

**TOWARDS ISLAMIC BANKING IN UGANDA: AN ANALYSIS OF ITS
REGULATION, PROSPECTS AND CHALLENGES IN A SECULAR
LEGAL ENVIRONMENT**

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By

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DECLARATION

I, NATUKUNDA MASTULAH declare that this Thesis is my own work except where due acknowledgement is made in this text. It does not include materials for which only other University master's degree, degree or diploma has been awarded.

Signature -----

NATUKUNDA MASTULAH

REG No: 1153-01056-03699

Date -----

APPROVAL

I clarify that I have supervised and read this Thesis and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate in scope and quality as a Thesis for partial fulfillment for the award of Master of laws Degree of Kampala International University.

Signature of the Supervisor

Name of the Supervisor

Y.M LUWALIRA LUBOWA

Date

DEDICATION

I dedicate this thesis to my beloved parents; Mr. and Mrs. Kadir Kafureeka Nkorongo of Kabwohe, Sheema District, my husband Mohamoud and sons; Mahathir and Ainaam.

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I thank the Almighty Allah for the support He gave me and also making me look at Him whenever I had any need help, lifting me up whenever I had fallen and also helping me finish up my Master of Laws Degree because it has not been an easy journey. Thank you God.

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ABSTRACT

Islamic banking in Uganda derives its existence and power from the Financial Institutions (Amendment) Act 2016. The concept of Islamic banking is a new phenomenon in the banking system of Uganda's secular environment. Currently this concept is mainly regulated by the Financial Institutions (Amendment) Act 2016. This thesis analyzes the Islamic banking regulatory framework, prospects and the challenges which are likely to impede its operations. The thesis explains the fact that although Islamic financial institutions have to operate in accordance with *Shari'ah* principles, this may be restricted by the Central Bank's regulations and policies especially the Financial Institutions (Islamic Banking) Regulations 2018 and other regulations. In conducting the study the researcher relied on qualitative methodology. Accordingly, data was collected using both primary and secondary source of information. 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. There are laws and procedures that are likely to run counter to the principles of Islamic banks which if applied to them could cause undue unfairness to the Islamic banks and which would defeat the whole purpose of establishing Islamic banking in Uganda. The thesis 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.

LIST OF STATUTES

UGANDA STATUTES

Bank of Uganda Act, Cap 51
Civil Procedure Act, Cap 71
Civil Procedure Rules
Companies Act 2012
Constitution of the Republic of Uganda, 1995
Contracts Act 2010
Evidence Act Cap 6
Financial Institutions (Amendments) Act, 2016
Financial Institutions Act, 2004
Hire Purchase Act, 2009
Insurance Act, 2017
Judicature Act, Cap 31
Land Act, Cap 227 (As amended)
Marriage and Divorce of Mohammedan Act, Cap 252
Micro Finance Deposit Taking Institutions Act, 2004
Partnership Act, 2010
Sale of Goods Act, Cap 82
Tier 4 Microfinance Institutions and Money Lenders Act, 2016

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

ABBREVIATIONS

AAOIFI	- Accounting and Auditing Organization for Islamic Financial Institutions
BAFIA	- Banking and Financial Institutions Act
BCBS	- Basel Committee on Banking Supervision
BCP	- Basel Core Principles for Effective Bank Supervision
BNM	- Bank Negara Malaysia
BOU	- Bank of Uganda
CSAC	- Central <i>Shari'ah</i> Advisory Council
CB	- Conventional Banking
DIF	- Deposit Insurance Fund
EAC	- East Africa Community
FIA	- Financial Institutions Act
IAS	- International Accounting Standards
IB	- Islamic Banking
IBA	- Islamic Banking Act 1983
IDB	- Islamic Development Bank
IFRS	- International Financial Reporting Standards
IFSB	- Islamic Financial Service Board
IMF	- International Monetary Fund
OIC	- Organisation Islamic Conference
PLS	- Profit and loss sharing
PSIA	- Profit sharing investment account
SAB	- <i>Shari'ah</i> Advisory Body
SSB	- <i>Shari'ah</i> Supervisory Board
SSC	- <i>Shari'ah</i> Supervisory Council
UAE	- United Arab Emirates
UDB	- Uganda Development Bank
UMSC	- Uganda Muslim Supreme Council

LIST OF CASES

Arab Malaysian Finance Berhad V Taman Ihsan Jaya Sdn Bhd and others (2008)5 MLJ 631

Bank Islam Malaysia Berhad V Lim Kok Hoe and Anor and other Appeals (2009)6 MLJ 839

Bank Kerjasama Rakyat Malaysia v Emcee Corporation

BIMB V Adnan Bin Omar (1994)3 CLJ 73

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

Investment Company Of The Gulf (Bahamas) Limited v Symphony Gems N.V. and Ors [2002]

West Law 346969, QBD (Comm. Ct.

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

Malayan Banking Berhad v Ya'kup bin Oje & Anor. [2007] 6 MLJ 398

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

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

Woods V Martin Bank Ltd (1959)1QB 55

CHAPTER ONE

GENERAL INTRODUCTION

1.1 Background to the study

Uganda has a population of 34.5 million people of which about 13.5 % are Muslims.¹ Muslims form a significant portion of the total population and live in different parts of the country. Uganda does not adopt a state religion.² Every person has a right to practice any religion and manifest such practice which include; the right to belong to and participate in the practices of any religious body or organization in a manner consistent with the Constitution.³ Islamic law in Uganda is only applicable in a very limited sphere, for example marriage, divorce, inheritance of property and guardianship.⁴ Uganda is one of the latest countries in East Africa that has embraced Islamic banking under the *Financial Institutions (Amendment) Act 2016* even though it is not an Islamic State. This amendment has revolutionised banking sector by putting forward new banking products that have not been known in the Ugandan's conventional banking system. 'Islamic banking' in this case therefore, refers to a system of banking that is consistent with the principles of *Shari'ah*/Islamic law and its practical application through the development of Islamic economics. *Shar'iah* is the main source of Islamic economy and finance. In addition *Sharia'h* is Islam's legal system derived from both the Quran and the rulings of Islamic scholars devised to provide guidance to Muslims.⁵

Islamic law or *shari'ah* covers not only religious rituals but also many aspects of day-to-day life, politics, economics, banking, business or contract law and social issues. The Islamic canon law is derived from three sources; these include the *quran*, *sunna* and *hadith*. The Quran is the revealed holy book for Muslims whereas *sunnah* means the practices and traditions of the prophet

¹2014, Uganda National Census.

² Article 7, *The Constitution of the Republic of Uganda* of 1995.

³ Article 29(1) (c) *Constitution of the Republic of Uganda* of 1995

⁴ Article 129(1)(d), *ibid*.

⁵ KR.Sargenti, "The Growth of Islamic Banking: A Singaporean Study on the Legal Conflicts of Embracing Shari'ah Law" (2010) *Santa Clara J.Int'l*, pg 8.

Mohammad and *hadith* is the sayings of prophet Mohammad.⁶ It is further reinforced by three features that is *ijma* (consensus), *qiyas* (analogy) and *ijtihad* (discourse).⁷

Although Islamic banking is based on a religious law, it is nevertheless, not a religious product or service that is the exclusive preserve of people of a particular faith or religion. It is universally accessible to and enjoyed by people of diverse religious persuasions or ethical beliefs across the globe.

An “Islamic bank” is defined as an Islamic financial institution which is a bank.⁸ Islamic financial institutions is 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 operations are and will be conducted in accordance with the *Shari’ah*.⁹

Islamic banking is a faith based system of financial management which derives its principles from the *shari’ah*.¹⁰ For the banks to be considered to be offering Islamic services they are required to conform to the Islamic rules and norms; this means that they should make religious features integral to their operations.

Islamic banking is based on the following principles; firstly is the prohibition of interest (*riba*) in all transactions. Secondly, is that the business and investments are undertaken on the basis of *halal* (legal/permitted) activities. Thirdly, *maysir* (gambling) is prohibited and transactions should be free from *gharar* (speculation or unreasonable uncertainty). Furthermore, *zakat* is to be paid by the banks for the benefit of society and all activities should be in line with Islamic principles. Finally, there should be a special *Sharia’h* Board to supervise and advise the bank on the propriety of the transaction.¹¹

⁶M Parker, “The Growth and Current Developments and Challenges For Global Islamic Finance” Forum on Islamic Finance and Investment, Renaissance Hotel, Moscow, Russian 26-27 May 2010, page 3.

⁷Ibid.

⁸ Section 2, Financial Institutions (Amendment) Act 2016.

⁹Ibid.

¹⁰M Parker, note 6, pg 3.

¹¹M. Kabir Hassan and K Mervyn Lewis, *Handbook of Islamic Banking* (Eds.), Edward Elgar Publishing Limited, Cheltenham,, 2001, Vol.38, page 3.

Practitioners need to understand these principles in order to be able to provide services and products demanded by consumers that want to comply with Islamic principles. At the same time, supervisors need to know the challenges that these new financial products and institutions will impose on the regulated entities, as well as the potential implications of the interaction between Islamic and conventional banks. The nature of the relationship between customers and the Islamic bank is different from that of the conventional banks. In conventional banking the relationship is that of a bank and borrower or depositor while in Islamic banking the relationship is that of a bank and a partner.¹² Therefore, in Islamic banking customers are regarded as investors and entrepreneurs, the banks usually provide finances through participation whereby profits gained and losses incurred are shared according to pre-agreed ratio.¹³ Lastly, Islamic banking and finance views money as not a commodity unlike conventional banking which is interest based.

The Islamic banking and finance systems are relatively new compared to conventional banking system. Islamic Banking emerged as early as 1940's this was as a result of resentment against the imposition of capitalist banking which was dominant in the Islamic world during the colonial era.¹⁴ Interest-based system of banking continued even after when these countries had attained their independence.¹⁵ It is against this background that Muslim intellectuals and economists started to write about Islamic economics and financial system notably in the Indian subcontinent and Egypt. The early writings expounded the philosophy and the concepts of interest-free finance along with its effects on the socio-economic welfare of the society. The first modes of Islamic financing that operated without any concept of interest were two-tiered mudarabah finance structure, in this case, the Islamic bank on one hand would receive deposits as an agent (mudarib) of its customers; and on the other hand provide finance to an investment or enterprise as principal (sleeping partner or rabb-al mal).¹⁶

¹² Ibid.

¹³ M. Mustafa Mzee 'The Legislative Challenges of Islamic Banking in Tanzania', (2016) 45, *Journal of Law, Policy and Globalization*, pg 131.

¹⁴ Kylee R. Sargenti, 'The Growth of Islamic Banking: A Singaporean Study On the Legal Conflicts of Embracing Shari'ah Law', (2010) 431, *Santa Clara J. Intl L.* page 435.

¹⁵ S Syed, *Islamic Banking and Finance: Fundamentals and Contemporary Issues*, (ed) Islamic Research and Training Institute, Universiti Brunei Darussalam, 2004, page 1.

¹⁶ S Syed Ali, above, page 1.

Initiative to finance enterprises based on interest free principle started in earnest in the 1970's with the personal initiative of respective Muslims to eliminate *riba*. It should be noted that the collapse of Uthumanic Kalipha or Empire in Turkey created fear in the minds of Muslims that Islamic teachings are erasing from the humankind and a preventive measures are needed to revive it in the so called modern way of life; During this time Ahamed al Naggar who is said to the father of Islamic banking was residing in Germany and he witnessed how the German government was operating the social saving bank to sustain the economic growth of the country.¹⁷ It is against this background that the father of Islamic banking was desirous of implementing the some concept in Egypt which was accepted by Egyptian government and later alone, the first Islamic bank in the name of Mit al Gamar Local Saving Bank in the Nile Delta in Egypt was established to achieve the objective of exploring possibilities of mobilization of saving and local credits as an essential condition for social and economic development.¹⁸ The earliest Islamic institution was traced in the form of savings institution based on profit sharing. Nevertheless, this was a small project in a relatively poor area where Muslims needed banking services and were provided to them on *sharia'h* compliant basis. However Mit al Gamar bank was closed due to various reasons.

The breakthrough of Islamic banking as seen today emerged in 1970's at the 2nd conference of foreign ministers of Muslim countries which was held in Karachi- Pakistan and it was also at this conference that the idea of full fledged banking system was established.¹⁹ In 1975 the Islamic Development Bank (IDB) was established in Jeddah. This was followed by the establishment of the Dubai Islamic Bank in the United Arab Emirates (UAE) in the same year. The success of these banks led to establishment of series of similar banks, including Faisal Islamic Bank in Egypt and Sudan which was created in 1977 and at the sometime Kuwait Finance House was established in Kuwait. In 1978 Jordan Islamic Bank was created in Jordan and in 1983 Malaysia created its first fully pledged Islamic bank, Bank Islam Berhad, Citibank of United States is the first conventional bank in the world to provide Islamic *sharia'h* products. By 1997 there were 177 Islamic banks in

¹⁷ U Ibrahim et al, "Conflicts Facing Islamic Banking in Malaysia: Dual Banking System Versus Dual Legal System", (2012) 6(11) *Australian journal of Basic and Applied Sciences*, pp 246-251.

¹⁸ Ibid.

¹⁹ M S Issak Josephat Kwasira, "Strategic Factors Influencing the Growth of Islamic Banks in Nakuru Sub County Kenya", (2012) in *J Journal of Science and Research*, page 446.

the world. Among these 51 banks are in South Asia, 36 banks in Africa, 31 banks in South East Asia, 37 banks in the middle East and 12 banks in Europe, Central Asia and Europe.²⁰

In the 1960s and early 1970s, the developments were more theoretical and short of any practical experimentation. It is worth noting that his accumulated theoretical knowledge prepared the ground and developed sufficient collective will for the emergence of first Islamic banks one in Private sector, Dubai Islamic Bank and another as a multilateral organization, Islamic Development Bank (IDB) both of which came into being in the early 1970s. Many more Islamic banks and financial institutions were created in the following years. A combination of practical realities of the business and constraints of the regulatory environment forced the Islamic banks to rely mostly on *murabahah* and leasing contracts for the financing activities instead of the originally conceived *mudarabah* contract in the second tier. So much is the use of *murabahah* that some authors referred to this practice as *murabahah* syndrome.²¹

Islamic banking emerged with concepts, techniques and instruments since very long back but the full fledged system came into existence in 1980's.²² *Sharia'h* has developed specific forms of financial transaction as means of earning without resorting to income generation through interest (*riba*) means. The main purpose of Islam is welfare of humanity and hence Islamic banking is not restricted to only Muslims but also non muslims can benefit from it. This concept has been experimented and applied by some Islamic countries like Iran and Pakistan. They have implemented Islamic banking as the sole banking system while others have adopted a dual banking system (i.e. some governments have permitted conventional banks to offer Islamic products along with conventional products).²³ This has spread in many countries.

²⁰ Uzaimah Ibrahim, "Conflicts Facing Islamic Banking in Malaysia: Dual Banking System Versus Dual Legal System" (2012) *Australian Journal of Basic and Applied Sciences* 243, page 247.

²¹ S Sayed , above, pg.2.

²² A Mohanty and A Sani, "A Comparison of Islamic Banking and Conventional Banking System in India, A Conceptual Approach", *Research gate*. <http://www.researchgate.net/publication/263672950> page 1.

²³ Ibid, page 2.

Islamic finance has grown beyond banking since 1990s and expanded to the realm of capital markets. Currently Islamic financial industry comprises of Islamic banks, investment funds, asset management companies, house financing companies, and insurance companies. The Islamic banking industry has expanded and grown at the highest speed in the in last decade.²⁴ This expansion has brought up a number of practical issues and problems that serve as guiding posts for determining the direction of applied research in the field. Such research has become more active. For example, we see that a larger proportion of the *fiqh* questions and issues discussed by Organization of Islamic Conference (OIC).

Malaysia is one of the countries in the forefront in Islamic banking. The world is looking to this country and trying to learn from its experience in developing modern and sophisticated instruments which are said to be *Sharia'h* compliant. This is the first country in the world to introduce and promote an Islamic inter-bank money market to link all the market players and promote short-term liquidity. The main contributing factor leading to its success is the undeniable support of the Government.²⁵ Other countries in the Far East, like Singapore, Indonesia and Thailand have set up legal framework for facilitating Islamic banking transactions.

According to Earnest and Young Report, countries that have embraced Islamic banking in Africa include Kenya, South Africa, Mozambique, Tanzania, Eritrea and Botswana and among others.²⁶ The Report adds that by 2014, there were still about 70 countries that had embraced Islamic banking of which 37 are from moslem countries and 34 are from non moslem countries.²⁷ It is assumed that such a rise has been due to awareness about Islamic banking and its advantages.

Uganda's banking sector has evolved from the first commercial bank established in 1906 with the National Bank of India which later become the Grindlays Bank and is now the Stanbic Bank. The

²⁴ S Sayed, above, pg. 2.

²⁵ NM. Yasin, "Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies", (2001) 1 *IJUM Law Journal*, pg 5.

²⁶ New Vision, Friday, June 30, 2017 page 45.

²⁷ Ibid.

sector has undergone several policies, legal and regulatory reforms with various degrees of results.²⁸ The evolution of the banking sector has been characterized by bank closures, mergers and acquisitions. Before the country's independence in 1962, the banking sector was dominated mainly by foreign owned commercial banks.²⁹

Uganda Credit and Savings Bank which became Uganda Commercial Bank (UCB) in 1969 was established in 1965. The first local commercial bank in Uganda was established in 1965. Bank of Baroda was established first in 1953 but regularized as a commercial bank in 1969 with the enactment of the *Banking Act of 1969*. This was the first legal framework for regulation of the banking sector following the country's independence. The Bank of Uganda- country's Central bank which was established in 1966 under the *Bank of Uganda Act (1966)*, The BOU was followed by the establishment of the Uganda Development Bank (UDB), with the establishment of UCB and UDB, the government owned banks dominated the banking industry. UDB received all foreign loans and channeled them to the local companies for development, UCB, with the biggest number of branches (about 67 in number), handled the majority of the customers while the East African Development Bank which was established in 1967 handled the East African Community (EAC) business.³⁰

²⁸Lawrence .B. & Luka Jovita O., *Banking Sector Liberalisation in Uganda*, SOMO, 2010 pg 10.

²⁹Ibid.

³⁰ Ibid.

