



Enhancing financial inclusion in Uganda: Is Islamic financing a potential solution?

Overview

The theme of Uganda’s second National Development Plan (NDP II) is strengthening Uganda’s Competitiveness for Sustainable Wealth Creation, Employment and Inclusive Growth. Access to financial services is viewed as a vehicle to alleviate poverty through financial inclusion and its potential to create entrepreneurship.

Financial inclusion is broadly defined as a measure of the proportion of individuals and firms that use financial services. It is one of the most critical avenues for households and enterprises to create wealth, employment and sustainable growth which is necessary to propel the country to middle income status. Additionally, it seeks to ensure that all households and enterprises regardless of income level have access to, and can effectively use the appropriate financial services that they need to improve their lives.

Traditionally, financial inclusion of an economy is measured by the proportion of the population covered by commercial bank branches and automated teller machines (ATMs), sizes of deposits and loans made by low-income households and Small Medium Enterprises (SMEs). However, availability of financial services may not equal financial inclusion, because people may voluntarily exclude themselves from the financial services for religious or cultural reasons, even though they do have access and can afford these services.

This policy brief discusses a new product of Islamic financing and its role in increasing financial inclusion. In addition, it discusses the bottlenecks and makes recommendations.

Key Issues

To foster the desired inclusiveness, it is important to address the bottlenecks under Islamic microfinance. These include;

- Difficulty in using the applicable accounting standards.
- Absence of the necessary regulatory framework and oversight.
- Knowledge gap regarding Sharia rules.
- Myths and sentiments surrounding Islamic finance.
- Inadequate staffing levels of the implementing institution.

Introduction

Islamic Microfinance is guided by the Tier 4 Microfinance Institutions and Money Lenders Act (2016).

The Microfinance Support Centre (MSC) was identified by the Government of Uganda to spearhead the implementation of the microfinance sector. The MSC, with support from Islamic Development Bank and Bank of Khartoum (IRADA Microfinance) commenced development of the Islamic Microfinance Framework in 2015, and subsequently started disbursement in 2017.

Islamic Microfinance is guided by the principles of Islamic (Sharia) law that emphasizes moral and ethical values in all dealings, prohibiting the payment or receipt of interest (*riba*). It also prohibits investment in businesses involving piggery, alcohol, prostitution and gambling among others.



Project financing is given after comprehensive feasibility assessments of the client projects that meet Sharia compliance conditions regardless of religious affiliation of the business owners.

Models of Islamic Micro-financing

The MSC currently offers six (6) models of Islamic microfinancing, these include:

a) **Musharaka (Equity financing /partnership)**

This is a joint venture between two or more partners, in which the partner contributes the capital (Musharaka capital) and shares profits and losses generated by the venture in accordance with the percentage contributed to the Musharaka contract.

b) **Murabaha (cost plus financing)**

This is a transaction of sale of goods at their capital cost plus an agreed profit mark up. In this mode of financing, the seller declares the cost at which the goods were purchased, and stipulates the amount of profit. The purchase price and the profit should be known to the purchaser.

c) **Mudaraba (profit sharing)**

This is a form of partnership where one party - the financier or the investment capital owner (*Rab-Alma*), provides the investment capital; while the other party, who operates the business (*Mudarib*), provides expertise and effort to run the business. *Rab- Almal* may not engage in the management process, but will periodically monitor the progress of the project financed.

d) **Salam (Forward sale)**

This is a contract where advanced payment is made for goods to be delivered at an agreed future date. The price is referred to as *Salam*

capital/fund, and the good as *Salam* good. The *Salam* capital could be in cash or kind.

e) **Muqawala**

This is a contract where one party undertakes to manufacture an item, or perform work for compensation.

f) **Istisna**

This is a long-term contract where a party undertakes to manufacture, build or construct an asset, with an obligation from the manufacturer to deliver the asset to the customer at a future date for a fixed, agreed-upon price and with product specification that both parties agree to.

The introduction of Islamic finance has the potential to boost financial inclusion as it does not require ownership of a physical asset, a requirement that has prohibited many people from accessing loans. The asset in this case is intangible and heavily relies on the security of the business.

How Islamic microfinance works

Islamic Financing has the same purpose as conventional microfinancing, except that it operates on a profit and loss sharing principle. For instance, when a financial institution (MSC in this case) invests in a client's project, the proceeds from the project are shared.

Conversely the conventional banking system is based on paying interest at a predetermined rate on money deposited. Since both payment and receipt of interest is prohibited by the Sharia law, Muslims generally abstain from banking. Through Islamic banking, financial inclusion can be promoted and a larger pool of savings can be brought into the economy.

With Islamic Financing, there is no concept of loaning, this promotes deeper financial inclusion that has a direct correlation with economic growth acceleration. In addition,



Islamic micro finance provides an alternative to tap voluntarily unbankable individuals who have refrained from using formal financial services due to religious or ethical reasons.

Key beneficiaries

From the periodic assessments, the projects have benefited 15,585 individuals, of which 33% were female and 67% male, as detailed in the table below. Unfortunately, age and regional disaggregated data was unavailable since the project had just started and emphasis was on social economic development models.

