability that full fledged Islamic banks possess in Ethiopia.
- To figure out the major setbacks that the newly forming Islamic banks might face while operating in Ethiopia.

1.4 RESEARCH QUESTIONS

The study addresses the following questions

- What are the risks and challenges of applying Islamic banking principles in Ethiopia?
- Does the future look bright to full fledged Islamic banks in a way that it will give chance to a fresh set of customers that were not being benefited from other conventional banks or Islamic banking services within conventional banks?
- Does a banking service that operates according to sharia principles have an economic effect on the country?

1.5 SIGNIFICANCE OF THE STUDY

This paper will be significant because it deals with the issues which the newly coming full fledged interest free Islamic banks might be facing in the future while operating in Ethiopia for the first time. Given that the significant or sizeable means of income generation for conventional banks comes from interest on loans and advances, it is greatly mandatory to the study the challenges which this interest free banks might encounter and the prospects they might have in this new market environment.

In light of the challenges that full fledged Islamic banks in other countries had in the past and having now, in terms of maintaining a substantial income, dealing with financial regulatory policies and considering Ethiopia's financial, market and demographic environment, this study will give insight for these new banks in Ethiopia what the challenges might be while operating in this country and what their prospects might be in the future. this helps in considering the

existence of this challenges and preparing in confronting them in less risky way that will bring a maximal and productive prospect.

1.6 SCOPE OF THE STUDY

This paper is limited to studying the challenges and prospects of Islamic banks that are planning to operate in a full fledged manner in Ethiopia. Although part of the Islamic financial system, the paper will not be addressing any Islamic microfinance institutions, Insurance institutions or other Financial institutions that might be out there.

1.7 LIMITATIONS OF THE STUDY

shortage of time to conduct the research in a more detailed and in a relatively even deeper manner was one of the biggest challenges faced during this research conduction process. Also the unfortunate occurrence of the outbreak of COVID 19 pandemic which interred Ethiopia during around the same time this research was on progress, brought the biggest challenge by making it extremely difficult to conduct an interview that would have brought additional data. so this research was conducted with the available time and applicable data tool.

1.8 PAPER ORGANIZATION

This research paper is organized in five chapters. In the first chapter contains the introductory part which includes background of the study, statement of the problem, objective of the study, significance of the study, scope and limitations of the study. The second chapter of the paper contains the review of theoretical and empirical literatures. In the third chapter the research methodology by which the research was conducted is shown. Chapter four contains data presentation and analysis. Lastly chapter five presents summary of findings, conclusion and recommendations.

CHAPTER TWO

LITERATURE REVIEW

In this chapter different theoretical and empirical literatures that has to do with Islamic financial activities, laws and principles under which interest free banks based on, and the practical point of view on the applicability and compatibility are tried to review. In the first part the theoretical review section will cover theoretical literatures that studied the basic elements that are a principal foundations of the Islamic faith based banks follow and the principles of transaction and general business activity performance according to the Sharia way. Empirical literatures are reviewed in the second section and at the end of the chapter, the research gap in the general study of the interest free banks is showed.

2.THEORETICAL RIVIEW

DEFINITION AND OVERALL TRENDS

Islamic banks can be defined as a financial institution that abides by *shariah* principles in all of its activities through its role as a financial intermediary between savers and investors provides banking services within the framework of legitimate contracts and achieves a balance between economic and social return. The beliefs of Islam encompass all aspects of a Muslim's life, determining the articles of their faith, their moral and behavioral code, relationships between man and God, and between human beings as well as giving the framework for their daily activities (Haseeb 2018).

The most important feature of this banking system is that it is interest-free. 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. Interest has no place in the Islamic order. The injunctions regarding the prohibition of “Riba” (as interest is referred to) are contained in the Holy Qu0ran, the basic source of Islamic ideology. It must be mentioned at this point that other religious faiths are also equivocal in condemning interest in modern business/commerce. Islam prohibits Muslims from taking or giving interest (riba) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. Some attempts have been made to distinguish between usury and interest and between loans for consumption and for production.

It has also been argued by some scholars that riba refers to usury practiced by petty money lenders and not to interest charged by modern banks and that no riba is involved when interest is imposed on productive loans but these arguments have no general acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between riba and interest (Ofurum 2019).

The Islamic economic model has been developed over time based on the rulings of *Sharia* on commercial and financial transactions. The Islamic financial framework, as seen today, stems from the principles developed within this model. While some of these principles and rules are based on clear and explicit rulings of *Sharia*, others are derived from *Sharia* scholars' interpretations and understanding of the law, known as *Fiqh*, as set out in the Qur'an. These interpretations can and of course do differ between *Sharia* scholars. For example, certain contractual terms deemed to be valid under *Sharia* by the scholars of one school of *Fiqh* may not be acceptable to scholars from another school. This has had significant implications for the development of Islamic finance (Hassan 2015).

2.1 ISLAMIC FINANCIAL SYSTEM

For a Muslim person, the teachings of Islam affects or controls almost every corner of a person's life according to the denominations on the scriptures of the faith. such as on their values and characters, interactions with God and with one another, and generally their day to day practices. The sharia which is taken from Quran and which in turn includes the sayings as well as activities of prophet Mohammed, gives directions and regulations for every Muslim person's economic and social activities, attitudes and morals. Directly Quran itself as well as scholars of Quran are who drive the meanings and implications of the scripture are the main sources of the rules and principles of sharia and its implications, which is called *Fiqh*, in accordance with the Quran. (Financial Services Authority, Islamic Finance in the UK: Regulation and Challenges, November 2007) www.ubl.com.uk

2.1.1. STRESS ON JUSTICE

This is shown in the belief that everyone that is carrying out a business transaction or economic activity makes informed decisions and is not deceived. on a bigger and general sense the islamic economic model believes in social justice and the financial success of the whole community. For instance specific Shariah laws are directed on reduction of concentrated wealth in a few hands, which may have a negative effect on society.

2.1.2 THE FINANCIAL RIGHTS OF PEOPLE

The religion Islam supports the premise that anyone is entitled to make money and ensure his own financial security. But restricts and clarifies the ways of making money that are allowed and those which are forbidden. For instance, trading of business activity that is associated with alcohol, pork related items, artillery, gambling, and other generally harmful activities are not acceptable under sharia law.

2.1.3. FIRM AND CLEAR RESTRICTION OF RIBA

This is one of the most important rules of sharia on financial activities of Muslims. It is a clear restriction of 'riba' which refers to usury or interest. Actions involving interest payments whether or not it is in a banking system, is considered riba by sharia scholars.

To mitigate this problem, a way has been developed by Islamic banks to gain the income from the interest by flows from profitable activities like returns from wealth generating investment activities and operations. These include profits from selling or buying real assets and cash flows generated from rent, franchising etc...

2.1.4. PROFIT OR LOSS SHARING

Islamic banking is based on the profit or loss sharing idea. so Islamic banks are more or less the same as conventional banks in transaction procedures and equity based transactions in rewarding performance. But the Islam religion through sharia go stronger and proceeds to encourage the idea that profit making or profit distribution based on effort rather than a reward for just owning capital.

2.1.5. ISLAMIC CONTRACT LAW

Islamic contract law has a big significance within Islamic financial system. Islamic commercial law philosophy *fihi Al-muamalat* sets rules and principles about whether certain transactions are acceptable or not in the context of the religion Islam. This is where the Islamic law of contracts comes in, as it is the center of that principle. so according to this rule, under sharia law anything that can bring doubts and lack of assurance which may cause disputes can stop the contract process or disqualify the contract.