Uganda's efforts in establishing Islamic banking business can be traced to early 1990's when the late Dr. Suleiman Kiggundu (former Governor Bank of Uganda and Managing Director Greenland Bank now in liquidation) and other prominent Muslims businessmen wanted to establish a business conglomerate, the first Islamic Bank in Uganda which failed.³¹ This issue was also discussed in 2008 during the Organization of Islamic Conference (OIC) business forum organized by Uganda. It was during this forum that the President of the Abu Dhabi Investment firm subsidiary, International Investment House, unveiled their proposed merger with the National Bank of Commerce Uganda to transform it into the National Islamic Bank of Uganda.³² The National Bank of Commerce Uganda then went into insolvency and was liquidated by the Bank of Uganda in 2015. It was also suggested that the Islamic Chamber of Commerce and Industry for Global Islamic companies be set up to ease exploration of investment opportunities with the aim of enhancing the financing of Islamic Banking projects in Uganda.³³

After that Conference and further consultations Bank of Uganda embarked on its efforts of drafting the legal frame work for the Islamic banking in Uganda. It started carrying out consultations from various countries which offer Islamic banking like Malaysia, United Arab Emirates and Indonesia. It sent out its staff in those countries to train in Islamic banking. Later, it submitted its proposed amendments of the FIA to the Cabinet which were later forwarded to the Parliament as a Bill. The Bill was passed and then assented to by the president in early 2016. The Regulations on Islamic banking have been produced by the Minister of Finance by Statutory Instrument No. 2 of 2018. These Regulations are called *The Financial Institutions (Islamic Banking Regulations, 2018*. Therefore, the long awaited operation of Islamic banking is yet to begin after the gazzeting of these regulations.

In 2008 the Bank of Uganda first received an application from an institution which was desirous of operating as an Islamic Bank. Later alone the central bank (Bank of Uganda) received numerous

³¹ 50 Sulaiman Lujja, Mustapha Omar Muhammad and Rusni Bt Hassan, "The Feasibility of Adopting Islamic Banking System Under the Existing Laws in Uganda", emerald Insight at:www.emeraldinsight.com/1753.8394.htm, page 418.

³² Ibid. page 419.

³³ Ibid.

inquiries from most of the commercial banks in Uganda seeking to offer Islamic financial products through Islamic banking “windows”. At this time the Central Bank of Kenya had licensed two Islamic Banks while National Bank of Rwanda had licensed an Islamic Micro finance Institution and Bank of Tanzania had commercial banks offering Islamic Financial Services through windows.³⁴ An Islamic window means part of the financial institution, other than an Islamic financial institution, which conducts Islamic financial business.³⁵

Islamic banking is a new concept in Uganda as compared to conventional banking system. This system was established in Uganda’s banking system by the Financial Institutions (Amendment) Act 2016. Nevertheless, there are other laws in Uganda which will also affect Islamic banking system. This thesis will analyze different legal issues which relates to functioning of Islamic banking in Uganda.

1.2 Statement of the Problem

The main piece of legislation regulating the banking sector is the Financial Institutions (Amendment) Act 2016³⁶ but there are other laws which affect banking sector in Uganda. However, most of these laws may not be compatible to the functioning of the Islamic banking in Uganda since this is a new phenomena in the banking sector and it is likely to bring about conflicts in their normal operation. This thesis intends to delve into various legal issues relating to operation of Islamic banking in Uganda.

Bank of Uganda Act³⁷, The Financial Institutions (Amendment) Act 2016, Micro Finance Deposits Taking Institutions Act, 2003 and The Tier 4 Micro Finance Institutions and Money Lenders Act 2016 are the main laws which provide for comprehensive regulations of banks and financial

³⁴ TM Emmanuel, Islamic Banking in Emerging Markets- Forging Uganda’s economic progress, at the Islamic banking Conference, Kampala, 13th May 2016.

³⁵ Section 115A (3) FIA 2016.

³⁶ FIA(Amended), 2016.

³⁷ Bank of Uganda Act, Cap 51.

institutions. Despite their significance for the bank sector in the country, these laws may not be friendly for application of Islamic banks. Some problems may arise from the nature of supervision and licensing of any bank which has to be a body corporate, the operation of deposit insurance scheme, the Uganda tax regime, and Uganda's legal system which is based on the English Common Law, the liquidity issue and restriction to trade by banks. This is because Islamic banking is different in operation from conventional banking.

The issue of supervision of banks in Uganda under the FIA is placed under the Central Bank. This depends on an assessment of the value of assets of the banks supervised.³⁸ The regulations that are currently used by the BOU in supervising banks may not be applicable to Islamic banking since the Islamic banking has new features as opposed to the conventional banks. The Islamic banking has its own regulations, The Financial Institutions (Islamic Banking) Regulations, 2018. Besides those regulations, Islamic banks will also be subjected to other regulations of Bank of Uganda. Furthermore, Bank of Uganda serves as a lender of last resort under the FIA. Although the Bank of Uganda will supervise Islamic banks, Islamic banks cannot benefit from these loans as they are provided on the basis of interest.

It is simply an accepted fact that there are sufficient investors and borrowers both Muslims and non-Muslim to warrant the attention of traditional banks who seek to serve such clients and capture a potentially profitable slice of a still relatively untapped market. This study serves to clear away some of the mysteries that surround Islamic financial services and shows how such financial system can fit alongside a conventional interest-bearing banking system in Uganda and rules relating to Islamic finance emerge out of context of Islamic law more generally. Thus underlying Islamic finance are the concerns, issues, sources and methodologies of Islamic law. The relevant sources include the Holy Quran, which is the most important source of the law, and the *sunna* (tradition) of the prophet Muhammad. The book provides the key principles of Islamic banking and how it can be implemented in conventional banking.

³⁸ Section 79, *Financial Institutions Act*, 2004.

Islamic banking transactions and legal documentation are likely to be subject to the following laws:- Islamic law; Ugandan statutes as well as procedural laws and English Common law and rules of equity. Islamic commercial documentation must satisfy the requirement of existing laws. For instance, if it is financing for land, the legal documentation must satisfy all the requirements as laid down by the Land laws, securities law and Insurance Laws³⁹ and other rules and regulations as set by the statutory bodies in Uganda. The thesis argues that the potential legal risk will be where the Civil law and procedure law are in conflict with *Shari'ah* and its principles. The operation and practice of Islamic banking is likely to face such challenges.

The thesis argues that to ensure a proper, speedy and supporting Islamic banking legal system, amendments in existing laws, which are likely to be repugnant to Islamic banking, are required to promulgate Islamic banking law compliant products. This thesis argues that there is a need to amend some of the existing laws in order to accommodate Islamic banking in Uganda,

The introduction of Islamic banking in Uganda meant that Islamic banking will operate alongside the conventional banking which attracts interest because both are under the same Act. However, the adoption of Islamic banking is likely to have some legislative challenges which cannot effectively serve the true operation of Islamic banking. There are laws and procedures that are likely to run counter to the principles of Islamic banks which if applied to them, could cause undue unfairness to the Islamic banks and which would defeat the whole purpose of Financial Institution (Amendment) Act of 2016.

The establishment of Islamic banking in Uganda is likely to be challenged by the fact that some people fear that it will promote religion and will be discriminative. Those opposing Islamic banking see it as an attempt to Islamize Uganda. However, this is not true because Islamic banking is inclusive and takes care of all sorts of people and groups with different needs.

³⁹ Land Act, Cap, Registration of Titles Act, Mortgage Act, Stamps Act and others.

This thesis therefore, intends to discuss what Uganda as an economy is likely to benefit from Islamic banking as a new concept in the banking sector of Uganda.

1.3 Research Questions

In order to achieve the intended objectives of the study and to address the research problem properly certain research questions are designed accordingly. In light of this, the research ponders to answer the following research questions:

- a) What is the nature and scope of Islamic banking and its products and services?
- b) What is the legal frame work of Islamic banking in Uganda?
- c) What are impediments of the existing laws towards adopting Islamic banking system?
- d) What are appropriate amendments in the existing laws to allow the establishment and regulation of Islamic banking a long side conventional banking in Uganda?
- e) What are the likely prospects that Ugandans will generate from the establishment of Islamic banking in the banking sector?

1.4 Objectives of the Study

This thesis specifically strives to achieve the following objectives.

1.4.1 General objective

The general objective of the study is to analyze the Islamic banking regulatory frame work, prospects and challenges in Uganda's legal environment. Therefore, the study tries to analyze the regulations, prospects and challenges that Islamic banking sector is likely to face in Ugandan banking system.

1.4.2 Specific objectives

This thesis specifically strives to achieve the following objectives:

- (a) To examine the nature of and scope of Islamic banking and discuss different Islamic banking products and services;
- (b) To examine the legal framework of Islamic banking in Uganda.
- (c) To explore the impediment of the existing laws towards adopting Islamic banking system;
- (d) To examine the appropriate amendment in the existing laws to allow establishment and regulation of Islamic banking alongside conventional banking in Uganda;
- (e) To highlight the likely prospects that Ugandans will generate from the establishment of Islamic banking in the banking sector.

1.5 Significance of the Study

The introduction of Islamic banking is of immense importance to various sectors in the Ugandan economy. Therefore, the significance of the study can be as follows: This study will be an academic research of Islamic banking law which has not been widely covered from the Ugandan legal perspective. The outputs from this study will provide basic essentials for the Islamic banking transactions. This study will help the existing efforts made to improve the perception, awareness and knowledge of Ugandan towards Islamic Banking products. This study also renders as a source of reference to policy makers and academicians which is rather scarce in both academic and professional circles. This will help them formulate policies that will aid the development of Islamic Banking business in Uganda. The study will help banks and other financial institutions that require an understanding of regulatory challenges faced by the Islamic Banks in Uganda with a view of formulating appropriate responses to those challenges. The suggestions or recommendations provided by this study can be implemented to reduce the potential problems related to legal procedures likely to affect full operation of Islamic banking in Uganda. The findings of this study will have its contribution to legal knowledge building and academic research by helping other researchers to undertake a further detailed investigation on the subject.

1.6 Geographical Scope

The scope of this study is limited to Uganda. However, Islamic banking legal framework from other jurisdictions will be analyzed in order to benchmark with Uganda. Examples will be drawn from countries that have common law legal system and at the same time operate Islamic banking. In particular, Malaysia, Singapore, Kenya, Tanzania to mention but a few.

1.7 Methodology

To successfully work on the set objectives, the researcher employed doctrinal methodology in the study since this is a legal research. Accordingly, the data was collected using both primary sources and secondary sources of information.

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 secondary sources of information furnish the information derived from primary sources. Data was collected basing on the following sources; critical study from textbooks, journals, workshops, articles from newspapers, working papers, conference papers and internet sources which are relevant to Islamic banking. In addition, the library is the main source to accomplish the mission of this study. All these sources will be analyzed in order to achieve the desired objectives of the research.

1.7.1 Data Analysis

Qualitative method of data collection focuses on selection other observation. The author referred to statutes, law reports, textbooks, journals, seminar papers, working papers, conference papers which are relevant to Islamic banking transactions.

Much of the work was collected on internet because there is no much material about the subject since Islamic banking is a new phenomenon in Uganda's banking system. The author did not apply questionnaire and interview methodology since Islamic banking business has not yet commenced, most of the population do not know its applicability and much more even the bank staff in the existing banks do not know how this system works because most of them were trained about conventional banking not Islamic banking. Therefore, the author could not attempt to ask about something that has not yet commenced. Islamic banking system was established in Uganda's conventional banking system by the Financial Institutions (Amendment) Act 2016. However it has not yet commenced because the minister of Finance has not issued a commenced instrument and commencement date.

1.8 Literature Review

It should be noted that Islamic banking in Uganda has limited literature as it is a new phenomena 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 paper⁴⁰ traced the history of Islamic banking in the Muslim world and how Islamic banking was spread in Europe and some Far East. The author provided the advantages of Islamic banking compared to conventional banking. The author also discussed the legal framework of Islamic banking in some selected countries. She commented on the establishment of Islamic Banking in Tanzania and Kenya. She also provided the history and development of Islamic Banking in Uganda. She also identified some of the challenges likely to hinder the progress of Islamic banking in Uganda. However, the author did not comment on the nature of the legal

⁴⁰ 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.

framework needed for conducting Islamic banking businesses and the best model Uganda could adopt, Whether a separate piece of legislation for Islamic banking or combined legislation for conventional and Islamic banking.

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*,⁴¹ discussed the nature of Islamic Banking and how it can be integrated into global financial markets. The authors provided the background of establishment of Islamic Banking in Uganda from the 1990's up to early 2015 with the enactment of the Financial Institution Amendment Bill 2015. The paper explored the extent of relevance of the existing laws towards the introduction of Islamic Banking in Uganda. Their study examined the Malaysian experiences in Islamic banking regulation to benchmark the Ugandan experience with best practices. They suggested for the amendment for some laws in order to accommodate Islamic Banking. However article did not go into the details of the law to be amended in order to allow flexible Islamic banking. They proposed the best model Uganda could adopt. In general, the article advocates for gradual process on regulating Islamic banking Law.

Emmanuel Tumusiime Mutebile, the Governor Bank of Uganda in his paper *Islamic Banking Emerging Markets Forging Uganda's Economic Progress*,⁴² stated that like conventional banking, Islamic banking can only thrive with the existence of an enabling legal and supervisory framework. He noted that BOU accordingly undertook a study on the Islamic Banking model to explore its fit in the legislative framework. The study revealed that the Financial Institutions Act, 2004 (FIA 2004), contained prohibitions which could not facilitate the operations which could not facilitate the operations of Islamic banking. In recognition of this fact, therefore, Bank of Uganda proposed amendments to the FIA 2014, which were approved by the parliament and hence the enactment of the Financial Institutions (Amendment) Act 2016 in January 2016. However, the author did not

⁴¹ 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.

⁴² TM Emmanuel "Islamic Banking in Emerging Markets Forging Uganda's Economic Progress", at *Islamic banking conference, Kampala*, 13th may 2016.

specify specific sections of the FIA 2014 that could hinder Islamic banking. This thesis intends to bring out the required amendments in the FIA 2014 to ensure smooth implementation of Islamic banking in Uganda.

Burhanur, R. In his study titled *Islamic Banking in India: Challenges and Prospects*⁴³ highlighted the greater role of participatory financing in offering finance to socially and economically relevant developmental projects. The paper suggested the need to amend the existing legal framework for implementation of Islamic banking by referring the prevalent models of Islamic Bank of Britain, Islamic Banks of Thailand, Singapore and USA. This work is good because it has examples which Uganda can adopt in promoting Islamic banking. However the author makes no reference to Uganda although they both have similar legal systems.

Raqeeb, in his study titled “*Problems and Prospects of Islamic Banking in India–Road Map Ahead*”⁴⁴ tried to identify the major problems in implementation of Islamic banking in India and way out by referring the global examples from United Kingdom, Malaysia and Singapore. He has suggested for a parallel system (based on equity instead of debt.) catering the unbanked segments more specially of the marginalized and minorities -particularly Muslims in the country. However, this model may not work for Uganda because Uganda has a one legislation model.

Kerrie Sadiq and Ann Black, in their paper titled “*Embracing Shari’ah- Compliant Products through Regulatory Amendments to Achieve Parity of Treatment*”⁴⁵ argued that rather than requiring any separate regulatory regime, the current regulatory impediments may be overcome through amendments to existing laws to ensure parity of treatment between the Islamic finance market and the conventional market. Nevertheless, the author did not specify which laws are to be amended.

⁴³ 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>, accessed 17th June 2016).

⁴⁴ Raqeeb “Interest-free banking ideal for India” 2009 & Raquibuz et, “Islamic Banking A Performance Analysis”2006.

⁴⁵ K Sadiq and Ann Black , “Embracing Shari’ah-Compliant Products through Regulatory Amendments to Achieve Parity of Treatment” (2012) 34 *Sydney Law Review* 189.

Norhashimah Mohd. Yasin, in her study titled, “*Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies*”⁴⁶ stated that Malaysia is at forefront of Islamic Banking and finance.

The support from the government, corporate bodies and the society at large are instrumental to its major success. In addition, the strict supervisory role of the Central Bank assures good corporate governance of Islamic banks and conventional banks. The author noted that in spite

The author noted that in spite of all this, the legal framework has not been too supportive and conclusive to facilitate the smooth running of the Islamic banking industry. Furthermore the infrastructure with in which Islamic banking is operating is very sophisticated and is ahead of other countries around the globe but on the other hand the legal frame work seems to suggest the exact opposite. 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 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*⁴⁷ 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

⁴⁶ N Mohd. Yasin, “Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies”, (2001)1 *IJUM Law Journal* 20.

⁴⁷ Ibid.

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 et al in their study titled, “*Islamic Banking Products: Regulations, Issues and Challenges*”⁴⁸ 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 Organization of the thesis

This thesis will comprise of five chapters. The First chapter deals with the background of the study, statement of the problem, significance of the study, the research questions and objectives of the study, geographical scope, methodology and literature review. Second chapter will discuss the nature of Islamic banking and its products. Third chapter will analyze the legal frame work of Islamic banking in Uganda. Due consideration will be given to the FIA 2016 and how it will affect Islamic banking in Uganda. Chapter Four will analyze the challenges and prospects of Islamic banking in Uganda. Chapter five will present the research findings, suggestions and recommendations and the Conclusion. A range of proposals will be put forward for consideration by the government and other stakeholders.

⁴⁸ Nooraslinda and others, “Islamic Banking Products: Regulations, Issues and Challenges”, (2013) 29 No.4, *Journal of Applied Business Research*, p.1146.

1.10 Conclusion

This Chapter has presented the background to the introduction of Islamic banking system in Uganda. It presents Islamic banking as an alternative to conventional banking in Uganda. It presents a case for the dual system in Uganda and the challenges it is likely to face. The second chapter will discuss the nature of Islamic banking in general.

CHAPTER TWO

THE NATURE AND OPERATIONS OF ISLAMIC BANKING

2.1 Introduction

Islamic banking is a banking system which is consistent with the Islamic *sharia'h*. It is carried out in accordance with the rules of *sharia'h*, known as *fiqh muamalat*, (rules of behavior) which do not allow the paying or receiving of '*riba*' (interest) with the goal of promoting greater degree of fairness and equity in the conduct of banking business.¹ In Islam, the definition of interest is summarized as 'any excess paid or received on the principal'. *Shari'ah* is Islam's legal system, derived from both the Quran as the word of God and the rulings of Islamic scholars called (*fatwas*) devised to provide guidance to Muslims.² *Sharia'h* informs and governs every aspect of a Muslim's life.³ In practice many Muslims turn to *sharia'h* to assist them in making decisions about direction in their day today lives.⁴ This chapter discusses the nature and operations of Islamic banking.

2.2 Features Of Islamic Financing And Banking

Islamic law in relation to Islamic banking is based on the following set of prohibitions: the prohibition of *riba* or usury. This one emphasizes removal of interest-based financing from the economy; prohibition of gambling and games of chances (*maysir*); the prohibition of excessive risk and uncertainty (*gharar*). This one encompasses full disclosure of information and removal of any asymmetrical information in the contract; the prohibition of financing and dealing in activities and commodities which according to Islamic law are considered to be *haram* (unlawful). These among others include businesses involved with selling of pork and alcohol.⁵

¹ Mabid Ali Al-jarh, "Islamic Finance: An Efficient and Equitable Option", *The Islamic Research and Training Institute*, Jeddah, Saudi Arabia.

