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The feasibility of adopting Islamic Banking system under the existing laws in Uganda

Sulaiman Lujja, Mustafa Omar Mohammad and Rusni Bt. Hassan
Institute of Islamic Banking and Finance, International Islamic University, Kuala Lumpur, Malaysia, and
Umar A. Oseni
IIUM Institute of Islamic Banking and Finance, International Islamic University Malaysia, Kuala Lumpur, Malaysia

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Abstract

Purpose – In 2014, Islamic finance assets are estimated to have exceeded US$2 trillion with over 100 products and an annual growth of over 20.7 per cent, across more than 76 countries, most of which are members of the Organization of Islamic Cooperation (OIC). Despite this remarkable market expansion, numerous OIC members such as Uganda are yet to fully adopt this unique financial system because of regulatory constraints. Thus, the purpose of this paper is to examine the extent to which Uganda can benchmark the Malaysian experience and best practices to overcome the regulatory challenges in introducing Islamic Banking.

Design/methodology/approach – This exploratory study adopts qualitative research methods through documentary review to elicit relevant information from the existing laws in Uganda that would accommodate the Islamic Banking system. Interpretive analysis and analytical methods are used to analyze data.

Findings – The Malaysian experience and best practices of Islamic Banking regulation need to be benchmarked by regulators. Relevant laws which require some amendments include section 37(a) and 38(1) of the Financial Institutions Act 2004 and section 29(3)(a) of the Bank of Uganda Act 2000. Similarly, tax legislation needs amendments to ensure a level playing field for Islamic finance and conventional finance products.

Originality/value – This is one of the earliest studies on models of Islamic Banking regulation suitable for adoption in Uganda. This study contributes to literature on how other jurisdictions (especially those with less regulatory prudence) could regulate Islamic Banking in a dual banking system jurisdiction.

Keywords Malaysia, Uganda, Islamic Banking, Legal framework, Sharīʿah governance

Paper type Conceptual paper

Introduction

Islamic finance has been globally embraced by both Muslim and non-Muslim countries with total assets in Sharīʿah-compliant financial institutions exceeding US$2 trillion in 2014, an annual growth rate of over 20 per cent across more than 76 countries (Hassan *et al.*, 2013)[1]. Generally, the compound annual growth rate has been steadily maintained at a competitive rate of 16 per cent (Global Islamic Finance Forum, 2014). Given that expansion at a global scale in the past decades, Islamic Banking has remained small in Africa (especially in the sub-Saharan Africa). However, it has huge

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potential for growth in this region, as Africa remains largely untapped from the economic perspective and its huge potentials for Islamic finance consumers. Numerous features of Africa make Islamic Banking relevant in the region, such as the demographic structure of the continent and potential for financial deepening through the promotion of small and medium enterprises (SMEs) and micro-credit activities. Similarly, regulators also have the potential to expedite *Ṣukūk* issuance to attract foreign investors (Malik, 2010; Gelbard *et al.*, 2014).

Nevertheless, the challenge for Africa still lies in exploring new avenues of tackling the prevalent problems that hinder the development of Islamic Banking in the region. As a remedy, international bodies such as the International Monetary Fund (IMF), World Bank and the Islamic Development Bank have a crucial role to play in sharing international experiences and providing advice on the direction of this industry in the region (Gelbard *et al.*, 2014). For a start, African countries may need to adopt a more feasible model of Islamic Banking and Sharīʿah governance, given their country specifics (for instance, the dominance of the secular system). Sudin (2004) established that numerous developing countries such as Indonesia, Brunei, Pakistan and Bangladesh adopted the Malaysian model of Islamic Banking and sought Malaysia's assistance during the early stage of developing their respective Islamic Banking systems. This has portrayed the Malaysian model as a more feasible and viable alternative for adoption by not only Organization of Islamic Cooperation (OIC) member countries but also other commonwealth developing countries especially in the sub-Saharan Africa.

Despite this remarkable acceptance, several other OIC member countries, including Uganda, are yet to establish the Islamic Banking system because of legal impediments. This is because Islamic Banking has to integrate within the overall ambit of the global financial system. Ideally, accommodating Islamic Banking within the existing legal framework may attract certain challenges especially in this era when bank regulation has become a global phenomenon which is spearheaded by the Basel Committee on Banking Supervision (BCBS). As a matter of fact, all bank regulators comply with the pronouncements and bank governance requirements of the BCBS rules. The BCBS is a forum for regular cooperation on banking regulatory and supervisory matters that aims at developing the quality of banking supervision worldwide. In that regard, it sets standards to secure international convergence on supervisory regulations of internationally active banks (Goodhart, 2011). Adoption of these standards promotes an effective risk management culture in Islamic banks, which helps them develop effective internal rating and control systems that ultimately improve and enhance their external rating and stability (Basel Committee on Banking Supervision, 2006). Similarly, the model of Sharīʿah governance to be adopted needs to be critically analyzed to determine whether to involve regulatory authorities in regulating Sharīʿah governance or propose a self-regulation model. This helps to build public confidence in the industry.

