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Review Article

Market Landscape and Gap Analysis of Interest-Free Banking and Finance in Ethiopia

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Abstract

Interest-free banking and finance (IFB) has evolved from a marginal regulatory accommodation into an increasingly significant segment of Ethiopia's financial sector within little more than a decade. This paper presents a market landscape and gap analysis of Ethiopia's IFB industry, examining its institutional evolution, market structure, regulatory architecture, growth trajectory, opportunities, and persistent structural challenges. Drawing on the National Bank of Ethiopia's Financial Stability Reports, recent regulatory directives, institutional reports, and industry evidence, the analysis indicates that deposits under IFB services reached ETB 379.1 billion by June 2025, supported by nine fully fledged institutions and 48 window-based providers across the banking, microfinance, and insurance sectors. Despite this substantial expansion, significant gaps remain in capital-market depth, Sharia-compliant liquidity-management instruments, financing-to-deposit conversion, technological capacity, specialized human capital, product diversification, and Shariah governance. The evolving regulatory and financial-market environment, including Banking Business Proclamation No. 1360/2025 and the establishment of the Ethiopian Securities Exchange, presents opportunities for developing Sukuk, Takaful, and other innovative IFB products. The reviews suggest that IFB represents an underexploited pathway for enhancing financial inclusion, particularly among Ethiopia's Muslim population. However, sustainable growth requires stronger regulatory parity, improved liquidity infrastructure, enhanced Shariah-compliant capital-market instruments, greater technological and human-resource capacity, and increased consumer awareness. Coordinated action among regulators, financial institutions, researchers, and industry stakeholders is therefore essential for developing a resilient, inclusive, and competitive IFB ecosystem in Ethiopia.

Keywords

Interest-free Banking and Finance, Ethiopia, Market Landscape, Market Gaps, Financial Inclusion, Shariah Governance, Sukuk, Takaful

1. Introduction

The global Islamic finance industry has expanded into a multi-trillion-dollar sector encompassing banking, insurance (takaful), capital markets, and investment management. Rooted in Shariah principles, it prohibits riba (interest), gharar (excessive uncertainty), and maysir (speculation) while emphasizing risk-sharing, ethical investment, and asset-backed [12].

In Ethiopia, the financial sector was historically dominated

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by conventional, interest-based banking, excluding large segments of the population whose religious beliefs prevented engagement with interest-bearing products. Interest-free banking, grounded in Islamic commercial law and characterized by profit-and-loss sharing and asset-backing requirements, emerged as a structurally distinct alternative. Although the conceptual case for Islamic finance was recognized in the late 2000s, regulatory accommodation only materialized in 2011, when the National Bank of Ethiopia (NBE) permitted conventional banks to operate interest-free "windows" rather than license stand-alone Islamic banks [2, 20, 23]. This cautious approach has constrained sectoral growth for nearly a decade. A significant change occurred in 2019/2020 when the NBE permitted the establishment of fully fledged interest-free banks [17]. ZamZam Bank became the first such institution in 2021, followed by Hijra, Ramis, and Shebelle Banks, marking a new era of regulatory liberalization. This shift was driven by recognition of Ethiopia's unmet demand, with Muslims comprising roughly one-third of the country's 120 million citizens, many of whom had previously been excluded from formal banking [10, 22].

2. Overview of Ethiopia's Financial Sector

Ethiopia's financial sector remains heavily bank-dominated, with commercial banks accounting for the vast majority of around 96% financial assets. The sector is overseen by the National Bank of Ethiopia (NBE), whose mandate was restructured under the NBE Proclamation No. 1359/2025 and the Banking Business Proclamation No. 1360/2025, representing the most significant legal overhaul in over a decade. As of the latest reporting, 31 domestically owned banks held deposits of ETB 2.2 trillion and assets of ETB 2.85 trillion, with the state-owned Commercial Bank of Ethiopia (CBE) alone controlling nearly 49.5 per cent of total assets, underscoring its systemic importance. By late 2025, the number of licensed banks rose to 32, with most being privately owned, reflecting accelerating private sector participation [9].

