

**“The influence of Islamic Banking on Financial Inclusion and  
Economic Development in Uganda.”**

**by**

**KAWOOYA IDRIS**

**A Dissertation submitted to the Faculty of Law**

**In partial fulfillment of the requirements for the award degree of**

**Bachelors of laws**

**Of Uganda Christian University Main Campus**

**Mukono, Uganda in May 2024**

**DECLARATION**

I declare that this research has been composed solely by myself and that it has not been submitted, in whole or in part, in any previous application for a degree. Except where states otherwise by reference or acknowledgment, the work presented is entirely my own.

Signed.....

Date.....

**APPROVAL**

I certify that I have supervised and read this study and that in my opinion conforms to acceptable standards of scholarly presentation and is fully adequate in scope and quality as a dissertation in the fulfillment for the award of degree of Bachelor of laws at Uganda Christian University.

Supervisor: .....

Signature:.....

Date:.....

## **DEDICATION**

This research is dedicated to Nabitaka Rehema. A mother and best friend. I am grateful to God for all she is. Your life is a blessing, you are loved beyond words and missed beyond measure. I also dedicate this work to the Muslim Community as a whole, the UCU Community, my family and friends. I also dedicate this to the global population living below the poverty line and the youth hustling with life to make the earth become a better place for them because they have been a big aspiration towards my final publication of this work and lastly to all the Financial Institutions trying to ensure there is development of our economy and ensuring that we leave the “Third world Country state” through promoting profitable Islamic Banking

## **ACKNOWLEDGEMENT**

First and foremost, praise galore and thanks to the Almighty Allah, for His showers of blessings throughout my life, career and for seeing me through this research. He's graced me with opportunities that I know are not of my hand or any other human hand.

I would also like to express my sincere gratitude to my supervisor, for all her time, wisdom, inspiration, patience and understanding. Her encouragement, support, criticism and comments have been invaluable and most helpful throughout the time of this research. She has taught me the methodology to carry out the research and to present the research works as clearly as possible. It was a great privilege and honor to work and study under her guidance. I am extremely grateful for what she has offered me and may she be blessed.

I am eternally grateful to my parents who have ensured that my dreams stay valid and have facilitated me spiritually and financially to ensure my research bears its fruits. And also extend gratitude to my siblings Bushirah and Mahad for the emotional support. The courage and significance you all gave me every day is unparalleled. Am grateful.

## **LIST OF AUTHORITIES**

The 1995 Constitution of The Republic OF Uganda as amended

## **LIST OF STATUTES**

The Financial Institutions Act 2004

The Financial Institutions Amendment Act 2016

The Bank of Uganda Act Cap 51

The Companies Act 2012

The Insurance Act, 2017

The Judicature Act, Cap 31

The Partnership Act, 2010

The Sale of Goods Act, Cap 82

The Tier 4 Microfinance Institutions and Money Lenders Act, 2016

The Uganda Credit and Savings Bank Act, Ordinance number 20 of 1950.

The Money Lenders Ordinance number 31 of 1951,

## **REGULATIONS**

Financial Institutions (Islamic Banking) Regulations 2018

## **GUIDELINES**

Bank of Uganda Financial Consumer Protection Guide Lines, 2012

Code of Good Banking Practice, 2009

## **MALAYSIAN ACT**

Islamic Banking Act 1983 Of Malaysia (As amended)

Banking and Financial Institutions Act 1989 (as amended) (Malaysia) Bank Negara Malaysia Act.

Malaysian Income Tax Act 1967,

## LIST OF CASES

*Woods V Martin Bank Ltd (1959)1QB 55*

*Investment Dar Co KSSC v Blom Developments Bank Sal [2009] All ER (D) 145*

*Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others 2004] 1 Lloyd's Rep 1  
28.*

*Musawi v R.E. International (UK) Ltd and Others [2007] EWHC 2981 (Ch*

*Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd [2007] MLJ 722.*

## LIST OF ABBREVIATIONS

AAOIFI - Accounting and Auditing Organization for Islamic Financial Institutions

AFI - Alliance for Financial Inclusion

BAFIA - Banking and Financial Institutions Act

BCBS - Basel Committee on Banking Supervision

BOU - Bank of Uganda

CSAC- Central Shari'ah Advisory Council

FIA - Financial Institutions Act

PLS - Profit and loss sharing

PSIA - Profit sharing investment account

SAB - Shari'ah Advisory Body

SSB - Shari'ah Supervisory Board

SSC - Shari'ah Supervisory Council

UAE - United Arab Emirates

UDB - Uganda Development Bank

UMSC - Uganda Muslim Supreme Council

## **ABSTRACT**

This research examines the impact of Islamic banking on financial inclusion and economic development in Uganda. In Uganda's secular banking sector, the idea of Islamic banking is a recent development. Islamic banking is governed by the Financial Institutions (Amendment) Act of 2016, which also gives it existence. The study clarifies how Islamic banks will affect Uganda's economy and financial inclusion generally, even though they must operate in line with Shari'ah principles. It also highlights how these principles may be restricted by Central Bank policies and regulations, particularly the Financial Institutions (Islamic Banking) Regulations 2018 and other policies. The authorities want to conduct thorough research and work hard to create a framework of laws and regulations that would effectively support Uganda's Islamic finance sector. Efforts ought to be undertaken to adjust the current framework in order to deliver superior goods and services while adhering to Islamic law. All parties involved should be aware of the current state of affairs and strive to create an economic system that is genuinely reflective of the precepts of Islam. In conducting the study, the researcher relied on qualitative methodology. Accordingly, data was collected using both primary and secondary source of information, using the doctrinal research. The researcher used qualitative methods to carry out the investigation. The key findings show that the adoption of Islamic banking is likely to have some legislative challenges which cannot effectively serve the true operation of Islamic banking. It has also been discovered that the modes of Islamic Banking practiced in Uganda have led and will lead to Economic development and financial inclusion through the regulation and implementation of Islamic laws particularly the financial institutions act 2016. The study recommends that to ensure a proper and supporting Islamic banking legal system in Uganda, amendments in existing laws, which are likely to be repugnant to Islamic banking, are required to promote Islamic banking law compliant products and adopting other legal methods like alternative dispute resolution among others.

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# CHAPTER ONE

## INTRODUCTION

### 1.0 Introduction

This Chapter gives an overview of the Research Problem, as it provides readers with the background information for the research, statement of the problem, aims and objectives of the study, methodology, research questions, the scope of study, significance of study, justification of study and the chapter synopsis.

### 1.1 Background

Before the introduction of Islamic banking, Uganda's economy has in recent times like any other, experienced growths and declines. However, after the introduction of Islamic Banking system in 2016 by the Financial Institutions Amendment Act<sup>1</sup>, the Gross Domestic Product (GDP) estimates for the financial year (FY) 2022/23 indicate that the economy grew by 5.3 per cent, which is 0.7 percentage points higher than the growth of 4.6 per cent achieved in the FY 2021/22.<sup>2</sup> An Implication of the development of the economy. The incumbent government (National Resistance Movement) in Uganda has since 1987 embarked on liberalizing the economy through privatization which subsequently led to growth in the private sector.<sup>3</sup> In contrast, only about 4 million people, or 10% of the population, have bank accounts, according to the World Bank<sup>4</sup> The population has mainly shied away from banks because of their increasingly strict terms for borrowing caused by worsening quality of loans that has trimmed private sector credit by interest rates typically range between 22 and 25%, and depending on the duration of the loan, where consumers end up paying more than twice the value of the original amount.<sup>5</sup> It's at this point that in 2016 when the Government of Uganda amended the Financial Institutions Act to make provision for Islamic

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<sup>1</sup>Musa Mayanja Lwanga Islamic Banking in Uganda By pg. no 1 <https://ugandabankers.org/publication/view/islamic-banking-article-10th-june2019> In 2016 the government of ,this initiative within the sector. Accessed on 22<sup>nd</sup> March 2024

<sup>2</sup> Uganda Bureau Of Statistics (UBOS) Statistical Abstract 2016. Available at [http://www.ubos.org/onlinefiles/uploads/ubos/statistical\\_abstracts/2023%20Statistical%20Abstract.pdf](http://www.ubos.org/onlinefiles/uploads/ubos/statistical_abstracts/2023%20Statistical%20Abstract.pdf) accessed on 22<sup>nd</sup> March, 2024.

<sup>3</sup> Augustus Nuwagaba, 'Globalization and Competitiveness; Implications for poverty reduction in Uganda.' *Michigan State University Journal of social development in Africa* Vol 16. No 2 2001 at page 37.

<sup>4</sup> <https://www.linkedin.com/pulse/expanding-financial-inclusion-uganda-why-banks-must-eugene#:~:text=As%20of%202021%2C%20about%2053,according%20to%20the%20World%20Bank>. Accessed on 22<sup>nd</sup> March 2024.

<sup>5</sup> <https://blogs.worldbank.org/en/african/in-uganda-greater-financial-inclusion-is-the-key-to-unlocking-rapid-growth> accessed on 22<sup>nd</sup> March 2024.

Banking. Islamic finance prohibits the charging of ‘*riba*’ (interest).<sup>6</sup> The rationale behind the prohibition of *riba* on consumption loans is to redistribute the purchasing power from the rich to the poor.<sup>7</sup> This type of banking is based on *Shari’ah*.<sup>8</sup> There is a global surge of states and business persons dealing or seeking to invest in Islamic banking and finance.<sup>9</sup> This makes it a lucrative business venture since in 2019, the global Islamic financial assets stood at USD 2.733 Trillion with USD 2.014 Trillion (74%) for Islamic Banking, USD 476 Billion (17%) for Islamic bonds (Sukuk), USD 120 Billion (4%) for Islamic Funds, USD 53 Billion (2%) for Islamic Insurance (Takaful), USD 30 Billion (1%) for Islamic Microfinance<sup>10</sup> The Profit and Loss Sharing<sup>11</sup> aspect of Islamic banking is also an alternative to interest-based banking for those seeking credit. This is because unlike conventional banks, Islamic banks do not charge interest on principal debts carried out by borrowers.<sup>12</sup> Thus the lucrative nature of the concept has attracted the Ugandan government to jump on to this Islamic finance wagon in an attempt to harness the said opportunities it presents.<sup>13</sup> Thus it has even led to the amendment of the Financial Institutions Act 2004 in order to lift the aforementioned restrictions so as to allow Islamic banking flourish which contributes to the spread of real-asset-based finance principles and is ideal for financing infrastructure projects.<sup>14</sup> On the other hand, there are existing schools of thought that are opposed to Islamic banking such as those that argue that the Islamic concept of replacing of interest with profit and loss sharing is not feasible. Timur Kuran for example argues that the *Murabaha* mode of finance requirement for

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<sup>6</sup> “Those who charge *riba* are in the same position as those controlled by the devil’s influence...as for those who persist in *riba*, they incur hell, wherein they abide forever” –*Qur’an* 2; 275

<sup>7</sup> Noorzoy, M.S. (1982, Feb). Islamic Laws on *Riba* (interest) and their Economic Implications. *Int. J. Middle East Stud.* 14(1). 6.

<sup>8</sup> Islamic principles and laws extracted from the Oxford Learners Dictionary 8<sup>th</sup> edition

<sup>9</sup> Ernst and Young, World Islamic Banking Competitiveness Report 2016 at page 10. Available at [http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report2016/\\$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf](http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf) accessed on 5th Feb 2024

<sup>10</sup> <https://www.msc.co.ug/products-services/finance-products/islamic-finance/#:~:text=In%202019%2C%20the%20global%20Islamic,for%20Islamic%20Microfinance%2C%20and%20USD> accessed on 22<sup>nd</sup> March 2024.

<sup>11</sup> Under this system, instead of charging a fixed rate of interest on its lending, the bank enters into an equity sharing relationship with the client and shares in the risk and return, as well as profit and loss of a joint venture. M. Khan M Bhatti, ‘*Developments in Islamic Banking; case of the Pakistani*’ at page 81.

<sup>12</sup> *Ibid.*

<sup>13</sup> The Executive Director Supervision, Bank of Uganda (BoU), Ms. Justine Bagyenda during an interview with a national daily said one of the reasons for Uganda adopting Islamic banking was due to its exponential growth and resilience to financial crises. Ismail Musa Ladu, ‘Islamic banking cleared for business, says regulator’. *The Daily Monitor* available at <http://www.monitor.co.ug/Business/Islamic-banking-cleared-businessregulator/688322-3204576-14o1789z/index.html> accessed on 5th Feb 2024. <sup>27</sup> Emmanuel Tumusiime Mutebile op cit (n22).

<sup>14</sup> *ibid.*

payment of time-value for money is equivalent to an interest-based conventional bank loan.<sup>15</sup> As it requires that a trader submits a list of requirements he wants to purchase to the Islamic bank which then buys the goods.<sup>16</sup> The bank then sets a markup price as its compensation for the service rendered and upon payment the bank transfers ownership to the client.<sup>17</sup> The bank however sends the client a bill at an inflated price because of the risk it bears from the time it purchases the consignment to the time transfer is made because it does indeed bear the risk during this time and would pay in case of damage.<sup>18</sup> The bank has no risk, and the client pays for the time-value of money.<sup>35</sup> The only difference is in form and not in substance, which is that the client's payment is called a "markup" in Islamic banking and "interest" in conventional banking.<sup>19</sup> Reliance on Islamic principles leads the sector to operate in an 'unorthodox' manner distinguishable from its conventional counterparts since the former unlike the latter does not deny existence of a link between banking sector and religion.<sup>20</sup>

Thus, the research will conduct a compatibility assessment between Islam banking and economic development and financial inclusion in Uganda. It will propose amendment of tax laws to avoid double taxation challenges faced by Islamic finance and how the different modes of Islamic Banking have led to the development of the economy in Uganda today.

## 1.2. Statement of the Problem

There has been the struggle to push Uganda's economy from a third world country to an economically stable country however, this has been on a gradual growth. The Government of Uganda has enacted the Bank of Uganda Act to regulate the Financial Institutions and develop the economy through giving out loans. It has even gone further to enact the Financial Institutions Act

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<sup>15</sup> Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press) 2004. This is also provided for by Section 1(m) of the FIA 2016 which in defining Islamic financial business provides that it is a business of receiving property into profit sharing investment accounts.

<sup>16</sup> *ibid.*

<sup>17</sup> *ibid.*

<sup>18</sup> *ibid.*

<sup>19</sup> Timur Kuran also argues in *The Financial Times* article, 'Islamic finance sits awkwardly in a modern business school' that "Islamic banks give and take interest as a matter of course, though under the guise of commissions, fees, penalties or profit shares. The holder of a "halal" credit card pays a penalty on unpaid balances; this penalty is proportionate to the size of the balance, which makes it equivalent to interest". He further posits that the *Shari'ah* code was suited to the Middle Ages, when it assumed its classical form and that at least on matters of economics and finance, it has not advanced measurably since then. See <https://www.ft.com/content/ee2a2b36-9de5-11e2-9ccc-00144feabdc0#axzz3Qlujrt5w> (accessed on 5<sup>th</sup> February 2024).

<sup>20</sup> Iqbal, Zamir, and Abbas Mirakhor. 'An introduction to Islamic finance: theory and practice'. Vol. 687. *John Wiley & Sons*, 2011.

of 2004 This act gives mandate to financial institutions like banks to conduct business between people in order to make them inclusive in the economic development. However, this has not yet been enough to develop the economy as the Ugandan economy is still low.<sup>21</sup>

This has enabled the people of Uganda to make businesses as manifested through money lending businesses, there are also a lot of existing banks, mobile money services among others but there has not been a new advancement of economy as people dwell in such unprofitable businesses.

It is worth noting that, there has been a decline at the economic upgrade through the use of banks since many of the youth who make the highest population in Uganda are not inclusive with the business of saving money in banks. Furthermore, the population has mainly shied away from banks because of their increasingly strict terms for borrowing caused by worsening quality of loans with high rates of interest rates attached, if there was a proper forum of banking with maybe lesser or no interest rates, the economy in Uganda would have upgraded to a higher level and gained stability.

Because of the state of the economy, Uganda has had such low development that even bank account holders have fled the country, believing there is no point in saving money or applying for bank loans. Thus, in order to improve and have an economic impact, a new banking forum that will benefit the majority population and advance the nation as a whole must be introduced. As a result, the development of the Islamic banking industry is the mainstay of Islamic finance and is expected to continue expanding at a high rate within the global financial sector.<sup>22</sup> This type of banking is based on *Shari'ah* or Islamic Principles, the research embarks on finding out the proper way of implementing Islamic banking modes, legislations and how to make it more profitable to the economy of Uganda without interfering onto the system of working at Conventional banks.

### 1.3 Aims and Objectives

#### 1.3.1 General Objective

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<sup>21</sup> World Bank Group Global Report on Islamic Finance 2016; Islamic Finance; A Catalyst for Shared Prosperity at page 3. Accessible at <https://openknowledge.worldbank.org/handle/10986/25738?show=full> accessed on 5<sup>th</sup> Feb 2024

<sup>22</sup> World Bank Group Global Report on Islamic Finance 2016; Islamic Finance; A Catalyst for Shared Prosperity at page 3. Accessible at <https://openknowledge.worldbank.org/handle/10986/25738?show=full> accessed on 5<sup>th</sup> Feb 2024

1. The General Objective is to analyze the influence of Islamic Banking on Financial Inclusion and Economic Development in Uganda.

### **1.3.2 Specific Objectives**

The specific objectives of the study are as follows:

- I. To Identify the different forms of Islamic banking, their relevance and benefit to the growth of the Uganda economy and economic stability,
- II. To analyze the regulatory and supervisory structure of Islamic banking in Uganda under the Financial Institutions (Amendment) Act and other legislations.
- III. To give recommendations in light of the challenges faced under Islamic banks which will enhance financial inclusion and enable Islamic banks contribute to the development of the economy in Uganda.

### **1.4 Research Questions**

- I. What are the different forms of Islamic banking, their relevance and benefit to the growth of the Uganda economy and economic stability,
- II. What is the regulatory and supervisory structure of Islamic banking in Uganda under the Financial Institutions (Amendment) Act and other legislations.
- III. What are the recommendations in light of the challenges faced under Islamic banking and how to make it more practical in Uganda's Finance and fill such lacunas.

## **1.5 SCOPE OF THE STUDY**

### **1.4.1 Subject/contextual scope.**

The study was done on the Impact of Islamic banking on the financial inclusion and economic development in Uganda.

### **1.4.2. Geographical scope.**

The research was conducted in the urban areas in the central region comprising Of Kampala, Wakiso, Mukono, Masaka, Luwero, the Eastern region, southern region and the Northern region of Uganda. Such places have been the priority because these are the places where the Islamic banks are located and where people conduct the Islamic modes of financing This will enable the researcher get clear image and relation to how Islamic banks are running in Uganda today.

### **1.4.3. Time scope**

The research will cover the time period from 1951 to date, this is due to the fact that the laws on the financial development and the banking system were developed and they are the reason for the existence of Islamic bank and the Banking system as well and these include; The Uganda Credit and Savings Bank Act, Ordinance number 20 of 1950. The Money Lenders Ordinance number 31 of 1951, the 1995 Constitution, the Bank of Uganda Act Cap 1966, the Financial Institutions Act 2004, the Financial Institutions Amendment Act 2016

## **1.6 SIGNIFICANCE OF THE STUDY**

This research is intended to explore how Islamic financial principles can impact economic growth as it examines the potential benefits and challenges of implementing Islamic principles in Uganda,

### **1.6.1 Government.**

The research will help the policy makers and economists understand how to make Islamic banking more profitable and improve on the financial stability and inclusivity in order to promote a more sustainable economy.

### **1.6.2 Academia**

It will act as source of reference in the academia as it will also help different students and more researchers get knowledge on the concept of Islamic Banking and how it functions which contributes to the academic development and expand legal knowledge on Islamic Banking.

### **1.6.3 The researcher**

The research will help the researcher gain recognition by the Institutions due to the research made on a unique topic of study as well as helping him gain an award from the institution in form of marks to fulfill his study of the bachelor of Laws Degree as he gains more knowledge on research and particularly on Islamic banking.

### **1.6.4 The Public**

Such research is intended to be published on social media for easy access and also be printed into the newspaper articles to enable the people of Uganda and the world at large to get access to it in order to gain legal knowledge and entice them to engage in Islamic banking in order to save them from the heavily charged banking loans schedules.

