AMENDMENT TO THE FINANCIAL INSTITUTIONS ACT AND THE CONCEPT OF ISLAMIC FINANCE IN UGANDA
PART A: INTRODUCTION OF ISLAMIC FINANCE

INTRODUCTION

In response to the global fame of Islamic finance, a growing finance sector in Uganda and the increased need for measured liberalisation of banking regulation, Parliament made a number of regulatory changes to the governing law, the Financial Institutions Act 2004 (the “FIA”), by passing the Financial Institutions (Amendment) Act 2016 (the “FIA Amendment Act”). The FIA Amendment Act was passed by Parliament on 6 January 2016 and received Presidential assent on 19 January 2016.

This article examines the key highlights of Islamic banking as recently introduced by the Financial Institutions (Amendment) Act 2016 (the “FIA Amendment Act”) and other notable aspects such as bancassurance and agent banking.

What are the fundamentals of Islamic finance?

The face of the banking industry in Uganda is set to change in the wake of the passing of the FIA Amendment Act. In what is the singular most important development, the FIA Amendment Act introduces a dual system of Islamic banking alongside conventional banking.

Islamic finance is a financial system governed by Shari’ah law.1 Here below are a few facts on Islamic banking that everyone should be aware of. Shari’ah (or Islamic) law is derived from the religious text of the Koran, and Islamic finance represents a part of these laws. The original and fundamental source for Islamic finance, including Islamic banking, is Shari’ah law, which plays a varying role in different countries. Whereas in several jurisdictions (for example, Saudi Arabia and Sudan), Shari’ah law is the fundamental law of the land (or a key source of the law of the land), in Uganda it does not constitute part of the legal framework. However, Islamic banking has certain inherently attractive requirements and characteristics that would make it a lucrative product for the banking industry.

Why Introduce Islamic Banking in Uganda?

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 2017.2 According to Ernst & Young, by 2020, the global Islamic banking industry profit pool is expected to reach US$30.3 billion.3

1 All italicised words are of Arabic origin
Malaysia, United Arab Emirates, Turkey are on course to touch US$1.8 trillion by 2019. Such growth is partly due to more competitive offers when it comes to Islamic and Shariah-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.

**Who can engage in this type of financing?**

Islamic finance is not limited to Islamic institutions; conventional financial institutions may also adopt this finance system provided they adhere to the principles of Shariah law. Financial Institutions’ clients, both Muslims and non-Muslims, who would have historically used traditional products, will now have the option of choosing Shariah-compliant options.

**Will the existing banks be required to obtain a separate licence to carry out Islamic banking?**

Yes, the existing financial institutions will require a separate license. The FIA Amendment Act allows an already licensed financial institution carrying on financial institutions business to apply to the Central Bank to carry on Islamic financial business in addition to its existing licensed business. The FIA Amendment Act also empowers the Central Bank, in consultation with the Minister of Finance, to make regulations with special provisions for the licensing and operation of Islamic banking. It is expected that since Uganda is a non-Shariah law jurisdiction, the regulations that will be passed under the FIA Amendment Act will provide for licensing requirements that explicitly address the issue of Shariah compliance. It is expected that the regulations will also prescribe a distinct and separate set of fit and proper criteria applicable only to Islamic finance. In regard to fit and proper requirements, it is important for Islamic banking management to be trained and experienced in Islamic banking operations given the unique features of Islamic finance.

To be able to conduct Islamic banking, the FIA Amendment Act states that the already licensed financial institution which is permitted to carry out Islamic banking can only do such business through an “Islamic window”. The Islamic window is defined as that part of the financial Institution, other than an Islamic financial institution, which conducts Islamic financial business. This means that where existing financial institutions acquire a licence to carry on Islamic banking business, it will be distinct from the mainstream financial institutions business. Islamic banking services/products will definitely benefit from the experience and systems that the conventional banking business has. The Islamic window will make possible liquidity management because of the easy access to liquidity support from the conventional banking division of the financial institutions. With anticipated limited market and demand for Islamic banking services in the initial stages, the Islamic window could be the only feasible way of providing Islamic banking services, thus enhancing financial inclusion.