The Banking Business Proclamation No. 1360/2025 also opened the market to foreign participation, permitting up to 100 per cent foreign ownership of subsidiaries, a liberalization expected to influence capital inflows, competition, and technology transfer across all segments, including interest-free institutions [9]. Parallel reforms in capital markets, through the establishment of the Ethiopian Capital Market Authority (ECMA) under the Capital Market Proclamation No. 1248/2021, culminated in the launch of the Ethiopian Securities Exchange (ESX), which began trading with around 50 listed entities, including offerings tied to Ethiopian Investment Holdings, the sovereign wealth fund [15].

Within this broader architecture, interest-free banking has transitioned from a peripheral service to a distinct and growing sub-sector. By June 2025, Ethiopia's interest-free finance ecosystem comprised nine fully fledged institutions, four banks and five microfinance institutions, alongside 48 window-based providers operating across 25 conventional banks, 15 microfinance institutions, and 8 insurance companies [4]. (Birr Metrics, 2026 a). Aggregate deposits reached 379.1 billion Birr, while takaful windows wrote 299.8 million Birr in premiums. NBE officials have described this trajectory as the result of seven years of decisive regulatory commitment to mainstreaming Sharia-compliant finance [4].

3. Gap Analysis of Interest-Free Banking and Finance in Ethiopia

The Interest-Free Banking and Finance (IFBF) has expanded considerably in Ethiopia; several gaps continue to hinder its full development. The sector remains heavily concentrated in basic products such as deposit accounts and Murabaha financing, while advanced Islamic financial instruments, including Sukuk, Takaful, and Islamic investment funds, are largely absent [12]. Regulatory and legal frameworks have improved in recent years; however, comprehensive regulations governing the broader Islamic finance industry remain underdeveloped [18].

Additionally, shortages of qualified professionals with expertise in both Islamic finance and conventional banking limit innovation and operational efficiency. Public awareness and understanding of interest-free financial products also remain relatively low, reducing the sector's potential outreach and market penetration [10]. Furthermore, despite growing demand, a significant proportion of the population remains outside the formal financial system, indicating substantial untapped market potential. Recent initiatives by the Commercial Bank of Ethiopia to attract an additional 500,000 users to its Noor interest-free banking service highlight both the growth opportunities and the existing inclusion gap [6, 14]. Addressing these shortcomings through regulatory enhancement, product diversification, capacity building, and public awareness programs is essential for the sustainable growth of IFBF in Ethiopia.

4. Current Landscape of Interest-Free Banking and Finance in Ethiopia

Ethiopia's interest-free finance ecosystem has evolved into a dual institutional structure comprising fully fledged Islamic banks and interest-free windows within conventional institutions. Fully fledged providers, such as ZamZam Bank, launched in 2021 and exceeding minimum capital requirements, and Hijra Bank, established in 2022 with pre-tax profits of 721 million Birr and assets of 19 billion Birr by June 2025, demonstrate credible financial performance despite being smaller than conventional peers (Birr Metrics, 2026 b). In parallel, interest-free windows authorized under NBE Directive No. SBB/72/2019 and updated under Directive No.

608/2021 remain widespread, with 48 windows operating across 25 banks, 15 microfinance institutions, and 8 insurance companies as of June 2025, reflecting both commercial viability and the challenges faced by fully fledged entrants in displacing incumbents [4, 9].

Market size indicators highlight rapid growth, with aggregate deposits reaching 379.1 billion Birr by June 2025, up from 250 billion Birr in 2024. However, financing disbursement lags behind, with only 104.1 billion Birr, about 40 per cent of deposits, deployed into Sharia-compliant instruments such as Murabaha, leaving significant idle liquidity (Shega, 2025; Birr Metrics, 2026 a). Balance sheet data from ZamZam Bank corroborates this trend, showing liquid-assets ratios near 40 per cent. Meanwhile, the takaful segment, though smaller, is expanding, with premiums of 299.8 million Birr written by June 2025 [4, 6].

The regulatory framework has progressed through three phases: the 2011 windows-only directive, the 2019-2020 liberalization permitting fully fledged institutions, and the 2025 licensing directive aimed at strengthening institutions and promoting sustainable growth. This latest directive introduced innovations such as expanded Murabaha authorizations, micro-takaful schemes, enhanced consumer protections, and a national agri-finance roadmap prioritizing Sharia-compliant agricultural finance [4]. In late 2025, the NBE lifted credit growth caps for Sharia-compliant lenders while maintaining restrictions for conventional banks, signaling regulatory equalization and recognition of interest-free banking as a core component of Ethiopia's financial system. Both ZamZam and Hijra Bank anticipated this shift, adjusting their operational strategies, accordingly, and underscoring growing institutional sophistication [3].