## **1.7 Justification of the Study**

Uganda has made significant strides in Financial Inclusion but many Muslims remain excluded from the formal financial system due to religious beliefs, however Islamic Banking can cater for

this underserved population, thus the research is intended to deliver an overview about the role of Islamic banking in the Uganda's economy as well as its impact to the economic development of Uganda and to develop measures on how it can be improved to better standards and promote a wealthy stable economy.

## 1.8. LITERATURE REVIEW

It should be noted that Islamic banking in Uganda has limited literature as it is a new phenomenon in the banking sector. Not many people have written about it. However, a rich literature is available from other jurisdictions who have established a clear legal framework for Islamic banking as will be seen below.

**Afuah Sebyala** in her paper "*The Prospects of Islamic Banking in Uganda*"<sup>23</sup> examined how Islamic banking originated in the Muslim world and how it extended to parts of Europe and the Far East. The benefits of Islamic banking over traditional banking were discussed by the author. The author also covered the legal foundation for Islamic banking in a few chosen nations. Regarding the introduction of Islamic banking in Tanzania and Kenya, she offered her thoughts. She also discussed the introduction and growth of Islamic banking in Uganda. She also noted a few obstacles that could prevent Islamic banking from developing further in Uganda. The author did not, however, address the type of legal framework required to operate Islamic banking operations or the most effective model Uganda may use, such as a distinct piece of legislation for Islamic banking or combined legislation for conventional and Islamic banking and neither did she expound on how it can influence the economy which happens to be the gist of this research.

**Sulaiman Lujja, Mustapha Omar Mohammad Rusri Bt Hassan, Umar** in their article titled *The Feasibility of Adopting Islamic Banking System Under the Existing Laws in Uganda*,<sup>24</sup> talked about the characteristics of Islamic banking and how international financial markets can include it. The writers outlined the history of Islamic banking in Uganda from the 1990s until the Financial Institution Amendment Bill 2015 was passed in the early months of 2015. The extent to which the current laws are relevant to Uganda's implementation of Islamic banking was examined in this

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23 Afuah.S., "Prospects of Islamic Banking in Uganda". (2008) *OIC Business Forum Paper* presented at 2009 UMYA Ramadhan Seminar at Kibuli Primary Teachers Collage, Kampala.

24 L Sulaiman Mustapha Omar Mohammad and Rusni Bt. Hassan, "The Feasibility of Adopting Islamic Banking System Under the Existing Law in Uganda" *Emerald Insight at: [www.emerladinsight.com/1753.8394.htm](http://www.emerladinsight.com/1753.8394.htm)*.

article. In order to compare Uganda's experience with best practices, their study looked at Malaysia's experiences with Islamic banking legislation. They recommended changing a few laws to make room for Islamic banking. The report did not, however, delve into the specifics of the legislation that has to be changed to permit flexible Islamic banking. They suggested the ideal model for Uganda to follow. In general, the article advocates for gradual process on regulating Islamic banking Law. Their article did not expound on the Financial Institutions Amendment of 2016, which currently happens to be the general law governing Islamic banks as per this research.

**Emmanuel Tumusiime Mutebile, the Governor Bank of Uganda** in his paper *Islamic Banking Emerging Markets Forging Uganda's Economic Progress*,<sup>25</sup> stated that, similar to traditional banking, the growth of Islamic banking depends on the presence of supportive regulatory and legal environments. He mentioned that BOU, in light of this, conducted research on the Islamic Banking model to determine how well it fit within the existing legal framework. According to the study, there were prohibitions in the Financial Institutions Act, 2004 (FIA 2004) that made it difficult for Islamic banks to conduct business. The Financial Institutions (Amendment) Act 2016 was enacted in January 2016 as a result of the parliament's approval of the Bank of Uganda's proposed revisions to the FIA 2014. However, the author did not specify specific sections of the FIA 2014 that could hinder Islamic banking. This research intends to bring out the required amendments in the FIA 2016 to ensure smooth implementation of Islamic banking in Uganda in addition to its proponents.

**Burhanur, R.** In his study titled *Islamic Banking in India: Challenges and Prospects*<sup>26</sup> highlighted the increased contribution of participatory financing to development projects that are pertinent to both the social and economic spheres. The study cited the widely used models of Islamic banks in the United Kingdom, Thailand, Singapore, and the United States to argue that the current legal framework for the implementation of Islamic banking has to be amended. The reason this effort is good is that Uganda can use the models it provides to promote Islamic banking. However, the author makes no reference to Uganda although they both have similar legal systems.

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25 TM Emmanuel "Islamic Banking in Emerging Markets Forging Uganda's Economic Progress", at *Islamic banking conference, Kampala*, 13<sup>th</sup> may 2016.

26 R Burhanur, "Islamic Banking in India: Challenges and Prospects". IANS, 2010, Separate Law Needed for Islamic Banking in India": RBI. (Online at [http://timesofindia.indiatimes.com/business/India-business/separate-law-needed-for-Islamic-banking-in-India-RBI/article show/5954287.cms](http://timesofindia.indiatimes.com/business/India-business/separate-law-needed-for-Islamic-banking-in-India-RBI/article-show/5954287.cms), accessed 17<sup>th</sup> June 2016).

**Raqeeb**, in his study titled “*Problems and Prospects of Islamic Banking in India–Road Map Ahead*”<sup>27</sup> attempted to pinpoint the main issues with the introduction of Islamic banking in India and provide solutions by using international examples from Singapore, Malaysia, and the United Kingdom. He has advocated for the creation of a parallel system that would serve the unbanked portions of society, particularly the marginalized and minorities in the nation, particularly Muslims, and be based on equity rather than debt. But since Uganda only has one legislative mode, which this research aims to supply, this model might not apply there.

**Kerrie Sadiq and Ann Black**, in their paper titled “*Embracing Shari’ah- Compliant Products through Regulatory Amendments to Achieve Parity of Treatment*”<sup>28</sup> suggested that the current regulatory barriers may be removed by amending the current legislation to provide equal treatment for the Islamic finance industry and the conventional market, as opposed to the need for a separate regulatory system. Although this study outlines the revised laws of the Financial Institutions Act 2004 that are appearing in the 2016 FIA Amendment Act, the author did not identify which laws are to be amended.

**Norhashimah Mohd. Yasin**, in her study titled, “*Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies*”<sup>29</sup> stated that Malaysia is a leader in Islamic finance and banking. Its significant achievement is largely due to the backing of the government, businesses, and society at large. Furthermore, the Central Bank's stringent oversight function guarantees sound corporate governance for both conventional and Islamic institutions. Despite all of this, the author pointed out, the legal structure has not been very encouraging or definitive to help the Islamic banking sector function smoothly. Furthermore, Islamic banking operates within a highly developed infrastructure that is superior to that of other nations worldwide, but the legal framework appears to indicate the exact reverse.. The legal system of the country is lagging behind the rapid development that has taken place within the Islamic principles of doing business by the establishment of the *Shari’ah* Supervisory Council (SSC) at the central bank, upon disputes the court which has jurisdiction is still vested with the civil court. She also noted that the civil courts

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27 Raqeeb “Interest-free banking ideal for India” 2009 & Raquibuz et, “Islamic Banking A Performance Analysis” 2006.

28 K Sadiq and Ann Black, “Embracing Shari’ah-Compliant Products through Regulatory Amendments to Achieve Parity of Treatment” (2012) 34 *Sydney Law Review* 189.

29 N Mohd. Yasin, “Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies”, (2001)1 *IJUM Law Journal* 20.

have jurisdiction to hear all cases falling under the federal list. Thus, banking and its related matters fall within the ambit of the federal list. Her work evaluates the Malaysian legal system in relation to Islamic banking. Such information is useful to Uganda as it has embarked on Islamic banking.

**Uzaimah Ibrahim** et al, in their study titled, *Conflicts Facing Islamic Banking in Malaysia: Dual Banking System Versus Dual Legal System*<sup>30</sup> looked at conflicts facing Islamic banking and dual banking system versus dual legal system. The authors provide that Malaysia has succeeded in creating a fully-fledged Islamic banking system parallel to existing conventional irrespective of challenges faced. The new Central Bank Act of Malaysia has dual financial system that works in parallel that are conventional and Islamic banking system. The adoption of dual banking system is however been perceived as creating room for possible legal conflicts. The possible legal conflicts may be due to the fact that the law applicable to Islamic banking is not totally derived from Islamic law and the judiciary system of the country is complex as the court that hears Islamic banking matters are civil courts. However, the dual legal system may not work in Uganda given the nature of the Uganda's constitution unlike in Malaysia where Islam is a state religion.

**Nooraslinda Abdul Aris** in their study titled, *“Islamic Banking Products: Regulations, Issues and Challenges”*<sup>31</sup> argued that the introduction of new Islamic products does not impose some challenges not only to the practitioners and shari'ah council members, but also to society at large, as they are the ultimate users of the products. Their study looked at the development and regulations of the new Islamic banking products with focus given more on Islamic house financing. However, the challenges will be more appreciated if Islamic banking commences business in Uganda.

## 1.9 METHODOLOGY

Primarily, the research shall adopt the doctrinal approach through comparative analysis of relevant legislation of countries with Islamic finance with more emphasis on Uganda and other relevant

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<sup>30</sup> Ibid.

<sup>31</sup> Nooraslinda and others, “Islamic Banking Products: Regulations, Issues and Challenges”, (2013) 29 No.4, *Journal of Applied Business Research*, p.1146.

countries like Malaysia, Saudi Arabia among others so as to best position subsequent recommendations. Reference shall also be, made to case law.

First the primary source contains original information. Primary source of information used in collecting data include; The Constitution of the Republic of Uganda 1995, statutes, and law Reports. Data was also collected from the sources of Islamic law namely the holy *Quran* (holy book for Moslems), *Hadith* (sayings of prophet Mohammad), *Sunnas* (actions of prophet Mohammad) and *Qiyas* (general consensus). These all contain first hand and in -depth information on this study.

The research will also use the narrative methodology in reviewing the literature. This is because since the narrative literature review surveys the state of knowledge on a particular topic and yet there is scarcely any written paper concerning this study in Uganda. Therefore, the literature reviewed ranges from papers in *Google scholars*, *web pages*, *newspaper articles* and *government documents*. The intention is to recommend a standardized regulatory framework for Uganda and other law development countries with Islamic banking.

The research shall also rely on secondary sources such as *journals and articles published by the Bank of Uganda*, *Ministry of Finance*, *Planning and Economic Development of Uganda*, *as well as international financial institutions such as The World Bank and The International Monetary Fund* and other authorities from other jurisdictions where Islamic banking has been prevailing.

In order to fully comprehend the likely impact of Islamic banking in Uganda, historical research about the evolution of the banking sector in the country will also play an important role in the study. Materials such as *Budget speeches*, *Ministerial instruments*, *cabinet white papers*, *draft legislation*, *press releases*, *news articles*, *previous legislation* and older case law will be referred to in order to outline the deeper nuances of contextual and historical perspective of the subject matter at hand, and the changes proposed in the current legislation.

## **1.10. CHAPTERISATION**

**Chapter One** gives an overview of the Research Problem, as it provides readers with the background information for the research reported in the paper. Its purpose is to establish a framework for the focus of your research topic, it will have the background, statement of the

problem, the methodology, significance, justification, literature review and the scope of the research.

**Chapter Two** addresses the history of banking in Uganda to show the developments of the country's banking sector at different intervals. It explains what Islamic banking entails, the principles/modes of Islamic finance. The rules and regulations that govern the concept according to the Quran. Overall, this chapter answers the question, whether Islamic banking is beneficial in solving the challenges hindering financial inclusion and economic development at large.

**Chapter Three** addresses the relevant authorities and manifesting the legal framework of Islamic Banking concerning the International and Domestic laws contributing to the development of Islamic Banks in Uganda.

**Chapter four** assesses the summary of findings, conclusions and recommendations obtained from the research.

## **CHAPTER TWO**

### **THE EVOLUTION OF FINANCIAL INSTITUTIONS IN UGANDA**

#### **2.0 Introduction**

This Chapter will address the history of banking in Uganda to show the developments the country's banking sector has taken. It also covers the economic and financial inclusion status of the country mostly to assist elucidate the degree of impact that Islamic banking is likely to have on Uganda as discussed in the section that follows next, the Islamic Banking Modes existing and to give a contextual background into the economic challenges the country faces as of today.

#### **2.1 The evolution of financial institutions in Uganda and the status of the economy and financial inclusion.**

##### **2.1.1. Background and Evolution of The Banking Sector in Uganda.**

###### **Pre-Independence Era.**

The first financial institution in Uganda was established in November 1906 and it was the National Bank of India, six years later, the second bank, Standard Bank of South Africa Limited was established in September 1912 followed by Barclays bank in 1927 and in 1954 Bank of India, Bank of Baroda and lastly the Lombank Uganda Limited opened in 1958 which introduced the hire purchase system of shopping in Uganda<sup>32</sup>. However, the banking system at that time in Uganda did not control much of the financial liquidity that was in circulation across the board in the country as Saben states that *'Much of the money was controlled in the bazaars and other channels which were predominantly controlled by people of the Asian origin. However, areas where banks were non-existent, merchants in those areas played the part of the banks.'*<sup>33</sup>

Other alternative sources of accessing credit at the time were from regular moneylenders and through domestic lending, that is, people borrowing from family members or friends for short terms and without interest.<sup>34</sup> Even the few moneylenders' activities that existed were frustrated by a legislation passed by the Uganda Protectorate government in 1951.<sup>35</sup> This Ordinance provided, *inter alia*, that money lending agreements should be in writing, all money lenders should be

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<sup>32</sup> Henry Lubega, 'The First Bank In Uganda' *Daily Monitor* March 1, 2016. Available at <http://www.monitor.co.ug/News/Insight/The-first-bank-in-Uganda/688338-2638762-tje191z/index.html> accessed on 22nd March 2024.

<sup>33</sup> HBT. "Saben's Commercial Directory and Handbook of Uganda, 1947-48." (1948): 100-100.

<sup>34</sup> Department of Cooperative Development Annual Report 1948 at Page 5.

<sup>35</sup> The Money Lenders Ordinance number 31 of 1951.

licensed, interest rates were capped at 23 per cent and no special protection was afforded to African borrowers.<sup>36</sup> Further, during the colonial times leading up to independence in October 1962, Ugandans did not hold substantive securities to obtain credit from the commercial banks and this was because they were mainly vested in subsistence agriculture and little output was left for commercial purposes.<sup>37</sup> In 1950, cognizant of this barrier to credit access, the colonial government passed the Uganda Credit and Savings Bank Act<sup>38</sup> that established the Uganda Credit and Savings Bank. Its mandate was to provide credit to Africans with the objective of furthering agriculture, commercial building and cooperative society purposes in the protectorate.<sup>39</sup> In 1950, it issued 830 application forms between 2<sup>nd</sup> October and 31<sup>st</sup> December and in response, 298 members of the general public submitted forms to the bank requesting for loans worth Uganda Shillings (UGX) 4,533,900/= . Of these, only 166 worth UGX 829,300/= were approved.<sup>40</sup>

### **Post-Independence Era; A Nascent Banking Sector**

In 1966 the Bank of Uganda (BOU) was established as the nation's Central Bank.<sup>41</sup> The Bank of Uganda under the Act had powers to control credit of banks and determine rates of interest commercial banks were to follow.<sup>42</sup> Section 4 of the BOU Act stipulates the functions of the bank. Where subsection (1), the bank is mandated with maintaining monetary stability;<sup>43</sup> be the banker to financial institutions;<sup>44</sup> supervise, regulate, control and discipline all financial institutions and pension funds institutions;<sup>45</sup>

Then followed the Idd Amin(1972-1979) era which was characterized by misguided financial policies and intermittent wars which grossly affected the banking sector.<sup>46</sup> Out of the 290 commercial bank branches existent in Uganda in 1970, only 84 existed by the end of 1987, of which 58 branches were operated by government-owned banks.<sup>47</sup> The already established foreign

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<sup>36</sup> Saben's *op cit* (n 45).

<sup>37</sup> Diana M. Hunt, 'Agricultural Credit in Uganda' *University of East Africa, 1967*. <sup>54</sup> Uganda Government Statistical Abstract 1957, P.79.

<sup>38</sup> Under Uganda Credit and Savings Bank Act, Ordinance number 20 of 1950.

<sup>39</sup> Saben *op cit* (n 45).

<sup>40</sup> Uganda Credit and Savings Bank, Annual Report, 1950, P.2.

<sup>41</sup> Established under Bank of Uganda Act 1966 which now operationalizes Article 161 of the Constitution of the Republic of Uganda, 1995 (as amended).

<sup>42</sup> section 2 of the Bank of Uganda Act Cap

<sup>43</sup> Section 4(2)(a).

<sup>44</sup> Section 4(2)(h)

<sup>45</sup> section 4(2)(j)

<sup>46</sup>The economy was suffocated by extensive administrative controls over imports, foreign exchange, financial markets, and prices of commodities all of which subsequently led to acute distortions and contraction of the formal and monetized economy.

<sup>47</sup> The History of Banks Uganda Bankers' Association. <http://ugandabankers.org/history-of-banks/> accessed on 22<sup>nd</sup> March 2024

banks, for fear of being persecuted by the government,<sup>48</sup> had to reduce further investment into the sector because of the looming uncertainty over their heads and this inadvertently and subsequently led to a reduction in bank activities in the nation.<sup>49</sup> The expulsion of the foreigners subsequently led to the expansion of government owned Uganda Commercial Bank and Cooperative Bank as the foreign owned businesses were nationalized and assimilated by public ones.<sup>50</sup>

### **A New Dawn: Bank And Economic Reform**

With the advent of the National Resistance Movement (NRM) regime in 1986, security was restored to most of the country which invigorated the banking sector and economy at large.<sup>51</sup> Many of the administrative controls on the economy were subsequently liberalized and this saw the number of branches begin to increase gradually and a rise in banking activity signaled a resilient economic recuperation.<sup>52</sup> By 1990, the number of commercial bank branches had risen to 237, consequently increasing access by the populace to financial services provided by the banks.<sup>53</sup> In between late 1980's to mid-2000, the banking sector underwent several policy, legal and regulatory reforms. There was a renewed interest in the country by the International Monetary Fund and the World Bank which gave technical and monetary assistance to restructure the Ugandan economy, mainly through Policy Framework Papers, which played a fundamental role in the economic reform of Uganda starting from 1988.<sup>54</sup> In 1987, the government with the support of both IMF and World Bank established the comprehensive Economic Recovery Program (ERP) with an aim to restore fiscal discipline, monetary stability, and price liberalization, attract foreign exchange inflows, improve the climate for private investment and savings, and rehabilitate the economy through bringing down the inflation rate and reducing the imbalances in the economy.<sup>55</sup>

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<sup>48</sup> Idi Amin had alluded to foreigners as “*bloodsuckers*” and accused them of milking the Ugandan economy of its wealth. M.Brownbridge op cit (n 80).

<sup>49</sup> *ibid.*

<sup>50</sup> The History of Banks, op cit (n80)

<sup>51</sup> Bategeka, Lawrence, and Luka Jovita Okumu. ‘Banking Sector Liberalization in Uganda: Process, Results and Policy Options.’ *SOMO Centre for research on multinational corporations, Netherland* (2010).

<sup>52</sup> *Ibid.*

<sup>53</sup> Mukwanason, Hyuha, 1994 ‘Interest rate policy and the saving-investment process in Uganda: a policy stance’, Uganda Institute of Bankers Journal, 23

<sup>54</sup> See IMF, *Experimental IMF Report on Observance of Standards and Codes: Uganda*, Washington D.C. (1999).

<sup>55</sup> John K Baffoe, “*Structural Adjustment and Agriculture in Uganda*” International Labor Organization Working Paper –WP.149 available at [http://nointervention.com/archive/Africa/Uganda/ilo\\_pub-index.htm](http://nointervention.com/archive/Africa/Uganda/ilo_pub-index.htm) last accessed on 22nd March 2024. Also see ;( World Bank, 1990, 1993; Kibirango and Kasekende, 1992; Bategeka, 1999).