The management and board of the already existing financial institutions will have to be sufficiently attuned to the unique risks inherent in Islamic banking activities. Shariah Advisory Boards are charged with the responsibility of advising, approving and reviewing the activities of Islamic financial business in order to ensure that the financial institution complies with Shariah.

The law has created Shariah Advisory Boards. What are they for?

The FIA Amendment Act requires every financial institution which conducts Islamic financial business to appoint and maintain a Shariah Advisory Board. The Shariah Advisory Board must be separate and distinct from the board of directors appointed for conventional banking operations, and the FIA Amendment Act prohibits a member of a Shariah Advisory Board in any financial institution from being appointed as a director on the main board of directors of a financial institution while he or she holds that position and it is tasked to advise, approve and review activities of the Islamic financial business in order to ensure that the financial institution complies with Shariah law.

However, this does not mean that the financial institutions’ main board of directors is excused from its oversight role. The FIA Amendment Act gives additional responsibility and authority of the main board of directors in relation to Shariah compliance, though, typically, the Shariah Advisory Boards have the ultimate responsibility and authority in advising on Shariah matters.

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4 Ibid.
5 Section 115A of the FIA Amendment Act
6 Section 115A (3) of the FIA Amendment Act
7 Section 115B of the FIA Amendment Act
8 Section 16 of the FIA Amendment Act, amending section 52 of the FIA.
9 Section 115B (4) of FIA Amendment Act
How will financial institutions carrying out Islamic financing be supervised?

The Islamic financing business in the financial institutions will follow the traditional form of supervision at present, and the supervisory authority is Bank of Uganda. However, the FIA Amendment Act has also introduced a Central Shari’ah Advisory Council in the Bank of Uganda to advise the Central Bank on matters of regulation and supervision of Islamic banking systems and approve any product to be offered by financial institutions conducting Islamic banking.10 As in conventional banking, prudential supervision is key to help reduce risks to the soundness of the Islamic banking system. The prescriptions on risk management contained in the existing regulatory framework before the passing of the FIA Amendment Act will apply to all banks in the supervisory process. However, because Islamic banking has special characteristics, the conduct of banking supervision will need to be undertaken in a manner that addresses these characteristics. This is because Islamic financing works within the Shari’ah framework following certain restrictions. Firstly, financial institutions cannot provide finance for an activity which is prohibited by Shari’ah law irrespective of its profitability and economic viability e.g. business of liquor, prohibited foodstuffs under Shari’ah law (such as consumption of pork) and pornography. Secondly, financial institutions will not lend any amount in cash for interest (riba). Consequently, certain financial needs of some sections of the society will be ignored in Islamic financing including personal loans and working capital requirements of not-for-profit organisations. Thirdly, under Islamic financial system when financing is provided, profit and loss have to be shared as per agreement between the parties involved.

Are there other international bodies that oversee Shari’ah finance?

Internationally, there are two significant bodies responsible for the regulation of Islamic finance:

- the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) which determines accounting, auditing, governance, ethics and Shari’ah Standards for Islamic Financial Institutions; and
- the Islamic Financial Services Board (IFSB) which comprises regulatory and supervisory agencies focused on the soundness and stability of the Islamic financial services industry.

We anticipate that these bodies will give guidance to the industry in Uganda.

Are there transactions or products prohibited under Islamic finance?

Islamic finance is largely prohibition driven. Shari’ah imposes a set of ethics that militates against exploitation, and prohibits involvement in activities that are considered morally distasteful. The following are some other examples of prohibited activities/actions:

- **Haram**: The Islamic legal code stipulates that Muslims must not get involved with industries or products that are considered haram (sinful), such as alcohol, gambling, drugs, weapons and pig-related industry. Therefore, these sectors and sub-sectors cannot be the subject of any Islamic financing.

- **Interest**: Islamic finance prohibits interest-based transactions/instruments. Riba (interest) means to increase, grow, or multiply into more than what would be due. Riba is generally prohibited by Islam because it creates societal injustice. The preferred mode of lending should involve equity, sale or leasing. Indeed, the central concept driving the Islamic finance industry is the prohibition of interest on money, which is considered sinful. The rule forbidding the paying or receiving of interest makes it hard for Muslims to use conventional bank products such as savings accounts, loans and mortgages.