5. Opportunities for Interest-Free Banking and Finance in Ethiopia

Ethiopia's Interest-Free Banking and Finance (IFBF) sector presents significant opportunities for expansion and integration within the national financial system. The most fundamental opportunity lies in the scale of unmet demographic demand, with Ethiopia's Muslim population exceeding 40 million, roughly one-third of the total population, many of whom have historically avoided conventional banking for religious reasons. This untapped market could bring up to 380,000 households into the formal financial system initially, with a maximum potential inclusion impact of 7.55 million households, including non-Muslim customers attracted by ethical and risk-sharing features of Islamic finance [5, 8, 13].

The sector's alignment with Ethiopia's National Financial Inclusion Strategy II (2021-2025) further strengthens its role. The strategy priorities expanding services in Muslim-majority areas, contributing to financial inclusion growth from 22 per cent in 2014 to 45 per cent by 2020, with a national target of 70 per cent by 2025. Interest-free banking is therefore positioned as a structural necessity rather than a supplementary option [18, 22].

Capital market integration also offers promising prospects. The establishment of the Ethiopian Securities Exchange and the Ethiopian Capital Market Authority provides a pathway for Sukuk and Shariah-compliant equity instruments. Ethiopia has been identified internationally as a potential jurisdiction for Sukuk issuance, with global Sukuk markets projected to reach USD 190 to 200 billion in 2025 and the broader Islamic finance industry expected to grow from USD 5.4 trillion in 2024 to USD 9.75 trillion by 2029 [7, 11, 19, 21].

Additionally, micro-takaful initiatives and the national Agri-Finance Roadmap create opportunities to extend Sharia-compliant risk-sharing instruments into Ethiopia's agricultural sector, which employs most of the rural population and remains underserved by conventional insurance and credit markets [4].

Finally, regulatory equalization momentum is evident in the lifting of credit growth caps for Sharia-compliant lenders and the liberalization of foreign ownership under the Banking Business Proclamation No. 1360/2025. These reforms open the door for foreign Islamic finance institutions, particularly from the Gulf Cooperation Council, to enter Ethiopia with capital, expertise, and innovative products, at a time when GCC Islamic finance assets are projected to exceed USD 5 trillion by 2029 [3, 7].

6. Challenges of Interest-Free Banking and Finance in Ethiopia

The Ethiopian Interest-Free Banking and Finance (IFBF) sector faces several structural and operational challenges that hinder its growth and competitiveness. One of the most pressing issues is the absence of a Sharia-compliant interbank money market. While Ethiopia has recently introduced an interbank facility to ease systemic liquidity pressures, its interest-based design renders it unusable for Islamic banks, leaving them without mechanisms to access short-term liquidity support during funding stress [4, 5]. This gap has been highlighted by Hijra Bank's leadership as evidence of limited regulatory understanding of the sector's unique requirements.

Another major constraint is the financing-to-deposit conversion gap. As of June 2024, only about 40 per cent of interest-free deposits had been converted into financing, with ZamZam Bank's liquid-assets ratio standing at approximately 40 per cent of total assets. This reflects conservative risk management practices, limited diversity in Sharia-compliant financing products, and underdeveloped capacity to structure complex transactions such as Murabaha, Ijara, and Musharaka at scale [22].

Fully fledged Islamic banks also suffer from a first-mover disadvantage. Conventional banks that launched interest-free windows earlier secured a durable advantage in customer acquisition, making it difficult for newer entrants such as Zam-Zam, Hijra, and Ramis to attract clients away from established window-based relationships [1].

Capacity and technology constraints further exacerbate the situation. Limited managerial expertise in Sharia-compliant product structuring and weak digital financial service capabilities pose risks to competitiveness. Analysts warn that without adequate investment in digital channels, Islamic banks risk marginalization as Ethiopia transitions toward a cash-lite, digitally dominant financial system [21, 22].

7. Future Prospects of Interest-Free Banking and Finance in Ethiopia

The trajectory of Ethiopia's interest-free banking sector over the next five years will likely be shaped by the convergence of three structural forces already in motion.