### **2.1.2. Status Of the Economy development and Financial Inclusion in Uganda.**

The banking sector is a central player in economic growth and inclusivity since it is a conduit through which finances are distributed.<sup>56</sup> The status of financial inclusion in Uganda is sound, since as a member of the Alliance for Financial Inclusion (AFI), the Bank of Uganda (BOU) signed the Maya Declaration<sup>57</sup> wherein it committed to formulate financial inclusion strategies<sup>58</sup> Economic growth has accelerated slightly despite external shocks<sup>59</sup>. GDP grew by 5.3% during the first quarter of FY24, The Bank of Uganda (BoU) – the central bank – tightened monetary policy in March 2024 to curb possible passthrough effects of a fast-depreciating shilling. Low inflation, averaging 2.9% during the first half of FY24, benefitted both investments and poor households. During the second half of FY24, inflation increased – gradually to 3.4% in February 2024 but is forecast to accelerate towards the target of 5%, partly on account of the shilling depreciation recently driven by intensified portfolio outflows. Hence, on March 6, 2024, BoU raised its policy rate to 10% from the 9.5% maintained since August 2023. Accelerated growth may reduce poverty (measured at the \$2.15/day international poverty line) from 41.3% in 2024 to 40.1% by 2026.<sup>60</sup> Furthermore currently, The BOU should be lauded for this achievement however, there remains a question of whether these statistics indeed reflect what is on ground. Rachel Mindra Katoroogo, a lecturer at Makerere University Business School, Department of Finance, disagrees.<sup>61</sup> As she asserts that *“the definition of financial inclusion does not simply mean access to financial services but most importantly availability, usage and quality of the formal financial system for all income segments of the economy both urban and rural alike with dignity.”*<sup>62</sup> This assertion is valid since people may have bank accounts and operative mobile

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<sup>56</sup> Nombulelo Gumata, Eliphaz Ndou argue that banking flows lead to sectoral credit reallocations in their text, ‘Bank Credit Extension and Real Economic Activity in South Africa: The Impact of Capital Flow Dynamics, Bank Regulation and Selected Macro-Prudential Tools’ Palgrave *Macmillan* p.137.

<sup>57</sup> The Maya Declaration is the first global and measurable set of commitments made by developing countries to increase financial inclusion. It was endorsed at the Global Policy Forum held in September 2011 in the historical city of Riviera Maya in Mexico by AFI member institutions from 19 countries. They publicly declared their commitment to providing formal financial services to the then 2.5 billion people excluded from formal financial services. <https://www.afi-global.org/wp-content/uploads/2022/11/2022-Maya-Declaration-Progress-Report.pdf>

<sup>58</sup> The government formulated Vision 2040, as well as the Uganda National Development Plan 2010/11-2014/15 wherein there are commitments to improve financial inclusion based on four pillars namely; Financial Literacy, Financial Consumer Protection, Financial innovations and Improving Financial Services Data and Measurement.

<sup>59</sup> Uganda Overview: Development news, research, data | World Bank “Uganda at Glance” updated on April 03<sup>rd</sup> 2024 <https://www.worldbank.org/en/country/uganda/overview#1> Accessed 15<sup>th</sup> April 2024

<sup>60</sup> Uganda Overview: Development news, research, data | World Bank “Uganda at Glance” updated on April 03<sup>rd</sup> 2024 <https://www.worldbank.org/en/country/uganda/overview#1> Accessed 15<sup>th</sup> April 2024

<sup>61</sup> Rachel Mindra Katoroogo ‘Maya Declaration; Reality v Uganda’s commitment’ *New Vision* Available at [http://www.newvision.co.ug/new\\_vision/news/1418352/maya-declaration-reality-vs-uganda-commitment](http://www.newvision.co.ug/new_vision/news/1418352/maya-declaration-reality-vs-uganda-commitment) accessed on 22<sup>nd</sup> March 2024

<sup>62</sup> *ibid.*

money profiles but this is irrelevant if there is no availability of finances. Further the numbers do not reflect the number of withdrawals, deposits or credit/debit card swipes on accounts per month and the frequency of mobile money transactions on average per month.<sup>63</sup> So while there may be a significant number of people with accounts, this may not necessarily mean that they have access to credit.

## **2.2. The Development of Islamic Banking and its Projected Impact on Inclusive Economic Growth in Uganda**

### **2.2.1. Evolution Of Islamic Banking and its current status in Uganda**

Islamic banking system is a financial system governed by *Shari'ah* law. This is religious law derived from precepts of Islam, particularly the *Quran* and the *Hadith* which are records narrating the words, actions or habits of the legendary Islamic Prophet Muhammad (Peace Be Upon Him (PBUH))<sup>64</sup>. The origin of Islamic banking can be traced back to the dawn of Islam 1,400 years ago. Historical scholars indicate that the early years of Islam show that during the first century of Islam (AD 600), there were some forms of Islamic finance that were similar to contemporary banking transactions such as Islamic partnerships (known as *Mudarabah* in modern Islamic finance).<sup>65</sup> The medieval era began with the end of the reign of Caliph Uthman in 661 A.C though banking activities which were practiced in the former era were continued.<sup>66</sup> With the fall of the Islamic empire occasioned by the rise of the Roman Empire, there were substantial consequences on the fiscal activities of Muslim nations.<sup>67</sup>

Islamic finance revivalism however in response was first re-established in *Mit Ghamr, Egypt 1963 with the Mit Ghamr Savings Bank* and this provided a basic financial institution bouquet which included deposits, loans, equity participation, direct investments and it relied on *Shari'ah* philosophy and was welcomed by the local populace.<sup>68</sup> With time, the system spread over and by the 1970's many Islamic banks were thriving.<sup>69</sup> Some countries that were practicing Islamic finance came together under the auspices of the umbrella group, the Organization of Islamic

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<sup>63</sup> *ibid*

<sup>64</sup> Hadith come second to the Quran in development of Islamic Jurisprudence. Ibn Hajar, Ahmad. *Al-Nukat ala Kitab ibn al Salah*, Vol 1. P.90. Maktabah al-Furqan.

<sup>65</sup> Ahmad Alharbi 'Development of the Islamic Banking System' *Journal of Islamic Banking and Finance* June 2015, Vol. 3, No. 1, pp. 12-25 available at [http://jibfnet.com/journals/jibf/Vol\\_3\\_No\\_1\\_June\\_2015/2.pdf](http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/2.pdf) last accessed 22nd March 2024

<sup>66</sup> *ibid*.

<sup>67</sup> *Ibid*.

<sup>68</sup> *ibid*.

<sup>69</sup> Ariff, M, (1982). Monetary Policy in an Interest-free Islamic Economy - Nature and Scope. In Ariff, M. (Ed.), *Monetary and Fiscal Economics of Islam*. International Centre for Research in Islamic Economics, Jeddah 1982.

countries (OIC) in 1974, and established a global bank called Islamic Development Bank (IDB).<sup>70</sup> Its objective was to engage in intergovernmental activities primarily to furnish funds for economic development of projects in member countries. Thus, in Uganda on June 16<sup>th</sup> 2008 at the organization of Islamic Conference Business Forum in Kampala, The Bank of Uganda worked on the amendment of the Financial Institutions Act 2004 and submitted the proposed amendment to the Finance Ministry and the decision was taken by Parliament thus enacted the 2016 Financial Institutions Amendment Act to cater for ISLAMIC banking<sup>71</sup>

### **2.2.2 Current Status of Islamic Banking at The Global Stage and Uganda**

The global Islamic finance industry grew from US\$1.66 trillion in 2013 to US\$2.1 trillion in 2014.<sup>72</sup> Consultancy firm PricewaterhouseCoopers has projected that this industry will grow to US\$2.7 trillion by end of 2017.<sup>73</sup> According to Ernst & Young, the Islamic retail and commercial banking assets continued to grow at 16% in 2014 and 2015 by 2020, the global Islamic banking industry profit pool is slated to peak at US\$30.3 billion.<sup>74</sup> In 2019, the global Islamic financial assets stood at USD 2.733 Trillion with USD 2.014 Trillion (74%) for Islamic banking.<sup>75</sup> Such success stories on the international scene can be replicated in Uganda's emerging markets if Islamic Banking principles are properly adhered to through proper regulation

### **2.2.2. Principles/Islamic Finance Modes of Islamic Banking as a major catalyst for financial inclusion and economic development in Uganda.**

Islamic economics and finance are derived from principles rooted in the rulings of *sharia'h*. Islamic financial instruments not only need to afford the different parties a feasible profit but to do so in a manner compliant with the Islamic Law. The FIA amendment 2016 in Clause 1 (amending section 3 of the Financial Institutions Act) defines an **Islamic financial institution** as “*a company licensed to carry on financial institution business in Uganda whose entire business comprises Islamic financial business and which has declared to the Central Bank that its entire*

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<sup>70</sup> Per the Islam Development Bank website available at [http://www.isdb.org/irj/portal/anonymous/idb\\_faq\\_ar](http://www.isdb.org/irj/portal/anonymous/idb_faq_ar)

<sup>71</sup> Emmanuel Tumusiime-Mutebile: Islamic banking in emerging markets – forging Uganda's economic progress Keynote speech by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the Islamic Banking Conference, Kampala, 13 May 2016.

<sup>72</sup> PricewaterhouseCoopers, 'Islamic Finance: Creating Value,' available at [https://www.pwc.com/m1/en/publications/islamic\\_finance\\_capability\\_statement.pdf](https://www.pwc.com/m1/en/publications/islamic_finance_capability_statement.pdf) (accessed on 22nd March 2024)

<sup>73</sup> Ibid.

<sup>74</sup> Ernst & Young World Islamic Banking Competitiveness Report (2014 – 2015) available at <http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamicbanking-competitiveness-report-2014-15> accessed on 22nd March 2024

<sup>75</sup> <https://www.blossomfinance.com/series/essentials-of-islamic-finance>. Accessed on 22<sup>nd</sup> March 2024

*operations are and will be conducted in accordance with the Shari'ah.*"<sup>76</sup> then defines Islamic financial business as being financial institutions business which includes the business of receiving property into profit-sharing investment accounts or of managing such accounts any other business of a financial institution which is carried out *Shari'ah* and which includes (1) equity or partnership financing, including *musharakah*, *musharakah mutanaqisah* and *mudarahah*, (2) lease based financing, including *al-ijarah*, *alijarah muntahia bi al-tamlik* and *al-ijarah thumma al-bai*, (3) sale based financing, including *istisna'*, *bai' bithaman ajil*, *bai' salam*, *murabahah* and *musawamah*, (4) currency exchange contracts and (5) fee based activity, including *wakalah*.<sup>77</sup>

#### A) **Profit and Loss Sharing (Mudarahah)**

This is where a partner gives money to another for investing in a commercial enterprise, this money comes from the first partner called the "rabbul-ul-mal" (Investor) and the management and work is an exclusive responsibility of the "Mudarib" (Manager). The ingredients for it to be valid are that, the parties must agree right at the beginning on a definite proportion of the actual profit to give each other. It is also worth noting that the loss is suffered by the investor only since the manager didn't invest money but just the labor to work but this is on condition that the manager worked with due diligence as required, if he didn't work as required then the loss shall be shared between the two parties. Under this Principle, an Islamic bank's lending operations are based on the same principle of risk sharing, that is, when the bank lends money to a firm, it agrees to share in the losses of the underwritten business activities in return for a share of any profits.

For example, suppose a bank lent ZAR 1000 to an entrepreneur seeking to kick start a project, at 5 percent interest for a period of one year; the bank would be entitled to exactly ZAR 1050 at the end of the year, since its return is predetermined. However, the entrepreneur's return depends on the success of their project. That is, if their project's revenue exceeds ZAR 1050, they will make a profit. If it is below ZAR 1050, they will incur a loss. This draws the line between conventional Banking which is interest-based lending that vests the risk of loss entirely on the borrower (entrepreneur in this hypothetical) which under the interpretation of Islam is prohibited as sinful and unfair. So, an alternative mode of funding is used in Islamic banking, ergo Profit and Loss Sharing.

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<sup>76</sup> Section 1(m) The Financial Institutions Amendment Act

<sup>77</sup> See also Craig Nethercott and David Eisenberg, 'Islamic Finance: Law and Practice' *Oxford University Press*, 2012 in addition to section 1 of The Financial Institutions Amendment Act

Unlike conventional banking, Islamic financing is more of a trading activity than a financing one since it is mainly based on risk participation of all parties implying that two or more parties share not only the profits but also the risks of a joint venture.<sup>78</sup> This resultantly, in comparison to interest-based finance, is a fairer bargain to the parties and more so the debtor. This is because profit from business is uncertain whereas the excess amount the debtor pays accruing from interest is certain since it is predetermined. It is for this reason that Islamic banking was initially impossible to operate by virtue of sections 37 and 38 of the then FIA, 2004 but these were repealed by the FIA Amendment Act 2016 to allow this finance based module operate.<sup>79</sup> This has made way for the emergence of the Islamic finance mode of Profits and Loss Sharing possible to be applicable which has developed the economy due the less rates possessed, even the Investor is a participant in the project which makes them part of the loss and the profit.

#### B) Musharakah / Joint Venture<sup>80</sup>

This is joint enterprise in which all the partners share the profit or loss of the Joint venture through a mutual contract, and in case of the loss each partner suffers the loss according to their level of investment. With *Musharakah*, the entrepreneur makes a financial commitment to his project by supplementing with some of his own capital to that already supplied by the investor(s), exposing himself to a risk of capital loss.<sup>81</sup> Therefore unlike conventional banks that base their loan disbursement decisions mainly on creditworthiness of its applicants,<sup>82</sup> This is good for Uganda's economy where only 1 in 10,000 entrepreneurs has access to credit.<sup>83</sup> This is because although an applicant entrepreneur may not be creditworthy and with no property to use as collateral security, if their proposed project is economically promising they may succeed in securing a loan from an Islamic bank yet fail to secure a conventional bank loan for their project. This would promote

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<sup>78</sup> Mervyn K Lewis, Mohamed Ariff, Shamsheer Mohamad, 'Risk and Regulation of Islamic Banking' *Edward Elgar Publishing 2014* at page 107

<sup>79</sup> Section 37 prohibited Financial Institutions from directly or indirectly engaging in Trade, Commerce and Industry. This restriction inevitably hindered the smooth operation of Islamic Banking given that Islamic Banking is reliant on financial institutions' participation in these particular fields. Section 38 prohibited Financial Institutions from acquiring immovable property that was not intended for use in conducting banking business which basically constrained the operation of Islamic finance since in some Islamic Banking contracts, a Financial Institution must buy and therefore own the asset before reselling it to the customer at a profit.

<sup>80</sup> Section 1(m)(b)(I) FIA 2016

<sup>81</sup> Ibid

<sup>82</sup> The FI Amendment Act 2016 also introduces the Credit Reference Bureaus concept under sections 26, 78A which make it mandatory for banks to conduct credit checks on all customers applying to them for credit. <sup>208</sup> Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press) p15

<sup>83</sup> Andrew Rugasira, op cit (n138)

deeper financial inclusion status in Uganda and ease access to credit and encourage productivity and real economic activity.

### **Diminishing Musharakah.**

There is also what is known as *diminishing Musharakah* where a financier and his client participate either in joint ownership of a property or an equipment or a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically which increases the clients' own share and incase all the units are purchased the clients will become the sole owner of the property or the venture.

Therefore, unlike their conventional counterparts, Islamic banks are involved in the implementation of the projects the entrepreneur underwrites, and at times they even supply managerial know-how.<sup>84</sup> Proponents of Islamic finance posit that this technique is highly similar to the venture capital industry which has fostered the rise of many new enterprises in many advanced economies and that Islamic banking can replicate those same results.<sup>85</sup> This technical knowledge addition is likely to improve the project's success prospects and ensure returns than one where money is just disbursed without diligence done about the project's viability.

Thus, on that premise, there are high chances that Islamic banking can make an equally significant contribution to Uganda's economic development. A banking structure that pegs its loan disbursement decisions on project viability does not reject projects with excellent long-term prospects or would be entrepreneurs merely because of a bad financial track record. Consequently, it would seem to advance credit more efficiently than one that insists on demonstrated creditworthiness. The direct implication of this is rapid inclusive growth and benefit for all involved stakeholders: entrepreneurs, who find it easier to finance their projects; financial institutions, who share in the profits of the projects they underwrite; and depositors, whose investment accounts earn greater returns.

It is therefore worth to note that both *Mudarabah* and *Musharakah* require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed fairly. Consequently, given their complexity and repayment schedule and lack of proper accounting, they

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<sup>84</sup> Kuran, Timur. 'Islam and Mammon: The economic predicaments of Islamism'. *Princeton University Press*, 2004

<sup>85</sup> *ibid*

may result in substantial operating costs, particularly for micro and small enterprises that are not accustomed to formal accounting.<sup>86</sup>

### C) Murabaha/ Sale based financing<sup>87</sup>

Under this mode, a trader submits a list of goods they want to purchase to the bank. The bank then buys the goods and marks up its price as compensation for the service rendered upon which it then transfers the ownership to the client.<sup>88</sup> This exposes risk to the bank for that period before transfer. It is for this reason that the client then receives a bill at an inflated price to be paid at a date in the future.<sup>89</sup> Some scholars have criticized this as un-Islamic since the risk involved could be negligible, given that there is no minimum duration period of the bank's ownership; a minute suffices to make the transaction legitimate.<sup>90</sup> This makes *Murabaha* equivalent to an interest-based conventional banking loan: the bank bears no risk, and the client pays for the time-value of money and ultimately the only difference lies in semantics, which is that the client's payment is titled "service charge" or "markup" in one case and "interest" in the other. However Islamic banking under *Murabaha* does not involve penalties for late payment, while conventional banking requires it under interest and as such the former may be a less strenuous mode of credit access.<sup>91</sup> However for this model to be instrumental in deepening financial inclusion by reducing cost of obtaining credit, care must be made in the way banks and clients structure their arrangements. This is because managing the transfer of the assets results in operational costs that are often higher than disbursement of cash in conventional microfinance, costs that are likely passed on to the consumer.<sup>92</sup> However it should be noted that *Murabaha* is valid only where the exact cost of a commodity can be ascertained and where the commodity cannot be ascertained, it must be sold on "Musawamah" (bargaining) basis without any reference to the cost or the ratio of the profit which price will be determined in lumpsum by mutual consent.

Another mode under this branch is known as the '*bai salam*' as stipulated under Section 1(m)(b)(iii) FIA 2016. This is a sale whereby the seller undertakes to supply some specific goods

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<sup>86</sup> El-Zoghbi, Mayada, and Michael Tarazi. "Trends in Sharia-Compliant Financial Inclusion." *Brief. Washington, DC: CGAP* (2013)

<sup>87</sup> Section 1(m)(b)(iii) FIA 2016

<sup>88</sup> Usmani, Taqi. *An Introduction to Islamic Finance*. Creative Commons Attribution-No Derivative Works 3.0. p. 65.

<sup>89</sup> Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press) 2004

<sup>90</sup> Ibid

<sup>91</sup> Ibid

<sup>92</sup> El-Zoghbi, Mayada, and Michael Tarazi. "Trends in Sharia-Compliant Financial Inclusion." *Brief. Washington, DC: CGAP* (2013).

to the buyer at a future date in exchange for an advance price fully paid on spot.<sup>93</sup> The basic purpose of this sale contract is to meet the needs of the small farmers who need money to grow their crops and to feed their families up until the time of harvest.<sup>94</sup> This is a critical tool for improving credit access to the 69 percent of the Ugandan population directly and indirectly involved in agriculture.<sup>221</sup> This would subsequently improve the agricultural sector which contributes to 26 percent of the nation's Gross Domestic Product.<sup>95</sup>

#### D) *Ijara/Lease finance*<sup>96</sup>

This means a contract which enables possession of a particular intended usufruct<sup>97</sup> of the leased asset for a consideration.<sup>98</sup> The bank rents an asset to the client who is an end user for a specified duration of time at an agreed rental fee that reflects the assets' cost as <sup>99</sup>well as time-value of money. The end user retains the option of buying the asset. This has the underlying concept of risk sharing since the bank owns the asset for some time and if it is damaged during the lease period, the resulting loss would be vested on the bank.<sup>100</sup> It is worth noting that the corpus of the property remains in the ownership of the transferor but only in the usufruct.