² Dominic Casciani Q&A Sharia Law Explained BBC NEWS July 4,2008,<http://news.bbc.co.uk/2/hi/uk-news/7234870.stm>.

³ Ibid.

⁴ Ibid.

⁵ Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An Overview of Islamic Finance", *IMF Working Paper*, June 2015, page 6.

2.2.1 Prohibition of interest (riba)

Riba according to *sharia'h* law means 'excess' and 'unlawful gain'.⁶ Any lending activity for profit or which is attached to conditions that commercially benefit the lender is strictly prohibited even if the rate charged is considered as a penalty for unauthorized borrowing or for a late payment. Some Islamic banks do not keep this money charged and paid as penalty for persistent late payments on their bank accounts but instead donate sums received to charity so as not to benefit directly from the additional charge. However, according to Islamic teachings, banks should be lenient and allow debtors to reschedule their debts without any further payments and should refrain from making charges routine.⁷ Any kind of lending that involves charging and payment of extra fee is inconsistent with *shari'ah* and thus prohibited in Islamic teaching because this activity is unfair whether the borrower is an entrepreneur seeking to start up the business as only the lender is guaranteed a financial return or a borrower with a particular need because the lender could exploit the former's vulnerability.⁸

Interest in conventional banking is compensation charged on a loan contract as well as charged in rescheduling debts. However, in Islamic banking *riba* is interest, unlike in the conventional banking system where it is regarded as the price of the debt.⁹ In Islamic banking concept and *sharia'h* law usury is the same as *riba*, 'usury or *riba* means an excess or addition above the principal lent.¹⁰ Charging of interest on a loan has never got support on ethics. The issue of *riba* or interest charging is an old religious issue forbidden by all revealed religions like Islam, Judaism, Christianity and Hinduism.¹¹

In Judaism, the Old Testament (Torah) Ex.22:25 states that, "*if you lend money to any of my people with you who are poor, you shall not be to him as a creditor neither shall you require usury from*

⁶ Salim Farrar, "Accommodating Islamic Banking And Finance In Australia", (2011)3, *UNSW Law Journal*, page 417.

⁷ Ibid.

⁸ Ibid.

⁹ Salah Abdi Sheikh, "Factors That Led To Emergence of Islamic Banking in Kenya And The Regulatory Challenges Facing The Industry", *Thesis, MBA, School of Business, University of Nairobi*, 2009, page 12.

¹⁰ Ibid.

¹¹ Ibid.

him”. This statement is interpreted to mean that lending through usury is not allowed between the Jews.

According to Old Testament of the Bible, Deuteronomy 23:19 states that: “Thou shall not lend upon usury to thy brother; usury of money, usury of victuals and usury of anything that is lent upon usury.” Meaning that even in Christianity religion, usury or *riba* (interest) is also prohibited as it is justified by the above verse of the Bible.

Riba or interest is forbidden according to Islamic law because of the following reasons;¹² Firstly, it contradicts the principle of profit and loss sharing. This principle is among the main features of Islamic banking and it aims at creating a proper balance between the lender and the borrower. In addition, *riba* is a form of social corruption. Arabic scholars have gone ahead to refer to it as *fasad* (beyond legal bounds). Interest or *riba* involves the wrongful appropriation of other people’s property without justification thus usury or interest is a property right claimed outside the lawful framework of identified property rights that create a balance between rich and poor people. Furthermore, *riba* decreases the resources of the state through a negative effect and this affects the growth of the economy. *Riba* further leads to money being made from money and this practice is unacceptable in Islamic finance system. According to Islamic teachings money is an exchange instrument that has no value in itself. It is therefore argued that those who place their money as deposit in a bank or lend it to gain interest earn money without effort or risk. *Sharia’h* law emphasizes people to be productive and useful but by only investing their money in useful trade and economic enterprise.

Nevertheless, the most essential reason for the prohibition of *riba* is that it is unfair because it affects the borrowers and the lenders alike. The borrower must pay interest and repay the capital as well as bearing any losses from the use of these funds, a form of double charging for both the funds and use of funds. Lastly, *riba* is also regarded as being unjust to the lender. This is because the real rate of interest may become negative if say the rate of inflation is higher than rate of interest.

¹² Ibid.

2.2.2 Some of the Quranic teachings on *riba*

The act of prohibiting interest or *riba* in Islamic financial dealings is divine. It has its roots from the Holy Quran and the Hadiths of the prophet (Peace Be Upon Him). The following selected verses from the Holy Quran justify the prohibition of interest or *riba* from Islamic banking or financial dealings:

Quran 2:275 states that “*Those who devour usury will not stand except as stands one whom the Satan by his touch has driven to madness. That is because they say: “Trade is like usury,” but Allah has permitted trade and forbidden usury.*”

Quran 2:276 of the Quran also states that, “*Allah will deprive usury of all the blessings but will give increase for deeds of charit....*” Also Quran 2:278 provides that “*O you who believe, fear Allah, and give up what remains of your demand for usury, if indeed you are believers.*” Instructions are clear, no ambiguity is left. If a person believes in revelations then he or she should avoid charging interest and seek the pleasure of Allah.

According to Islamic teachings in relation to Islamic banking and finance, lawful gains can be obtained by charging fees, leasing, trading of assets and profit and loss investment activities. In this respect, Islamic banks are allowed to charge fees for looking after their client’s money through a concept called *wadi’ah*, for remitting funds (*hawalah*) and when participating in financial transactions on their client’s behalf commonly known as (*wakalah*).¹³

By and large, dealing in interest is unlawful under Islamic banking and the design of conventional banking is based on interest. However, the important role of conventional banks cannot be rejected in the modern economy, so change in design and philosophy of commercial banking is required to meet the religious obligation. Therefore, it is the responsibility of all true believers in God (Jews, Christians and Muslims) to give up interest based transactions from their personal lives

¹³ Salim Farrar, “Accommodating Islamic Banking and Finance in Australia”, (2011) 34(1), *UNSW Law Journal*, page418.

immediately and input their energies collectively to design promote and implement a financial system which is free of interest.

2.2.3 Prohibition of excessive risk and uncertainty (*gharar*)

Gharar means sale of probable items whose existence or characteristics are not certain, and due to the risky nature make the trade similar to gambling.¹⁴ Alternatively, *gharar* refers to something unknown, to exclusion of the doubtful. Therefore, *gharar* is a byproduct of uncertainty and it is invalid precisely because of the excessive uncertainty and risk involved. *Gharar* transactions occur when the purchaser does not know what he has bought and the seller does not

know what he has sold. Therefore, the transacting parties have a moral duty to disclose information before engaging in a contract, thereby reducing information asymmetry, otherwise the presence of *gharar* would nullify the contract.¹⁵

It should be noted that gambles and decisions under uncertainty are not the same. Unlike gambles, it is argued that decisions under uncertainty consist of evaluating the market value of causality such that the value of these causes can offset any potential losses.¹⁶

2.2.4 Prohibitions of gambling and games of chance (*maysir*)

Islamic law forbids games of chances commonly known as *maysir* and gambling. These among others include; lotteries, lotto, casino-type games, sports betting and betting on the outcome of animal race. Gambling and games of chance share a strategy for earning a profit through pre-

¹⁴ Sherin Kunhibava and Shanthi Rachagan, "Shari'ah and Law in Relation to Islamic Banking and Finance", Banking and Finance Law Review 26 Research Gate, page 551.

¹⁵ Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An Overview of Islamic Finance", *IMF Working Paper*, 2015 page 6.

¹⁶ Salah Abdi Sheikh, "Factors that Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry", *Thesis, MBA, School of Business, University of Nairobi*, 2009 page 14.

meditated risk-taking.¹⁷ *Maysir* is often described as attaining something without effort and this is one of the reasons why it is prohibited in Islam, other reasons include; gambling results in taking away of one's property without lawful or proper exchange. In addition gambling causes anger and frustration caused by losing. Gambling can also be addictive and compulsive which may lead to bankruptcy. Lastly, gambling can cause a person to forget his duty as a Muslim. The prohibition of *maysir* is divine based on evidence from the holy *Quran*.

Quran 5:90 provides: "*O, you who believe! Intoxicants (all kinds of alcoholic drinks), gambling and Al-ansab (animals that are sacrificed in the name of idols on the altars) and Al-Azlam (arrows thrown for seeking luck or decision) are an abomination of Satan's handwork. So avoid that (abomination) in order that you may be successful.*"

Furthermore, Quran 2: 219 states that: "*They question thee about alcoholic drinks and games of chance (speculation). Say: in this is great sin and some utility for men, but it is sin is greater than its usefulness.*" These fore mentioned verses strengthen the non- permissibility of *maysir* or games of chances.

In Uganda, gambling is controlled by "*The Lotteries and Gaming Act 2016*. In economic terms games of chance and gambling cannot add any surplus to societal wealth thus leading to greater financial and societal problems. Gambling is becoming a common activity for the youth. Sports betting is a becoming a lucrative business in many of trading centers in Uganda. It is an activity that attract most of the jobless youth. Most of the youth population now days spend most of their time in sports betting instead of working in productive activities thus hindering economic growth. They want to earn quick money without sweating for it.

¹⁷ Ibid. pg 14.

2.2.5 Prohibition of dealing in forbidden commodities.

Islamic law also forbids investing or dealing in unlawful business sectors. It prohibits on moral grounds activities related to investment in piggery, casinos, tobacco companies, wineries, pornography and armaments and destructive weapons. It should be noted that neither individuals nor institutions are allowed to trade or finance enterprises that deal in forbidden items.¹⁸ This is because these businesses are deemed to be unethical and immoral in accordance with Islamic law.

2.3 How Islamic Banks Use Their Fund

After obtaining funds from numerous *sharia'h* compliant sources, Islamic banks use these funds in different channels. The most common structures to use funds in Islamic banking include two main sectors, that is, retail sectors and corporate sectors. Islamic banks make arrangement for these structures to enter into business activities in accordance with *sharia'h* principles.

Islamic commercial banks offer a broad spectrum of structures ranging from simple to sophisticated *sharia'h* compliant products such as trust financing, international Islamic banking business, Islamic financial intermediation services, Islamic factoring business and Islamic leasing business. Although these financing modes appear similar to that of conventional financial intermediaries, Islamic financial intermediation modes of operations are relatively different in their unique nature of contracts that comply with *sharia'h* principles and their relationship with the customers.

Not all the financial structures and instruments offered by Islamic commercial banks are acceptable to all *sharia'h* scholars and Muslim scholars worldwide. This controversy is a consequence of the different schools of thought and their various interpretations of *sharia'h* principles. For example the *shias* and *sunnis* have different interpretations.

¹⁸ Ibid.

2.4 Islamic Modes Of Financing

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. Islamic modes of finance may take an equity form or a profit and loss sharing approach, a credit purchase or deferred payment and lease agreement. Islamic modes of financing are as follows: *Mudarabah* (capital trusts); *Musharakah* (partnership); *Murabah* (differed payment); Diminishing *musharakah* (declining partnership); *Ijara* (leasing); *Istisna* (procurement engagement); and *Salam* (advance payment). These modes of Islamic financial business are considered under section 3 of the *Financial Institutions (Amendment) Act 2016*. The legal analyses of these modes are discussed in the subsequent chapter.

2.4.1 Mudarabah (capital trusts)

Mudarabah is a special type of partnership in which the capital owner, *rabb-al mal*, a sleeping partner in this case, advances money to an investment manager, *mudharib* to trade with it and in which they share the profits according to the contractually agreed ratio.¹⁹ In *mudaraba* banking, the Islamic bank accepts funds from the depositors under the risk sharing arrangement. The Islamic bank either invests the funds in profitable investments or extends them to entrepreneurs on a risk sharing basis. The Islamic bank shares profits or losses made on *mudaraba* investments with its depositors.²⁰

This arrangement is done with the view of generating profits. The share in profits is determined by mutual agreements but losses if any are borne entirely by the financier unless they result from the *mudharib*'s negligence, misconduct or breach of conduct's terms.²¹

¹⁹ Salim Ferrar, "Accommodating Islamic Banking And Finance In Australia", (2011) 34(1), *UNSW Law Journal*, page 420.

²⁰ Dr. Mohammad Imran Ashraf Usmani, "A Guide To Islamic Banking", First Edition 2007, Publisher Darul-ishaat, Urdu Bazar Karaachi- Pakistan page 110.

²¹ Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An overview of Islamic Finance", *IMF Working Paper*, 2015, page 7.

Mudarabah contracts are used in two ways by Islamic banks, often termed two-tier *mudarabah*. Firstly, the bank as the *mudarib* and the depositor as the *rabb-al-mal*. In this instance, the bank receives the money under a contract of safe keeping and then invests the depositor's money (with his consent, formerly obtained when opening the Islamic bank account in various schemes. Secondly, with the bank as the *rabb-al-mal*, providing start-up capital to an entrepreneur yet in this instance the bank will often require collateral and impose conditions on the client. In both instances, profits supposing there is any, will be shared between the bank and the client in relationship to their prior agreement. This arrangement takes the place of interest paid or received by the conventional bank.²² Losses are born solely by the capital owner with the investment manager risking only his labour and time.

Mudarabah transactions offer the investor potentially greater returns than they would receive via an interest rate. The *mudaraba* contract also exposes the investor to the risk to the loss and the customer's original deposits may not be guaranteed. However, this has not stopped some Islamic banks from utilizing 'liberal' interpretations in an attempt to guarantee profits in order to mirror the returns investors obtain in conventional banks.²³

Working capital financing is a cornerstone of all financial systems. Although, there are religious and cultural differences between different nations, financial institutions throughout modern civilization face similar business challenges. These include maintaining adequate capital ratios, financing inventories, fixed assets and extending credit sales.²⁴ A study of Islamic finance usually necessitates an analysis of what implications the religious rulings have on the operations of functioning financial institutions.

²² Salim Farrar, note 19, pg420.

²³ Ibid.

²⁴ Gait and Worthington 2002, above.

2.4.2 Musharakah (full partnership)

Under the concept of musharakah, the financier (one who provides financial funds) and the entrepreneur share profits and losses and also the risks that are involved in the business. Mudaraba and musharaka modes of Islamic financing involve the concept of profit and loss sharing theory.

Musharakah is a partnership or joint venture for specific business where by the distribution of profits will be apportioned according to an agreed ratio. In case of losses both parties will share the losses on the basis of their equity participation.²⁵ It is an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour management with the view of generating profits.²⁶ The modern Islamic banking finance industry tends to allow unlimited partnership in which the partners contractually determine the precise shares of the profits in excess or below their actual proportionate financial contribution with the losses fixed according to that proportionate share.²⁷

In *musharakah* banking, the Islamic bank contributes to the depositors funds to operate a joint enterprise with the client (an entrepreneur). In this case, the Islamic bank allows the client to manage all the affairs of *musharakah* business. The Islamic bank and the client mutually share the profits or losses made on the *musharakah* investments.²⁸ In a typical profit and loss sharing arrangement, an Islamic bank provides the capital to the firm in which managers are responsible for making strategic and operational decisions.²⁹ The bank shares the profits and is liable to any financial loss.

²⁵ Hajjat Afuah Sebyala, "Prospects of Islamic Banking in Uganda", OIC Business Forum, paper presented at UMYA Ramadhan Seminar at Kibuli Primary Teachers' College, Kampala, 2008, page 2.

²⁶ Mumtaz Hussein, Asghar Shahmorad and Rima Turk, "An Overview Islamic Finance", *IMF Working Paper*, June 2015, Page 7.

²⁷ Ibid.

²⁸ Dr. Muhammad Imran Ashraf Usmani, *A Guide To Islamic Banking*, 1st Edition, Darul Ishaat, Karachi Pakistan, 2007 page 87.

²⁹ Ibid page 105.

Islamic finance is a practice where people invest their money profitably without any injustice to either lenders or borrowers and both parties are entitled to share the profits or losses from the shared investment. The reason for profit sharing is to distribute in equal measure the risk of their business according to the ratio of the capital contributed to the project. Therefore in Islamic banking investors take equity positions in all business ventures financed.

By and large, according to Islamic economics, commercial gains should be linked tangibly to actual production of goods and services and not derived synthetically from mere sales on financial markets.

The law of Partnership in Uganda is governed by the Partnership Act, 2010. The law will have an impact on the operation of Islamic banking.

2.4.3 Diminishing Musharakah

Diminishing *musharakah* is a form of declining partnership between Islamic financial institution and the client.³⁰ In relation to this concept, the financier and his client participates either in a joint ownership of the property or in a joint commercial enterprise.³¹ The share of the financier is divided into a number of units and the client is entitled to purchase the units of the share of the financier one by one periodically, hence increasing his own shares until all the units of the share of the financier are purchased by him so as to make him the sole owner of the property or the commercial enterprise as the case may be.³² Diminishing *musharakah* is normally used to finance real estates and has successfully replaced conventional mortgages. Under the concept of diminishing *musharakah*, the Islamic bank rents out its shares to the client and earns rentals. Any profit earning on property is distributed among the co-owners according to agreed ratios however losses should be shared in proportion of equity.³³

³⁰Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking", (2011) 2(2) *int'l Journal of Business and Social Science*, page 174.

³¹ Dr. Muhammad Imran Ashraf Usmani, above, page 115.

³² Ibid.

³³ Ibid.

Furthermore, under diminishing *musharakah* the customer will request an Islamic bank to finance the purchase of an asset then the Islamic bank will have to participate in the ownership of the asset by contributing the required finance. Certain portion of 20% of price must be paid by the customer and 80% of the price by the financier. Total equity of the bank is divided into units of smaller amounts which are purchased by the clients in installments. Under this mode of financing one of the partners (clients) promises to buy the equity shares of other partner (Islamic bank) gradually until the title to the equity is completely transferred to him.³⁴ The sale and purchase of equity units has to be independent of partnership contract and this should also be stipulated in the partnership contract.³⁵ In Uganda, mortgage financing is governed by the *Mortgage Act, 2009* and *Mortgage Regulation 2012* and *Registration of Titles Act*.

2.4.4 Murabaha (deferred payment sale)

This form of Islamic mode of financing requires the bank to buy the goods or commodities from the supplier and then sells them to the customer for spot delivery but with a deferred payment at a cost plus mark-up.³⁶ Payments can either be made in installments or balloon payment and in case of default amount of installment or price of the asset cannot be increased or decreased.³⁷ A penalty is stipulated in a *murabaha* contract against a client who defaults to make prompt payments and the amount of penalty for default in prompt payment recovered cannot be included in income of Islamic financial institution in any case, it must be spent for charity.³⁸

Under conventional banking system, a client can only finance the purchase of the property by a mortgage arrangement.³⁹ In this case a mortgage is taken over the real property by the lender. The buyer buys the property with the money borrowed from the lender and title is transferred to that

³⁴ Ibid.