2.1.6 ‘Riba’

Riba can take the rough translation of "surplus" or "amplify". And the sharia uses this concept to refer to compensation with no actual effort. (effort does not include time value of money). This is meant to imply directly to interest on loans as written by economists choudhury and malik (1992). The islamic financial system has practiced according to this sharia's prohibition of interest.

In the Islamic study of law, in the classical period, *riba* was defined as excess amount in real time and that numerical value is not important. During this period, where there is a benchmark metal that defined other metals being traded like gold and silver, to add interest value on the benchmark metal wasn't reasonable. these tradable metals can't be created. it was just possible to add value to them. usury in Islam had been band on several verses in quran since around 600AD and was reinforced by prophet Mohammed. (Choudhury, Malik, 1992)

2.1.7 ‘Mudarabah’

Mudarabah is a business partnership type for people who want to involve in an investment where the money for the investment comes from one partner and the other one exclusively runs the management process in the partnership. the one who covers the funding is called *rabb-ul-mal* and the one that manages the investment is called *mudarib*.

The *rabb-ul-mal* provides 100 percent of the investment capital and the *mudarib* provides skill, knowledge and expertise on the investment and management process of the process. in other words a process of investment that a bank provides the finance and the entrepreneur provides the labor which is Mudarabah is a case where they share both profit and risk.

2.1.8 ‘Musharaka’

Musharaka is a way of doing business in a fair play manner. in this situation partners who want to do business come together to form a joint venture, to work together and gain profit. But this is a totally different idea than fixed income investing and in this case the financial providers can actually involve in the management process unlike Mudarabah in musharaka, there could be a number of participants or members who could be more than two which contribute capital and share the profit or loss according to their contribution. Even if these two concepts Mudarabah and Mushakara doesn't have significance in current times they show the characters and features of Islamic banking.

In the Islamic banks the bank may act as a fund earning party in the eyes of the depositors who act as "Rubbulmals" other methods are also there to doing business. Floating rate interest loans will be given or lent to users by Islamic banks. Then after they paid the principal amount of the loan, they will end the profit sharing deal. Also if the bank is the one who contributes the capital, the same principles will take place. According to sharia, the profit will be entitled to the party that takes the financial risk that comes along with it. There is some separate aspect between these two concepts, the "Musharaka" and "Mudaraba". In the case of "Mushakara" every participant puts in their part of the capital. When in "Mudaraba" only one party, for instance a bank, contributes all the capital and the other party will not contribute financial capital. (Farhad, Rahnama, and Ali (Islamic Economic Systems, Zed books limited, 1994)
[Http://www.Islamicbankingandfinance.Com/Home.Css](http://www.Islamicbankingandfinance.Com/Home.Css)"

2.1.9 Murabaha'

Murabaha is a way of doing business by the bank where the bank buys some asset in order to finance it on behalf of the client who then pays for it by adding a mark up on the top of its original price.

This idea is the same as selling goods with a profit. The bank makes a profit by adding a time value of its money. This is useful for buying real asset and the money that the bank spends is considered a fixed income loan and real asset, and the money that the bank spends is considered as a fixed income loan. Real assets like buildings and cars can be the items that can be acquired by this way. the bank takes a risk while buying the goods and selling them, then acquires a fixed rate profit according to the margin of profit. <http://ifptest.law.harvard.edu>

2.1.10 'Baimuajjal'

For payments that were separate in time, it is considered acceptable to charge higher prices. this kind of exchange situation is called trade not a loan. Baimuajjal is a property financing for those kinds of transaction that have a time difference.

2.1.11 'Bai' bithaman ajil' (deferred payment sale)

The idea of this is the activity of selling goods that have a price base difference by adding certain amount of profit that is agreed by the participants of the transaction. Bai bithaman ajil is a concept of Islamic financial institution as '*Bai'-al-'inah*' is. it is not considered as interest payment in a way that the customer is paying for the sale price not a payment on a loan. (<http://www.badalislami.com/glossary/> <http://www.azmilaw.com/Article>)

2.1.12 'Bai' al 'inah' (sale and buy-back agreement)

This is an economic institution that consists of a purchase transaction process that involves the user of the institution and the financier. In this case the financier will buy the asset from the user (customer) on face value. The buying process is with addition of the institution's grant to the user's business. Then after that the asset will be sold to the user in different price scale and which can be paid in segments. The purpose of this is to create a sense of responsibility on the service user.

2.1.13 Ijara (Lease)

Ijarah the Arabic word can be fairly translated as lease. This is a practice of basically processing an asset and selling the benefit to the user for a fixed amount of time and price. In this case the bank possesses a field, building vehicles or machineries and leases it to users up on agreed duration of time and amount of fee.

The financial institution will probably purchase the asset and then leases it to the users by smaller segments of fee. In the case of Interest free banks leasing (Ijarah) activity, the user will not have to pay penalty payment because the banks profit is not or, cannot be revealed in the first place. As a safeguard for the bank the user have to provide a collateral which will be proportional to the damage, if there is going to be payment withdrawal.

For those who need a loan for a house, there is a concept called Musharaka al-mutanaqisa, which is a creative form of loan supply that involves the finance institution and the user forming an entity by providing capital from both sides as partners to buy the possession. Then the bank will again rents the house to the user but they will share the income from the rent according to their proportion in the partnership entity. Simultaneously the user will start to buy the stock of the entity they collaborated on in small segments of payment until the property entirely becomes in the users name.

2.1.14 '*Ijarah thumma al bai*' (hire purchase)

This is another form of leasing but with additional features. The first leasing technique is Ijarah which entails the process of renting out a property for a specific amount of time. This second process is called Bai. In this case when that specific time frame of rent is finished, trading or buying procedure is activated.

There is going to be a contract for the two parties. For that contract the bank will first assess its profit by considering different aspects like time value of money, the price of the property, the depreciation of the property after the leasing period and different aspects. After that, the contract will be made that ensures the profit of the bank.

2.1.15 '*Ijarah-wal-iqtina*'

This system is used by an interest free bank that already is leasing out a property to the user in which there will be a contract that will be transferring the property under rental leasing technique which may be a vehicle, a field, a house or other property will be under the users name or

transferred to the user when the time period of the lease agreement ends. In this contract when the duration of the lease contract under the rent is over the property will be sold to the user without considering additional requirements that maybe agreed up on the lease contract. The bank will first calculate its profit from the rent and the final trade which are fixed amounts from the time that the contract is set out.

2.1.16 ‘Bai-salam’

This is an activity made when a factory owner or someone in a manufacturing industry wants a financial support. In this case the producer will sell products to the financial entity, at a lower price before the product is even manufactured.

This system called Bai salam is a way that a purchase is made and the actual product will be delivered after some time. After the full amount of money for the commodity is paid for the manufacturer, it is now clear that the production process is supportively financed and the production will be undertaken. In this case since the full price for the product is paid, the manufacturer has to make sure that the quality quantity and other specifications of the product are fully met according to the previous contract that has been set out at the time of the payment. This system of interest free banking will work on or applied to any item that can be put on a price except gold and silver.

2.1.17 ‘Musawamah’

When two sides of the trading process have definitive reference of price that they intend on offering, it is called Musawamah. In this process the seller and buyer of the item will negotiate without necessarily knowing the cost of the product or property.

In this process even if the seller does not know the price of the item that they are about to trade, neither one of them are required to disclose the true price of the item while they are negotiating. The main difference in this case with Murabaha is that the requirement of disclosure with the two parties. This method is used very often as it may be very profitable than Murabaha with only this difference in disclosure requirement.

2.1.18 Payment certificate

The method of purchasing products in credit is also one of the activities of interest free banking. When the buyer purchases a certain item with credit they will do it with a payment certificate which will enable the seller to receive his money from the bank with a discount that will lead to more profit.