This mode unlike *Mudarabah* and *Musharakah* has low costs of loan administration and monitoring because of its simple repayment schedule that allows for flexibility.<sup>101</sup> This could be instrumental to helping farmers access credit in Uganda. For example, if a farmer is in need of initial physical capital like a tractor or any equipment, the Islamic financial institution can buy the equipment and lease them to the client.<sup>102</sup> If the farmer however wishes to buy the equipment, the bank sells it to them at a markup price.<sup>103</sup> The farmer (client) pays back the price in agreed upon installments in the future.

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<sup>93</sup> Kaleem, Ahmad, and Saima Ahmad. "Bankers' perception towards Bai Salam method for agriculture financing in Pakistan." *Journal of Financial Services Marketing* 15.3 (2010): 215-227.

<sup>94</sup> Usmani, M.T. (1998) *An Introduction to Islamic Finance*. Karachi, Pakistan: Idaratul Ma'arif, p.186 Deloitte, 'Uganda Economic Outlook 2016.; *The Story Behind the Numbers* at page 10

<sup>95</sup> Ibid

<sup>96</sup> Section 1(m)(b)(ii) FIA 2016

<sup>97</sup> Usufruct is the legal right to use and derive profit or benefit from property that belongs to another person as long as the property is not damaged as defined in the Oxford Learners Dictionary 7<sup>th</sup> Edition.

<sup>98</sup> Section 1(m)(b)(iii) FIA 2016

<sup>99</sup> Ghuddah, Abdul Sattar Abu. 'Ijarah (lease).' *Dallah Al-Baraka Group Al-Baraka Banking Group (ABG) Department of Research & Development* (1998)

<sup>100</sup> Timur Kuran, op cit (n30)

<sup>101</sup> Hassan, Abul. 'Financial inclusion of the poor: from microcredit to Islamic micro financial services.' *Humanomics* 31.3 (2015): 354-371.

<sup>102</sup> Iqbal, Zamir, and Abbas Mirakhor. 'Economic development and Islamic finance.' *World Bank Group*, 2013.

<sup>103</sup> *ibid*.

#### E) **Salam (Forward sale)**

This comes as an exception, from the general rule in Islamic Banking. The General rule from validity of a sale in Shariah is the commodity intended to be sold must be in the physical or constructive possession of the seller. However, under Salam, the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.<sup>104</sup> The conditions for such a sale are that the buyer pays in full to the seller at the time of effecting the sale, it can be effected in contracts commodities only the quality and quantity of which can be specified exactly, It is done only where the quality of the commodity is to be fully specified leaving no ambiguity which may lead to a dispute and where the quantity of the commodity is agreed upon in unequivocal terms and lastly, the exact date and place of delivery must be specified in the contract. It should be noted that salam cannot be affected in respect of things which must be delivered on spot.<sup>105</sup> This nature of Islamic Banking is normally framed to fulfill the needs of traders and farmers which encourage productivity and real economic activity through agricultural farming support and facilitation.

#### F) **Istisna (Manufacturing contract)**

This is the second kind of sale where a commodity is transacted before it comes into existence. This means to order for a specific commodity from a manufacturer by a purchaser which has not yet been manufactured.<sup>106</sup> For its validity, the price must be fixed with the consent of the parties and that necessary specification of the commodity is fully settled between them. However, it must be noted that its only on goods that need manufacturing, it isn't necessary to pay full amount and the purchaser has the power to cancel the contract before the manufacturer starts the work.<sup>107</sup>

#### G) **Sukuk (Islamic Bonds)**

These are Islamic equalities to bonds, Suku securities are structured to comply with Islamic law since fixed income, interest bearing bonds are not permissible as these prohibit the charging and

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<sup>104</sup>Article 21 in Learning Series “[Essentials of Islamic Finance](https://www.blossomfinance.com/series/essentials-of-islamic-finance)” Introduction to Salam (Forward Sale) Contracts <https://www.blossomfinance.com/series/essentials-of-islamic-finance> accessed on 22nd March 2024

<sup>105</sup> Ibid

<sup>106</sup> Article 26 in Learning Series “[Essentials of Islamic Finance](https://www.blossomfinance.com/posts/application-of-istisna-in-islamic-financial-institutions)” “Application of Istisna in Islamic Financial Institutions” accessible on April 26<sup>th</sup> 2020 <https://www.blossomfinance.com/posts/application-of-istisna-in-islamic-financial-institutions> accessed on 22nd March 2024.

<sup>107</sup> Ibid

paying of interest.<sup>108</sup> The basic concept behind Sukuk is for the holders of the sukuk to share in the profits of large enterprises or in the revenues and among the benefits of sukuk. It enables financing large enterprises that are beyond the ability of a single party to finance, it also represents an excellent way of managing liquidity for banks and Islamic financial Institution when they are in need of disposing of excess liquidity, they may purchase sukuk and when they are in need of liquidity, they may sell their sukuk into the secondary market. The most common type of Sukuk is in form of Trust certificates<sup>109</sup>

#### H) **Bai muajjal (deferred payments)**

This means deferred payment or credit sale where by the seller notifies the buyer the cost and selling price and the final payment may be made in installments or in lump sums. *Bai muajjal* may include *bai- muajjal murabaha* since all deferred payments are in installments or lump sum Spot price may be lower than deferred payment price.<sup>110</sup> There are certain conditions that must be fulfilled in *bai muajjal* transactions. These among others include; the price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without qualms as *riba*. Secondly, complete or total possession of the object in question must be given to the buyer while the deferred price is to be treated as debt against him. Lastly, in order to secure the payment of price, the seller may ask the buyer to furnish a security either in the form of mortgage or in the form of an item.<sup>111</sup>

#### I) **Kafalah (Guarantee)**

*Kafalah* is a financial guarantee where by the bank gives a pledge to the creditor on behalf of the debtor to cover fines or any other personal liability.<sup>112</sup> These guarantee transactions are widely used in conjunction with other financing modes or documentary credits.<sup>113</sup> In otherwards, these are guarantee transactions provided by the insurer, *kafil* to the third party or insured to fulfill the obligation of the second party. Under this kind of transaction, the bank acts as the provider of the

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<sup>108</sup> What is a Sukuk? Sharia-complaint Bond-Like Financial Instruments by Akhilesh Ganti accessible on May 13, 2022 <https://www.investopedia.com/terms/s/sukuk.asp> accessed on 22nd March 2024

<sup>109</sup> ibid

<sup>110</sup> Enrique Gelbard, Mumtaz Hussein, Rodolf Maino, Vibin Mu and Etienne B Vehove, “Islamic Finance in SubSaharan Africa: Status and Prospects”, *IMF Working Paper* 2014, page 8.

<sup>111</sup> Dr. Muhammad Imran Ashraf Usmani, “A Guide to Islamic Banking”, above, page 132.

<sup>112</sup> Mumtaz Husein, Asghar Shahmoradi and Rima Turk, “An Overview of Islamic Finance”, *IMF Working Paper*, 2015, pg10.

<sup>113</sup> Ibid page 10

guarantee in fulfilling customer's obligation to the third party. In Uganda, guarantees are generally provided for under the *Contracts Act 2010*. Guarantees are good securities used in business transactions.

#### J) **Takaful (Islamic insurance)**

*Takaful*, is an alternative to conventional insurance. Unlike conventional insurance which is a commercial contract based on the happening of the event, *takaful* insurance is the insurance based on the *shari'ah* concepts of mutuality and cooperation. That is, several individuals agree to pool resources with the understanding that in case of need, each of them is entitled to draw resources from the pool.<sup>114</sup> The arrangement is beneficial for both the operator and the participant. Conventional insurance is not permitted in Islamic banking because it involves the trading of uncertainties which is against Islamic teachings. In this case the insured party pays the insure for an object, for example the monetary compensation in case of an accident that she may never receive (that's to say if the accident never takes place).<sup>115</sup> It should also be noted that conventional insurance is similar to gambling (*qimar*) which is prohibited in Islamic teachings in relation to Islamic banking and finance. Alternatively, conventional insurance is not accepted in Islamic banking because of insurance's practices of holding interest-bearing assets.<sup>116</sup>

However, Islamic insurance can be conducted by Islamic financial intuitions under Part X11B of the *Financial Institutions (Amendment) Act 2016*. This part covers Banc assurance by financial institutions. Banc assurance has been defined under section 115D (4) of FIA 2016 to mean "using a financial institution and its branches, sales network and customer relationship to sell insurance products." In addition, *Takaful* has been introduced under section 3 of the *Insurance Act, 2016*. However, the Insurance Act does not provide details on how it will be conducted. It is assumed that this can be provided for in the regulations.

#### K) **Wakala (Agency Contract)**

This product is based on an agency contract or relationship. It results from the bank acting as the agent of the customer in a trade transaction or issuing a letter of credit facility.<sup>117</sup> In Uganda, the

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114 Juan Sole, "Introducing Islamic Banking System", *IMF Working Paper* 2007, page 12.

115 Ibid

116 Ibid

117 Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An Overview of Islamic Finance", *IMF Working Paper*, 2015.

law of agency is under the Contract Act, 2010. However, the Financial Institution (Amendment) Act 2016 states that all contracts for Islamic finance business have to comply with *shari'ah* and satisfy any conditions specified by the Bank of Uganda for that purpose.<sup>118</sup> It is evident that the FIA 2016 will be followed by a number of regulations to operationalize it. At the moment, the Regulations for Islamic banking is not yet gazetted.

In a nutshell, from analyzing all these modes of Islamic finance, it is seen that the capital structure of Islamic banks as seen above comprises of substantial portion of equity participation with comparatively higher equity to asset ratio. This trait renders Islamic finance with a superior stability position than its conventional counterparts.<sup>119</sup> The same reasons have been advanced for Islamic finance's resilience in the midst of the 2008 global financial crisis.<sup>120</sup> This would therefore be important for Uganda whose banking sector has been characterized by instabilities.

### 2.2.3. The Islamic windows

Under section 115 A (1 to 3) of the FIA 2016, a financial institution carrying on business, may apply to the Central Bank to carry on Islamic financial business in addition to its existing licensed business through an Islamic window. This means the part of a financial institution, other than an Islamic financial institution, which conducts Islamic financial business.

This is beneficial to Islamic finance because Islamic banking services benefit/freeload from the structures and network that conventional banks have already established without having to start from scratch. This would subsequently improve the quality of services and lower their cost, which could improve intermediation between the two.<sup>121</sup> As seen in chapter 2, one of the key challenges faced by government in deepening financial inclusion is the high cost of accessing credit.<sup>122</sup> Therefore the lowering of costs that come with the Islamic banking windows could help alleviate this challenge. Windows also do this by increasing competition in the market, which could reduce the cost of credit access for *Shari'ah*-compliant products.<sup>234</sup>

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118 Section 1 (m) *FIA 2016*

119 Ahmed, Habib. "Financial crisis, risks and lessons for Islamic finance." *ISRA International Journal of Islamic Finance* 1.1 (2009): 7-32.

120 Chapra, M. Umer. "The global financial crisis: can Islamic finance help?" *Islamic Economics and Finance*. Palgrave Macmillan UK, 2011. 135-142.

121 Inwon Song and Carel Ousthuizen, "Islamic Banking Regulation and Supervision; Survey results and challenges," IMF Working Paper 14/220 (Washington: International Monetary Fund 2014).

122 Uganda ranks in the 120<sup>th</sup> position out of 138 states in affordability of financial services. The Economic Forum Global Competitiveness Report (2016-2017) <sup>234</sup> Inwon Song, op cit (n232).

Further, Islamic banking windows facilitate liquidity management, especially in countries where Islamic liquidity instruments are finite.<sup>123</sup> Windows usually have easy access to liquidity support from the conventional part of the bank. This could assist in stabilizing the banking sector which as seen in chapter 2 under challenges hindering financial inclusion, is growing concern.<sup>124</sup> In addition for countries with small demand for Islamic banking services especially those with a low Muslim population, (like Uganda<sup>125</sup>) the window could be the only feasible way of providing Islamic Banking services, thus increasing financial inclusion.<sup>126</sup>

In conclusion, as discussed above, Islamic finance emphasizes trade in assets more than it does in financing consequently facilitating trade by assisting business people get the usufructs of assets which they could not have owned by themselves hence inducing a productive inclusive economy. Therefore, for this to work out properly there needs to be a well-founded regulatory and supervisory structure that not only heed to *Shari'ah* law of finance but also allows the banking sector to thrive.

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<sup>123</sup> *ibid.*

<sup>124</sup> The third biggest bank in Uganda, Crane Bank was according to the Central Bank shut down because it was under-capitalized and that had posed systemic risk to the banking sector. See Governor Bank Of Uganda Press release available at [https://www.bou.or.ug/bou/bou-downloads/press\\_releases/2016/Oct/PRESS-RELEASECrane-Bank-Oct-20-2016.pdf](https://www.bou.or.ug/bou/bou-downloads/press_releases/2016/Oct/PRESS-RELEASECrane-Bank-Oct-20-2016.pdf) last accessed on 22nd March 2024.

<sup>125</sup> According to the 2014 census, 14 percent of the population adhered to Islam.

<sup>126</sup> Inwon Song, *op cit* (n232).

## CHAPTER THREE

### LEGISLATIVE FRAMEWORK, PROSPECTS AND CHALLENGES OF ISLAMIC BANKING IN UGANDA.

#### 3.0. Introduction

Islamic banks are prone to a variety of risks; therefore, they need legal and regulatory frameworks as much as conventional banks do. The aim of these frameworks should be to reinforce bank's operating environment, internal governance and market discipline to help address moral hazard considerations, safeguard the interest of demand depositors, and systemic risk. Therefore, this Chapter will address the legal framework of Islamic banks in connection to the supreme supervisory board (The bank Of Uganda) and the Shariah Advisory board. At the feet of this chapter, the research gives an analysis on the key issues affecting Islamic banking business under the Uganda legal framework especially by examining the FIA 2016 and other laws that govern Islamic Banks Today.

#### 3.1. Legislative Framework and Challenges of Islamic Banking

##### 3.1.1 International Instruments that Regulate Islamic Banking System

The growth opportunity as well as the challenges facing the development of Islamic financial industry in the global market have raised public policy issues in the jurisdiction in which they operate internationally. These have led international Organizations, International Standard Setters, National Regulatory Authorities, policy makers and academia to examine various aspects of Islamic Finance intermediation each from their own perspective. Focus has been directed notably on the Islamic Financial Institutions, risk management practices, the broad institutional environment in which they operate and the regulatory framework that governs them.<sup>127</sup>

It is worth noting that there are a number of institutions have been established to become focal points on major issues. These Institutions in particular are The Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI). This is an Islamic international autonomous accounting, auditing, governance, ethics and *shari'ah* standards for Islamic financial institutions and the industry professional qualification programs. These programs include the

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127 D.El-Hawary, "Regulating Islamic Financial Institutions, The Nature of the Regulated", George Washington University, pg. 2, available at <http://www.researchgate.net/...Islamic->

CIPA, the *Shari'ah* Adviser and Audit “CSAA” and the Corporate Compliance Programs) which are presented now by the AAOIFI in its efforts to enhance the industry’s human resources base and governance structures.<sup>128</sup> The International Islamic Rating Agency (IIRA) has been set up to provide independent assessments to issuers and issues that conform to principles of Islamic finance. IIRA’s special focus is on development of local capital markets, primarily in the region of the Organization of Islamic Conference (OIC) and to provide impetus through its ratings to ethical finance across the globe.<sup>129</sup> The Islamic Financial Services Board (IFSB) is an international body that sets standards and offers guidance for Islamic banking and Finance Regulation and Supervisory Agencies. This is an Islam specialized international standard-setting organization. It promotes stability of the Islamic banking sector by issuing international prudential standards and guiding principles for the sector, generally defined to include banking, capital markets and insurance sectors.<sup>130</sup> It researches and coordinates initiatives on Islamic finance related issues and organizes seminars and conferences for regulators and industry stakeholders.<sup>131</sup> Unlike the BCBS which relies on regulatory frameworks and best practices developed by leading banks as a background to its global framework; the IFSB has the task of developing on its own mind, the framework specifically for Islamic banks.<sup>132</sup> The Liquidity Management Center (LMC) is a wholesale Islamic bank regulated by the Central Bank of Bahrain. Its aim is to provide optimal Islamic financing and investment solutions which contribute to the growth of the Islamic capital markets.

### **3.1.2 Regional Laws that govern Islamic Banking**

In jurisdictions such as Iran<sup>133</sup> and Malaysia<sup>134</sup> there are specific Islamic banking laws, and in other jurisdictions such as Kuwait there have been separate provisions added to the banking law to cater for Islamic finance.<sup>135</sup> In most Arab jurisdictions Islamic finance is governed at the regulatory level. In North Africa there are no comprehensive Islamic banking laws apart from the

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<sup>128</sup> AAOIFI, available at [aaoifi.com/](http://aaoifi.com/)

<sup>130</sup> LMC available at [www.imcbahrain.com/](http://www.imcbahrain.com/)...

<sup>129</sup> IIRA, available at [iirating.com/corprofile.ax](http://iirating.com/corprofile.ax)

<sup>130</sup> See <http://www.ifsb.org/> (last accessed on 22<sup>nd</sup> March 2024).

<sup>131</sup> *ibid.*

<sup>132</sup> Rifaat Ahmed, Abdel Karim, Simon Archer. *Islamic Finance; The New Regulatory Challenge*. Wiley Publishers. Pg 8.

<sup>133</sup> Law on Usury Free Banking, Iran, Tehran, 1983.32

<sup>134</sup> Islamic Banking Act of Malaysia, Kuala Lumpur, 1983 33

<sup>135</sup> Central Bank of Kuwait, Legislation, Safat, 2004, Section 10

limited provisions made in Egypt under law number 48 of 1977. The licensing requirements for Islamic banks are identical to those for conventional banks in terms of capital requirements, however there has not been regional laws that Govern Islamic banking thus all the African countries that practice Islamic Banking have formulated their own legislations which govern the Islamic banking system.

### **3.1.3 Domestic legislations Regulating and Controlling the Financial sector in Uganda**

#### **1. The 1995 Constitution of Uganda as amended**

The *Constitution of Uganda*<sup>136</sup> or the ones before it did not provide for anything related to Islamic banking. This is because the constitution cannot provide for all laws in the country, as it is only meant to serve as an enabling law. The Constitution establishes the Central bank (Bank of Uganda),<sup>137</sup> this acts as the central bank of the entire banking sector under which Islamic banking falls. The Central Bank is also mandated in the same Constitution to supervise the entire banking sector as its central role.<sup>138</sup> The parliament is mandated to make laws prescribing and regulating the functions of Bank of Uganda.<sup>139</sup> It is from this background therefore that the parliament and other arms of Government are mandated to license and supervise Islamic banks subject to the provisions of the constitution.

#### **2. The Bank of Uganda Act**

**The Bank of Uganda** (which serves as the Central bank) was established on the August 15<sup>th</sup> 1966. The enactment of *Bank of Uganda Act*<sup>140</sup> promoted the banking sector since it enhanced the implementation of monetary policy. The *Bank of Uganda Act* provides the central bank (Bank of Uganda) with the responsibility of overseeing the country's monetary policy. The powers are derived from Article 161 of the *Constitution of the Republic of Uganda of 1995* which provides that, "The Bank of Uganda shall be the Central bank of Uganda and shall be the only authority to issue the currency of Uganda." The functions of the Bank of Uganda are considered under Article 162(1) of the *Constitution* which provides the Bank of Uganda shall promote and maintain the

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136 Article 161, *Constitution of the Republic of Uganda 1995*.

137 The *Constitution of the Republic of Uganda 1995*.

138 Ibid.

139 Article 162 (3), *Constitution of the Republic of Uganda 1995*.

140 Cap 51.

stability of the value of the currency of Uganda, regulate the currency system in the interest of the economic progress of Uganda, encourage and promote economic development and efficient utilization of the resources of Uganda through effective and efficient operation of a banking and credit system.

