



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

**CHALLENGES AND OPPORTUNITIES OF ISLAMIC BANKING IN ETHIOPIA IN THE CASE OF  
ZAMZAM BANK S.C.**

**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**

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

**BY: ANWAR ABDU**

**JANUARY 2025**

**ADDIS ABABA**

## TABLE OF CONTENTS

### CHAPTER ONE

1. Introduction -----	1
1.1 Background of the study -----	1
1.2 Statement of the Problem -----	3
1.3 Objectives of the study -----	4
1.3.1 General objective-----	4
1.3.2 Specific objective -----	4
1.4 Research Questions -----	5
1.5 Scope of the study-----	5
1.6 Significance of the study -----	6
1.7 Limitation of the study -----	6
1.7 Organization of the study -----	7

### CHAPTER TWO

2. Literature Review -----	6
2.1 Theoretical literature Review-----	6
2.2 Empirical literature Review-----	20
2.3 Research Gap -----	23

### CHAPTER THREE

3. Research Metrology-----	24
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3.1	Research Design-----	24
3.2	Data Collection Method-----	24
3.3	Sample Size and Sampling Techniques -----	24
3.4	Data Analysis Methods-----	24

## **CHAPTER FOUR**

4.	Data presentation and analysis -----	25
4.1	Introduction -----	25
4.2	Data presentation and discussion -----	25
4.2.1	Challenges of Islamic Banking-----	25
4.2.2	Opportunity of Islamic Banking -----	36

## **CHAPTER FIVE**

5.	Finding summary-----	41
5.1	Conclusion -----	41
5.2	Recommendations-----	42
5.3	Reference-----	43
5.4	Annex -----	45

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## **DECLARATION**

I Anwar Abdu declare this thesis "Challenge and opportunities of Islamic Banking in Ethiopia in the case of Zamzam Bank S.C." 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.

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## ENDORSEMENT

This thesis has been submitted to St. Mary's University, School of Graduate Studies for examination with my approval as a university advisory.

Adviser's Name and Signature

Mohammed Seid (Ass/t professor)

Signature \_\_\_\_\_

Date \_\_\_\_\_

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## **Abstract**

The purpose of the study was to identify the challenges and opportunities of Islamic banking in Ethiopia, with a focus on ZamZam Bank S.C. The study used mainly a quantitative research approach and data was collected from both primary and secondary sources. Primary data was collected through questionnaires and secondary data was collected from various sources. Convenience sampling was also used. A total of 55 responses from five branches of ZamZam bank employees and customers. A descriptive research design applied. Data is analyzed using statistical tools SPSS 2020 and presented as a descriptive analysis result. The result indicates serious challenges that need attention and hard work and capitalize on various opportunities.

The research concluded that the potential opportunities identified and forward recommendations to reduce the expected challenge and sustainability of Islamic banking in Ethiopia.

**Key Words;** Shariah, IFB, Interest and Sharing of profit

# CHAPTER ONE

## 1. INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

Islamic banking is grounded in the tenets of the Islamic faith as they relate to commercial transactions. The principles of Islamic banking are derived from the Quran, the central religious text of Islam. In Islamic banking, all transactions must comply with Shariah, the legal code of Islam based on the teachings of the Quran. The rules that govern commercial transactions in Islamic banking are referred to as *fiqh al-muamalat* Evan (2023).

Islamic banking refers to a system of banking that complies with Islamic law also known as Shariah law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset (Bank Negara Malaysia, 2019). These principles are supported by Islamic banking's core values whereby activities that cultivate entrepreneurship, trade and commerce and bring societal development or benefit is encouraged. Activities that involve interest (riba), gambling (maisir) and speculative trading (gharar) are prohibited. Through the use of various Islamic finance concepts such as ijarah (leasing), mudharabah (profit sharing), musyarakah (partnership), financial institutions have a great deal of flexibility

Creativity and choice in the creation of Islamic finance products. Furthermore, by emphasizing the need for transactions to be supported by genuine trade or business related activities, Islamic banking sets a higher standard for investments and promotes greater accountability and risk mitigation.

The first Interest-Free Bank (IFB), ZamZam Bank (ZZB), has received a green light from the National Bank of Ethiopia (NBE) after 13 years in restless efforts (Business News, 2020). The bank was a pioneer when it started its activity in 2007 after the government had shown interest in allowing the bank to operate under the Islamic Banking principle. However, this was short-lived when the government enforced that interest-free banking will operate alongside conventional banking. This decision was not conducive for the founders of the bank who wanted to only run an interest-free bank. This led the bank to refund the collected sum to its share buyers. On the upside for the bank, the government for the past two and a half years had been undergoing political reform. The government has now allowed its citizens to invest in fully-fledged IFBs.

This had re-sparked the interest of ZamZam Bank which recently commenced its activities under formation by collecting huge amounts of funds in a short time. ZamZam has now received its license from the regulatory body, NBE. This will make ZZB the first Interest Free Bank in the country. According to the information that Capital obtained from NBE, the regulatory body will officially award the license to ZZB on Monday 12, October 2020. While the bank declined to comment on the issue, it is crystal clear that it will commence operation in the near future. The bank boasts a shareholder's base of 11,200 and a subscribed capital of over 1.7 billion birr. ZamZam Bank aims to enhance financial inclusion, especially for individuals marginalized due to religious beliefs. The bank offers a range of Sharia-compliant products and services, including Murabahah (Cost Plus Profit) Mode of Financing, Bai' Salam, Istisna', Ijarah, Musharakah, Mudarabah, Kafalah (Letter of Guarantee), and Personal Financing (Ethiopian Capital Market.2024). Despite its pioneering status, Islamic banking in Ethiopia faces several challenges, including low awareness, regulatory and supervisory challenges, lack of qualified human resources, and misconceptions about Islamic banking. However, there are also significant opportunities, such as the potential for financial inclusion and the growing interest in Sharia-compliant financial products (Muhammad. 2012).

## **1.2 STATEMENT OF THE PROBLEM**

Despite the establishment of Zamzam Bank S.C., the first fully licensed Islamic bank in Ethiopia, the Islamic banking sector in the country faces significant challenges. These include regulatory hurdles, a lack of public awareness, and limited product offerings. However, there are substantial opportunities for growth, particularly in promoting financial inclusion and ethical banking. This research aims to investigate these challenges and opportunities to provide insights for the sustainable development of Islamic banking in Ethiopia Bacha, O. I., & Mirakhor, A. (2019).

## **1.3 OBJECTIVE OF THE STUDY**

### **1.3.1 GENERAL OBJECTIVE**

Is To explore and analyze the current state of interest-free banking in Ethiopia, identify the challenges and opportunities faced by ZamZam Bank S.C. and provide strategic recommendations for the sustainable growth and integration of Islamic banking within the Ethiopian financial system.

### **1.3.2 SPECIFIC OBJECTIVES**

To assess the current status of interest-free banking in Ethiopia?

To identify and analyze the main challenges faced by Zamzam Bank S.C., in implementing and expanding Islamic banking services in Ethiopia.

To evaluate the potential opportunities for growth and development of Islamic banking within the Ethiopian financial sector, particularly for Zamzam Bank S.C.

### **1.4 RESEARCH QUESTIONS**

What is the current status of Islamic Banking Service in Ethiopia?

What are the primary challenges faced by Zamzam Bank S.C., in promoting and implementing Islamic banking services in Ethiopia?

What opportunities exist for Zamzam Bank to expand its market share and enhance its service offerings within the Ethiopian banking sector?

### **1.5 SCOPE OF THE STUDY**

This study is concentrated on Addis Ababa, specifically focusing on five branches of Zamzam Bank S.C. located within the city. The research will analyze the regulatory environment, market conditions, and operational challenges specific to Islamic banking at these five branches. It will assess the awareness and understanding of Islamic banking among residents and financial professionals in the vicinity of these branches. The study will evaluate the product offerings of Zamzam Bank S.C. at these branches and compare them to conventional banking products available in the city. Opportunities for growth within these branches, including strategies for promoting financial inclusion and ethical banking practices, will be explored. The research will cover the period from the establishment of these branches to the present day, offering a contemporary analysis of Islamic banking in these locations. Qualitative data collection and analysis. Data sources will include interviews with key stakeholders and quaternaries both of customers and employees of Zamzam Bank, and analysis of regulatory documents and financial reports specific to these branches. The study will not cover Islamic banking practices in regions outside of Addis Ababa.

### **1.6 SIGNIFICANCE OF THE STUDY**

This study on the challenges and opportunities of Islamic banking in Ethiopia, with a focus on

Zamzam Bank S.C., holds significant value for multiple stakeholders:

**Financial Sector Development:** By identifying the regulatory, market, and operational challenges faced by Islamic banks, this research can provide valuable insights for policymakers to create a more conducive regulatory environment. This can help in promoting a more inclusive and diverse financial sector in Ethiopia.

**Banking Industry:** The findings from this study can aid Islamic banks, especially Zamzam Bank S.C., in understanding the specific hurdles they face and developing strategies to overcome them. It can also highlight potential areas for product development and market expansion.

**Consumers:** For consumers, especially those who prefer banking practices aligned with Sharia principles, this study can enhance their understanding of Islamic banking products and services. It can also identify ways to increase public awareness and acceptance of Islamic banking.