- **Speculation/Chance**: There is also an instruction to avoid gharar – excessive risk-taking (for instance spread betting and hedge funds). Gharar (uncertainty/speculation) is prohibited because of the ‘ignorance’ or ‘lack of knowledge’ and the general risk of uncertainty. Gharar exists when two parties enter a contract and one party lacks complete information or when both parties lack control over the underlying transaction. Whilst Islamic teaching encourages trading, investment and charitable giving, it bans the creation of money by money. Furthermore, pure financing such as derivative transactions and hedging instruments is not permitted.

What are the key products or services under Islamic financing?11

Islamic financing is more of a trading activity than a financing activity. Islamic finance is based on risk participation of all parties implying that two or more parties share the risks of a joint venture.

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10 Section 115B (2) of the FIA Amendment Act
11 Section 115B (2) of the FIA Amendment Act. See also Craig Nethercott and David Eisenberg, Islamic Finance: Law and Practice (Oxford University Press, 2012)
The FIA Amendment Act defines Islamic financial institutions as being financial institutions business which includes the business of receiving property into profit-sharing investment accounts or of managing such accounts any other business of a financial institution which is carried out Shari’ah and which includes (1) equity or partnership financing, including musharakah, musharakah mutanaqisah and mudarabah, (2) lease based financing, including al-ijarah, alijarah muntahia bi al-tamlik and al-ijarah thumma al-bai, (3) sale based financing, including istinsa’, bai’ bithaman ajil, bai’ salam, murabahah and musawamah, (4) currency exchange contracts and (5) fee based activity, including wakalaah;

In general, products of Islamic financing can also be listed as ijarah (leasing), istinsa’ (deferred payment, deferred delivery), mudarabah, murabahah, musharakah, qard (benevolent loan), salam (prepayment, deferred delivery), sukuk al istithmar, tawarruq, wadi’ah (demand deposits) and wakalah (agency). Whilst some of the products above are similar to those in conventional banking, commonly used and particular to Islamic financing products are:

- **Mudarabah:** Under mudarabah, a three party arrangement is made where the customer places an order with the financial institution to purchase goods from a supplier. The financial institution, having purchased the goods from the supplier, then sells them to the customer at a price including an agreed mark up with a fixed credit period. The main point here is that the customer has information of the cost of acquiring the specified product from the supplier and the profit margin is negotiated between the customer and the financial institution. The total cost is usually paid in instalments.

- **Musharaka:** This product involves universal cooperation/agreement of two or more parties in a specific venture and whereby the interests of each party are defined. Under musharaka, while the financing institution contributes capital, other party contributes capital and expertise. Like mudarabah financing, earnings are shared based on a pre-agreed percentage. Losses, on the other hand, are shared pro rata to capital contribution.

- **Murabaha:** Similar to the musharaka, it also relates to the financing of a common venture. What is peculiar to the mudaraba is that one party provides capital and the other investment management. Ordinarily, only one party bears the financial loss since the other party’s contribution is management of the venture.

- **Sukuk:** Referred to as Islamic bonds, sukuk are trade-able securities similar to bonds. There are various types of sukuk structures relating to the nature of the underlying asset. However, in common terms, sukuk can be defined as a certificate representing a proportionate ownership interest in any right deriving from underlying tangible asset or revenue (such as ownership of an asset, management agreement, business, partnership, construction agreement). In this regard, the purchaser of a sukuk certificate replaces the issuer in pro-rated ownership of the assets. The issuer is obliged to pay the sukuk holders irrespective of the performance of the asset.

- **Takaful:** The alternative to conventional insurance. Unlike conventional insurance which is a commercial contract based on the happening of an event, takaful insurance is insurance based on Shari’ah concepts of mutuality and cooperation. The arrangement is beneficial for both the operator and the participant.

- **Wakala:** This product is based on an agency contract/relationship. The principal (investor) appoints the agent (wakeel) to manage specific tasks on its behalf; for instance sale and purchase of an asset and investment aspects of a business. The investor only receives the profits agreed upon at the commencement of the arrangement and any additional revenue is for the account of the agent.

