

**LOAN PORTFOLIO UNDER THE ISLAMIC BANKING SYSTEM: AN ANALYSIS OF
THE LAW IN UGANDA**

BY

KOMAKECH BRIAN

1152-01056-03174

**A THESIS SUBMITTED TO THE COLLEGE OF HIGHER DEGREES AND
RESEARCH OF LAW OF KAMPALA INTERNATIONAL UNIVERSITY IN
PARTIAL FULFILMENT FOR THE AWARD OF
MASTERS DEGREE IN LAW**

JUNE, 2018

DECLARATION

I, hereby declare that this is my original own work at the best of my knowledge and belief. It has never been produced by anyone or institution for any academic award in and outside Kampala International University or other institute of higher learning, except where due acknowledgment has been made in the text.

Signature of student:

Candidate: **Komakech Brian**

Registration Number: 1152-01056-03174

Date :

APPROVAL BY SUPERVISOR

I certify 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 in partial fulfillment for the award of Degree of Masters of Laws of Kampala International University.

Signature:

Dr. Tajudeen Sanni

Date :

ACKNOWLEDGEMENT

With excitement, I pass on my sincere gratitude to the Lord God for having provided for me in all ways throughout my research and specially for blessing me with the gift of my dear mom Oyella Filder Jane who has contributed a lot of her resourceful time to making sure that I am successful.

I also want to thank my supervisor, Dr. Tajudeen Sanni for sparing his precious time, his valuable comments and commitment in the process of preparing this work.

Further special recognition goes to my aunties Nakimera Lillian, Mrs. Ofumbi Rosemary, and their families for the support they have extended to me both morally and financially. I couldn't have gone far without what they granted me at the time when I needed it most.

My heartily appreciation goes on to my daughter Lani Neveah Limaro and my fiancée Nalwadda Grace for the encouraging words you gave me when the road seemed impenetrable.

Lots of gratitude to the IUIU Library staff for granting me free use of the library and also the entire LLM-CL class, for the love, and togetherness we shared. I pray that we take on that spirit even outside the walls of Kampala International University.

STATUTES

Bank of Uganda Act, Cap 51

Financial Institutions Act, 2004

Financial Institutions (Amendment) Act, 2016

TABLE OF INTERNATIONAL TREATIES AND ACCORDS

1. Basel I Accord
2. Basel II Accord
3. Basel III Accord

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
BMF	Bahrain Monetary Agency
BNM	Bank Negara Malaysia
BOU	Bank of Uganda
DJIM	Dow Jones Islamic Market index
FIA	Financial Institutions Act
GCIBFI	General Council of Islamic Banks and Financial Institutions
HSBC	Hong Kong and Shanghai Banking Corporation
IDB	Islamic Development Bank
IFSB	Islamic Financial Service Board
IIRA	International Islamic Rating Agency
IMF	International Monetary Fund
PSIA	Profit Sharing Investment Accounts
UAE	United Arab Emirates
UGX	Uganda shillings
USD	United states dollar

TABLE OF CONTENTS

DECLARATION	ii
APPROVAL BY SUPERVISOR	iii
ACKNOWLEDGEMENT	iv
STATUTES	v
LIST OF ABBREVIATIONS	vi
TABLE OF CONTENTS	vii
ABSTRACT	xii
CHAPTER ONE	1
GENERAL INTRODUCTION.....	1
1.1 Background of the study	1
1.2 Statement of the Problem	9
1.3 Objectives of the Study.....	10
1.4 Research Questions.....	10
1.5 Scope of the study	11
1.6 Methodology	11
1.7 Literature review	11
1.8 Arrangement of Chapters.....	15
1.9 Conclusion	15
CHAPTER TWO	16
HISTORICAL DEVELOPMENT OF ISLAMIC BANKING AND ITS KEY PRINCIPLES	16
2.0 Introduction	16
2.1 Historical Background of Islamic Banking	16
2.1.1 Islamic Banking in Muslim Countries	19
2.1.1.1 Religion.....	20
2.1.1.2 Economic Factors	20
2.1.2 Growth of Islamic Banking in Non-Muslim Countries	21
2.2 Historical Development of Islamic Banking in Uganda	21
2.3 Concepts of Islamic Banking and its main Products and Services	24

2.3.1 Prohibition of <i>Riba</i>	26
2.3.2 Prohibition of Trading in Uncertainty (<i>Gharar</i>)	27
2.3.3 Prohibition of Gambling (<i>Maisir</i>)	27
2.3.4 Prohibition of Investing in Haram Activities	28
2.4 Theories of Sharia	28
2.4.1 Protection of Religion.....	28
2.4.2 Protection of Human Life	29
2.4.3 Protection of the mind	29
2.4.4 Protection of progeny	30
2.4.5 Protection of property.....	30
2.5 Conclusion	30
CHAPTER THREE	32
METHODS OF ISLAMIC FINANCING UNDER THE ISLAMIC BANKING SYSTEM	32
3.0 Introduction	32
3.1 Mudarabah	32
3.1.1 Business of Mudarabah	33
3.1.2 Distribution of the profit.....	34
3.1.3 Types of Mudarabah	35
3.1.4 Termination of Mudarabah	36
3.2 Musharakah	37
3.2.1 Basic rules of Musharakah.....	40
3.2.2 Management of Musharakah	40
3.2.3 Basic rules of distribution of profit	41
3.2.4 Basic rules of distribution of Loss.....	42
3.2.5 Termination of Musharakah.....	43
3.3 Murabahah	45
3.3.1 Basic rules for <i>Murabahah</i>	46
3.3.2 The procedure of <i>Murabahah</i> Financing	48
3.4 Bai-Muajjal.....	49

3.4.1 Features of <i>Bai-Muajjal</i>	50
3.5 Salam.....	51
3.5.1 Importance of <i>Salam</i>	52
3.5.2 Conditions of <i>Salam</i>	52
3.5.3 Parallel <i>Salam</i>	53
3.6 Istisna.....	54
3.6.1 Cancellation of Contract.....	55
3.6.2 <i>Istisna</i> as a mode of financing.....	55
3.7 Ijarah.....	56
3.7.1 Basic rules of <i>Ijarah</i>	57
3.7.2 Termination of Lease.....	58
3.8 Conclusion.....	59
CHAPTER FOUR.....	60
INTERNATIONAL AND NATIONAL REGULATION OF ISLAMIC BANKING.....	60
4.0 Introduction.....	60
4.1 International Legal and Institutional Framework for Islamic Banking.....	60
4.1.1 The Islamic Financial Services Board (IFSB).....	61
4.1.2 Islamic Development Bank (IDB).....	64
4.1.3 International Islamic Financial Market (IIFM).....	65
4.1.4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).....	66
4.1.5 International Islamic Rating Agency (IIRA).....	67
4.1.6 International Islamic Centre for Reconciliation and Commercial Arbitration.....	68
4.1.7 General Council of Islamic Banks and Financial Institutions (GCIBFI).....	69
4.2 Legal Instruments.....	70
4.2.1 Basel I.....	70
4.2.2 Basel II.....	70
4.2.3 Basel III.....	72
4.3 Summary and Conclusion.....	74
4.4 Legal and Regulatory Framework of Islamic Banking in Uganda.....	75
4.4.1 The Judicature Act.....	77

4.4.2 Bank of Uganda Act.	78
4.4.3 The Financial Institutions (Amendment) Act of 2016.	79
4.5 Institutional Framework of Islamic Banking in Uganda	83
4.5.1 The Central Bank of Uganda.	83
4.5.2 Shari’ah board.....	84
4.5.3 The Financial Intelligence Board	85
4.6 Challenges Facing the Regulation of Islamic Banking in Uganda.	85
4.6.1 Sharia Boards and Sharia Compliance	85
4.6.2 Lack of Institutional Framework.....	86
4.6.3 Lack of Open Market Operations.....	86
4.6.4 Lender of Last Resort and the Inter-Bank borrowing.....	86
4.6.5 Lack of coordination between the Central Bank and Sharia Boards	87
4.6.6 Lack of Trained Personnel in Islamic Banking	87
4.7 Conclusion	87
CHAPTER FIVE:	89
SUMMARY OF FINDINGS, RECOMMENDATIONS AND GENERAL CONCLUSION	89
5.0 Introduction	89
5.1 Summary of Findings.....	89
5.1.1 Development and Concepts of Islamic Banking in Uganda.....	89
5.1.2 Methods of Islamic Finance	89
5.1.3 Regulation of Islamic banking.....	90
5.2 Recommendations	91
5.2.1 Central Authority for Shari’ah	91
5.2.2 Have approved Standards to adhere to	92
5.2.3 Invest in research.....	92
5.2.4 Define all aspects of Islamic Banking	93
5.2.5 Creation of a Legal, Regulatory and Institutional Framework to govern Islamic Banking.....	93
5.2.6 Adoption of Global Legal and Regulatory best practices for Islamic Banking	94

5.2.7 Creation of awareness among the general public.....	94
5.2.8 Development of Human Capital	95
5.2.9 Development of Innovative Islamic Banking Products	95
5.3 Conclusion	96
Bibliography	97

ABSTRACT

This study looks into Loan Portfolio under the Islamic Banking system: An analysis of the law in Uganda. Despite the fact that there is a growing interest of Islamic banking system in many financial institutions, many Ugandans have not adopted it yet since some are either unaware of how it works or some banks have not yet started providing Islamic financial services this is in spite of the fact that the Financial Institutions Act of 2016 already recognizes this form of banking. The main aim of the study was to analyze the law regulating loan portfolio under the Islamic banking system in Uganda. The research findings were analyzed basing on the specific objectives which were: To analyze the principles and trends in the historical evolution of Islamic Banking, To examine the different methods of Islamic financing under the Islamic Banking system, To examine the existing framework for loan portfolio in Islamic banking system in Uganda and Internationally. The major findings of the study were that there is no law regulating loan portfolio in Uganda and that there is need to separate Islamic Banking from conventional Banking by specifically making separate legislation for the two. The recommendations on the other hand were teaching the public of Islamic banking products, investment in research among others.

CHAPTER ONE

GENERAL INTRODUCTION

1.1 Background of the study

Islamic banking or Participant banking is the banking or banking activity that is consistent with the principles of Islamic law (sharia) and its practical application through the development of Islamic economic system. Sharia prohibits the payment or acceptance of specific interest or fees (known as *Riba* or usury) for loans of money¹

Islamic banking is based on principles which emphasize moral and ethical values in all dealings with wide universal appeal. Shari'ah prohibits the payment or acceptance of interest charges (*riba*) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th Century that a number of Islamic banks were formed to provide an alternative to Muslims although Islamic banking is not restricted to Muslims.²

The financial services industry plays an important role in the modern economy by mobilizing funds from savers and investors and channeling the same to investments in trade and business. Banks participate in financing of business through the acquisition and allocation of financial resources. The primary role of banks is financial intermediation. Intermediation is a two-step process. A bank obtains funds from savers in the form of deposits by issuing a financial claim representing its obligation to repay the deposited funds or to transfer them to others at the depositor's request and secondly, the bank uses the acquired funds to purchase the financial claims of others. These claims include loans to consumers and businesses, and securities of state or local

¹AlyKhorshid.(2009) Encyclopedia of Islamic Finance, Euromoney PLC. P. 134

² Ibid.

governments. Intermediation provides savers with an outlet for their funds while simultaneously providing funds to borrowers to finance their spending plans³.

In conventional banking, interest plays a major role in financial resource allocation. Banks pay interest to depositors and charge interest for loans advanced. Interest therefore is seen as price of money or return on capital. The simple dictionary definition of interest is 'a charge made for a loan or credit facility'. Islam and Capitalism both agree that money is used as a store of wealth and also as a means of exchange. Islam, however, unlike Capitalism does not view money as a commodity which can be bought and sold at a profit⁴. The prohibition in Islam of dealing in interest necessitates the development of an alternative financial system that serves the needs of Muslims.

Financing, investment, working capital management and redistribution decisions in Islamic Finance must conform to the dictates of Islamic Shari'ah⁵. Islamic banking is a banking activity which is consistent with the Islamic Shari'ah. It is carried out in accordance with the rules of Shari'ah, known as *fiqhmuamalat* (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 business⁶. In Islam the definition of interest is summarized as 'any excess paid or received on the principal'⁷

Islamic banking operates in consonance with the ethos and value system of Islam. It is governed, in addition to the conventional good governance and risk management rules, by a regulatory mechanism laid down by Islamic Shari'ah⁸. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest-

³Samuelson, P.A. and Nordhaus, W.D. (1989), Economics 13th edition, McGraw-Hill, New York, NY.P.233.

⁴ Why Islam has prohibited Interest & Islamic Alternatives for financing, (2005) First Ethical Trust, Bolton, UK. P.10.

⁵Khurshid Ahmad (1980), Studies in Islamic Economics, International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia. P. 65.

⁶Mabid Ali Al-Jarhi (undated), Islamic Finance: An efficient & Equitable option, The Islamic Research and Training Institute, Jeddah, Saudi Arabia. P.63.

⁷www.inter-islam.org accessed 13th.January. 2017.

⁸Iqbal, M. and R. Wilson (eds) (2005), Islamic Perspective on Wealth Creation, Edinburg University: Edinburgh Islamic Development Bank. (1999) Financing Trade in an Islamic Economy, Research Paper No.51.

based transactions, prohibited in the Islamic Shari'ah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy.

Islamic Shari'ah prohibits 'interest' but it does not prohibit all gains on capital. It is only the increase stipulated or sought over the principal of a loan or debt that is prohibited. The prohibition of a risk free return and permission of trading makes the financial activities in an Islamic set-up real asset-backed⁹.

Islamic banking system is based on risk-sharing, owning and handling of physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of finance¹⁰ as such, Islamic banks deal with asset management for the purpose of income generation. Once the banks have a stable stream of *Halal* (lawful) income, depositors will also receive stable and *Halal* income.

Profit on the other hand has been recognized as 'reward' for use of capital¹¹ and Islam permits gainful deployment of surplus resources for enhancement of their value. However, along with the entitlement of profit, the liability of risk of loss on capital rests with the capital itself; no other factor can be made to bear the burden of the risk of loss. Financial transactions, in order to be permissible, should be associated with goods, services or benefits. In the wider context, this feature of Islamic finance can be helpful in creating better discipline in conduct of fiscal and monetary policies.

Islamic Banking and Finance predates the spread of Islam in the 6th century in Arabia, many of the Islamic finance methods were practiced before the Islamic Shari'ah was codified in the Qur'an. Arabia at the time was very much dependent on trade and various innovations of business and finance emerged. Islam spread rapidly to Asia, Europe and North Africa. The Islamic mode of business was adopted invariably by

⁹Holy Qur'an 2:275.

¹⁰http://in.doccity.com/index.php/en-docs/islamic_banking-Ethics-Assignment >Islamic accessed on 13th.January.2017.

¹¹ John Maynard Keynes, (1964) General Theory of employment, Interest and Money, New York, Harcourt, Brace and World, First Harbinger Edition. P.14.

Muslims all over the world until the Ottoman Empire failed and colonial rule took its place. The colonialists brought conventional interest based finance to the Muslim world. Interest based finance is usually perpetuated by the banking sector which practices interest-based banking in financial intermediation. While Islamic Finance providers practice profit and loss sharing, modern banks charge interest for providing loans and advances to businesses. Although no banks provided any sort of Islamic Finance, an active market for funds existed informally between Muslims where no interest was charged for personal loans. Devout Muslims overcame the interest constraint of modern banking by going into partnerships and taking equity positions when supplying capital to projects.¹²

The global Islamic finance industry grew from US\$1.66 trillion in 2013 to US\$2.1 trillion by the end of 2014. Consultancy firm PricewaterhouseCoopers has projected that this industry will grow to US\$2.7 trillion by 2017¹³. According to Ernst & Young, by 2020, the global Islamic banking industry profit pool is expected to reach US\$30.3 billion¹⁴. The Islamic retail and commercial banking assets continued to grow at 16% in 2014 and 2015. Islamic banking assets in six core markets of Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates (UAE), Turkey are on course to touch US\$1.8 trillion by 2019¹⁵. Such growth is partly due to more competitive offers when it comes to Islamic and Shari'ah-compliant products. With the introduction and regulation of Islamic banking, Ugandan banks will have the option of offering clients access to Islamic finance products and services which could turn out to be competitive.

By 2015, the Islamic finance industry had expanded rapidly over the past decade, growing at 10-12% annually. Today, Sharia-compliant financial assets are estimated at roughly US\$2 trillion, covering bank and non-bank financial institutions, capital markets,

¹² 'The Journal of Arabic and Islamic Studies' www.revolvy.com accessed on 13th.January.2017.

¹³ PricewaterhouseCoopers, 'Islamic Finance: Creating Value,' <https://www.pwc.com/m1/en/publications/islamic_finance_capability_statement.pdf. Accessed 20th .December. 2016.

¹⁴ Ernst & Young World Islamic Banking Competitiveness Report (2014 – 2015) <http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamic-banking-competitiveness-report-2014-15>.Accessed 20th December 2016.

¹⁵Ibid.

money markets and insurance (*Takafu*)¹⁶. Large Western multinational banks such as Citibank, Hong Kong and Shanghai Banking Corporation (HSBC), Barkley's and Merrill Lynch have recently begun offering Islamic modes of financing to diversify their large client base, which implies that the Islamic banking system is becoming increasingly accepted. This has also made the Islamic banking system much more challenging. In addition, Dow Jones has also introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with Shari'ah. The progress of the past few decades proves that Islamic finance is here to stay, and is not just a passing phenomenon¹⁷.

Today the world economic system, that is based on interest has resulted in concentrating the wealth in the hands of selected few creating monopolies and widening the gap between the rich and the poor. In contrast Islam encourages circulation of wealth and regards its role as important to an economy as the flow of blood to our human body. Just as clotting of blood paralyzes human body, concentration of wealth paralyzes economy. The fact is that today 10 richest men in the world have more wealth than 48 poorest countries of the world. Millions are malnourished, lack access to safe water, cannot read and write, in short the quality of life has decayed and the graph continues to go down¹⁸.

Economic justice requires a viable economic system supported by an efficient banking system. Interest based banking has proved to be inefficient as it fails to equitably distribute wealth which is necessary for the well-being of mankind. On the other hand Islamic banking is efficient and ensures equitable distribution of wealth thus laying foundation for an inflation free economy and socially responsible banking system¹⁹.

The last few years have witnessed a dramatic increase in Islamic banking in the world over. At least two hundred Islamic banks and financial institutions have been set up.

¹⁶<http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>. Accessed 13th.January. 2017.

¹⁷ "Beyond Interest-Free Banking", U.A.E Banking Review Business Intelligence for Decision Makers, Vol.VI, no.4 (June-July2005)

¹⁸Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic banking' p.13.

¹⁹El Qorchi, M. "Islamic Finance Gears Up," IMF, *Finance and Development*, 42. 2005.

According to a research report, the growth rate of these institutions is 15% per annum. At least two hundred billion US dollars are invested in this system. Many multinational banks have opened Islamic banking windows or subsidiary of Islamic banking²⁰.

An efficient financial intermediation requires a stable banking system to channel surplus funds into savings for investments to promote rapid economic growth²¹. This is done through the creation of loan assets by banks and other financial intermediaries. However, the creation of the loan assets exposes banks to the risk of defaults by borrowers as well as liquidity constraints. This does not only affect the bank profitability but also the stability of the banking system.

Loans and advances are major business activities among Ugandan universal banks and other financial institutions around the globe. It is normally seen in the quantum of credits and advances which reflects in the financial statements and annual reports of both local and multinational banks in Uganda and the increment in the quantity of advances profited to borrowers in both formal and casual parts of the economy. According to Brown, Fazzari and Petersen, the allowing of loans is a noteworthy business for most widespread banks²². Loan portfolio regularly shapes a more noteworthy bit of a bank's assets and a wellspring of wage for business banks.

The evolution of Islamic Finance in modern history is only a small part of overall banking history, and its current form only spans a period of around 60 years. This does not imply that Islamic Finance did not exist prior to the mid-1960s. comparable to other modes of financing, it has gone through periods of increased as well as diminished popularity and ceased to exist for long periods of time²³

The origin of modern Islamic bank can be traced to the very birth of Islamic when the prophet himself acted as an agent for his wife's trading operations. Islamic partnerships

²⁰ Ibid.

²¹ The Quarterly Journal of Economics:(1993)King and Levine. <https://academic.oup.com>. Accessed on 15th-December-2016.

²²The journal of finance.The journal of THE AMERICAN FINANCE ASSOCIATION by James, Brown, Steven, Fazzari and Peterson.

²³ Natalie Schoon 'Modern Islamic Banking' p. 42.

(*Mudarabah*) dominated the business world for centuries and the concept of interest found very little application in day-to-day transactions²⁴. Such partnership performed an important economic function. They combined three most important factors of production, namely: capital, labor and entrepreneurship, the latter two functions usually combined in one person. The capital-owner contributed the money and the partner managed the business. Each shared in a pre-determined share of the profits. If there was a loss, the capital-provider lost his money and the manager lost his time and labor.