The *Bank of Uganda Act, Cap 51* plays a major role in terms of regulating the aspects of supervision and monitoring of the implementation of Islamic banking in Uganda. For instance, in providing effective *Shari'ah* governance of the *Shari'ah* Advisory Board of various Islamic financial institutions. *Section 4 of the Bank of Uganda Act* provides the functions of Bank of Uganda. In particular *section 4(2)(j) of Bank of Uganda Act* provides that BOU shall “Supervise, regulate, control and discipline all financial institutions and pension funds institutions.” The Central Bank has the duty of supervising, regulating, controlling and disciplining all financial institutions. The *Bank of Uganda Act*<sup>141</sup> vests Bank of Uganda with the authority of issuing the legal tender, maintaining the value of legal tender and sustaining monetary stability and sound financial system in the country and acts as the banker and financial adviser of the government, it also acts as the banker of the last resort and as the clearing house for financial institution.<sup>142</sup>

### **3) The Financial Institutions Act 2004**

*Section 79 FIA 2004* provides for the inspection of financial institutions in Uganda. The aim is to promote and maintain adequate and reasonable banking services for the public and to ensure high standards of conduct and management throughout the banking system. *Section 88(1) FIA 2004* provides that the Central Bank may take over the management of a financial institution if it is conducting its business in a manner contrary to the Act; the continuation of its activities is detrimental to the interests of depositors; it refuses to submit itself to inspection by the Central Bank; its license has been revoked under the Act and it is engaged in or is knowingly facilitating criminal activities. *Section 88(1) FIA 2004* provides that the Central Bank may take over the management of a financial institution if it is conducting its business in a manner contrary to the Act; the continuation of its activities is detrimental to the interests of depositors; it refuses to submit itself to inspection by the Central Bank; its license has been revoked under the Act and it is engaged in or is knowingly facilitating criminal activities.

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<sup>141</sup> 2000, Cap 51.

<sup>142</sup> Part vii, sub section 36-39, Bank of Uganda Act 2000, Cap 51.

## 2) The Financial Institutions Amendment Act 2016

### The Shariah Advisory Board

The FIA 2016 establishes a Central *Shar'iah* Advisory Council at the Bank of Uganda. The Bank of Uganda shall have a Central *Shari'ah* Advisory Council to advise the Bank of Uganda on matters of regulations and supervision of Islamic banking systems in Uganda and to approve any product to be offered by financial institutions conducting Islamic banking.<sup>143</sup> In addition, every financial institution which conducts Islamic financial business to appoint and maintain a *Shari'ah* Advisory Board.<sup>144</sup> It is a requirement that every financial institution that conducts Islamic financial business have its own *Shari'ah* Advisory Board with the bank itself. A “*Shari'ah* Advisory Board” is a Board appointed by a financial institution in accordance with the FIA to advise, approve and review activities of an Islamic financial business in order to ensure that the financial institution complies with the *Sharia'h*.<sup>145</sup> In practice, this board will have to operate under the guidelines offered by the Central *Shari'ah* Advisory Council.

The Central Bank shall be the one to make regulations in respect of *Shari'ah* Advisory Boards including, the size, functions, duties and responsibilities, governance and conduct of *Shari'ah* Advisory Boards, the competency, interests and terms of engagement of a members of a *Shari'ah* Advisory Board; and the policies, procedures, record-keeping, reviews, reporting and disclosure.<sup>146</sup> However, the appointment, maintenance, operation and conduct of a *Shari'ah* Advisory Board shall at all times be carried out in accordance with any applicable rules and policies of the respective financial institution and it shall be the responsibility of the board of directors of the financial institution.<sup>147</sup> As *Shari'ah*-compliance is the lifeblood of Islamic banking, an Islamic bank's compliance with applicable *Shari'ah* standards will be determined by Central *Shari'ah* Advisory Council.

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143 Section 115 B (2) FIA 2016.

144 Section 115 B FIA 2016.

145 Section 115 (2) FIA 2016.

146 Section 115B (3) FIA 2016.

147 Section 115B (4) FIA 2016.

It should be noted that the Act does not spell out whether the ruling of the Central *Shari'ah* Advisory Council shall be final and binding to institutions offering Islamic banking and financial products in Uganda. Unlike in Malaysia, under sections 55 to 57 of the *Central Bank of Malaysia Act 2009* make it a requirement for Islamic financial institutions, the court or an arbitrator to refer matters that involve ascertainment of Islamic law to the *Shar'iah* Advisory Council whose ruling shall be final and binding. The absence of a clear position on the powers of the Central *Shari'ah* Advisory Council may create conflict of jurisdiction and conflicts among the stakeholders within the Islamic banking business.

The Act makes it compulsory to the financial institution to follow and meet all the guidelines and procedures issued by *Shari'ah* Advisory Boards. The financial institution should apply to the Central Bank for its approval, of a person nominated to be appointed as a member of the financial institution's *Shari'ah* Advisory Board.<sup>148</sup> The Central Bank shall in considering an application for approval take into consideration whether the person proposed for appointment possesses sufficient qualifications and experiences in *Shari'ah* and Islamic banking, possesses sufficient experience of the financial services industry and in respect of the chairperson, has served on the *Shari'ah* Advisory Board of another reputable financial institution conducting Islamic financial business.<sup>149</sup> It is submitted that a person should possess necessary knowledge, expertise or experience in Islamic jurisprudence (*Usul al-Fiqh*); or Islamic transaction/commercial law (*Fiqh al-Mu'amalat*) in order to be a member of *Shari'ah* Advisory Board. It should be noted that members of a *Shari'ah* Advisory Board are deemed to be public officers. An officer or servant of a financial institution "or a member of a *Shari'ah* Advisory Board" shall be deemed to be a person employed in the public service for the purposes of sections 87, 89 and 93 of the *Penal Code Act*.<sup>150</sup> In particular, those sections under the *Penal Code Act* refer to the abuse of office, issuing false certificates and threat of injury to persons employed in public service, respectively. Any person violating those provisions commits an offence and liable for conviction as stated in the Penal Code, accordingly. The fit and proper person criteria as provided under the 3<sup>rd</sup> Schedule to the FIA 2004 is not sufficient to cater for the basic qualification for a desirable person to be fit person to sit on a *Shari'ah* Advisory board. The ingredients provided to determine the fit and proper

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148 Rule 13(1), The Financial Institutions (Islamic Banking) Regulations, 2018.

149 Rule 13 (2) *ibid*.

150 Section 121 FIA 2016.

person leaves out the members of the *Shari'ah* Advisory Board. Specific guidelines should be worked upon for proper operations of the Islamic financial business.

### **Regulation under the FIA**

One of the milestones of Uganda banking law developments is the *Financial Institutions (Amendment) Act 2016* which amended some of the provisions of the *Financial Institutions Act 2004*. The amendments introduced Islamic banking into Ugandan banking sector. Another important feature of the amendment is the introduction of dual banking systems in Uganda under a single regulatory framework unlike in some countries like Malaysia that have separate legislation for Islamic banking.

Like conventional banking, Islamic banking can only thrive with the existence of an enabling legal and supervisory framework. In recognition of this fact, therefore, Bank of Uganda proposed amendment of the FIA 2004 which were approved by the parliament and hence the enactment of the *Financial Institutions (Amendment) Act 2016*, in January 2016.<sup>151</sup> The amendments to then FIA, 2004 were intended to embrace Islamic banking and focused on the impediments that will also be discussed in this study.

A bank is defined under the FIA 2016 as a company licensed to carry on financial institution business as its principal business, as specified in the Second Schedule of the Act and includes all branches and offices of that company in Uganda.<sup>152</sup> In case law, the definition of a bank, two cardinal principles have been laid down by the courts in constructing the common law definition. In the first place, the meaning of banking business can change from time to time. In the case of **Woods Vs Martin Bank Ltd**<sup>153</sup>, Court was invited to determine whether the giving of advice on the financial matters constituted banking business. Salmon J at page 70 that, “*The limit of a banker’s license cannot be laid down as a matter of law; the nature of such a case can be a matter of fact and accordingly cannot be treated as if it were matter of pure law.*” On the above case, Court relied on the fact that the bank held itself as being in a position to advise its customers on the investment.

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<sup>151</sup> Tumusiime.E. Mutebile, above, p.1

<sup>152</sup> Section 3, *FIA* 2004.

<sup>153</sup> (1959)1 QB55.

*Section 2 of FIA* provides that the Act applies to a financial institution as defined in *section 3 of this Act*. This means that the Act applies to both Islamic financial institutions and conventional banks. In practice, Uganda so far has a dual banking system; that is conventional banking and Islamic banking systems which are regulated by one legislation i.e. the *Financial Institutions (Amendment) Act 2016*. *Section 3 of the Financial Institutions Act, 2004*, defines a financial institution to mean a company licensed to carry or conduct financial institutions business in Uganda and includes a commercial bank, merchant bank, mortgage bank, post office saving bank, credit institution, a building society, an acceptance house, a discount house, a finance house or any institution which by regulation is classified as a financial institution by the Central Bank. The second schedule of the Financial Institutions Act provides more details of the types of financial institutions and their related businesses. As part of the single regulatory framework, a bank carrying out Islamic banking activities will be required to comply with the same set of rules and regulations as any other bank in Uganda although there are some exemptions or waivers given to Islamic financial banks. In addition, Islamic banks will have separate regulations on specific item for their operations as specified under the FIA 2016.

However, there are various laws that affect the financial sector in general. The financial regulatory framework addresses risks to a bank's soundness like risk to solvency, liquidity risk, credit risk and market risk which both Islamic and conventional banks are exposed to.

**“Islamic bank”** means an Islamic financial institution which is a bank.<sup>154</sup> An Islamic financial institution is a company licensed to carry on financial institution business in Uganda whose entire business comprises Islamic financial business and has declared to the Central bank that its operations are and will be conducted in accordance with *Shari'ah*.<sup>155</sup> A financial institution may describe its Islamic financing business as “Islamic banking business” and if it is an Islamic financial institution, may describe its self as an “Islamic bank”.<sup>156</sup> This means that an Islamic financial institution will have to make a declaration to the Central Bank that it intends to operate Islamic financial services.

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154 Section 1(m), *FIA* 2016.

155 Section 1(e) note 18.

156 Section 3 note 18.

The financial institutions were prohibited from directly or indirectly engaging in trade, commerce and industry.<sup>157</sup> This restriction inevitably impeded the smooth operation of Islamic banking given that Islamic banking is anchored on financial institutions' participation in these sectors. Financial institutions were also prohibited from acquiring immovable property that was not intended for use in conducting banking business.<sup>158</sup> According to the Islamic banking and finance law, some Islamic banking contracts require a financial institution to buy and own the assets before reselling them to the customer at a profit. This very critical process was rendered impossible under the FIA, 2004. The FIA 2004 was therefore amended to lift the above-mentioned restrictions for Islamic banks and conventional banks that would want to offer Islamic banking products and services.

### **Nature of Islamic banking Products under the Act**

Part XIII A of the *Financial Institutions (Amendment) Act 2016* provides for special provisions on Islamic Banking. The *Financial Institutions (Amendment) Act 2016* defines "Islamic financial business" to mean financial institution business which conforms to the *Shari'ah* and includes; the business of receiving property into profit sharing investment accounts or of managing such accounts; any other business of a financial institution which involves or is intended to involve the entry into one or more contracts under *Shari'ah* or otherwise carried out or purported to be carried out in accordance with the *Shari'ah* including: equity or partnership financing, including *Musharakah*, *Musharakah mutanaqisah* and *mudarabah*; lease based financing, including *alijarah*, *alijarah muntahia bi al-tamlik* and *al-ijarah thumma al-bai*; sale based financing, including *istisna`*, *bai` bithaman ajil*, *bai` salam*, *murabahah* and *musawamah*; currency exchange contracts; fee based activity, including *wakalah*; the purchase of bills of exchange, certificates of Islamic deposit or other negotiable instruments; the acceptance or guarantee of any liability, obligation or duty of any person; the business of providing finance by all means including through the acquisition, disposal or leasing of assets or through the provision of services which have similar economic effect and are economically equivalent to any other financial institution business;<sup>159</sup>

Islamic financial institutions will also engage in Profit Sharing Investment Accounts. Profit Sharing Investment Accounts is defined under *section 3 FIA 2016* as accounts managed by a

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157 Section 37, *FIA*, 2004.

158 Section 38, *FIA*, 2004.

159 Section 3 *FIA (Amendment) Act 2016*.

financial institution in relation to property of any kind including currency specified by the Central Bank by regulations, held for or within the account as part of its Islamic financial business; and under the terms of an agreement where the account holder agrees to share any profit with the financial institution as manager of the account in accordance with a determined specified percentage or ratio; and the account holder agrees that he or she will bear any losses in the absence of negligence or breach of contract on the part of the financial institution.

Islamic banking will also cover Purchase agreement which will include Islamic contracts specified for that purpose by the Central Bank by regulations.<sup>160</sup> In addition, Islamic banking will also cover “short position” or “short open position” or “oversold position” of a financial institution in a foreign currency which is a holding by the financial institution of that foreign currency for its own account is less than all its contractual spot, same day value and forward transaction commitments in that foreign currency or economically equivalent positions or holdings in respect of Islamic contracts.<sup>161</sup>

The Second Schedule (Part B) to the Act provides the Non-Bank Financial Institutions. This part covers credit institutions, finance houses and Islamic Financial Institutions. Part (iv)(a) of the Second Schedule covers Islamic Financial Institutions. Services to be offered are: to mobilise funds in the form of deposits such as savings deposits, or other compatible forms based on contracts compatible with *Shari'ah*; to invest in products based on contracts compatible *Shari'ah*; to distribute financing of leasing moveable or immovable goods to customers based on the contract *ijarah* or lease purchase in the form of *ijarah* or other contract compatible with *sharia'h*; to grant loans or debt based on contracts compatible with *shari'ah* ; to conduct custody for the interest of other parties, such as providing safety deposit boxes, based on contracts compatible with *shari'ah*; to transfer money both for own interest and interest of the customers based on the contracts compatible with *shari'ah*, to function as trustees based on contracts of *wakala*, to provide letters of credit facilities and bank guarantees based on contracts compatible with *shari'ah* and to engage in any other *shari'ah* compliant banking business.

The *Financial Institution (Amendments) Act, 2016* also amended some of the definitions under section 3 by incorporating Islamic banking in their definitions. In particular Islamic banking

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160 Section 3 FIA 2016 as amended

161 Ibid.

business is expected to cover the following: “acceptance house, Commercial bank, deposit substitutes, discount house, and finance house, financial institution and merchant bank, microfinance business and mortgage bank.<sup>162</sup> The Financial Institutions (Amendment) Act had added on their original definitions under FIA 2004 the following words: “and economically equivalent Islamic financial business subject to any restrictions specified by the Central Bank by regulations.” The nature of these products and services which are to be offered by an Islamic financial institution are discussed in chapter two of this study. It should be noted that in all those definitions, an Islamic financial institution will operate subject to any restriction specified by the Central Bank by regulation. Although these banks have to operate in accordance with *Shari’ah* principles but the *Shari’ah* principles may be restricted by the Central Bank’s regulations. At the writing of this study, the Islamic banking regulations are not yet in place to determine whether they are in conformity with the *Shari’ah* principle or not.

### **Licensing Islamic Financial Business**

Section 4(1) of FIA provides that “a person shall not transact any deposit-taking or other financial institution business in Uganda without a valid license granted for that purpose under this Act”. Furthermore, no person shall be granted a license to transact business as a financial institution unless it is a company within the meaning of the Act<sup>163</sup>. In addition, a person licensed to carry out financial institutions business may carry out the licensed business through an agent.<sup>164</sup> In order to transact the business properly the Central Bank in consultation with the Minister shall make regulations in respect of agents and agent banking. Financial institution shall not transact any financial institution business not specified in its license or effect any major changes or additions to its licensed business or principal activities without the approval of the Central Bank.<sup>165</sup> This implies that the BOU must approve all business transactions. Any person intending to establish an Islamic bank should apply for a license in accordance with the Financial Institutions (Licensing) Regulations, 2005.<sup>166</sup> Furthermore an already licensed financial institution may apply to the Central Bank, for the approval to carry on Islamic financial business through an Islamic

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162 Ibid

163 Section 4(2), FIA(Amendment) 2016.

164 Ibid.

165 Section 4(3), note 31.

166 Regulation 4, The Financial Institutions (Islamic Banking) Regulations, 2018.

window.<sup>167</sup> Holding the appropriate license for an Islamic financial institution and to hold deposits a bank shall comply with Section 4(4) (c) FIA 2016. A bank should not enter into Islamic contracts or conduct Islamic financial business which is not in accordance with this Act.<sup>168</sup> It is submitted that for an Islamic financial business to operate in accordance with *Shari'ah* it must conform to the provisions of the *Financial Institutions Act*. It should be noted that not all the provisions of the Act are in conformity with *Shari'ah* principles. The strength of this concept will depend on the mandate given to the Central *Shari'ah* Advisory Council and also under the Islamic banking Regulations.

An Islamic financial institution licensed under the FIA has to comply with section 7(3a) of FIA 2016. A financial institution that is entitled to call itself a bank may describe its Islamic financing business as “Islamic banking business” and, if it is an Islamic financial institution, may describe itself as an “Islamic bank.”<sup>169</sup> A bank has to choose any of the two.

#### ***Procedure for licencing***

A company proposing to transact or carry on business as a financial institution shall apply, in writing, to the Central Bank for a licence under the Act. An application for a licence shall contain the information provided under section 10(2) of FIA. An Islamic banking business has to apply for a licence as specified in the Second Schedule of the Act.<sup>170</sup> The business of an Islamic bank is covered under Class 9<sup>171</sup> while the business of an Islamic financial institution which is a non-bank financial institution is covered under Class 10 of the Second Schedule to the Act.<sup>172</sup>

Besides the normal requirements, an application should to be accompanied by the applicant’s memorandum and articles of association or other instrument under which the company is incorporated, the certificate of incorporation and in the case of a person intending to conduct Islamic financial business, a statement stating that the business of the financial institution operations shall be conducted in accordance with the *Shari'ah*.<sup>173</sup> In addition, section 10(6)(d) FIA 2016 requires an applicant proposing to be an Islamic financial institution, a declaration signed by all the directors and persons proposing to become directors, in a form specified by the

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167 Ibid.

168 Section 4(4) (d) supra.

169 Section 7(3) (a), supra.

<sup>170</sup> Section 10 (3), supra.

171 Section 10 (3)(I), supra.

172 Section 10 (j) (3), supra.

173 Section 10 (6) (a), supra.

Central Bank in regulations made under the Act, to the effect that the entire business operations of the applicant will be conducted in accordance with the *Shari'ah*. This is a big task on the side of the directors to ensure that they comply with *Shari'ah* principles. This section is rather wide and does not discriminate between a Muslim and non-Muslim director.

The licensing and operation of Islamic financial business will have to be done under special provisions by a statutory instrument.<sup>174</sup> This means that the ordinary licensing regulations will not be applicable to Islamic financial business. In addition, an Islamic financial institution will have to comply with the provisions of the *Companies Act 2012* or the *Building Societies Act*.<sup>175</sup> It is noted that several elements of an appropriate licensing process are common to Islamic banks and conventional banks, but certain modifications are needed to be taken into account due to the nature of Islamic banking. In particular, in countries where *Shari'ah* law constitutes a portion of the fundamental law of the country, applicants for Islamic banking licenses are required to provide information on their plans for *Shari'ah* compliance. This, in turn, entails providing evidence that a robust corporate governance structure tailored to Islamic banking is in place. However, few jurisdictions apply fit and proper requirements to *Shari'ah* advisory board members and to staff in Islamic banks in charge of *Shari'ah* compliance. Developing and implementing these fit and proper requirements would be important.<sup>176</sup>

On the issue of capital requirement, an Islamic bank will adhere to minimum capital requirement for financial institutions business as required under sections 26, 27 and 28 of FIA as amended 2016. However, the Minister may review the requirements of minimum capital of a financial institution by statutory instrument.<sup>177</sup> This means that an Islamic bank capital requirement may be adjusted by a statutory instrument. An Islamic financial institution will have to abide by section 18 FIA 2016 which limits the shareholding of any financial institution. This section prohibits a person or group of persons to acquire more than forty-nine per cent of the shares of a financial institution. In addition, no financial institution shall, except with the permission of the Central Bank, allot or issue, or register the transfer of five per cent or more of any of its shares to one

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174 Section 115 A (5) FIA 2016.

<sup>175</sup> Section 123, *ibid*.

<sup>176</sup> Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, "Regulations and Supervision of Islamic Banks", *IMF Working Paper*, WP/14/219, December 2014, pg. 17.