The FIA Amendment Act states that all contracts for Islamic finance business have to comply with Shari’ah and satisfy any conditions specified by the Bank of Uganda for that purpose. It is evident that the FIA Amendment Act will be followed by a number of regulations to operationalise it.

An important purpose underlying the regulatory framework for Islamic banking is to avoid undermining the stability of the financial system. Key elements to achieve this objective include: i) understanding the nature of Islamic banking activities, ii) making appropriate changes to the existing regulatory framework for financial institutions to support Islamic financing and iii) levelling the playing field between Islamic banking and conventional banking.

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12 In light of section 11 and 115D of the FIA Amendment Act, financial institutions can now engage in bancassurance business.

13 Section 1(m) of the FIA Amendment Act.
PART B: OTHER NOTABLE AMENDMENTS TO THE FINANCIAL INSTITUTIONS ACT

Other notable amendments to the Financial Institutions Act are:

**BANCASSURANCE**

In an initiative designed to achieve increased liberalisation of banking laws, the FIA Amendment Act now permits financial institutions to provide bank insurance (more commonly referred to as bancassurance) with the written authorisation of the Central Bank.\(^4\) Previously, there was an express prohibition in both the FIA and the Insurance Act Cap 213 that barred financial institutions from engaging, directly or indirectly for its own account, alone or with others, in insurance.\(^5\)

The Insurance (Amendment) Act 2011 lifted this prohibition and specifically classified bancassurance as insurance business\(^6\), and the consequential amendment in the FIA Amendment Act now permits licensed entities in the banking and insurance sectors to collaborate freely.

Bancassurance is an arrangement between a financial institution and an insurance company in which the financial institution and insurance company sell insurance products (life and non-life) to the bank’s customer base, and using facilities and channels provided by the financial institution. The FIA Amendment Act defines bancassurance to mean using a financial institution and its branches, sales network and customer relationships to sell insurance products.

From the point of view of a financial institution, bancassurance enables the provision of integrated and tailor-made financial services to the bank’s customers while simultaneously increasing its revenue streams. Bancassurance also achieves the added economic benefit of distributing insurance products to a wider mass market.

The common models under which bancassurance is undertaken are (a) a tie-up with an insurance company, where the bank only markets the products of the insurance company or (b) full integration, where there is a merger of banking and insurance services and the bank sells the insurance products on its own account and under its name. In such cases, it is common for banks to form fully-fledged bancassurance business divisions or to incorporate specialist bancassurance subsidiaries.

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\(^4\) Sections 11 and 11.5D of the FIA Amendment Act

\(^5\) Section 37(a) of the FIA barred financial institutions from engaging in insurance or insurance-related business. Under section 5(b), the Insurance Act did not include bancassurance as part of non-life insurance business.

\(^6\) Section 3(b)(xi) of the Insurance (Amendment) Act 2011.
Agency banking
The FIA Amendment Act now permits the conduct of agent banking with the authorisation of the Central Bank. Agent banking means the conduct by a person of financial institution business on behalf of a financial institution, and an agent is a person contracted by a financial institution to provide financial institution business on its behalf.

Notably, agent banking will allow financial institutions to expand their branch networks without having to incur the significant capital outlay of setting up actual physical branches. This capital cost will now be passed onto the agent.

The introduction of agent banking is a further initiative designed to achieve increased liberalisation of banking and simultaneously enable the extension of financial services to Uganda’s vast un-banked population.

Definition of non-performing asset to include rent and other payments
The FIA Amendment Act has re-cast the definition of a non-performing asset to include the aspect of outstanding rent and any other payment. The previous definition of the non-performing asset under the FIA meant a loan, credit accommodation or asset whose principal or interest has been due and unpaid for ninety days or more, or where its principal or interest payments, overdue by ninety days or more have been capitalized, restructured or renewed.

The re-cast definition is now expanded to include principal, interest, rent or other payment that has been due and unpaid of ninety days or more.

Shareholding in financial institutions
The protection and preservation of the controlling interest in a financial institution has been strengthened in the following ways:

- The prohibition on acquiring more than forty nine per cent shareholding in a financial institution has been extended to:
  - a group of related persons; and
  - a corporate body owned directly or indirectly by a group of related persons.