2.1.19 Special current account

This service is given by very few Islamic banks. For this service there is going to be a specific account opened by the user and for more convenience the service is usually given with a special agreement with the conventional banks.

It is a form of current account where there is no transactional cost on the user, as well as with the absence of interest payment due to the apparent religious laws.

2.1.20 *Hibah* 'gifts'

In the Islamic banking system, there are no interests given for depositors. but with the banks' free will, the institution may give Hibah which is a gift to its depositors by considering their balance in the account. the gift may not always be monetary.

Usually these gifts will be given to the depositor after a loan to accelerate the process as an incentive. Hibah is a free will practice that does not always necessarily happen and it will be something that the institution gives for the profit made using the customers saved money in the bank.

This system is aimed to enhance the saving habit of depositors and to inspire and get more money on the saving account of the customer. Hibah is a practice that might be confused with interest paid on savings account by conventional banks. But in this case the gift is only given willingly by the bank as an appreciation to the customers and make the depositors save more money in order to get a larger Hibah and that will have a positive result for the bank to get more money through savings deposit which is necessary to the banks' capital. This practice comes from the idea that the bank better to share some segment of its profit made from its monetary capital. (<http://www.rhbislamicbank.com>)

2.1.21 *Qard hassan* (Appreciation loan)

In Hibah, the institution which works with depositor customers willingly gives extra gift from the profit it made. In this case, when the financial institution extends the payback time on a loan, for a customer in a total willingness the customer may pay the loan with extra money than the amount they were loaned. This practice of customers paying extra for their extended loan payback period is totally voluntary from both the bank as well as the customer, and neither party is obligated to do so.

In interest free banking the process of lending and borrowing money should be totally interest free and no one should work with interests paid for the time value of money that they loaned or deposited because of the prohibition of Riba. But in this case, since the activity is done through a total free will, some Islamic religious experts argue that it is acceptable practice since the extra payment are not done to overcome monetary depreciation.

2.1.22 '*Sukuk*' (Islamic bonds)

This particular certificate called Sukuk are a way of assurance that a certain body who made a payment that will be paid back later. It is an Islamic form of a bond with particular qualities. In the case of sukuk, the bonds are not interest based bonds or fixed income bonds for that matter. Since Islamic law or the Sharia law prohibits interest and free extra payments Sukuk only works with the absence of those features, it does not fully comply with the Islamic principles.

2.1.23 Takaful (Islamic Insurance)

This is a service given by Islamic institutions that has a form of insurance. A particular person may use Takaful to avoid or be compensated for some unfortunate incident. The Islamic faith believe that some kind of unfortunate incident in one particular person might close down with a mass of people that has the risk of encountering it. In this way that particular person will then be privileged by those platforms that will be given for the incidents.

([http:// www. irfi.org/articles/articles_301_350/is_islamic_banking_islamic.htm](http://www.irfi.org/articles/articles_301_350/is_islamic_banking_islamic.htm))

2.1.24 Islamic equity funds

These kinds of institutions have been widely underrated in the past, but now a days Islamic investment equity funds are gradually becoming the market of Islamic finance. All over the world there are more or less 100 Islamic equity funds and becoming more known and preferable by users that at this point a compilation of more than 5 billion dollars of asset are being managed using this Islamic financial service and is constantly growing with a yearly growth of 12-15%.

The Islamic equity fund's popularity is increasing with even developed countries have shown interest in this service as well as in the general Islamic financial system and convenience. So for that reason it is greatly believed that more large funds will be launched.

This funding service faces challenges that lead to seizing of the function of some funds. That problem arises from the fact that it lacks inclusiveness of the lower investment capital and concentrating on the big capital corporation alone. (Dow Jones. 1999

<http://www.bloomberg.com/apps/news?pid=20601092&sid=aOsOLE8uiNOg&refer=italy>

Retail Islamic Banking Products

2.1.25 Current Account (*Alwadiyah*)

In the small level and retail capacity, interest free institutions give somewhat the universal service of current, savings and investment account. But in the Islamic banking scenario, the current account serves as a trusted safe keeper by the interest free bank for the user to use it to manage his cash for daily routine needs. This account is termed as Alwadiyah.

The service is like the commonly used conventional banking service. the depositor saves money in the account that the bank makes sure to keep it safe and also use it for the bank's activities in different sectors. At the same time in addition to keeping the money safe, the bank insures that the depositor's money will be repaid fully as well as the outstanding amount whenever the depositor needs his money back. The special feature in Islamic banking is, when refunding the depositor's money happens, there will not be any additional interest money. But there might be

additional payments to the original money to the depositor only as an appreciative gift or Hibah. which is not a mandatory activity and which only happens with the banks free will.

2.1.26 Savings Account

The system of Alwadhiah also provides a separate financial room for savings account that will enable users get a relatively larger return. The interest free institution might provide a higher money to the user of the savings account according to the banks own profit. This higher payment structure is also done with the banks free will. Also the payment rate or amount is not pre determined or even guaranteed as it may not even happen hence free will of the bank.

2.1.27 Investment Account

The interest free bank exercises the investment account service under the Mudarabah domain. users of this service know and agree to the fact that this account type has a specific withdrawal period, which means it is not possible for the user to debit their money before that maturity period. While exercising with this service retail investors will only be sharing their profits and not their loses. When the investment is made in a low risk market, the profit sharing will also decreases in monetary value.

The Mudarabah domain has various types of systems regarding the payback or the profit sharing period.

2.1.28 Islamic principles on business activities

In the Sharia law, a principle of Islamic guidelines doesn't allow followers of the faith that are highly uncertain like any games in which the involved party plays for the chance of winning money, in other word, gambling. in this regard various thing are considered uncertain activities or as Hadith which involve guaranteeing the involved party's health or properties for a chance to win money. The Sharia also forbids Bayu al-gharar which is a business activity which has extremely high risk.

An Islamic academy of law called the Hanafi madib explains the prohibited activity of Bayu al-gharar as an activity with unknown results. with this kind of activity the involved starts his activity without knowing the actual result or in other words the involved will be acting in an activity that will have two outcomes in which one or the other happens at the end.

while defining the term, another law school called Hanabali writes that it is an activity 'whose results or consequences are unknown' or in different expression, an activity whose consequences are undeliverable, that is something which one doesn't know if the result is even going to happen. The school of Zahiri says that when the user doesn't know the service or product that they purchased it is called Gharar, which also applies when the provider of the service or product is not certain with the thing that they provide for money. Professor Mustafa Al-zarqa, who is considered as one of the scholars in modern Islamic study, defined the word Gharar as the activity of doing business that involves uncertain merchandize in a way that it's realness,

specifications or uses are probable. When some kind of business holds a high degree of probability or risk, it is in Islamic principle will have a characteristics of gambling. Dr. Sami al-suwailem, a scholar in modern Islamic study, gave the word Gharar a specific and technical definition by saying "a zero sum game with unequal payoffs".

The Quran forbids various activities which fit into the denominations of Gharar. It lists those things so that followers could avoid them. For instance, among the things that are considered Gharar includes trading of non pet birds, animals harboring in the water specifically fish, a conceived calf that is not yet born and other activities are listed. There are a lot of scholars who came up with a number of explanatory definitions for Gharar and to differentiate the concept of gambling or the concept of high risk business from that of the acceptable trade activity, the scholars introduced the word 'Yasir' (minor risk) and this kind of business activity is considered acceptable as opposed to the high risk financial transaction (bayu al-gharar) which is considered as gambling and forbidden.