³⁵ Ibid.

³⁶ Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An Overview Of Islamic Finance", *IMF Working Paper*, 2015 page 7.

³⁷ Arif A Jamal and Ferzana Haq, "Introduction To Islamic Finance", Centre for Banking and Finance Law, Faculty of Law, University of Singapore, Muslim Law Practice Committee Seminar 2014, page 8.

³⁸ Ibid

³⁹ Kerrie Sadiq and Ann Black, "Embracing Sharia-Compliant Products Through Regulatory Amendments to Achieve Parity of Treatment" (2012) *Sydney Law Review* 206.

borrower and then the borrower repays the lender the principal and interest as stipulated in the contract.⁴⁰ If the borrower defaults on the repayment, the lender can enforce a sale of the property as they hold the property as security for the loan agreement.⁴¹ This conventional mortgage arrangement is against Islamic teachings and law because the contract bears an interest component.⁴²

Muslims can enter into a *murabaha* arrangement as an alternative means of conventional financing to finance the purchase of a property. The subject of *murabahah* is often real estate, metals, oil or any item so long as it is not expressly prohibited by Islamic teachings such as pork, pornography and alcohol.

2.4.5 Ijara (Leasing)

Ijara is a source of financing where by usufruct of an asset is transferred to lease for agreed amounts of rentals.⁴³ In other words *ijara* is a rental contract where by the Islamic Financial Institution leases an asset for a specific rent and period to the client.⁴⁴

Ijara therefore requires certainty in the following four elements; Asset, parties, term and termination of a contract. The subject matter must be a tangible asset with an intrinsic value, it should be identified, quantified and also be capable of being leased without being consumed. A lessor must have ownership interest in the asset (either legal or beneficial) and *sharia* 'h also holds the lessor responsible for all damages, repairs, maintenance, insurance and depreciation of the leased asset.⁴⁵ This requirement is seen as a problem for commercial banks. While the preference is for *sharia* 'h-compliant insurance (*takaful*) to be obtained, it is not always available and therefore conventional insurance is permitted, because of lack of *sharia* 'h compliant alternatives. The term of lease must be fixed and the rental fee must be agreed at the outset. The lease can only be

⁴⁰ Ibid

⁴¹ Ibid

⁴² Ibid

⁴³ Muhammad Hanif, above, pg 170.

⁴⁴ Ibid, page 174.

⁴⁵ Shamim Njeri Kinyanjui, "Challenges Facing the Development of Islamic Banking", (2013) 5 (22) *European Journal of Business and Management*, page 96.

terminated at the end of the term, although there can be an option for a lessee to purchase the ownership from the lessor.⁴⁶

In order to avoid the islamically prohibited “sale within a sale”, the parties should prepare separate legal documentation for the tenancy agreement and the option to purchase and avoid stipulating the making of the lease contingent upon making the agreement to purchase.⁴⁷

Leasing or *ijara* has some rationale and it operates in similar fashion with conventional lease, except that the responsibility for maintenance and Islamic insurance rests with the lessor. It should be noted that Islamic hire-purchase commonly known as *ijara wa iqtina* is a core business of any Islamic bank, allowing individuals, small businesses and large corporations to rent a movable and immovable asset with the option to purchase the asset at the end of the lease.⁴⁸

It is worth noting that *ijara* or leasing is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for agreed period against an agreed consideration. Nevertheless, some financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest.⁴⁹

2.4.6 Bai salam (advance payment)

Bai salam is a forward sale contract in which the seller pays in advance the price of goods that are to be delivered to him at a specified future date.⁵⁰ *Bai salam* is practically used in financing of agricultural needs of farmers in the Islamic economy.⁵¹ Farmers sell their crops prior to harvesting

⁴⁶ Arif A Jamal and Ferzana Haq, “Introduction to Islamic Finance,” Centre for Banking and Finance Law”, Faculty of Law, National University of Singapore, April 2015 page 8.

⁴⁷ Salim Farrar, above, pg 418.

⁴⁸ Ibid page 420.

⁴⁹ Dr. Mohammad Imran Ashraf Usmani, above, pg149.

⁵⁰ Ibid.pg133.

⁵¹ Ibid.

to an Islamic bank in order to get money to purchase seeds and fertilizers. *Sharia*’h stipulates that the terms and conditions of *bai salam* contract, such as price, quantity and quality of goods should be clearly determined without involving any features of interest, *gharar* (speculation) or dubious sale.⁵²

Bai salam as a mode of Islamic financing recommends that for the transaction to be valid, the buyer should pay the price in full to the seller at the time of effecting the sale. In absence of full amount it will tantamount to a sale of a debt against a debt which is inconsistent with Islamic teachings. The basic aim of allowing *salam* is to fulfill the “instant need” of the seller. If it is not paid in full amount the basic purpose will not be achieved.⁵³

2.4.7 Istisna (procurement engagement)

This is a sale transaction where a commodity is transacted before it comes into existence.⁵⁴ In this case the client gives the manufacturer an order to manufacture specific commodity for him and the manufacturer uses his own materials to manufacture the required items.⁵⁵ Under *istsna* transaction, the client gives the manufacturer all necessary specifications of the commodity.

According to *shari’ah* teachings in relation to *istsna*, either party can cancel the contract before the manufacturer has begun its work provided the interested party has given a prior notice.⁵⁶ However once the work has been started the contract cannot be cancelled unilaterally.

⁵²Shamim Njeri Kinyanjui, above, page 96.

⁵³ Dr. Muhammad Imran Ashraf Usmani, “A Guide To Islamic Banking”, 2007 First Edition, Darul Ishaat Karachi Pakistan, Pg 134.

⁵⁴ Dr.Muhammad Imran Ashraf Usmani, above, page 139.

⁵⁵ Ibid

⁵⁶ Ibid

2.4.8 Sukuk (bonds)

Sukuk are Islamic bonds. However, they are best described as trust or investment certificates representing proportionate or undivided shares in the profits or revenues of large enterprises.⁵⁷

Bond means long term debt instruments sold to investors either by government or companies. In this case the investor agrees to loan the government or company money at a predetermined rate of interest. The conventional bond is inconsistent with *sharia'h* law it has interest component and there is no underlying asset. The *sukuk* is asset backed with the owner of the certificate holding an undivided share in a *shari'ah*- compliant underlying asset. The returns on *sukuk* arrangement are paid in line with the proportional ownership of the underlying asset in accordance with the performance of that asset.⁵⁸

Unlike conventional bonds, certificate holders should be true owners of the portion of the underlying asset and share in the success or failure of the enterprise. *Sukuk* arrangement has some legal structures on which they can be based and among others these include *ijarah*, *murabahah*, *musharakah* or *mudarabah* concepts. However, where the underlying contract is a *murabaha*, the *sukuk* cannot be sold on the secondary market because of the prohibitions surrounding debt sales in *sharia'h* law.⁵⁹

2.4.9 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.⁶⁰ In Uganda, the 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

⁵⁷ 57 Salim Farrar "Accommodating Islamic banking and Finance in Australia" 2011 Vol.34(1) *UNSW Law Journal* page 421.

⁵⁸ Kerrie Sadiq and Ann Black, "Embracing Sharia-Compliant Products Through Regulatory Amendment to Achieve Parity of Treatment", (2012) Vol. 34 *Sydney Law Review* page 208.

⁵⁹ Ibid

⁶⁰ Mumtaz Hussein, Asghar Shahmoradi and Rima Turk, "An Overview of Islamic Finance", *IMF Working Paper*, 2015.

satisfy any conditions specified by the Bank of Uganda for that purpose.⁶¹ 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 are not yet gazetted.

2.4. 10 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.⁶² 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).⁶³ 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.⁶⁴

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.

⁶¹ Section 1 (m) *FIA 2016*

⁶² Juan Sole, “Introducing Islamic Banking System”, *IMF Working Paper* 2007, page 12.

⁶³ *Ibid*

⁶⁴ *Ibid*

2.4.11 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.⁶⁵ These guarantee transactions are widely used in conjunction with other financing modes or documentary credits.⁶⁶ 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 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.

2.4.12 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.⁶⁷ 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.⁶⁸

⁶⁵ Mumtaz Husein, Asghar Shahmoradi and Rima Turk, "An Overview of Islamic Finance", *IMF Working Paper*, 2015, pg10.

⁶⁶ Ibid page 10.

⁶⁷ Enrique Gelbard, Mumtaz Hussein, Rodolf Maino, Vibin Mu and Etienne B Vehove, "Islamic Finance in Sub-Saharan Africa: Status and Prospects", *IMF Working Paper* 2014, page 8.

⁶⁸ Dr. Muhammad Imran Ashraf Usmani, "A Guide To Islamic Banking", above, page 132.

2.5 Characteristics Of Islamic Banking Compared To Conventional Banking

Islamic banking and conventional banking share many similarities. One of them is profit maximizing entities which are crucial for efficient allocation of resources, they also help reduce transaction costs and thus facilitate diversification for small savers and investors. Since these are financial intermediaries, they also provide services such as; asset transformation, a payment system, custodial services and risk management.⁶⁹

The main difference between Islamic banks and conventional banks is the prohibition of interest or usury. *Gharar* is also forbidden which means excessive uncertainty. In addition, Islamic banks are not allowed to engage in trading activities or investments which are forbidden in Islamic teachings. Among others these include trading in pork, alcohol, tobacco or financing the construction of a casino etc. However all these prohibited features exist in conventional banking, which are incompliant with the *sharia'h* and hence may lead to higher risks.

Unlike conventional bank accounts, deposits into an Islamic bank account using the contract of *wadiah* or *mudharaba* do not receive interest. The depositor's money is kept and invested in a legal and *sharia'h* way. The profit is then allocated between the bank and its depositors proportionately as both parties are considered partners. In this manner, the bank acts as the depositors' agent, dispersing funds on their behalf to worthy customers. In this regard both sides of financial intermediation are based on sharing risks and gains.

Under a financing facility, in which customers wish to own a house, the bank will buy the property identified by the customer and resell it to the customer at a mark-up amount. The reselling price is said to have the profit element allowable under the *sharia'h* and therefore is recognized as profit to the bank. The customer will then pay the financing at mark-up value in a period that is stated and agreed upon. Notwithstanding, the bank is allowed to charge or impose a compensation fee

⁶⁹ 69 Alejandro Lopez Mejia, Sulaiman Aljabrin, Rachid Awad, Mohammad Noral and Inwon Song, "Regulation and Supervision of Islamic Bank", *IMF Working paper* Dec 2014, pg 20.

should the customer fail to pay when it is due. However the penalty imposed to the customer is minimal and non-compounding, as Islam promotes the principle of truth, fairness and justice.

Another distinct feature between the two banking system is that money has no value in itself in Islamic banking thus implying that money cannot make money. This means that money has no intrinsic utility meaning that if one is stuck on a desert, he cannot eat drink or wear that money justifying the reason for money not having value in its self.

Today, Islam is the only religion that still maintains the prohibition of usury, although this has not always been the case. The two other Abrahamic religions, as well as Hinduism, have earlier forbidden usury. All big religions were previously against interest rates as this is stated out in the holy books. In Christianity, there were prohibitions or strict limitations upon usury for more than 1400 years, meaning that the taking of all types of interest was permissible. However, this has gradually changed within these religions through the development of laws to abolish only exorbitant interest, and this excessive type of interest is still considered to be usurious.⁷⁰

Both Islamic and conventional banks act as intermediaries and trustees for their customers assets. What differs Islamic banking from the conventional system is how it shares its losses and profits with its clients, meaning that an element of mutuality is created and that the depositors are offered certain owner-ship rights. The risk-sharing philosophy of Islamic banking is based on the belief that the lender must share the borrower's risk. When using predetermined interest rates, as in conventional banking, a return to the lender is guaranteed and strikes the borrower disproportionately, which in the religion of Islam is seen as economical waste and inappropriate in a social.⁷¹

⁷⁰ Linnéa Hallberg and Yasmine Åkermark 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 Thesis , International Business/Marketing Spring 2011, 2.

⁷¹Ibid.

Therefore, profit and loss sharing (PLS) is preferred in Islamic banking compared to conventional banking where the interest based principle is used. By using, PLS principle, Islamic banks are able to create a relationship between borrower, lender and intermediary that is built on financial trust and partnership. Another vital element in Islamic banking is the need for social and economic development accomplished through business practices that are in line with Islamic principles and through *Zakat*.⁷² Both Islamic and conventional banks are governmentally regulated. Additionally Islamic banks must have a *shari'ah* board to control that they are following the religious guidelines of Islam, as mentioned earlier.

In comparison to a conventional bank, which basically can be seen as a borrower and lender of funds, an Islamic bank is considered to be a partner with its depositors, on one hand, and a partner with entrepreneurs, on the other hand, when disposing the funds of the depositors in productive direct investment. This means that Islamic banks have different stockholder relationships since the depositors are directly involved in the financial stake in the bank's investment. The fundamental philosophy of Islamic banking is to meet the financial needs of its participants with integrity and in a manner that is just and fair. The governance structure of Islamic banks is yet another aspect in which they differ from conventional banks, as the banks must meet the expectations of the Muslim community and follow the rules of the *Quran* by offering financing methods that are acceptable within the religion of Islam.⁷³

In Islamic banking, one of the main visions is to go through the financial system; create a society which is built upon an equal distribution of credit in order to diminish poverty, unemployment and concentration of wealth and income. The banking system aims to be a counterpart to the conventional, which in Islam is considered to contribute to making the rich richer by exploiting the poor.

⁷² Ibid, pg 24.

⁷³ Ibid pg 25.

2.5.2 Resource Mobilization

The Second Schedule (Part A (i)(a)) of the FIA 2004 has been amended by FIA 2016 to cater for the services provided by Islamic Banks. Islamic Banks are expected to mobilize funds in the form of deposits such as demand deposits, savings or other compatible forms based on contracts compatible with *Shari'ah*; to invest in products based on contracts acceptable in *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 *Shari'ah*.

Under Islamic banking concept, resources are typically mobilized from shareholders and savers. Shareholders are owners of the bank's equity while savers participate in the investments by providing funds on the basis of return sharing. Savers or depositors are considered as co-owners of funds for investment operations. Thus a deposit agreement is not a lending contract but rather a contract to provide funds that will be managed by the bank on behalf of the depositors (funds owners).¹²² There are three ways to mobilize savings:

- a) Investment deposits: these deposits share the net return on investment in proportion of the amount deposited and based on the maturity of the investment;
- b) Demand or current account deposits: these represent guaranteed liabilities but earn no return;
- c) Bonds: are used to mobilize savings through the issuance of *sukuk*, which are Islamic bonds representing undivided shares in the ownership of tangible assets such as debts (*sukuk murabaha*), assets (*sukuk Al ijara*), project (*sukuk al istisna*) or investment (*sukuk isthithmar*).¹²³

¹²² Enrique Gelbard, Mumtaz Hussein, Rodolfo Maino, Yibin Mu and Etienne B Vehove, "Islamic Finance In Sub-Saharan Africa: Status And Prospects", *IMF Working Paper*, 2014 page 8.

¹²³ Ibid.

2.5.3 Sharia'h Advisory Council

Islamic banks or banking institutions that offer Islamic banking products and services are required to establish a *Sharia'h* Supervisory Board (SSB) to advise them and ensure that the operations and activities of the banking institutions comply with *sharia'h* principles.

Financial regulators should also appoint their own *sharia'h* experts who would provide advice on the instruments and services offered by the institutions. Consultation with these experts would be crucial to ascertain whether the regulations issued by the supervisor with regard to Islamic institutions as well as the licensing of different activities are compatible with Islamic principles.¹²⁴

The spread of Islamic finance in an increasing number of countries has hastened the need for a set of internationally accepted regulations. To satisfy this need, the Islamic Financial Services Board (IFSB) was created in 2002, with the mandate to develop prudential and regulatory standards for the Islamic industry, and to identify and publicize reorganized international best practice in several areas.¹²⁵

In 2005, the IFSB issued two regulatory standards on capital adequacy and risk management for Islamic institutions. It is also planning to issue additional standards in other important areas, such as corporate governance and the supervisory review, among others. Regulatory bodies newly acquainted with Islamic banking should establish a working relationship with this body. Like other jurisdictions, Uganda has provided for the Central *Shari'ah* Advisory Council and *Shar'iah* Advisory Board under the Financial Institutions (Amendment) Act 2016 to guide the operations of the Islamic financial business. An analysis of the *Shari'ah* boards under the FIA 2016 is discussed in Chapter three of this thesis.

¹²⁴ Juan Sole above, page 4.

¹²⁵ Ibid pg 7.

2.6 Conclusion

It should be noted that, the main differences between Islamic and conventional banking are the different principles regarding the use of interest, and while the conventional system emphasizes profit-maximization within the legal framework, the Islamic banking system is in addition led by ethical and religiously inspired goals¹²⁶.

This chapter has presented the nature of Islamic banking as perceived under *Shari'ah*. The chapter has also considered the products commonly offered by Islamic banks. The manner in which Islamic banks operate through those products is analyzed. Key issues that are necessary for the operations of an Islamic banking system are also considered. The next chapter will consider how Islamic banking can operate under the Ugandan legal framework.

¹²⁶ Linnéa Hallberg and Yasmine Åkermark 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 Thesis , International Business/Marketing Spring 2011, p. 25.

CHAPTER 3

THE LEGAL FRAMEWORK OF ISLAMIC BANKING IN UGANDA

3.1 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.¹ A sound legal framework is a key precondition for a safe development of Islamic bank. In order to provide the legal foundations for the supervision of Islamic banks, general banking laws (or specific laws related to Islamic banks) need to define the nature of these banks and their operating relationship with the central bank and other conventional banks. Given that Islamic banks operate across countries in very different legal environments that reflect diverse legal traditions and divergent views on the *Shari'ah* as source of law, jurisdictions have adopted different approaches when developing the legal framework that allows the operation of Islamic banks.²

An important decision to be made by jurisdictions allowing Islamic banking is whether to maintain a unified core set of banking laws or regulations for Islamic banks and conventional banks. Some jurisdictions which are relatively new to Islamic banking seem to have preferred issuing separate laws and regulations for example Lebanon, Morocco and Oman, probably to increase transparency and compensate for lack of experience, whereas some mature markets for example Malaysia have maintained the separation for development purposes. However, most jurisdictions have adopted a unified core set of banking laws and regulations covering Islamic banking and conventional

¹ 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, page 13.