According to Mahlknecht, western commercial banks date from about two and a quarter centuries ago, when the western world was dispensing with moral and ethical considerations in economics. When the Muslim world came into contact with the west, Muslims had two choices:

- a) To accept commercial banking, arguing that the interest charged by them did not contain the element of *riba* prohibited in the Quran; or,
- b) To accept that interest charged was *riba* and try to develop an alternative system of banking.

But ancient Muslim institutions, such as the Shari'ah courts, had been made ineffective by the colonial powers. Muslims had no alternative but to work with the colonial institutions, including commercial banking²⁵.

Nevertheless, during the 19th century, several religious scholars argued that the term *riba* referred to loans for consumptions, which people found it difficult to repay, and not to commercial banking loans, where the debtor can repay from the profits. But the Quran makes no distinction between loans for consumption and loans for productive purposes. So their views were rejected. As a consequence, modern commercial banking did not make much headway in Muslim countries and to this day the presents of the conventional framework still dominates the national financial system²⁶.

²⁴Sait, Siraj; Lim, Hillary (2006) ' Land, Law and Islam' New York p. 194.

²⁵Mahlknecht, Michael (2009). 'Islamic Capital Markets and Risk Management' p.60.

²⁶AlyKhorshid, (2009) Encyclopedia of Islamic Finance, Euromoney PLC.

When, in the 1960s, Muslim thinkers began to explore ways and means of organizing commercial banking on an interest-free basis, economists dismissed their work as wishful thinking. But, in 1963, in *MitGhamr*, in Egypt, the first Islamic interest-free bank came into being. *MitGhamr* was a rural area and the people were religious. They did not place their savings in any bank, knowing that interest was forbidden in Islam. In these circumstances, the task was not only to respect Islamic values concerning interest, but also to educate the people about the use of banking²⁷. The types of accounts were: savings accounts, investment accounts and zakat accounts. No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short-term, interest-free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit-sharing. The zakat account attracted the official amount of zakat.

The *MitGhamr* project was successful, as deposits increased from 1963 to 1966. The bank was cautious, rejecting about 60% of loan applications and the default ratio was zero in economically good times. But project was eventually abandoned for political reasons. Nevertheless, it had shown that commercial banking could be organized on a non-interest basis.²⁸

According to Rosly, Islamic banking is growing at a rate of 10-15% per year and with signs of consistent future growth. Islamic banks have more than 300 institutions spread over 51 countries, including Uganda and other Islamic countries²⁹.

In Uganda, the history of Islamic Banking in Uganda can be traced to 2008 when the Bank of Uganda (BoU) first received an application from an institution which was desirous of operating as an Islamic Bank. Subsequently, BoU received numerous inquiries from most of the commercial banks in Uganda seeking to offer Islamic financial products through Islamic Banking "windows". At that time, the Central Bank of Kenya had licensed two Islamic Banks while National Bank of Rwanda had licensed an

²⁷Benedikt Koehler (2009) *Islamic Finance as a Progenitor of Venture Capital* p.44.

²⁸ Ibid.

²⁹Rosly, SaifulAzhar (2006) *Critical Issues on Islamic Banking and Finance* p.106.

Islamic Microfinance Institution and Bank of Tanzania had commercial banks offering Islamic Financial Services through windows.³⁰

In November 2009, Bank of Uganda conducted an in-house training on Islamic Banking and Finance and the participants included regulators of the financial sector from Bank of Uganda, the then Insurance Commission, Capital Markets Authority and the Uganda Revenue Authority.³¹

Like Conventional Banking, Islamic Banking can only thrive with the existence of an enabling Legal and Supervisory Framework. BoU accordingly undertook a study on the Islamic Banking model to explore its fit in the existing legislative framework. The study revealed that the **Financial Institutions Act, 2004** (FIA 2004), contained prohibitions, which could not facilitate the operation of Islamic Banking. In recognition of this fact, therefore, Bank of Uganda proposed amendments to the FIA, 2004, which were approved by Parliament and hence the enactment of the **Financial Institutions (Amendment) Act 2016**, in January 2016 of which the amendments to the then FIA, 2004 were intended to embrace Islamic Banking³².

1.2 Statement of the Problem

Upon perusal of the laws regulating Islamic banking in Uganda and internationally there is no provision providing for loan portfolio under Islamic banking for instance the Financial Institutions Act is silent on loan portfolio which itself is a problem.

As such banking institutions that wish to survive competition and succeed should ensure that, they follow banking rules and regulations³³. One set of rules that is particularly important for banking institutions progress are the Islamic rules and regulations³⁴, given their numerous benefits such as building confidence and trust between the bank and

³⁰Islamic Banking in emerging markets.Forgoing Uganda's economic progress.Keynote speech by Mr. Emmanuel TumusiimeMutebile, Governor of the Bank of Uganda, at the Islamic Banking Conference, Kampala, 13th May 2016.<https://www.bou.or.ug>. Accessed on 16th December-2016.

³¹ Ibid.

³² Ibid.

³³ Abdallah, A. (1987). 'Islamic Banking', Journal of Islamic Banking and Finance, 33(4).

³⁴ Abdel-magib, M.F. (1981). 'Theory of Islamic Banks: accounting implications'.

the customers, sharing of profits and losses, enabling the poor to acquire loans and accumulate capital for investment purposes and the like.³⁵

While the emergence of Islamic banking in Uganda is a positive movement that will support entrepreneurship and economic growth, religious and social complexities have proved to be barriers against better understanding by regulators, policymakers, researchers and practitioners. Whereas there could be several factors affecting banking success, Islamic banking rules and regulations seem to be very important³⁶, though there is scriptural guidance on loan portfolio in Uganda there is currently no systematic set of rules approved by the Bank of Uganda for Loan Portfolio. Therefore there is need to codify sharia law provisions into the legal regime by amending statutes, by enacting regulations which provide for loan portfolio in Uganda and internationally though the same has not yet been tested in Uganda.

1.3 Objectives of the Study

- 1) To analyze the principles and trends in the historical evolution of Islamic Banking
- 2) To examine the different methods of Islamic financing under the Islamic Banking system
- 3) To examine the existing framework for loan portfolio in Islamic banking system in Uganda and Internationally.

1.4 Research Questions

- 1) What is the trend and principles in the historical evolution of Islamic banking in Uganda?
- 2) What are the different modes of Islamic financing?
- 3) What is the existing legal framework for loan portfolio in Uganda and Internationally?

³⁵Chakravorti, B. (2003). The slow pace of fast change: Bringing Innovations college-United Kingdom. Comparative perspective. Oxford: Oxford University press.

³⁶ Abdel-magib, M.F. (1981). 'Theory of Islamic Banks: accounting implications'.

1.5 Scope of the study

This study will focus on the current challenges to incorporate Islamic Banking and loan portfolio as a legally acceptable form of banking and its implementation hence changing the traditional perception of banking. The paper will also look at experiences other countries have had with Islamic Banking and how Islamic banking has been incorporated in those countries, in terms of legal regulation and social development.

1.6 Methodology

This research is mainly desktop based. Both primary and secondary sources of data were used in this research. Primary sources included the holy Quran, Teachings of the Prophet- Muhammad (Peace be Upon Him), government reports, statute law and case law. Secondary sources included textbooks, journals, articles and the internet, which provided a large knowledge base from which information was gathered. The fieldwork used comprised of an interview with an Islamic banking practitioner who wished to remain anonymous.

1.7 Literature review

Aldohni³⁷ discusses the operations of Islamic banks and examines *Riba*/interest from both a Sharia law and conventional law perspective. His examination of interest free banking is mainly limited to the United Kingdom and a few other Islamic jurisdictions such as Malaysia. He concludes that there is still little done with respect to the legal and regulatory aspects of Islamic banking.

Muhammad³⁸ explains the various distinct transactions carried on by Islamic banks which include *Musharakah*, *Ijarah*, *Istisna'a*, *Murabaha* and *Mudaraba*. He analyses these Islamic banking products and services from a business perspective. However, he does not discuss the various statutes that govern these transactions and the possible effects of Islamic banks carrying out business.

³⁷ Abdul Karim Aldohni 'The Legal and Regulatory Aspects of Islamic Banking' A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p.77-82.

³⁸ Dr. Muhammad Ashraf Usmani 'A guide to Islamic Banking' p.87-147.

Effective prudential supervision of banks is necessary and desirable in Islamic banks just as in conventional banks. Errico L. and Farah Baksh M. ³⁹discuss a number of standards and best practices established by the Basel Committee on Banking Supervision which are useful and provide a valuable reference in trying to reach the goal of effective prudential regulation.

Chapra and Khan⁴⁰ aver that since greater market discipline is an inherent feature of the Islamic financial services industry, its continued growth should have a positive impact on systemic stability in the global markets. Nevertheless, they affirm that regulation and supervision of this industry are important policy concerns because of the unique nature of its deposits and modes of finance. Therefore, they feel that it is necessary to examine whether the conventional regulatory standards and supervisory oversight are adequate for safeguarding the interests of providers as well as users of funds and ensuring systemic stability, or something else is also needed. This is especially important because Islamic banks, especially those in non-Muslim countries, are expected to conform to the regulatory standards which are in place for conventional banks. The latter proving to be problematic as these regulations at times contradicts the tenets of Islamic banking which is governed by Sharia law.

Abdullahi⁴¹ is of the view that, like all financial institutions, Islamic financial institutions need to be regulated for compliance with tenets of Islamic Finance practice. To achieve this level of regulation, he asserts that there is need to have a country level regulatory authority that will generate the right policies and supervise these institutions. Individual financial institutions also need to have a Sharia Board to help the bank plan, execute and evaluate its transactions and certify that they are in line with the Sharia.

³⁹ Working Paper of the International Monetary Fund, 'Islamic Banking: Issues in Prudential Regulations and Supervision', (International Monetary Fund 1998) WP/98/30, P. 3

⁴⁰ Udovitch, 1970, pp.77-78.

⁴¹ Ibrahim Farah Abdullahi in the essay (2007) 'The Islamic Windows in conventional banks: The Kenyan Experience'

Emmanuel Mutebile⁴² in his Key note speech at the Islamic banking conference points out that Islamic Banking can only thrive with the existence of an enabling law and supervisory framework.

All the above scholars agree that in order for Islamic banking to grow and develop to the point where it can effectively compete with its conventional counterpart, there is need to set up proper legal, regulatory and institutional frameworks that are dedicated to the governance of Islamic banks and adheres to the principles of Sharia law.

Islamic banks are not authorized to offer fixed interest and /or predetermined rates on deposits and they are not allowed to charge interest on loans. El-Gamal⁴³disagrees from this fact that the perception of a predetermined fixed rate, completely disconnected from the actual performance of the underlying asset is not lawful. The interest is replaced by a sharing of profits and losses (Profit and Loss Sharing principle, PLS), which reduces the antagonism between the providers of capital and those who thrive of it by their work and expertise. The lender and the borrower must agree to share the risk, the losses and profits. Every fund holder must be exposed to the risk of loss to legitimate his gain. The two parties must engage in a transaction that is fair and have to exercise activities that go towards public wellbeing.

Makiyan⁴⁴ provides a good summary overview of the major financial risk issues faced by Islamic institutions in today's modern economy. From a conventional financial perspective issues such as continual development of financial instruments and markets, the creation of a lender of last resort and an adoption of a uniform regulatory standard are common financial risk themes to any developing economy and financial system let alone the Islamic financial system. However, Shariah-adherence and compliance also exacerbate certain well known financial risk but also create specialized risk to the Islamic financial system most notably Profit Loss Sharing risk based on Islamic financial precepts and liquidity risk.

⁴² Islamic Banking in the emerging markets. Forgoing Uganda's economic progress. Keynote speech by Mr Emmanuel Mutebile, Governor of the Bank of Uganda, at the Islamic banking conference, Kampala, 13th May 2016.

⁴³El-Gamal, A Basic guide to contemporary Islamic Banking and Finance.

⁴⁴Seyed-NezamuddinMakiyan (2008), Risk management and challenges in Islamic Banks.

Khan and Bhatti⁴⁵ suggest that the conceptual paradigm of Islamic banking and finance has to change to meet its modern financial needs. Predominately, it is advocated that Islamic banking and finance can learn a lot from the conventional finance in terms of product development and risk management. There is also a basic need and market requirement for further development of both risk management tools and strategies and leading central regulatory bodies such as the Islamic Financial Services Board have been working towards establishing a stronger, more robust and standardized framework for Islamic financial innovation.

Pushing on from arguments pertaining to a need for new Islamic financial tools arising from its rapid development and inception into conventional finance, Dar and Presley⁴⁶ have suggested a more introspective argument for financial innovation within Islamic finance. Aside from having to manage the need for new risk management tools to contend with the proliferation of additional risk from integrating into a conventional financial system, there is also a need to establish these tools to contend with the vulnerabilities of Islamic finance in the modern economy. The emphasis and dependence on both Profit and Loss Sharing and debt financing modes have created an inability to deal with these new risk types and the illiquidity of Islamic tools.

The above review indicates that little has been written with regard to the legal and regulatory framework of Loan portfolio under Islamic banking in Uganda. This is so despite the establishment of legislation on Islamic banking and services in the country. Further, there has been little information on how Islamic banking is currently governed in Uganda so as to ensure compliance with Shari'ah law. This study seeks to analyze the current legal environment that Islamic banking is subject to both internationally and in Uganda with a view of filling the gaps in knowledge, mapping out the challenges

⁴⁵ M. Mansoor Khan, M. IshaqBhatti (2008), "Development in Islamic Banking: a financial risk allocation approach"

⁴⁶Dar, Humayon A. and John R. Presley. (2000). "Lack of Profit and Loss Sharing in Islamic Banking: management and Control Imbalances." International Journal of Islamic Finance P.3-18.

facing this industry and providing recommendations on steps that need to be taken to ensure the growth and development of Islamic banking in Uganda.

1.8 Organizational Layout

Chapter One basically contains the introduction to the study, the objectives, and the significance, the methodology involved in the study, literature Review and arrangement of chapters.

Chapter Two traces the principles and trends in the historical evolution of Islamic banking and its key principles. It also outlines and discusses the major concepts underlying Islamic banking.

Chapter Three discusses the various methods of Islamic Financing under the Islamic Banking system;

Chapter Four traces the existing framework for loan portfolio in Islamic banking system in Uganda and Internationally.

Chapter Five provides the summary of findings, recommendations and general conclusion.

1.9 Conclusion

In a nut shell therefore, the materials cited deal with general principles of Islamic banking. They are however contextualized in the particular case study of Uganda of which gap this research tends to fill.

CHAPTER TWO

HISTORICAL DEVELOPMENT OF ISLAMIC BANKING AND ITS KEY PRINCIPLES

2.0 Introduction

Although Islamic banking has developed rapidly within the last thirty years, Islamic financial systems have a history that spans as far back as the 8th Century. Muslims were able to establish a system of finance that did not involve payment of interest but was able to mobilize resources to finance productive activities and consumer needs.⁴⁷ The Muslim society never approved interest throughout its 13th centuries of existence before the domination of western colonial powers.⁴⁸ This chapter analyzes the historical development of Islamic banking in both Muslim⁴⁹ and non-Muslim⁵⁰ countries and outlines the principles that govern this sector of banking.

2.1 Historical Background of Islamic Banking

The concept of Islamic banking is regarded as among the few original and creative Islamic ideas that have successfully been tried in recent times. After the Industrial Revolution,⁵¹ the entire banking system in all Muslim countries was designed according to the western banking model, the latter being inconsistent with Islamic law. This inconsistency mainly stems from the disapproval of Riba which is interest in Islam.⁵² Attempts to avoid dealing in interest led to the introduction of a non-interest banking system, commonly known as 'Islamic banking'.⁵³

Islamic banking has a rich heritage and history. First, the laws that governed Muslims in terms of their day to day affairs, including financial matters were the holy Quran, which is direct speech of Allah as conveyed by the prophet Mohammed, and the Sunnah.⁵⁴

⁴⁷ M. Umer Chapra and Tariqullah Khan, "Regulation and Supervision of Islamic Banks", (Islamic Development Bank and Islamic Research And Training Institute 2000) Occasion Paper No.3, p. 1.

⁴⁸ New Horizon, No. 82 (December 1998) at 1, p. 7-8.

⁴⁹ This includes Iran, Pakistan, Malaysia and Sudan.

⁵⁰ This includes the United Kingdom and Kenya.

⁵¹ This took place from the year 1760 to 1840.

⁵² Shahrukh Rafi Khan, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking', (OUP 1987) P. 1

⁵³ Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (Cardiff Law School 2003-2004).

⁵⁴ Salah A. Sheikh, 'Factors that led to Emergence of Islamic banking in Kenya and Regulatory Challenges facing the Industry', (unpublished MBA project, university of Nairobi 2009) p.10.

The Sunnah contains the traditions, customs and norms of Prophet Mohammed and comes in the form of express verbal instructions, actions and omissions.⁵⁵ From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilizing resources to finance productive activities and consumer needs. The system used to finance business activities was based largely on the profit-and-loss sharing (PLS) modes of *Mudaraba* (passive partnership) and *Musharakah* (active partnership). Deferred trading and interest-free loans, *Qurud-hasanah*, were also used to finance consumers’ as well as business transactions.⁵⁶

The system worked quite effectively during the times of Islamic civilization⁵⁷ and for centuries thereafter, mainly because the Islamic modes of financing, *Mudaraba* and *Musharaka*, were able to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long-distance trade.⁵⁸

Financiers were known in the early Muslim history as *sarrafs*⁵⁹ and they performed most of the basic functions of modern banks.⁶⁰ They had their own markets, something akin to the Wall Street in New York, and fulfilled all the banking needs of commerce, industry and agriculture⁶¹ within the constraints of the then-prevailing technological environment. The legal instruments necessary for the extensive use of financing through *Mudaraba* and *Musharaka* were already available in the earliest Islamic period.⁶² These instruments, which constituted an important feature of both trade and

⁵⁵ Abdul KarimAldohni, ‘The Legal and Regulatory Aspects of Islamic Banking’, A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p. 29.

⁵⁶ M. UmerChapra and Tariqullah Khan, ;’Regulation and Supervision of Islamic Banks’, (Islamic Development Bank and Islamic Research And Training Institute 2000) Occasion Paper No. 3, p. 1

⁵⁷ This is between the 8th and 12th century.

⁵⁸Udovitch, (1970), p.180 and 261.

⁵⁹ These were also called *sayarifah*. Another less popular word used for *sarrafs* was *jahabidhah*. The *sarrafs* were, more widespread because they provided banking facilities to the public sector as well as an extensive private sector. The *jahabidhah* were less prevalent because they served mainly the public sector.

⁶⁰See Fischel, (1992).

⁶¹Dūrī, (1986), p.898.

⁶²Udovitch, (1970), p.77.

industry and provided a framework for investment, are found in a developed form in some of the earliest Islamic legal works.⁶³

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality.⁶⁴ Hence a number of the Islamic institutions, including the Islamic system of financial intermediation, became displaced by Western institutions.⁶⁵ The decline of application of Islamic financial principles was as result of two main factors: First, the shifting of economic centre to Europe and America after the Islamic states collapsed, and secondly, the Industrial Revolution resulted in the exponential growth of commercial banks in western countries and development of an advanced banking system.⁶⁶

This conventional banking system introduced by the Western countries was built upon the fundamentals of debtor-creditor relationship with interest being the price of credit and reflecting the opportunity cost of money. Hence, money is a commodity. This position is contrary to Islamic finance which views money as a means to an end and not an end in itself. The functions and operating modes of conventional banks are based on fully manmade principles which are largely capitalist in nature as opposed to Islamic finance whose mode of operation is based on the principles of Islamic Sharia. Further, while Islamic banking promotes risk sharing between the investor and the entrepreneur, conventional banking holds that the investor or lender has a guarantee of a predetermined rate of interest or return. Participation in partnership business is the fundamental function of the Islamic banks while lending money and getting it back with compounding interest is the fundamental function of conventional banks.⁶⁷

⁶³Ibid, p.77-78.

⁶⁴ See Chapra, (2000), p.173-252.

⁶⁵These include the United Kingdom, America, France and other European countries.

⁶⁶New Horizon, No. 82 (December 1998) at 1, p. 9.

⁶⁷ Mohamed Hassan Abdullahl 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'. (unreported thesis) p. 54.

Muslims were forced to conduct their financial affairs according to the prevailing conventional conditions, but the independence of Muslim countries⁶⁸ witnessed the revival of Islam and there is a longing among Muslim intellectuals and ordinary Muslims to gradually reinstate most of the lost institutions, including the Islamic financial system.⁶⁹ Religious, political and economic factors coupled with the constant need to break from the economic and social inequities of non-Islamic economies led to the re-emergence of the Islamic banking.⁷⁰

2.1.1 Islamic Banking in Muslim Countries

A Muslim country is one in which the population consists largely of people who are governed by Islamic laws and who practice Islamic cultures. In the early stages of Islamic history,⁷¹ banks as financial institutions were unknown, though different financial intermediaries were carried out by some individuals. The Muslim state was able to establish a system that mobilized the required funds to finance transactions without using interest. The basic principle of Islamic finance, partnership and profit-and-loss sharing, were the basis of any financial transaction.⁷²

No specific institutions carried out the financial transactions that banks are involved in today, meaning that the fundamental ideas of Islamic banking were carried out from the early stages of Islamic history. Application of Islamic financial principles declined due to a number of reasons. First, the western world became the economic centre after the decline of the Islamic state.⁷³ Second, commercial banks flourished in the west due to the Industrial Revolution.⁷⁴ This is because the Industrial Revolution led to

⁶⁸ This independence began in earnest in 1947 onwards although countries such as Afghanistan and Iran have to some extent always remained independent. The countries that gained independence include: Bahrain- 1971; Kuwait- 1961; Malaysia- 1957; Pakistan- 1947; United Arab Emirates- 1971.