Due to lack of measuring benchmark for the riskiness of a business scholars weren't able to come together on a specific meaning of gharar. because in order to give one meaning there has to be a measurement tool for the business to be called a high risk or not. But now a days measurement derivatives are becoming part of the Islamic bank services' link stock options. Now some interest free banks are including brokerage services to involve and participate in stock market.

(http://www.irti.org/irj/go/km/docs/documents/IDBDvelopments/Internet/English/IRTI/CM/downloads/IES_Articles)

2.1.29 Microfinance

Microfinance is thought as being a big deal in the Islamic Sharia governed financial world. The microfinance is also required to follow the sharia principle and in a practical point of view it has a great deal of desirability and endures a huge capacity of mutual benefit. This Sharia compliant version of microfinance gives a trusted and more reliable sense of ownership and as a primary goal of microfinance has a great potential of improving the business activity of the lower economic class.

Some countries are already widely using the Islamic version of microfinance services like Afghanistan and they are doing it in way that doesn't violate the laws of the Islamic faith, Quran. Microfinance are usually designed with the involvement of interest as used in the conventional microfinance systems. But in this case it is made to not involve any time value of money by modifying it with the Islamic financial system agreements like Mudarabah, Murabaha and Mushakarah which makes it possible to avoid the extra money payment.

(68<http://ifptest.law.harvard.edu>

<http://www.learnislamicfinance.com>,<http://knowledge.insead.edu/islamicmicrofinance080205.cfm>),

2.1.30 Uncertainty contingency techniques and innovations

The interest free financial institutions are becoming a more preferable and forward thinking also who introduce futuristic creations of systems which enable them to be more comfortable for the customers. This came together as a result of a number of effective dedication that will result in the transformation of the Islamic economic world.

Islamic law and finance scholars have been able to come up with money transaction business and investment tools and models that will enable the service user or provider to conduct business in a way that will abide Sharia law and can be hugely beneficial profit wise. Even though the tools and models were prepared to facilitate better for the followers of Islamic faith, they can be equally used and comfortable for a non Muslim user.

2.1.31 Islamic Derivatives

This helps as to provide a more suitable banking service that can serve both Muslim and non Muslim user. For instance we can see one shariah compliant derivative that was set out in 2010, which was written with the collaboration of a stock market, based on Bahrain and international swaps and derivative association which is based in New York. (<http://www.isda.org/media/press/2010/press030110.html> Hedging Master Agreement]” provides a structure under which institutions can trade derivatives such as profit-rate and currency swaps.

2.1.32. *Wiqā'* Forward Rate Contract

This system of property and profit protection contract is the first innovative approach to manage uncertainty, which was developed in 2006. this system facilitates the in-house risk management for the financial institutions by being a tool of financial hedging and simultaneously benefiting the customers with enhancing their bank credits and transaction score which intern enable them to benefit from hedge profit rates. When financial institution adopts and uses this system it will have the benefit of lowering by great extent of their possible risk of exposure to fixed rate payments. The non interest financial institutions for this system, will collaborate with conventional banks for floating rate payments.

(<http://www.humanitarianinfo.org/sumatra/reliefrecovery/livelihood/docs/doc/pdf>,

2.1.33 *Wiqā'* Profit Rate Swaps

This agreement type can be seen as the follow up system to the previous forward rate contract in which for both for both the involved parties, it will be a ground work of platform to exchange a number of profit payments. in this system, as long as the working currency type is the same with the both parties involved, they will be able to exchange the profit payments according to the predetermined level of money and tenor.

2.1.34. Islamic Cross Currencies Swap

To mitigate uncertainties and Islamic hedging, the gap that arises before with the above systems was managed to be overcome through this system by some innovative interest free institutions which will alleviate the Islamic financial service and which inhibit the interest rate fluctuations between the service giver and the user by rotating and exchanging floating rate and fixed rate interest occurrences.

In the conventional financial system, there could be possible interest rate changes that arises from some circumstances happening between the service giver financial institution and the customer. where in the interest free financial system there is a whole new line to follow in order to avoid interest from the equation. Which is called 'commodity murabaha' which replaces the interest rate with profit rate, and which is used by the Islamic cross currencies swap and the forward rate contract. (<http://www.ruf.rice.edu>)

2.1.35. Commodity ‘Murabahah’

This system called commodity murabahah is developed to make a Sharia compliant trade of commodities. The commodity murabahah uses the London stock exchange and to facilitate the trade, there will be a selected broker. When someone tries to buy an item, according to the principle of Quran, the item will be bought and delivered without any time lapse and the payment will be done in a way that will ensure a profit for the seller.

(<http://ifptest.law.harvard.edu>

<http://www.learnislamicfinance.com>,<http://knowledge.insead.edu/islamicmicrofinance080205.cfm>)

2.1.36 Shariah Advisory Council/Consultant

Interest free financial institutions have to provide a quality professional banking service while obeying and complying with the fundamental Islamic rules and regulations. In order to do that, interest free financial institutions have to organize a group of Sharia experts as an advisory council to advise and direct the institution. So as to make sure that the bank is serving and operating according to the laws of Quran.

To give this service, now a days there are even consultancy organizations which operate independently on their own to give this consultancy service, under contract to the Islamic banks. while operating with the help of these kinds of firms, some Islamic financial institutions have been in doubt and raising a bias and conflict of interest questions while working with an outside, out sourced advisory firm. To get more information, to provide a better service, World Database for Islamic Banking and Finance has been on use that can work for someone who wishes to get a background data, the websites of those banks and compare and contrast for selection of the preferable one. (Suadiq H. 2020)

2.1.37 Islamic Banking Literature versus in Practice

Now a days, lots of researchers and writers are doing empirical studies on interest free banking activities. the earliest and perhaps the most frequently referred empirical study was conducted by Khan(1983). As a strictly religious way of conducting business and relatively newer upcoming activity as a modern activity, the paper by Khan was focused on the practice and showed in the result that interest free financial institutions are struggling and having a hard time conducting the practical modern banking service strictly according to the Sharia law.

The study also compared the effectiveness of the Interest free banks with the conventional banks and found that the Islamic banks were having a 9 to 20 percent of profit range, which was a fairly competitive score in relation to the non Islamic banks operating in the same vicinity, and also when the two types of banks were compared with rates of return for depositors it was also competitive. As the study found out that the Islamic bank ones were in a range of 8 to 15.

In the study it was shown that users prefer more of the Islamic banking service for their real estate business activities and for trade finance. The other result shown was that because of the urge of the Islamic banks, and the banking experts who were pioneering in the development and innovation of the interest free banking to show the promising future of the new banking system through the positive outcome, the users were getting a fast return which made the banks preferable.

2.2 Empirical Evidences on Islamic Banking

In the research of Nienhaus (1988) it is said that the success of Islamic banks that were operating in the middle east was because of the real estate boom at the time. It was also noted that heavy losses also happened with the fall of that industry.

In the book written by Iqbal and Mirakhor called An Introduction For Islamic Finance: Theory and Practice, showed a good empirical information on the experiences of Iran and Pakistan but those countries were trying to turn all banks into Islamic banks.

This book gives strong impressions that bank's asset is more on short term credit rather than a long term investment partnership. And this happens to be not the intention of the Islamic banking strategy. But in the other hand much asset concentration on a limited asset might be risky. so the researchers said it was less interesting to the banks.