Uganda's ambition of establishing Islamic Banking can be traced to early 1990s when Dr Suleiman Kiggundu and other prominent Muslims wanted to establish a conglomerate, the First Islamic Bank of Africa, which failed. Over the years, this ambition has still been under deliberation as it was also discussed in 2008 during the OIC business forum hosted by Uganda. It was during this forum that the President of the Abu Dhabi Investment firm subsidiary, International Investment House, unveiled their proposed merger with the National Bank of Commerce Uganda to transform it into the

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National Islamic Bank of Uganda. It was also suggested that the Islamic Chamber of Commerce and Industry for global Islamic companies be set up to ease exploration of investment opportunities with the aim of enhancing the financing of Islamic Banking projects in Uganda (The Independent, 2010; Lujja, 2013).

Bank of Uganda (BoU) has proposed to have the first Islamic bank and Islamic Banking windows established. It has also made enough preparations for Islamic Banking by training its staff and consulting other prominent jurisdictions such as UAE, Malaysia and Indonesia (Samboh, 2011). It submitted the proposed amendments in The Financial Institutions Act, 2004 to the Ministry of Finance which was subsequently tabled before the Cabinet of Uganda. After the approval of the Cabinet of Ministers, Bill No. 16 (2015) was presented to the Parliament by the Minister of State for Finance, Planning and Economic Development for the first reading on August 13, 2015. The Bill was then sent to the Finance Committee of the Parliament, where different stakeholders' submissions will be incorporated. Ultimately, the Bill will come back to the plenary for the second and third reading to become a law that will, among others, allow the BoU to license the first Islamic banks in Uganda. All these developments have been at policy and institutional levels. However, the challenge still remains as the implementation of Islamic Banking in Uganda requires some essential amendments in the existing laws. Similarly, in terms of approach, it requires benchmarking experience from some other leading jurisdictions for adoption of best practices.

This paper therefore explores the extent of relevance of the existing laws toward the introduction of Islamic Banking in Uganda. To accomplish this objective, the study examines the Malaysian experience in Islamic Banking regulation to benchmark the Ugandan experience with best practices. Presently, there is hardly any study undertaken in this regard. This makes the present study inevitable to fill this gap in the existing literature. This paper is divided into five sections. Following the introduction, Section 2 reviews the existing literature which includes the regulatory framework of Islamic Banking in Malaysia, Malaysia's strength in Islamic Banking regulation and the extent to which the existing laws in Uganda can accommodate Islamic Banking. Section 3 provides the methodology applied to accomplish this study. Section 4 discusses the findings of the study, and Section 5 concludes the paper with some important recommendations.

Literature review

Learning from the Malaysian regulatory framework for Islamic Banking

A well-regulated dual banking system. It is pertinent to begin with an exploration of best practice in the law and regulation of Islamic Banking. Malaysia has proved to be an advanced jurisdiction with which any emerging jurisdiction can benchmark its reforms for a successful experiment (Aziz, 2014; Oseni and Ahmad, 2016; Hasan, 2007; Kuala Lumpur Business School, 2012). The dual banking environment in Malaysia allows the Islamic Banking system to operate alongside conventional banking. The Islamic financial system in this sense entails the Islamic Banking system, Islamic Money Market, Islamic Capital Market, Islamic insurance (*takaful*) and other specialized financial institutions that offer Sharīʿah-compliant alternative sources of financing. These structural components interdepend on each other to create an environment conducive for resource mobilization to finance productive economic activities. It is no doubt that the robust Islamic financial system has enabled Malaysia to withstand

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financial shocks. It is from this background that Malaysia has merged and rationalized its regulatory laws to realize a more cohesive legislative framework through a dual banking system under the Financial Services Act (2013) and the Islamic Financial Services Act (2013). These two separate Acts regulate conventional and Islamic Banking businesses, respectively. Under these legislations, Bank Negara Malaysia (BNM) exercises oversight role over financial groups that are licensed with one or more institutions (Bank Negara Malaysia, 2003).

Flexibility in regulation. Malaysia has capitalized on the strength of its conventional regulatory framework to strengthen the Islamic Banking system. This is because of the long existence and success of the conventional framework which has been utilized to approach similar risks in Islamic Banking system. This existing framework has been gradually modified to address prominent features of Islamic finance. It is from this background that the legislators allowed flexibility to Islamic banks to engage in a broad range of Sharīʿah-compliant transactions and permitted conventional banks to participate in Islamic Banking business.

Hasan (2010) maintains that Islamic Banking products especially for debt financing contain trading which requires double or multiple contracts, for example, promise, sell, purchase and lease agreement in a single financing contract of home financing for instance. Additionally, whenever the parties adjust the duration or financing amount, a fresh agreement is entered. All these agreements attract separate stamp duties, which mean double/multiple taxation. This is not the case with conventional banks as their transaction is deemed to be loan advancement. In a bid to promote Islamic Banking, the Malaysian Government introduced incentives in terms of tax exemption for Islamic financial Institutions and institutions offering Islamic financial services. This made all legal documentations that incorporate trading transactions of Islamic banks to exclusively incur a normal cost of tax stipulated under the Stamp Act (1948). This provision was aimed at making Islamic Banking products competitive when subjected to stump duty in a manner conventional banks are. This flexibility in regulation has motivated Islamic financial institutions and institutions offering Islamic financial services to conveniently operate Islamic Banking business. More specifically, Stamp Duty (Exemption) Order 2000 [P.U. (A) 64] provides for a tax incentive on Islamic financial products' instruments.