⁶⁹ Abdul KarimAldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p.3.

⁷⁰AbdiazizSamak, 'Islamic finance and solutions to the world economic crisis' (conference at Cairo University, Cairo 2010).

⁷¹This is about 1400 years ago when the Quran was revealed.

⁷² Abdul KarimAldohni, 'The Legal and Regulatory Aspects of Islamic Banking: A Comparative look at the United Kingdom and Malaysia' (Routledge 2011) p. 9.

⁷³ Decline of the Islamic took place between the 12th to 13th century.

⁷⁴MunawarIqbal and Phillip Molyneux,' Thirty Years of Islamic Banking, History, Performance and Prospects', (Palgrave Macmillan, 2005) p.36.

unprecedented economic growth thus increasing the wealth of many which in turn necessitated the establishment of banks to deal with the increase in capital in the economy.

The re-emergence of Islamic banking in Muslim countries⁷⁵ resulted from a range of factors which combined together over a long period to translate Islamic banking principles again from the theoretical to the practical sphere. These factors were religious, political and economic.

2.1.1.1 Religion

The religious factor was fundamentally connected to the political aspect. In the post-World War II era, the Muslim world experienced a rise in revolutionary ideas. This included a call for cultural authenticity against western occupation. In this context, religion contributed to a large extent to Islamic culture. In the 20th century, therefore, neo-revivalism emerged as a movement calling for cultural authenticity based mainly on the religious legacy. Neo-revivalism stresses that Islam as a religion is adequate to instruct all aspects of life. Thus the regulations, principles and rules that the Quran and Sunnah contain should apply to all aspects of life.⁷⁶

2.1.1.2 Economic Factors

The oil wealth of the Gulf⁷⁷ is the most important economic driver behind the growth of Islamic banking. The Gulf States have an inherently conservative nature and the Islamic cultural authenticity movement has a very strong influence in the region. Implementation of Islamic banking and finance in the Muslim world has taken two forms which reflect the political and ideological variation in that region. On the one hand, some countries have taken drastic steps to convert the whole economic system into a sharia compliant model.⁷⁸ Such a model is characterized by the existence of only Islamic banks with no room for conventional banking systems. This is the case in

⁷⁵This occurred in the 1970s.

⁷⁶Abdullah Saeed, 'Islamic Banking and Interest' (Brill: Leiden, 1999) p.8.

⁷⁷The Gulf countries include Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

⁷⁸ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking: A Comparative look at the United Kingdom and Malaysia' (Routledge 2011) p. 12.

Pakistan and Iran. On the other hand, some Muslim countries prefer to offer a wide scope that allows both the conventional and Islamic banking systems on an equal level. This is done in Malaysia and Bahrain.

2.1.2 Growth of Islamic Banking in Non-Muslim Countries

Non-Muslim countries are those whose population is not governed based on Islamic law and do not practice Islamic culture on a large scale. Islamic banking has emerged in the west as a thriving sector. Different elements led to the development of Islamic banking in non-Muslim countries, mainly economic. Islamic banking in the west was considered a lucrative business that would bring more diversity to the market. Other factors that led to development of Islamic banking in the west include: the danger of having informal Islamic institutions, which are feared to finance terrorism;⁷⁹ the attraction of countries with oil wealth, many of which are predominantly Islamic, has necessitated the establishment of Islamic banks;⁸⁰ investing and saving the growing wealth of the Muslim minority, many of whom are unbanked due to the lack of banks which adhere to Sharia law;⁸¹ and, economic globalization which has resulted in integration and interdependence of world economies thus requiring western states to adopt the Islamic banking model to cater for cross-border services.⁸² The development of Islamic banking in Asia is mainly as a result of the response to the need of faith based finance as the Asian markets are home to a large Muslim population.⁸³ In Africa, Islamic banking developed both as a response to the need of the Muslim population that desired a banking system that catered to their faith as well as an economic tool.

2.2 Historical Development of Islamic Banking in Uganda

Information on this infant sector of banking in Uganda reveals that Islamic Banking emerged as a financial innovation because of worldwide trends towards Islamic

⁷⁹Fath E. Rahman Abdalla Sheikh, "The Underground Banking System and their Impact on Control of Money Laundering: With Special Reference to Islamic Bank" (2002) 6, Journal of Money Laundering Control 42.

⁸⁰Hazem Bedlawi, 'The Arab Gulf Economy in a Turbulent Age' (St. Martin Press: New York 1984) p. 13.

⁸¹ Gordon Rankin, "Islamic Banking Expands in London", 26 April 2005, <<http://news.bbc.co.uk/1/hi/england/london/4487749.stm>> Accessed on 15th February 2017.

⁸² Robert W. Cox, 'A Perspective on Globalization', in James H. Mittelman, Globalization: Critical Reflection, (Lynne Rienner Publishers 1996) p.22.

⁸³ Kuwait Finance House, 'Islamic Finance in Asia: Development, Growth and Opportunities,' <<http://www.mifc.com/?ch=55&pg=195&ac=99&bb=uploadpdf>> Accessed on 15th February 2017.

Banking, shareholder expectation of returns and market demand from the Muslim population in the country.⁸⁴ Research conducted by the BoU found that there was a lot of money in circulation in the economy that was unaccounted for within the banking system. Further investigation revealed that these monies were associated with the Muslim community who did not bank their money with conventional banks that did not adhere to the principles of Islamic Sharia but, opted to bank with institutions not licensed to carry out banking activities such as forex bureaus, and *Hawala* money remittance services providers. This discovery necessitated the establishment of Islamic banks that would attract this group of people and ensure that their needs were being met.⁸⁵

The history of Islamic Banking in Uganda can be traced to 2008 when the Bank of Uganda (BoU) first received an application from an institution which was desirous of operating as an Islamic Bank. Subsequently, BoU received numerous inquiries from most of the commercial banks in Uganda seeking to offer Islamic financial products through Islamic Banking “windows”. At that time, the Central Bank of Kenya had licensed two Islamic Banks while National Bank of Rwanda had licensed an Islamic Microfinance Institution and Bank of Tanzania had commercial banks offering Islamic Financial Services through windows.⁸⁶

In November 2009, Bank of Uganda conducted an in-house training on Islamic Banking and Finance and the participants included regulators of the financial sector from Bank of Uganda, the then Insurance Commission, Capital Markets Authority and the Uganda Revenue Authority.⁸⁷

Like Conventional Banking, Islamic Banking can only thrive with the existence of an enabling Legal and Supervisory Framework. BoU accordingly undertook a study on the

⁸⁴ Robert W. Cox, “A Perspective on Globalization”, in James H. Mittelman, *Globalization: Critical Reflection*, (Lynne Rienner Publishers 1996) p.22.

⁸⁵ This information was acquired from an interview with an employee of the Central Bank of Uganda that was held on 17th February 2017.

⁸⁶ Keynote speech by Emmanuel Tumusiime Mutebile, Governor of the Bank of Uganda, at the Islamic Banking Conference, Kampala, 13 May 2016.

⁸⁷ Ibid.

Islamic Banking model to explore its fit in the existing legislative framework. The study revealed that the Financial Institutions Act, 2004 (FIA 2004), contained prohibitions, which could not facilitate the operation of Islamic Banking. In recognition of this fact, therefore, Bank of Uganda proposed amendments to the FIA, 2004, which were approved by Parliament and hence the enactment of the Financial Institutions (Amendment) Act 2016, in January 2016. The amendments to the then FIA, 2004 were intended to embrace Islamic Banking and focused on the impediments highlighted as below:⁸⁸

First, Section 37 of the then FIA, 2004 prohibited Financial Institutions from directly or indirectly engaging in Trade, Commerce and Industry. This restriction inevitably impeded the smooth operation of Islamic Banking given that Islamic Banking is anchored on financial institutions' participation in these very sectors.

Second, Section 38 of the then FIA, 2004 prohibited Financial Institutions from acquiring immovable property that was not intended for use in conducting banking business. As the available literature on Islamic Banking suggests, in some Islamic Banking contracts, a Financial Institution must buy and therefore own the asset before reselling it to the customer at a profit. This very critical process was rendered impossible under the then FIA, 2004.

The FIA 2004 was, therefore, amended to lift the above-mentioned restrictions for Islamic Banks and/or Conventional Banks that would want to offer Islamic Windows.

From the advent of Islamic Banking in Uganda in 2016, Bank of Uganda (BoU) has so far licensed no Islamic banks. This is because according to BoU Governor Emmanuel Tumusiime Mutebile said that the Central Bank will begin licensing Islamic Banking financial institutions before the end of 2017. Mutebile further said there was need to

⁸⁸ Ibid.

give time to the public to appreciate the benefits and risks in Islamic Banking and Finance.⁸⁹

2.3 Concepts of Islamic Banking and its main Products and Services

Islamic finance which includes Islamic banking is guided by principles of sharia. Sharia has two constituent components namely *Ibadat* and *Muamalat*. *Ibadat* entails different rituals and the worship of Allah.⁹⁰ *Muamalat* concerns itself with the day to day activities in a person's life including banking. There are a number of themes in Islamic jurisprudence (*fiqh*) that affects the field of Islamic banking. They include the reprehensibility of unjust enrichment, equity and the concept of legal personality.⁹¹

a) The reprehensibility of unjust enrichment;

A common maxim in Islamic jurisprudence is that enterprise begets money and that money does not beget money.⁹² This principle requires an investor to assume the risk of a venture as charging any interest on a loan is unearned. This principle does not allow a lender to be at an arm's length, assuming no responsibility for any loss but profiting from the venture, whether or not the said venture is profitable. If he bears no risk, it is unjust for him to profit.

b) The concept of legal personality (*Dhimma*);⁹³ and

This concept is usually applied to distinguish human beings from other living things,⁹⁴ thus making it a central tenet of Islamic legal thought. Legal personality forms the substratum of obligations, the capacity to be obliged or to be subject to an obligation.⁹⁵ This means that when a person takes a loan or any financing option, the position of the

⁸⁹ Workshop Organized by the Parliamentary Forum on Islamic Banking and Finance. 24th.March.2017.

www.dispatch.ug/2017/03/24/bank-uganda-license-islamic-banks-year-ends/ Accessed on 20th.June. 2017.

⁹⁰NjugunaNdungu: The future of sharia compliant banking and finance in Kenya- Address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the official launch of the National Bank of Kenya's sharia compliant banking "The National Amanah", Nairobi, 29 April 2013<http://www.bis.org/review/r130515d.pdf>

⁹¹ Ibid.

⁹²A Khursyid, 'Studies in Islamic Economics', (Leicester: Islamic Foundation 1990).

⁹³Shahrukh Rafi Khan, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking', (OUP 1987) P. 1.

⁹⁴Sarakhsi in Usul, (Vol 11) p. 332-336.

⁹⁵Baber Johansen "The Concept of Debt in Islamic Law", (Seminar at Harvard Law School, session 6) p. 2.

debt is on him, philosophically speaking and he has a personal obligation to fulfill his duty.

This is so because debt is viewed as a character flaw incapable of being passed to someone else in any way. This means that an Islamic mortgage cannot be assigned to a third party or bought by a debt collection agency.⁹⁶ The rationale is that when a person advances credit to another in trade, he does so on his personal knowledge of the debtor and any recommendations made on his behalf. Passing the debt to a third party places the creditor at a risk he did not undertake. Islamic financial agreements are therefore based on the *dhimma* as opposed to the asset being acquired.

The Islamic viewpoint of legal personality can be contrasted with the conventional corporate viewpoint. The latter is founded upon the principle of separate legal personality whereby the corporation is a separate legal entity from the individuals forming it therefore any liability incurred by the company does not affect the individual beyond any undertaking on their part to be bound.

c) Equity and Public Interest

Islamic jurisprudence places great emphasis on the protection of the poor in society. This extends to the Quran where lenders are urged to only recover their principle, which they are to also forego in the event the debtor is unable to pay.⁹⁷ This is because a debt is seen as a taint on the legal personality of the debtor that follows him even in death. On the contrary, a creditor who dies with debts still owed to him has some sort of medal on his *dhimma*. This is why lenders are encouraged to give freely and equitably.⁹⁸

The *dhimma* of corporations and their ability to borrow was not contemplated by classical Islamic law and is a fundamental question in Islamic jurisprudence.⁹⁹ Islam

⁹⁶ Muhammad Imran Ashraf Usmani, Meezan "Bank's Guide to Islamic Banking", (Darul-Ishaat 2002) p. 7.

⁹⁷ Surah al-Baqarah, Chapter 2 verses 275-81.

⁹⁸ Muhammad Imran Ashraf Usmani, 'Meezan Bank's Guide to Islamic Banking', (Darul-Ishaat 2002) p. 8.

⁹⁹ Ibid.

ensures that public good (*maslaha*) is served in financial matters as well as other prohibitions that urge morality. The rationale is that regulating the conduct of an individual creates an ethical system that is ultimately beneficial to the whole community.

2.3.1 Prohibition of *Riba*

One of the canon principles of Islam is the prohibition of *riba*. *Riba* is an Islamic term which has been defined as an excess or additional compensation without due consideration. This prohibition has necessitated innovation by Islamic banks in a bid to find alternative means of earning returns on their investments.¹⁰⁰ *Riba* has been strictly prohibited in the Quran in many occasions including:

“O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the prophet so that you may receive mercy.”¹⁰¹

The *Hadith* also prohibits *riba* with the prophet condemning not only those who take it, but also those who pay it as well as witnesses to the transaction. However, the Quran has not forbidden all types of excesses. There is a clear distinction between capital excesses resulting from sale and excesses resulting from interest. The former is permissible but the latter is considered to be haram: “Seized in this state they say: Buying and selling is but a kind of interest, even though Allah has made buying and selling lawful, and interest unlawful”.¹⁰²

There are different types of *riba* including:

i. *Riba Al Nasiyah*. This is the primary form of *riba*. Imam Abu Bakr Hassan Razi has defined this form of *riba* as: “that kind of loan where specified repayment period and an amount in excess of capital are predetermined”.

¹⁰⁰Ibid

¹⁰¹Surah Al Imran, verses 130-21.

¹⁰²Al Baqarah 2:275.

ii. *Riba Fadl*. This form of *riba* is established in the Sunnah and is referred to as *Riba Al Hadees*. It is defined to mean an excess compensation taken in exchange for specific commodities.

The main rationale for the prohibition of *riba* in Islamic jurisprudence stems from the principles of equity and *maslaha* that have been put in place to protect the poor in society from exploitation.¹⁰³

2.3.2 Prohibition of Trading in Uncertainty (*Gharar*)

Gharar is the sale of probable items whose existence or characteristics are not certain due to risky nature which makes the trade similar to gambling¹⁰⁴. Professor Mustafa Al-Zarqa stated that "*Gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling".¹⁰⁵ The hadith has specifically prohibited *Gharar* equating it to the sale of fish in the sea or the birds in the air.

In today's setting however, there is continued scholarly speculation as to what amounts to *gharar*. The rationale for its prohibition is from a *maslaha* point of view whose purpose is to keep Muslims from vices that can lead to gambling and greed. In order to deal with these matters of uncertainty and unpredictability, Islamic banks are required to establish sharia advisory committees which ensure that the operations of the bank are sharia compliant.¹⁰⁶

2.3.3 Prohibition of Gambling (*Maisir*)

This refers to speculative transactions which is expressly prohibited by sharia and outlawed by the Quran. It is prohibited as a measure directed at ridding society of vices such as gambling.

¹⁰³ S TahirGhazaly and SOS Agil, (1992) 'Readiness in Microeconomics: An Islamic Perspective'.

¹⁰⁴ El-Gamal, Mahmoud Amin (2000), A Basic Guide to Contemporary Islamic Banking and Finance p.17

¹⁰⁵ www.Islamicfinanceandbanking.blogspot accessed on 12th.July.2017.

¹⁰⁶ Abdul KarimAldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p.13.

2.3.4 Prohibition of Investing in Haram Activities¹⁰⁷

The term haram means activities expressly prohibited by sharia that individuals and by extension, Islamic banks, cannot finance or get involved in. they include pornography, gambling, alcohol, trade in pork and conventional financial services. The rationale is that Islam advocates for the good of the public and therefore the financing of these activities would be deleterious to this cause.

2.4 Theories of Sharia

The purpose of the Islamic Law is for humans to achieve happiness in this world and the hereafter, by following the law of adopting the good and neglecting the bad. The Islamic Law does not command anything that is not good for people, and it does not forbid anything that is not bad for them.

Islamic Law therefore was made to protect five things (religion, self, mind, offspring, and property), which are the main rights of human in this life.¹⁰⁸

2.4.1 Protection of Religion

Because religion is the main reformer in every aspect of human life, it is normal for laws to protect it, considering it one of human rights and the most important right, by making laws that help to protect it from everything might affect it.

To protect faith and religion, Allah (S.W) forbade believing in someone else except him, either by belief or by action. He (S.W) forbade everything leads to that such as exaggeration of obeying the prophets and the righteous, to believe they are agents between Allah (S.W) and his creation, and to believe that good or bad is in anyone else's hand except Allah (S.W). Allah (S.W) obligated the community and the government to protect religion, to ease the means of practicing it. Thus, it must defend it; prevent everything that leads to disobedience and disbelieving, by stopping the guilty and performing the punishments according to the law.¹⁰⁹

¹⁰⁷ Ibid.

¹⁰⁸¹⁰⁸<https://abdulqadeerbaksh.wordpress.com/2013/07/12/the-five-higher-goals-of-shariah-law/>. Accessed 12th.January.2017

¹⁰⁹ Ibid.

As such Islamic financial institutions must adhere to the best practices of corporate governance however they have one extra layer of supervision in the form of religious boards. An Islamic financial institution is required to establish operating procedures to ensure that no form of investment or business activity is undertaken that has not been approved in advance by the religious board. The rationale of religion in Islamic banking is that Islam is a total way of life. Its system of laws permeates social, economic, political and cultural life.¹¹⁰

2.4.2 Protection of Human Life

Life is considered Allah's (S.W) gift to human, and no one has the right to trespass it, even the person himself; Allah (S.W) creates humans and honors them to perform His (S.W) tasks on earth, and to test their capabilities of performing of worshipping Him (S.W). Islam protected humanity by its laws. It obligates the community to look after the poor and give them the basic needs, shelter, food, drink, clothing and other needs of life. It obligates charity and almsgiving, which come under the law of cooperation and helping one another among individuals and organizations to achieve social solidity in the society. Islam guarantees a good and noble life for humanity; thus forbidding humiliation, annoyance, and harm.¹¹¹

As such Islamic banking pays close attention to whom and what to finance. Islamic banks do not, for example, finance alcohol- and gambling-related businesses, such as liquor stores or gambling casinos. It also does not finance environmentally irresponsible companies and businesses that are not fair to their employees.

2.4.3 Protection of the mind

Islam considers the mind entrusted and responsible for religious and secular responsibilities. The mind is the means that leads and guides a person to know the great facts, which Allah (S.W) asks us to discover using sound reasoning, and not just blind faith. Islam forbids neglecting the mind doing its duties of showing and leading a

¹¹⁰ www.islamic-banking.com accessed on 15th.June.2017.

¹¹¹ Ibid.

person to the truth, welfare, and the goodness of his/her life on earth and in the hereafter. Therefore, Allah (S.W) forbids magic, sorcery, and any other deeds that affect our mind and prevent it from performing its duties.¹¹²

2.4.4 Protection of progeny

Sexual reproduction is the means that keeps human species in existence, and for that reason, Allah (S.W) creates the sexual impulse in both sexes. Allah (S.W) calls humans to keep their progeny by forming families through marriage, which Islam considers is the only lawful way of having children and maintaining our species.

Islam encourages marriage and states its rules, restraints, and duties in a perfect social system, which organizes the relationships between the husband and wife and among the family in general. Islam also imposes a number of duties on the parents towards their children, among these are to raise and educate them well, to care for them, to meet their needs, and many other things, which are the requirements of ideal parenthood. In addition, Islam forbids aggression on the child by burying him/her alive or by intentional abortion, and considers it a great sin.¹¹³

2.4.5 Protection of property

Property is the mainstay of life, and Islam considers it as Allah's (S.W), which He (S.W) makes man a guardian over it, and allows him/her to earn them in lawful ways and use them moderately.¹¹⁴

Islam encourages work, production, and earning money and other property by lawful means.

2.5 Conclusion

Islamic banking has a history that spans centuries and that has withstood the threat of extinction by western colonial powers. Following the independence of Muslim states,

¹¹² Ibid.

¹¹³ Ibid.

¹¹⁴ Ibid.

political, religious and economic factors coupled with the desire to be free from apparent economic and social inequities of western economies led to the re-emergence of Islamic banking. Because Islamic banking provided various products and services with new innovations coming up, the regulatory framework for this sector had to be developed in order to keep up with the rapid changes.