Table 1.1 shows the categories of beneficiaries in different sectors by March 2018.

Table 1.1 Categories of beneficiaries by 1st March 2018

Category of beneficiaries	No.	Sector	No. of end beneficiaries
SACCOs	17	Agriculture value chain	5,500
Unions	3	Agriculture(Livestock, Coffee & Cotton)	7,850
SMEs	38	Commercial & Agriculture	1,250
Village Savings and Loan Associations/ Groups	3	Agriculture, Commercial & Service	420
Micro Finance Institutions	2	Agriculture	565
Total	63		15,585

Source: MSC Headquarters

Categories of beneficiaries include: women who operate through partnerships such as- Numa Feeds Limited, which is a small-scale rural-based agribusiness company located in the districts of Bushenyi, Mbarara and Ibanda. By purchasing raw materials from the local farmers, Numa provides a source of income to the people which they use to pay school fees, buy food and generally afford to live better. Majority of the farmers are mainly progressive women who specialize in growing; cassava, maize, soya, rice and millet, this has helped empower them to support their families. The activities of Numa

have significantly assisted in reducing malnutrition especially among children and pregnant women, improved food security at household level, and provided employment to 15 women groups (327 members) and 4 groups of youth (63 members).

Savings and Credit Cooperatives (SACCOs) for example Kihanga Mparo, Buhanga and Chahi Dukore were funded under the mode of unrestricted *Mudaraba*. Through this mode of financing, most women and the youths are reached as long as they are engaged in Sharia compliant businesses.

Performance of Islamic Micro financing

Under the Rural Income & Employment Enhancement Project, USD 9.035 million was allocated for Islamic financing. As at March 2018, the MSC had disbursed 82% of the allocated funds to 63 client projects country wide, some to a tune of up to UGX 2bn. From the disbursements, the uptake of the Islamic product has increased, representing 41% of the total disbursements by half year FY 2017/18.

By 31st December 2017, the company had a 40% increase in outstanding portfolio to UGX 91.50bn from UGX 65bn at 30th June, 2017 growth in disbursement points to expanded funding on account of Islamic funding. Kampala zone with the biggest region had the highest value of loans (UGX 10.109bn disbursed), 60% attributed to the enrolment of Islamic financing.

Key-bottlenecks to Islamic Micro financing

Difficulty in using applicable accounting standards: Absence of accounting standards has substantially constrained the expansion of Sharia-compliant microfinance. This is due to inability to report on them by the financial institutions using internationally accepted reporting standards.

Absence of the necessary regulatory framework and oversight: Although Islamic microfinance is developing fast, the Central



Bank has not yet incorporated this special category into the existing regulatory and accounting framework. Sound regulation is essential for a well-functioning financial sector. More effort is needed to ensure effective regulation of Islamic financial institutions.

Inadequate staffing levels: The MSC zonal offices are understaffed with an average of five staff hence it is difficult to adequately monitor the activities of several SACCOs in different districts. Field findings by the Budget Monitoring and Accountability Unit (BMAU) in January 2018 showed an increase in the number of Islamic financing clients in Mbarara zonal office, however due to limited staff, monitoring and implementation of action plans drawn with clients, and follow up on loans becomes a challenge since the same few staff are expected to carry out other responsibilities as well.

Knowledge gap regarding Sharia rules: There is limited awareness within the workforce on Sharia rules. Uganda also still lacks professional human capital on Islamic banking. This challenges the potential of Islamic financing since the industry is still in its infant stage. The knowledge gap increases the risk of the institutions' deviation from Sharia rules and deters Sharia-compliant financial product innovation.

Myths and sentiments surrounding Islamic finance: As the awareness continues to increase, there are some sections of the target beneficiaries that bear myths and sentiments surrounding Islamic finance. Some believe that it is only for Muslims. The MSC Islamic Finance Implementation Unit continues to sensitize and train prospective beneficiaries, although this has also faced a challenge of limited capacity building funds to effectively cover the target group.

Conclusion

Islamic Micro financing is transformable into a widely available and valid source of micro finance. Its contribution to increased production of coffee and cotton, which are strategic crops would lead to an increase in export production and foreign exchange earnings. The modality is faced with some challenges for example myths and sentiments surrounding Islamic finance, difficulty in using applicable accounting standards. There is need for education, training, better coordination and the development of an enabling regulatory and policy environment.

Recommendations

- Religious and cultural differences should be effectively and efficiently resolved if Islamic banking is to prosper. This can be addressed by the Central Bank, religious bodies, and Islamic banking institutions creating adequate awareness about the needs, objectives and advantages of the project.
- Uganda should benchmark financial inclusion methods in countries such as India, Malaysia, and Bangladesh that have managed to entrench it among women and rural communities through technology and digitalization. This can be coupled with other measures such as agency banking and mobile money to extend financial inclusion.

References

- The MSC Head office and BMAU Field findings.
- Financial Institutions Act, 2004
- Government of Uganda, Second National Development Plan (NDPII) 2015/16-2019/20.

Budget Monitoring and Accountability Unit
Ministry of Finance, Planning and Economic
Development. Plot 2-12 Apollo Kaggwa Road,
P.O. Box 8147 Kampala. www.finance.go.ug