**Academic Contribution:** This study fills a research gap by providing empirical data on the performance and impact of Islamic banking in Ethiopia. It contributes to the existing body of knowledge on Islamic finance and can serve as a foundation for future research in this area.

**Economic Development:** By promoting financial inclusion through ethical banking practices, Islamic banking can play a crucial role in the economic development of Ethiopia. This study can provide a roadmap for leveraging Islamic banking to achieve broader economic goals.

**Global Perspective:** The experiences and strategies of Zamzam Bank S.C. can offer valuable lessons for other countries with similar contexts looking to develop their Islamic banking sectors. This study can contribute to the global discourse on the challenges and opportunities of Islamic banking.

## **1.7 LIMITATION OF THE STUDY**

This study has several limitations:

The research focuses only on five branches of Zamzam Bank S.C. in Addis Ababa, which may not fully represent the entire Islamic banking landscape in Ethiopia. The study examines data from the establishment of the bank to the present, potentially missing long-term trends and developments in the Islamic banking sector. The reliance on qualitative interviews and quantitative may introduce bias and limit the generalizability of the findings. The study does not delve into the theological aspects of Sharia law beyond their application to banking practices. These limitations should be considered when interpreting the findings and implications of this study.

## **1.8 ORGANIZATION OF THE STUDY**

Chapter one of the study consists of the general introduction, which includes the background of the study, the statement of the problem, the objectives of the study, the research questions, the significance of the study, the scope of the study, the limitations of the study, and the organization of the study.

Chapter two Theoretical Framework, Empirical Literature Overview of Islamic Banking Islamic Banking in Ethiopia Challenges of Islamic Banking Opportunities for Islamic Banking

Chapter three discusses the methodology employed in the study, including the research design, population and sample size, sampling techniques, data collection methods, and the tools used for data analysis. This chapter ensures the transparency and reproducibility of the research process.

Chapter four presents the results of the study and provides a detailed analysis and interpretation of the findings in relation to the research objectives and questions. This chapter connects the findings to the theoretical and conceptual frameworks outlined in chapter two.

Finally, chapter five concludes the study by summarizing the key findings, discussing their implications, and providing recommendations for practice, policy, and future research. This chapter also includes a reflective discussion on the limitations of the study and their potential impact on the results.

## CHAPTER TWO

### 2. LITERATURE REVIEW

This chapter studies conducted to assess the challenges and opportunity of Islamic banking are summarized. In the first section the theoretical review opportunity and challenges of Islamic banking are illustrated including shrei'a principles and practices and Empirical literatures are reviewed the second section, the research gap in the general study of the in interest free banks is showed

#### 2.1 Theoretical literature Review

Islamic banking or Islamic finance is a form of Sharia (Islamic law)- compliant finance. Here, the banking and financial practices strictly adhere to Islamic legal practices. It incorporates cultural and ethical components into finance. Some practices like Islamic banking loans, profit sharing, and investing significantly differ from conventional banking. Islamic banking system is the lifeline of any modern economy which helps in the financial intermediation by mobilizing deposits and disbursement of credit. Banking in a modern sense is the process of accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and with draw able by cheque, draft, order or otherwise (Audil , 2011).

The principal function of a Bank is to bring into a common fund or pool of idle money of the general public, for the purpose of making advances to others, to gain a return in the form of interest, fee and dividends in making advances and providing services to others. Interest being the cogwheel of the modern banking, is strictly prohibited in Islam and hence there can be no banking system in Islam as Interest. An Islamic bank is a financial institution which identifies itself with the spirit of Shariah, as laid down by the Holy Qur'an and Sunnah, as regards its objectives, principles, practices and operations. The veterans of Islam propose that a sound system of Banking is possible in Islam which should be based on the concepts of Mudharaba, Murabaha and Profit and Loss Sharing (PLS). Islamic finance was practiced predominantly in the Muslim world throughout the middle Ages, fostering trade and business activities. In Spain and the Mediterranean and Baltic States, Islamic merchants became indispensable middlemen for trading activities. It is claimed that many concepts, techniques, and instruments of Islamic finance were later adopted by European financiers

and businessmen. Islamic Banking is no longer a novel experiment but a practicable reality. The modern Islamic Banks have positioned themselves sustainably into a full-fledged Interest-free system with a range of competitive products to offer so as to compete with the Modern Interest based Banking system. Besides their range of equity, trade-financing and lending operations, Islamic banks also offer a full spectrum of fee paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travelers' cheques, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking. Islamic banking because of its value-orientated ethos enables it to draw finances from both Muslims and non-Muslims alike.

### **2.1.2 Sources & Use of Funds of Islamic Banks**

The corporate objective of Islamic banks is to provide banking facilities and services following Islamic principles, rules, and practices. The Islamic principles, rules, and practices belong to the body of Islamic principles on commercial transactions (Ahkam M, 2024). Consequently, the modes of operation of Islamic banks have evolved in conformity with these principles, rules, and practices as approved by the Ulamas (Islamic scholars) in various Islamic countries. Conventional and Islamic banks are trading most funds from sources other than themselves. But they differ in both raising funds and using the same for profit.

### **2.1.3 Sources of Funds of Islamic Banks**

The Islamic banks' financial resources consist of ordinary capital resources comprising paid-up capital and reserves and funds raised through borrowings from the Central Bank and other Banks (inter- bank borrowing), an issue of Islamic financial instruments. However, the major pan of their operational funds is derived from the different categories of deposits accepted on the Islamic principles of Al-Wadiah (safe custodianship) and Al-Mudarabah (trust financing).

### **2.1.4 Shareholders' Equity (Al-Musharakah/Joint-Venture Profit-Sharing)**

Islamic bank raises their initial equity (or paid-up capital) straightforwardly through the Islamic equity-financing contract of Al-Musharakah among its initial shareholders. Only one class of shares-ordinary shares – are initially issued, usually quoted in the share market.

### **2.1.5 Islamic Banks may further issue shares, such as:**

Special Share (or Golden Share) to be subscribed by the Government. New ordinary shares in the form of the Employee Share Option Scheme (ESOS). New ordinary shares in exchange for Syarikat Takaful share with its minority shareholders. New ordinary shares in the rights issue. New ordinary shares in public issue.

### **2.1.6 Customers' Deposits in Current Accounts (Contract: Al- Wadiah Yad Dhamanah/Guaranteed Custody)**

Islamic bank mobilizes its customers' deposits in Current Accounts on the contract of Al-Wadiah Yad Dhamanah. This is neither equity financing nor strictly debt financing. Rather, it is based on the combination of two other categories of Islamic Commercial Contracts, namely Al-Wadiih (Custody) and Al-Dhamanah (Guarantee). The details are as follows:

The Bank accepts deposits from its customers looking for the safe custody of their funds and absolute convenience in their use in the form of Current Accounts on the principle of Al-Wadiah Yad Dhamanah.

The Bank requests permission from such customers to use their funds so long as they remain with the Bank. The customers may withdraw a part of the whole of their balances at any time if they desire, and the Bank guarantees the refund of such balances. All the profits generated by the bank from the use of such funds belong to the Bank. However, in contrast with Current Accounts, the Bank may, at its absolute discretion, reward the customers by returning a portion of the profits generated from the use of their funds from time to time. (<https://www.iedunote.com/>)

The Bank provides its customers with Savings Passbook and other usual services connected with Savings Accounts. The Bank may also provide Automated Teller Machine (ATM) services for these accounts.

### **2.1.6 Customers' Deposits in Savings Accounts (Contract: Al- Wadiah Yad Dhamanah/Guaranteed Custody)**

The Bank takes customers' deposits in Savings Accounts on the same contract with modification on the payment of profit at the absolute discretion of the Bank. The details are as follows:

The Bank accepts deposits from its customers looking for the safe custody of their funds, a degree of convenience in their use, and the possibility of some profits in the form of Savings Accounts on the principle of Al-Wadiah Yad Dhamanah.

The Bank requests permission from such customers to use their funds so long as they remain with the Bank. The customers may withdraw a part of the whole of their balances at any time if they desire, and the Bank guarantees the refund of such balances.

All the profits generated by the bank from the use of such funds belong to the Bank. However, in contrast with Current Accounts, the Bank may, at its absolute discretion, reward the customers by returning a portion of the profits generated from the use of their funds from time to time.

The Bank provides its customers with Savings Passbook and other usual services connected with Savings Accounts. The Bank may also provide Automated Teller Machine (ATM) services for these accounts.

### **2.1.7 Customers' Deposits in General Investment Accounts (Contract: Al-Mudharabah/Trustee Profit-Sharing)**

Islamic banks can mobilize their deposits in General Investment Accounts from their customers on the equity-financing contract of Al-Mudharabah.

The Bank may accept deposits from its customers looking for investment opportunities for their funds in the form of General Investment Accounts on the principle of Al-Mudharabah. The deposits will have to be for a specified period. The Bank may also accept deposits for the following periods:

1 month 18 months, 3 months 24 months, 6 months 36 months, 9 months 48 months, 12 months 60 months, and over 15 months

In the basic Shariah relationship, in this case, the Bank acts as the ‘entrepreneur’ and the customers as the ‘provider of capital.’ Both will agree, among others, on how to distribute the profits generated by the Bank from the funds’ investment. The Bank may offer the distribution in the ratio of 70 percent to the customers and 30 percent to the Bank. This offer of the ratio of the distribution of profits may vary from time to time. In the event of a loss in the investment, the customer bears all the loss. The customer does not participate in managing the investment of the funds.