After the government had realized the viability of Islamic finance, it allowed a tax deduction for five years (in its Federal Budget, 2003) on expenses incurred by the Institutions offering Islamic financial services in issuing *Ṣukūk* based on *ijārah*, *muḍārabah* and *mushārakah*. Similarly, a five-year tax deduction was also given for *Ṣukūk* based on *Istiṣnā'a*. In the Federal Budget (2005), announcements were made to eliminate any tax or duty on Islamic Capital Market products as long as such products were approved by the Sharīʿah Advisory Council of Securities Commission (Laldin, 2008).

Sound governance. It is essential for the financial institutions to have good governance, which takes into consideration the financial, ethical, religious and other values to safeguard the interests of their stakeholders. For Islamic financial institutions and institutions offering Islamic financial services, stakeholders require a corporate structure that enables the institution to apply good governance and compliance of their operations with Sharīʿah doctrines (Grais and Pellegrini, 2006; Grais, 2008). Thus, Malaysia's Islamic financial system operates under robust legal and Sharīʿah

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frameworks. It is this prudent governance that has enabled Malaysia develop into a global Islamic finance hub.

In light of the above, the Deputy Governor of Bank Negara Malaysia emphasized that the established Islamic finance centers (Malaysia in particular) are more than ready to share their experience with the new entrants for them to eliminate costly mistakes. This will attract more jurisdictions to adopt Islamic finance, hence enhancing the potentials of the industry (Bank Negara Malaysia, 2014). What has made Malaysia successful in regulating this industry needs to be critically studied by other countries to benchmark best practices. This has been recommended by numerous other studies among others; Oseni and Ahmad (2016); Laldin (2008); Khiyar (2012); Sudin (2004).

The extent to which the existing laws can accommodate Islamic Banking in Uganda

Profile of Uganda

Uganda's banking system. Uganda's banking sector started with the first bank established in 1906 (the National Bank of India), which later turned into Grindlays Bank and consequently the Stanbic Bank. The banking sector currently has 25 commercial banks, four credit institutions, and four microfinance deposit-taking institutions (MDIs). This sector has evolved through bank closures, mergers and acquisitions such as the National Bank of India, which merged with Standard Bank in 1912, the Bank of Netherlands that merged with Grindlays Bank, Uganda Credit and Savings Bank, which revolved into the first local commercial bank (Uganda Commercial Bank - UCB) in 1969, Bank of Baroda which was regularized as a commercial bank in 1969 with the enactment of the Banking Act of 1969 – the first legal framework for regulation of the banking sector following the country's independence in 1962 (Beck and Hesse, 2006, 2009; Bategeka and Okumu, 2010).

BoU was established in 1966 by the Bank of Uganda Act (1966). This was followed by the establishment of the Uganda Development Bank under the Uganda Development Bank Decree (1972). Since 1906, over 40 commercial banks have been established in Uganda, majority of which were established after independence, particularly after government Structural Adjustment Programs that were adopted in 1987, which were massively supported by the World Bank and the IMF (Beck and Hesse, 2006).

The World Bank and IMF significantly contributed to Uganda's financial-sector reforms mainly through Policy Framework Papers to ensure that Uganda remains on a very strong course of economic reforms. Examples of these reforms and performance benchmarks among others included establishment of new legal and regulatory framework for banking sector, liberalization of the interest rate market, closure of failing banks, establishment of Non-Performing Asset and Recovery Trust, liberalization of the foreign exchange market and adoption of the internally accepted standards in banking particularly the Basel standards (IMF, 1999; Beck and Hesse, 2006; Bategeka and Okumu, 2010).

When government adopted the privatization program, it ceased to provide banking services, thus, the dominance of state owned banks from 1960s decreased in the late 1980s and numerous private-owned banks were established in the 1990s. Over ten private banks were licensed by BoU from 1988 to 1999. Most of these banks were local banks, for example, Teefee Bank Ltd, the Greenland Bank Ltd, the Gold Trust Bank Ltd, the Cooperative Bank Ltd, Nile Bank Ltd and the TransAfrica Bank Ltd. Similarly,

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another ten banks were licensed between 2000 and 2009 with seven of them being licensed in 2008 and 2009 because of the ban on bank licensing that extended from 1997 and lifted in July 2007. During this period, other non-bank financial institutions were also established, including the International Credit Bank Ltd and other credit institutions and MDIs (Hauner and Peiris, 2008).

Most of the locally owned banks had closed through merger, acquisition, outright closure for failure or restructured and renamed. This led to intensive reduction in bank branches and limited access to financial services. Ultimately, the economy experienced a stronger and robust financial system that improved public confidence in the financial system. Currently, there are 25 commercial banks (Tier I), four credit institutions (Tier II), four MDIs (Tier III) and two Development Banks (Tier IV). (Bategeka and Okumu, 2010).

With regard to ownership of these banks, about 87 per cent of the existing banks are registered in Uganda as legal entities but are subsidiaries of their parent banks in foreign countries. It is in this spirit that the majority of the banking assets are controlled by foreign banks. This factor, in addition to having superior management expertise in risk management particularly, renders the foreign banks more profitable than their local counterparts. However, it should be acknowledged that the success and performance of these foreign banks and the sector at large is also partly attributed to the existing policy environments, legal and regulatory framework in Uganda that were vital in shaping the directing the adjustment program (Hauner and Peiris, 2008).