One of the key reasons for the survival of Islamic banking is its adherence to Islamic principles, especially the prohibition of interest, which is a major attraction to many Muslims who for a long time desired a system of banking that was in line with their faith. However, this mode of banking has also developed in non-Muslim countries mostly as a safeguard against the circulation of money that is unaccounted for in the economy by Muslims who do not feel comfortable banking with banks that do not comply with the principles of sharia.

CHAPTER THREE

METHODS OF ISLAMIC FINANCING UNDER THE ISLAMIC BANKING SYSTEM

3.0 Introduction

From the onset this chapter looks at the different mode or the applicability of Islamic financial contracts is unique. 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. There are a number of traditional Islamic financial contracts, and through financial engineering new contracts can be designed in compliance with the prohibition of Riba and Gharar.

Contracts governing economic activities can be classified into transactional and intermediation contracts. Transactional contracts govern real sector transactions that include exchange, trade and the financing of economic activities. The role of intermediation contracts is to facilitate an efficient and transparent execution of transactional contracts.

Transactional contracts combined with intermediation contracts offer a set of instruments with varying purposes, maturities and degrees of risk to satisfy a diverse group of economic agents. Broadly Islamic modes of finance may take either an equity form or therefore a profit and loss sharing approach, a credit purchases where payment is deferred or a lease agreement.

3.1 Mudarabah

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called "*Rab-ul-Maal*" (Investor/ person who brings capital) while the management and work is an exclusive responsibility of the other, who is called "*Mudarib*" (Working Partner/ brings efforts) and the profits generated are shared in a predetermined ratio.

Mudaraba is a mode of financing through which the bank, the owner of the capital or *rab-ul-maal*, provides capital finance for a specific venture indicated by the customer; the entrepreneur or *mudarib*. In other words, Mudarabah is a contract between two

parties: an investor; individual or bank that provides a second party, the entrepreneur, with financial resources to finance a particular enterprise. Profits are then shared between the two parties, *rab-ul-maal* and *mudarib*, according to some pre-agreed ratio. The investor bears all financial losses and the entrepreneur the operating losses; principally the opportunity cost of their own efforts.

Distribution of profits and losses is an equitable approach that conforms to Islamic Shari'ah. In a financial intermediation form, the *Ras-ul-maal* is a customer who deposits capital in a bank, representing the *Mudarib*, to invest according to Mudarabah. Mudarabah deposits could be compounded in a public pool for investment, which is a permissible way for the bank to mix Mudarabah deposits with its own funds¹¹⁵. The profits would then be distributed according to an agreed formula, but losses once again remain the liability of the capital providers. This is an extension of what is essentially a trade practice into formal banking environment. It can be argued that the profit sharing Mudarabah was practiced in Arabia when the labor or management owner or the *Mudarib* has the idea and skills of business but no capital of his own.

Working capital financing is a cornerstone of all financial systems. Although there are religious and cultural differences between different nations, financial institutions throughout modern civilizations face similar business challenges. These include maintaining adequate capital ratios, financing inventories, fixed assets, and extending credit sales.

3.1.1 Business of Mudarabah

The *rabb-ul-mal* may specify a particular business for the *mudarib*, in which case he shall invest the money in that particular business only. This is called *al-mudarabah al-muqayyadah* (restricted Mudarabah). But if he left it open for the *mudarib* shall be authorized to invest the money in any business he deems fit. This type of Mudarabah is called "*al-mudarabah al-mutlaqah*" (unrestricted Mudarabah)

¹¹⁵ Al-Jahri and MunawarIqbal (2001), Islamic Banking: Answers to Some Frequently Asked Questions, Jeddah: Islamic Research and Training Institute, Islamic Development Bank.

A *rabbul-mal* can contract Mudarabah with more than one person through a single transaction. It means that he can offer his money to **A** and **B** both, so that each one of them can act for him as *mudarib* and the capital of the *Mudarabah* shall be utilized by both of them jointly, and the share of *mudarib* shall be distributed between them according to the agreed proportion.¹¹⁶ In this case both the *mudaribs* shall run the business as if they were partners inter se.

The *mudarib* or *mudaribs*, as the case may be, are authorized to do anything which is normally done in the course of business. However, if they want to do an extraordinary work, which is beyond the normal routine of the traders, they cannot do so without express permission from the *rabb-ul-mal*.

3.1.2 Distribution of the profit

It is necessary for the validity of Mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. No particular proportion has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the *rabb-ul-mal* and the *mudarib*. However, they cannot allocate a lump sum amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is 100,000/-Uganda shillings they cannot agree on a condition that 10,000/- Uganda shillings out of the profit shall be the share of the *mudarib*, nor can they say that 20% of the capital shall be given to *rabb-ul-mal*. However, they can agree on that 40% of the actual profit shall go to the *mudarib* and 60% to the *rabb-ul-mal* or vice versa.

It is also allowed that different proportions are agreed in different situations. For example the *rabb-ul-mal* can say to *mudarib*, "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can

¹¹⁶ Mufti Muhammad Taqi Usmani 'An Introduction to Islamic Finance' at p.49.

say "If you do the business in your town, you will be entitled to 30% of the profit, and if you do it in another town, your share will be 50% of the profit"¹¹⁷.

A part from the agreed proportion of the profit, as determined in the above manner, the *mudarib* cannot claim any periodical salary or a fee or remuneration for the work done by him for the *mudarabah*¹¹⁸.

All the schools of Islamic *Fiqh* are unanimous on this point. However, Imam Ahmad has allowed for the *mudarib* to draw his daily expenses of food only from the *Mudarabah* account¹¹⁹.

The *Hanafi* Jurists restrict this right of the *mudarib* only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc., but he is not entitled to get anything as daily allowances when he is in his own city¹²⁰.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio¹²¹.

3.1.3 Types of Mudarabah

There are basically two (2) types of *Mudarabah* and these are briefly discussed below:

Al Mudarabah Al Muqayyadah: *Rab-ul-Maal* may specify a particular business or a particular place for the *mudarib*, in which case he shall invest the money in that particular business or place. This is called *Al Mudarabah Al Muqayyadah* (restricted *Mudarabah*)¹²².

¹¹⁷Ibid 69 p.50-51.

¹¹⁸Sarakhsi, *Almabsur 'An Introduction to Islamic Finance'* vol. 22 p. 149-150.

¹¹⁹ Mufti Muhammad Taqi Usmani 'An Introduction to Islamic Finance' at p.51.

¹²⁰ Ibid.

¹²¹ Ibid.

¹²² Dr. Muhammad Imran Ashraf Usmani 'A Guide to Islamic Banking' at p. 105.

Al Mudarabah Al Mutlaqah: However if *Rab-ul-maal* gives full freedom to *Mudarib* to undertake whatever business he deems fit, this is called *Al Mudarabah Al Mutlaqah* (unrestricted Mudarabah). However *mudarib* cannot, without the consent of *Rab-ul-Maal*, lend money to anyone. *Mudarib* is authorized to do anything, which is normally done in the course of business. However if they want to have an extraordinary work, which is beyond the normal routine of the traders, he cannot do so without express permission from *Rab-ul-Maal*. He is also not authorized to¹²³:

- a) Keep another *Mudarib* or a partner
- b) Mix his own investment in that particular Mudarabah without the consent of *Rab-ul-Maal*.

Conditions of offer and acceptance are applicable to both. A *Rab-ul-Maal* can contract Mudarabah with more than one person through a single transaction. It means that he can offer his money to 'A' and 'B' both so that each one of them can act for him as *Mudarib* and the capital of the Mudarabah shall be utilized by both of them jointly, and the share of the *Mudarib*¹²⁴.

3.1.4 Termination of Mudarabah

The contract of Mudarabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the Mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the Mudarabah are not in the cash form, the *mudarib* shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined¹²⁵.

There is however a difference of opinion among the Muslim jurists about the question whether the contract of *Mudarabah* can be effected for a specified period after which it terminates automatically. The Hanafi and Hanbali schools are of the view that the

¹²³ Ibid.

¹²⁴ Ibid.

¹²⁵ Mufti Muhammad Taqi Usmani 'An Introduction to Islamic Finance' p. 51-52.

Mudarabah can be restricted to a particular term, like one year, six months, etc, after which it will come to an end without a notice. On the contrary, Shafii and Maliki schools are of the opinion that the *Mudarabah* cannot be restricted to a particular time¹²⁶.

However, this difference of opinion relates only to the maximum time-limit of *Mudarabah*. Can a minimum time-limit also be fixed by the parties before which *Mudarabah* cannot be terminated? No express answer to this question is found in the books of Islamic *Fiqh*, but it appears from the general principles enumerated therein that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he/she wishes¹²⁷.

This unlimited power of the parties to terminate the *Mudarabah* at their pleasure may create some difficulties in the context of the present circumstances, because most of the commercial enterprises today need time to bring fruits. They also demand constant and complex efforts. Therefore, it may be disastrous to the project, if the *rabb-ul-mal* terminates the *Mudarabah* right in the beginning of the enterprise. Specially, it may bring a severe set-back to the *mudarib* who will earn nothing despite all his efforts. Therefore, if the parties agree, when entering into the *Mudarabah*, that no party shall terminate it during a specified period, except in specified circumstances, it does not seem to violate any principle of Shari'ah, particularly in the light of famous *hadith*, already quoted, which says:

All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful¹²⁸.

3.2 Musharakah

The literal meaning of *Musharakah* is sharing. The root of the word "Musharakah" in Arabic is *Shirkah*, which means being a partner. It is used in the same context as the term "*shirk*" meaning partner to Allah. Under Islamic jurisprudence, *Musharakah* means a joint enterprise formed for conducting some business in which all partners share the

¹²⁶Ibid p. 52.

¹²⁷ Ibid p. 52

¹²⁸Ibid p.53.

profit according to a specific ratio while the loss is shared according to the ratio of the contribution¹²⁹.

Musharakah is an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labor and management as a general rule¹³⁰. Both profits and losses from Musharakah are shared among the parties on a pre-agreed ratio. Musharakah is mostly used for financing private or public companies and project financing.

In Islamic banking, Musharakah is viewed as a joint venture between an Islamic bank and a customer or business firm for certain operations. The Islamic bank can potentially act as the fund provider to finance an industry, trade and any legal enterprises through either equity investment or direct participation.

It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution. The connotation of this term is little limited than the term "*Shirkah*" more commonly used in the Islamic jurisprudence. *Shirkah* means sharing and in the terminology of Islamic *Fiqh*, it has been divided into two kinds:

- (1) *Shirkat-ul-milk*: this simply means joint ownership of two or more persons in a particular property. This kind of *Shirkah* may come into existence in two different ways¹³¹:
 - (a) Optional (*Ikhtiar*): at the option of the parties e.g. if two or more persons purchase equipments, it will be owned jointly by both of them and the relationship between them with regard to that property is called *Shirkat-ul-milk*. Here this relationship between has to come into existence at their own option, as they themselves elected to purchase the equipment jointly.
 - (b) Compulsory (*Ghair Ikhtiar*): this comes into operation automatically without any effort/action taken by the parties. For example, after the death of a person, all

¹²⁹ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking'. p.87.

¹³⁰ Munawar Iqbal and Philip Molyneux (2005), Thirty Years of Islamic Banking. History, Performance and Prospects, Palgrave p.260

¹³¹ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 87-88.

his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person¹³².

(2) *Shirkat-ul-Aqd*: This is the second type of *Shirkah*, which means, a partnership effected by a mutual contract. It is also divided into three kinds namely:

(a) *Shirkat-ul-Amwal* where all partners invest some capital into a commercial enterprise.

(b) *Shirkat-ul-Aamal* where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done.

(c) *Shirkat-ul-wujooh*. The word has its root in Arabic word *Wajahat* meaning goodwill. Here the partners have no investment at all. They purchase commodities on deferred price, by getting capital on loan because of their goodwill and sell them at spot. The profit so earned is distributed between them at an agreed ratio¹³³.

Musharakah contracts therefore can be established in one of two ways. The first way of these is a permanent contract which ensures for its parties, the investor, bank and entrepreneur, an equitable share in the annual profit/loss on pre-agreed terms. This kind of permanent contract holds constant for a limited or unlimited period according to the original agreement¹³⁴.

The second type of Musharakah is a diminishing contract preferred by bankers because it allows the bank to reduce its share of equity each year and receive periodic profits based on the reducing equity balance. In this form, the equity share of the customer in

¹³²Ibid p. 88.

¹³³Ibid p. 89.

¹³⁴Lewis, M. K. and L.M. Algoud (2001), 'Islamic Banking, Cheltenham' Edward Elgar.

the capital of enterprise increases over time until he or she becomes the sole owner of the enterprise.

Musharakah is very beneficial to all parties to the business transaction and Islamic scholars agree on its authenticity under Islamic Shari'ah. However it has been observed that most of the parties in Musharakah contracts usually require the help of legal experts to ensure that any potential Riba or Gharar is carefully avoided¹³⁵.

3.2.1 Basic rules of Musharakah

Musharakah is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with the free consent of the parties without any duress, fraud or misrepresentation, etc¹³⁶.

However, there are certain ingredients, which are peculiar to the contract of Musharakah for instance Musharakah agreement should be qualified i.e. how much is each party contributing, should be specified i.e. specified currency, and not necessarily in liquid form i.e. capital share may be contributed either in cash / liquid or in the form of commodities. In case of a commodity, the market value of the commodity shall determine the share of the partner in the capital¹³⁷.

3.2.2 Management of Musharakah

The normal principle of Musharakah is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the Musharakah. But in this case the sleeping partner shall be entitled to the profit allocated to him should not exceed the ratio of his investment¹³⁸.

¹³⁵ El-Gamal, Mahmoud Amin (2000), A Basic Guide to Contemporary Islamic Banking and Finance.

¹³⁶ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 91.

¹³⁷ Ibid p. 92.

¹³⁸ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 92.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business. Any work done by one of them in normal course of business shall be deemed as authorized by all partners¹³⁹.

3.2.3 Basic rules of distribution of profit

The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business and not in proportion to the actual profit accrued to the business and not in proportion to the capital invested by him. E.g. if it is agreed between them that 'A' will get 1% of his investment, the contract is not valid¹⁴⁰.

It is not allowed to fix a lump sum amount for anyone of the parties or any rate of profit tied up with his investment. Therefore if 'A' & 'B' enter into a partnership and it is agreed between them that 'A' shall be given 10,000/- UGX per month as his share in the profit and the rest will go to 'B', the partnership is invalid¹⁴¹.

If both partners agree that each will get percentage of profit based on his capital percentage, whether both work or not, it is allowed¹⁴².

It is also allowed that if an investor is working, his profit share (percentage) could be more than his capital base (percentage) irrespective whether the other partner is working or not. For example if 'A' & 'B' have invested 1000/- UGX each in a business and it is agreed that only 'A' will work and will get 2/3rd of the profit while 'B' will get 1/3rd. similarly if the condition of work is also the proportion of profit for 'A' can be more than his investment¹⁴³.

If a partner has put an express condition in the agreement that he will not work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then his share of profit cannot be more than the ratio of his investment. However,

¹³⁹ Ibid.

¹⁴⁰ Ibid.

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid.

Hanbali school of thought considers fixing the sleeping partners share more than his investment to be permissible¹⁴⁴.

It is also allowed that if a partner is not working, his profit share can be established as less than his capital share¹⁴⁵.

If both are working partners, the share of profit can differ from the ratio of investment. For example Brian and Grace both have invested 10,000/- UGX each. However Brian gets 1/3rd of the total profit and Grace 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit but also labour and work. Therefore although the investment of two partners is the same but in some cases quantity and quality of work might differ¹⁴⁶.

If only a few partners are active and others are only sleeping partners, then the share in the profit of the active partner could be fixed at higher than his ratio of investment e.g. 'A' & 'B' put in 1000/- UGX each and it is agreed that only 'A' will work, then 'A' can take more than 50% of the profit as his share. The excess he receives over his investment will be compensation for his services¹⁴⁷.

3.2.4 Basic rules of distribution of Loss

All scholars are unanimous on the principle of loss sharing in Shari'ah based on the saying of Syedna Ali Ibn Talib that is as follows:

"Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners¹⁴⁸."

Therefore the loss is always subject to the ratio of investment e.g. If 'A' has invested 40% of the capital and 'B' 60%, they must suffer the loss in the same ratio, not more, not less. Any condition contrary to this principle shall render the contract invalid¹⁴⁹.

¹⁴⁴Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 93.

¹⁴⁵ Ibid.

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸Ibid p. 94.

3.2.5 Termination of Musharakah

Musharakah will stand terminated in the following cases:

If the purpose of forming the *Shirkah* has been achieved. For example, if two partners had formed a *Shirkah* for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. The distribution of profit will be as per the agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment¹⁵⁰.

Every partner has the right to terminate the Musharakah at any time after his partner a notice that will cause the Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:

- a) to liquidate the assets or
- b) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred. This is because after the termination of Musharakah, all the assets are in the joint ownership of the partners and co-owner has a right to seek partition or separation and no one can compel him on liquidation. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed¹⁵¹.

In case of death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.

In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the

¹⁴⁹ Ibid.

¹⁵⁰ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 95.

¹⁵¹ Ibid.

share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated¹⁵².

If one of the partners wants termination of the Musharakah, while the other partner or partners like to continue with business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of Musharakah with one partner does not imply its termination between the other partners¹⁵³.

However, in this case, the price of the share of the living partner must be determined by mutual consent. If there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the living partner may compel other partners on the liquidation or on the distribution of the assets themselves.

The question rises whether the partners can agree, while entering into the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so. And that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation¹⁵⁴. This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success, and the liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long-term project, and one of the partners seek liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or

¹⁵² Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 95.

¹⁵³ Ibid p. 96.

¹⁵⁴ Ibid.

separation. Therefore, such a condition seems to be justified, and it can be supported by the general principle laid down by the Holy prophet in his famous hadith¹⁵⁵:

"All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful"

3.3 Murabahah

Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred and sells it to another person by adding some profit thereon. Thus *Murabahah* is not a loan given on interest; it is a sale of a commodity for cash or deferred price¹⁵⁶.

The *Bai' Murabahah* involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. In other words rather than advancing money to a borrower, which is how the system would work in a convention banking agreement, the bank will buy the goods from a third party and sell those goods on to the customer for pre-agreed price. *Murabahah* is a mode of financing as old as *Musharakah*. Today in Islamic banks world-wide 66% of all investment transactions are through *Murabahah*¹⁵⁷.

This is an Islamic instrument for buying and reselling the purchase or import of capital goods and other commodities by institutions, including banks and firms. In *Murabahah* arrangement, the customer provides the bank with the descriptions and prices of the goods to be purchased or imported. The Islamic bank studies the application and collects information about the specifications and prices of the goods, focusing especially on the price and conditions for payment. When the bank and its client agree on the terms of the deal, the bank purchases the goods or commodities and resells them to the customer.

¹⁵⁵Ibid p. 97.

¹⁵⁶Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 125.

¹⁵⁷ Ibid.

The fundamental principles attached to *Murabahah* are: (i) goods must be classified, clearly identified according to commonly accepted standards and must exist at the time of sale; (ii) goods for sale must be in the ownership of the bank at the time of sale; (iii) the cost price must be known at the time of sale and this should be declared to the client. This is especially the case if the bank succeeds in obtaining a discount where the profit margin is calculated on the net purchase price. This means discounts also provide benefits to the client; (iv) the time of delivery of the goods and the time of payment must be specified¹⁵⁸.

Murabahah contract is considered as a two-party buying and selling contract between bank and customer involving no financial intermediation or financing. In other words, the bank offers this service to clients who should pay the cost of the goods plus a profit margin to the bank immediately following receipt. The client can pay for the goods and the bank's profit margin by deferred installments or a deferred lump sum without an increase over the original value. This type of contract is referred to as *Baimuajjal-Murabbah* or *Baibithamanajjal*.

It is therefore paramount to note that there is a difference between *Murabahah* and Sale (*Musawamah*) and the difference is that a sale is a bargaining without disclosing or referring to what the cost price is. However when the cost price is disclosed to the client it is called *Murabahah*¹⁵⁹.

3.3.1 Basic rules for *Murabahah*

The subject of sale must exist at the time of the sale. Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to Shari'ah. For example 'A' sells the unborn calf of his cow to 'B'. The sale therefore is void¹⁶⁰.

¹⁵⁸El-Gamal, Mahmoud Amin (2000), 'A Basic Guide to Contemporary Islamic Banking and Finance' p. 45.

¹⁵⁹Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p.125-126.

¹⁶⁰ Mufti Muhammad Taqi Usmani 'An Introduction to Islamic Finance'. p. 97.

The subject matter should be in the ownership of the seller at the time of sale. If he sells something that he has not acquired himself then the sale becomes void¹⁶¹. Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void. For example 'A' sells to 'B' a car which is presently owned by 'C', but 'A' is hopeful that he will buy it from 'C' and shall deliver it to 'B' subsequently. The sale is void, because the car was not owned by 'A' at the time of sale.