### **2.1.8 Customers’ Deposits in Special Investment Accounts (Contract: Al-Mudharabah/Trustee Profit-sharing)**

In addition to the above facilities for accepting deposits from its ordinary customers, the Islamic bank may also selectively accept deposits from its government or corporate customers in the form of Special Investment Accounts. These accounts are also operated on the principle of al-Mudharabah. Still, the modes of investment of the funds and the ratios of profit distribution may usually be individually negotiated. Effectively, this is one of the Bank’s money market operations on the liability side. The Bank’s Treasury Department may usually manage the operations. Some other money market operations may also be added by keeping the spirit of Shariah.

## **2.2 Uses of Funds of Islamic Banks**

Now we move to the main items of use of the Islamic banks’ funds:

**2.2.1 Statutory Reserve (Contract: Al-Wadiah Yad Dhamanah/Guaranteed custody)** this is the statutory requirement that Islamic banks, like traditional banks, are also required to maintain reserves with the country’s central bank. The reserve must be maintained with all types of customer deposits but not of the shareholders’ funds. The country’s central bank determines the reserve ratio to deposits to be maintained from time to time. The probable contract is Al-Wadiah Yad Dhamanah. In such a case, the central bank does not pay any profit on the reserve maintained by the Islamic banks. From a regulatory and institutional point of view, the statutory reserve may serve as a safety valve for the Islamic bank’s solvency. It faces serious difficulty and is a monetary instrument for the central bank to conduct its monetary policy.

### **2.2.2 Liquidity Requirements (Contract: Al-Qardh ALHasan/Benevolent Loan)**

There may be a statutory requirement that the bank should maintain certain ratios of defined liquid assets to its various types of deposits at all times. The central bank stipulates the ratios from time to time. An important asset that the bank can hold for this purpose is the Government Investment Certificates or Gov't Bonds Conceptually. Government Bonds are certificates showing the borrowing by the Government from the country's financial institutions, etc. Effectively it is the loan taken by the Government from its own citizens. The Government usually requires a loan to finance its recurrent expenditure or development expenditure for public projects. These may be issued on the Islamic contract of Al- Qardh Al-Hasan. They are of various maturities: short-dated and long-dated. Each certificate carries a face value in multiples of any denomination and is issued at par. It is also redeemable at maturity or on-demand at par. Al-Qardh Al-Hasan is a benevolent debt financing contract quite distinct from the strictly commercial deferred contracts of exchange. The benevolent nature of this contract is aptly suitable for lending by the country's citizens to their Government for financing its operation and development of social projects. Under Al-Qardh Al-Hasan, the borrower is not Obligated but has the option to reward the lender for his benevolent deed. The Government thus has the absolute discretion whether to reward the holder of such instruments or not and, if so, by how much. It may also vary the rewards /or the short-dated and the long-dated bonds. The absolute discretion that the Government has in respect of reward holds the potential of making such a suitable instrument of monetary policy under the Islamic banking and financial system.

### **2.2.3 Investment Financing**

After meeting the statutory reserve requirement and holding the required level of liquid assets, the Islamic bank is free to apply the remainder of the customers' deposits and the shareholders' funds for banking operations.

### **2.2.4 Project Financing (Contract: Al-Mudharabah/Trustee Profit-Sharing)**

The bank may undertake to finance the acceptable project under the principle of Al-Mudliarabah. In this instance, the bank is the "provider of capital" and will provide 100 percent financing for the relevant project. In this instance, the bank is the "provider of capital" and will provide 100 percent financing for the relevant project. "The initiator of the project is the entrepreneur" who

will manage the project. The bank cannot interfere in the management of the project but has the right to undertake the follow-up and supervision task. 'The project's initiator is the entrepreneur' who will manage the project. The bank cannot interfere in the management of the project but has the right to undertake the follow-up and supervision task. Both parties agree through negotiation on the ratio of the distribution of the profits generated from the project. In the event of a loss in the project, the bank bears all the losses.

### **2.2.5 Project Financing (Contract: Al-Musharakah/Joint- venture Profit-Sharing)**

The bank may undertake to finance the acceptable project under the principle of Al-Musharakah. In this instance, the bank and the initiator or initiators of the relevant project will provide the whole financing for the project in agreed proportions. All parties, including the bank, have the right to participate in project management; but all parties can waive such right. All parties agree through negotiation on the ratio of the distribution of the profits generated from the project, if any. Such a ratio need not coincide with the ratio of participation in the projects financing. In the event of a loss in the project, all parties bear the loss in proportion to their shares in financing.

### **2.2.6 Financing Acquisition of Assets (Contract: Al-Bai Bithaman Ajil/Deferred Installment Sale)**

The bank may finance customers who wish to acquire a given asset but want to defer the payment for the asset for a specific period or wish to pay by installments under the principle of al-Bai Bithaman Ajil. The bank first determines the requirements of the customer regarding his period and manner of repayment. The bank purchases the asset concerned. The bank subsequently sells the relevant asset to the customer at an agreed price which comprises: The actual cost of the asset to the bank; and the bank's margin or profit allows the customer to settle the payment in installments within the period and in the manner so agreed upon.

### **2.2.7 Financing the Use of Services of Assets (Contract: Al- Ijarah/Leasing)**

The bank may finance its customers to acquire the right to use the services of a given asset under the principle of Al-Ijarah. The bank first purchases the asset required by the customer. Subsequently, the bank leases the asset to the customer for a fixed period, lease rentals, and other terms and conditions as both parties agree.

### **2.2.8 Syndication Services (Contract: Al-Ujr/Fee)**

It might be briefly mentioned that the above facilities may be organized on a syndication basis for a fee if the financial requirements are beyond the capability of a single bank or if it is desirable to spread the risk. Similar Syndication services also apply to trade finance facilities which will be explained below. The bank has led-managed and participated in some syndications regarding facility investment financing above.

### **2.2.9 Securitization and Debt Trading (Contract: Bai Al- Dayn/Debt-Trading)**

Facilities (c) al-Bai Bithaman Ajil and (d) Al-Ijarah, as we have seen, are debt-financing modes. They give rise to debt or Al-Dayn. The Islamic debt market will be enormously enhanced by the securitization of such debt and the creation of an institutional framework for trading in such debt instruments.

### **2.2.10 Trade Financing**

The bank may provide specific facilities and financings, mostly short-term, to facilitate trade or working capital requirements for its customers. These facilities may be granted in connection with the purchase/import and sale/export of goods and machinery and the acquisition and holding of stock and inventories, spares and replacements, raw materials, and semi-finished goods.

### **2.2.11 Letter of Credit (Contract: Al-Wakalah/ Agency)**

The customer informs the bank about his Letter of Credit requirements and requests the bank to provide the facility. The bank may require the customer to place a deposit of the full amount of the price of the goods to be purchased/ imported, which the bank accepts under the principle of Al-Wadi'ah Yad Dhamanah. The bank establishes the Letter of Credit, pays the proceeds to negotiate with the bank utilizing the customer's deposit, and subsequently releases the documents. The bank charges customer fees and commissions under the Al-Ujr (Fee) principle.

### **2.2.12 Letter of Credit (Contract: Al-Musharakah/ Joint-Venture Profit-Sharing)**

The customer informs the bank of his Letter of Credit requirements and negotiates the terms of

Al-Musharakah financing for his requirements. The customer places a deposit for his share of the cost of goods to be purchased/imported as per the Al-Musharakah agreement, which the bank accepts under the principle of Al-Wadiah Yad Dhamanah. The bank establishes the Letter of Credit and pays the proceeds to negotiate bank utilizing the customer's deposit and its own shares of financing. Subsequently, it releases the documents to the customers. The customer takes possession of the goods and disposes of these manners agreed in the agreement. The bank and the customer share in the profit from the venture as provided for in the agreement.

#### **2.2.13 Letter of Credit (Contract: Al-Murabahah/ Deferred Lump-Sum Sale or Cost Plus)**

The customer informs the bank of his Letter of Credit requirements and requests the bank to purchase/import the goods, thereby indicating that he would be willing to purchase the goods from the bank on their arrival on the principal of Al-Murabahah. The bank establishes the Letter of Credit and pays the proceeds to the negotiating bank utilizing its own funds. The bank sells the goods to the customer at a sale price comprising its cost and a profit margin under the principle of Al-Murabahah for settlement on a deferred term.

#### **2.2.14 Letter of Guarantee (Contract: ALKafalah/ Guarantee)**

The bank may provide the facility of a Letter of Guarantee to its customers for certain purposes under the principle of ALKafalah. The Letter of Guarantee may be provided regarding the performance of a task or the settlement of a loan. The bank may require the customer to place a certain amount of deposits for this facility which the bank accepts under the principle of Al-Wadiah Yad Dhamanah. The bank charges the customer a fee for the services it provides.