The banking sector is categorized into the Central Bank, commercial banks, credit institutions, MDIs and development banks. Credit institutions and MDIs are known as non-bank financial institutions. Although BoU supervises commercial banks, credit institutions and MDIs, it does not supervise development banks (Hauner and Peiris, 2008).

Typically, banks are part of the financial system that play a major role toward economic development of the country. They bridge the gap between deficit and surplus spending units to ensure economic welfare of the people. The question still stands whether globally banks have fulfilled this responsibility. Based on the evident financial crises and economic depressions, conventional banks do not seem to adequately fulfill this requirement. This has prompted scholars and researchers to attribute this to liquidity problems and interest on loans that have discouraged investments especially in many African economies (Njanike, 2012). Uganda's financial system (financial institutions, financial markets, financial instruments and the regulatory frameworks governing them), particularly banking system, is among the weakest in the sub-Saharan Africa because of its oligopolistic nature and its inadequacy in performing many basic banking functions for the period between 1960 and 1980. This inefficiency is attributed to the unpopular financial policies adopted by government to control the banking market and foster economic development (Bigsten and Kayizzi-Mugerwa, 1999). Most informal financial institutions are village savings, and loan associations and formal institutions are less prevalent in rural than urban areas. In regard with access to finance, 62 per cent of the population in the country have no access to financial services. The level of unbanked and the under-banked population is too high with the number of population holding accounts in banks being four million (33 per cent of the 12 million who are bankable). The ration of savings to gross domestic product (GDP) is very low at only 16 per cent. Consequently, the ratio of financial intermediation to GDP is at 11.8 per cent (Nakayiza, 2013). Over the period of more than half a century, the entire laws in

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Uganda have been amended several times to regulate conventional banking system. An examination of the efficacy of the existing laws toward accommodation of Islamic Banking system needs to be undertaken. These laws include Constitution of the Republic of Uganda (1995), the The Financial Institutions Act (2004) and The Bank of Uganda Act (2000) (Cap 51). A close scrutiny of these laws will reveal areas where legal reforms are needed to accommodate Islamic Banking in the country.

Islamic Banking and the Constitution of the Republic of Uganda, 1995. It should be noted that the Constitution of the Republic of Uganda (1995) or the ones before it do/did not provide for anything relating to Islamic Banking. This is because the Constitution cannot provide for all laws in the country, as it is only meant to serve as an enabling law. However, the overall banking system (under which Islamic Banking falls) is provided for under Chapter 9, Section 161, where the Constitution establishes the Central Bank (BoU). Section 162 provides for various functions of BoU in supervising the banking sector. In this spirit, section 162(3) particularly mandates the Parliament to make laws prescribing and regulating the functions of BoU. It is from this background, therefore, that the Parliament would mandate BoU to license and supervise Islamic banks, subject to the provisions of the Constitution.

It should also be noted at this juncture that the Constitution adopts the status of Hans Kelsen's concept of grundnorm that authenticates all the valid norms. These are the basic norms, that is, the common source of validity for all norms that belong to the same order and reason for their validity (Morrison, 1997). It is on this ground that all the banking laws in Uganda have their roots attributed to the Constitution under the jurisprudence of valid norms. In the event that these norms were enacted before the 1995 Constitution, the legitimacy of the same laws is designated into the Constitution as if the Constitution empowered their designation. Hence, their operation is not affected by the coming into force of the 1995 Constitution. This is provided for in section 274 of the Constitution where the expression "existing law" is used to depict the written and unwritten laws of Uganda or any part of it before and after the coming into force of the Constitution. Therefore, all the banking laws that will be explored within this paper fall under this category (Constitution of the Republic of Uganda, 1995).

Islamic Banking under The Financial Institutions Act, 2004 (Cap. 52). The Financial Institutions Act (2004) does not have any provision for Islamic Banking. Most of the day-to-day transactions in Islamic banks, for example, *muḍārabah, mushāraka, bay' bithaman ājil (BBA) and ijārah*, cannot be practiced under The Financial Institutions Act (2004) since Section 37(a) of The Financial Institutions Act (2004) stipulates that:

> A financial institution shall not engage directly or indirectly for its own account, alone or with others in trade, commerce, industry, insurance or agriculture, except in the course of the satisfaction of debts due to it in which case all such activities and interest shall be deposited of at the earliest reasonable opportunity.

It therefore becomes impossible for BoU to grant license to an Islamic bank whose core business is based on trade and investment through equity financing especially under mushārakah financing. The allowance provided in the same section (b) for engagement in trade not more than 25 per cent of the bank's core capital is also not appropriate for Islamic banks whose typical trading transactions constitute not less than 70 per cent of their activities (The Financial Institutions Act, 2004).

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Similarly, no where in The Financial Institutions Act (2004) was Islamic Banking recognized or could facilitate the smooth operation of this banking system. All provisions in The Financial Institutions Act (2004) were intended for interest-based financial institutions. More specifically, Section 3 of The Financial Institutions Act (2004) describes a "financial institution" as a company licensed to undertake financial institutions business among others; accepting deposits, issuing deposits substitutes, lending or extending credit and dealing in foreign exchange business involving forward and option type of contracts for the future sale of foreign currencies. (The Financial Institutions Act, 2004). Many of these businesses are not in harmony with Sharīʿah principles, which render Islamic Banking system unrealistic under this Act.