The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity passed on to him including the risk of its destruction¹⁶². For example 'A' has purchased a car from 'B'. 'B' has not yet delivered it to 'A' or to his agent. 'A' cannot sell the car to 'C'. If he sells it before taking its delivery from 'B', the sale is void.

The exception to the above are related with respect to two types of sale, namely: *Bai' salam* and *Istisna*.

The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void¹⁶³. For example 'A' tells 'B' on 1st January that he will sell his car on 1st February to 'B'; the sale is void because it is attributed to a future date.

The subject matter should be a property having value. Thus a good having no value cannot be sold or purchased¹⁶⁴.

The subject of sale must be specifically known and identified to the buyer¹⁶⁵. For example, 'A' owner of an apartment building says to 'B' that he will sell an apartment to

¹⁶¹Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p.126.

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴Ibid. p. 127.

¹⁶⁵ Ibid.

'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.

The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void¹⁶⁶.

3.3.2 The procedure of *Murabahah* Financing

The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy the commodity from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up-to which the facility may be availed¹⁶⁷.

An agency agreement is signed by both parties in which the institution appoints the client as his agents for purchasing the commodity on its behalf.

The client purchases the commodity on behalf of the institution and takes possession as the agent of the institution.

The client informs the institution that it has purchased the commodity and simultaneously makes an offer to purchase it from the institution.

The institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the client¹⁶⁸.

All the above conditions are necessary to effect a valid *Murabahah*. If the institution purchases the commodity directly from the supplier, it does not need any agency agreement.

¹⁶⁶ Ibid.

¹⁶⁷ Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic Banking' p. 127.

¹⁶⁸ Ibid. p. 128.

3.4 Bai-Muajjal

The term *Bai-Muajjal* has been derived from Arabic words *Bai'un* and *Ajalun*. The word *Bai'un* means purchase and sale and the word *Ajalun* means a fixed time or a fixed period. *Bai-Muajjal* means sale for which payment is made at a future fixed date or within a fixed period. In short it is a sale on credit¹⁶⁹.

Bai-Muajjal may be defined as a contract between a Buyer and a seller under which the seller sells certain specific goods permissible under Islamic Shari'ah to the buyer at an agreed fixed price payable at a fixed installment. The seller may also sell the goods purchased by him as per order and specification of the buyer¹⁷⁰.

In this Bank, *Bai-Muajjal* is treated as a contract between the Bank and the client under which the Bank sells the goods, purchased as per order and specification of the client, to the client at an agreed price payable at any fixed future date in lump sum or within a fixed period by fixed installments¹⁷¹.

Thus it is a credit sale of goods by which ownership of the goods is transferred by the Bank to the client but the payment of sale price by the client is deferred for a fixed period.

It may be noted here that in case of *Bai-Muajjal*, the Islamic Bank is a financier to the client not in the sense that the bank finances the purchase of goods by the client, rather it is a financier by deferring the receipt of the sale price of goods, and it sells to the client. If the bank does not purchase the goods or does not make any purchase agreement with the seller under *Bai-Muajjal* agreement that will be a remittance/payment of the amount shall be nothing but interest (*Riba*).

Therefore, purchase of goods by the bank should be for and on behalf of the bank and the payment of price of goods by the bank must be made for and on behalf of the

¹⁶⁹www.islamibankbd.com last accessed on 23rd.June.2017. Islami Bank Bangladesh Limited.

¹⁷⁰ Ibid.

¹⁷¹ Ibid.

bank. If in any way the payment of price of goods is turned into a payment for and on behalf of the client or it is paid to the client, any excess on it will be *Riba*¹⁷².

3.4.1 Features of *Bai-Muajjal*

It is permissible for the client to offer an order to purchase by the Bank particular goods deciding its specification and committing himself to buy the same from the bank on *Bai-Muajjal* i.e. deferred payment sale at fixed price¹⁷³.

It is permissible to make the promise binding upon the client to purchase from the bank, that is, he is to either satisfy the promise or to indemnify the damages caused by breaking the promise without excuse¹⁷⁴.

It is permissible to take cash / collateral security to guarantee the implementation of the promise or to indemnify the damages¹⁷⁵.

It is also permissible to document the debt resulting from *Bai-Muajjal* by a guarantor, or a mortgage or both like any other debt. Mortgage / guarantee / cash security may be obtained prior to signing the agreement.

Stock and availability of goods is a basic condition for signing a *Bai-Muajjal* agreement, therefore, the bank must purchase the goods as per specification of the client to acquire ownership of the same before signing the *Bai-Muajjal* agreement with the client¹⁷⁶.

After purchase of goods the bank must bear the risk of goods until those are actually delivered to the client.

The bank must deliver the specified goods to the client on specified date and at specified place of delivery as per contract.

The bank may sell the goods at a higher price than the purchase price to earn profit.

¹⁷² Ibid.

¹⁷³ Ibid.

¹⁷⁴ Ibid.

¹⁷⁵ Ibid.

¹⁷⁶ www.islamibankbd.com last accessed on 23rd.June.2017. Islami Bank Bangladesh Limited.

The price once fixed as per agreement and deferred cannot be further increased.

The Bank may sell the goods at one agreed price which will include both the cost price and the profit. Unlike *Murabahah*, the bank may not disclose the cost price and the profit mark-up separately to the client¹⁷⁷.

3.5 Salam

This mode of financing can be used by the modern banks and financial institutions especially to finance the agricultural sector. In *Salam*, the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The price is in cash, but the supply of purchased goods is deferred.¹⁷⁸

Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on pre-agreed date. For the payment in advance, the contracting parties stipulate a future date for the supply of goods of specified quantity and quality.¹⁷⁹

Salam may be considered as a kind of debt, because the object of the *Salam* contract is the liability of the seller, up to the agreed future date, to deliver the object for which advanced payment of the price has already been made. There is consensus among Muslim jurists on the permissibility of *Salam*, notwithstanding the general principle of the *Shari'ah* that does not permit the sale of a commodity which is not in the possession of the seller; because the object of the contract is that are a recompense for the price paid in advance, just as the price is recompense paid for getting the goods in advance. The transaction is considered *Salam* if the buyer has paid the purchase price to the seller in full at the time of sale. The idea of *Salam* is to provide a mechanism that ensures that the seller has the liquidity they expected from entering into the transaction in the first place. Muslim jurists are unanimous that full payment of the purchase price is key for *Salam* to exist. However, *Salam* cannot take place in money or currencies or forex exchange as these are subject to rules relating to *bai al-sarf*, (a contract of

¹⁷⁷ Ibid.

¹⁷⁸ Dr. Muhammad Imran Ashraf Usmani 'A Guide to Islamic Banking' at p.133.

¹⁷⁹ www.financialislam.com last accessed on 25th.June.2017.

exchange of money for money or forex exchange) wherein exchange has to be simultaneous¹⁸⁰.

Salam cannot take place in money because the *Salam* contract deals with the delivery of an asset which is not in existence, the *Shari'ah* highlights that strict rules must be adhered to in order to ensure that the right of all parties are protected¹⁸¹.

3.5.1 Importance of *Salam*

To meet the need of small farmers who need money to grow their crops and to feed their family up to the time of harvest. When Allah declared *Riba haram*, the farmers could not take usurious loans. Therefore, Holy Prophet allowed them to sell their agricultural products in advance¹⁸².

To meet the need of traders for import and export business. Under *Salam*, it is allowed for them that they sell the goods in advance so that after receiving their cash price, they can easily undertake the aforesaid business. *Salam* is beneficial to the seller because he received the price in advance and it was beneficial to the buyer also because normally the price in *Salam* is lower than the price in spot sales¹⁸³.

3.5.2 Conditions of *Salam*

The permissibility of *Salam* is an exception to the general rule that prohibits forward sale and therefore it is subject to strict conditions, which are as follows:

It is necessary for the validity of *Salam* that the buyer pays the price in full to the seller at the time of effecting the sale. In the absence of full payment, it will be tantamount to sale of a debt against a debt, which is expressly prohibited by the Holy Prophet. Moreover the basic wisdom for allowing *Salam* is to fulfill the instant need of the seller. If its not paid in full, the basic purpose will not be achieved¹⁸⁴.

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² Dr. Muhammad Imran Ashraf Usmani. 'A Guide to Islamic Banking' at p.133.

¹⁸³ Ibid.

¹⁸⁴ Ibid.

Only those goods can be sold through a *Salam* contract in which the quantity and quality can be exactly specified e.g. Precious stones cannot be sold on the basis of *Salam* because each stone differ in quality, size, weight and their exact specification is not possible¹⁸⁵.

All details in respect to quality of goods sold must be expressly specified leaving no ambiguity, which may lead to a dispute.

The exact date, time and place of deliver must be specified in the contract. The time of deliver should at least be fifteen days or one month from the date of agreement. Price in *Salam* is generally lower than the price on spot sale. The period should be long enough to affect prices. It is all right to have an earlier date of delivery if the seller consents to it¹⁸⁶.

Furthermore, a *Salam* contract can stipulate that in the event of late delivery of the goods, the supplier pays a certain amount as a penalty to the buyer, which amount must be used for a charitable purpose; it cannot be taken into the buyer's income¹⁸⁷.

The buyer has also the right to demand security or collateral from the seller to ensure that the seller delivers the goods on the agreed date. The security can be in the form of a guarantee, mortgage or hypothecation may be required¹⁸⁸.

3.5.3 Parallel *Salam*

This is a *Salam* contract in which the seller or buyer in the original / previous *Salam* becomes a buyer or seller, respectively, in another contract which entails the delivery and taking delivery of the same underlying commodity, without making the execution of the previous one¹⁸⁹.

In an arrangement of Parallel *Salam* there must be two different and independent contracts; one where the bank is a buyer and the other in which it is a seller. The two

¹⁸⁵ Ibid.

¹⁸⁶ Ibid.

¹⁸⁷ www.financialislam.com last accessed on 25th.June.2017.

¹⁸⁸ Ibid.

¹⁸⁹ www.investment-and-finance.net last assessed on 25th.June.2017.

contracts cannot be tied up and performance of one should not be contingent on the other. For example, if 'A' has purchased from 'B' 1000 bags of wheat by way of *Salam* to be delivered on 31st.December, 'A' can contract a parallel *Salam* with 'C' to deliver to him 1000 bags of wheat on 31st.December. But while contracting Parallel *Salam* with 'C', the delivery of wheat to 'C' cannot be conditioned with taking delivery from 'B'. Therefore, even if 'B' did not deliver wheat on 31st.december, 'A' is duty bound to deliver 1000 bags of wheat to 'C'. He can seek whatever recourse he has against 'B', but he cannot rid himself from his liability to deliver wheat to 'C'. Similarly, if 'B' has delivered defective goods, which do not conform to the agreed specifications, 'A' is still obligated to deliver the goods to 'C' according to the specifications agreed with him¹⁹⁰.

A *Salam* arrangement cannot be used as a buy back facility where the seller in the first contract is also the purchaser in the second. Even if the purchaser in the second contract is a separate legal entity, but owned by the seller in the first contract; it would not tantamount to a valid parallel *Salam* agreement. For example, 'A' has purchased 1000bags of wheat by way of *Salam* from 'B' a joint stock company. 'B' has a subsidiary 'C', which is a separate legal entity but fully owned by 'B'. 'A' cannot contract the parallel *Salam* with 'C'. However, if 'C' is not wholly owned by 'B', 'A' can contract parallel *Salam* with it, even if some share-holders are common between 'B' and 'C'¹⁹¹.

3.6 Istisna

Istisna is a sale transaction where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods¹⁹² for example the manufacturer can be ordered to make shoes, furniture among others.

Istisna is a *Shari'ah* mode of financing widely used by Islamic banks and financial institutions to finance different kind of projects: housing, construction of buildings,

¹⁹⁰Dr. Muhammad Imran Ashraf Usmani 'A Guide to Islamic Banking' at p.137-138.

¹⁹¹ Ibid.

¹⁹²Ibid. p. 138.

plants, roads, etc, manufacturing of aircrafts, ships, machines and equipment, etc. It can also be used for export, financing as well as to meet working capital requirements in industries where sale orders are received in advance. Banks may undertake financing based on *Istisna* by getting the subject of *Istisna* manufactured through another such contract. Accordingly, they can serve both as manufacturers and purchasers. However, *Istisna* cannot be used for natural things or products that are not manufactured, such as animals, fruits, etc¹⁹³.

In particular, *Istisna* can be potentially used by Islamic banks to finance industries where production can be monitored by measurement and specifications, such as in the food processing industry; or in high technology industries such as the aircraft, locomotive and shipbuilding industries, and to provide financing for the various types of machines produced in big factories or workshops. The *Istisna* contract can also be drawn-up for real estate developments on designated land owned either by the purchaser or the contractor, or on land¹⁹⁴.

3.6.1 Cancellation of Contract

The contract of *Istisna* creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving a notice to the other. However, after the manufacture has started the work, the contract cannot be cancelled unilaterally¹⁹⁵.

3.6.2 *Istisna* as a mode of financing

Istisna may be used to provide financing for house financing. If the client owns a land and seeks financing for the construction of a house, the financier may undertake to construct the house on the basis of an *Istisna*. If the client does not own the land and wants to purchase that too, the financier can provide him with a constructed house on a specified piece of land. The financier does not have to construct have to construct the house himself. The Financier does not have to construct the house himself. He can

¹⁹³ www.financialislam.com accessed on 25th.june.2017.

¹⁹⁴ Ibid.

¹⁹⁵ www.blomdevelopment.com accessed on 25th.June.2016.

either enter into a parallel *Istisna* with a third party or hire the services of a contractor (other than the client). He must calculate his cost and fix the price of *Istisna* with his client that allows him to make a reasonable profit over his cost¹⁹⁶.

The payment of installments by the client may start right from the day when the contract of *Istisna* is signed by the parties. In order to secure the payment of installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security until the last installment is paid by the client. The financier will be responsible to strictly conform to the specifications in the agreement for the construction of the house. The cost of correcting any discrepancy would have to be borne by him¹⁹⁷.

The modern BOT (buy, operate and transfer) agreements may be formalized through an *Istisna* agreement as well. So, if the government wants to build a highway, it may enter into an *Istisna* contract with the builder. The price of *Istisna* maybe the right of the builder to operate the highway and collect tolls for a specific period¹⁹⁸.

3.7 Ijarah

Ijarah is a term of Islamic *fiqh*. Lexically, it means to give something on rent. In the Islamic jurisprudence, the term *Ijarah* is used for two different situations. In the first place, it means to employ the services of a person on wages given to him as a consideration for his hired services. The employer is called *musta'jir* while the employee is called *ajir*¹⁹⁹.

Lease 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 an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on basis of interest.

¹⁹⁶ Dr. Muhammad Imran Ashraf Usmani 'A Guide to Islamic Banking' at p.141.

¹⁹⁷ Ibid.

¹⁹⁸ Ibid.

¹⁹⁹ www.islamicbanker.com accessed on 26th.June.2017.

3.7.1 Basic rules of *Ijarah*

Transferring of usufruct not ownership. In leasing an owner transfers its usufruct or benefit to another person for an agreed period, at an agreed consideration²⁰⁰.

The subject of lessee should be valuable, identified and quantified. All consumable things cannot be leased out as the corpus of the leased property remains in the ownership of the seller. Thus, anything, which cannot be used without consuming, cannot be leased out for example money, wheat etc²⁰¹.

All liabilities of ownership are borne by lessor. As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor²⁰². If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset loses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent²⁰³.

The period of lease must be determined in clear terms at the time of the contract. It is further necessary for a valid lease that the leased asset is fully identified by the parties.

The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement; the lessee can use it for whatever purpose it is used in the normal course²⁰⁴.

The lessee is liable to compensate the lessor for every damage to the leased asset caused by any misuse or negligence. The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor²⁰⁵.

A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all joint owners according to the proportion of their respective

²⁰⁰Dr. Muhammad Imran Ashraf Usmani. 'A Guide to Islamic Banking' at p.147.

²⁰¹ Ibid.

²⁰² Ibid.

²⁰³www.aims.education accessed on 26th.June.2017.

²⁰⁴Ibid.

²⁰⁵ Ibid.

shares in the property. A joint owner of a property can lease his proportionate share only to his co-sharer, and not to any other person²⁰⁶.

The determination of rent must be at the time of contract for the whole period of lease. It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid. As such, the lessor cannot increase the rent unilaterally, and any agreement to this effect is void²⁰⁷.

The lease period shall commence from the date on which the leased asset has been delivered to the lessee.

If the leased asset has totally lost the function for which it was leased, the contract will stand terminated²⁰⁸.

3.7.2 Termination of Lease

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the financial lease it has been noticed that the lessor has unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of Shari'ah²⁰⁹.

In some agreements of the financial lease a condition has been found to the effect that in case of the termination of lease, even at the option of the lessor, the lessee shall pay the rent of the remaining lease period. Naturally, such a condition cannot be acceptable to Shari'ah. The logical consequence of the termination of lease is that the lessor should take the asset back. The lessee should be asked to pay the rent as due up to the date

²⁰⁶ Dr. Muhammad Imran Ashraf Usmani 'A Guide to Islamic Banking' at p.148

²⁰⁷ Ibid.

²⁰⁸ Ibid.

²⁰⁹ Ibid at p.157.

of termination. If the termination has been effected due to misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be compelled to pay the rent of the remaining period²¹⁰.

3.8 Conclusion

The appearance of Islamic banking and finance on the scene of global financial world and its rapid growth is an important development of the modern time. With all this, the various modes of financing only support practices or products that are not forbidden (i.e. Transactions in unethical goods and services; Earning returns from a loan contract (Riba/interest): Compensation-based restricting of debts; Excessive uncertainty in contracts (Gharar): Gambling and chance based games (Qimar).

²¹⁰ Ibid.

CHAPTER FOUR

INTERNATIONAL AND NATIONAL REGULATION OF ISLAMIC BANKING

4.0 Introduction

The growth and development of Islamic banking, relies on having a comprehensive legal framework. The success of the implementation of Islamic banking relies on the correct approach of its legal facilities. Islamic financial institutions have the duty to be Sharia compliant as well as meet other statutory laws either substantial or procedural²¹¹. This chapter will analyze Islamic banking regulation at the international level and in Uganda so as to identify how Islamic Banking is regulated, the challenges facing regulation in Uganda as well as best practices that can be adopted for the continued growth and development of Islamic banking.

4.1 International Legal and Institutional Framework for Islamic Banking

The Islamic financial services industry has substantially expanded over the last three decades. During this time, Islamic banking institutions have tried to benefit from the existing conventional banking systems.²¹² The latter, however, have not been able to meet the specific needs of Islamic banks. The process of building institutions for the Islamic financial industry has therefore been underway and various international institutions have been established to ensure the continued growth of this industry.

A number of initiatives have been taken to strengthen the Islamic financial architecture. Under the leadership of the Islamic Development Bank²¹³ and with active support from international institutions such as the World Bank, International Monetary Fund and the Basel Committee, several international Islamic financial institutions have been established. In addition, though many of the traditional infrastructure arrangements for conventional finance, such as payment systems, trading arrangements and information

²¹¹Zulkifli Hasan, "The Effectiveness of the Legal Framework of the Islamic Banking System in Malaysia", (Islamic University College of Malaysia), p. 1-14.

²¹² The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Q'adah 1393H, corresponding to December 1973. The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e. Islamic Law.

²¹³ Ibid.

systems, are available to Islamic Financial Institutions, in most cases the operational modalities have been adjusted in varying degrees to accommodate the specific requirements of Islamic Financial Institutions.²¹⁴

While there is no doubt that the emerging Islamic financial architecture requires further strengthening, two other requirements are also urgent. One is the need to consolidate the emerging set-up and to coordinate the activities of the newly established institutions so as to avoid duplication. The other is the need to integrate the Islamic financial architecture into the global institutional framework without losing its specificities. In this respect the impact of the current trend towards globalization as well as the technological developments which are changing the shape of financial firms need to be seriously considered and responded to.²¹⁵

The Islamic Financial Institutions that are highlighted include: Islamic Financial Services Board (IFSB); Islamic Development Bank (IDB); International Islamic Financial Market (IIFM); Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); International Islamic Rating Agency (IIRA); International Islamic Centre for Reconciliation and Commercial Arbitration; and General Council of Islamic Banks and Financial Institutions (GCIBFI). An analysis of these institutions shows that the members are mainly from Muslim countries. Though these institutions do not fall under the same umbrella, they are all mainly geared toward the growth and development of Islamic banking, and an analysis shows there are some overlaps in their functions.

4.1.1 The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related

²¹⁴ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 378.

