

# **Islamic Banking in Uganda**

**By**

**Musa Mayanja Lwanga**

**Head of Research and Market Development**

In 2016 the government of Uganda amended the Financial Institutions Act (FIA) 2004 to make provision for Islamic Banking. Financial Institutions then embarked on strengthening both their technical and operational capacity to roll out this initiative within the sector. Staff of supervised financial institutions continue to participate in capacity building/training programs on Islamic Banking. Regulators and Policy makers continue to facilitate the creation of an enabling environment that is supporting the operationalization of Islamic Banking in Uganda.

The introduction of Islamic banking creates an opportunity for Ugandans to access a wider range of financial options and choice of banking products and services; this will ultimately contribute to the financial inclusion agenda.

## **What Islamic Banking is about?**

Islamic banking, also known as non-interest banking, is a system based on the principles of Islamic or Shari'ah law and guided by Islamic economics. Islamic banks offer financial services, without using the conventional interest based system, providing for the sharing of net profit/loss and the risk involved in a proportional manner between the lender and the beneficiary. As such, a financial Institution not only expects to claim a proportion of the profits of a project, but also carries a proportional share of the loss of that project. Thus, in Islamic banking, financial Institutions make a profit through equity participation which requires a borrower to give the bank a share in their profits rather than paying interest.

## **Who regulates Islamic Banking in Uganda**

All Financial Institutions offering Islamic banking products and services are regulated by the Central Bank of Uganda. Islamic banking regulations were gazetted in February 2018 and these cover, license to conduct Islamic financial business, deposits in Islamic financial business, capital adequacy, liquidity and profits, credit provision in Islamic financial business, Shari'ah advisory board, central Shari'ah advisory council as well as remedial measures and administrative sanctions, and other macro prudential metrics to ensure stability of the financial system. Because Islamic Financial Institutions are required to follow Islamic or Shari'ah commercial laws, the Central Bank is to establish a Central Shari'ah Advisory Board to advise the Central Bank on matters of regulation and supervision of Islamic banking systems in Uganda and to approve any product to be offered by financial institutions conducting Islamic banking. On the fiscal side, the Ministry of Finance, Planning and Economic development through consultations with various stakeholders including the Uganda Bankers' Association, is to put in place policy regulations and guidelines that will aid the taxation of transactions based on Islamic Banking.

## **Who qualifies to carryout Islamic Banking?**

A financial institution already licensed by Bank of Uganda and intending to carry out Islamic Banking will apply to the central bank to carry on Islamic financial business through an Islamic banking window. A

financial institution approved to conduct Islamic Banking shall appoint and maintain a Shari'ah Advisory Board whose function among others will be to approve and review the Islamic business of the financial institution to ensure it complies with the Shari'ah.

### **An Overview of Islamic Banking Products**

Like the traditional banking system, Islamic banks shall operate two sides of the balance sheet i.e. the asset side and the liability side. However, these products shall be based on Islamic contracts as following;

- i) *The Liability Side*; This side include the demand deposits, which are risk-free and provide no fixed return to the depositor apart from the bank discretionally gift (hiba) and the investment deposits, which expose the customer to the risk of losses from investments made by the bank. Contracts commonly used on this side include benevolent loan (Qardh) and guaranteed safe custody (wadi'a yad dhamanah).
- ii) *The Asset Side*; after obtaining funds from the liability side, Islamic banks use these funds in different channels including retail and corporate sectors by offering a broad spectrum of products such as Islamic financial intermediation and Islamic leasing, Islamic Bond (Sukuk) among others.

### **Difference between Islamic Banking and Conventional Banking System**

The Islamic Banking System promotes risk sharing between financial institutions and their customers whereas the Conventional Banking System operates on predetermined rate of interest.

With Islamic Banking system, functions and operating modes are based on Shari'ah law. Financial Institutions have to ensure that all business activities are in compliance with Shari'ah requirements whereas with the Conventional Banking System, functions and operating modes are based on secular principles and not based on any religious law or guidelines which render them miss an ethical ground.

Under the Profit and Loss Sharing arrangement, Islamic Banks assume returns only if there is a profit by customer this promotes sound projects and support managerial competence of the entrepreneur while with the Conventional Banking System emphasis is on credit worthiness.

### **Benefits of Islamic Banking**

Apart from availing Ugandans with a range of financial options and choice of banking products and services, Islamic banking has some unique advantages including reducing the impact of harmful products and practices, offering financial justice, encouraging stability in investments as well as accelerating economic development.

#### ***Reducing the impact of harmful products and practices on society***

Shari'ah principles forbid any transactions that support industries or activities which are forbidden in Islam regardless of whether the activities are legal or not in the place of transaction. Such activities include usury, speculation, prostitution, alcohol and gambling.

#### ***Principle of financial justice***

Financial justice is a requirement that helps Islamic banking products function in a Shari'ah compliant way. The conventional financial system looks at making profit through interest payments and makes the beneficiary liable for any risk. Islamic banking paves way for the sharing of profit/loss and risk involved in proportional manner. Conventional financing looks at profit through interest payments and makes the beneficiary completely liable for any risk. Contrary to this, Islamic banking paves the way for the sharing of net profit/loss and the risk involved in a proportional manner between the lender and the beneficiary. Therefore, if a financier is expecting a claim on profits of a project, it is necessary that he/she should also carry a proportional share of the loss of that project.

#### ***Encouraging stability in investments***

In Islamic banking, investments are approached with a slower, insightful decision-making process, when compared to conventional banking. Companies whose financial practices and operations are too risky are usually kept away by Islamic banking companies. By performing intensive audits and analyses, Islamic banking promotes the reduction of risk and creates the space for a greater investment stability.

#### ***Accelerating economic development***

Islamic banking companies certainly have profit creation and growth as their objectives. For which, they choose to invest in businesses based on their potential for growth and success. Thus, in the Islamic banking industry, each bank will invest in promising business ventures and attempt to out-perform its competitors, in order to attract more funds from its depositors. This will eventually result in a high return on investments both for the financial institution and the depositors. This is unlikely in a financial institution offering conventional financial services, where depositors redeem returns on their deposits based on a pre-determined interest rate.

#### ***Can Islamic Finance Co-exist with Conventional Banking?***

The answer is yes. It is worth noting that Uganda is not the first secular state to adopt Islamic Banking and as such this is a good opportunity for peer learning. Other countries including the United Kingdom, have adopted Islamic banking alongside conventional banking.