Islamic Banking under The Bank of Uganda Act, 2000 (Cap 51). BoU was established on the August 15, 1966. It works in close association with the Ministry of Finance, Planning and Economic Development. The enactment of Bank of Uganda Act augmented the banking sector as it enhanced the implementation of monetary policy. This Act charges BoU with the responsibility of overseeing the country's monetary policy through tight regulation and administration of financial institutions. Part VII Subsection 36-39 of The Bank of Uganda Act (2000) (Cap 51) vests BoU with the authority of issuing the legal tender, maintaining the value of the legal tender and sustaining monetary stability and sound financial system in the country and acts as the banker and financial adviser of the government, as the banker of the last resort and as a clearinghouse for financial institution (The Bank of Uganda Act, 2000).

Given the present mandate of BoU, there would be a lot of difficulties in its relationship with Islamic banks under its prevailing interest-based operation that is mandated to it by the existing Act, which generally includes controlling credit and interest rates by statutorily prescribing the maximum and minimum rates of interest that should be paid by financial institutions on different categories of deposits, liabilities and bank credit extended in any form.

Subject to the provisions of the Constitution of the Republic of Uganda (1995), the Parliament may enact enabling laws (which accommodate Islamic Banking) to be categorized under some of the functioning of BoU.

Islamic Banking and the existing tax laws. The existing tax regulation would charge double taxation in form of stamp duty if Sharīʿah-compliant financial products/double staged transaction are structured, for instance, *Murābahah*-financed residential contracts, *Ijārah underlying contracts for home purchase and diminishing partnership-based mortgages (Mushārakah Mutanāqisah). The stamp duty would be charged twice on a single house purchased as two separate sale transactions are completed. This will make the Sharī*ʿah-compliant products more expensive and, thus, uncompetitive in the market, as a similar product in conventional financial system gets favorable treatment (one stamp duty on a loan contract) under the same regulator. For instance, the Stamp Duty Act (2014) did not provide for any tax exemption of incentives for Islamic Banking products or similar alternative financing products, as Islamic Banking is still at the conceptual stage in the country.

In a bid to promote Islamic Banking, the government needs to provide a level playing field for both Islamic Banking and conventional banking by allowing incentives in terms of tax exemptions on Sharīʿah-compliant contracts that would attract double or multiple taxation. These provisions will allow Islamic banks incur a common tax stipulated under the Stamp Act, in the same manner conventional banks do.

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In short, all the existing laws in Uganda that regulate the banking system have been analyzed, and it is found that they cannot accommodate Islamic Banking in their current form. Thus, appropriate amendments are required to enable these laws accommodate Islamic Banking system.

Methodology

All the deliberations undertaken at policy and institutional levels to bring about Islamic Banking indicate its potential success in Uganda. However, there is currently a huge research gap in literature that could link this potential success to reality. This gap is to study the efficacy of the existing laws toward establishment of Islamic Banking in Uganda. The findings of the study would have implications for theory, practice and for researchers.

This study is an exploratory analysis done qualitatively using documentary review. The study reviewed numerous documents such as relevant statutes (Constitution of the Republic of Uganda, 1995; The Financial Institutions Act, 2004; and The Bank of Uganda Act, 2000 – Cap 51) and other important regulatory documents to elicit relevant information from the existing laws that would accommodate Islamic Banking system. These documents were accessed through the internet and websites of regulatory bodies. Similarly, an examination of Malaysia's Islamic Banking laws and regulation (the Federal Constitution of Malaysia, the Sharīah Governance Framework, 2010, and Islamic Financial Services Act, 2013) was done to establish how it has undergone this experience for a period of more than three decades. This was intended to export Malaysia's strength and best practices into Uganda. The Malaysian model would be more relevant for adoption in Uganda as both countries share a lot in common. For example, both are member countries of OIC and commonwealth; they have relatively same population size, and both are developing countries.

To analyze data, the study made use of analytical and interpretive analysis. Data collected were classified proportionately as data relating to the legal framework and Sharīʿah governance of Islamic Banking. After that, the data were analyzed using legal interpretations. A comparative analysis between Ugandan and Malaysian legal frameworks was utilized to benchmark best practices from the Malaysian Islamic Banking legal and regulatory framework for adoption into Uganda. Similarly, Uganda's existing legal stumbling blocks to Islamic Banking were also unveiled. This enabled the present study reach results and conclusions that are well based on legal and practical characteristics of Uganda.

Findings and discussion

The need for a legal and regulatory framework of Islamic Banking

It is incumbent on BoU to maintain more prudent regulations over Islamic banks when established and ensure financial inclusion to cater for the potential Islamic Banking customers in the country. The call for stringent regulatory control of Islamic banks is not a present-day innovation, rather it was deliberated way back in 1981 by governors of Central Banks and monetary authorities of OIC member countries in their detailed report titled: "Promotion, Regulation and Supervision of Islamic Banks" and approved in their fourth meeting in Khartoum. Therefore, Islamic banks are more strictly required to comply with the Central Bank regulations and policies. In the event of non-compliance with regulations, Part VI of The Bank of Uganda Act, 2000 mandates BoU, or with the

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directive of the Minister of finance to make an investigation (under conditions of secrecy) of the accounts and specific transactions that are deemed detrimental to the interests of customers (The Bank of Uganda Act, 2000).