²¹⁵ Ibid.

issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders.²¹⁶ The IFSB was launched in 2003 as a result of the International Monetary Fund (IMF), the IDB and support of the Bahrain Monetary Agency (BMA), Bank Negara Malaysia (BNM) and some other central banks from Muslim countries, coming together to form an institution whose mandate is to set industry wide regulatory standards.²¹⁷

The members of the IFSB include international, regional and national organizations and market players who share the organization's objectives. Membership to the IFSB is allowed for organizations who aspire to contribute their knowledge, resources and expertise.²¹⁸ The IFSB has three categories of membership: Full, Associate and Observer. Full membership is accessible to supervisory authorities responsible for the supervision of the banking industry, securities and/or insurance / Takâful industries of sovereign countries that recognizes Islamic financial services, whether by legislation or regulation or by established practice, and international inter-governmental organizations having an explicit mandate for promoting Islamic finance. Associate membership is accessible to any central bank, monetary authority, financial supervisory or regulatory organization or international organization that is involved in setting or promoting standards for the stability and soundness of international and national monetary and financial systems which does not qualify or does not seek to become IFSB Full member. Observer membership is available to any: national, regional, international professional or industry association; institution that offers Islamic financial services; or firm or organization that provides professional services, including accounting, legal, rating, research or training services to any aforementioned institutions. Nevertheless, the Council of the IFSB may, as the circumstances may determine, admit any applicant as a

²¹⁶ Islamic Financial Services Board, 'Defining New Standards in Islamic Finance', <http://www.ifsb.org/> Accessed on 4th.July.2017.

²¹⁷ Nigel Dudley, "Structure is a Necessary Target", (Middle East and Africa: Islamic Banking, The Banker 2003) p. 121.

²¹⁸Islamic Financial Services Board, 'Requirements and Benefits', <<http://www.ifsb.org/requirement.php>> Accessed on 4th.July.2016.

member in the specific category of membership which the Council deems fit.²¹⁹ As at April 2016, the IFSB had 188 members from 45 jurisdictions comprising of 61 regulatory and supervisory authorities, 8 international inter-governmental organizations and 119 market players which includes financial institutions, professional firms and industry associations.²²⁰ The IFSB's constitutive document is its Articles of Agreement whose purpose was to establish a body for coordinating and giving guidance on good practices in the regulation and supervision of Islamic financial services.²²¹ Professor Rifaat Ahmed Abdel Karim, the Secretary General of the IFSB stated that, "The creation of IFSB marks a new beginning for the industry."²²² He emphasizes that this institution would assist Islamic banking regulators to "coordinate their approach and enable the industry to gain credibility."²²³ He said that the IFSB purposes to ensure there is a prudent and transparent structure by creating new standards and adopting those that are already in existence.²²⁴ The guidelines and standards set by the IFSB are geared towards the development of a prudent and transparent Islamic financial services industry through the introduction of new international standards or adapting existing ones consistent with sharia principles, and recommending them for adaptation.²²⁵

Since its inception, the IFSB has issued seven standards, guiding principles and technical note for the Islamic financial services industry focusing on Risk Management, Capital Adequacy, Corporate Governance, Supervisory Review Process, Transparency and Market Discipline, Recognition of Ratings on Shari'ah -Compliant Financial Instruments as well as the Development of Islamic Money Markets. The IFSB is also

²¹⁹ Ibid.

²²⁰Islamic Financial Services Board, 'List of Members: By Category', <http://www.ifsb.org/membership.php>. Accessed 4th-July-2016.

²²¹ The Islamic Financial Services Board, 'Articles Of Agreement', [http://www.ifsb.org/docs/Articles%20of%20Agreement%20\(Amended%20October%202013\).pdf](http://www.ifsb.org/docs/Articles%20of%20Agreement%20(Amended%20October%202013).pdf). Accessed 4th-July-2016.

²²²3rd.November. 2002.

²²³ Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (unpublished LLM thesis submitted at Cardiff Law School 2003-2004) p. 49.

²²⁴ M. Kabir Hassan and Mervyn K. Lewis, "Handbook of Islamic Banking", (Edward Elgar Publishing Limited, 2007).

²²⁵Islamic Financial Services Board, 'Objectives', <http://www.ifsb.org/objectif.php>. Accessed 4th-July-2016.

working on new standards and guidelines on:²²⁶ Special Issues in Capital Adequacy; Governance of Investment Funds; Corporate Governance in Takaful Operations; Shari'ah Governance; and Conduct of Business.

4.1.2 Islamic Development Bank (IDB)

The Islamic Development Bank is an international development financial institution established pursuant to the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in December 1973.²²⁷ The objective of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Islamic Law.²²⁸ The members of the IDB include Kazakhstan, Malaysia, Saudi Arabia, Kuwait, Iran, Egypt, Turkey, United Arab Emirates, Morocco, Bangladesh, Guinea, Guinea Bissau, Indonesia, Libya, Mauritania, Pakistan, Sierra Leone, Senegal and Sudan. The basic condition for membership is that the prospective member country should be a member of the Organization of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.²²⁹

In fulfilling its objectives, the IDB supports member countries in terms of project finance and communities in non-Muslim countries by establishing and operating special funds for special purposes. The bank also participates in equity capital and granting loans for productive projects besides providing financial assistance to member countries in various forms for economic and social development.²³⁰ The Bank is accepts deposits and mobilizes financial resources through Sharia compatible modes. It also assists in the promotion of foreign trade especially in capital goods, among member countries;

²²⁶ Abdullah Haron, "Globalization in Islamic Capital Market Instruments : The Role of Islamic Financial Services Board", www.ifsb.org. Accessed on 4th-July-2017.

²²⁷ Islamic Development Bank, 'Establishment', http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 4th. July. 2017.

²²⁸ Islamic Development Bank, 'Purpose', http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 4th. July. 2017.

²²⁹ <http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://24de0d5f10da906da85e96ac356b7af0>

²³⁰ Islamic Development Bank, 'Functions', http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 4th July .2016.

providing technical assistance to member countries; and extending training facilities for personnel engaged in development activities in Muslim countries to conform to Islamic law.²³¹

The apex body of the IDB is the Board of Governors. In order to become a member, a country has to make a specified contribution to the capital of the IDB and undertake to accept terms and conditions to be decided upon by its Board of Governors.

The IDB conducts its development assistance mainly through financial operations which include: ordinary operations comprising project financing and technical assistance operations; Waqf Fund²³² operations; and trade financing operations. Financing is provided through Islamic modes of finance including interest free loans, equity participation, and installment sale and leasing.

4.1.3 International Islamic Financial Market (IIFM)

The International Islamic Financial Market (IIFM) is a standard-setting body for the Islamic financial services industry focusing on standardization of Islamic financial contracts and product templates relating to the capital and money market, corporate finance and trade finance segments of the Islamic financial services industry.²³³ The establishment of this organization came as a result of challenges that were facing the Islamic banking industry including: product innovation so as to meet demands of investors in a market environment that is fast-changing, support infrastructure to address the critical need for liquidity management among Islamic financial institutions; and standardization and codification of laws and market practices.²³⁴ As a result of the foregoing, financial authorities from various Muslim countries came together and saw the need for the establishment of an organization to fill this gap, thus the creation of

²³¹ Ibid.

²³² This is an inalienable religious endowment in Islamic law, typically donating a building or plot of land or even cash for Muslim religious or charitable purposes with no intention of reclaiming the assets. The donated assets may be held by a charitable trust.

²³³ International Islamic Financial Market, 'Corporate Profile', http://www.iifm.net/about_iifm/corporate-profile Accessed on 4th.July.2017.

²³⁴ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 379.

the International Islamic Financial Market. Its founding members include the Islamic Development Bank, Bahrain Monetary Agency, Labuan Offshore Financial Services Authority, Central Bank of Sudan, Central Bank of Indonesia and Ministry of Finance Brunei Darussalam.

The IIFM's constitutive document is its Articles of Association which sets out its objective as the unification of the Islamic financial market, particularly the standardization of Islamic Capital and Money market products.²³⁵ IIFM became operational in 2002 with its main objective being the facilitation of international secondary market trading of Islamic financial instruments so as to promote extra-territorial acceptance of Islamic financial instruments and strengthen cooperation among Muslim countries.²³⁶ At the beginning, the IIFM did not have an active operational program. However, it has now become more active and intends to achieve its objectives through the following:²³⁷

Providing guidelines for the issuance of new Islamic financial instruments, undertaking research for the development of Islamic financial markets, developing a market for independent sharia enhancement of existing or new Islamic financial instruments through increasing the number of issuance and participants; and Enhancing cooperation among market participants by encouraging product development and trading of instruments in the secondary market.²³⁸

4.1.4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Issues of transparency and corporate governance are of great importance for financial institutions so as to foster trust among its customers. To this end, the preparation of financial statements in a manner that provides sufficient and comparable information is

²³⁵International Islamic Financial Market, 'Objectives', http://www.iifm.net/about_iifm/objectives>. Accessed on 4th-July-2017.

²³⁶ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007), p. 379.

²³⁷ Ibid.

²³⁸International Islamic Financial Markets, 'Objectives', http://www.iifm.net/about_iifm/objectives>. Accessed on 4th-July-2017.

important so that investors, shareholders and depositors can assess the state of the institution. The central banks are the ones usually charged with laying down the rules and procedures of disclosure, but the unique specificities of Islamic banks require special treatment. If preparation of financial statements by these institutions applied similar standards, this would facilitate objective comparison between them.²³⁹

This realization by industry leaders led to the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in accordance with the Agreement of Association signed by Islamic financial institutions on 26th. February.1990. the founding members of AAOIFI include the Islamic Development Bank, Dar Al- Mal Al-Islami (represented by Shamil Bank of Bahrain), Al-Rajhi Banking and Investment Corporation, Dallah Albaraka Group, Kuwait Finance House, and Bukhary Capital (Malaysia).

The AAOIFI is a non-profit entity that prepares accounting, auditing, and governance, ethics and sharia standards for Islamic financial institutions and has so far produced up to 56 standards. Though its standards are not automatic but advisory in nature, the AAOIFI has taken significant strides to encourage the adoption and enforcement of its standards worldwide.²⁴⁰

4.1.5 International Islamic Rating Agency (IIRA)

External rating systems and accounting standards are vital in improving the availability of information to investors, bankers and regulators. An institution with a good rating is able to attract funds from other institutions and investors. Islamic financial institutions have expanded and are now operating in countries whereby the institutions and regulatory authorities may not fully understand the specific characteristics or the risk profile of Islamic financial institutions.²⁴¹ Both issuers and their respective instruments have to be rated in terms of their inherent risk in such markets. In order to compete in the global financial arena, Islamic financial institutions need to obtain a good rating.

²³⁹ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007), p. 373.

²⁴⁰ Ibid.

²⁴¹Ibid p.379.

Since conventional rating systems are mostly concerned with the financial strength of counterparties rather than sharia compliance, the need for an Islamic rating agency was greatly felt. As a result, the International Islamic Rating Agency was established in 2002 in Bahrain. The main role of IIRA is to conduct research, analysis, rating of the obligations, dues and commitments, and other securities so as to give an independent assessment of compliance of the institution or its instruments with sharia.²⁴² The IIRA seeks to carve out a distinct market niche where it will rate funds being raised for the Islamic market as well as banks and insurance companies established or operating in IDB member states.²⁴³ So far, IIRA has received formal recognition from Central Bank of Bahrain as an External Credit Assessment Institution (ECAI). IIRA is also on the list of approved rating agencies of Islamic Development Bank.²⁴⁴

4.1.6 International Islamic Centre for Reconciliation and Commercial Arbitration

Islamic financial institutions operate in different legal jurisdictions and therefore, their legal basis in the ordinary laws of a country may not be clear due to their unique nature. This can lead to disputes between parties which can prove to be difficult to resolve in court. In light of this, the General Council of IBFI and the IDB jointly established an arbitration Centre for resolving disputes that may arise. Consequently, the International Islamic Centre for Reconciliation and Commercial Arbitration was created for the Islamic financial industry in 2005. Its Board of Trustees comprises of various banks and Islamic financial institutions.²⁴⁵ The constitutive statute of this Centre is known as the Chart and Arbitration and Reconciliation Procedures that establishes the Centre, its powers and headquarters, which is in the United Arab Emirates. It lays down

²⁴²Islamic International Rating Agency, 'Corporate Profile', <http://www.iirating.com/>. Accessed on 4th-July-2017.

²⁴³ M. Kabir Hassan and Mervyn K. Lewis, „Handbook of Islamic Banking“, (Edward Elgar Publishing Limited, 2007) p. 380.

²⁴⁴Islamic International Rating Agency, 'Corporate Profile', <http://www.iirating.com/>>. Accessed on 4th-July-2017.

²⁴⁵ Islamic Development Bank, General Council of Islamic Banks and Financial Institutions, Abu Dhabi Islamic Bank (UAE), Dubai Islamic Bank (UAE), Bahrain Islamic Bank (Bahrain), Al Jazeera Bank (Saudi Arabia), Kuwait Financial House (Kuwait), Qatar Islamic Bank (Qatar), EN Bank (Iran), Family Finance Institution (Turkey), Bank Islam Malaysia (Malaysia), Saudi-Tunisian Finance House (Tunisia), Association of Sudanese Banks (Sudan), Jordan Islamic Bank (Jordan) and Bangladesh Islamic Bank (Bangladesh).

the procedures for reconciliation and arbitration with the costs related to each.²⁴⁶ Its objective is to resolve financial and commercial disputes between such institutions that have accepted sharia law. Disputes involving third parties are also resolved through arbitration and reconciliation.²⁴⁷

4.1.7 General Council of Islamic Banks and Financial Institutions (GCIBFI)

The General Council of Islamic Banks and Financial Institutions is an international autonomous non-profit body which represents Islamic banks and financial institutions globally. Its constitutive document is its Articles of Association which establishes the general council for Islamic banks and financial institutions with a constituent committee consisting of ten Islamic banks and financial institutions and related Islamic organizations. It provides for the location of its headquarters which is in Bahrain. It also provides the Council's objectives which includes the promotion of Islamic financial institutions, dissemination of concepts, rules and relevant provisions, and enhancing Islamic banking regionally and globally.²⁴⁸ It seeks to support and promote the Islamic financial services industry as the organizational umbrella for the Islamic Financial Institutions (IFIs). It offers services to the industry through media, information, research and development, consultancy and human resource development. Its objectives include:²⁴⁹

Improving and enforcing the growth of the IFIs by providing them with the needed advisory and consultancy services; Providing the IFIs with the information needed for their development and growth; Contributing to the growth of the IFIs by providing research and development services; Contributing to the human resource development required to face global challenges and meet growth opportunities; and Promoting the Islamic financial services industry and enhance its image.

²⁴⁶ <file:///C:/Users/user/Downloads/http--icra.com-admin-downloads-arb.pdf>. Accessed on 7th-July-2017.

²⁴⁷ M. Kabir Hassan and Mervyn K. Lewis, "Handbook of Islamic Banking", (Edward Elgar Publishing Limited, 2007) p. 380-381.

²⁴⁸ General Council for Islamic Banks and Financial Institutions, 'CIBAFI Articles of Association', <http://www.cibafi.org/ControlPanel/Documents/CIBAFILAW/ArticlesofAssociation.pdf>. Accessed on 7th-July-2017.

²⁴⁹ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 381.

4.2 Legal Instruments

4.2.1 Basel I

The 1980"s were referred to as the "saving and loan crisis" period as bank failures were prevalent due to their extensive lending, while their countries" external indebtedness grew at an unsustainable rate. Thus, the low security of international banks increased their potential for bankruptcy. So as to prevent this risk, the Basel Committee on banking supervision which comprised of central banks and supervisory authorities of 10 countries, met in 1987 in Basel Switzerland.²⁵⁰ The committee drafted a document setting an international minimum amount of capital that banks should hold. In 1988, the Basel I Accord was created to strengthen the stability of the international banking system and set up a fair and consistent international banking system so as to decrease competitive inequality among international banks.²⁵¹ Defining bank capital and the bank capital ratio have been the main achievements of Basel I.

This Accord provided for conventional banks and did not make any considerations for Islamic banking systems. The enactment of Basel II was therefore timely as it made provisions that are favorable to Islamic banks.

4.2.2 Basel II

Before 1999, the Basel Committee for Banking Supervision worked hard to issue the Basel II Accord relating to Banks" capital adequacy standard in a way that reflected the changes in the structure and practice of financial markets and banks. Before issuing the Basel II Accord, the Committee discussed the causes of banking crisis in many countries and discovered that the most significant causes leading to these crises is that banks did not manage the banking risks facing them, in addition to the weakness of external and

²⁵⁰Fadi Zaher, 'How Basel I Affected Banks', <http://www.investopedia.com/articles/07/baselcapitalaccord.asp> Accessed on 7th-July-2017.

²⁵¹ Ibid.

internal supervision. Thus, the new Accord focused on handling these problems so as to ensure banks' strength.²⁵²

Basel II aimed to establish greater market discipline necessary for the stability of the international financial system. Promoting market discipline through greater transparency and disclosure is said to be another pillar of Basel II. Six categories were identified for financial disclosure and transparency: financial performance, financial position, risk management strategies and practices, risk exposure, accounting policies and basic business, management and corporate government information.²⁵³

Inclusion of Islamic banking has enhanced the Basel II applications and has brought international recognition to Islamic banks. The nature of different Islamic products is that they are similar to those of conventional banks, for example mutual funds, leasing companies, venture capital companies and risk participation companies. Such unique financial structure is very much in line with the international trend and Basel II.²⁵⁴

Basel II aimed to establish greater market discipline necessary for the stability of the international financial system. Promoting market discipline through greater transparency and disclosure is said to be another pillar of Basel II. Six categories were identified for financial disclosure and transparency: financial performance, financial position, risk management strategies and practices, risk exposure, accounting policies and basic business, management and corporate government information.²⁵⁵

Inclusion of Islamic banking has enhanced the Basel II applications and has brought international recognition to Islamic banks. The nature of different Islamic products is that they are similar to those of conventional banks, for example mutual funds, leasing

²⁵² Nabil Hashad, 'Islamic Banking and Basel II: Challenges and Opportunities', online Article <https://www.scribd.com/document/81015619/Islamic-Banking-BaselII-Challenges-Opportunities>. Accessed on 9th September. 2016.

²⁵³ Hassan, M.K, and M.A.M. Chowdhury, 'Islamic Banking Regulations in Light of Basel II', (Proceedings of the Fifth Harvard Research Forum on Islamic Finance April 12, 2004), p. 11.

²⁵⁴ M. Kabir Hassan et al, 'Basel II and Regulatory Framework for Islamic Banks' (University of New Orleans).

²⁵⁵ Hassan, M.K, and M.A.M. Chowdhury, 'Islamic Banking Regulations in Light of Basel II', (Proceedings of the Fifth Harvard Research Forum on Islamic Finance April 12, 2004), p. 11.

companies, venture capital companies and risk participation companies. Such unique financial structure is very much in line with the international trend and Basel II.²⁵⁶

The Basel II convention introduced a new approach to evaluating credit risk. Although the scope of Basel II does not expressly include Islamic banks, the new models of credit risk rating introduce compatibility for Islamic banks.²⁵⁷

4.2.3 Basel III

The Basel III framework was put in place with the objective of enhancing the understanding of key supervisory issues and improving the quality of banking supervision worldwide.²⁵⁸ Basel III has put in place measures to strengthen global capital and liquidity rules with the goal of strengthening the resilience of the global banking system. Basel III aims to strengthen the quality of capital held by banking institutions as well as implement the new definition of regulatory capital, which provides greater focus on common equity, while also strengthening the eligibility criteria for other capital instruments.²⁵⁹

Basel III has also introduced measures to strengthen capital requirements for trading book and complex securitization exposures, as well as that for counterparty credit risk exposures arising from derivatives, repo and securities financing activities. Basel III introduces a Leverage Ratio which is intended to reinforce risk-based requirements and constrain the build-up of leverage, thus mitigating the effects of excessive deleveraging in the banking system during distressed periods.²⁶⁰

²⁵⁶ M. Kabir Hassan et al, 'Basel II and Regulatory Framework for Islamic Banks' (University of New Orleans).

²⁵⁷ Ibid.

²⁵⁸ Adel Harzi, 'The impact of Basel III on Islamic banks: A theoretical study and comparison with conventional Banks', http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CDMQFjAA&url=http%3A%2F%2Fiei.kau.edu.sa%2FGetFile.aspx%3Fid%3D143465%26Lng%3DEN%26fn%3DSorbon8.pdf&ei=dgT9UrPbMla47Aapu4G4CA&usg=AFQjCNHrJmhTWsgzPmlThgvXHHuC_6vbBw. Accessed on 7th-July-2017.

²⁵⁹ Prudential Financial Policy Department, 'Implementation of Basel III'.

²⁶⁰ For example, the Internal Ratings-Based approach for credit risk and the Internal Models Approach for market risk.

The capital requirements provided in Basel III are not as strict as those in Islamic banks.²⁶¹ Profit-sharing investment accounts in Islamic financial institutions could not be included as a component of capital in Basel III because of their risk-absorbing capability. Further, Islamic banks are not able to pursue distribution policies that are inconsistent with sound capital conservation principles as banks have to build capital buffers during prosperous times, so that they can utilize them when the economy contracts to absorb losses. Basel III differs from Basel I and Basel II because it combines micro- and macro-prudential reforms to address both institution-level and system-level risks. In fact, the reforms include new macro-prudential standards promoting the buildup of capital buffers in good times that can be drawn down in periods of stress.²⁶²

Basel Accord makes no distinction between conventional and Islamic financial institutions for capital requirements as the Basel Committee did not take into account the unique features of Profit Sharing Investment Accounts (PSIA).²⁶³ PSIA assets do not attract financial risks for Islamic banks as the risk is taken by the investment account shareholders, but still PSIA assets are not considered as equity capital by the Basel regulators.²⁶⁴

Basel III improves the risk coverage of capital market activities, especially counterparty credit risk on over the counter derivatives and in the trading books of banks.²⁶⁵ Harzi argues that an Islamic bank requires far lesser Risk Weighted Assets than the conventional banks under Basel III because trading book business and short selling is prohibited in Islamic banking²⁶⁶.