In a number of case studies done outside Ethiopia try to show practices that are common and those which somehow vary from bank to bank. In those studies done for example in Pakistan by (kahf 2001) tried to show that the practice of saving deposits and current account resembles the idea of alwadhiah in all studies. In the other way there are practices that are different from one institution to the other like, usage of resources and profit and loss sharing ratio. [Http://Www.Faithfreedom.Org/Articles/Ohmyrus/Islamic_Banking.Htm](http://Www.Faithfreedom.Org/Articles/Ohmyrus/Islamic_Banking.Htm)

The Malaysian experience in Islamic banking has been encouraging. Man's study shows that the average return to depositors has been quite competitive with that offered by conventional banks.

Finally, in the most recent contribution to the growing Islamic banking literature, Nienhaus (1988) concludes that Islamic banking is viable⁹¹. Nienhaus points out that there are some failures stories⁹² in which he has noted as troubles of individual banks that had specific causes and would be inappropriate to draw general conclusions from particular cases. Nienhaus notes that the high growth rates of the initial years have been falling off, but he rejects the thesis that the Islamic banks have reached their 'limits of growth' after filling a market gap. But rather, the growth performance of Islamic banks has been relatively better in most cases than that of conventional banks in recent years. According to Nienhaus, the market shares of many Islamic banks have increased over time, notwithstanding with the deceleration in the growth of deposits.

Despite the growth of Islamic banking over the last 30 years, one of the main challenges facing Islamic banking is the poor understanding about its operations.

[Http://Www.Cid.Harvard.Edu/Eflri](http://Www.Cid.Harvard.Edu/Eflri)

Islamic banking is at an early stage of learning and experience, lacking the flexibility to choose arrangements which best suits their need in reacting to structural shifts in the economic setting as well as changes in consumer preferences. For example, Islamic banks, without having an interest-free money and capital market, will not have adequate instruments to meet the pre-condition for liquidity management and effective maturity transformation.

So, adequate financial mechanism still has to be developed, without which financial intermediation, especially the risk and maturity transformation, will not be performed properly. Moreover, however well integrated it may be, any system cannot thrive exclusively on its built-in elements. It has to depend on a number of link institutions and Islamic banking is not an exception to this rule. <http://www.iran-daily.com/1388/12/11/MainPaper/3630/Page/5/Index.htm>

They also need research and training forums in order to promote entrepreneurship amongst their clients. Such support services properly oriented towards Islamic banking are yet to be developed in many countries.

The relationship between Islamic banks and monetary authorities is a delicate one. Whatever the goals and functions are, Islamic banks came into existence in an environment where the laws, institutions training and attitude are set to serve an economy based on the principles of interest. For example, the operations of Islamic banks are on a profit and loss share basis (PLS), which actually does not come fully under the jurisdiction of the existing civil laws.

In non-Muslim counties (i.e. countries with less than 50% Muslim population), central banks are very stringent in granting licenses for Islamic banks to operate. Islamic banks must also meet the additional requirements of other government and non-government authorities. (So, apart from legal constraints, there are economic measures that result operations of Islamic banks in non-Muslim world difficult)

Many Islamic banks lack liquidity instruments such as treasury bills and other marketable securities, which could be utilized either to cover liquidity shortages or to manage excess liquidity. This problem is aggravated since many Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the

central banks from controlling or giving support to Islamic banks if a liquidity gap should occur. (Mohammed 2012)

2.3 Research Gap

All those researches show the experiences of other countries on Islamic banking. There is though a gap on researches. There are no studies done on full fledged Islamic banking operating in Ethiopia because full fledged Islamic banks are new to the country.

CHAPTER THREE

Research methodology

3.1 Research Design

The research tries to investigate the prospects and challenges of the new coming full fledged Islamic banks in Ethiopia. To conduct this study and to realize the objectives of the study, descriptive research design of census method which was observational in its nature will be used due to its appropriateness.

The research also tries to explore the prospects, opportunities, problems and challenges that Islamic banks face. Qualitative data will be collected to explore and figure out those issues.

3.2. STUDY POPULATION

This paper will study all full fledged interest free Islamic banks that are planning to operate in Ethiopia. Zemzem bank, Hijra bank, Zad bank, Ramis bank, and Shebele bank have officially started the process of formation and all these banks will be subjects of the study. project managers of these newly starting banks will be participants of the study who will be giving us the data. Due to the small size of the population which is less than fifty, this paper will be studying all the population without selecting a sample.

3.3 METHODS AND TOOLS OF DATA COLLECTION

This study will be using primary and secondary data. As a primary data source, a questionnaire will be used. The questionnaires will be filled by the project managers of the newly forming full fledged Islamic banks. Questionnaire was written with the help of some Islamic banking experts which gives this questionnaire the ability to be a meaningful tool that will figure out the challenges and prospects of Islamic banks in Ethiopia. As a secondary data source the holy Qur'an, unpublished case study reports and IMF's finance manuals were used.

3.4 PLAN OF DATA ANALYSIS

After collecting data the data will then be checked and screened for validity and any errors. Then it's prepared in a way that it's convenient for analysis.

Appropriate and applicable statistical tool was used in order to analyze the data collected, after checking and screening for validity of the data. Meaning that checking the data for omissions and/or errors.

The primary data was collected through questionnaires and an appropriate computer aided analysis program called statistical package for social science (SPSS) was used in order to analyze the collected data. Descriptive statistics in the form of percentiles was used to show and present the results of the research.

CHAPTER FOUR

Data presentation and analysis

This chapter deals with the results of the paper. The findings of the research will be presented along with the data collected from respondents to assess the challenges and prospects of full fledged Islamic banking.

4.1 Introduction

Islamic banking is already being practiced by some conventional banks in Ethiopia. Although these Islamic banking practices are done by incorporating only few Sharia-compliant products. Those conventional banks and some microfinance institutions try to reach more of the Muslim community by offering financial products like Amamah, Mudarabah, Murabaha and Alwadhiah. but this alone can't serve the wider Muslim community. In order to address the wider and major amount of the followers of Islamic religion, some new banks are coming to existence that address those people by giving the full set of Sharia compliant financial services and transactions.

4.2. Data presentation and discussion

4.2.1 Challenges that full fledged banks in Ethiopia might face

In this portion the challenges that Islamic banks are likely to face are compared according to the opinions of the respondents.

Statistics (1)

		do you think that the Muslim community has awareness	will it be difficult to find bankers	do you think there is a gap in research about Islamic banking	do the regulations pose setbacks on Islamic banking	should Islamic banks have different regulations than other banks	does lack of supportive link institutions pose difficulty on Islamic banking
N	Valid	5	5	5	5	5	5
	Missing	0	0	0	0	0	0
Mean		2.80	3.60	4.00	3.60	4.00	3.60

Median	2.00	4.00	4.00	4.00	4.00	4.00
Mode	2	4	4	4	4	4
Std. Deviation	1.095	.894	.000	.894	.000	.894
Sum	14	18	20	18	20	18

Source: SPSS result 2020

A) Awareness about Islamic banking

In a country that harbors a massive number of followers of Islamic religion, and a large number of general population which is growing even higher, it's important to have people who are aware about the general concept as well as services of the interest free banks. One of the most important concepts that should be known by people is that interest free banking is not something that is designed and involve only the Muslim community. It also have a great benefit for a non Muslim community. This also is one of the major misconceptions along with the lack of awareness about what a Sharia compliant interest free banking is even among the Muslim population.

So, one of the research questions in order to address the research objectives was whether they think that the Muslim community has awareness about Islamic banking. since the level of awareness is important to understand how they will react to the Islamic banking service.

Table (1)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	3	60.0	60.0	60.0
	Agree	2	40.0	40.0	100.0
	Total	5	100.0	100.0	

According to table (1) 60% of respondents think that the Muslim community doesn't have enough awareness about Islamic banking. where 40% of the respondents think that the Muslim community has awareness about Islamic banking.