#### **2.2.15 Financing Working Capital (Contract: AJ Murabahah/Deferred Lump-Sum Sale or Cost Plus)**

The customer may approach the bank to provide financing for his working capital requirements to purchase stocks and inventories, spares and replacements, or semi-finished goods and raw materials.

The bank first purchases or appoints the customer as its agent to purchase the required goods on its behalf and settles the purchase price from its own funds. The bank subsequently sells the goods to the customer at an agreed price comprising its purchase price and a profit margin and

allows the customer to settle this sale price on a deferred term of 30 days, 60 days, 90 days, or any other period the case may be. The customer pays the bank the agreed sale price on the due date. Securitization and Islamic Accepted Bill (IAB

#### **2.2.16 (Contract: Bai aLDayn/Debt-Trading)**

The previous working capital financing under Al-Murabahah, which gives rise to debt, or Al-Dayn may indeed be securitized. In that instance, the bank draws a bill of exchange and is accepted by the customer. This Bill of Exchange will be drawn for the full amount of the bank's selling price on the maturity date of the financing.

#### **2.2.17 Use of Funds in Direct Investment**

The bank may also utilize the customers' deposits and the shareholders' funds to undertake the following types of direct investment. In all cases where it involves other parties, the contractual form is Al-Musharakah/Joint-Venture Profit-Sharing: Setting up wholly-owned subsidiaries.

Taking up equity as a shareholder in unquoted companies. Purchase of shares in public companies quoted on the stock market for long-term investment. Portfolio investment in shares of public companies quoted on the stock market. (<https://www.iedunote.com/islamic-bank-funds-sources-uses>). 2024

#### **2.2.18 Nature of some risks faced by IBs and CBs is different. - Shariah compliance risk:**

Inadequate compliance with Shariah law could weaken consumer protection as a result of fraudulent activities and misinterpretations of the fundamental Shariah rules. If depositors lose confidence in IBs' Shariah compliance, a bank could face financial problems, starting possibly with liquidity and developing ultimately into solvency issues (which could become systemic if the IB is sufficiently large and connected).

**Equity investment risk:** It arises from entering into a partnership for the purpose of undertaking or participating in a business activity and in which the provider of funds shares the business risks.

**Rate of return risk:** It arises when an increase in benchmark rates results in expectations of higher rates of return on investment accounts, even though the actual rate cannot be exactly determined until the end of the investment holding period.

**Displaced commercial risk:** This risk is a consequence of the rate of return risk. It arises when an Islamic bank is under pressure of paying its investment account holders (IAHs) a rate of return higher than what would be payable under the “actual” El-Hawary, Grais and Iqbal .2004 and Mohammad, O .2017.

**Profit equalization reserves (PER):** It is an amount set aside from the investment profits before allocation between the shareholders and the unrestricted investment account holders and the calculation of the bank’s share of profits. It is used to reduce the variability of profit payouts on investment deposits to offer returns that are aligned to a market rate of return without the need for the bank to forgo any of its shares when investment returns decline.

**Investment risk reserves (IRR):** It is the amount appropriated by the institution offering Islamic financial services out of the income of investment account holders after deducting the share of the bank. It can be used to redistribute over time income which accrues to investment accounts, so as to cushion against future investment losses and maintain payouts.

**Credit risk:** The overall credit risk faced by IBs can be greater than in conventional banks given the unique characteristics of some of the financial instruments they offer.

In the case of receivables (e.g., Murabahah contracts), which represent a high percentage of IBs’ assets, IBs may have no option to sell at discount or to repackage and sell these financial assets as securities to take the risk off their balance sheets (these receivables have to be held until maturity).

**Operational risk:** This risk, which is the risk of losses as a result of failed internal processes, people and systems, is likely to be more relevant for IBs than for CBs (although there is no strong empirical evidence). Its importance reflects the nature of IB’s financing, which is closely tied to real transactions and the special contractual features (e.g., buy and sell back). Risks include: i) improper documentation of or mistakes in the acquisition of real assets ordered by and disposed by the client; ii) cancellation risk in a nonbinding Murabahah contracts; and iii) managing commodity inventories and other real assets in illiquid markets (Greuning and Iqbal, 2008).

**Liquidity risk:** This risk is exacerbated in IBs due to several factors, including that they: i) rely on short-term retail funding; ii) tend to operate in environments with underdeveloped Shariah-compliant interbank and money markets and government securities; iii) have limited ability to hedge certain risks due to prohibitions against the use of conventional derivatives, and iv) have limited access to lender of last resort facilities. While in recent years initial steps have been taken to help develop Islamic money market instruments and Islamic lender of last resort models (Čihák and Hesse, 2008), most of the factors exacerbating liquidity risks remain present.

**Transparency risk:** This risk, which can lead to losses due to bad decisions based on incomplete or inaccurate information (e.g., opacity of balance sheets and complex asset structures). This risk is important in IBs given the use of nonstandard conventions for reporting Islamic financial contracts and the lack of uniform standards of reporting among banks. Differences in financial reporting, auditing and accounting treatment partly reflect differences in interpretation of Shariah rules.

**Legal risk:** The lack of consensus among Islamic scholars regarding Sharia compliant transactions creates significant legal uncertainty. Lack of contract standardization and varying criteria on Shariah compliant contracts may add to the legal risk borne by IBs. Poor enforceability of contractual agreements increases IBs' exposure to counter-party risks of default and delinquency (El-Hawary, Grais and Iqbal, 2004).

**Fiduciary risk:** This risk has a specific nature in the case of IBs given the PLS feature of Islamic finance. It is defined as the legal liability arising from a breach of the investment contract for mismanagement of investors' funds (for examples, see Greuning and Iqbal, 2008). This legal liability exposes the bank to the direct losses associated with the breach of its fiduciary responsibility toward unrestricted account holders and to indirect losses associated with a decline in the market price of its listed shares (El-Hawary, Grais and Iqbal, 2004).

ZamZam Bank S.C., the pioneering Islamic financial institution, has charted a course from turbulent financial waters to profitability, marking a significant turnaround in its operations. Revealed during a recent shareholder meeting at the Millennium Hall, company directors and executives spoke of the Bank's resilience in the face of economic adversities and its strategic insight in navigating the unique landscape of Islamic banking. (Bershbell G Nov, 2023 addis fortune.news).

Nasir Dino (PhD), chairman of the Board, and Melika Bedri, the Bank's President, presented these upbeat financial results before thousands of shareholders, reflecting on the Bank's journey since its inception. ZamZam Bank, which had weathered a loss of 145.42 million Br in its first year, has reversed its fortunes, posting a net profit of 24.1 million Br. The shift is primarily attributed to the Bank's strategies for boosting its income through financing and investment activities. ZamZam's aggressive expansion strategy, encompassing the opening of 35 new branches within the year, played a crucial role in its financial turnaround. The expansion resulted in a significant increase in income from financing and investment activities, soaring to 337.57 million Br, up from 6.85 Million Br in the previous year. According to company executives, this growth trajectory highlights the Bank's robust approach to market penetration and customer reach. Running the branch in Haji Ture Building at the heart of Merkato, which averages 14,000 customers annually, Yesun Taye attributed the increased earnings to expanding branches across the country.

"Businesspeople across the regional states have used our branches well," he told Fortune.

Nasir, a long-time proponent of Islamic banking in Ethiopia, emphasized the Bank's success despite global and domestic economic challenges. He assured shareholders of prospective profit-sharing in the coming years, signaling confidence in ZamZam's continued growth. Nasir unveiled plans for constructing ZamZam's headquarters on a 4,135sqm plot in Addis Ababa financial district.

However, financial analysts like Abdulmenan Mohammed (PhD) caution about the rising operational cost, a byproduct of the Bank's rapid expansion. He noted wages and benefits have tripled to 295.96 million Br, and general administration expenses more than doubled to 196.71 million Br, calling for strategic financial management to sustain the growth momentum in the forthcoming years. Binyam Tesfaye, the executive assistant director for the President of the Bank, attributed the profit to prudent loan portfolio management, strategic marketing, and effective cost management, despite the complexities of a Sharia-compliant financial model. "We have optimized our expense management," he told Fortune.