² Ibid, pg 15.

banking. This has the advantage of avoiding duplication of legal and regulatory provisions that are equally important for both types of banking.³

Common law and civil law systems have their own framework for implementation of commercial and financial contracts and transaction, this system also applies to *shari'ah* law. However, commercial, banking and company laws which are essential elements for the implementation of Islamic banking and financial contracts do not exist in many countries. Therefore, with regard to this many countries that have established Islamic banking in their banking sector treat financial contracts as buying and selling of properties and thus taxed twice⁴. However in some countries like United Kingdom and Singapore, double stamp duty on some Islamic home finance schemes has been abolished so as to provide tax neutrality.⁵ This chapter will analyze the key issues affecting Islamic banking business under the Uganda legal framework especially by examining the FIA 2016 and other laws.

3.2 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 Organisations, 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.⁶

A number of institutions have been established to become focal points on major issues, in particular the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), the

³ Ibid.

⁴ Abu Umar Faruq, "Legal and Regulatory Issues of Islamic Finance in Australia", (2009)2 No.2 pg 306 available at www.emeradin.sight.com 1753-8394 htm

⁵ Ibid, pg 306.

⁶ D.El-Hawary, "Regulating Islamic Financial Institutions, The Nature of the Regulated", George Washington University, pg 2, available at <http://www.researchgate.net/...Islamic-..>

International Islamic Rating Agency (IIRA), the Islamic Financial Services Board (IFSB) and Liquidity Management Center (LMC).⁷

AAOIFI is an Islamic international autonomous accounting, auditing, governance, ethics and *shari'ah* standards for Islamic financial institutions and the industry professional qualification programs (notably CIPA, the *Shari'ah* Adviser and Audit “CSAA” and the Corporate Compliance Programs) are presented now by the AAOIFI in its efforts to enhance the industry’s human resources base and governance structures.⁸

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.⁹

IFBS is an international body that sets standards and offers guidance for Islamic banking and Finance Regulation and Supervisory Agencies.

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.¹⁰

⁷Ibid.

⁸ AAOIFI, available at [aaoifi. Com/? Lang=en](http://aaoifi.com/?Lang=en).

⁹ IIRA, available at iirating.com/corprofile.aspx

¹⁰ LMC available at www.imcbahrain.com/...

3.3 Regulating and Control of the Financial sector by Bank of Uganda

The *Constitution of Uganda*¹¹ 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),¹² 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.¹³ The parliament is mandated to make laws prescribing and regulating the functions of Bank of Uganda.¹⁴ It is from this background therefore that the parliament would mandate to license and supervise Islamic banks subject to the provisions of the constitution.

Bank of Uganda (which serves as the Central bank) was established on the August 15th 1966. The enactment of *Bank of Uganda Act*¹⁵ 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. This is done through tight regulation and administration of financial institutions.

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.¹⁶ A sound legal framework is a key precondition for a safe development of Islamic bank. In order to provide the

¹¹Article 161, *Constitution of the Republic of Uganda 1995*.

¹² The *Constitution of the Republic of Uganda 1995*.

¹³ Ibid.

¹⁴ Article 162 (3), *Constitution of the Republic of Uganda 1995*.

¹⁵ Cap 51.

¹⁶ 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, page 13.

legal foundations for the supervision of Islamic banks, general banking laws (or specific laws related to Islamic banks) need to define the nature of these banks and their operating relationship with the central bank and other conventional banks. Given that Islamic banks operate across countries in very different legal environments that reflect diverse legal traditions and divergent views on the *Shari'ah* as source of law, jurisdictions have adopted different approaches when developing the legal framework that allows the operation of Islamic banks.¹⁷

The regulation and control of banking business is under the Central bank. 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 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.

Apart from the FIA, 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. Section 79 FIA provides for the inspection of financial institutions in Uganda. The aim is to promote and maintain

¹⁷ Ibid, pg 15.

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 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 CB; its license has been revoked under the Act and it is engaged in or is knowingly facilitating criminal activities.

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The *Bank of Uganda Act*¹⁸ 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.¹⁹

With the establishment of Islamic banking in Uganda's banking system, there is likely to be some difficulties in the relationship between Islamic banks and the central bank if no clear policies are in place. This is because of the mandate that is given by the Act to the Bank of Uganda to operate on interest based system which is incompatible with *shari'ah* teachings in relation to Islamic banking. The operation of the Central Bank is based on controlling credit and interest rates by

¹⁸ 2000, Cap 51.

¹⁹ Part vii, sub section 36-39, Bank of Uganda Act 2000, Cap 51.

statutorily prescribing maximum and minimum rates of interest that should be paid by the financial institutions on different categories of deposits, liabilities and bank credit extended in any form.

3.4 Legal framework of Islamic financial business in Uganda

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. Bank of Uganda accordingly undertook a study on the Islamic banking model to explore its fit in the existing legislative framework. The study revealed that the *FIA 2004*, contained prohibitions which could not facilitate the operation of Islamic banking. In recognition of this fact, therefore, BoU 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 2016.²⁰ The amendments to then FIA, 2004 were intended to embrace Islamic banking and focused on the impediments that will also be discussed in this thesis.

A bank is defined under the FIA2016 as a company licensed to carry on financial institution business as its principle business, as specified in the Second Schedule of the Act and includes all branches and offices of that company in Uganda.²¹ 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

²⁰ Tumusiime .E. Mutebile, above, p.1

²¹ Section 3, *FIA 2004*.

Woods Vs Martin Bank Ltd²², Coourt 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.

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.

²² (1959)1 QB55.

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.²³ 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*.²⁴ 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”.²⁵ 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.

The financial institutions were prohibited from directly or indirectly engaging in trade, commerce and industry.²⁶ 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.²⁷ 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.

²³ Section 1(m), FIA 2016.

²⁴ Section 1(e) note 18.

²⁵ Section 3 note 18.

²⁶ Section 37, FIA, 2004.

²⁷ Section 38, FIA, 2004.

3.5 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 *al-ijarah*, *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;²⁸ Islamic financial institutions will also engage in Profit Sharing Investment Accounts. Profit Sharing Investment Accounts is defined under section 3 FIA 2016.²⁹

Islamic financial institutions business will also cover profit sharing investment accounts. Profit sharing investment accounts are defined under section 2 of the FIA 2016 as accounts managed by a 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

²⁸ Section 3 FIA (Amendment) Act 2016.

²⁹ “An account managed by a financial institutions-(a) in relation to property of any kind including currency specified by the Central Bank by regulation , held for or within the account;(b) as part of the Islamic financial business; and (c) under the terms of an agreement where –(i) an 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 (ii) the account holder agrees that he or she will bear any losses in the absence of the negligence or breach of contract, on the part of the financial institution.”

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.

Profit Sharing Investment Account (PSIA) has been explained by one author as a contract by which an investor/depositor opens an investment fund with an Islamic bank (IB) on the basis of *Mudharabah*. The IB could have restricted or full discretionary power in making investment decisions. The IB acts as an entrepreneur while the PSIA holder acts as a capital provider. Both parties agree on a ratio of profit sharing, which must be disclosed and agreed upon at the time of opening the account. Profits generated by the IB are shared with the PSIA holder in accordance with the terms of the *Mudharabah* agreement while losses are borne solely by the PSIA holder, unless they are due to IB's misconduct, negligence or breach of the contract terms. Usually the IB's money (bank capital) is invested in the same income-producing assets or economic activities. Hence, low income (losses) affect the IB through low (negative) return on shareholders' invested capital and low (zero) income from managing PSIA accounts.³⁰

The Central Bank will make regulations providing for profit sharing investment accounts, including the terms on which such accounts may be offered, profit sharing and incentives, disclosures to customers, the form and content of advertisements and prudential requirement,³¹ sanctions for non-compliance with *Shari'ah* principles among others regulations.³² It is submitted that such regulations are urgently needed for proper compliance, guidance and operations of the Islamic financial business.

³⁰ 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 27.

³¹ Section 132(1a) FIA 2016.

³² Section 132 (1c) FIA 2016.

Islamic banking will also cover Purchase agreement which will include Islamic contracts specified for that purpose by the Central Bank by regulations.³³ 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.³⁴

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 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.”³⁵ The Financial Institutions (Amendment) Act had

³³ Section 3 FIA 2016 as amended

³⁴ Ibid.

³⁵ Ibid

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 thesis.

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 thesis, the Islamic banking regulations are not yet in place to determine whether they are in conformity with the *Shari’ah* principle or not.

3.6 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 licence to transact business as a financial institution unless it is a company within the meaning of the Act³⁶. In addition, a person licensed to carry out financial institutions business may carry out the licensed business through an agent.³⁷ 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.³⁸ This implies that the BOU must approve all business transactions.

³⁶ Section 4(2), FIA(Amendment) 2016.

³⁷ Ibid.

³⁸ Section 4(3), note 31.

Any person intending to establish an Islamic bank should apply for a license in accordance with the Financial Institutions (Licensing) Regulations, 2005.³⁹ Furthermore an already licensed financial institution may apply to the Central Bank, for the approval to carry on Islamic financial business through an Islamic window.⁴⁰

Holding the appropriate licence 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.⁴¹

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.”⁴² A bank has to choose any of the two.

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.⁴³ The business of an Islamic bank is

³⁹ Regulation 4, The Financial Institutions (Islamic Banking) Regulations, 2018.

⁴⁰ Ibid.

⁴¹ Section 4(4) (d) supra.

⁴² Section 7(3) (a), supra.

⁴³ Section 10 (3), supra.

covered under Class 9⁴⁴ 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.⁴⁵

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*.⁴⁶ 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 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.⁴⁷ This means that the ordinarily 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*.⁴⁸

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

⁴⁴ Section 10 (3)(I), *supra*.

⁴⁵Section 10 (j) (3),*supra*.

⁴⁶ Section 10 (6) (a), *supra*.

⁴⁷ Section 115 A (5) FIA 2016.

⁴⁸ Section 123, *ibid*.

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.⁴⁹

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.⁵⁰ This means that an Islamic bank capital requirement may be adjusted by a statutory instrument.

An Islamic financial institutional 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 person 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 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.⁵¹ The consent of the Central Bank is paramount for it to be effective.

⁴⁹ 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.

⁵⁰ Section 26(5) FIA 2016.

⁵¹ Section 20 FIA, note 43.

3.7 Offering Islamic Banking Business Through “Islamic Window”

Owing to the increasing demand by *Shari’ah* compliant financial products, commercial banks which will be interested in entering the market of Islamic financial products will do so under a window.

An “Islamic Window” means part of a financial institution, other than an Islamic financial institution, which conducts Islamic financial business.⁵² This option is intended to increase the number of Islamic Bank services.

One of the most important principles behind the Islamic banking and financial system is the desire to maintain the moral purity of all transactions. The funds intended for *shari’ah*-compatible investments should not be mixed with those of non-Islamic investment. This means that a bank intending to open an Islamic window must establish the appropriate firewalls to avoid co-mingling of the Islamic and conventional funds. In other words, the banks wishing to offer Islamic banking products must guarantee that the funds devoted to conventional activities will not be mixed with Islamic activities. This requires banks to establish different capital funds, accounts and reporting systems for each type of activity. In this sense then, when a conventional bank opens an Islamic window, it is in fact establishing a separate entity from the rest of the bank.⁵³ The Central bank should in consultation with the minister, by statutory instrument, make special provisions for the licensing and operation of Islamic banking. An already licenced financial institution may apply to the Central bank, for approval to carry on Islamic financial business through an Islamic window.⁵⁴

According to supervisory authorities who allow windows consider that this structure has the following advantages; Firstly, Islamic banking services or products benefit from the experience of conventional banks. This might improve the quality of services or products and lower their costs, which could enhance their intermediation. Windows also facilitate liquidity management especially in countries where liquidity instruments are limited. Windows usually have easy access

⁵² Section 115 A(3) *supra*.

⁵³ Juan Sole, above, pg8.

⁵⁴ Regulation 4, Financial Institutions (Islamic Banking) Regulations, 2018.

to liquidity support from the conventional part of the bank. Furthermore, windows enhance competition in the market which would lower the cost of finance for *shari'ah* compliant products.⁵⁵

By and large, for countries with small demand for Islamic banking services, opening an Islamic window could be the only feasible way of providing Islamic banking services, thus enhancing financial inclusion.

However, conventional banks that offer Islamic banking services under Islamic windows do witness the following risks: Firstly, the commingling of Islamic windows with conventional assets and liabilities could have significant reputational risk, as depositors in windows might suddenly withdraw their money if rumors regarding commingling arise. Furthermore, it raises issues related to consumer protection and segregation of funds. It is argued that the windows could hinder the establishment of effective corporate governance and risk management systems. The management and board of a conventional bank may not be sufficiently attuned to the unique risks inherent in Islamic banking activities. Fit and proper criteria in conventional banks operating windows are unlikely to be met in the Islamic banking part of the bank. *Shari'ah* Boards might be unable to verify the complete segregation of assets and liabilities.⁵⁶

The operation of windows could lead to regulatory arbitrage or unfair practices. For example, given the profit-and-loss sharing nature of windows' accounts, risky financing could be encouraged to get Islamic financing through windows because, in the case of default, the account holders of windows will bear the losses. Windows could hinder effective financial oversight. Some prudential ratios that might differ for Islamic banking could be difficult to monitor appropriately. Windows could also hinder the preparation of proper financial statements.⁵⁷

⁵⁵A. Lopez. M, Regulation and Supervision of Islamic Banks, *IMF Working Paper*, WP/14/219, December 2014, 29.

⁵⁶ Ibid.

⁵⁷ Ibid.

3.8 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.⁵⁸ 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 immoveable 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 accost 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 amounts of rentals.)

⁵⁸ Section 37 (a) FIA 2004.

3.9 Establishment of Central *Shari'ah* Advisory Council

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.⁵⁹

In addition, every financial institution which conducts Islamic financial business to appoint and maintain a *Shari'ah* Advisory Board.⁶⁰ 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*.⁶¹ 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.⁶² 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.⁶³ 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.

⁵⁹Section 115 B (2) FIA 2016.

⁶⁰ Section 115 B FIA 2016.

⁶¹ Section 115 (2) FIA 2016.

⁶² Section 115B (3) FIA 2016.

⁶³ 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.⁶⁴ 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.⁶⁵ 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*.⁶⁶

⁶⁴Rule 13(1), The Financial Institutions (Islamic Banking) Regulations, 2018.

⁶⁵ Rule 13 (2) *ibid*.

⁶⁶ Section 121 FIA 2016.

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 3rd 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 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.

3.10 *Shari'ah* Governance Standards

The nature of the Islamic banking business model gives rise to unique governance challenges, including safeguarding the interests of investment account holders and defining the role of *Shari'ah* compliance governance. *Shari'ah*-compliance is a unique feature of Islamic banking and is key to help ensure the integrity of Islamic banking.⁶⁷

It has been noted by one author that a centralized *Shari'ah* Supervisory Board (SSB) has the advantage of harmonizing *Shari'ah*-rulings, reducing *Shari'ah* and compliance costs to Islamic banks.⁶⁸ The practice in setting up a SSB varies across countries. The lack of uniformity in the application of *Shari'ah* governance standards largely reflects variations in the approach to *Shari'ah* issues across countries, constraints on the local availability of qualified scholars, Inmost *Shari'ah* incorporated jurisdictions, Islamic banks are required to have a *Shari'ah* Board and, in some cases, its work has been complemented by the establishment of a centralized SSB. In some jurisdictions, for example in Sudan, Turkey, the United Arab Emirates, the centralized SSBs have

⁶⁷ Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, “Regulation and Supervision of Islamic Banks”, *IMF Working Paper*, pg 15.

⁶⁸ Ibid.

been set up as an independent public institutions, while in other countries like Afghanistan, Bahrain, Malaysia, Pakistan, and Palestine, the SSB has been set up at the central bank.⁶⁹

It has been observed that SSBs also tend to differ in their mandate and accountability to the IBs' board of directors. On accountability, a key challenge is whether SSB members are accountable to the IBs' board of directors. In most cases, it seems that the relationship of an IB's SSB with the bank is of an advisory type as the ultimate responsibility for *Shari'ah* compliance appears to lie with the bank's board of directors.⁷⁰

3.11 Corporate Governance And Operations Of Islamic Financial Business

Every financial institution should have a board of directors of not less than five directors.⁷¹ 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.⁷² 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.⁷³ This is intended to avoid conflict of interest that might arise during the banking operation.

⁶⁹ Ibid.

⁷⁰ Ibid pg 16.

⁷¹ Section 52 (1) FIA 2016.

⁷² Section 52 (5) FIA.

⁷³Section 52 (8) supra.

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.⁷⁴ 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.⁷⁵

The amendment brought in section 55(c) of FIA 2016, specifically for the operations of Islamic financial business. It provides that 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*.⁷⁶

Financial Institutions (Amendment) Act 2016 provides for the audit committee of the board of a financial institution.⁷⁷ 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*.⁷⁸ In addition, Islamic financial Institutions shall be inspected by the Central Bank in accordance with section 79 and 80(m) of FIA.

⁷⁴ Section 54 (1) *supra*.

⁷⁵ Section 54 (2) *supra*.

⁷⁶ Section 55(e) FIA 2016.

⁷⁷ Section 59 FIA 2016.

⁷⁸ Section 59 (7) (b) FIA 2016.

3.12 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.⁷⁹ 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.⁸⁰

The implication of this section is that an Islamic bank will have to ensure that it monitors non-performing 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.

3.13 Deposit Insurance Fund and its Impact on Islamic banking

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.⁸¹

⁷⁹ Section 78 (2) FIA 2016.

⁸⁰ Section 80(2) FIA 2016.

⁸¹ Section 108(2) FIA 2016.

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.⁸²

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.⁸³

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 thesis.

3.14 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.⁸⁴ Banc assurance or Islamic insurance business activities of any financial institution must comply with

⁸² Section 109 FIA 2016.

⁸³ Section 111C (5) FIA 2016.

⁸⁴ Section 115 D FIA 2016.

the Insurance Act. “Banc assurance” is defined to mean “using a financial institution and its branches, sales network and customer relationships to sell insurance products.”⁸⁵

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.

Bancassurance 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.”⁸⁶ 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.

3.15 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.”⁸⁷

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

⁸⁵ Section 3 FIA 2016.

⁸⁶ Section 3 Insurance Act 2017.

⁸⁷ Section 3 Anti Money Laundering Act 2013.

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

3.16 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.⁸⁸

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.

⁸⁸ Section 126(1) FIA 2016.

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.⁸⁹ This provision makes members of *Shari'ah* Advisory Board liable for their acts and omissions.

3.17 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*.

⁸⁹ Section 127 FIA 2016.

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.⁹⁰ 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.⁹¹

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 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.

⁹⁰ Section 14 (2) Judicature Act, Cap 13.

⁹¹ Ibid.