A study done in Islamic banks in Palestine on Islamic banking by Hisham J. 2002 also found that one of the biggest setbacks and is that people don't have enough understanding about Islamic banking services as it was also a newly establishing banking system in Palestine at the time. The research put lack of awareness as one of the most serious challenges of the newly establishing Islamic banks and recommended that those Islamic banks should work hard on promoting their services and educating the public about Islamic banking.

(B) Finding enough man-power

The next question was if they think that the newly forming Islamic banks in Ethiopia will find it difficult to find enough banking professionals with adequate knowledge of the Sharia principles.

Table (2)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	20.0	20.0	20.0
	Agree	4	80.0	80.0	100.0
	Total	5	100.0	100.0	

As presented in table (2) 80% of respondents think that there will be a difficulty in finding banking professionals that also have enough knowledge of the Sharia law and only 20% of respondents disagreed, which means there is not going to be a difficulty finding those bankers.

(C) Lack of research and development

As Islamic banking is something that is yet a developing concept and practice in Ethiopia, it was required to know whether there is enough researches and training programs to help the full fledged Islamic banking by asking if they think that there is a gap in research and development in Islamic studies programs in higher educational institutions to fill in the gap in human resource.

Table (3)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	100.0	100.0	100.0

Table (3) shows that all (100%) of respondents think that there is a gap in research and development in higher learning institutions in Islamic studies.

The problem of lack of research and development about Islamic banking system and the problem of shortage of Shariah knowledgeable banking professionals are big concerns when it comes to challenges of FFIBs. This result is the same with Suadiq (2020). The study noted that, even though there is an abundant amount of Muslim community and a number of universities in Ethiopia, not a single University or Educational institution provides Islamic financial course even as a single subject. Neither are there seminars or trainings about Islamic finance in any higher educational institution in the country that would help in providing enough man power for the Islamic financial institutions. This can be shown in conventional banks that have already started Islamic banking windows. Those Islamic banking windows operate by the help of shariah advisory board. The members of the board are just religious leaders who help out the banking professionals about the shariah violations and abiding activities. the reason this happens is because of the fact that there is a lack of Islamic financial trainings, courses and programs and so

trained shariah knowledgeable banking professionals. And these are going to be some of the problems that full fledged Islamic banks might face.

(D) The government's approach towards banks

The forming Islamic banks in Ethiopia will have different challenges than conventional banks since it's a new concept. the next question was if they believe that policy of financial institutions that govern initial paid up capital, reserve requirements and risk management approach pose setbacks on full fledged Islamic banks.

Table (4)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	20.0	20.0	20.0
	Agree	4	80.0	80.0	100.0
	Total	5	100.0	100.0	

And 80% of respondents think that is the case where only 20% of respondents responded otherwise.

(E) Should Islamic banks be governed by different regulations

The follow up question was if they think that Islamic banks should be governed by different set of regulations as they differ from conventional banks in many ways like risk structure form of ownership and governance.

Table (5)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	100.0	100.0	100.0

As presented in table (5) 100% of respondents think that full fledged Islamic banks should be governed by different regulations than those formulated for conventional banks.

Regulations which will be suitable for Islamic banks had been a big issue. According to Mohammed (2019), Because of the high demand of Islamic banking In Ethiopia, a banking regulation that have been working in Ethiopia until 1994 was amended and reformulated to consider the Muslim community and allow the practice of Islamic banking within the conventional banking system. Following that, Zemez bank wrote a proposal to the government about opening full fledged Islamic bank and in a way to alert the NEB about the necessity of having FFIBs in Ethiopia. as mentioned above in the Islamic banking in Ethiopia section, The request of zemez bank was denied by the NBE. But it was able to trigger future changes and

bring on the another regulatory directive. The Directive No. SBB/51/2011. This directive was better formulated and more comprehensive than the previous directive in 2008. This regulation allows for existing banks to create interest free banking window and for Ethiopian nationals to establish a bank exclusively engaged in interest free banking. Using this directive Zemez bank started establishment process. But the bank was forced to abort the Establishment process because of the requirement of the directive about the amount of initial paid up capital that was the same with the conventional banks which is hard to achieve for a newly forming FFIBs.

(F) Is there a lack of supportive institutions

The respondents were asked if they think that there is a lack of supportive and link institutions like interest free money market and capital markets that would create liquidity and other operational difficulties to Islamic banks.

Table (6)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	20.0	20.0	20.0
	Agree	4	80.0	80.0	100.0
	Total	5	100.0	100.0	

Table (6) shows that 80% of the respondents think that the lack of supportive and link institutions pose difficulties on the operations of Islamic banks. And 20% of respondents disagreed.

4.2.2 Prospects of Islamic banks in Ethiopia

In the next part the researcher tried to figure out the prospects of full fledged banks in Ethiopia through respondents answers of the questions that are aimed to indicate future prospects.

Statistics Table (2)

		will the cyrrnt global financial trends	do you think there is a need for islamic banks	does your bank has plans s,m,l term plans to provide islamic banking service	do you think that the likely muslim's reasons not to use banking is loan interest	do you think people would use investment loan due to its accesability	is the high interest rates the reason why people dont use loan services that much
N	Valid	5	5	5	5	5	5

Missing	0	0	0	0	0	0
Mean	3.60	4.40	4.00	4.00	3.80	2.60
Median	4.00	4.00	4.00	4.00	4.00	2.00
Mode	4	4	4	4	4	2
Std. Deviation	.894	.548	.000	.000	1.095	.894

Source: SPSS result 2020

(A) Current global trends and Islamic banking in Ethiopia

The first question that was asked to figure out the prospects of full fledged banks in Ethiopia was if they believe that the current global trends in financial services will have positive manifestations on the future of Islamic banks in Ethiopia.

Table (7)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	disagree	1	20.0	20.0	20.0
	Agree	4	80.0	80.0	100.0
	Total	5	100.0	100.0	

Table (8) suggests that 80% of the respondents think that the current global trends are going to have a positive prospects to Ethiopian full fledged banks. where the other 20% disagree with this idea.

(B) Is there a need for Islamic banks in Ethiopia

Next the respondents were asked if they think there is a need for full fledged banks in Ethiopia so that will alleviate the financial services deprivation of the Muslim community

Table (8)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	3	60.0	60.0	60.0
	strongly agree	2	40.0	40.0	100.0
	Total	5	100.0	100.0	

The respondents opinion as shown in table (9) was that 60% of the respondents agreed that there is a need for full fledged Islamic banks among the Muslim community. where the other 40% strongly agree with this statement.

The global trend which shows a growing need and the local scenario which also shows a growing demand is illustrative of a positive prospect for the full fledged Islamic banks in Ethiopia. This

result also shows similarity with Suadiq (2020). The study shows that there is a high demand so big profitable prospect, first, because of a high and growing population number of the Muslim community. with a 35% of Muslim in Ethiopia, which is 38.5 million in numbers, Islamic banking will have a big market potential. The second is simply a high demand indicators. There is a high popular demand for full fledged Islamic banks in Ethiopia. According to the study, some of the indicators of the high popular demand are the fact that the repeated request from the Ethiopian Muslim Diaspora association representatives, and the establishment struggle and process of Zemzem bank from 2008 to 2011 which has its ups and downs but came back and succeeded up to also bring the emergence of other full fledged Islamic banks with it.

(C) Short, medium and long term plan of the new full fledged banks in Ethiopia

The respondents from the newly forming Islamic banks in Ethiopia were asked if their banks have short medium and long term plan to engage in Islamic commercial banking activities and take full advantage of the untapped potential of growth and opportunity that Islamic banks provide.