On the stringent level required in Islamic Banking, Sole (2007) established that the prudential supervision of the Central Bank over conventional financial institutions is much felt by Islamic banks, as the latter relies more on profit and loss sharing. Such supervision and prudential roles were reemphasized in an Islamic Banking-related case decided by the High Court of Uganda in 2012. In *International Investment House Company LLC & Emirates Africa Link for Strategic Alliance LLC* v. *Amos Nzeyi, Ruhakana Rugunda & National Bank of Commerce* [Civil Suit No. 73 of 2012), the issue of a strategic plan to implement a business plan which involves uplifting National Bank of Commerce to a "world-class financial institution and Islamic finance bank" came up. It was evident in the case as revealed by the court that the quest to control the third respondent company (National Bank of Commerce), which was supposed to be upgraded to an Islamic bank, was the main bone of contention.

Although the decision of the court was on share allotment which might not be relevant here, it suffices to say that in arriving at its decision, the court took a number of factors into consideration. Such factors included the role of BoU in its prudential regulation of banks; the alleged recapitalization of the National Bank of Commerce; the implication of the dispute and the decision of the court on other parties who are not parties before the court; and "sentimental value of failure or potential failure to set up an Islamic Bank". Though a temporary injunction was granted in favor of the applicants to restrain the respondents, their agents, servants or otherwise from dealing in shares purchased by the applicants, one important lesson learnt is the role of BoU in regulating the banking sector which potentially includes Islamic Banking as evident in the case. For instance, The Financial Institutions Act (2004) requires any director of a financial institution to be approved by the BoU, and this requirement was violated in the case.

However, Chapra and Khan (2000) reported the claim of Islamic banks that they do not create credit (there is no creditor–debtor relationship, instead their relationship is participatory with the users of funds) as is the case with conventional banks, thus, they should not be subjected to similar regulations of credit control. To strike a balance, Siddiqi (1989) observed that the truth lies somewhere in the middle. He established that credit (additional money supply) is not created by any bank (conventional or Islamic) in isolation. It is the commercial banking system as a whole that creates credit. In conventional banking, the advance made by one commercial bank does not leave the banking system. It is transferred to other commercial banks in the form of deposits and other receipts. Similarly, the advances made by Islamic banks in form of *Murābahah* (letter of credit or any other mean) do not leave the banking system. This credit is also transferred to the same bank or another Islamic bank (sometimes to a conventional bank). Sole's argument renders the opposing views as misunderstanding of the concept of need for prudential supervision. He, therefore, affirms that the regulatory authority's role should be two-folded, that is, prudential supervision and industrial development. In support of Sole's view, Erric and Farrahbaksh (1998) demonstrated certain features of Islamic banks that justify the need for prudential supervision to the extent of conventional banking system, that is moral hazards consideration, safeguarding the interest of demand depositors and systemic considerations. Sole (2007) established the second role of the Central Bank – industrial development. BoU should foster an

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environment conducive for Islamic Banking customers and Islamic Banking system sustainability to develop alongside conventional banking system. Sole (2007) further postulates that at the initial stage of implementing Islamic Banking system, some Islamic transactions will fall out of the precincts of the existing laws. Similarly, the public may refrain from such transaction as a result of their unfamiliarity with them. Borrowing from the UK system, he urged the authorities to adopt the British Financial Services Authority's policy of "no obstacles, no special favours". Similarly, Belouafi and Belabes (2010) establish that it is the responsibility of authorities to carefully manage the incorporation of the newly emerging Islamic finance industry and products under this prudential regulatory umbrella.

Lessons from the Malaysian model of Islamic Banking regulation for adoption into Uganda

Malaysia adopted a dual banking system where Islamic Banking operates side by side with conventional banking under the BNM regulation. The legal architecture and infrastructure within which Islamic Banking operates is more robust and ahead of other countries around the globe, which make it viable for adoption into other developing countries. Malaysia has developed this sound legal architecture through stages where several statutes were enacted to govern and regulate its financial sector, that is, the Islamic Banking Act (IBA) 1983 (now repealed) to govern Islamic banks offering exclusively Islamic Banking products, the Government Investment Act (GIA) 1983 to enable government receive money from Islamic banks for a fixed period and pay dividends or gift (hibah) thereon instead of interest and the *Takaful* Act (TA) 1984 to regulate Islamic insurance business. After the full monopoly of Bank Islam Malaysia Berhard had lasted for 10 years, conventional banks were given the opportunity to do Islamic Banking business (under the pilot project of the interest-free banking scheme) to test the market for the viability of Islamic Banking products when they are being offered along with conventional products under the same roof. These Islamic Banking windows were governed under the Banking and Financial Institutions Act (BAFIA) 1989 (now repealed), which governed conventional banking institutions. The BAFIA (1989) provided a legal ground for conventional banks to operate Islamic Banking business under one provision that was stipulated in Section 124(1):

> Except as provided in section 33, northing in this Act or the Islamic Banking Act (1983) shall prohibit or restrict any licensed institution from carrying on Islamic banking business or Islamic financial business, in addition to its existing licensed business, provided that the licensed institution shall consult the bank before it carries on Islamic banking business or any Islamic financial business.