3.18 An Overview of Legal framework of Islamic banking in some jurisdictions

Many countries that have introduced Islamic banking system in their banking sector have not yet enacted specific laws and legislations to authorize Islamic banking. More so, most non-Muslim countries do not have specific laws and legislation to regulate Islamic banking. Nevertheless, there are few selected countries that have made significant efforts to regulate Islamic banks separately from conventional banks; these include Malaysia, Iran, Sudan, Indonesia and Pakistan. Iran has also taken steps to move its entire banking system towards *shari'ah* based banking system.⁹²

Pakistan and Sudan had also attempted to move their entire banking system to Islamic banking, but they have failed and they therefore have dual banking system that is Islamic and conventional banking. Countries like Bahrain, Saudi Arabia, UAE, Kuwait Turkey and Jordan have Islamic banks that operate alongside conventional banks.⁹³

Many countries that have licensed the operation of Islamic banks in their banking system still subject Islamic banking institutions under a secular legal and regulatory framework without provision for Islamic financial infrastructure. Nevertheless, Malaysia is the only country so far that has made tireless efforts to introduce a new Islamic banking rules and regulations known as *Islamic Financial Service Act 2013* (IFSA 2013), other countries like Qatar, UAE, and Pakistan have also followed Malaysian path.⁹⁴

Malaysia has a dual banking system where by Islamic banking operates side by side with conventional banking and it is regulated under the authority of the central bank, Bank Negara Malaysia. In this context, Bank Negara Malaysia, as the central bank of Malaysia, holds authority to control and regulate the banking operations in the country. The central bank is an authoritative

⁹² Mohammad Zulkhir Abdul Majid and Reza Ghazal, "Comparative Analysis of Islamic Banking Supervision and Regulation Development", Islamic Development Bank, Jeddah Saudi Arabia, pg 117.

⁹³ Ibid.

⁹⁴ Ibid.

body vested with the comprehensive legal power to regulate and supervise the financial system in Malaysia. Therefore, Islamic banks as well as Malaysian conventional banks are under the supervision and regulation of the Central Bank of Malaysia.⁹⁵

Islamic finance industry, like conventional banking needs also to be supported by a strong regulatory and supervisory framework. This is to ensure that the operations of Islamic financial institutions are sound and not a source of susceptibility to the banking system.⁹⁶

3.19 The Supervision Of Islamic Banking in Some jurisdiction

As is the case in conventional banking, prudential supervision in an Islamic banking framework is a key to ensure safety and soundness of individual Islamic banks and help reduce risks to the stability of the financial system. The conduct of banking supervision needs to be undertaken in a manner that addresses the special characteristics of Islamic banks. Thus, supervisors need to understand the challenges inherent in Islamic banking and the potential implications of the Interactions between Islamic banks and Conventional banks, including the potential for regulatory arbitrage.⁹⁷

There are two models of supervision of IBs in jurisdictions where Islamic and conventional banks are present. In the first model, Islamic banks and Conventional banks are subject to the supervision of a single supervisory authority for example Saudi Arabia, Ethiopia, Kazakhstan, Kenya, Kuwait, Qatar, Tunisia, Turkey, the United Arab Emirates, and the United Kingdom). In the second model, supervision rests with separate supervisory units within a single supervisory authority for example

⁹⁵ Shafi'i Abdul Azeez Bello and Abdul Ganiyyi Abdur Raheem Zubaedy, "Shariah Governance Framework Model for Malaysian Islamic Banking and Finance: A Critical Analysis," *Journal of Business and Management (IOSR-JBM)* Vol.17, Issue 10. Ver.1 page 15.

⁹⁶ Mohammad Zulkhair Abud Majid and Reza Ghazaal, "Comparative Analysis of Islamic Banking, Supervision and Regulation Development" (2012) 6(3) *Money and Economy* pg 307.

⁹⁷ 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 20.

Bahrain, Indonesia, Jordan, Lebanon, Pakistan, and Syria. In the first model a single supervisory framework applies to all banks whether Islamic or conventional bank, while in the second model, separate supervisory frameworks may be applied to IBs by the separate supervisory units.⁹⁸

3.20 Introduction of Islamic Microfinance Operations

In addition to Islamic banking, the government of Uganda has also introduced Islamic microfinance governed by a different regime and not under the Financial Institutions (Amendment) Act 2016. Islamic Microfinance will be regulated by the ***Tier 4 Microfinance Institutions and Money Lenders Act 2016***.

Section 3 (1) of the said Act provides one of the purpose of the Act as to facilitate the Microfinance industry to promote social and economic development. The transactions of Islamic micro finance will have to comply with the Islamic contract. The Act does not apply to microfinance business conducted by institutions regulated by the Central bank except as otherwise provided.⁹⁹ Tier 4 microfinance institution means “an institution specified in section 4 of the Act and covers SACCO, non deposit taking microfinance institutions, self help groups and community based microfinance institutions. SACCO refers to savings and credit cooperatives.

Islamic microfinance is defined under Section 5 of the Act to mean” the business of engaging in micro finance activities in accordance with *shari’ah* and includes;

- (a) The business of receiving property into profit sharing investment account or of managing such accounts;
- (b) The business of providing finance through the acquisition, disposal of leasing of assets or other services which have a similar economic effect or are otherwise economically equivalent to any other microfinance business, or

⁹⁸ Ibid.

⁹⁹ Section 2(2) *Tier4 Microfinance Institutions and Money Lenders Act 2016*

- (c) Any other microfinance business which involves the entry into one or more Islamic contracts or which is otherwise carried out or purported to be carried out in accordance with *Shari'ah*.”

Section 5 of the Act defines Islamic contract to mean “a contract which complies with the *Shari'ah* and satisfies the conditions specified by the Authority. There will be an authority established under section 6 of the Act to regulate and supervise such transactions.

In addition, an institution that intends to operate Islamic microfinance shall apply to the Authority for approval.¹⁰⁰ The nature of the application which should be accompanied by the following:

- (a) Proof that the proposed dealings and transactions in Islamic microfinance shall be in accordance with *Shari'ah* law.
- (b) A nominee to be appointed as *Shari'ah* adviser.
- (c) The modes of finance and products structures proposed to be used for raising resources and extending financial assistance to the client.
- (d) A *Shari'ah* compliance mechanism
- (e) A method of segregating the Islamic microfinance business from the conventional microfinance business.¹⁰¹

Furthermore, the Authority may withdraw the approval granted under the Act if the Authority is satisfied that the applicant made a material misrepresentation or concealment of information.¹⁰²

This is another area where the operation of Islamic microfinance will operate alongside the conventional microfinance business. The challenges that are likely to affect Islamic banking will also affect the Islamic microfinance because the operations and the principles are almost the same. It should be noted that the regulations governing the Islamic microfinance are not yet produced.

¹⁰⁰ Section 105(i) supra.

¹⁰¹ Section 105(2) supra.

¹⁰² Section 105(4) supra.

3.21 Conclusion

This Chapter has examined the provisions pertaining to Islamic financial business under the Financial Institutions (Amendment) Act 2016 and the Financial Institutions Act, 2004. Islamic banking by its nature is subject to the same regulatory infrastructure which applies to conventional financial institutions taking into consideration the characteristics of Islamic banks and also the review of their compliance with Islamic principles. However, there are specific modifications under the FIA 2016 which are intended to smoothen the operation of Islamic banking business although more are needed. This chapter considered some of the compliance issues and their legal ramifications. The next chapter will consider the prospects and challenges which are likely to hinder the operations of Islamic banking.

CHAPTER 4

PROSPECTS AND CHALLENGES OF THE OPERATION OF ISLAMIC BANKING IN UGANDA

4.1 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 centre for Islamic finance.¹ 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.

4.2 Prospects for Islamic Banking in Uganda

4.2.1 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

¹ Nooraslinda Abdul Aris, "Islamic Banking Products: Regulations, Issues and Challenges", (2013) 29(4) *Journal of Applied Business and Challenges*, page 1145.

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 2008.²

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 comes 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.³ 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.

4.2.2 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

² Linnéa Hallberg and Yasmine Å. 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 Thesis , Spring 2011 *International Business/Marketing*, pg 27 .

³ Ibid. pg 28.

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.

4.2.3 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.

4.2.4 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.

4.2.5 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.

4.3 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 practioners 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:-

4.3.1 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.⁴ 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 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.⁵

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

⁴ Annual Supervision Report.

⁵ Section 79 (1) and (2), FIA, 2004.

available to investor (transparency), to ensure the soundness of the financial system and to improve control of monetary policy.⁶ 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 strengthened⁷.

4.3.2 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 the same 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.⁸ Although Bank of Uganda supervises Islamic banks, Islamic banks can not benefit from their loans because they are provided on the basis of interest. Therefore, there is a need for creating other forms of returns to the Bank of Uganda so that the Islamic banks can benefit from loans granted by the Central bank.

4.3.3 *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

⁶ Mzee Mustapha, "The Legislative Challenges of Islamic Banking in Tanzania"(2016) 45 *Journal of Law, Policy and Globalization*. pg135.

⁷ Ibid.

⁸ BoU Act.

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.⁹

4.3.4 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.¹⁰ Such a situation is also likely to happen in Uganda.

4.3.5 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.¹¹

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

⁹ 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.

¹⁰ Linnéa Hallberg and Yasmine .Å. 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 Thesis , *International Business/Marketing Spring 2011*, pg 28.

¹¹ New vision, Friday June 30th 2017 page 45.

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.¹² Uganda will not be an exception to this perception happening elsewhere because Uganda has also experienced the same in Kampala in the last few years.

4.3.6 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.¹³ 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.¹⁴

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 analysed in terms of how safe they are for the bank to be engaged in, they must also be examined so that 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.¹⁵ However those interested in its services should conform to its principles.

¹² Ibid, pg 28.

¹³ Ibid, pg 29.

¹⁴ Ibid, pg 26.

¹⁵ Ibid, pg 27.

4.3.7 Deposit insurance fund as a challenge

Effective dealing with the issue of deposit insurance is a key to promote the stability of Islamic banks. In the case of Islamic bank, the main challenge for deposit insurance is to identify its scope, including whether it covers profit sharing investment accounts. Toward this end, the existence of a sound approach to determine the value of the alpha factor would be instrumental in determining the level of coverage needed for investment account holders. In practice, the protection of deposits in Islamic banks has little uniformity among jurisdictions. Deposit protection schemes range from single schemes applied to all banks to separate schemes where Islamic and conventional banks are covered separately. Where there is a separate deposit protection scheme for Islamic depositors (investors), such a scheme typically invests its funds from ex ante contributions only in *Shari'ah* compliant investments.¹⁶

Under the law regulating banking system in Uganda, there is a concept of Deposit Protection Fund.¹⁷ The deposit protection fund is established in the Central bank and it is managed by an independent body.¹⁸ The purpose of a deposit protection fund is that, it is a deposit insurance scheme for customers of contributing institutions. In addition, it can also act as a receiver or liquidator of a financial institution, if appointed for that purpose by the central bank.¹⁹ Every bank whether conventional bank or Islamic bank has to contribute to the fund.²⁰ Monies paid into the Deposit protection fund are contributed by the banks in order to secure their customers in case those banks suffer from failures. When this happens the fund pays back to the bank an amount which is greater than that which had been earlier on contributed by the banks.²¹

The challenge of these sections is that since deposit insurance involves the exchange of money for money and the exchange occurs with different values and is an interest based transaction which is not acceptable according to Islamic laws. The interest element could also exist in deposit insurance

¹⁶ 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 20.

¹⁷ Part XII, *Financial Institutions (Amendment) Act 2016*

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Section 111 (1), *Financial Institutions (Amendment) Act 2016*.

²¹ Mzee Mustapha Mzee, above, page 135.

when the deposit insurance fund is invested in interest –based transactions or projects not approved by Islamic *shari'ah*. The profit would not be viewed as not permissible and thus doubtful to be applied in paying an Islamic bank when it has failed.²² In order to overcome this challenge, Islamic banks need to pool their funds together under the supervision of the Central bank to help each other in times of need. This money can be invested in *shari'ah* compliant liquid assets until they are required.²³

The financial crisis highlighted the need for deposit insurance regimes that effectively protect depositors and promote financial stability. As Uganda has embraced Islamic banking, a deposit insurance schemes will also have to cater for the *Shari'ah*-compliant, tailored for local environments, and consistent with international effective deposit insurance standards. Risk-based deposit insurance premiums are preferable, to promote good governance and deter moral hazard, including by avoiding the subsidisation of risky banks by stable banks. *Shari'ah*-compliant models that allow risk-based premiums should be considered.

It has been noted that in 2014, the Indonesia Deposit Insurance Corporation announced plans to create a separate deposit insurance framework for Islamic bank deposits, including to ameliorate the potential adverse consequences for Islamic banks under Basel III (e.g to quality as “stable” deposits under Basel’s Liquidity Coverage Ratio (the “Basel LCR”) framework, retail demand deposits must, inter alia, be covered up to specific numerical coverage limits by explicit, ex ante, deposit insurance schemes. In 2013, Qatar’s Central Bank, Financial Centre Regulatory Authority, and Financial Markets Authority unveiled a strategic plan to build “a resilient financial sector that operates at the highest standards of regulation and supervision,” and includes an explicit deposit protection regime for the increasing scale of operations of the Islamic banking sector in Qatar.²⁴ Jordan in November 2014, amended its law to establish an Islamic deposit insurance framework, to operate alongside its existing conventional system.²⁵

²² Ibid.

²³ Ibid.

²⁴ Hdeel Abdelhahy, “Deposit insurance frameworks for Islamic banks: Design and policy considerations,” (2015) *Butterworth Journal of International Banking and Financial Law*, page 99.

²⁵ Ibid, page 99.

Shari'ah scholars have disapproved of standard deposit insurance model, arguing that it entails (like conventional insurance) excessive uncertainty (*gharar*), as the insured risk might not materialise. As to Islamic frameworks, opinions differ as to legal and operational models, as illustrated by the Islamic deposit insurance models of Sudan and Malaysia.²⁶

Sudan's banking system is wholly Islamic as is naturally its deposit insurance scheme that is administered by the Bank Deposit Security Fund (BDSF). Sudan's deposit insurance model is based on *takaful* (an Islamic mutual or solidarity model) and was approved by its central bank-housed *Shari'ah* High Advisory Board. Participation is mandatory for domestic banks and branches of foreign banks.²⁷ Malaysia operates a dual deposit insurance framework that is managed by the Malaysia Deposit Insurance Corporation (MDIC) and covers, through separately funded, maintained, and segregated conventional and Islamic funds, covered deposits held by conventional and Islamic banks.²⁸

The insurance fund is funded by Islamic banks (which contribute their own funds to cover deposit (demand) and savings accounts, and, on behalf of investment account holders, funds to cover investment accounts. The funds are owned by the MDIC. Under the MDIC's priority rules, deposit (demand) and savings accounts take priority over investment accounts; the rationale for the priority rules is that Islamic banks are not responsible to investment account holders for capital and uncredited profit losses. The fee character of the premiums paid by banks to the MDIC is important, as it allows the MDIC to assess risk-based premiums.

4.3.8 *Shari'ah* knowledge by the Supervisory authority

The Bank of Uganda as the supervisory authority may lack Islamic banking knowledge. Thus, it becomes troublesome for the supervisory authority to regulate accordingly. Any assistance that may be required by Islamic banks for their operations will not be met. Also, any supervision and regulation will be made based upon the experiences gained from conventional banks. However, the differences between Islamic banks and conventional banks fail such attempts. For most

²⁶ Ibid, page 100.

²⁷ Ibid.

²⁸ Ibid.

effective regulation, Islamic banks should be regulated and supervised by authorities who have extensive knowledge and experience in Islamic banking.²⁹ In case of lack of experience and knowledge, consultation with IFSB should be seen as an alternative centralized effort to resolve Islamic banking related issues.³⁰ However, the Governor, BoU noted that the government of Uganda had sent out its staff overseas to study Islamic banking.³¹

4.4 Legislative Challenges Which Are Likely To Frustrate Islamic Banking In Uganda.

The *Financial Institutions Act 2004*³², *Bank of Uganda Act*³³ and *Financial Institutions (Islamic Banking) Regulations 2018* are the main laws which provide for comprehensive regulations of banks and financial institutions with the view of maintaining the stability, safety and soundness of the financial system aimed at reduction of risk of loss to depositors. However, there are other related legislations which are so significant in the implementation of Islamic banking. However most of these laws are not favorable to the functioning of Islamic banking as their enactment preceded the introduction of this type of the banking. This means that, the Islamic banking is alien to these laws and thus a need to make necessary amendments. These laws and the challenges wedged against them are as follows:

4.4.1 The Constitution of the Republic of Uganda of 1995

The Constitution of the Republic of Uganda 1995 is the supreme law of the country; the constitution states that “*Uganda shall not adopt a state religion*”.³⁴ This means that the government is not aligned to any religions available in the country, though it recognizes peoples’ individual faiths. Therefore, it is not engaged into the religious affairs of its people. The Constitution limits the government to only recognize such faiths but strictly forbids it to engage itself with the management of the affairs of any religious body.

²⁹ M. Kabir Hassan and Mehmet F. Dicle, “Basel II and Regulatory Framework for Islamic Banks” University of New Orleans, page 13.

³⁰ Ibid.

³¹ Tusiime .E. Mutebile, Islamic Banking in Emerging Markets-Forging Uganda’s Economic Progress, Islamic Banking Conference, Kampala, 13th May 2016.

³² *Financial Institutions Act 2004*(Amended 2016).

³³ *Bank of Uganda Act*.

³⁴ *Article 7, The Constitution of the Republic of Uganda, 1995.*

4.4.2 The Judicature Act, Cap 13

The *Judicature Act*³⁵ is the principle law that declared laws applicable to the Republic of Uganda. It specifically states these laws to be the substance of the common law, the doctrines of equity and the procedure and practice observed in courts of justice. The law recognized the application of customary law.³⁶ The applied law, common law and the doctrines of equity should be in force only in so far as the circumstances of Uganda and of its people permit and subject to such qualifications as circumstances may render necessary.³⁷ Common law and doctrines of equity mean those parts of the law of Uganda, other than the written law, the applied law or the customary law, observed and administered by the High court as the common law and the doctrines of equity respectively.³⁸ Administering Islamic law related issues may not be an easy task.

4.4.3 Islamic Bank As A Body Corporate

Any financial institution willing to carry out banking business in Uganda cannot operate as a bank without acquiring license from Bank of Uganda. No person can be granted a license to transact banking business unless it is a company.³⁹ For this purpose, a company means a company incorporated or registered under the Companies Act.⁴⁰ In this case, a company can even be any institution classified as a financial institution.⁴¹ From this observation, therefore, an Islamic bank must be a company to be given a license to operate its business. This is likely to be a challenge for the operation of Islamic banking in Uganda since the concept of a company is not acceptable in Islamic *shari'ah* as it is argued by some scholars. The main reason why there is no corporation in Islam is that, it is natural persons who have connection and thus are answerable to God for their deeds while corporate law theory postulates that a company has an artificial personality responsible for its own deeds. This theoretical constructs on responsibility of a company is not recognised in Islamic philosophy as the company has no faculty of mind as an individual person.⁴²

³⁵ Cap 13.