<sup>177</sup> Section 26(5) FIA 2016.

person. It further prevents the registrar of companies not to register any transfer or allotment of shares of a financial institution without the written consent of the Central Bank.<sup>178</sup> The consent of the Central Bank is paramount for it to be effective.

### **Islamic Banks Engaging in Trade and Investments in immovable property**

A financial institution should not engage directly or indirectly for its own account, alone or with others in trade, commerce, industry, insurance or agriculture, except in the course of the satisfaction of debts due to it in which case all such activities and interests should be disposed of at the earliest reasonable opportunity.<sup>179</sup> However, the *Financial Institutions (Amendment) Act 2016* amended this section for the proper operation of Islamic banking. However, section 115C of FIA 2016 exempted Islamic financial business from the operation of section 37 and 38 of FIA which was initially meant for conventional banks. These sections prohibit financial institutions from engaging in trade, commerce, industry and investments in immovable property. This means that Islamic banks will transact business in relation to those businesses which conventional banks cannot do.

Section 38 of FIA had prevented a financial institution from purchasing or acquiring any immovable property or any right in it except in exceptional circumstances. However, the amendment brought in sub-section 38 (3) which allows a financial institution in securing a debt on any immovable property in case of default of payment of the debt and for holding the immovable property for realization at the earliest reasonable opportunity to the financial institution. The exception also allows a financial institution purchasing or acquiring moveable or immovable property as part of a business involving the purchase or acquisition of such property for immediate lease or resale after obtaining consent from the Central Bank. This implies that the FIA 2016 recognizes the *murabaha* Islamic mode of financing (in this case the bank buys items from the supplier and then resells it to the client on spot delivery but at a deferred payment sale at cost plus mark-up) and *ijara* Islamic mode of Islamic financing (whereby in this case the usufruct of an asset is transferred to the lease for an agreed number of rentals.)

### **Corporate Governance and Operations of Islamic Financial Business**

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178 Section 20 FIA, note 43.

179 Section 37 (a) FIA 2004.

Every financial institution should have a board of directors of not less than five directors.<sup>180</sup> Section 52 (4) of FIA further provides that “no person who is not a fit and proper person in accordance with the fit and proper test specified in the Third Schedule shall become or remain a director of a financial institution, and for the purposes of this subsection, the Central Bank shall vet all persons proposed as directors of a financial institution within six months and notify the financial institution accordingly”. It should be noted that no appointment of a director of a financial institution shall have legal effect for the purposes of the Act or any other law unless that person has complied with the requirements of section 52 (4) of FIA.<sup>181</sup> It should be noted that “a member of a *Shari’ah* Advisory Board in any financial institution shall not be appointed as a director of a financial institution while he or she holds that position.<sup>182</sup> This is intended to avoid conflict of interest that might arise during the banking operation.

On the issue of conflict of interest of *Shari’ah* Advisory Board, a director, an officer or a member of a *Shari’ah* Advisory Board of a financial institution should not take part in the discussion of or taking a decision on any matter in which that person or any of his or her related interest has an interest.<sup>183</sup> However, an officer or director may inform the meeting of his or her interest and to the extent that the discussion or decision concerns any matter in which he or she has an interest, should exclude himself or herself from further attendance at that meeting.<sup>184</sup> The amendment brought in section 55(c) of FIA 2016, specifically for the operations of Islamic financial business. It provides those other duties of ensuring that the business of the financial institution is carried on in compliance with all applicable laws and regulations, and in the case of a financial institution that conducts Islamic financial business, the business of the financial institution complies with the *Shari’ah*, and is conducive to safe and sound banking practices.

Corporate governance is further explained as to cover the overall environment in which the financial institution operates, comprising a system of checks and balances which promotes a healthy balancing of risk and return, and in the case of a financial institution which conducts Islamic financial business, promotes compliance with the *Shari’ah*.<sup>185</sup> *Financial Institutions*

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180 Section 52 (1) FIA 2016.

181 Section 52 (5) FIA.

182 Section 52 (8) supra.

183 Section 54 (1) supra.

184 Section 54 (2) supra

185 Section 55(e) FIA 2016.

*(Amendment) Act 2016* provides for the audit committee of the board of a financial institution.<sup>186</sup> The 2016 amendment introduced section 59 (7)(b) to cater for the operation of Islamic financial business. The audit committee shall review the internal controls, operating procedures and systems and management information systems of the financial institution and in the case of a financial institution which conducts Islamic financial business, those controls, procedures and systems designed to ensure compliance with the *Shari'ah*.<sup>187</sup> In addition, Islamic financial Institutions shall be inspected by the Central Bank in accordance with section 79 and 80(m) of FIA.

### **Credit Reference Bureau Compliance**

The law provides that all financial institutions should promptly report to the Credit Reference Bureau for all the details of non-performing loans and other accredited credit facilities.<sup>188</sup> The 2016 amendment brought section 78A which provides that it shall be a duty of an Islamic financial institution to carry out credit check on customer applying for credit. Every financial institution shall perform a credit check on a customer who applies for credit from the financial institution.

In Uganda, the regulations that monitor CRB is the Financial Institution (Credit Reference Bureau) Regulations, 2005. Rule 3 of the FICRBR defines CRB to mean a legal entity established as a company that allows financial institutions to exchange information on their client's repayment history and current debt profile which compiles a data base that collects, stores, consolidates and processes information related to persons companies and enterprises. The purpose of the regulation is to provide accurate information on borrower's debt profile and repayment history. Financial institution should report to the Central Bank all loans and other credit accommodations and other credit granted or extended to insiders at least once every quarter of the financial year.<sup>189</sup> The implication of this section is that an Islamic bank will have to ensure that it monitors nonperforming loans. The public may abuse the Islamic banking process as many would think that there will not be any interest charged even if the period for the repayment of the loan prolongs. CRB is important as it monitors loan defaulters.

### **Deposit Insurance Fund and its Impact on Islamic banking**

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186 Section 59 FIA 2016.

187 Section 59 (7) (b) FIA 2016.

188 Section 78 (2) FIA 2016.

189 Section 80(2) FIA 2016.

Part X11 of the FIA 2016 provides new regime for the Deposit Protection Fund. The deposit insurance Fund should be a body corporate with perpetual succession and may sue or be sued in its corporate name and the Fund should also be a separate legal entity from the Central Bank.<sup>190</sup> The purpose of the Fund is to act a deposit insurance scheme for customers of contributing institutions, acting as a receiver or liquidator of a financial institution, if appointed for that purpose by the Central Bank or performing such other functions as may be conferred upon it by law.<sup>191</sup> In particular, section 111(1) of FIA 2016 indicates that every financial institution has to contribute to the Fund. The implication for non-compliance is that any financial institution which, for any reason, does not pay its contribution to the Fund within the period specified shall be liable to pay to the Fund a civil penalty interest charge of 0.5 per cent of the unpaid amount for every day outside the notice period on which the amount remains unpaid.

Payments out of the Fund are done in accordance with section 111C (1) FIA 2016. In particular, for the administrative expenses of the Board, repayment of money borrowed by the Board and payments made in respect of protected deposits. Payment of the protected deposit to customers are made within ninety days after closure of the financial institution.<sup>192</sup> The effect of this Fund to Islamic finance business is that the provisions are general in nature and do not provide specific exceptions to Islamic banking because of the issue of “interest” available under the conventional deposit insurance fund. The applicable model for the deposit insurance scheme is discussed in chapter four of this study.

### **Islamic banks engaging in banc assurance business**

Islamic financial institution may also engage in banc assurance business as provided under Section 115D FIA 2016. A financial institution should not engage in banc assurance or Islamic insurance business in Uganda as a principal or agent without prior written authorization by the Central Bank and in a format and manner prescribed by the Insurance Regulatory Authority of Uganda.<sup>193</sup> Banc assurance or Islamic insurance business activities of any financial institution must comply with the Insurance Act. “Banc assurance” is defined to means “using a financial institution and its

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<sup>190</sup> Section 108(2) FIA 2016.

<sup>191</sup> Section 109 FIA 2016.

<sup>192</sup> Section 111C (5) FIA 2016.

<sup>193</sup> Section 115 D FIA 2016.

branches, sales network and customer relationships to sell insurance products.”<sup>194</sup> The insurance business in Uganda is regulated by the Insurance Regulatory Authority of Uganda as provided under section 12 of the *Insurance Act, 2017*. Some of the functions of that Authority are to regulate, supervise, monitor and control the insurance sector among others. Islamic insurance has been brought in Uganda under the new *Insurance Act 2017*. Under that Act, Islamic insurance is known as *Takaful*. Section 3 of *Insurance Act 2017*, defines *Takaful* to mean “insurance conducted in accordance with *Shari’ah* principles. **Banc assurance** is further defined under the *Insurance Act, 2017* to mean “an arrangement between a financial institution and insurer or health membership organization (HMO) under which the financial institution distributes to its customers through its distribution channels, an insurance product of insurer or HMO.<sup>195</sup> Under this arrangement, a financial institution acts as an agent for the insurer.” However, it is not the intention of this research to go into the detailed discussion of Islamic insurance.

### **Control of money laundering**

Money laundering is defined under the *Anti-Money Laundering Act, 2013*, to mean” the process of turning illegitimately obtained property into seemingly legitimate property and it includes concealing or disguising the nature, source, location, disposition, or movement of the proceeds of crime and any activity which constitutes a crime.<sup>196</sup> According to the long title of the Act, it was passed to provide for the prohibition and prevention of money laundering, the establishment of a Financial Intelligence Authority and a Financial Intelligence Authority Board in order to combat money laundering activities; to impose certain duties on institutions and other persons, businesses and professions who might be used for money laundering purposes; to make orders in relation to proceeds of crime and properties of offenders; to provide for international cooperation in investigations, prosecution and other legal processes of prohibiting and preventing money laundering; to designate money laundering as an extraditable offence; and to provide for other related matters. An Islamic financial institution will have to observe money laundering controls as provided under section 129 and 130 of FIA 2004. This implies that an Islamic financial

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194 Section 3 FIA 2016.

195 Section 3 Insurance Act 2017.

196 Section 3 Anti Money Laundering Act 2013.

institution will also have to comply with the provisions of the *Anti-Money Laundering Act, 2013* and its *Regulations*.

### **Liabilities of Islamic Bank officials and Shari'ah Advisory Board**

The FIA provides offences for the officers of a financial institution. In particular, any person who, being a director, manager or officer of a financial Institution or a member of a *Shari'ah* Advisory Board fails to take any reasonable steps to secure compliance with the requirements of the Act, knowingly or recklessly makes any statement or gives any information which is false or misleading in any material particular in answer to any request for information made under any provisions of the Act or is privy to the furnishing of any false information supplied under this Act, commits an offence and is liable on conviction, to a fine not exceeding two hundred and fifty currency points (Shs. 5,000,000/=) or imprisonment not exceeding three years or both.<sup>197</sup>

An offence may also occur where a director or officer of a financial institution or a member of a *Shari'ah* Advisory Board authorizes a contravention of, or contravenes any provision of the Act, he or she shall be personally liable to the penalty specified in relation to the contravention. It is submitted that the imposition of such punishment is to deter members of the *Shari'ah* board from neglecting their duties and to be compliant with the provisions of the Act and their terms of references for their offices.

Officers of a financial institution may be summoned by the Central Bank. In particular, where the Central Bank is of the opinion that any officer, director, shareholder or a member of a *Shari'ah* Advisory Board, past or present, of a financial institution has any information relating to the operations of the financial institution which the Central Bank considers necessary for the performance of its supervisory functions, the Central Bank may on notice summon that officer, director or shareholder or member of a *Shari'ah* Advisory Board, for an examination if he or she does not comply, commits an offence and is liable on conviction to imprisonment not exceeding two years.<sup>198</sup> This provision makes members of *Shari'ah* Advisory Board liable for their acts and omissions.

### **Deposit Protection Fund**

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<sup>197</sup> Section 126(1) FIA 2016.

<sup>198</sup> Section 127 FIA 2016.

Section 108(1) of the FIA establishes the Deposit Protection Fund which is controlled and managed by the Central Bank.<sup>199</sup> Monies paid into the Deposit Protection Fund are contributed by banks in order to secure their customers in case those banks are distressed and fail consequently being resolved.<sup>200</sup> When this occurs, the Fund pays back to the bank an amount which is higher than that which had been earlier on contributed by the banks as a result of interest. This is seen under section 108(6) of the FIA which provides that money constituting the Fund shall be placed in an account with the Central Bank to be invested in such manner as it deems appropriate and any income from the investment shall be credited to the Fund.

These sections present a problem since deposit insurance involves the exchange of money for money and the exchange occurs on an interest-based transaction and therefore contrary to Islamic values.<sup>201</sup> The interest element could also exist if the Protection Fund monies are invested in interest-based transactions or other ventures considered immoral and not approved by Islamic *Shariah* thus *haram*.<sup>202</sup> The profit would be viewed as not permissible and thus tainted in *sin* to be applied in refunding an Islamic bank when it has closed.<sup>203</sup>

### **Risk Management through Credit Reference Bureaus.**

The FIA 2016 also introduces the Credit Reference Bureaus concept under sections 26, 78A which make it mandatory for banks to conduct credit checks on all customers applying to them for credit. It also mandates banks under section 78 (2)(a) to report to the Credit Reference Bureau all Non-Performing Loans classified as doubtful or loss in their portfolio.

This is meant to provide prudential guidance to banks on whether an applicant has in the past failed in his obligation to pay and is otherwise un-creditworthy. This compulsory procedure impairs the Islamic banks from disbursing credit even though as seen in the previous chapter, creditworthiness is not significant requirement for one to access credit in Islamic finance.

This is because although an applicant may not be creditworthy and with no property to use as collateral security, if their proposed project is economically promising they may succeed in

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<sup>199</sup> Section 108(2) of the FIA

<sup>200</sup> section 108(3) of the FIA

<sup>201</sup> Iqbal, Munawar, Auşāf Aḥmad, and Tariqullah Khan. 'Challenges facing Islamic banking'. *Islamic Research and Training Institute*, 1998.

<sup>202</sup> *ibid*

<sup>203</sup> *ibid*

securing a loan from an Islamic bank yet fail to secure an ordinary bank loan for their project. This would promote deeper financial inclusion status in Uganda and ease access to credit and encourage productivity and real economic activity. This requirement does not capture the primary expectations of Islamic banking in the loan client since the Islamic bank does business in a partnership with a client it is not much interested in the latter's creditworthy but rather whether their proposed venture has high prospects of success.

#### **Limitation to invest on equity and assets**

Directives on this aspect are obtained from The *Financial Institutions (Limits on Credit Concentration and Large Exposures) Regulations, 2005*. The main objective of these Regulations, among others, is to prescribe limits for investment in equity and fixed assets.<sup>204</sup> Investment and trade in assets and equities in Islamic banking cannot be separated as has been discussed throughout the paper. Assets are a critical and underlying basis for any Islamic banking business and money in Islamic banking is inferior to property; as such these limitations curtail its effective operation.<sup>205</sup>

#### **Conflict of Jurisdiction Over Islamic Banking Businesses**

Islamic banking in Uganda derives its **power from the *Financial Institutions (Amendment) Act 2016***. Any jurisdiction or power that it purports to possess must be expressly provided in that Act or regulations under the Act. Nevertheless, this may also cover *shari'ah* principles on Islamic banking. The issue of supremacy of the *Financial Institutions Act* over other laws is provided under section 133 of FIA. Section 133 of FIA provides that for "the purposes of any matter concerning financial institutions, this Act shall take precedence over any enactment and in the case of conflict, this Act shall Prevail." This means that FIA will be supreme to any law and in case of conflict FIA shall prevail. This may pose a challenge to the operations of Islamic banking business. In conducting Islamic banking business there is likely to be a conflict between the conventional banking and the principles of *Shari'ah*. This implies that *Shari'ah* will have to be interpreted within the confines of the provisions of the *Financial Institutions Act*.

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<sup>204</sup> Regulation 4 (1)

<sup>205</sup> Mzee Mustafa Mzee. op cit (n267)

**Furthermore**, Article 138 of the Ugandan Constitution states that there shall be a High court of Uganda and article 139 provides this court with original and unlimited jurisdiction.<sup>206</sup> The High Court has divisions among which is the commercial division. This handle matters of a commercial nature such as companies and banks.<sup>207</sup> Regulation 4(1) of the Constitution (Commercial Court) (Practice)(Directions) S-1 Constitutional 6 states that the business of the commercial court shall comprise of all actions arising out of any relationship of a commercial or business nature including banking. As Islamic banks disputes fall under the same purview, all disputes arising out of Islamic bank transactions will be subject to the same procedure and process as experienced by its conventional counterpart The **High court has unlimited jurisdiction in all matters** and such appellate and other jurisdiction as may be conferred on it by the constitution, or any other law.<sup>208</sup> Furthermore, the High court's jurisdictions is exercised in conformity with written law, common law, doctrine of equity, established custom and usage, and where no express law provides, then principles of justice, equity and good conscious are applied.<sup>209</sup> Although FIA 2016 provides for the operations of Islamic financial business which have to comply with the *Shari'ah* principle, the *Shari'ah* component is not a written law. *Shari'ah* is still regarded as unwritten law because much of it is not yet codified. According to the FIA, it appears that cases on Islamic banking will be under the jurisdiction of the civil courts. The judges in civil courts may face difficulties to understand certain concepts and terms of Islamic finance because of the nature of their training. Section 33 of the *Judicature Act* provides general remedies. It provides that: *The High Court shall, in the exercise of the jurisdiction vested in it by the constitution, this Act, or any written law, grant absolutely or on such terms and conditions as it thinks just, all such remedies as any of the parties to a cause or matter is entitled to in respect of any legal or equitable claim properly brought before it, so that as far as possible all matters in controversy between the parties may be completely and finally determined and a multiplicities of legal proceedings concerning of those matter avoided.* In light of the above, it is almost settled law that the jurisdiction of Islamic banking cases was placed under the auspices of civil courts. This position is clearly mentioned by the Court of Appeal in the case of ***Bank Kerjasama Rakyat Malaysia v Emcee Corporation*** where

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<sup>206</sup> Also provided for by section 133(1)(b) of the Judicature Act Cap 13

<sup>207</sup> The High Court Commercial Division was created by Legal Notice No 5 of 1996 which was codified in the Constitution (Commercial Court) (Practice) Directions S-I 6

<sup>208</sup> Section 14 (2) Judicature Act, Cap 13.

<sup>209</sup> *ibid*

the learned judge stated, “*The law was mentioned at the beginning of this judgment; the facility is an Islamic banking facility, but that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under the conventional banking.*” Indeed, in actual fact, the disputed cases relating to Islamic banking normally involve a mixture of issues and not Islamic law per se. Therefore, the function of the civil court in dealing with Islamic banking cases is to render a judicially considered decision on the particular facts of the specific case before it according to law. The civil court has a constitutional duty to ensure that Islamic financial instruments are within the spirit of the law.

### **Case Law on Islamic Banking from other legislations**

Since Islamic Banking is still at the shores of its existence In Uganda, in our research we dwell case law from Malaysia and United Kingdom where courts have clarified on the principles of Islamic banking as stated below.

The case of *Investment Company of The Gulf (Bahamas) Limited v Symphony Gems N.V. and Ors*<sup>210</sup> is the first case in the English courts pertaining to Islamic finance. The issues involved in this case referred to the question of the validity of the *murabaha* agreement. Under this *murabaha* deal, the plaintiff agreed to finance the defendant via a revolving facility to purchase precious stones and gems. The defendant defaulted and the plaintiff brought the case to court. The main issues discussed *inter alia* in this case referred to: (i) the determination of the effect of the *murabaha* agreement on the risk of failure to deliver, (ii) the *Shari'ah* issue as a legal defence and (iii) the doctrine of *ultra vires*.

With regard to the first issue, the learned judge rejected the argument by the defendant on the default payment of failure of delivery. The contract clearly stated that the defendant was obligated unconditionally to purchase the gems from the plaintiff. In fact, delivery was not a prerequisite to payment by the defendant. The court referred to the relevant clause provided in the contractual agreement which clearly stated that the plaintiff would not be liable for any failure of delivery or defects or any deficiency. In essence, the court in this case chose to literally interpret the contract employing a classic common law approach by construing strictly the agreement in its terms and conditions.

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210 [2002] West Law 346969, QBD (Comm. Ct.)