Table (9)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	100.0	100.0	100.0

All 100% of respondents agreed with the above question.

(D) Muslim community's banking service preference

For this part the responders were asked to answer if they think that one of the likely reasons that the many Muslims are not using banking services currently are due to savings and loan services mostly consist interest.

Table (10)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	100.0	100.0	100.0

As table (11) shows all the respondents agreed with the question that asks if they think the reason for the lack of usage of banking services among Muslim community is due to the involvement of interest in most of the services in the current conventional banks.

(E) Investment loan of Islamic banks.

The next question was whether or not the respondents think that people will be using Investment loan that is provided by full fledged Islamic banks due to it's attractiveness and ease access

Table (11)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	20.0	20.0	20.0
	Agree	3	60.0	60.0	80.0
	strongly agree	1	20.0	20.0	100.0
	Total	5	100.0	100.0	

Table (11) shows that 60% of the respondents agreed 20% of the respondents Strongly agreed and 20% of the respondents disagreed.

(F) The problem with conventional banking

In the next question respondents were asked if they think that the high prohibitive interest rates that conventional banks charge is the main reason that loan services are not currently widely used.

Table (12)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	3	60.0	60.0	60.0
	neutral	1	20.0	20.0	80.0
	Disagree	1	20.0	20.0	100.0
	Total	5	100.0	100.0	

In this portion 60% of the respondents agreed, 20% responded with disagree and 20% with neutral.

The other opportunities for FFIBs are the system itself is preferred and comfortable for users. Like the investment loan and also the Islamic banking system is profitable by its nature. The evidence for this is, first the respondents opinions that shows from the result that most respondents think that the reason most Muslims are not using loan services from conventional banks is because of the high prohibitive interest rates that conventional banks charge. the second thing is when seeing the advantages of giving interest free banking service other than the high demand for interest free banking service is, the high profit tendency of interest free deposit schemes. According to the study by Suadiq (2020) which has the same result on this

topic, shows that there has been a profitable experience from interest free Islamic banking windows by conventional banks by collecting a big amount of money through interest free deposit schemes. The research by Suadiq also says that there has been a significant increase in amount of deposit collected and income generated thorough interest free Islamic banking windows over the years. This indicates the potential effectiveness and positive prospect for full fledged Islamic banks.

4.2.3 respondents giving rates for the challenges of full fledged Islamic banks

Among the different challenges that Islamic banks are currently facing, some might be more pressing and serious ones than the other that might hinder the operations and profitability of full fledged Islamic banks. To figure out which challenge might be affecting the banks more and requires more attention, the respondents were asked to give rates to the challenges according to their seriousness. the respondents were asked to right "1" to the most serious challenge, "2" to the second most serious challenge,"3" for the third most serious challenge and so on. based on this instructions respondents gave their opinions on what they think are the biggest challenges according to their seriousness.

Table(13)

	Major challenges	1st	2nd	3rd	4th	5th	6th	7th
1	Lack of awareness and understanding		20%	60%	20%			
2	Legal supervisory, regulatory and/ or institutional challenge	100 %						
3	Capital resource constraints				20%	20%	60%	
4	Lack of trained human resource		40%		40%	20%		
5	Negative attitude of people (wrong association with religion)				20%	40%	40%	
6	Lack of demand and market potential							100 %
7	Lack of suitable banking policies		40%	40%		20%		

The respondents were able to rate the challenges as they perceived was the first second third up to seventh challenge was. The results show that some challenges were by far the most serious ones and some are not that much to think about. According to the above result findings, all (100%) of the respondents, rated Legal supervisory, regulatory and Institutional challenge as the

number one challenge That the full fledged Islamic banks face. 40% of the respondents rated Lack of suitable banking policy as the second most serious challenge while 40% of respondents rated it as the third most pressing challenge. The other 20% rated it as the fifth serious challenge. when coming to the lack of trained human resource, 40% of the respondents rated it as the second most serious challenge while 40% of respondents say that it's the fourth most serious challenge. while the other 20 think it's the fifth issue when talking about challenges. About the lack of awareness and understanding, 60% of the respondents think it's the third most serious challenge. The respondents rated Negative (religious related) attitude of people 40% as fifth and 40% as sixth. capital resource constraints was rated sixth by 60% of the respondents. All 100% of the respondents rated lack of demand as the least (seventh) most serious challenge.

This result is the same with a study done on Islamic banking in Nigeria by Gambo B. 2007 in a way which Gambo's study also presented that legal and regulatory guidelines are the major challenges Islamic banks there are facing. This shows that even in some other countries there is a problem of governing Islamic banks with the same regulations as conventional banks. The study shows that 71.8% of the respondents believed that legal and regulatory guidelines are the biggest challenges for the Islamic banks in Nigeria.

Even after the new proclamation No: 1159/2019 which allowed Zenzem bank and others to establish into reality, there are problems that need to be addressed. The proclamation states *"Without prejudice to the requirements of specified under the provisions of the proclamation the national bank may issue a directive to prescribe additional conditions of licensing, supervision and requirements to establish interest free bank"*. The research by Suadiq (2020) which also listed regulatory challenges under the challenges of Islamic banking, says that it is questionable issue whether Islamic banking principles will be with full compliance with the guidelines under the banking business proclamations which ratified by NBE or not.

CHAPTER FIVE

Summery, Conclusion And Recommendation

5.1 Introduction

In this last part the summary of the findings from the responses of respondents of the study challenges and prospects of Islamic Banks in Ethiopia will be presented. After that this chapter will go on to conclude on what have been assessed and resulted from this paper on the conclusion part. And final for this chapter will be the recommendation.

5.2 Summery of findings

The aim of this paper was to point out and show what stands out as the main challenges of full fledged Islamic banks and present the factually anticipated prospects for the full fledged Islamic banks from the respondents was indicative and helpful to address this aim of the research paper.

The first challenge that was said to be faced by Islamic banks was the issue of awareness of the concept of Islamic banking. because of the fact that conventional banks are now giving some Islamic banking services there is now some level of awareness about Islamic banking activity. But the result from the research study shows that according to the opinions of the respondents, there is still a lack of awareness among the Muslim community about Islamic banking. as 60% of the respondents answered the question by saying that there is a problem in awareness while only 40% disagreed with this concept.

The second challenge that the respondents pointed out was the notion that there is a shortage in man power in the market. which means that there is a lack of enough banking professionals who also know the Sharia principles of handling financial activities. This was shown as 80% of the respondents said there is a shortage in enough Sharia knowledgeable banking professionals. The other Issue is that there is a gap in research and development in Islamic studies in higher learning institutions that would fill the gap in human resource. All of the respondents agreed that this is true. Which might be the reason why there is a shortage of bankers with Sharia Knowledge.

The next question which asks if the current financial regulations and supervisory rules such as those governing initial paid up capital, reserve requirements and risk management approaches bring a setback to the establishment efforts of full fledged Islamic banks. And 80% of the respondents agreed with the existence of this challenge. Because of the fact that the full fledged Islamic banking is new to the country, the regulations on the initial paid up capital, reserve requirements and risk management approaches are posing setbacks on the ongoing initiatives to establish full fledged Islamic institutions. To help resolve this problem, the respondents were presented with the next question. the next question was to see if the respondents believe that the newly forming full fledged Islamic institutions should be governed by different set of regulations as they differ from conventional banks. 100% of the respondents believe that this should be the case. which suggests that this is a serious issue that the newly forming Islamic banks are facing. A lack of supportive and link institutions like interest free money market and capital markets would create liquidity and other operational difficulties to Islamic banks as it is considered as one, on the challenges of full fledged Islamic by the 80% of the respondents. This is also suggestive that it is going to be somehow a challenging environment for the newly forming Islamic banks.