³⁶ Section 15 (1), *Judicature Act Cap 13*.

³⁷ Section 14 (3), above.

³⁸ Section 14 (5), note 36.

³⁹ Section 4 (2), *Financial Institutions Act 2004*.

⁴⁰ Section 3, note 39.

⁴¹ Ibid.

⁴² Mzee Mustapha Mzee, "The Legislative Challenges of Islamic Banking in Tanzania", (2016) 45 *Journal of Law, Policy and Globalization*, 134.

4.4.4 Maintenance of liquid assets ratios

Every financial institution should maintain a minimum holding of liquid assets, as it may be determined by the Central bank.⁴³ Liquidity refers to the flexibility to an asset that can be converted into cash quickly and easily. It is the liability to sell an asset and convert it into cash, at a price equal or close to its true value, in a short period of time it is the moneyness of an asset.⁴⁴

The *Financial Institutions Act* as amended makes it mandatory that all banks including Islamic banks should maintain liquid assets at levels which the Bank of Uganda prescribes indiscriminately. Islamic law in relation to Islamic banking forbids dealing in most of liquid assets and as such a vast majority of Islamic bank's assets are maintained in form of illiquid assets. The most liquid asset is money and Islamic banks do not deal with money but deal with assets which is the foundation of Islamic banking financing.⁴⁵ These liquid assets provide a return in form of interests which is in incompatible with *sharia'h* law which is the cardinal regulation of Islamic banking. However, there is no objection to investing in liquid assets but the returns earned on these liquid assets should be in conformity with the *sharia'h*.⁴⁶

In addition, Rule 9 and 10 of the *Financial Institutions (Islamic Banking) Regulations*, 2018, provides for the maintenance of capital adequacy and liquidity requirements for an Islamic financial institution and requirements relating to profits to be shared with holders of profit sharing investments, respectively. This is slightly different from the conventional banking.

4.4.5 Transparency and disclosure

Improving disclosure is a key to provide the supervisory authorities and the public with a better understanding of banks' strategies and relevant risks. Disclosure requirements should aim at providing sufficient information to assess: (i) the appropriateness of policies regarding portfolio diversification and investment objectives (including with respect to concentration); (ii) the degree of exposure to illiquid assets, which could be the case particularly in banks operating under a two-tier *Mudharabah* arrangement; iii) the main risk factors associated with the investment portfolio and the quality of the internal procedures, organization and infrastructure for monitoring and

⁴³ Section 28(1), FIA 2004.

⁴⁴ Mzee Mustapha Mzee, , above , page 134.

⁴⁵ Ibid.

⁴⁶ Ibid.

handling these risks; (iv) the adequacy of arrangements for internal controls, which is a complex issue given the need to determine PLS ratios on projects financed by the bank; and (v) the methodology used by the bank to calculate its performance to help investors choose well managed institutions when placing their investment deposits.⁴⁷

4.4.6 Capital adequacy

Islamic banks operate with many products that do not exist in conventional banking. These unique products bring many risks that require unique risk measurement and capital adequacy measure. Islamic banks should adopt Basel II and integrate suggested systems to their operations for many reasons. Any failure of an Islamic bank will generate systemic risk for the financial system overall thus damaging the Islamic banking sector. Also, in order for Islamic banks to receive international recognition they will have to fulfill many criteria and compliance with international standards is one of them.⁴⁸

4.5 Accounting Standards

Current account holders are exposed to investment risks. The losses on investments may deplete the capital and may force Islamic banks to default on their liabilities. The same risk applies to investment deposits but since they participate to risk directly, their concern is centered on the capital level of the Islamic bank and on the regulation of Islamic bank in terms of misconduct and excessive risk. Such regulation is necessary for *Shari'ah* compliance as well.⁴⁹

The financial system should also be protected against systemic effects of Islamic banks' withdrawal runs. Since investment funds are financed with PLS accounts, current accounts and equity, and since PLS accounts and current accounts can be withdrawn at any time, Islamic banks are susceptible to the risk of withdrawals. Such susceptibility creates a systemic risk and proper regulation should be enforced.⁵⁰

⁴⁷ Alejandro López Mejía, Suliman Aljabrin, Rachid Awad, Mohamed Norat, and Inwon Song, above, pg 18.

⁴⁸ M. Kabir Hassan and Mehmet F. Dicle, above, page 13.

⁴⁹ Ibid page 9.

⁵⁰ Ibid.

In terms of accounting standards, Islamic banks follow the regulations of their domicile. Application of International Accounting Standards (IAS) is possible if IAS is accepted throughout their countries. Accounting standards prepared specially for Islamic banks will provide better accounting practices that are in line with Islamic financial products. They will also ensure reliability of financial statements and comparability.⁵¹ Such issues were raised in some countries which have introduced Islamic banking in their banking sector, Uganda may not be an exceptional to this.

4.6 Sale of Goods Act - The legal concept of goods

Goods are defined as all chattels personal, things in action and money, all emblements, industrial, growing crops and things attached to or forming part of land which are agreed to be severed before sale or under the contract of sale.⁵² Ugandan laws which are relevant to Islamic banking in relation to goods are; *Sale of Goods Act 2017* and the *Contract Act 2010*. Islamic banking involves trade financing. As a means of providing finance to the client, the bank will have to buy goods from the client on credit. In this case the bank procures goods or services and resells them to the client at a profit.

The definition of goods does not cater for some of Islamic banking modes of financing for example ‘*bai-salam*’ mode of financing which is mainly used for sales of goods such as crops which have not been planted or severed from the farm. This is a challenge to the establishment and growth of Islamic banking in Uganda since these goods are not recognized as goods that can be sold under the Sale of Goods Act.⁵³

In addition, the law of sale of goods does not categorize goods which are *haram* (unlawful) or not. Islamic banking law renders some goods to be *haram* (unlawful) and therefore unacceptable in Islamic transactions. These among others include tobacco, breweries, pork etc. This will also be a challenge to the growth and development of Islamic banking in Uganda, this is because Islamic law ensures moral purity and values.

⁵¹ Ibid.

⁵²Section 1 (h), *Sale of Goods Act 2017*

⁵³ 2017.

4.7 Existing Tax Laws

The Uganda tax regime is also another issue that is likely to affect the operation of Islamic banking in Uganda. The Islamic banking will have to conform to stamp duty fee under the *Stamp Duty Act*,⁵⁴ if the *shari'ah* compliant - financial products or double staged transactions are structured for example, *murabaha*-financed residential contracts, *ijarah* underlying contracts for home purchase and diminishing partnership-based mortgages under the existing laws. The stamp duty would be charged twice on a single house purchased as two separate sale transactions are completed. This will make the *shari'ah* compliant products more expensive and thus uncompetitive in the market, as a similar product in the conventional bank system gets favorable treatment (one stamp duty on a loan contract) under some regulator.⁵⁵ The concept of Islamic banking involves trade financing, in this case there is transfer of titles twice, once from seller to the bank and then from bank to buyer and therefore both these transactions are twice taxed.

Stamp duty is usually paid when the ownership in the asset is transferred. Therefore, the buyer is supposed to pay over and above the purchase price paid to the seller. However, with Islamic sales the bank buys the property instead and then resells it to the client with appropriate mark up. The taxation problem is; these two transactions would normally incur two separate stamp duty payments.⁵⁶

In conventional banking the interest received is regarded as a “passive” income while profit received by the Islamic bank is regarded as an earned income which is treated differently for purposes of tax.⁵⁷

The legislative and supervisory problems are the key impediments that are likely to frustrate the growth and development of Islamic banking industry in Uganda. Other foreign jurisdictions have reorganised these key impediments and addressed the need for amending legislation. For example regulatory and tax amendments have already been introduced in jurisdictions such as the United Kingdom, Malaysia and Singapore in order to accommodate Islamic banking products.

⁵⁴ Cap 342.

⁵⁵ Sulaiman Lujja, Mustapha Omar Muhammad and Rusni Bt Hassan, above, Pg 424.

⁵⁶ Mzee Mustapha Mzee, above, pg 136.

⁵⁷ Ibid.

4.8 Hire Purchase Act, 2009

The Hire-Purchase Act, 2009 regulates the business of hire purchase financing which is normally carried out by credit companies licensed under the Act. Islamic banking products especially for debt financing involve trading transaction. It is different with conventional bank whereby it only involves a loan transaction. Basically this concept refers to the financing of houses, motor vehicles, lands, consumer goods, cash line facilities, education financing packages and personal consumption. This is likely to affect Islamic banking industry if no amendment is made to this Act.

4.9 Jurisdiction of the court in Uganda in Islamic banks disputes.

Given the fact that Uganda was a British colony, the English legal system and law are predominant in Uganda; its legal system is based on the English common law. Judicial functions are administered by various courts established in accordance with the law. The court system in Uganda is adversarial in nature where litigants present their cases before the presiding officers who will decide based on the evidence adduced and submissions forwarded by the respective parties or their respective counsels. Since all Islamic banks dispute fall under the some purview, all disputes arising out of Islamic bank transactions will be subject to the some procedure and process as experienced by its conventional counterpart without considering the different nature of Islamic legal system. This situation may result into a bad decision on Islamic banking matters keeping into consideration that many of those presiding judges and magistrates may not have the requisite knowledge of Islamic banking system.⁵⁸

In Uganda, it is assumed that cases on Islamic banking will be under the jurisdiction of the civil courts. It is submitted that judges in civil courts may face difficulties in understanding certain concepts and terms of Islamic finance. As a matter of fact it would be appropriate to set up a special High Court in the Commercial Division (Islamic Banking & Finance Bench) by a Practice Directive. This special high Court will only hear cases on Islamic banking and finance.

⁵⁸ Umar A Oseni and Dr.Abu Umar Faruq Ahmad, “Dispute Resolution in Islamic Finance; A case Analysis of Malaysia”.8th Conference on Islamic economic and Finance, Center for Islamic economics and finance, Qatar, Faculty of Islamic studies, Qatar Foundation, Qatar., (www.oja.oj.go.th...oja 14610206812.

Islamic law is now part of the law of the land as per the *Financial Institutions (Amendment) Act*⁵⁹ of which the court must take judicial notice. Facts which court must take judicial notice are; all Acts and Ordinances enacted or hereafter to be enacted and all laws and legislations which are in force.⁶⁰ In this case the *Financial Institutions (Amendment) Act*⁶¹ which is so far the law that legislates Islamic banking in Uganda is a judicial notice as per the stated provision.

The judge is presumed to know the law or at any rate be able to find it in statutes, case law reports or academic writings and if necessary the judge will interpret the law and apply it before he or she comes to a decision.⁶² However, since the magistrates and judges are trained in secular and common law institutions it is easy to assume that the law that the magistrates and judges might find and apply is that of common law or English law.⁶³

The disadvantage of Islamic banking and financial matters falling under the civil court and triable by civil trained judges is that it may lead to the application of laws and concepts that contradict *shari'ah* law.

It should be noted that if the presiding judge is unclear about any part of the law (Islamic law and Islamic banking), he or she is free to call an expert witness to assist the court in order to promote justices and equity which is the ultimate aim of the courts of law. Expert evidence from Islamic scholars on Islamic commercial matters needs to be called upon to explain the issues under dispute.⁶⁴ The *Evidence Act Cap 6* justifies this as follows;

*When the court has to form an opinion upon a point of a foreign law of science or art or as to identity or genuineness of handwriting or finger impressions, the opinions upon that point of persons specially skilled in that foreign law, science or art or in questions as to identity or genuineness of handwriting or finger impressions, are relevant facts, such persons are called experts.*⁶⁵

⁵⁹ 2016.

⁶⁰ Section 56, *Evidence Act*, Cap 6.

⁶¹ 2016.

⁶² Norhashimah Mohd. Yasin, "Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies", (2009)1 *IUM Law Journal*, p.13.

⁶³ Ibid.

⁶⁴ Norhashimah, above pg 14.

⁶⁵ Section 43, *Evidence Act Cap 6*.

Shari'ah courts have jurisdiction only over persons professing the religion of Islam.⁶⁶ However, it does not mean that if both parties to an Islamic banking transaction are not Muslims, the matter cannot fall under the *shari'ah* jurisdiction.⁶⁷ In Islamic banking activities, the parties involved range from Muslims, non-Muslims, companies, partnerships and statutory bodies. Hence, giving jurisdiction on that matter to the *shari'ah* courts would be impossible. Even the Islamic banks cannot be considered as persons professing the religion of Islam since they are not individuals, what more conventional banks.

4.10 Outlook On International Islamic Banking Cases

While Islamic finance is expected to keep up its growth momentum, certain challenges that may be hurdles to its development should be addressed wisely. One of the key unresolved issues pertaining to Islamic finance is the question of having a proper legal regime and framework. In recent years, a number of Islamic finance cases have been brought before the courts for adjudication in different jurisdictions. The court decisions on Islamic finance disputes have raised uncertainties for investors and market participants regarding the security of their investments.⁶⁸ With the emergence of Islamic banking litigation as demonstrated below, this thesis attempts to critically review and analyse selected court decisions on Islamic banking disputes. The research highlights the distinctive approaches of courts in making decisions pertaining to Islamic banking issues in some jurisdictions, namely Malaysia and the United Kingdom, among others.

4.10.1 Malaysian Islamic Banking Cases

In Malaysian case of **Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Others**⁶⁹ 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

⁶⁶ Norhashimah Mohd. Yasin, above, pg 6.

⁶⁷ Ibid.

⁶⁸ Zulkifli Hasan and Mehmet Asutay An Analysis Of The Courts' Decisions On Islamic Finance Disputes(2011) 2 *International Journal of Islamic Finance* pp. 41, 42.

⁶⁹ [2008] 5 MLJ 631.

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

Justice Patail's decision was eventually overturned by the Court of Appeal in **Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeals**⁷⁰. In overturning Justice Patail's decision, the Court of Appeal stated that the judge in lower court had misinterpreted the meaning of 'Islamic banking business' under section 2 of the **Islamic Banking Act 1983**. The Court of Appeal disagreed with his interpretation of the meaning and import of 'Islamic banking business' under section 2 of the Act and explicitly stated that the aims and operations of the business need not be approved by all the four mazhabs. They also issued a reminder that there are other secondary sources of law in addition to the four schools of jurisprudence (Hanafi, Shafii, Maliki, Hambali).

It is submitted that such a scenario discussed above is likely to occur in Uganda in future. Therefore, civil courts should have the expertise to handle cases related to Islamic banking. Therefore, it would be appropriate for the civil courts in Uganda to consult the Central *Shari'ah* Advisory Council of the Bank of Uganda before reaching its decision over Islamic banking business dispute.

⁷⁰ [2009] 6 MLJ 839.

In the case of *Bank Islam Malaysia Berhad v Adnan Omar*⁷¹ the High Court held that the defendant was bound to pay the whole amount of the selling price based on the grounds that he knew the terms of the contract and knowingly entered into the agreement. In this respect, the court applied the classic common law interpretational approach where the parties are bound by the terms and conditions of the contract. The court did not look further into the issue as to whether the facility involved an element not approved by the Shariah as stipulated under the *Islamic Banking Act 1983* and the *Banking and Financial Institutions Act 1989* of Malaysia.

In the cases of *Affin Bank Berhad v Zulkifli Abdullah and Malayan Banking Berhad v Marilyn Ho Siok Lin*.⁷², the learned judges in this case indirectly criticized the attitude of the earlier court decisions for using a narrow interpretation and heavily applying the classic common law approach. The proper approach, they opted, was for the court to examine further the practices of Islamic banking as to whether they were contrary to the religion of Islam. The court held that the Islamic contract was similar to a conventional loan and hence the Islamic banks could not claim the unearned profits because it was equal to interest calculation.

It should be noted that although the learned judges arrived at their decisions by rejecting the Islamic banks' claim on the unearned profits, the judgment in these two cases did not question the validity and legality of profits derived from the facility. The courts also were silent upon the interpretation of *riba* and usury and did not declare the profits gained from the facility as unlawful.

In the case of *Malayan Banking Berhad v Ya'kup bin Oje & Anor*.⁷³ the learned judge in this case presented a comprehensive examination of the application of the banking facility by analysing the overall aspect of the facility both from the legal and *Shari'ah* perspectives. This position indicates the improvement in the judges' level of awareness and understanding of Islamic finance.

*In Kerjasama Rakyat Malaysia Bhd v PSC Naval Dockyard Sdn Bhd*⁷⁴ the court upheld the earlier decisions on the validity of the Islamic banking contract, the court clearly indicated the new

⁷¹ [1994] 3 CLJ 735.

⁷² [2006] 3 MLJ 67.

⁷³ [2007] 6 MLJ 398,

⁷⁴ [2007] MLJ 722.

constructive approach of the courts towards Islamic banking cases, particularly in resolving issues pertaining to the facility. In the case of *Arab Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors* was the beginning of the proactive attitude of the courts in examining the validity of Islamic banking practices and determining the issues involved in Islamic banking cases. The case encompassed twelve separate civil suits involving Bank Islam Malaysia Berhad and Arab-Malaysian Finance Berhad as the plaintiffs. All the twelve civil suits involved issues pertaining to the BBA facility where the defendants were asked to pay the whole amount of the selling price in the event of default. The Court of Appeal held that the BBA contract was valid and the notion of replacing the sale price under the Property Purchase Agreement with an “equitable interpretation”, which would lead to the obligation of the customer to pay the sale price with a “loan amount” and “profit” computed on a daily basis, constituted an act of rewriting the contract of the parties. It is trite law that the court should not rewrite the terms of a contract between parties that it deems to be fair or equitable.

The development of Islamic finance cases in Malaysia reflects the dynamic quality and reality of Islamic banking practices within the legal environment they operate in. The evolution of court cases since the implementation of Islamic banking provides an overview with regard to how numerous legal issues involved can be solved and be treated accordingly without impeding the development of the industry.⁷⁵

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 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

⁷⁵ Zulkifli Hasan and Mehmet Asutay An Analysis Of The Courts’ Decisions On Islamic Finance Disputes (2011) 2 *International Journal of Islamic Finance* 41, 42.

according to law. The civil court has a constitutional duty to ensure that Islamic financial instruments are within the spirit of the law.

In the case of **BIMB v Adnan Bin Omar**,⁷⁶ there was a preliminary objection raised by the defendant (Adnan) which was not reported and no written judgment was supplied. The issue was about the court's jurisdiction. The defendant argued that since the plaintiff (BIMB) is an Islamic bank and the civil court had no jurisdiction to hear the case. The judge, N.H Chan, overruled the objection and submitted that the matter was rightly brought before the civil court. It was further held that since BIMB is a corporate body, it does not have a religion and therefore is not within the jurisdiction of the *sharia* 'h court.

However such a decision can be reached in any common law jurisdiction if no clear amendments are made to the existing laws.