²⁶¹Huma Ayub, 'Basel Accord III –Implication for the Financing Behaviour of Islamic Banks', <conference.qfis.edu.qa/app/media/7054>. Accessed on 7th-July-2017.

²⁶² Ibid.

²⁶³Errico, Luca, and Mitra Farahbaksh, 'Islamic Banking-Issues in Prudential Regulations and Supervision', (International Monetary Fund, 1998).

²⁶⁴Huma Ayub, 'Basel Accord III –Implication for the Financing Behaviour of Islamic Banks', <conference.qfis.edu.qa/app/media/7054>. Accessed on 7th-July-2017.

²⁶⁵ Ibid.

²⁶⁶ Adel Harzi, 'The impact of Basel III on Islamic banks: A theoretical study and comparison with conventional

Despite the emergence of Islamic finance on the global stage, Basel III does not make any distinction between conventional banks and Islamic financial institutions. The Islamic banking industry has been less impacted by Basel III as compared with conventional banks. This is because the business model of Islamic banks is more conservative than their conventional counterparts.²⁶⁷ Therefore, Islamic banks cannot adopt Basel III without modification according to their specificities

4.3 Summary and Conclusion

Upon the recognition that the infrastructure required to fortify the Islamic financial industry keeps on evolving, the Islamic development bank took up a number of initiatives including the establishment of specialized institutions such as the AAOIFI, the IFSB, an Islamic financial market, and an Islamic rating agency. These institutions, as well as the inherent features of Islamic finance, have strengthened the international financial architecture, especially banking and promoted greater financial stability.²⁶⁸

For the most part, these international Islamic institutions have functioned independently. However, the need for the consolidation of the activities of these institutions has been recognized in order to spur the growth of the Islamic financial sector. For instance, all institutions should comply with the AAOIFI standards and adopt international special risk standards set by the IFSB. The Islamic Rating Agency, for example, has to rely on the standards of IFSB and AAOIFI for its own work. The usefulness of the Islamic financial architecture depends on the complete consolidation of operations of these institutions so as to avoid overlapping functions and different standards.²⁶⁹

Banks', (Paper presented first time at the research chair "ethics and financial norms" of University Paris 1 La Sorbonne and the King Abdul University Jeddah, 2012).

²⁶⁷William A Fischel, *Journal of Economic Literature*, 171-177(1992).

²⁶⁸ Ahmad Mohamed Ali, (2000) 'The Emerging Islamic Financial Architecture: The Way Ahead', (Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University, p. 147-159.

²⁶⁹ Ibid.

4.4 Legal and Regulatory Framework of Islamic Banking in Uganda

Despite the demand for Islamic financial products, more so by the Muslim population in Uganda, the supply of institutions that offer sharia compliant products and services is still wanting. The major cause of this is the weaknesses in the legal and regulatory framework governing Islamic banking in Uganda. An analysis of the subsisting legal and policy framework is therefore necessary so as to determine areas which require reform.

The Constitution of the Republic of Uganda 1995 as amended.

The Constitution is the supreme law of the land and it supersedes all other laws. This supremacy is declared in **Article 2(1)**: "This constitution is the supreme law of the Republic and binds all persons and all state organs at both levels of government."

In its supremacy, the Constitution gives authority to Parliament and legislative assemblies in county governments the authority to enact laws existing as well as emerging areas of life as well as commerce so as to ensure the development of our society. Islamic finance is an emerging facet of finance which requires to be legislated over.

The constitution has established various courts which have jurisdiction to hear and determine different matters touching both on public and private law. **Article 129 (1) (d)** establishes the Qadhis' court whose jurisdiction is limited to determining matters which fall within the sphere of a person's personal law, such as marriage and inheritance. A liberal interpretation of this article would allow the application of Islamic law to financial matters in cases of inheritance and divorce. This is because when a person dies they can leave behind shares in an Islamic bank. Thus by implication, such an Islamic banking institution would expect Sharia law to be applied in any matter that may arise between itself and the estate of the deceased.

***Article 29 (1) (c)** of the constitution states that everyone has the right to freedom to practice any religion and manifest such practice which shall include the right to belong to and participate in the practices of any religious body or organization in a manner consistent with this Constitution.*

This provision could be interpreted to include Islamic finance as the protection of the right „...to manifest any religion or belief through...practice or observance...” allows a Muslim to conduct his affairs according to his beliefs. Therefore, one can choose Islamic finance because it is sharia compliant and in line with his or her beliefs. One can further argue that the absence of a framework for Islamic banking that would allow Muslims to conduct their affairs according to their faith is an infringement of their constitutional right as provided under the above article. However, there has been no judicial interpretation of this provision.

Article 29 (1) (e) of the Constitution provides that every person has the right to freedom of association, which includes the right to form, join or participate in the activities of an association of any kind. This provision means that persons who want to form a bank that is governed by Islamic law are at liberty to do so and the registration of such an entity should not be unreasonably withheld. This being the case, then the legislature should ensure that the formation and development of such an association should not be frustrated by the lack of an enabling infrastructure within which it can operate. Though the application of Islamic law in Qadhis’ courts has been limited to a person’s personal law, **Article 29 (1) (c)** allows people to express their religious beliefs through practice. This means that even though the room for enacting legislation in the Constitution is small, it still allows the legislature to make laws that will govern Islamic banking without infringing the constitution.

Article 37 of the Constitution states that every person has the right to use the language, and to participate in the cultural life of their choice. This provision is favorable to Islamic banking in that the culture of Islam dictates that all economic activities carried out should be in accordance with Sharia law.

4.4.1 The Judicature Act

The sources of law that are applicable to Uganda are set out in the Judicature Act at section 16.²⁷⁰ These sources and their hierarchy are as follows: The Constitution; Primary as well as subsidiary legislation; common law, doctrines of equity and statutes of general application in force in England by 12th .August. 1897. These shall apply as far as the circumstances of Uganda and its inhabitant permit and subject to any qualifications necessary; and African customary law. This applies in civil cases where both parties are subject to these laws and as long as the said laws are not repugnant to justice and morality or inconsistent with any written law.

In this context, Islamic law would seem to fall under the fourth category as all laws that were specific to native Ugandans were considered to be African customary law.²⁷¹ This position however, leaves Islamic law at a very vulnerable position as it would be subordinate to other written laws. This inferiority can be seen in the Islamic banking sector where Islamic banks which follow sharia law, have been forced to comply with conventional banking laws which often contradict its core tenets such as the prohibition from the imposition of *riba*. Further, the nature of African customary law is that it is unwritten and was passed down verbally from generation to generation while Islamic law is written and can be found in the Quran and *Sunna*. Though the rules of Islamic banking which are part of Islamic law are not adequately captured in this Act, the Act itself is not at fault. This is because if there was legislation that specifically dealt with Islamic law in banking, its hierarchy in the Judicature Act would be at the same position as the laws enacted to govern conventional banks. Therefore, the different categories of law have been well captured in this Act and what remains is for the legislature to recognize that Islamic banking is a different system of banking altogether that requires separate enactments of law to enable it to function at a level similar to that which is enjoyed by conventional banking.

²⁷⁰ Cap 13, Laws of Uganda.

²⁷¹RoselineNjogu, 'Commercial Bank of God?: Islamic Banking Law and Religion', (Lambert Academic Publishing), p. 20.

4.4.2 Bank of Uganda Act Cap 51

This is an Act of Parliament that was enacted to establish the Central Bank of Uganda and provide for its operations. The Act provides under **Section 4(1)** that the principal object of the Bank is to formulate and implement monetary policy directed at achieving and maintaining a general level of prices stability and to foster the liquidity, solvency and proper functioning of a stable market-based financial system.²⁷²

Section 4(2)²⁷³ of the Act sets out the functions of the bank, which affect both conventional and Islamic banks. They include formulation and implementation of foreign exchange policy; licensing and supervising authorized dealers; formulating and implementing policies that best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems; and Issuing currency notes and coins.

The Act allows the bank to license, supervise and inspect the books of, and advise persons engaging in the business of foreign exchange²⁷⁴. Further, the Act under **section 29(1) (e)** permits the Central Bank to grant loans or advances to banks against treasury bills or other government securities. Treasury bills are by nature interest based thus cannot be useful to Islamic banks as interest (*riba*) is expressly forbidden by sharia.

The Act makes provisions that allow the Central Bank to set minimum levels of capital reserves that banks are required to deposit with it for purposes of maintaining liquidity of the bank and protecting depositors. This provision is often problematic to Islamic banks because unlike conventional banks which generally trade in money, Islamic bank transactions is mainly asset and equity based.²⁷⁵ As a result, Islamic banks may be financially stable but have low liquidity. Considering that liquidity is important for the stability of a bank, Islamic banks have come up with liquidity management tools such as

²⁷²Bank of Uganda Act. Cap 51 Laws of Uganda.

²⁷³ Ibid.

²⁷⁴ Ibid.

²⁷⁵ Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (unpublished LLM thesis Submitted at Cardiff Law School 2003-2004).

commodity *murabaha* (a deferred sale or installment credit sale which uses commodity as an underlying asset for the transaction), interbank placement of funds under various profit sharing arrangements and Islamic mutual funds.²⁷⁶ It is important to note that commodity *murabaha* can be conducted between a bank and a central bank as is the case with Bank Negara of Malaysia.²⁷⁷ In light of the foregoing, the Act should be amended so as to make provisions that accommodate the forms of liquidity developed by Islamic banks in order to enable them to adhere to Sharia law.

4.4.3 The Financial Institutions (Amendment) Act of 2016

This is the main Act with regard to the regulation of banking business in Kenya and applies to both conventional and Islamic banks as there is no separate legal framework for Islamic banks. The disparity between conventional and Islamic banks is seen right from the beginning with the definition of banks and banking business.

In Islamic banking, a bank cannot employ the money of a customer for investment without their consent, which is contrary to the definition of banking business that does not seem to require the consent of the depositor to use the money they have deposited in the bank. In Islamic banks, the contractual relationship between the bank and the depositor does not predetermine any rates of return but only sets the ratio according to which profits and losses are distributed between the parties to the deposit contract.²⁷⁸ Further, while the definition of banking business places the risk of investing money on the investor, Islamic banks deal on the principle of profit and loss sharing where the bank and its customers bear the risk and reward of any investment.

All along the Financial Institutions Act of Uganda under **Section 37**²⁷⁹ delayed the smooth operation of Islamic Banking as it restricted financial Institutions from directly

²⁷⁶ Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Market (2008), Islamic Financial Services Board, http://www.ifsb.org/docs/mar2008_liquidity.pdf Accessed on 5th July. 2017.

²⁷⁷ Iwona Sobol, 'Liquidity Management Practices in Islamic Banking Liquidity Management Practices in Islamic Banking', p. 571 < http://zif.wzr.pl/pim/2013_2_1_46.pdf > Accessed on 5th July. 2017.

²⁷⁸ Financial Islam-Islamic Finance, 'Deposits', <http://www.financialislam.com/deposits.html>. Accessed on 5th July- 2017.

²⁷⁹ Financial Institutions Act, 2004.

or indirectly engaging in trade, commerce, industry, insurance among others yet these are the basic tenets of Islamic finance and banking.

It is suffice to note that in East Africa, Uganda was the last to recognize Islamic Banking as her neighbors i.e. Kenya's Central Bank, National Bank of Rwanda and Bank of Tanzania had already licensed Islamic banking.

Islamic banking was introduced in Uganda and provided for by way of amending the Financial Institutions Act of 2004 to the Financial Institutions (Amendment) Act of 2016 to provide for principles and regulation of Islamic banking to fit in the regulatory framework of bank of Uganda and the Ugandan economy as a whole.

Islamic Banking according to the act under **Section 1 (m)**²⁸⁰ is defined as a company licensed to carry on financial institution business in Uganda whose entire business comprises Islamic financial business and which has declared to the central bank that its entire operations are and will be conducted in accordance with the Shari'ah

Islamic banking in Uganda is also currently regulated in Uganda by the way of establishing the Insurance Regulatory Authority of Uganda which regulates any bank intending to engage in bancassurance or Islamic Insurance business in Uganda after consultation with the bank of Uganda. Bancassurance is further given a meaning under **Section 155D (4)**²⁸¹ as using a financial institution and its branches, sales network and customer relationship to sell insurance products. This implies that since **Section 155D (1)**²⁸² calls for prior written authorization from the central Bank, the Bank of Uganda thus regulates Islamic banking in Uganda by way of regulating insurance in Islamic Banks called Bancassurance.

Islamic banking in Uganda is also regulated through the Financial Intelligence Authority that is established under **Sections 46 and 47 (1)**²⁸³ which stipulates that;

²⁸⁰ The Financial Institutions (Amendment) act of 2016.

²⁸¹ Ibid.

²⁸² Ibid.

²⁸³ Ibid.

"(1) A financial institution shall promptly report to the Financial Intelligence Authority any suspected money laundering activity related to any account held with the financial institution."

This is aimed at protecting Islamic Banks from fraudsters or money launderers in the trade or banking hemisphere thus it can be said that Islamic Banking in Uganda is regulated through the Financial Intelligence Authority.

Furthermore the Islamic banking sector is currently regulated in Uganda through the second schedule of the Financial Institutions (Amendment) act 2016 which specifies the packages and business / banking products that the Islamic banks are licensed to offer under **Section 49**²⁸⁴ to include;

- To invest in products based on contracts acceptable in Shari'ah
- To grant loans or debt based on contracts compatible with Shari'ah among others.

This helps set a guideline on Islamic banking thus enabling its regulation in Uganda be observed as inherent in the Financial Institutions (Amendment) Act 2016.

Similarly **Section 1 (m)**²⁸⁵ also shows and lays out the type of business that is meant to be involved in Islamic Banking but rather I would say this all stems to the point of being Shari'ah complaint to this a popular belief may persist that Islamic banking is simply an interest free financial structure but in fact Islamic economics is a complete system of social and economic justice. It rather deals with property rights, the incentive system, and the allocation of resources, economic freedom and decision making and the proper role of government.

Islamic Banking is regulated in Uganda currently through the Bank of Uganda by way of powers vested in it under **Section 4**²⁸⁶ by setting out classes to include;

²⁸⁴The Financial Institutions (Amendment) Act of 2016.

²⁸⁵ Ibid.

²⁸⁶The Financial Institutions (Amendment) Act of 2016.

- (1) Business of Islamic Banking (class 9)
- (2) Business of Islamic financial Institution which is a non- banking financial Institution which is a non- banking financial Institution (class 10)

And similarly the mode of application under **Section 4(c) (a)**²⁸⁷ by way of submitting a memorandum and articles of association among other instrument and of all a statement stating that the business of financial institution operations shall be conducted in accordance with the Shari'ah. This shows how Islamic Banking is currently regulated in Uganda and how efficient the Financial Institutions (Amendment) Act of 2016 has been in regulating Islamic banking in Uganda.

However just like it is clearly known that a high number of Ugandans are not Muslims and as such find hard time to conform to Shari'ah doctrines Islamic Banking as a whole has still had set backs today currently as the financial Institutions (Amendment) Act 2016 has some loopholes that show its lack of efficiency in some aspects as follows;

The Financial Institutions (Amendment) Act 2016 doesn't clearly set up a framework based on principles of Shari'ah as it doesn't distinguish it from other banks but rather takes it as a package.

In other words considering the amendment, it is prima facie shows that Islamic Banks have to also pay taxes, as well as do or engage in competition with other banks that will purport to provide Islamic finance yet they will also be engaged in other types of banking for interest.

From the highlighted disparities between Islamic and conventional banking, it is clear that Islamic banking is a system on its own which requires its own rules and regulations that would enable its development. Fundamental provisions such as the definition of banking business in the Act makes it unsuitable in offering the legislative platform required to cover all areas of Islamic banking and piecemeal exemptions will not be adequate to address matters such as liquidity, trade, leasing and insurance which take

²⁸⁷ Ibid.

a unique form under Islamic banking. Legislative stagnation can therefore lead to either Islamic banks adopting convention products which are invariably against Sharia law or the stagnation and ultimate closure of Islamic banks

4.5 Institutional Framework of Islamic Banking in Uganda

The institutions which perform certain roles in the regulation of the banking sector is the Central Bank, which is the main regulatory body.

4.5.1 The Central Bank of Uganda

The Central Bank is the main institution that regulates the banking sector in Uganda. Under the Bank of Uganda Act, the responsibility for determining the policy of the Bank, other than the formulation of monetary policy, is given to the Board of Directors. The Board comprises members consisting of the Chairperson, the Governor, Deputy Governor, who is the Deputy Chairman, the Secretary to the Treasury who is a member and at most four (4) non-executive Directors. The Governor, the Deputy Governor and all other members of the board are appointed by the president with the approval of parliament and hold office for a period of five years but shall be eligible for re-appointment. Persons eligible to be appointed to the Board must be citizens of Uganda who are knowledgeable or experienced in monetary, financial, banking and economic matters or other disciplines relevant to the functions of the Bank.²⁸⁸

An entity that undertakes banking business (including Islamic banks), financial business or the business of a mortgage finance company must obtain a license from the Central Bank of Uganda. When granting a license, the Central Bank may impose any conditions it deems to be necessary for the operation of such institutions and may from time to time add, vary or substitute such conditions. It may also give directives on measures to improve the business methods of an institution, or appoint a person who can advise and assist the institution.²⁸⁹ This means that

Islamic banks operate according to the directives of the Central Bank and have to comply with any directives from them especially considering the fact that there is no

²⁸⁸Bank of Uganda.www.bou.or.ug. Accessed on 5th.July. 2017.

²⁸⁹ Ibid.

legislation in place that specifically provides for Islamic banks. Though this might give Islamic banks flexibility for growth, lack of guidelines specifically geared towards Islamic banks can dissuade investors who want to ensure that their investments are properly protected. Further, the composition of the Central bank may be such that it does not have personnel who are well versed in Islamic banking sector which can lead to the issuing of detrimental directives which can hinder the operation and development of Islamic banks.

4.5.2 Shari'ah board

Islamic banks have Sharia Advisory boards which are usually set up by the bank's board of directors. The purpose of these boards is to ensure that the products offered by the banks are sharia compliant. The boards also audit the products to ensure that Islamic principles are implemented. The boards are made up of Islamic scholars who are well versed with Islamic jurisprudence and Islamic law in general. These scholars are well known to the Muslim community and they command a strong following. Even before the advent of Islamic banking they were widely consulted by the community for guidance on what constitutes lawful business investment or transaction. By having respected scholars in their management, Islamic banks have gained the trust of their customers. Trust is essential for any bank to prosper.²⁹⁰

In order to ensure that the practices and activities of Islamic banks do not contradict the Islamic ethics, Islamic banks are expected to establish a Religious Supervisory Board. This board consists of Muslim jurists, who act as independent Shari'ah auditors and advisers to the banks, and are involved in vetting all new contracts, auditing existing contracts, and approving new product developments. Also the Shari'ah Board

²⁹⁰Badrudeen Shariff, 'Factors contributing to the growth of Islamic finance in Kenya', p. 22. <http://badrudeenshareef.blogspot.com/2013/05/factors-contributing-to-growth-of.html>. Accessed on 5th-July-2017.

oversees the collection and distribution of zakat. This additional layer of governance is quite different from that for a conventional bank.²⁹¹

4.5.3 The Financial Intelligence Board

The Financial intelligence Board was established under **Section 23** of The Anti-Money Laundering Act²⁹² and began its operations in 2013. The main role of the Board is to assist in the identification of proceeds of crime and combating money laundering. All banks, financial institutions, mortgage finance companies and forex bureau are mandated to monitor and report activities that are suspected to involve money laundering to the centre, verify customer identity, establish and maintain customer records and maintain internal reporting procedures. The Anti-Money Laundering Act states that an institution is to monitor all transactions that may be specified in its enacted regulations and pay attention on patterns of transactions that are unusual or insignificant with no apparent economic or lawful purpose. These provisions can affect Islamic banks because the lack of proper regulations of these institutions can result in them being used to finance money laundering schemes and terrorists. The problem of underground banking extended from being just an economic threat but to a threat to national and international threat after the 9/11 attack on America. This is because underground banking offers clandestine channels through which to move finance to terrorists and criminal groups.²⁹³

4.6 Challenges Facing the Regulation of Islamic Banking in Uganda

4.6.1 Sharia Boards and Sharia Compliance

International Islamic Rating Agency has set out elements of Sharia Compliance requirements that banks need to meet in order to carry out Sharia Compliant Banking activities. They include: Sharia Board membership; Rules and procedures of Sharia control; and Internal Sharia Control membership and Qualifications. Although all banks

²⁹¹Algamoud, I.M. and M.K. Lewis (1999), 'Corporate governance in Islamic Banking; the case of Bahrain; International journal of Business Studies 7(1), p.56-86.

²⁹² 2013.