ZamZam's total assets have witnessed a substantial increase of 137.3pc to 7.49 billion Br, indicating robust growth and a solid financial position. The Bank has also significantly increased

its disbursement of interest-free financing, including profit receivable on Murabaha, reaching 4.34 billion Br, a fourfold increase from the previous year. The Mudarabah investment scheme, a profit-sharing arrangement with depositors instead of traditional interest, has dramatically increased to 8.07 million Br from 338,300 Br in the previous year. Biniyam revealed that ZamZam Bank is crafting a road map for efficient capital deployment with an increased focus on customer acquisition and retention, investment diversification, loan portfolio expansion, and innovation in interest-free products. With a significant Muslim population, Ethiopia offers an attractive market for Islamic banking, a sector that was untapped until the emergence of ZamZam Bank in 2021. ZamZam Bank, named after the Holy Spring in Mecca, commenced with a substantial initial capital base of 872 million Br paid-up and 1.68 billion Br subscribed. Over the year, its 13,000 shareholders have increased the paid-up capital by 26.9pc to 1.7 billion Br. The capital infusion, although significant, is still short of the minimum threshold set for 2026 by the National Bank of Ethiopia (NBE). However, shareholders' anticipation of profit sharing remains high, with optimism about the future of the Islamic banking industry. Nadim Abdulemed, one of the 11,200 founding shareholders retaining shares valued at 40 million Br, has expressed confidence in the Mudarabah investment scheme offered by ZamZam, describing it as a "rewarding investment." Nadim recommends Bank executives focus on digital core banking and customer service, staying one step ahead of peers. ZamZam is focused on digital core banking and customer service enhancement platforms. Melika, a notable figure in the Ethiopian banking industry, disclosed the development of an in-house mobile application and partnership with Eth Switch for interbank connectivity. Her leadership, marked by a tenure as the Chief Financial Officer at the state-owned Commercial Bank of Ethiopia (CBE), has been instrumental in navigating the Bank through its formative years. The foray into Sharia-compliant banking has set a precedent for others in the industry, such as Hijira Bank, with ZamZam leading the way. Its financial performance is noteworthy. Private banks' average assets and liabilities were 62.9 billion Br and 50.5 billion Br, respectively, last year, indicating the scale of operations and trust from depositors. The net interest income

averaged at 3.4 billion Br, with an average net profit close to 1.3 billion Br. The Return on Assets (RoA) and Return on Equity (RoE) averaged 2.36pc and 17.69pc, respectively, highlighting the efficiency of asset and equity usage in generating profits. ZamZam's liquidity measures were also promising, with cash and bank balances (20.5pc) representing a healthy share of its total assets and liabilities (26pc). Its capital adequacy ratio (CAR) stood at 35.6pc, signaling a substantial resource pool for future expansion in interest-free financing and investment activities. It has mobilized 4.98 billion Br in savings from 266,394 accounts, a 214pc jump, and its interest-free financing to saving ratio has surged to 87.15pc from 52.9pc from its inaugural year (addisfortune.news, 2023).

## **2.2 Empirical literature Review**

The first interest-free institution with "bank" in its name, Nasser Social Bank, was established in Egypt in 1971. This was the first time a government in a Muslim country provided public support for incorporating an interest-free institution. Even though the objectives of the Nasser Social Bank were mainly social, such as providing interest-free loans to the poor and needy; scholarships to students; and micro-credits to small projects on a PLS basis; the involvement of a public authority in interest-free banking sent important signals to Muslim businessmen having surplus funds Ahmad, A (2015).

In Ethiopia, where a community of around 40 million Muslims resides, equivalent to the entire population of nations such as Canada, Iraq, Afghanistan, and Uganda, Islamic finance plays a pivotal role in fostering financial inclusion. By adhering to Shariah compliant financial principles, financial institutions can create avenues for the Muslim population to access financial services tailored to their religious beliefs. The nature of Islamic finance (concept of risk and liability sharing) may even better fit the needs of poor and vulnerable populations given their limited incomes and limited possession of valuable assets that impede their access to and participation in the formal and conventional financial services sector. Hence, Islamic finance not only ensures the equitable participation of the Muslim community in the country's economic activities but also promotes a more inclusive and diverse financial landscape in Ethiopia Palgrave, M (2020). Review of 2023 Despite recent formidable challenges, including the impact of the COVID-19 pandemic, war, and specific issues within the banking and capital markets, Ethiopia stands out as one of the few countries actively incorporating Islamic finance into its

financial system responding to the long-standing demand from its sizable Muslim population. In 2020, the government adopted a series of regulations welcoming the introduction of Shariah compliant financing services. By the end of 2023, the National Bank of Ethiopia jointly with the international finance community has achieved notable success in the development of Islamic finance which resulted in the establishment of two full-fledged Islamic banking institutions and many conventional banks and microfinance institutions (MFIs) initiated the operational “windows” for offering Shariah compliant financing and deposit taking services. Though the Ethiopian government and banks are making efforts to reduce the financing gap for the Muslim population, local studies revealed that there is still a large aggregate disparity in satisfying the demand for Shariah compliant financial services. This disparity can be attributed not only to the relatively nascent but growing supply of such services but also to a significant lack of awareness among the population regarding the benefits of Islamic finance. The need for better education becomes paramount in bridging this gap, as many potential users may not fully comprehend the advantages and principles of Shariah compliant financial products. There is also a notable lack of studies focusing on the utilization and awareness of Islamic financial services among some of the most marginalized populations in Ethiopia, including rural women and youth. This lack of research poses a challenge to understanding the specific needs, preferences, and barriers faced by these groups in accessing Shariah compliant financial products. In- depth studies targeting these marginalized populations along with regulatory and institutional frameworks enhancing public awareness remain essential to identify opportunities for tailored financial solutions, address potential awareness gaps, and promote financial inclusion that resonates with the unique circumstances of rural women, youth, and other vulnerable groups in Ethiopia. Preview of 2024 the overall lack of capital in Ethiopia also presents another significant obstacle to the expanded supply of Islamic finance. The scarcity of financial resources constrains the ability of Islamic financial institutions to scale up operations and offer a broader range of Shariah compliant products and services. This capital shortage not only limits the growth potential of existing Islamic finance institutions but also hampers the establishment of new ones. However, the Ethiopian government is actively working to enhance its regulatory framework for Islamic finance and address the challenge of capital shortage through concerted efforts to attract investment, fortify financial infrastructure through digitization, and create an enabling environment for increased capital flow into the Islamic finance sector. As part of this broader strategy, the Ethiopian government is planning the process of establishing a long-awaited capital

market, with plans for official operation by the end of 2023 or the first half of 2024. This initiative encompasses the introduction of Shariah compliant products and services. The Ethiopian Capital Market Authority (ECMA) is proactively developing a comprehensive framework to accommodate Islamic finance products, foreseeing demand based on stakeholder engagements <https://www.thereporterethiopia.com/36153/>. ECMA has already announced its preparation of directives and regulations, set to be implemented within the next three to six months. These measures aim to streamline the issuance of licenses for capital market service providers, including those offering Shariah compliant services. The impending launch of the Ethiopian Securities Exchange in early 2024 is also expected to mark a significant milestone, being the first to secure a capital market service provider license. This development is welcomed as a positive stride toward economic growth and the provision of an alternative funding source for Ethiopian companies including financial institutions. Conclusion Ethiopia, with a substantial Muslim population, has recognized the pivotal role of Islamic finance in fostering financial inclusion. Despite recent international and domestic challenges, Ethiopia has actively incorporated Islamic finance into its financial system, resulting in the establishment women and youth. The overall shortage of capital in Ethiopia poses another obstacle to the expanded supply of Islamic finance. Nevertheless, the Ethiopian government is proactively addressing these challenges by enhancing the regulatory framework, attracting investment, digitizing financial infrastructure, and planning the establishment of a capital market with Shariah compliant products. These efforts signify a positive stride toward economic growth and financial inclusion, promising a more inclusive and diverse financial landscape in Ethiopia Kamran,(2023).

On the upside for the bank, the government for the past two and a half years had been undergoing political reform. The government has now allowed its citizens to invest in fully-fledged IFBs. This had re-sparked the interest of ZamZam Bank which recently commenced its activities under formation by collecting huge amounts of funds in a short time.

ZamZam has now received its license from the regulatory body, NBE. This will make ZZB the first Interest Free Bank in the country. According to the information that Capital obtained from NBE, the regulatory body will officially award the license to ZZB on Monday 12, October 2020. While the bank declined to comment on the issue, it is crystal clear that it will commence operation in the near future. The bank boasts a shareholder's base of 11,200 and a subscribed capital of over 1.7 billion birr.

### **2.3 Research gap**

While previous studies have addressed the general principles and global practices of Islamic banking, there is a lack of comprehensive research focusing on the specific challenges and opportunities faced by Islamic banks in Ethiopia. Furthermore, there is limited empirical data on the performance and impact of the first fully licensed Islamic bank, Zamzam Bank S.C., in the Ethiopian financial sector. This study aims to fill this gap by examining the unique regulatory, market, and operational challenges faced by Zamzam Bank S.C. and exploring the potential opportunities for the growth and development of Islamic banking in Ethiopia.

## **CHAPTER THREE**

### **3. Research Methodology**

#### **3.1 Research Design:**

Utilize a mixed-methods approach, combining qualitative interviews and quantitative questionnaires to provide a comprehensive understanding of the challenges and opportunities of Islamic banking in Ethiopia, focusing on Zamzam Bank S.C.

#### **3.2.Data Collection Methods:**

**Qualitative Interviews:** Conduct semi-structured interviews with key stakeholders, including bank managers, financial experts and regulators. Develop an interview guide with open-ended questions to explore participants' experiences, perceptions, and insights related to Islamic banking. Aim to conduct at least 15-20 interviews to ensure a diverse range of perspectives.

**Questionnaires:** Design a structured questionnaire with open-ended questions to gather data on customers' awareness, attitudes, and experiences with Islamic banking.

#### **3.3. Sampling Size:**

Distribute the questionnaire to a sample of 55 customers and employees of Zamzam Bank in Addis Ababa. Focus on five branches of Zamzam Bank S.C.

**Quantitative Questionnaires:** Employees random sampling to ensure a representative sample of customers and financial professionals in Addis Ababa. Stratify the sample to ensure adequate representation of different demographic groups.