In relation to the second issue, the defendant argued that the *murabaha* agreement was invalid on the ground that it contradicted *Shari'ah* principles. In order to determine the validity of this *murabaha* contract, two experts were called to testify. Both experts said that the underlying contract was not based on an actual *murabaha* transaction. While the court agreed to hear the experts' views on the *murabaha* issue, it nevertheless at the end held that the contract was vividly valid from the English law point of view and dismissed the argument of *Shari'ah* non-compliance.

Pertaining to the final issue, the court also rejected the defendant's argument in claiming the common law doctrine of *ultra vires* upon Symphony Gems, which was incorporated under the law of Bahamas. Although a clause in the agreement stated that the defendant had to pay the plaintiff under any circumstances, which was against the *Shari'ah* principles, the court viewed that the doctrine of *ultra vires* was not relevant. After analyzing the *ultra vires* law of the Bahamas, the court took the view that the plaintiff was not subject to the *ultra vires* doctrine. The court ordered the defendant to pay the total amount of USD 10,060,354.28, inclusive of both principal and the compensation for late payments.

Furthermore, the English courts related to Islamic finance was the case of ***Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others***<sup>211</sup> In this case the defendant Beximco Pharmaceuticals Ltd and the other borrowers entered into a *murabaha* agreement with the plaintiff in 1995. The defendants defaulted and after a series of various termination events under the agreements, the plaintiff finally brought the case to court and made an application for summary judgment.

The central issue raised in this case referred to a construction of the governing law clause. The *murabahah* agreements contained the following governing law clause: "*Subject to the principles of the Glorious Shariah, this Agreement shall be governed by and construed in accordance with the laws of England.*" Based on this clause, the defendants argued that the *murabaha* agreements were invalid and unenforceable because they were in truth disguised loans charging interest. It was further argued that the *murabaha* agreements were then unenforceable due to *Shari'ah* noncompliance.

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211 2004] 1 Lloyd's Rep 1 28.

Both the High Court and the Court of Appeal dismissed the arguments put forward by the defendants and finally granted summary judgment to the plaintiff on its claims. The court held that the principles of *Shari'ah* did not apply to the *murabaha* agreements. The reference to the *Shari'ah* in the governing law clause was not meant to replace the English law as the governing law but merely intended to reflect the plaintiff's nature of business. The learned judge further stated that there could not be two separate systems of law governing a contract. In this regard, the court referred to the Rome Convention whereby the interpretation on the reference to a choice of law was to the law of a country and not to a non-national system of law such as the *Shari'ah*. The court rejected the arguments put forward by the defendant and noted that the *Shari'ah* defence elicited in this case was merely “a lawyer's construct” and this would defeat the commercial purpose of the transaction.

In this case of *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*<sup>212</sup> parties litigated all the way to the Court of Appeal over the governing law clause in a *Murabaha* agreement which read as follows: “Subject to the principles of the Glorious *Shari'ah* law, this agreement shall be governed by and construed in accordance with the laws of England”. The High Court judge below had ruled that on the proper construction of the clause, the *Shari'ah* law was not applicable at all. **The Court of Appeal upheld the decision of the High Court.** In its judgment, it held, inter alia, that the reference to the *Shari'ah* law was intended merely to reflect the Islamic legal principles according to which Shamil Bank held itself out as doing business and this, this was insufficient to incorporate the principles of *Shari'ah* law or any part of *Shari'ah* law into the agreements. The Court of Appeal pointed out that the incorporation clause in this contract was too vaguely worded and did not specify or make reference to those particular aspects of *Shari'ah* law that were to be applicable.

In *Musawi v R.E. International (UK) Ltd and Others*,<sup>213</sup> the High Court in the United Kingdom maintained that at common law, the proper law of a contract had to be either English law or the law of another country, and not any other system of to a contract. This was so even though in all the agreements between the parties, it was written that the governing law would be the *Shia Sharia* law. Ironically, the matter was brought before the High Court as an enforcement of an arbitration

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212 [2004] 1 WLR 1784.

213 [2007] EWHC 2981 (Ch)

award. The parties had entered into an arbitration agreement appointing Arbitrator and Islamic legal judge in settlement of the dispute according to Islamic legal standards and to accept it as a final judgment and submit to its findings. The High Court, in upholding the arbitration award by finding that the arbitration agreement was effective in English law. The Court did acknowledge that the arbitrator was entitled to apply *Shia Sharia* law as required by the arbitration agreement.

In the case of *Investment Dar Co KSSC v Blom Developments Bank Sal*<sup>214</sup>, the Investment Dar (TID) was an investment company registered in Kuwait and the Blom Developments Bank (BDB) was a bank incorporated in Lebanon. Both parties nevertheless agreed that the *wakÉlah* agreement entered into would be governed by the English law. When TID failed to perform its obligation under the *wakÉlah* agreement, the BDB sued them in the High Court of England and applied for summary judgment on the grounds of default in payment and the deposits held on trust. In response to the claim made by the plaintiff, TID raised the defence of *ultra vires* to defy payment of an obligation under the *wakÉlah* deal. Ironically, TID argued that the *wakÉlah* agreement which was approved by its own Shariah board did not comply with the Shariah and was therefore void because it was against TID's constitutional documents. On the other hand, the BDB argued that the transaction was Shariah compliant and in fact was duly certified by TID's own Shariah board and any argument of the invalidity of such a deal was therefore void. Unlike in the *Investment Company of The Gulf (Bahamas) Limited v Symphony Gems*, the court in this case allowed the appeal and held that there was a triable issue on both claims. The learned judge agreed that the issue of Shariah compliance needed to go to trial for proper deliberation, but considering the deposit, TID still had to pay the amount deposited of USD 10,733,292.55 to the BDB.

It is submitted that the majority of the cases discussed above relate to the issue of governing laws and the determination of the validity of contractual agreements from the Shariah perspective in the civil courts. Therefore, in promoting good governance on the legal frameworks of the Islamic financial system, cooperation between the Bank of Uganda and the judiciary is very important in delivering justice to all the parties in the dispute.

### **3.2. The Prospects and Challenges of Islamic Banking in Uganda.**

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214 [2009] All ER (D) 145

Globally, the prospects for Islamic banking model are promising. Some see the Islamic model as an alternative. Others see it as complementary to the system which has dominated the western world. London is emerging as a major financial center for Islamic finance.<sup>215</sup> Islamic banking products are also widely used by non-Muslims in many countries. The prospects of Islamic banking look bright to Ugandans who have been waiting for its establishment in the banking system for a long period of time.

Uganda having a reasonable population of Muslims offers huge opportunities to exploit. The size of the market is considered to be reasonably large as majority of Ugandans are looking for interest free financial services. There is a large number of Ugandans who do not bank, so Islamic banking would not only spread the catchment for banking services but also deepen it while meeting the religious needs of the Muslim community. It is pertinent to mention here that Islamic banking is not meant for Muslims only but non-Muslims may also avail the benefit of it. It is feasible to have a parallel banking system one based on *sharia'h* along with a conventional one. This chapter therefore discusses the prospects and challenges of Islamic banking as a new banking phenomenon in the Ugandan banking sector.

### **3.2.1. Prospects for Islamic Banking in Uganda**

#### **Islamic banking as safer option**

One of the greatest opportunities for Islamic banking could be the lack of trust that has been developed for the conventional banking system throughout the recent year's financial crisis. In March 2011, Earnest & Young conducted a survey in which the company found that 44% of retail banking customers worldwide claim that their trust for the banking industry has diminished during the past 12 months. As a result of this, Islamic banking could gain a stronger position on the financial market if being presented as a safer option to the clients as well as an option that provides more stability in the financial market. Islamic banking has moreover been the recent focus of economists worldwide as these banks have been less affected throughout the financial crisis that struck the world market in 2008.<sup>216</sup>

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215 Nooraslinda Abdul Aris, "Islamic Banking Products: Regulations, Issues and Challenges", (2013) 29(4) *Journal of Applied Business and Challenges*, page 1145.

216 Linnéa Hallberg and Yasmine. A. Nettelbladt, "Moving the World to Islamic Banking: A Study of Islamic Banking as A Financial System and An Analysis of How It Could Be Transferred to The Swedish Market", Bachelor Study, Spring 2011 *International Business/Marketing*, pg. 27.

It has been observed that the reason for this is that Islamic banks, in comparison to conventional banks, do not borrow in interbank markets, instead their funds come from their own deposits. Additionally, the Islamic banks have not been engaged in collateralized debt obligations as they are prohibited by the *Shari'ah* law to hold interests bearing securities. This has made Islamic banks much more attractive to investors, as many of these investors based in conventional banks have witnessed a decline in the value of their assets.

The growing Muslim population in the world could also be seen as an opportunity for Islamic banking. Over the next 20 years, the world's Muslim population is expected to grow twice as fast as the non-Muslim population, and by 2030 Muslims are anticipated to constitute more than a quarter of the global population. Due to this, Islamic banking will have the ability to appeal to a great part of the world population, and these booming figures can be considered to be a great possibility for Islamic banks as they might represent future clients. This type of demographic change can also mean that the Western society and culture will undergo a transformation during the next decades.<sup>3</sup> However such projection can only be achieved if there is peace in the world, greater awareness of Islamic banking and good cooperation with non-Muslim community.

### **Decreasing poverty and inequality**

As mentioned above, Islamic banking can be seen as a safer option in comparison to conventional banking, this is due to the belief of the bank being an investor rather than a lender. This means that Islamic banks are very cautious as they lend money to their client. Therefore, the risk for the borrower of capital is much smaller when using an Islamic bank, which may attract clients. In addition, the Islamic banking system, based upon the principle of profit-and-loss sharing, is said to contribute to a greater stability in the financial markets, something that might be welcomed after the recent years' financial crisis".

Islamic banking could also appeal to people since it has a human and ethical aspect that conventional banking is considered to be lacking. An important element in Islamic banking is the alms giving, the *zakat*, which means that the banks must contribute to the society economically. This results in the banks being an important part in the creation of a society that strives to decrease poverty and inequality. Thus, the clients can indirectly participate in the building of a just and fair environment within their community, which could be of interest to people as ethical alternatives today are in increasing demand at all levels of society.

Another important aspect in Islamic banking is the building of relationships, which is emphasized as it creates loyalty and trust between the client and the bank. The creation of relationships has become more significant during the last decades since customers want a more personal and closer contact with service providers. In addition, it leads to a perception of closeness and commitments making the customers feel important.

### **Providing an alternative to conventional banking**

Unlike conventional banking that views money not only as a medium of exchange but also as a commodity that can be sold at a price higher than its face value, Islamic banking views money as a medium of exchange and a store of value and therefore cannot be sold or rented out at a higher cost therefore forbidding interest. Islamic banking operates on the basis of profit and loss sharing between the bank and the client. If the growth needs of Ugandans are to be addressed, Islamic banking will provide the opportunity for development.

Islamic banking will provide an alternative to the conventional banking products that charge interest, sometimes at unreasonable levels. It is submitted that the high interest rates clog the growth of small and medium enterprises and repel both local and foreign investment, since investors look at the cost of capital as the major factor.

### **Increase access to cheap finance**

In addition, it is argued that Islamic banking will increase access to cheap finance for small and medium enterprises, creating employment and boosting production for export, which in the long term will improve the country's current account. The inadequate labor capital ratio, for informal sector workers and farmers associated with agriculture and manufacturing industries could be resolved through equity finance, which might be a revolution in our agriculture sector. With the improved labor capital ratio, our vulnerable workers associated with agriculture might be able to compete effectively with the formal sector workers. This Islamic banking may financially empower majority of Ugandan workers and farmers.

### **Government gaining Diplomatic advantages**

The introduction of Islamic banking will enable the Ugandan government gain diplomatic advantages to make financial dealings with Moslem dominated nations especially to attract dollars based on equity finance from the Gulf countries. However, Islamic banking should not be regarded

as religion-based banking business, but could be profitably used to resolve issues pertaining to the economy. Islamic banking will play a critical role in providing capital for development projects especially with international partners such as the Islamic Development Bank (IDB) and other Islamic banks across the world. If international partners can access the Ugandan market, then long term investment in infrastructure such as schools, vocational institutions, hospitals and agriculture will be enhanced because the loans are very participatory since there is no interest charged making it a win-win for the bank as the lender and the entrepreneur who benefits from the loan.

By and large, a small open economy like Uganda must attract new investment and expand exports in order to grow. In this case, Uganda needs capital for public and private projects. Islamic banking will therefore trigger new investments that will attract job creation and foreign investment, through attractive packages such as shared project risk and profits.

### **3.2.2 The Challenges facing Islamic banking**

Islamic banking in Uganda is likely to face some challenges in the banking sector. First is the *sharia'h* compliance in its operation in an environment which is dominated by interest-based practices. Second, is the perception of banking industry practitioners about its performance whether the system is able to serve the total needs of trade and industry. Thirdly is the perception of a large majority of Muslims whether the existing practice of Islamic banking is *sharia'h* compliant or a mere copy of conventional practices under the banner of *sharia'h*. These challenges are discussed below.

#### **Supervision of banks**

The bank regulation encompasses the legislative framework and guidelines which govern bank activities. The term supervision of bank is a process primarily aimed at promoting and maintaining a safe and sound banking system and preventing financial instability.<sup>217</sup> The central bank may periodically or at any time at its discretion, cause an inspection to be made, by an officer of the central bank or other person appointed by the central bank, of any financial institution and of its financial records and books of accounts on the premises of the financial institution and should provide to that financial institution a copy of the report on the inspection. The financial institution

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217 Annual Supervision Report.

should furnish to the officer making an inspection all such books of accounts and financial records and other documents as well as assets including cash, notes and securities held by the financial institution in its custody or power and furnish the officer with such statements or information relating to the affairs of the financial institution as the officer may require of it with in such reasonable time as the officer may specify.<sup>218</sup>

Supervision mainly relates to liquidity requirements and adequacy of capital in the banks. The two depend on an assessment of the value of assets of the banks supervised. The regulations used in supervising banks by the Bank of Uganda are not applicable to Islamic banking since the Islamic banking has new commands as opposed to conventional banking. The lack of effective supervisory framework is one of the challenges which deserve serious attention. There are three main reasons why regulation and supervision of the banking industry are important; to increase the information available to investor (transparency), to ensure the soundness of the financial system and to improve control of monetary policy.<sup>219</sup> In case of Islamic banking, the *shari'ah* board needs to supervise their activities. The role of both the central bank and *shari'ah* Advisory Boards need to be streamlined and strengthened<sup>220</sup>.

### **Central bank as the lender of the last resort**

Like conventional banks, Islamic banks are also prone to liquidity problems but they (Islamic banks) do not enjoy some facility in the form of the lender of the last resort which is available to the conventional banks for overcoming financial crisis when it suddenly occurs as a result of unanticipated financial problems. Where such facility is available to Islamic banks it is based on interest which is unacceptable because of its incompatibility with the *sharia'h* principles. Islamic law prohibits engaging in any financial transactions that involve interest (usury), thus Islamic banks are rendered as financial security disadvantaged and more exposed to liquidity problems than their conventional counterparts.

The Bank of Uganda serves as the lender of the last resort in times of liquidity.<sup>221</sup> Although Bank of Uganda supervises Islamic banks, Islamic banks cannot benefit from their loans because they are provided on the basis of interest. Therefore, there is a need for creating other foams of returns

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218 Section 79 (1) and (2), FIA, 2004.

219 Mzee Mustapha, "The Legislative Challenges of Islamic Banking in Tanzania" (2016) 45 *Journal of Law, Policy and Globalization*. pg135.

220 Ibid.

221 BoU Act.

to the Bank of Uganda so that the Islamic banks can benefit from loans granted by the Central bank.

### **Shari'ah compliance Risks**

The main risk that Islamic banks face which is unique to them is *Shari'ah* compliance risk. In addition to managing the risks faced by conventional banks, such as credit, market, operational risks, an Islamic bank will also have to ensure that it is in compliance with *Shari'ah* rulings as this carries significant reputational risk to the bank. It has been noted that while in theory Islamic banks are less susceptible to instability than conventional banks, in practice it is said they are just as exposed to risks as conventional banks. In theory, the comparative advantage of Islamic banks is its *risk sharing* feature for example banks participate in the risks of their counterparties and investment depositors share the risk of the banking business. In practice, this advantage is neutralized as Islamic banks end up paying to investment accounts holders competitive “market” returns regardless of their performance. Moreover, Islamic banks shift away from profit and loss sharing activities and their asset portfolios become largely composed of short-term, low profit and trade related transactions.<sup>222</sup>

### **Islamic banks as a business threat to Conventional Banks**

Over the last 30 years, Islamic banks have become established on the financial market, and during this time their success has posed a threat to conventional banks, and still does. As a result, conventional banks have begun to set up Islamic windows, since they do not want to lose clients to their Islamic counterpart. The Islamic windows are independent divisions within the conventional banks that are being monitored by a *Shari'ah* board so that their financial practices are in line with the Islamic law. With the introduction of Islamic windows conventional banks have been able to offer financial products that are *shari'ah* compliant.<sup>223</sup> Such a situation is also likely to happen in Uganda.

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222 Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, “Regulation and Supervision of Islamic Banks”, *IMF Working Paper*, WP/14/219, December 2014 pg. 9.

223 Linnéa Hallberg and Yasmine. A. Nettelbladt, “Moving the World to Islamic Banking: A Study of Islamic Banking as A Financial System and An Analysis of How It Could Be Transferred to The Swedish Market”, Bachelor Study, *International Business/Marketing Spring* 2011, pg. 28. <sup>11</sup> New vision, Friday June 30<sup>th</sup> 2017 page 45.

### **People's wrong Perception about Islamic Banking**

The development of Islamic banking will be challenged by the fact that some people fear that it will promote religion and will be discriminative, but these are not valid because Islamic banking is inclusive and takes care of all sorts of people and groups with different needs.

It is noteworthy that despite the good intentions of Islamic banking, there are misconceptions where by the Muslim community believe that there is free money coming in from Arab World while those opposing Islamic banking see it as an attempt to Islamize Uganda. Never the less, the perception of Islamic banking in the Western countries can be hard to separate from people's general opinions of Islam as a religion, and the financial system might therefore be perceived as monolithic, rigid and an old-fashioned belief system that cannot be easily adapted to the contemporary world economy. The system has often also been accused of being connected to terrorist organizations and Islamic extremism, a tendency that followed the attacks on September 11 in USA and seems to still be in place. Thus, Islamic banking has gained a harmful reputation around the world, which can be seen as a threat to the system.<sup>224</sup> Uganda will not be an exception to this perception happening elsewhere because Uganda has also experienced the some in Kampala in the last few years.

### **Critics from Financial scholars.**

The Islamic banking system is being criticized by some organizations for being a mirror of the conventional system veiled behind the name of Islam, and for not following the Quran.<sup>225</sup> One of the weaknesses in Islamic banking is that the system has been criticized by financial scholars and is sometimes said to be no different from conventional banking except for the name. The system has also been claimed to use the term Islamic as disguise in order to attract clients and that there is no such thing as an interest-free banking model, suggesting that *riba* is just another word for interest. This criticism will have a negative impact on Islamic banking, making people reluctant to use the system.<sup>226</sup> Another weakness identified is that thorough analysis that is made on the investment projects, as mentioned earlier, meaning that it can be harder to become a borrower in an Islamic bank than in a conventional bank. Not only are the investments analyzed in terms of how safe they are for the bank to be engaged in, they must also be examined so that

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224 Ibid, pg. 28.

225 Ibid, pg. 29.

226 Ibid,

they are not connected to anything that is considered to be *haram*. Thus, Islamic banking is considered to be somewhat niched as it is selective in its choice of clients and thereby not available to everyone.<sup>227</sup> However those interested in its services should conform to its principles.

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227 Ibid,

## CHAPTER FOUR

### SUMMARY OF FINDINGS, RECOMMENDATIONS AND CONCLUSION

#### 4.0 Introduction

Globally, the prospects for Islamic banking model are promising. Some see the Islamic model as an alternative. Others see it as complementary to the system which has dominated the western world. London is emerging as a major financial center for Islamic finance.<sup>228</sup> Islamic banking products are also widely used by non-Muslims in many countries Uganda being the first example. Thus, the Chapter shall address the summary of findings, and recommendations to enhance the development of Islamic Banking.