²⁹³Milan Vasely, 'On the Trail of Bin Laden's Finances', 272(African Business 29, 2002).

offering Islamic Banking products have Sharia Boards, qualifications and memberships are different. This poses a challenge as the criteria used to appoint an individual to a board is not clearly provided for and one is unsure as to whether members of a certain board have the requisite expertise to guide the bank in upholding principles of Islamic sharia. Further, sharia boards are usually financed by the bank in which they operate and this may compromise their objectivity and independence.

4.6.2 Lack of Institutional Framework

The Financial Institutions (Amendment) Act, Bank of Uganda Act and other regulations pose the greatest challenge to the development of Islamic Banking in Uganda. The Financial Institutions (Amendment) Act defines the Institutional framework for banks and sets reporting requirements. The Act does not define or acknowledge the existence of Islamic Banking and does not define its operations. Although certain exemptions were made in areas such as restrictions on trading and ownership of assets and reporting interest income in the case of Islamic Banks, the Act is seen by the industry players as being deficient in the scope of coverage of Islamic Banking.²⁹⁴

4.6.3 Lack of Open Market Operations

The Central Bank is involved in buying and selling of government securities in the financial markets to enforce its goals of controlling inflation, providing liquidity management for financial institutions and raising revenue for the government. Since government bonds pay interest, Islamic Banks cannot participate in the securities market. Central Bank has not developed a mechanism of bringing Islamic Banks into the securities market through development of Sharia Compliant bonds called Sukuk.²⁹⁵

4.6.4 Lender of Last Resort and the Inter-Bank borrowing

Central Bank is the lender of last resort providing overnight funding for banks and operating a mechanism for providing liquidity to Banks when in liquidity distress. Central Bank charges interest for this facility and this automatically excludes Islamic Banks. This

²⁹⁴ Mohamed Hassan Abdullah, The Legal and Regulatory Framework of Islamic Banking. (Unpublished project, University of Nairobi 2016) p.55.

²⁹⁵ Ibid.

means that Islamic banks do not participate in the inter-Bank borrowing which can be detrimental to them.

4.6.5 Lack of coordination between the Central Bank and Sharia Boards

There is no coordination between the Central Bank and Sharia Boards thus creating two different levels of compliance. Even though the Central Bank requires Islamic Banks' products to have the stamp of approval of the Sharia Boards, it does not have any other link with these Sharia regulators.

4.6.6 Lack of Trained Personnel in Islamic Banking

There are few Islamic scholars with expertise in Islamic Jurisprudence and specializing Islamic Finance and Contracts who would be necessary to constitute sharia Boards. The supply of trained or experienced bankers in light of the expansion of Islamic banking has lagged behind. Uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, among others. Thus, the results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors.²⁹⁶

There are no appropriate standards of credit analysis in Islamic banks. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation. Islamic banks have been established as separate legal entities; therefore, their relationships with central banks and/or other commercial banks are uncertain. Problems may be further aggravated when an Islamic bank is established in a non-Muslim nation like the case of Uganda, and is subject to that nation's rules and requirements.²⁹⁷

4.7 Conclusion

It is suffice to note that since the major intention of the Introduction of the Financial Institutions (Amendment) act 2016 was geared at introducing Islamic banking in Uganda, it has a good way to go although with challenges from competition and high

²⁹⁶ Ibid.

²⁹⁷ Ibid.

taxes levied in Uganda though the act²⁹⁸ is at least a manifest of highest level of efficiency in regulating Islamic banking currently in Uganda the loopholes being of lesser disadvantage.

Islamic banking at the international level has grown exponentially over the last three decades thus necessitating the need for Islamic banking institutions that are able to meet the needs of Islamic banks. This has been found to be important as conventional banking institutions have failed to meet these needs. Therefore, various international institutions have been established to ensure the continued growth of this industry. They include the IFSB and the IDB which have come up with guidelines for the regulation of Islamic banks that are in line with Sharia law.

²⁹⁸The Financial Institutions (Amendment) Act of 2016.

CHAPTER FIVE:

SUMMARY OF FINDINGS, RECOMMENDATIONS AND GENERAL CONCLUSION

5.0 Introduction

This Chapter discusses the summary of major findings of the study, conclusions and recommendations of the study that will be based on the specific objectives.

5.1 Summary of Findings

5.1.1 Development and Concepts of Islamic Banking in Uganda

Islamic Banking is a non interest system for financing projects that relies on the viability of the projects and less about collateral, facilitating direct trade finance and equity joint venture partnership. The bank therefore is a partner to the corporation or entrepreneur and they share profits and losses.²⁹⁹

As discussed in chapter two, Islamic funds undertake sustainable responsible investments in people over profits and as such, they do not invest in sin industry; narcotics, gambling, alcohol beverages, pork, cigarettes and arms.

Upon thorough research and critical analysis I come to the finding that the key principles that drive Islamic banks are the prohibition of pre-determined loan repayments as interest (riba), profit and loss sharing, making money out of money is unacceptable, financial transactions must be asset backed, prohibition of speculative behavior, only Shari'ah approved contracts are acceptable and the sanctity of contracts.

5.1.2 Methods of Islamic Finance

The most common lending product is trade financing cost plus method (Murabaha), the bank takes possession of goods and passes them to the entrepreneur at a markup that allows them to share profit.

The various methods of Islamic finance will increase savings and business financing emanating from more people accessing the formal financial system which some have

²⁹⁹ New Vision 19th May.2016 Islamic Banking presents new prospects for the banking industry.
www.newvision.co.ug Accessed on 17th.August.2017

avoided due to its incompatibility with non-negotiable religious dicta. Islamic banking will allow acceptable savings products that reward risk better through a share of project profits and thus make more finance available for projects with better risk price characteristics.

To the common man, a productive profitable venture will be required to get finance that was not available before the law was passed. Islamic banks rarely issue consumer loans (Qard Al Hassan) that are not productive. If they do, they come with no interest at all as there is no profit to share.

5.1.3 Regulation of Islamic banking

Generally, prudential supervision on banks is just as necessary and desirable in Islamic banking as it is in conventional banking. To help reach this goal, a number of standards and best practices established by the Basel Committee on Banking Supervision are useful and provide a valuable reference. These standards, however, are not always applicable to Islamic banking. An appropriate regulatory framework governing Islamic banks needs to place greater emphasis on the management of operational risks and information disclosure issues than is normally the case in conventional banking.

In order to provide the legal foundations for the supervision of Islamic banks, it is necessary that either the general banking laws or specific laws pertaining to Islamic banks define in detail the nature of these banks and their specific operating relationship with the central bank and other conventional banks, if applicable such a legal framework should contain provisions relating to licensing, permissible modes of financing, and state clearly powers to address compliance with laws and regulations. In particular, such provisions should determine which enterprises may call themselves Islamic banks, collect deposits, and carry out banking practices on the basis of Islamic principles. Moreover, laws should state clearly that the central bank

The growth of Islamic banking has outstripped that of conventional banking in recent years and with a total of Islamic banking assets crossing the US \$ 1.5 trillion mark as of

2013. The widely held expectation that this superior growth record will continue is understandable given that approximately one sixth of the world's population is Muslim-most of which is based in the middle east and Asia.

Taking note of this demand, a number of western countries have recently started allowing Islamic banks to operate in their respective jurisdictions. The UK became the first leading western country to issue a government Sukuk (Islamic bond). The full first pledged Islamic bank in Germany was launched earlier this year, while Japanese regulators have already considered issuing regulations that will allow Islamic banks to provide Islamic finance products in Japan.

Yet despite the increased interest Islamic banking penetration in non-Muslim countries has been slow as Islamic banks find it difficult to expand to the different jurisdictions and face regulatory and Shari'ah complications in terms of approvals.

Islamic banks are also finding it challenging to cope with the evolving global environment and making appropriate rules and regulations to cope with these challenges/changes while still remaining competitive with their conventional counterparts.

Additionally and in conclusion the Islamic banking industry lacks consistency in products, structures and investment practices that adversely affects its credibility, reputation, perception and regular capabilities.

5.2 Recommendations

5.2.1 Central Authority for Shari'ah

Since Islamic banking systems are essentially governed by their Shari'ah boards which are empowered, there is need to have a central Authority promulgating Shari'ah law in the whole World with binding powers.

This Authority should also be capable of teaching and sensitizing the public and consumers of Islamic Banking products of what is permissible and not permissible in Shari'ah.

5.2.2 Have approved Standards to adhere to

Islamic banks need to have approved standards to adhere to this is because there are no approved standards per se for Islamic banks to adhere to but rather they follow conventional banking regulations which are strictly different from Islamic banking practices.

A clear point is that of Uganda where Islamic Banking is still new to the system and thus regulated by the Bank of Uganda which follows conventional banking guidelines. In fact the Financial Institutions (Amendment) Act 2016 of Uganda that the Bank of Uganda considers as the pioneer of Islamic banking is still lacking as it doesn't establish clear cut guidelines that distinguish conventional banking from Islamic Banking that is Shari'ah compliant.

So in this veil there is need for Islamic banking to stand on solid grounds and stand the tide of stiff competition from conventional banking, there should be guidelines put in place that adhere to Shari'ah to protect Islamic Banks right from the central Regulatory bodies to the policy makers.

5.2.3 Invest in research

Islamic banks need to invest in research and development of new products that are acceptable by a "Global Shari'ah Board". Islamic banking as a whole is still new and not easily applicable to a non-Muslim community but given the fact that it is a compact or collection of banking packages, it can stand competition and attract customers if enough resources are invested in research about appealing packages as the world is ever advancing with the ever growing expectations from the populations.

It is this type of research that will enable Shari'ah Advisory Boards and Scholars know what to add to the already existing packages or remove yet the Islamic banking system remains defined in the ambits of Shari'ah compliance.

5.2.4 Define all aspects of Islamic Banking

There is need to have all the aspects of Islamic Banking systems have to be properly defined to the lay people and public by establishment of awareness seminars and workshops.

In Uganda's context seminars and workshops about Islamic banking are less known of and workshops about Islamic banking are less known of and very few people know that really Islamic banking systems were introduced in Uganda rather they mistake them for new banks being established in Uganda through the conventional Banking system under the umbrella of Islamic beliefs and norms.

Similarly Islamic organizations that teach about Islamic Banking systems worldwide like the Islamic financial services Board (IFSB) should have a binding effect and if not an ability to put in place their recommendations.

In fact when these organizations hold workshop they debate, exchange ideas and if all comes out well with recommendations that address the challenges that affect a particular aspect of the Islamic Banking system / Shari'ah yet these recommendations are at most usually not put in place.

5.2.5 Creation of a Legal, Regulatory and Institutional Framework to govern Islamic Banking

The Ugandan government needs to invest in this sector of banking by creating a separate and distinct legal, regulatory and institutional framework for Islamic banking that adheres to sharia law. This would entail the enactment of laws that specifically govern Islamic banks. This is important because the Financial Institutions (Amendment) Act, 2016 is very limiting with regard to the opportunities it has created for Islamic banks. Such a law would provide for the manner in which Islamic banks will be regulated and the institutions that will be charged with ensuring compliance by Islamic banks. In the UK for example, amendments to tax laws ensured equality among

conventional and Islamic banks.³⁰⁰ Malaysia on the other hand enacted the Islamic Banking Act in 1983 which specifically provided for the regulation of Islamic banks. This was because the Banking Act of 1973 governed conventional banks and was not able to address the peculiarities of Islamic banks.

5.2.6 Adoption of Global Legal and Regulatory best practices for Islamic Banking

As Islamic banking continues to become an international trend, it is important that Uganda adopts international standards that govern this industry so as to enable it to engage and compete on the global sphere with other countries which have implemented Islamic banking. The Basel II accord for instance aimed to establish greater market discipline through increased transparency and disclosure that would enable better monitoring of bank's activities thus ensuring banks do not reach the point of collapse. The Basel III accord on the other hand put in place measures for strengthening global capital and rules on liquidity in order to strengthen the resilience of the banking sector. The applying of these standards, although they were not specifically made for Islamic banks, would go a long way in ensuring the growth and stability of Islamic banks.

There are also standards and guidelines set by Islamic institutions that would greatly benefit Islamic banking in Uganda. For instance, the Islamic Financial Services Board issues standards and guiding principles that are aimed at enhancing the effectiveness of the Islamic financial services industry. Uganda has so far adopted those that touch on corporate governance and risk management but there are still other guidelines on matters such as capital adequacy, market discipline and Islamic money markets that have still not yet been adopted.

5.2.7 Creation of awareness among the general public

There is need for the Central Bank and other relevant governmental organs to create awareness among the general public about Islamic banking so as to demystify the

³⁰⁰ The Stamp Duty Land Tax was amended in order to ensure sharia compliant mortgages do not pay double stamp duty.

misconceptions that are held by many who believe that Islamic banking products and services are only meant for Muslims. Greater awareness through advertisement and other media platforms with regard to the products and services offered by Islamic banks will cause others who had stayed away from this mode of banking to invest in it and enhance the continued growth of this sector.

5.2.8 Development of Human Capital

Because Islamic banking is a relatively new phenomenon in Uganda, there are not many people who have the required expertise to understand and implement the principles that underlie this form of banking. This can result in banks purporting to be Islamic banks yet they do not follow the rules of Islamic sharia and there is no one to question their activities. The development of professionals in this sector will therefore ensure banks that offer Islamic banking products adhere to Sharia law. This endeavour will rely heavily on an enhanced regulatory capacity of the Islamic banking sector which would provide clear guidelines on the necessary qualifications required by practitioners in this sector. In Malaysia for example, the Bank of Negara set up the International Centre for Education in Islamic Finance in 2006 which is a global university for Islamic finance. It offers programs which among others, are aimed at producing finance professionals with expertise in Islamic finance as well as provide students with a comprehensive understanding of the economic, financial and legal environment in which providers of Islamic financial services operate.³⁰¹ In Uganda, the Central Bank has also been taking steps to deepen Islamic banking by collaborating with Institutes like Islamic University in Uganda (IUIU) to design a certification programme for senior bank and students on the governance of Islamic transactions and products.³⁰²

5.2.9 Development of Innovative Islamic Banking Products

As Islamic banks grow, there is a need for them to develop innovative products and services that will attract customers, foreign investors as well as enable them to compete

³⁰¹International Centre for Education in Islamic Finance, “what are the programmes offered at INCEIF?” <http://www.inceif.org/about/faq/>. Accessed on 12th-July-2017.

³⁰² Jacqueline P.N. Kigonya(commercial Bank department) Bank of Uganda: “Implementation of Islamic Banking in Uganda” presented to law students of the Islamic University in Uganda on October. 2nd. 2014.

with conventional banks. Islamic banking in countries like Malaysia have evolved from deposit taking and retail financial schemes into an integrated financial system that offers diverse financial solutions across product areas including equity markets and securitized debt markets.³⁰³

5.3 Conclusion

Much as Islamic Banking systems are still new in some countries like Uganda and still wanting as in satisfying and convincing the non-Muslim community, the issue of no interest is appealing though the haram concept raises eye brows, recommendations are still there to come and welcome but the utmost consideration and care should be placed on the issue of Shari'ah compliance thus any issues on recommendations that are not ring fenced on Shari'ah compliance are bound to be kicked out but for scholars it is a way to go with challenges, setbacks, achievements and recommendations.

³⁰³ Malaysia International Islamic Finance Center, "Technology and Innovation in Islamic Banking", <http://www.mifc.com/index.php?ch=28&pg=72&ac=119&bb=uploadpdf>. Accessed on 12th-July-2017.

Bibliography

Text Books

Abdel-Magib, M.F (1981). Theory of Islamic Banks: accounting implications

Abdullah Saed, 'Islamic Banking and Interest' (Brill: Leiden, 1999)

Abdul Karim Aldohni 'The legal and regulatory aspects of Islamic Banking' a comparative look at the UK and Malaysia, (Routledge 2011)

Alykhorshid, (2009) Encyclopedia of Islamic Finance, Euromoney PLC

Benedikt Koehler (2009) Islamic Finance as a Progenitor of Venture Capital

Chakravoti, B. (2003). The slow pace of fast change: Bringing innovations college-UK. Comparative perspective. Oxford University press.

Dr. Muhammad Imran Ashraf Usmani 'A guide to Islamic banking'

El-Gamal, Mahmoud Amin (2000), a Basic Guide to contemporary Islamic Banking and Finance

Ibrahim Farah Abdullahi (2007) 'The Islamic Windows in conventional banks: The Kenyan Experience

John Maynard Keynes, (1964) General theory of employment, Interest and money, New York, Harcourt, Brace and World, First Harbinger Edition

Khurshid Ahmad (1980), Studies in Islamic Economics, International centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia

Mabid Ali Al-Jarhi (undated), Islamic Finance: An efficient & equitable option, The Islamic Research and Training Institute, Jeddah, Saudi Arabia

Mahlknect, Michael (2009). 'Islamic Capital Markets and Risk Management

MunawarIqbal and Phillip Molyneux 'Thirty years of Islamic Banking, History, Performance and prospects; (Palgrave Macmillian, 2005)

M. kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking' (Edward Elgar Publishing Limited, 2007)

MunawarIqbal and Philip Molyneux (2005), thirty years of Islamic banking, Performance and prospects

Mufti Muhammad TaqiUsmani 'An introduction to Islamic Finance

Natalie Schoon 'Modern Islamic Banking'

Roseline Njogu, 'Commercial Bank of God: Islamic Banking Law and Religion', (Lambert Academic Publishing)

Rosly, Saiful Azhar (2006) Critical Issues on Islamic Banking and Finance

Samuelson, P.A. and Nordhaus, W.D (1989) Economics 13th edition, McGraw-Hill, New York, NY

Shahrukh Rafi Khan, 'profit and loss sharing: An Islamic Experiment in Finance and Banking

Sait, Siraj, Lim, Hillary (2006) 'Land, Law and Islam' New York

Sarakhasi, Almabsur 'An Introduction to Islamic Finance'

Journals

Addallah, A. (1987). 'Islamic Banking', Journal of Islamic Banking and Finance

Fath E. Rahman Addalla Sheikh, "The underground Banking system and their impact on control of money Laundering: with special reference to Islamic Bank" (2002) 6, Journal of Money Laundering Control

The Quartely Journal of Economics (1993) King and Levine

The journal of finance. The journal of The American Finance Association by James, Brown, Steven, Fazzari and Peterson

Reports

Adel Harzi, 'The impact of Basel III on Islamic Banks: A theoretical study and comparison with conventional Banks'

El Qorchi, M. "Islamic finance Gears up", IMF, Finance and Development Working Paper of the IMF, 'Islamic banking: Issues in prudential regulations and Supervision', (IMF1998) WP/98/30

Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (Unpublished LLM thesis submitted at Cardiff Law School 2003-2004)

Hassan, M.K, and M.A.M Chowdhury, 'Islamic Banking Regulations in Light of Basel II', (Proceedings of the Fifth Harvard Research Forum on Islamic Finance 12th April 2004)

Iqbal, M. and R. Wilson (eds) (2005), Islamic perspective on Wealth Creation, Edinburg University: Edinburg Islamic Development Bank. (1999) Financing Trade in an Islamic Economy, Research paper No.51

M. Kabir Hassan et al, 'Basel II and Regulatory Framework for Islamic Banks' (University of New Orleans)

Mohamed Hassan Abdullahi 'the Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'. (Unreported thesis)

Salah A. Sheikh, 'Factors that led to Emergence of Islamic banking in Kenya and Regulatory Challenges facing the industry' (unpublished MBA project, University of Nairobi 2009)

Zulkifli Hasan, "The effectiveness of the Legal Framework of the Islamic Banking system in Malaysia", (Islamic University College of Malaysia)

Keynote speeches

Islamic Banking in emerging markets. Forgoing Uganda's economic progress. Keynote speech by Mr. Emmanuel Tumusiime Mutebile, Governor of the Bank of Uganda, at the Islamic banking conference, Kampala, 13th May 2016

Njuguna Ndungu: the future of sharia compliant banking and finance in Kenya-address by Prof Njuguna Ndungu, Governor of the Central Bank of Kenya, at the official launch of the National Bank of Kenya's sharia compliant banking

Newspapers

New Vision 19th May.2016

Internet sources

http://in.docsity.com/index.php/en-docs/islamic_banking-ethics-assignment

https://www.pwc.com/m1/en/publications/Islamic_finance_capability_statement.pdf

<https://www.ey.com/EM/en/industries/financial-services/banking-capital-markets/EY-world-islamic-banking-competitiveness-report-2014-15>

<https://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>

<http://news.bbc.co.uk/1/hi/england/london/4487749.stm>

<http://www.mifc.com/?ch=55&pg=195&ac=99&bb=uploadpdf>

<https://abdulqadeerbaksh.wordpress.com>

<http://www.ifsb.org>

<http://www.ifsb.org/requirement.php>

www.inter-islam.org

www.revolvy.com

www.bou.or.ug

www.dispatch.ug/2017/03/24/bank-uganda-license-islamicbanks-year-ends

www.islamicfinanceandbanking.blogspot

www.islamic-banking.com

www.islamibankbd.com

www.financialislam.com

www.investment-and-finance.net

www.blomdevelopment.com

www.aims.education

www.ifsb.org/membership.php

www.ifsb.org/objectif.php

www.iifm.net/about_iifm/objectives

www.iirating.com