Full fledged Islamic banks' prospect is bright considering the results of the assessment on some major indicators of whether the prospects of full fledged Islamic banks are positive or not were presented for the respondents. And it shows a positive and promising prospect. At first the responders were asked if they think that the current global trends in financial services will have positive manifestations on the future of Islamic banks in Ethiopia. 80% of the respondents said that there is a global trend that will have a good impact for the full fledged banks in Ethiopia.

To have a good and profitable future, any institution must have a clear set out plan to execute their activities and have a positive prospect in order to survive and take advantage of the demand of a full fledged Islamic banking service. so the research questionnaire asks the respondents if their banks have a short medium and long term plan to engage in Islamic banking service and take full advantage of the untapped potential of growth and opportunity that Islamic banks provide. All respondents replied that they actually have those plans that will benefit them in their future venture in Ethiopian market. The main difference between conventional and Islamic banks are those activities that involve interest. So to attract the community, we have to know the preference of the Muslim community. To figure this out the researcher asked the respondents if they believe that the likely reason that many Muslims are not Using banking services is because of the fact that savings and loan services involve interest. To this all 100% of respondents said that is the reason. Which means that Islamic banks have the potential of bringing that part of the community to their pool of clients. That makes the full fledged Islamic banks have positive prospect in the Ethiopian market. Another prospect indicator was the fact that 80% of the respondents think that their investment loan service will be easily accessible and attractive to the user and it will make people want to use it widely.

while surveying about the biggest and most tackling challenges the respondents think that the major challenges to the full fledged Islamic banking is the legal supervisory and institutional

challenge and lack of suitable banking policy. But as the result suggests there is going to be a high demand for Islamic banking as the respondents rated the lack of demand as a least serious challenge.

5.3 Conclusion

Based on the analysis it can be concluded that there is a high demand for Islamic banking which is a positive prospect for the future of the newly forming full fledged Islamic banks in Ethiopia. Full fledged Islamic banks provide financial services that comply with Islamic principles of the Sharia law. By providing a banking activity that benefit the user of the banking service without violating the religious principles of the Muslim community, the full fledged banks in Ethiopia have the capacity to create a wide pool of customers that will intern be a positive prospect and a promising future.

But as a new venture and concept it is inevitable that the full fledged Islamic banks face challenges on pioneering in the Ethiopian market starting from the regulatory and policy based challenges to finding enough bankers to provide Islamic banking services that fully comply with the Sharia law. This research was able to find out this results and concludes that with hard work and help from the government, to improve and overcome the challenges for the establishing full fledged Islamic banks, there will be a promising future and a positive prospect to the full fledged Islamic banks in Ethiopia.

5.4 Recommendations

Based on the research findings, the following recommendations are suggested in order to create a comfortable environment for the full fledged Islamic banks that will greatly benefit the Muslim community.

- ✓ Since full fledged Islamic banks are new to Ethiopia, the government shall do a survey of its own on how to formulate a suitable financial regulations and banking policy as it is believed to be the greatest set back for the full fledged Islamic banks in Ethiopia.
- ✓ More people shall be encouraged to engage in Islamic study fields so as to improve the lack of bankers who also have sufficient knowledge on sharia law that benefits in correlating and working with the religious ethics of the Islamic faith.
- ✓ More work shall be exerted to create awareness about Islamic banking that will draw people to use Islamic banking without associating it with religion.

- ✓ More research studies shall be conducted on full fledged Islamic banks as they are new to Ethiopia in order to further clarify and help to improve the lack of documented references needed.

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APPENDIX

Data Collection Instruments

ST. MARRY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES
MBA PROGRAM

Questionnaire for data collection

This is a questionnaire aimed at assessing the challenges and prospects of full fledged Islamic banking in Ethiopia. Any information gathered will only be used for academic purposes. You don't need to write your name or reveal any personal information. Thank you for your cooperation in advance.

PART ONE- CHALLENGE ITEMS

Below are items which deal with respondents' view on challenges that face Islamic banks. please say strongly **disagree (SD)**, **Disagree (D)**, **Neutral (N)**, **Agree (A)** or **Strongly agree (SA)** for each item below.

No	Items	SD	D	N	A	SA
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1	Do you think that the Muslim community has awareness about Islamic banking system?					
2	Do you think that full fledged Islamic banks in Ethiopia will have difficulty in finding bankers who have adequate Islamic knowledge of sharia principles?					
3	Do you believe there is a gap in research and development in Islamic studies programs in higher education institutions (HEIs) to fill the gap in qualified human resource?					
4	Do you believe that the current financial institutions regulatory and supervisory rules such as those governing initial paid up capital reserve requirements and risk management approaches pose certain setbacks to the ongoing initiatives to establish Islamic financial institutions?					
5	Do you believe that Islamic financial institutions should be governed by different set of regulations as they differ from conventional banks in many aspects such as risk structure form of ownership and governance?					
6	Do you think that lack of supportive and link institutions like interest free money market and capital markets would create liquidity and other operational difficulties to Islamic banks?					
7	Do you think that FFIB will not have enough qualified scholars in Islamic banking services which are up to date and fully comply shariah law?					

PART TWO - PROSPECTS OF FULL FLEDGED ISLAMIC BANKING

		SD	D	N	A	SA
1.	Do you believe that the current global trends in financial services will have positive manifestations on the future of Islamic banks in Ethiopia.					

2.	Do you think there is a need for Islamic banks in Ethiopia so that it will alleviate the financial services deprivation of the Muslim community?					
3	Does your bank has short, medium ,long term plan to engage in Islamic commercial banking activities and take full advantage of the untapped potential growth and opportunity that Islamic banks provide?					
4	Do you think that the likely reason(s) that many Muslims are not using banking services currently is due to the fact that savings and loan services involve interest?					
5	Do you think that people would use investment loan service due to its attractiveness and ease access?					
6	Do you think that the high prohibitive interest rates that conventional banks charge is the main reason that conventional banks charge is the main reason that loan services are not currently widely used?					

PART TWO - PROSPECTS OF FULL FLEDGED ISLAMIC BANKING

		SD	D	N	A	SA
1.	Do you believe that the current global trends in financial services will have positive manifestations on the future of Islamic banks in Ethiopia.					
2.	Do you think there is a need for Islamic banks in Ethiopia so that it will alleviate the financial services deprivation of the Muslim community?					
3	Does your bank has short, medium ,long term plan to engage in Islamic commercial banking activities and take full advantage of the untapped potential growth and opportunity that Islamic					

	banks provide?					
4	Do you think that the likely reason(s) that many Muslims are not using banking services currently is due to the fact that savings and loan services involve interest?					
5	Do you think that people would use investment loan service due to its attractiveness and ease access?					
6	Do you think that the high prohibitive interest rates that conventional banks charge is the main reason that conventional banks charge is the main reason that loan services are not currently widely used?					

For the following table give your rate for each of the following items identified as major problems facing Islamic banking by putting them in the order of their difficulty according to your assessment. you will give 1 in the rate column in front of the description for the challenge that you assess as the most serious challenge, 2 for the second most serious challenge, 3 for the third most serious challenge and so forth.

The Intensity of challenges facing Islamic banking

	Major challenges facing Islamic banking	Rate
1.	Lack of awareness and understanding	
2	Legal supervisory, regulatory and/ or institutional challenge	
3	Capital resource constraints	
4	Lack of trained human resource	
5	Negative attitude of people (wrong association with religion)	

6	Lack of demand and market potential	
7	Lack of suitable banking policies	

Additional comments

Thank you for your cooperation.