#### 4.1. Summary of findings

An effective legal framework requires serious involvement of all individuals and institutions, Islamic financial institution as the key player, government as the regulatory body, and also too other persons related such as auditors, accountants, lawyers and consumers. A comprehensive legal framework is a vital component to guarantee a success on the implementation of any Islamic banking system. As regard to the future development of Islamic banking sector in Uganda, there is a need for a more effective and comprehensive legal framework. The phenomena of globalization require Uganda to mobilize all of its resources in maintaining the growth of Islamic banking sector that has been introduced under the *Financial Institutions (Amendments) Act 2016*. Islamic banking provides a viable alternative to conventional banking. It is potentially a large market which can provide greater stability and fairness in the economy. Uganda could consider providing additional incentives to develop its Islamic finance market in order to create a truly level playing field.

It has been established that Islamic banking in Uganda derives its existence from the *Financial Institutions (Amendment) Act 2016*. The researcher notes that there are similarities and differences between the Islamic banking and conventional banking. The study has considered the legal framework of Islamic banking under the *Financial Institutions (Amendment) Act 2016* and the challenges which are likely to impede its operations. It has been noted that while Islamic banks and conventional banks have important similarities, there are also differences which largely reflect

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<sup>228</sup> Nooraslinda Abdul Aris, "Islamic Banking Products: Regulations, Issues and Challenges", (2013) 29(4) *Journal of Applied Business and Challenges*, page 1145.

that Islamic banks need to comply with *Shari'ah* Law. The study notes that although the Islamic financial institutions have to operate in accordance with *Shari'ah* principles but this may be restricted by the Central Bank's regulations and policies. In conducting Islamic banking business, there is likely to be a conflict between the conventional banking and the principles of *Shari'ah*. This implies that *Shari'ah* will have to be interpreted within the confines of the provisions of the Financial Institutions Act. However, the researcher has noted that the adoption of Islamic banking is likely to have some legislative challenges which cannot effectively serve the true operation of Islamic banking. It has been established that there are laws and procedures that are likely to run counter to the principles of Islamic banks which if applied to them could cause un due unfairness to the Islamic banks and which would defeat the whole purpose of establishing Islamic banking in Uganda. The study has identified areas of amendment in the existing laws. The study recommends that a comprehensive legal framework is a vital component to guarantee success on the implementation of any Islamic banking system.

It is further established that Uganda's legal system is based on the English Common Law. Judicial functions are administered by various courts established in accordance with the law. The Islamic Bank disputes are likely to fall under the ordinary court's jurisdiction since the Act does not specify a special jurisdiction. As Islamic banks disputes fall under the same purview, all disputes arising out of Islamic bank transactions are likely to be subject to the same procedure and process as experienced by its conventional counterpart because the Act is standard. It is submitted that this situation may result into bad decisions on Islamic banking matters keep into consideration that, some of the current judges and magistrates do not have the requisite knowledge of Islamic banking system. This study has served to clear away some of the mysteries that surround Islamic financial services and it has showed how such financial system can fit alongside a conventional interest-bearing banking system in Uganda.

## **4.2. Recommendations**

### **Lessons from Malaysia.**

The Ernst and Young World Islamic Banking Competitiveness Report 2016 ranks Malaysia as a leading Islamic finance powerhouse globally.<sup>229</sup> Islamic finance has been a priority area in Malaysia for three decades with promulgation of Islamic fitting laws. In 2013, it enacted a

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<sup>229</sup> Ernst & Young, op cit (n40)

comprehensive Islamic Financial Services Act to consolidate Islamic financial sector regulations, improving *Shari'ah* governance, properly differentiate Islamic deposit taking from investment activities, and provide relevant regulations for both.<sup>230</sup> These efforts foster proper risk sharing between the financial institutions and their clients. The Act further graces the responsibility of overall supervision with the Central Bank of Malaysia; the Bank Negara Malaysia (BNM).<sup>231</sup> The BNM was established under the Central Bank of Malaysia Act 1958 which is currently amended by the Central Bank of Malaysia Act 2009.<sup>232</sup> Lessons and recommendations to take away from their banking law regime in aid of a young Ugandan Islamic law banking sector include the following.

In Malaysian case of **Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Others**<sup>233</sup> The civil courts had diligently applied contractual law in disputes involving Islamic banking transactions, more concerned with the civil aspects and not actually tackling the *Shari'ah* issues. Holding that there was no defence if the debtor had knowingly entered into the agreement. The court ruled that the *Al-Bai Bithaman Ajil* ('*BBA*') contract in the cases before him was not a bona fide sale but a financing transaction. The judge found that the profit portion rendered the transaction contrary to the Islamic Banking Act 1983 on the ground that it made the contract far more onerous than the conventional with *riba*. In reaching his decision, the court held that the civil court is not a mere rubber stamp and that its function included the examination of the application of the Islamic concepts and ensure that the transactions do not involve any element not approved in Islam. Justice Patail further stated that '*whether the court is a Syariah Court or not, that Allah is Omniscient must also be assumed where that court is required, in this case by law, to take cognizance of elements in the religion of Islam.*' Justice Patail went so far as to hold the words "not approved by the religion of Islam" in the **Islamic Banking Act 1983** means that '*unless the financing facility is plainly stated to be offered as specific to a particular mazhab, then*

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<sup>230</sup> Act 759 Laws of Malaysia, whose long title is, "An Act to provide for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with *Shari'ah* and for related, consequential or incidental matters".

<sup>231</sup> Section 6

<sup>232</sup> Section 3 of Act 701, Laws of Malaysia whose long title states that, "An Act to provide for the continued existence of the Central Bank of Malaysia and for the administration, objects, functions and powers of the Bank, for consequential or incidental matters".

<sup>233</sup> [2008] 5 MLJ 631.

*the fact it is offered generally to all Muslims means that it must not contain any element not approved by any of the recognized mazhabs’.*

### **Application of Alternative Dispute Resolution**

For an expedient and efficient supporting Islamic legal system, there is need to train judicial officers, lawyers and other officers of court about the intricacies of Islamic law. However, in the meantime, it is crucial to use Alternative Dispute Resolution (ADR) in solving any dispute which emerged from the Islamic banks in Uganda.

ADR firstly is a highly encouraged practice in Islam<sup>234</sup> and has been practiced since the advent of *Shari’ah law* over fourteen centuries ago.<sup>235</sup> Another reason why ADR is a suitable mechanism is that through the mediation and arbitration modes, the parties can employ an Islamic bank expert to facilitate their resolve or arbitration. This would overcome the challenge arising from the lack of acquainted personnel in the courts of law. Further, this mode is beneficial to both parties to the dispute as it may save time wasted in court litigating and also can foster confidentiality if the would-be litigants do not wish to wash their linen in public.

In Malaysia, ADR is prevalent and the Central Bank’s *Shari’ah* board has overall authority over *Shari’ah* issues arising out of banking and finance as the final arbiter in disputes on such issues.<sup>236</sup> Section 51 of the Central Bank of Malaysia Act 2009 establishes a *Shari’ah Advisory Council* and its ruling is not only binding but can be used as precedence by courts of law.<sup>237</sup>

The same is recommended for Uganda. This would bequeath the BoU *Shari’ah* advisory board legislative and adjudicative powers ensure quick, proper and informed decision making. If the members of BoU *Shari’ah* Board make good decisions, this could also create a wealth of Islamic finance jurisprudence for the court's guidance through this new nascent phenomenon.

### **Exemption from Double Taxation**

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<sup>234</sup> The Quran at Surah 4, verse 35, “*If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from hers; if they both wish for peace, Allah will cause their reconciliation. Indeed, Allah is Ever All-Knowing, Well-Acquainted with all things.*”

<sup>235</sup> Blazing The Trail: The Institutional Framework for Dispute Resolution in Malaysia’s Islamic Finance Industry Umar A. Oseni and Abu Umar Faruq Ahmad.

<sup>236</sup> Section 57 of the Central Bank of Malaysia Act 2009.

<sup>237</sup> Section 56(2) of the Central Bank of Malaysia Act 2009.

To remove tax discrimination between the application of conventional instruments and Islamic instruments, Malaysia made different amendments to its legislation regarding tax treatment of Islamic finance.

Under amendments to the Malaysian Income Tax Act 1967, Section 2(8) provided that “...*any reference in this Act to the disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank...as a scheme in accordance with the principles of Shari’ah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing*”. This implied that the Act allowed Islamic financing to continue without any tax issues relating to asset transfer or lease whilst though not evading taxes.<sup>238</sup>

Further the Malaysian Stamp Act 1949 has been amended by a variety of exemption orders for different transactions. These exempted from stamp duty on all instruments of *Ijara* lease agreement of immovable property executed between a client and a bank pursuant to the *Ijara* term financing facility;<sup>239</sup> instruments of asset sale agreements between client and bank made under principles of *Shari’ah* for the purpose of renewing any Islamic overdraft financing facility;<sup>240</sup> and like instruments that related to purchase of property for the purpose of lease back under *Shari’ah* principles.<sup>241</sup>

As analyzed in the previous chapter, Uganda’s tax regime if not amended will chock Islamic banking growth at the incipient stage. There is thus urgent need for modification of the tax laws to exempt the Islamic banks from double taxation on assets they acquire for financing purposes.<sup>242</sup>

### **Separate Deposit Protection Fund**

Malaysia has implemented a binary deposit insurance system following the September 2005 enactment of the Malaysia Deposit Insurance Corporation Act (MDIC Act)<sup>243</sup>. Malaysia’s Islamic

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<sup>238</sup> Section 2(7) also provided an amendment that, “*any reference to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Shari’ah*”.

<sup>239</sup> Stamp Duty (Exemption) (No.8) Order 2000

<sup>240</sup> Stamp Duty (Exemption) (No.9) Order 2000

<sup>241</sup> Stamp Duty (Exemption) (No.3) Order 2000

<sup>242</sup> Also see. Basiru Oyen Iran Fatai, ‘*Can Islamic Banking Work in Nigeria?*’ *Journal of Sustainable Development in Africa* (Volume 14, No.2, 2012).

<sup>243</sup> Now amended and cited as ‘Malaysia Deposit Insurance Corporation (Amendment) Act 2015’.

deposit insurance system operates separately from the conventional system, but both systems are administered solely by the Malaysia Deposit Insurance Corporation (MDIC).<sup>244</sup> This makes it easy to determine which money belongs to either bank and as such, money can be invested in *Shari'ah* compliant liquid assets until they are required.<sup>245</sup> Therefore in times of distress, the money appropriated for Islamic banks in the deposit protection fund can be used to revive a distressed Islam financial institution and nurse it back to normal health as a going concern

There is a need for creating other forms of returns to the BoU so that Islamic banks can benefit from loans granted by the Central Bank when in danger. The importance of this cannot be understated. In his text, "Lombard Street: A Description of the Money Market" (1873), Walter Bagehot postulates that unlike commercial banks, the role of the Central Bank is peculiar because it is the holder of liquid reserves. Therefore, when commercial banks encounter illiquidity or financial distress, the Central Bank has the capacity and duty to lend the commercial banks to satisfy liquidity demands. If BoU keeps a separate Fund that is interest free then in times of need, it can lend to the Islamic bank.

### **Twin Peaks model of financial regulation.**

Lastly is research not from the Malaysian context but one the author is inclined to recommend as necessary for economic stability and successful supervision of Islamic finance and Uganda's banking sector at large. This is based on the findings made throughout this paper and mainly those of the Judicial Commission of Inquiry instituted in January October 2000 to investigate the cause of the frequent collapse of banks. The commission chaired by Justice James Ogoola upon concluding its investigation found that weak supervision by the BOU was a major cause of these bank failures.<sup>246</sup> There had been laxity in decision making and the bank had not actively used its intervention powers at the early detection of distress by banks which was reiterated by the IMF.<sup>247</sup>

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<sup>244</sup> Section 3 states that, "there is hereby established a body corporate by the name of "Malaysia Deposit Insurance Corporation" with perpetual succession and a common seal, and which may sue and be sued in its corporate name."

<sup>245</sup> Mzee, Mzee Mustafa. "The Legislative Challenges of Islamic Banking in Tanzania." *JL Polly & Globalization* 45 (2016): 131.

<sup>246</sup> Ingves, Stefan, and Abdoulaye Bio Tchané. 'Uganda: Financial System Stability Assessment, Including Reports on the Observance of Standards and Codes on the Following Topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems.' (2003).

<sup>247</sup> See IMF Country report, *Uganda: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision,*

In light of this, the ‘Twin Peaks Model of financial regulation’ is recommended. This mode of financial regulation calls for the separation of the financial stability role to be administered by a one department and the supervision of banking practice and consumer protection mandate to be exercised by another department/regulator.<sup>325</sup> The first peak, the Financial Stability Commission, would ensure that there are adequate and sufficient prudential measures to ensure soundness of the financial system, capital adequacy of banks and control of risk. The second peak, the Consumer Protection Commission, would enforce business conduct regulations to ensure that customers received a fair, honest and transparent service.<sup>248</sup> This model has been applied by Australia, Netherlands, the UK and its off-shoots can be found in South Africa,<sup>249</sup> Spain and Canada.<sup>250</sup>

The introduction of Islamic finance in Uganda has widened the scope of financial industry and as such silo regulation has become untenable.<sup>251</sup> A research for a twin peak system in Uganda is essential especially in the wake of the BoU’s struggles with supervising national banks.<sup>252</sup> This would help reduce the load of responsibility the BoU has and instead of focusing on the whole economy, direct its attention on prudent supervision of Islamic banks and the sector at large.

### **Promote Marketing Strategy**

Islamic banks in Uganda will have to improve their marketing effectiveness by addressing the market ignorance about Islamic products and services. Islamic Banks will have to create awareness through aggressive marketing in different media and location across the country. These

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*Securities Regulation, and Payment Systems* at pg. 38 (10/4/03), Washington, D.C. <sup>325</sup> Michael Taylor, “Twin Peaks: A Regulatory Structure for the New Century”. Issue 20 of Centre for Study of Financial Innovation Series, 1995.

<sup>248</sup> Ibid

<sup>249</sup> Under the newly promulgated Financial Services Regulation Act, 2017.

<sup>250</sup> For a general discussion on Twin Peaks model and the various regulatory systems see Richard J. Herring & Jacopo Carmassi *The Structure of Cross-Sector Financial Supervision* Wharton School, University of Pennsylvania (unpublished) at pg. 10, accessed via <http://fic.wharton.upenn.edu/fic/papers/07/0734.pdf> (last visited on 22nd March 2024).

<sup>251</sup> Silo regulation means a regulatory framework based on supervision and regulation of according to industries, such as separate regulators for banking, insurance, securities and pensions. This differs from Twin Peaks in the sense that the peaks model regulates according to function, such as consumer treatment and systemic risk management. Silver Kayondo, “*Legal aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience*” dissertation presented in fulfillment of the requirements for the degree of Master of Laws (Banking and Finance) at the University of Pretoria. Page 59

<sup>252</sup> During the closure of Crane Bank, the BoU Governor admitted that they discovered “too late” that the bank had been involved in fraud, for lack of a better word, involving theft of depositors’ money. See Ivan Okuda, ‘Museveni okayed Crane Bank closure- Mutebile’ *The Daily Monitor* available at <http://www.monitor.co.ug/Business/Museveni-okayed-Crane-Bank-closure-Mutebile/688322-404096232dpb0/index.html> (accessed on 22nd March 2024)

banks have to attract non-Muslims customers through product innovations and market development. Therefore, it is important for Islamic banks to educate people about what they offer and the need to be heavily involved in the marketing of their products and services. There is a need to increase the awareness of Islamic products and services via brochures, pamphlets and seminars, which will enable Islamic banks to improve market share and retain financial resources in the country.

### **Amendments on procedural Laws**

Furthermore, the civil court needs to make necessary modifications to the governing and procedural laws in order to accommodate Islamic banking. The civil court has to make necessary modifications, as well as being flexible to the rules in view of greater development of Islamic banking in Uganda. Some of statutes as discussed in chapter 3 and 4 of this thesis which were enacted before the existence of Islamic banking should be amended, or else should be made exceptional to Islamic banks as there are some provisions that may be irrelevant or inapplicable to the operation of Islamic banks. In other words, the law should be interpreted actively in Favour of Islamic banking as laws are supposed to be organic pieces of legislation that always need modern application in order to achieve justice and fairness which is the cardinal principle of legal system.

### **Public Awareness on Islamic banking**

In Uganda, the majority of the population is non-Muslims. In order for Islamic banking to grow there is a need to encourage non-Muslims to use Islamic facilities. So far there is no empirical study on awareness on Islamic banking in Uganda. Muslims may have little idea but for the non-Muslims the gap is considered still wide.

To address the local lack of familiarity and expertise, more education and awareness raising initiatives about Islamic banking amongst Ugandans should be undertaken so as to build greater confidence in the market. This could be done by a combination of academic as well as practitioner orientated course, seminars, and workshops among others. The study also recommends that a strenuous effort be made to educate people before establishing Islamic banking to provide *sharia'h* compliant banking products and services, given the high level of ignorance of the underlying philosophy and the nature of Islamic banking and finance among people without discriminating those associated with the industry.

### **Promotion of the Image of Islamic banks**

The first action that deserves immediate attention is the promotion of the image of Islamic banks. Strategies have to be carefully devised so that the image of Islamic character and solvency as a bank is promoted. Islamic banks should clearly demonstrate by their actions that their banking practices are guided by profitability criterion thereby establishing that only Islamic banking practices ensures efficient allocation of resources and provide true market signals. Islamic banks should continuously monitor and disseminate through various means the impact of their operations on the distribution of income primarily between the bank and the other two parties: the depositors and the entrepreneurs, and then on different income groups of the society.<sup>253</sup>

Islamic banks, with a view to facing the growing competition either fellow-Islamic banks or the conventional banks which have launched Islamic banking practices, will have to adopt their functioning in line with modern business practices, though improvement and expansion of the range of dealing in the banking sector. Thus, it is necessary for them to provide comprehensive banking and investment services to clients and simultaneously to take advantage of modern technological breakthroughs in areas such as electronic communication, computerization, among others.<sup>5</sup> Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations.

### **Central *Shari'ah* Advisory Council as final**

There is a need to amend the provision on *Shari'ah* Boards. The effect of this amendment is expectedly to ensure that any deliberation of the *Shari'ah* Advisory Council will bind the court and should be followed by all Islamic financial institutions in Uganda as it done is in Malaysia. For example, in Malaysia, The *Central Bank Act*, Section 16 B (8) provides that where in any proceedings relating to Islamic banking business and Islamic financial business which is based on *Shari'ah* principles before any court or arbitrator any question arises concerning a *Shari'ah* matter, the court or the arbitrator may refer such question to the *Shari'ah* Advisory Council for its ruling. Any ruling made by the *Shari'ah* Advisory Council pursuant to a reference by a court, be taken into consideration by the court and if the reference was made by an arbitrator, be binding on the arbitrator.<sup>254</sup> If this is not put in place, there is likely to be conflict in the jurisdiction of Islamic banking matters because the civil courts will have to decide based on common law.

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253 Md. Abdul Awwal Sarker, "Islamic banking in Bangladesh: Performance, problems & prospects", *International Journal of Islamic Financial Services* Vol. 1 No.3, page 10. ([www.lefpedra.com/](http://www.lefpedra.com/) ...Islamic...)

254 Zulkifli Hasan, "The Effectiveness of the Legal Framework of the Islamic Banking System in Malaysia," *Working Paper Faculty of Syariah & Law Islamic University College of Malaysia* (KUIM), page 6.

### **4.3. Conclusion**

In a nutshell, while Islamic banking and finance is expected to remarkably contribute to inclusive economic growth and development in Uganda, it remains an emerging field in the financial system. Therefore, all stakeholders must first clearly acquaint themselves with the intricacies of Islamic finance modes; apprehend its unique tenets that distinguish it from conventional banking while also acknowledging the similarities between the two models. This will significantly contribute to the effective rollout and growth of the Islamic banking sector in Uganda. From the aforementioned, one thing is clear and that is all stakeholders, from the customers to the banks and regulatory authorities, there must be joint effort in kick starting Islamic Banking especially at this incipient stage. As discussed, because of its interest-free nature among other qualities, it has the potential to lower the cost of accessing credit which is a major challenge to financial inclusion.

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