The Financial Institutions (Ownership and Control) Regulations, 2005, which reiterate the less restrictive provision of the law, has not been amended. It is arguable that in so far as the regulations make reference to the FIA, they are indirectly amended by the FIA Amendment Act. Secondly, since an Act of Parliament is superior to the regulations made under it, the amendment to the FIA prevails.

- The requirement for written consent from the Central Bank before registration of any transfer of shares by a financial institution. Previously, the transfer was effected upon presentation of a letter of no objection from the Central Bank.

Capital adequacy
In addition to the increment of the minimum on-going capital requirements by statutory instrument, the Central Bank is authorised to require financial institutions to maintain capital buffers.

The requirement in the FIA Amendment Act to maintain capital buffers is consistent with the recommendation in the Basel III Accord. The Basel Accords are a set of voluntary bank supervision recommendations issued by the Basel Committee on Banking Supervision. The policy objective of requiring financial institutions to maintain capital buffers flows from the Basel III Accord, and is designed to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance and strengthen banks' transparency and disclosures.

Corporate governance
In line with corporate governance best practices and to enable the committee oversee the financial management of the institution without influence; an executive director is now prohibited from sitting on the audit committee.

The external auditor is required to disclose all shortcomings or any contravention of the law whether or not it is sufficiently fundamental to lead to qualification of accounts.

Access and use of credit reference bureau information
Information from the credit reference bureau can now be disseminated to credit or service providers subject to regulations that will be issued.

The Central Bank in its discretion can diversify the provision of credit reference bureau services and license a Biometric Identification Service Provider.

Conducting a credit check by financial institutions on all customers applying for credit is
now mandatory.28 No monetary or other threshold is provided which implies that the Bank should conduct a credit check on all applications for loans regardless of amount or risk. Financial institutions, credit and service providers are only allowed access to the credit reference bureau for purposes of conducting credit checks until the central bank by statutory instrument prescribes other situations that may warrant credit checks.

Supervision – Disclosure
The disclosure requirement for loans or other credit granted or extended to insiders has been relaxed and should be provided at least once every quarter as opposed to monthly.29

Corrective actions
In order to prevent adequately capitalised financial institutions from suffering large loss, the Central Bank is now also allowed to prohibit the financial institution from making any distributions, bonuses or increments in salary, emoluments and other benefits of directors and staff of the financial institution.30 Large loss has been defined to mean any loss that constitutes twenty five per cent of a financial institutions core capital.

Receivership and liquidation
Previously, the Central Bank was the only entity that could place a financial institution under receivership. The Central Bank now has powers to appoint a receiver to act on its behalf in implementing the options available under receivership.31

The frequency of publication of a notice requesting for creditors statements of claims for an institution under receivership has been stipulated. The notice must be published once a week for four consecutive weeks.32

The FIA Amendment Act limits the liquidator’s liability where he/she/it places reliance on a professional’s opinion or financial statements of the financial institution in making a decision.

The Central Bank may procure an order of the High Court to examine a person concealing, withholding or misappropriating property of the financial institution. The legal remedies available are restoration of the property or payment of compensation to the liquidator.33

The Deposit Protection Fund
The fund held by the Central Bank under the FIA will be merged with the fund under the Microfinance Deposit Taking Institutions Act. The deposit protection fund is now a body corporate and separate from the Central Bank governed by a board.34 The administration costs of the board will be paid from the fund. Institutions that show unsatisfactory or marginal ratings will no longer average out their charges as the provision that previously provided for this has been omitted in the FIA Amendment Act.35

Money laundering – Reporting requirements
The reporting requirement for suspected money laundering activities under the FIA and the Financial Institutions (Anti-Money Laundering) Regulations, 2010 to the national law enforcement agencies created several legal challenges for financial institutions.36 Notably, it was difficult to define which agency suspicious transactions were to be reported to, and there were reservations about the ability of the concerned agencies to maintain confidentiality of client information.

The FIA Amendment Act has resolved the challenges by providing that any suspected anti money laundering activity should be reported to the Financial Intelligence Authority.37 The Financial Intelligence Authority is a regulatory body established under the Anti-Money Laundering Act 2010 to enhance the identification of the proceeds of crime and the combating of money laundering.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.
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