The Malaysian Islamic Banking breakthrough was witnessed in 2013 when it rolled out a landmark law, the Islamic Financial Services Act, 2013 that consolidates the regulatory objectives and stringently upholds financial stability of their economy through prudent supervision of the Islamic Banking industry (Islamic financial institutions, Islamic money market and Islamic foreign exchange market). This new law entails all aspects of regulation and supervision from licensing to winding up (Lee and Oseni, 2015). This law repealed the Islamic Banking Act (1983), the *Takaful*Act (1984), the Payment System Act (2003) and the Exchange Control Act (1953). This has shown that the Malaysian regulatory authorities are at the forefront in developing this industry

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in terms of sound regulation to enhance public confidence (Miskam and Nasrul, 2013; Malaysia International Islamic Financial Centre, 2014).

The Malaysian adjustment to its existing laws to accommodate Islamic Banking system would provide important lessons for benchmarking into Uganda to create a legal atmosphere conducive for Islamic Banking without any unnecessary burdens. This is because their regulation has proved to be more robust since the very beginning of the establishment of the first Islamic bank, and they have shown steady rapid progress in this industry compared to other players.

Just like Malaysia, the regulatory framework of financial sector in Uganda comprises a multiplicity of bodies including BoU, which is responsible (under Section 4(2)(j) of The Bank of Uganda Act, 2000 - Cap 51) for the banking supervision, regulation, control and disciplining all financial institutions, and non-banking financial institutions such as pension fund institutions. BoU is also mandated by The Financial Institutions Act (2004) to regulate and supervise banks and credit institutions, whereas the Micro-Finance Deposit-Taking Institutions Act (2003) regulate non-banking financial institutions and micro-finance institutions. Ideally, the regulatory framework of BoU for financial institutions is confined to nine regulations, namely, Licensing, Capital Adequacy Requirements, Credit Classification and Provision, Corporate Governance, Lending Limits, Limits on Credit Concentration and Large Exposures, Liquidity, Ownership and Control and Credit Reference Bureaus as gazetted in 2005 (International Monetary Fund, 1999; ROSC, 2005).

With regard to the relevance of the existing laws in Uganda toward adoption of Islamic Banking, some Islamic Banking practices would amicably adapt themselves to integrate with the country's mainstream financial system even before modifying the existing laws. For instance, the most commonly used products in the market have some features which are consistent with Sharīʿah precepts such as current account, savings account, investment account and borrowing through leasing or hire purchase products. In this regard, if the parties in a contract wish to apply the principles of Sharīʿah, they can do so in their relevant contracting terms that will bind them, given that the contract itself is "the law of the land" as regards to that transaction. Here, the contract is enforceable in accordance with Sharīʿah to the extent that the Sharīʿah is incorporated in (or contains a part of) the laws of such jurisdiction (DeLorenzo *et al.*, 2007).

Like what the Malaysian authorities did to provide a legal ground for conventional banks to operate Islamic Banking window, BoU needs to amend Section 37(a) of the The Financial Institutions Act (2004) and Section 29(3)(a) of The Bank of Uganda Act (2000) (Cap 51), which prohibit commercial banks from engaging in trade, commerce, industry and agriculture. This will allow commercial banks to operate interest-free intervention not only with the public but also with BoU in regard to their cash reserve requirement and other statutory deposits on which they receive no interest. Similarly, Section 38(1) of The Financial Institutions Act (2004) should also be amended to allow commercial banks to invest in immovable property as part of their core business, as most of the Sharīʿah-compliant contracts in Islamic Banking require banks to buy and own assets before transferring them to their customers (Bill No. 16, 2015). The abovementioned amendments are possible if BoU arranges a profit and loss sharing system with

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Islamic banks because it pays interest to conventional banks for such deposits. In this sense, BoU and Islamic bank could take the position of *muḍārib* and *rabb al-māl*, respectively, depending on the nature of the transaction. This arrangement would be reversed when BoU buys shares of an Islamic bank. Here, it shares in both profit and loss as rabb al-māl. This relationship would not shrink its role of granting interest-free loans in dire times just as it does for conventional financial institutions.

Similarly, government needs to consider tax concession in the form of stamp duty that is payable on double-staged transactions of Sharīʿah-compliant products, for example, levying a single charge on what is substantially a single purchase even though two or more contracts are formally executed to comply with Sharīʿah tenets. Section 4 of the Stamp Duty Act (2014) provides for several instruments used in single transaction of sale, mortgage or settlement. This has great implications on some of the Sharīʿah-compliant products that will be transacted in the Islamic Banking industry in Uganda. Though the provision *prima facie* seems to support the nature of Islamic Banking products, a close scrutiny of the sub-sections reveals the possibility of double taxation. This section requires amendments to accommodate the true nature of Islamic Banking products. Such modifications to tax legislation would enable a like-for-like competition between Islamic and conventional banks.