#### **3.4. Data Analysis Methods**

After collecting data the data categorize the content into different themes or topics. This can help you organize the data and draw connections between different parts of the analysis. Appropriate and applicable statistical tool was used in order to analyze the data collected to interpret the result using qualitative research software (SPSS).

## CHAPTER FOUR

### 4. Data presentation and analysis

#### 4.1. Introduction

In this section, we delve into the findings of our study on the challenges and opportunities of Islamic banking in Ethiopia, focusing on ZamZam Bank S.C. The presentation of data and subsequent analysis provide a comprehensive understanding of the current landscape and future prospects of Islamic banking in the country.

#### 4.2 Data presentation and discussion

##### 4.2.1. Challenges of Islamic Banking

**Table 1**

	N	Sum	Mean	Std. Deviation
Specific challenges have you encountered while using Islamic banking services at Zamzam Bank S.C.	52	187	3.60	1.636
Could you provide examples or situations where you faced difficulties	52	209	4.02	1.863
How do regulatory and supervisory issues impact your experience with Islamic banking at Zamzam Bank S.C	52	195	3.75	1.691
In what ways do these regulations affect your daily banking activities	49	217	4.43	1.756
What do you think is the most significant obstacle to the growth of Islamic banking in Ethiopia, particularly at Zamzam Bank S.C.	52	197	3.79	1.903
Valid N (list wise)	49			

		Specific challenges have you encountered while using Islamic banking services at Zamzam Bank S.C.	Could you provide examples or situations where you faced difficulties	How do regulatory and supervisory issues impact your experience with Islamic banking at Zamzam Bank S.C	In what ways do these regulations affect your daily banking activities	What do you think is the most significant obstacle to the growth of Islamic banking in Ethiopia, particularly at Zamzam Bank S.C.
1		Customer Service	Technology Issues	Training and Knowledge Gaps	Delays in Transaction Approvals	Limited Public Awareness
2		Regulatory framework	Public Awareness	Compliance Delays	Delays in Transaction Approvals	High Compliance Costs
3		Public Awareness	Technology Issues	Product Development Restrictions	Limited Use of Digital Banking	Regulatory Uncertainty
4		Regulatory framework	Regulatory Delays	High Compliance Costs	Customer Support Availability	Limited Public Awareness
5		Limited Product Offerings	Regulatory Delays	Training and Knowledge Gaps	Increased Documentation Requirements	Operational Challenges
6		Technology and Infrastructure	Lack of Product Options	High Compliance Costs	Increased Paperwork	Lack of Expertise
7		Customer Service	Public Awareness	Lengthy Approval Processes	Limited Product Availability	Limited Public Awareness
8		Economic Conditions	Lack of Product Options	Limited Product Availability	Limited Access to Certain Services	Operational Challenges
<b>Total</b>	<b>N</b>	<b>52</b>	<b>52</b>	<b>52</b>	<b>49</b>	<b>52</b>
	<b>Mean</b>	<b>3.60</b>	<b>4.02</b>	<b>3.75</b>	<b>4.43</b>	<b>3.79</b>
	<b>Std. Deviation</b>	<b>1.636</b>	<b>1.863</b>	<b>1.691</b>	<b>1.756</b>	<b>1.903</b>

## **Specific challenges have you encountered while using Islamic banking services at Zamzam Bank S.C.**

A, Customer Service: Ensuring high-quality customer service can be challenging, especially when dealing with a unique product like Islamic banking.

Study by Hafiz. M 2023 Top Five Challenges For Islamic Banking

Lack of Standardization: Islamic banking principles are based on Sharia law, but there is significant variability in interpretation and application across different countries. This can lead to inconsistencies in customer service quality.

Service Quality: Ensuring high service quality is essential for customer satisfaction. Factors such as trustworthiness, responsiveness, credibility, security, and tangibility play a crucial role in determining customer satisfaction (COMCEC COORDINATION OFFICE, 2022).

A, Regulatory Framework: Navigating the regulatory environment and ensuring compliance with Sharia principles can be complex.. This could involve compliance with Sharia law and local financial regulations.

A study done in Islamic banks in Ethiopian Islamic banking by Muhammad, M.2012 (Islamic Banking: Prospects, Opportunities and Challenges in Ethiopia) The Ethiopian Muslim community often faces regulatory uncertainty due to the lack of a comprehensive framework tailored for Islamic banking. This uncertainty can lead to confusion and mistrust among potential customers who seek Sharia-compliant

Specialized Knowledge: The research indicates a lack of operation specialists who are well-versed in Islamic finance. This shortage of expertise can hinder the bank's ability to develop and offer Sharia-compliant products effectively. Taxation Issues: The research suggests that taxation issues related to Islamic banking products need to be addressed by the revenue authority.

Clear tax guidelines can help in promoting the adoption of Islamic banking services. Policy Considerations: The National Bank of Ethiopia is encouraged to take special considerations in policy-making regarding Islamic banking operations. Supportive policies can create a more conducive environment for the growth of Islamic banking

According Addis Insight (World Bank news, 2024) World Bank Support: The World Bank has approved a \$700 million credit for Ethiopia's Financial Sector Strengthening Project (FSSP). This project aims to modernize the regulatory and supervisory framework of the National Bank of Ethiopia (NBE), enhance governance reforms, and support the restructuring of key financial institutions<sup>1</sup>. This initiative is expected to improve the stability and resilience of Ethiopia's

financial sector, including Islamic banking

C, Public Awareness: Educating the public about the benefits and principles of Islamic banking is crucial for its acceptance and growth. A study of Challenges for Islamic Finance Growth by Fitch Ratings, Inc. 2021 (Awareness and Confidence Key Challenges for Islamic Finance Growth)

GCC Countries and Malaysia: These regions have the highest levels of awareness, confidence, and demand for Islamic products. Islamic banking has achieved systemic importance and mainstream relevance in these markets. Awareness Gaps: Despite high levels of awareness, there are still gaps. For example, in Malaysia, almost 60% of SMEs were not aware of the availability of Islamic financing facilities.

A study of Islamic Banks in Ethiopia by Banbul. S 2024 Awareness Levels: Public awareness of Islamic banking services at Zamzam Bank S.C. is relatively low. Many potential customers are not familiar with the principles and benefits of Islamic banking, which limits market penetration

D, Limited Product Offerings: Offering a diverse range of Islamic banking products can be limited due to regulatory and operational constraints. A-new-era-for-financial-inclusion by Eden, T. 2024 (ethiopianbusinessreview.net) Consumer Demand: There is a growing demand for a broader range of Sharia-compliant financial products. Customers are seeking more diverse options to meet their financial needs. Market Penetration: Limited product offerings can hinder market penetration and customer acquisition. Expanding the product range can attract a wider customer base and increase market share. Competitive Advantage: Offering a wider array of products can provide a competitive advantage over other banks. It can differentiate Zamzam Bank S.C. in the market and position it as a leader in Islamic banking. Customer Satisfaction: Diversifying product offerings can enhance customer satisfaction by providing tailored solutions that meet individual needs. This can lead to increased customer loyalty and retention. Innovation: Limited product offerings encourage banks to innovate and experiment with new products. This can lead to the discovery of successful new products that can be expanded into regular offerings

E, Technology and Infrastructure: Implementing the necessary technology and infrastructure to support Islamic banking operations can be challenging.

F, Economic Conditions: The broader economic environment can impact the performance and growth of Islamic banking services.

The analysis result you provided shows a mean score of 3.60 with a standard deviation of 1.636. This suggests that, on average, the challenges are moderately perceived, but there is some variation in how different respondents view these challenges.

Table 2

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Regulatory framework	8	14.8	15.4	15.4
	Public Awareness	20	37.0	38.5	53.8
	Limited Product Offerings	8	14.8	15.4	69.2
	Technology and Infrastructure	6	11.1	11.5	80.8
	Economic Conditions	5	9.3	9.6	90.4
	Customer Service	4	7.4	7.7	98.1
	Qualified Human Resources	1	1.9	1.9	100.0
	Total	52	96.3	100.0	
Missing	System	2	3.7		
Total		54	100.0		

**Could you provide examples or situations where you faced difficulties?**

A, Technology Issues: Banks facing technology issues may struggle with outdated systems that slow down transactions, lead to frequent downtimes, or make it difficult to integrate new digital banking services. For instance, customers may experience delays in processing transactions or accessing online banking platforms, which can lead to frustration and reduced trust in the bank's capabilities.

A Study by Louis .T 2024 Challenges for Banking Enterprises in 2025 Outdated Systems: Many banks still operate on legacy systems that are not equipped to handle modern digital demands. This can lead to inefficiencies, slow transaction processing, and difficulties in integrating new technologies.

Cyber security Threats: As banks digitize their operations, they become more vulnerable to cyber-attacks. Ensuring robust cyber security measures is crucial to protect sensitive data and maintain customer trust

B, Public Awareness: There can be a lack of understanding among potential customers about the benefits and principles of Islamic banking. This may result in lower adoption rates. For example, People might be unaware of how Islamic banking aligns with their ethical beliefs or how profit-sharing works, leading them to choose conventional banks over Islamic banks.