First, continued regulatory equalization exemplified by the 2025 licensing directive and the lifting of credit caps for Sharia-compliant lenders is likely to narrow the competitive gap between fully fledged institutions and conventional windows, particularly if the National Bank of Ethiopia extends similar treatment to liquidity access mechanisms [2-4].

Second, the maturation of the Ethiopian Securities Exchange and the Ethiopian Capital Market Authority's regulatory infrastructure create a realistic medium-term pathway toward sovereign or corporate Sukuk issuance, which would simultaneously address the sector's liquidity management gap and provide Ethiopian Islamic banks with a Sharia-compliant instrument for surplus liquidity deployment [11, 15, 16].

Third, the foreign ownership liberalization under the Banking Business Proclamation No. 1360/2025 is likely to attract Gulf Cooperation Council and Southeast Asian Islamic finance institutions seeking exposure to Ethiopia's large, underserved Muslim population, a dynamic consistent with the broader global pattern in which Islamic finance is expanding most rapidly in frontier and emerging markets outside its traditional Middle Eastern and Southeast Asian core [7].

These three forces converge favorably; Ethiopia's interest-free banking sector is well-positioned to move beyond its current deposit-heavy, financing-light profile toward a more balanced, productively deployed model that more fully realizes its financial inclusion potential.

8. Conclusions and Ways Forward

8.1. Conclusions

Ethiopia's interest-free banking and finance sector has achieved substantial nominal growth since the 2019-2020 regulatory liberalization, evolving from a single window-based accommodation into a multi-institutional ecosystem comprising nine fully fledged institutions and forty-eight conventional windows, with aggregate deposits reaching 379.1 billion birr by June 2025. Yet this growth has been accompanied by structural imbalances most notably a persistent financing-to-deposit conversion gap, the absence of Sharia-compliant liquidity management infrastructure, and a competitive disadvantage facing fully fledged Islamic banks relative to early-mover conventional windows. The sector's future development is closely intertwined with Ethiopia's broader financial liberalization agenda, particularly the maturation of the Ethiopian Securities Exchange and the prospective introduction of Sukuk instruments.

8.2. Ways Forward

1) *Liquidity Facility*: The National Bank of Ethiopia (NBE) should establish a Sharia-compliant interbank liquidity mechanism to help Islamic banks manage short-term shocks without relying on interest-based tools.
2) *Sukuk Framework*: Regulators and the Ethiopian Capital Market Authority should fast-track Sukuk regulations, leveraging the Ethiopian Securities Exchange to mobilize surplus deposits currently idle in low-yield liquid form.
3) *Product Diversification*: Interest-free banks must expand beyond Murabaha financing to include Ijara, Musharaka, and Diminishing Musharaka, supported by staff training and Sharia-compliant risk systems.
4) *Competitive Strategies*: Fully fledged Islamic banks should invest in digital services and rural agricultural finance partnerships to counter conventional banks' first-mover advantage.
5) *Sharia Governance*: NBE should harmonize Sharia governance standards across all providers to ensure product consistency and build consumer trust.
6) *Foreign Investment*: Policymakers should incentivize Gulf and Southeast Asian Islamic finance institutions to enter Ethiopia, bringing expertise, innovation, and capital.
7) *Empirical Research*: Future studies should analyse performance determinants of Islamic banks versus conventional windows and monitor the impact of Sukuk adoption.
8) *Education Programs*: Universities and training institutions should establish specialized Islamic banking and finance programs at undergraduate and postgraduate levels.
9) *Professional Development*: Regulators and financial institutions should provide certifications, executive courses, and continuous training for professionals in banking, insurance, and microfinance.

Abbreviations

ECMA	Ethiopian Capital Market Authority
ESX	Ethiopian Securities Exchange
ICD	Islamic Corporation for the Development
IFBF	Ethiopian Interest-Free Banking and Finance
LSEG	London Stock Exchange Group

MTA	Mesfin Tafesse & Associates
NBE	National Bank of Ethiopia

Author Contributions

Abebe Tilahun Kassaye: Conceptualization, Formal Analysis, Investigation, Writing – original draft, Writing – review & editing

Conflicts of Interest

The authors declare no conflicts of interest.

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