Appropriate Sharīʿah governance model for adoption in Uganda

Although various countries that practice Islamic Banking have demonstrated different practices and models of Sharīʿah governance with some favoring involvement of their regulatory authorities and others choosing otherwise, it is still debatable as to which model is predominant and appropriate for adoption in the emerging markets. It is therefore incumbent on promoters and regulators of Islamic Banking in these new emerging markets to study their country's specifics in relation to the existing models of Sharīʿah governance to choose what best suits their environment. It is from this background that Hasan (2010) categorized the existing models of Sharīʿah governance across different jurisdictions into five regulatory governance models. His categorization was based on three respective jurisdictions (from three predominantly different regions) as the case study, namely, Malaysia, Gulf Corporation Council (GCC) countries and the UK. The distinct governance models are the Proactive approach (e.g. Malaysia), Passive approach (e.g. Saudi Arabia), interventionist approach (e.g. Pakistan), minimalist approach (e.g. most GCC countries) and reactive approach (e.g. UK) (Hasan, 2010).

Given the Ugandan legal (which is not prudently well developed) and corporate environment (dependence on retail and wholesale banking), an effective framework for Sharīʿah governance at the Central Bank level needs to be established to avoid impediments of the system which could result in threatening of credibility and reputation of Islamic Banking industry in the eyes of the public thus causing instability of the industry. This is because the absence of supervision at a national level could result in dubious products and *Fatwas* (ruling). The implementation of Sharīʿah governance framework also mitigates Sharīʿah non-compliance risk, which could result in fund withdrawals and cancellation of investment contracts (Grassa, 2013; Hamza, 2013).

Unlike the developed economies that enjoy maximum prudence in terms of corporate culture and compliance with laws, emerging economies need more stringent regulations

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as their legal systems are yet to be well developed. Therefore, the pro-active model of Islamic Banking would be more robust and suitable for adoption in Uganda. Nevertheless, BoU should monitor the functions of Islamic financial services providers from a Sharīʿah view point to ensure harmonization of Islamic Banking practices. This is because typically Sharīʿah laws are open to various interpretations in different generations and locations. Therefore, different Sharīʿah scholars and councils could have divergent views over key Sharīʿah issues in the Islamic finance industry. In this regard, the regulators in Uganda would need to have a central Sharīʿah Advisory Council at the Central Bank level to decide on broader Sharīʿah issues that impact the whole industry. Meanwhile, detailed and minor Sharīʿah issues should be left to Sharīʿah boards/committees of different banks.

Conclusion and recommendations

This paper has explored the impediments of the existing laws toward adopting Islamic Banking system and their appropriate amendments in the existing laws to allow for establishment and regulation of Islamic Banking alongside conventional banking in Uganda. Although there is no explicit template to follow when introducing Islamic Banking in a conventional setting, experience from other countries has shown that there is no need to adopt or establish any Islamic Law to supersede the prevailing conventional statutes in predominantly non-Muslim countries. For prudential supervision, both Islamic and conventional banking supervision have to be subjected to the same level of supervision as bank regulation has to globally comply with the pronouncements and bank governance requirements of the BCBS to guarantee effective internal rating and control systems.

The Malaysian experience of Islamic Banking regulation has been explored to benchmark the best practices into Uganda. This is due to its robustness in retail and wholesale banking where both legal and Sharīʿah governance frameworks are essential in establishing a viable Islamic financial sector. Uganda being an emerging economy, it needs the pro-active model of Sharīʿah governance regulations, which is more robust to ensure harmonization of practices, although not to the extent of hindering innovation in the industry.

Although a separate Act for Islamic Banking would not be appropriate for Uganda because of the existing law system and "religio-political" ambience, necessary amendments or creation of a separate provision for Islamic banking in the existing law (as Malaysia initially did in the BAFIA) would suffice at this stage of implementation. Meanwhile, BoU would need to make detailed regulation (especially for Sharīʿah governance) for harmonization of *Fatwas* (rulings) on Islamic financial products. However, after establishment of a strong industry, a separate Act for Islamic Banking would be required to create an end-to-end regulation of Islamic banking business to enhance systemic stability.

The paper has observed the need to amend Section 37(a) of The Financial Institutions Act (2004) and Section 29(3)(a) of The Bank of Uganda Act (2000) (Cap 51), which prohibit commercial banks from engaging in trade, commerce, industry and agriculture. These activities constitute the core Islamic Banking business. More still, Section 38(1) of The Financial Institutions Act (2004) should also be amended to allow commercial banks to acquire immovable assets as part of their core business, as most of the Sharīʿah-compliant contracts require Islamic banks to buy and own assets before

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transferring them to their customers. Similarly, relevant modifications need to be considered to the tax legislation to enable a like-for-like competition between Islamic and conventional banking. Specifically, Section 4 of the Stamp Duty Act (2014) requires amendments to accommodate alternative financing modes such as Islamic finance products.

The study has established that Islamic Banking business will require considerable support (prudential supervision and industrial development) from regulators to uphold public trust, as the public have a lot of expectations from Islamic Banking, which the conventional has failed to deliver. This will build confidence in the general public, enhance the integrity of the Islamic financial industry and reduce Sharīʿah risks, thus contributing toward systemic stability.

Note

1. This paper was submitted to the journal when Islamic Banking was still at conceptual stage in the Ugandan Cabinet. Recommendations for amendments from this study were adopted by the Ugandan Parliamentary Finance Committee. The Parliament approved the amendments on January 6, 2016, which have now been incorporated into the Financial Institutions (Amendment) Act 2016.

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Corresponding author
Sulaiman Lujja can be contacted at: lujja.s@hotmail.com

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