C, Regulatory Delays: Regulatory delays can arise due to complex and lengthy approval processes for new products or services. These delays can hinder the bank's ability to innovate and stay competitive. For example, a bank might have to wait several months for approval to launch a new Sharia-compliant investment product, causing it to miss out on market opportunities.

D, Lack of Product Options: Limited product offerings can make it challenging for banks to meet the diverse needs of their customers. For instance, a customer looking for specific types of Sharia-compliant loans or investment opportunities might not find suitable options and could decide to switch to a conventional bank that offers a broader range of products.

Study by Salman. A 2011 Analysis of Challenges and Opportunities in Islamic Banking

Lack of Flexible Financing Options: Islamic banks often face challenges in offering flexible financing options due to the constraints of Sharia law. This can limit the variety of products available to customers compared to conventional banks.

Incomplete Product Mix: The product offerings in Islamic banking are sometimes incomplete, which can hinder the ability to meet diverse customer needs. This can result in customers seeking alternative financial institutions that provide a wider range of products.

Diseconomies: Islamic banks may experience scale diseconomies, making it difficult to achieve cost efficiencies and offer competitive pricing on a larger scale

Table 3

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Regulatory Delays	1	1.9	1.9	1.9
	Lack of Product Options	20	37.0	38.5	40.4
	Technology Issues	18	33.3	34.6	75.0
	Public Awareness	6	11.1	11.5	86.5
	5	2	3.7	3.8	90.4
	6	2	3.7	3.8	94.2
	7	3	5.6	5.8	100.0
	Total	52	96.3	100.0	
Missing	System	2	3.7		
Total		54	100.0		

**How do regulatory and supervisory issues impact your experience with Islamic banking at Zamzam Bank S.C**

A. Training and Knowledge Gaps: Insufficient training and knowledge among staff can lead to misunderstandings of Sharia principles and regulatory requirements, resulting in compliance issues and inefficiencies.

B. Compliance Delays: Delays in compliance processes can hinder the bank's ability to launch new products and services promptly, affecting competitiveness and customer satisfaction.

Operational Inefficiencies: Delays in compliance processes can slow down the bank's ability to launch new products and services, affecting overall operational efficiency. For example, a new Sharia-compliant investment product might face delays in regulatory approval, causing the bank to miss market opportunities.

Customer Dissatisfaction: Customers expect timely access to financial products and services. Delays in compliance can lead to frustration and dissatisfaction, potentially driving customers to seek alternatives with faster service.

**Competitive Disadvantage:** In a competitive market, delays in compliance can put the bank at a

disadvantage compared to conventional banks or other Islamic banks with more efficient processes. This can impact the bank's market share and growth potential. Journal of Islamic Accounting and Business Research from Volume: 1 Issue: 1, to Volume: 16 Issue: 1

**C. Product Development Restrictions:** Regulatory restrictions can limit the bank's ability to innovate and develop new products, stifling growth and customer choice.

**D. High Compliance Costs:** High costs associated with compliance can strain the bank's resources, diverting funds from other critical areas such as marketing and customer service.

**E. Lengthy Approval Processes:** Lengthy approval processes can slow down the bank's operational efficiency and responsiveness to market changes.

**F. Limited Product Availability:** Regulatory and supervisory issues can lead to a limited range of available products, reducing customer satisfaction and loyalty.

Table 4

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Compliance Delays	9	16.7	17.3	17.3
	Product Development Restrictions	4	7.4	7.7	25.0
	High Compliance Costs	6	11.1	11.5	36.5
	Ambiguity and Inconsistency	4	7.4	7.7	44.2
	Training and Knowledge Gaps	12	22.2	23.1	67.3
	Lengthy Approval Processes	4	7.4	7.7	75.0
	Limited Product Availability	13	24.1	25.0	100.0
	Total	52	96.3	100.0	
	Missing	System	2	3.7	
Total		54	100.0		

## **In what ways do these regulations affect your daily banking activities**

**A. Delays in Transaction Approvals:** Regulatory compliance can lead to delays in the approval of transactions, which affects the speed and efficiency of banking operations. Customers might experience longer wait times for their transactions to be processed, leading to frustration and dissatisfaction.

CFIUS Transaction Approvals Taking Longer by B.J. Altvater, David.F and Jonathan R 2023 The Committee on Foreign Investment in the United States (CFIUS) has seen an increase in the time taken to approve transactions. The heightened level of scrutiny and the requirement for mitigation agreements have contributed to longer approval times. This trend indicates that regulatory bodies are becoming more cautious and thorough in their reviews

**B. Limited Use of Digital Banking:** Regulatory restrictions may limit the use of digital banking services, hindering the adoption of modern banking technologies. Customers may have fewer options for conducting transactions online, affecting convenience and accessibility.

**C. Customer Support Availability:** Regulatory demands can divert resources away from customer support, affecting the availability and quality of service. This can lead to longer response times and decreased customer satisfaction.

**D. Increased Documentation Requirements:** Banks may require additional documentation to comply with regulations, resulting in increased paperwork for both the bank and customers. This can slow down processes and create a more cumbersome experience.

A Study Islamic Banking and Finance: Recent Empirical Literature and Directions for Future Research of by Pejman A, Shahid E, Philip M, and Amine T. 2014 Increased documentation requirements can lead to delays in transaction approvals and higher operational costs for Islamic banks. However, they are essential for maintaining compliance with Sharia principles and regulatory standards<sup>1</sup>. Streamlining documentation processes and leveraging technology can help mitigate these challenges while ensuring adherence to necessary requirements

**E. Limited Product Availability:** Regulatory constraints can limit the range of products that banks can offer, reducing customer choice and satisfaction. This can impact the bank's ability to

meet diverse customer needs. Limited Access to Certain Services Some banking services might be restricted due to regulatory requirements, affecting customer access to essential financial services. This can hinder the bank's ability to serve its customers effectively.

Table 5

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Delays in Transaction Approvals	3	5.6	6.1	6.1
	Limited Access to Certain Services	6	11.1	12.2	18.4
	Increased Documentation Requirements	5	9.3	10.2	28.6
	Limited Use of Digital Banking	8	14.8	16.3	44.9
	Higher Costs	13	24.1	26.5	71.4
	Customer Support Availability	9	16.7	18.4	89.8
	Increased Paperwork	4	7.4	8.2	98.0
	Limited Product Availability	1	1.9	2.0	100.0
	Total	49	90.7	100.0	
Missing	System	5	9.3		
Total		54	100.0		

**What do you think is the most significant obstacle to the growth of Islamic banking in Ethiopia, particularly at Zamzam Bank S.C.?**

**A. Limited Public Awareness:** Many potential customers may not understand the principles, benefits, or products offered by Islamic banks, leading to low adoption rates.

**B. High Compliance Costs:** The high costs associated with regulatory compliance can strain the bank's resources and divert funds from other critical areas.

**C. Regulatory Uncertainty:** Unclear or evolving regulatory frameworks can create challenges for Islamic banks in ensuring compliance and stability.

**D. Operational Challenges:** Operational inefficiencies can hinder the bank's ability to provide high-quality services and respond to market demands.

**E. Lack of Expertise:** A shortage of skilled professionals with knowledge of Islamic banking principles can limit the bank's ability to innovate and offer diverse products.

Table 6

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Regulatory Uncertainty	5	9.3	9.6	9.6
	Operational Challenges	11	20.4	21.2	30.8
	High Compliance Costs	9	16.7	17.3	48.1
	Limited Public Awareness	10	18.5	19.2	67.3
	Lack of Expertise	7	13.0	13.5	80.8
	6	3	5.6	5.8	86.5
	7	6	11.1	11.5	98.1
	8	1	1.9	1.9	100.0
	Total	52	96.3	100.0	
Missing	System	2	3.7		
Total		54	100.0		

#### 4.1.1. OPPURTUNITEY OF ISLAMIC BANKING

Table 7

	N	Minimum	Maximum	Mean	Std. Deviation
What oppourtunities do you see for the growth of Islamic banking in Ethiopia, especially at Zamzam Bank S.C	51	1	8	3.84	2.053
Are there specific areas where you believe Islamic Banking can expand?	49	1	7	3.76	1.762
How can Zamzam Bank S.C. improve its services to better meet customer needs?	51	1	7	4.24	1.716
Valid N (list wise)	49				

		<b>What opportunities do you see for the growth of Islamic banking in Ethiopia, especially at Zamzam Bank S.C</b>	<b>Are there specific areas where you believe Islamic Banking can expand?</b>	<b>How can Zamzam Bank S.C. improve its services to better meet Customer needs?</b>
1		Financial Inclusion	Agricultural Financing	Expand Product Range
2		Strategic Partnerships	SME Financing	Improve Customer Service
3		Expanding Market Reach	Retail Banking	Improve Customer Service
4		Government Support	Takaful (Islamic Insurance)	Develop Tailored Products
5		Educational Initiatives	Corporate and Investment Banking	Strengthen Technological Infrastructure
6		Technological Advancements	Microfinance	Increase Public Awareness
7		Strategic Partnerships	Corporate and Investment Banking	Strengthen Technological Infrastructure
8		Technological Advancements	Takaful (Islamic Insurance)	Expand Branch Network
Total	N	52	52	52
1	Mean	3.60	4.25	3.38
	Std. Deviation	1.636	2.605	2.326

**What opportunities do you see for the growth of Islamic banking in Ethiopia, especially at Zamzam Bank S.C**

**A. Financial Inclusion:** Increasing access to banking services for the unbanked and under banked populations, especially in rural areas.