4.10.2 United Kingdom Islamic Banking Cases

Islamic banking business has been conducted in the United Kingdom although there is no specific legislation. Much of the Islamic banking products are based on the law of contract.

The case of *Investment Company Of The Gulf (Bahamas) Limited v Symphony Gems N.V. and Ors*⁷⁷ 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

⁷⁶ (1994)3 CLJ 735.

⁷⁷ [2002] West Law 346969, QBD (Comm. Ct.)

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.

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.

Another landmark case in the English courts related to Islamic finance was the case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others* ⁷⁸ 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.

⁷⁸ 2004] 1 Lloyd's Rep 1 28.

The central issue raised in this case referred to a construction of the governing law clause. The *murābaḥah* 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* non-compliance.

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 transacti.

In this case of *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*⁷⁹ 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

⁷⁹ [2004] 1 WLR 1784.

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**,⁸⁰ 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 law 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 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 its 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**⁸¹, 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 *wak'alah* agreement entered into would be governed by the English law. When TID failed to perform its obligation under the *wak'alah* 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 *wak'alah* deal. Ironically, TID argued that the *wak'alah* 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

⁸⁰ [2007] EWHC 2981 (Ch)

⁸¹ [2009] All ER (D) 145

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.

4.11 Conclusion

This chapter has presented the case for opportunities and challenges for the Islamic banking in Uganda. Since Islamic banking operation has not taken off despite the enabling law, there are issues noted above that are likely to limit their full operations. Examples from other countries have revealed some of the areas that have to be worked on in order to improve Islamic banking business. Therefore, to solve these challenges is not a matter of the state alone but all the key stakeholders. This requires a short term and long term strategy. The next chapter will present specific areas that require urgent attention for proper operation of Islamic banking, especially by providing relevant recommendations.

CHAPTER 5

RESEARCH FINDINGS, RECOMMENDATIONS AND CONCLUSION.

5.1 Introduction

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.

5.2 Research Findings

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 thesis 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 that Islamic banks need to comply with *Shari'ah* Law. The thesis 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 undue unfairness to the Islamic banks and which would defeat the whole purpose of establishing Islamic banking in Uganda. The thesis has identified areas of amendment in the existing laws. The thesis 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 thesis 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.

5.3 Recommendations

There are certain key steps that can be taken to enhance the local Islamic banking and finance sector in Uganda. Therefore, in line with the set objectives of the thesis, the following recommendations are proposed.

5.3.1 Regulatory framework should be strengthened

The study recommends that the existing laws that directly or indirectly affect Islamic banking should be amended. It has been discussed in this study that Islamic and conventional banking systems have some differences, so there is a need to have some modifications in some laws so as

to achieve the objectives of Islamic banking in Uganda. However, there are some kind of resemblance between Islamic banking and conventional banking. Islamic banking laws and regulations should accordingly be amended with consideration for the international standards in order to accommodate exponential growth in Islamic banking and new concepts in international banking.¹

The study also recommends that the legal framework should be strengthened in order to enhance the growth and development of the Islamic banking system. Therefore, in order to aid the development of Islamic banking in Uganda and reap the most benefit for the country, clear regulations from FIA should be put in place to enhance the regulation of the industry.

In addition, the expansion and innovative development of Islamic banking products due to the rapid growth and global acceptance of Islamic banking system, brings a new legal and regulatory challenge. Therefore, ensuring sustainable, effective and smooth function of Islamic banking system requires prudential reforms for the purpose of strengthening the legal and regulatory framework. This in return requires the regulatory regime to fashion out a robust and enhanced risk-based regulatory approach that will provide a level playing field for the full-fledged Islamic banks, subsidiaries and Islamic windows of the conventional banks.²

5.3.2 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

¹ Abiola Sekoni, "Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System", *Munich Personal RePEc Archive*, 2015, page 6.

² Ibid, at 10.

arbitrator.³ 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.

5.3.3 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.⁴

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.⁵ Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations.

There is a need to assist the Islamic banking providers to understand customer behaviors and the criteria in the bank selection process. The customers will choose Islamic banking products not solely because of religious based decisions but more because of service quality and convenience. Islamic bankers need to increase their service quality and image.

³ 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 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/ ...Islamic...)

⁵ Ibid. page 10.

5.3.4 Introduction of Islamic Mortgages

The study recommends that the regulators in Uganda should introduce measures necessary to Islamic alternatives for interest based mortgages with the view of creating a level playing field for financial institutions and customers. Given the differing treatment of similar financial products, it is suggested that the government considers amending the *Mortgage Act 2009*, in order to facilitate mortgage transactions based on Islamic banking. This will help people who wish to own homes through Islamic mortgage financing.

5.3.5 Need to amend Tax Laws

Trading transaction requires two separate agreements namely purchase and selling agreement and these reflect double taxation. In order to stimulate the growth and the development of Islamic banking sector, the government has to introduce incentives for Islamic financial institutions through tax exemption. Any legal documentation that involves trading transaction will only incur a normal cost of tax as provided under the Stamp Act.

Since the Islamic banking scheme requires two agreements in a single financing facility or a new agreement whenever there is an adjustment to the duration or financing amount. Thus, Islamic banking products will involve more than one document and each document will attract stamp duty. As a result, Islamic banking products are less competitive as an alternative to conventional banking products. Therefore, in order to enhance the competitiveness of Islamic banking products, all instruments related to Islamic banking are subject to stamp duty similar to instruments used in conventional banking.

The government should implement favorable tax treatment and other incentives for Islamic banking transactions. As with any nascent industry, incentives should be given, and tax incentives especially would be a powerful tool to encourage an industry to develop until it has enough of a local market and demand to flourish by itself.

It is also recommended that there are certain key steps Ugandan government can take to enhance the local Islamic banking industry. The government should implement favorable tax treatment and other incentives for Islamic banking transactions. In a bid to promote Islamic banking, the

government needs to provide a level playing field for both Islamic banking products and conventional banking by allowing incentives in terms of tax exemptions on *shari'ah* compliant contracts that would attract double or multiple taxation. These provisions will allow Islamic banks incur a common tax stipulated under the Stamp Act, in the same manner conventional banks do. Therefore, there is a need to amend the *Income Tax Act* and *Stamps Act* in order to have a flexible Islamic banking arrangement.

5.3.6 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.

5.3.7 Bank Staff Training in Islamic banking

The banks staff personnel is an important factors for the development of Islamic banking in Uganda. In terms of banking concept, customer services are performed to assist the customers to achieve their needs and wants through tellers via banking counters, personal financial assistance, automatic teller machines, telephone banking and Internet banking. Human resource development is a powerful instrument in Islamic banking and should be developed. Since Islamic banking is a new phenomena in the Uganda's banking sector, there is an assumption that there is shortage of professional staff and managers with experience and knowledge in Islamic financial products and relevant *shariah* knowledge. Staff training in Islamic banking is very crucial for the development

of Islamic banking sector in Uganda. The government of Uganda as well as the whole banking sector have to address this challenge if they are to benefit under the Islamic banking business.

There is a need for experienced and *shari'ah* knowledgeable staff in the early stages, especially in the development stage. However, knowledge of *shari'ah* is necessary for the operation of Islamic banking. Moreover, Islamic banking staff lack training and there is a need for Islamic banks to explore the setting up of an Islamic Training Centre for bank related staff. It is submitted that the Uganda Institute of Bankers will have to make necessary changes by incorporating Islamic banking into its curriculum.

The misleading view among the customers is partly due to the lack of experience and knowledge among the bank personnel in giving correct and satisfactory explanations about Islamic banks product. It is argued that Islamic banks will require a diligent management team to balance the different levels of credit and also function as specialists in estimating project risk and estimated returns.

5.3.8 Specialized Court on Islamic banking

It is hereby recommended that the judicial body should set up a special High Court in the Commercial Division to consider disputes that arise from Islamic banking transactions. This means that cases involving Islamic banking issues will be heard in the High Court Commercial Division. It is proposed that the court may refer to the *Sharia'h* Advisory Council for advice and deliberation on any *sharia'h* issue involved in the disputed cases. This is due to the background of the judges who are trained in English law and lack knowledge of *sharia'h* aspects especially banking law.

The establishment of an Islamic division at the High court should not be seen as a revolutionary movement to change the country into an Islamic state. It is a relatively non- drastic change as compared to other possible changes that require some changes to the very basis of the 1995 Constitution of the Republic of Uganda. It merely puts Islamic law on specific items so that Islamic banking is not discriminated against when it comes to commercial matters. This will create justice and equitable results to the parties involved.

5.3.9 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.

5.3.10 Streamlining the *Sharia'h* Supervisory Board

The national *Sharia'h* Supervisory Board should be constituted as indicated in the FIA (2016) to guide the process of standardization and convergence of products, set qualification and certification of bank's *Sharia'h* Board members and set rules for *sharia'h* control. The qualifications of the board members should be well streamlined, otherwise Islamic banking would not be productive. For example Regulation 13(2)(a) which provides for one to "possess sufficient qualifications and experience in Shari and Islamic banking" seems to cover Muslim and Non-Muslims provided you have such qualifications. Therefore, the issue of religion may not be an issue. This is likely to bring conflict especially when one is not a Muslim and does not understand the Islamic jurisprudence.

The author examined the challenges of *Shari'ah* compliance regulation of Islamic Banks in this country.

5.3.11 Establishment of Islamic Bonds

The author further recommends that the government of Uganda should actively restructure its public debt to include *sukuk* components in order to allow for active participation of Islamic banking industry in Uganda. *Sukuk* are Islamic bonds. Bonds mean long term instruments sold to investors either by the government or companies. In this case, the investor agrees to loan the government or company money at a predetermined rate of interest. The *sukuk* is asset backed with

the owner of the certificate holding an undivided share in a *shari'ah* compliant underlying asset. The returns on *sukuk* arrangement are paid in line with the proportional ownership of the underlying asset in accordance with the performance of that asset. The conventional bond is inconsistent with *shari,ah* law because it has interest component and there is no underlying asset.

5.3.12 Restructuring Academic Programs

The study also recommends that Islamic banking course should be introduced at tertiary institutions and be incorporated into the curriculum. This will enable Islamic banking practioners to have requisite knowledge about Islamic banking and finance system since most of them are trained about common law legal system which in most cases lack Islamic banking elements. There is a need to invest in education in areas of Islamic law and finance; such education would build on the Uganda's existing legal infrastructure in terms of expertise in finance law amongst practitioners and within the courts.

5.3.13 The Need for Supporting Legal Institutions

There is also a need for development of supporting legal institutions closely related to the operation of Islamic banking which are not exclusively for Islamic banking. Such legal institutions are non-recourse project finance, leasing and asset securitization. Non-recourse project finance will serve as the tool for developing Islamic financing which is based on allocation and mitigation of risk between parties in a banking transaction where the return will be justified by the involvement of risk taking. Leasing will be the basis of mode of financing which will enable the creation of *Shari'ah* compatible asset securitization. However, merely securitizing the assets is not solving the problems as the assets to be securitized should be in the form of equity or any form that represent ownership over real assets. This necessitates the creation of an arrangement enabling the financier to hold the assets of the venture while securitizing some sort of right of ownership over the assets to the investor. Trust arrangement can easily achieve this through separating the legal ownership from the beneficial ownership.

5.3.14 Need for Standardization of *Shari'ah* Principles

The interpretation of *shari'ah* principles is open to the Muslim scholars. Different schools of thought may have a different interpretation of an Islamic aspect depending on geographical

location and traditions. Therefore, lack of standardization and clarity makes it difficult for some people to understand the idea of Islamic banking. As provided under the FIA 2016, every Islamic bank may appoint a *Shari'ah* advisory board to evaluate whether the bank transactions and other activities are in accordance with the Islamic *shari'ah*. The problem that is likely to occur is the various interpretations of Islamic products and their applications. The standardization is needed in the meaning of the terminologies of Islamic banking, financing instruments and their documentation and pricing formulas for Islamic products. This will enable the bank customers, bank official and the Central bank to understand Islamic banking effectively.

5.3.15 Need for Collaboration and Research

It is submitted that there is a need for collaboration among the *shari'ah* scholars, practitioners, researchers and regulators to undertake in depth studies and research towards the development of Islamic banking in Uganda. Uganda can learn from the experiences of other jurisdictions like Malaysia, Singapore, Indonesia, Nigeria and Sudan on how to manage Islamic banking transactions. Collaboration should also be re-enforced with the East African countries This will help the Islamic banking sector in guarding itself from financial risks that might arise in future.

5.3.16 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 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.

5.3.17 Amending Code of Good Banking Practice

There is a need to amend the Uganda's **Code of Good Banking Practice, 2009** authored by the Uganda Bankers' Association which was drafted based on conventional banking. The amendment is needed to incorporate Islamic banking business. The code provides services expected of a banker

to its customer under the conventional banking set up. It is a good guide to the banker on how to relate with its customers and state institutions. Islamic banking being different from conventional banking deserves attention under that code in order to assist bank customer relationship.

5.3.18 Amending Bank of Uganda Financial Consumer Protection Guidelines 2011

Clause 4 of *Bank of Uganda Financial Consumer Protection Guidelines 2011* provides the objects of these guidelines. The guidelines are intended to promote fair and equitable financial services practices services; by setting minimum standards for financial services providers in dealing with consumers; increasing transparency in order to inform and empower consumers of financial services; foster confidence in the financial services sector and provide efficient and effective mechanism for handling consumer complaints relating to the provision of financial products and services. It is submitted that these guidelines were made based on conventional banking. Therefore, with the introduction of Islamic banking in Uganda under the FIA 2016, there is a need to amend these guidelines to cater for Islamic banking businesses for the benefits of all the parties.

5.4 Conclusion

The thesis has tried to address the introduction of Islamic banking into the Ugandan conventional banking. It has discussed the features of Islamic banking in comparison with conventional banking. It has considered the legal frame work of Islamic banking under the FIA 2016 and the challenges 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 that Islamic banks need to comply with *Shari'ah* Law. Accordingly, there are differences in the nature of risks faced by Islamic banks and conventional banks. Given the risks faced by Islamic banks they need a legal, corporate, and regulatory framework as much as conventional bank does. A sound legal framework is a key precondition for a safe development of Islamic banking in any country. It has been noted that while authorities have adopted different approaches when developing the legal framework, an important decision to be made is whether to maintain a unified set of banking laws and regulations when Islamic banks and conventional banks operate in a particular jurisdiction. In this context, a unified set of banking laws and regulations covering Islamic banks and conventional banks is

advisable to avoid duplication of legal and regulatory provisions that are equally important for both types of banks.⁶

As seen above, the nature of the Islamic banking business model gives rise to unique governance challenges. First, divergence of interest between holders of investment accounts and shareholders needs to be recognized in the banks' governance structure.⁷ Secondly, governance challenge for Islamic banks relates to *Shari'ah* compliance. A sound *Shari'ah* compliance framework is expected to include a *Shari'ah* supervisory board, an internal *Shari'ah* review process, and periodic *Shari'ah* reviews. In general, there seems to be a need to enhance transparency regarding the mandate and accountability of *Shari'ah* Advisory boards to help reduce reputation and legal risks associated with *Shari'ah*-compliance.

The study concluded that Islamic banking will have to operate alongside the conventional banking since both have the same piece of legislation although Islamic banking will operate under different regulation; The Financial Institutions(Islamic Banking)Regulations, 2018. The growth and development of Islamic banking sector in Uganda is undeniably depending much by having a comprehensive legal framework. The success of the implementation of Islamic banking under FIA 2016 and its regulations relies on the correct approach of its legal facilities. Islamic financial intuitions are bound to meet the *sharia'h* compliance standard, legislations and regulations in addition to Bank of Uganda's directives.

The study has also established that besides the FIA 2016, there are other laws which will have effect on the operations of Islamic banking in Uganda. However, some of these laws may not be favorable to the operations of Islamic banking as their enactment preceded the introduction of Islamic. As seen above, such laws pose a challenge unless there has been necessary amendment.

As effective legal framework requires serious involvement of many stakeholders. A comprehensive legal framework is a vital component to guarantee a success on the implementation

⁶ 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 23.

⁷ Ibid, Pg 23.

of any Islamic banking system. It is submitted that Uganda has adopted a good legal framework that provides regulatory and *shari'ah* aspects. Effective implementation will be possible if Islamic banking regulations are complied with.

In addition to supervision from government regulator, Islamic financial institutions have to comply with directives from that international market regulators. Islamic banking in Uganda will have to comply with regulations and directions of international Islamic banking regulatory bodies like the Islamic Financial Services Board. (IFSB) and AAOIFI. IFSB is an association of Central banks, monetary authorities and other institutions responsible for regulating and supervision of Islamic financial services. Its primary purpose is to set and harmonize standards for supervision and regulation internationally and also ensure that they are consistent with *shari'ah* principles. The AAOIFI is an autonomous international Islamic organization which prepares accounting, auditing, governance, ethics and *shari'ah* standards for Islamic Banking and Finance service providers. Its members are drawn from certain Islamic financial institutions and academics.⁸ The rulings, standards and guidelines of this organization may have to be incorporated into Uganda's domestic laws.

All Islamic financial service providers in Uganda will have to comply with the Companies Act, 2012 on matters related to issuance of shares, debentures, disclosure and fundraising. In addition to Companies Act, Islamic financial institutions will have to abide by consumer laws even though Islamic products are normally referred to as “equity based” rather than “debt based”.

Therefore, the growth of Islamic banking in Uganda requires supportive government policies, government engagement with the private sector so as to achieve Islamic banking objectives. Impediments of the existing laws towards adopting Islamic banking should be identified in order to attain prospects of Islamic banking in Uganda. It is important to focus on deepening Islamic banking skills in areas of education, training, attainment of relevant qualifications and having appropriate *shari'ah* scholars.

It is hoped that this study will contribute to the relevant literature on the subject and also of help to effect the policies and new dimension towards Islamic banking. It is evident that there is scarcity of existing empirical literature on Islamic banking within Ugandan context. However, it is noted

⁸ Salim Farrar, “Accommodating Islamic Banking and Finance in Australia” (2011)34(1) *UNSW Law Journal* 413, 427.

that much of the literature is devoted to the nature of Islamic banking from the *Shari'ah* point of view without regard to the desirable legal framework. This has led the author to make reference to other jurisdiction.

It is submitted that with adequate laws, regulations, guidelines, governance and supervision compliance issues, Islamic banking will thrive in Uganda given its competitiveness nature. The challenges discussed above can be sorted out by adopting some of the recommendations herein provided; especially amending some of the laws that are likely to affect full operation of Islamic banking in Uganda. The future for the Islamic banking in Uganda looks optimistic but this will require Uganda to attract global players in order to promote the banking sector. There are plenty of issues which are yet to be explored. As a result future studies should be focused on flexible practices toward Islamic banking.

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