Account Ownership: About Global Findex Database 21. Accounts are a safe way to store money and build savings for the future. They also make it easier to pay bills, access credit, make purchases, and send or receive remittances. Around 76 percent of people worldwide have an account either at a bank or similarly regulated deposit-taking financial Institution, including mobile money service provider. Yet a regional or economy-level view of account ownership shows Among the 123 surveyed economies, account ownership ranges from just 6 percent in South Sudan to universal Ownership in high-income economies such as Canada, Germany, and the United Kingdom.

**B. Technological Advancements:** Leveraging technology to improve banking services and customer experience.

**C. Educational Initiatives:** Enhancing public understanding of Islamic banking principles through educational campaigns and programs

**D. Strategic Partnerships:** Establishing alliances with other Islamic financial institutions globally to share knowledge and resources

**E. Government Support:** Engaging with government agencies to create a supportive regulatory framework for Islamic banking.

Table 8

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Increasing Demand for Sharia-Compliant Products	7	13.7	13.7	13.7
	Financial Inclusion	13	25.5	25.5	39.2
	Technological Advancements	14	27.5	27.5	66.7
	Educational Initiatives	6	11.8	11.8	78.4
	Strategic Partnerships	3	5.9	5.9	84.3
	Government Support	3	5.9	5.9	90.2
	Expanding Market Reach	5	9.8	9.8	100.0
	Total	51	100.0	100.0	

## **Are there specific areas where you believe Islamic banking can expand**

**A. Agricultural Financing:** Expand Product Range By introducing diverse financing products tailored to different agricultural needs; Islamic banks can support farmers and agribusinesses more effectively. This can lead to increased agricultural productivity, sustainability, and economic growth.

**B. SME Financing:** Improve Customer Service Enhancing customer service for small and medium-sized enterprises (SMEs) can make Islamic banks more attractive to these businesses. Providing personalized support, quicker loan processing, and better advisory services can help SMEs thrive.

**C. Retail Banking:** Improve Customer Service Similar to SME financing; improving customer service in retail banking can attract more individual customers. Offering seamless banking experiences, user-friendly digital platforms, and responsive support can increase customer satisfaction and loyalty.

### **D. Takaful (Islamic Insurance):** Develop Tailored Products

Creating customized Takaful products can address specific insurance needs of different customer segments. This could include products for health, education, property, and more, making Islamic insurance more appealing and relevant.

**E. Corporate and Investment Banking:** Strengthen Technological Infrastructure investing in advanced technology for corporate and investment banking can enhance efficiency, security, and innovation. This can improve client services, streamline operations, and support complex financial transactions.

**F. Microfinance:** Increase Public Awareness Raising awareness about microfinance can help underserved populations understand and access financial services. This can promote financial inclusion, empower communities, and stimulate economic development.

**G. Corporate and Investment Banking:** Strengthen Technological Infrastructure As previously mentioned, enhancing technological infrastructure in corporate and investment banking is crucial for maintaining competitiveness and providing top-tier services.

Table 9

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Retail Banking	3	5.9	6.1	6.1
	SME Financing	12	23.5	24.5	30.6
	Agricultural Financing	10	19.6	20.4	51.0
	Housing and Real Estate Financing	7	13.7	14.3	65.3
	Takaful (Islamic Insurance)	7	13.7	14.3	79.6
	Microfinance	6	11.8	12.2	91.8
	Corporate and Investment Banking	4	7.8	8.2	100.0
	Total	49	96.1	100.0	
Missing	System	2	3.9		
Total		51	100.0		

**H. Takaful (Islamic Insurance): Expand Branch Network**

Expanding the branch network for Takaful can increase accessibility and convenience for customers. More branches can mean better Customer service, easier policy management, and greater market reach

## **CHAPTER FIVE**

### **Summery, Conclusion and Recommendation**

#### **5.1 Introduction**

Islamic banking, guided by Sharia principles, has been gaining traction globally as an alternative to conventional banking. In Ethiopia, Zamzam Bank S.C. has emerged as a key player in providing Sharia-compliant financial services. This summary explores the specific challenges faced by Zamzam Bank S.C. and highlights the opportunities for growth in the Ethiopian market.

#### **5.2 Summery of findings**

The primary challenges faced in using Islamic banking services at Zamzam Bank S.C. include poor customer service, an underdeveloped regulatory framework, low public awareness, technology and infrastructural gaps, limited product offerings, and challenging economic conditions. These issues collectively impact the overall customer experience, operational efficiency, and growth potential of Islamic banking in Ethiopia. Zamzam Bank S.C. has significant opportunities for growth by focusing on financial inclusion, strategic partnerships, expanding market reach, and leveraging technological advancements. Specific areas for expansion include agricultural financing, SME financing, retail banking, Takaful, corporate and investment banking, and microfinance. To better meet customer needs, the bank should expand its product range, improve customer service, develop tailored products, strengthen technological infrastructure, increase public awareness, and expand its branch network

#### **5.3 Conclusion**

Islamic banking in Ethiopia, as exemplified by Zamzam Bank S.C., presents a unique blend of challenges and opportunities. Despite facing significant hurdles such as low public awareness, regulatory limitations, and institutional barriers, the sector holds immense potential. The positive market response and growing interest indicate a promising future for Islamic banking in Ethiopia.

To harness this potential, concerted efforts must be made to increase public awareness and understanding of Islamic banking principles. Moreover, developing a supportive regulatory framework and investing in the training of qualified personnel are crucial steps toward creating an enabling environment for Islamic banking to thrive. Ultimately, Islamic banking can play a pivotal role in enhancing financial inclusion, fostering economic development, and providing ethical financial solutions. By addressing the existing challenges and capitalizing on the opportunities, Islamic banking in Ethiopia can emerge as a significant force in the national financial landscape.

## **5.4 Recommendations:**

**Expand Product Range:** Introduce new Sharia-compliant financial products such as different types of savings accounts, investment options, and specialized financing solutions. Cater to a wider range of customer needs, promote financial inclusion, and attract diverse customer segments.

**Improve Customer Service:** Train staff to provide personalized, responsive service and implement efficient complaint resolution processes. Enhance customer satisfaction and loyalty, leading to higher retention rates and positive word-of-mouth referrals. **Develop Tailored Products:** Create customized financial products that address specific customer requirements based on life stages, business sizes, and investment goals. Ensure customers find suitable products that meet their unique needs, increasing customer engagement and satisfaction.

**Strengthen Technological Infrastructure:** Invest in advanced technology for online and mobile banking platforms, security measures, and financial innovations. Improve operational efficiency, enhance customer experience, and ensure the bank remains competitive in the digital age.

**Increase Public Awareness:** Launch marketing campaigns, community outreach programs, and educational initiatives to highlight the benefits of Sharia-compliant banking. Attract new customers, build brand recognition, and promote the ethical values of Islamic banking.

**Expand Branch Network:** Open new branches in strategic locations to increase accessibility and convenience for customers. Reach a larger audience, provide better customer service, and strengthen market presence. By implementing these recommendations, Zamzam Bank S.C. can better serve its customers, foster growth, and contribute to the development of the Islamic banking sector.

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## 5.4 Annex Questionaries'

Thank you for taking the time to participate in this survey. Your input is invaluable in helping us understand the challenges and opportunities of Islamic banking in Ethiopia, with a specific focus on Zamzam Bank S.C.

### Section 1: Introduction and Background

1. Can you share a bit about your background and experience with Islamic banking?

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2. What led you to choose Islamic banking?

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3. How long have you been a customer of Zamzam Bank S.C.?

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4. Can you describe your initial experience with the bank?

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**Section 2: Challenges of Islamic Banking**

1. What specific challenges have you encountered while using Islamic banking services at Zamzam Bank S.C.?

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2. Could you provide examples or situations where you faced difficulties?

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3. How do regulatory and supervisory issues impact your experience with Islamic banking at Zamzam Bank S.C.?

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4. In what ways do these regulations affect your daily banking activities?

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5. What do you think is the most significant obstacle to the growth of Islamic banking in Ethiopia, particularly at Zamzam Bank S.C.?

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### Section 3: Opportunities for Islamic Banking

1. What opportunities do you see for the growth of Islamic banking in Ethiopia, especially at Zamzam Bank S.C.?

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2. Are there specific areas where you believe Islamic banking can expand?

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3. How can Zamzam Bank S.C. improve its services to better meet customer needs?

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4. Can you suggest any specific improvements or innovations?

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**Section 4: Public Awareness and Education**

1. How well do you think the public understands the principles and benefits of Islamic banking in Ethiopia?

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2. What can be done to improve public awareness and education?

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3. How did you first learn about Islamic banking and the services offered by Zamzam Bank S.C.?

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**Section 5: Future Outlook**

1. What are your expectations for the future of Islamic banking in Ethiopia, especially at Zamzam Bank S.C.?

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2. What role do you think the government should play in supporting the growth of Islamic banking in Ethiopia?

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3. Are there specific policies or actions you would recommend?

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