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FINANCIAL MARKETS IN ADVERSE LEGAL ENVIRONMENT: A CASE OF ISLAMIC BANKING IN TANZANIA

Abstract

The performance of financial markets largely depends on a legal environment that fosters stability, certainty, and regulatory clarity. Islamic banking, as a key player in financial markets in Tanzania is a *Shariah*-compliant entity in addition to observing laws of the land. On the part of the laws of the land however, Islamic banking is regulated by the legal framework primarily designed for conventional banking, offering inadequate accommodation to *Shariah*-compliant practices. This arrangement implies that, Islamic banking in Tanzania operates in an adverse legal environment. This fact awakened academic-curiosity of the Authors of this study to analyze the banking legal framework with a view of identifying legal challenges impacting Islamic banking operations. In so doing, the study employed documentary review and interview to gather relevant information. The information gathered, was interpreted qualitatively enhanced by a combination of a black-letter and socio-legal

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analysis. Findings of the study confirm that, Islamic banking in Tanzania operates in an adverse legal environment due to the existence of legal challenges that include: inadequate accommodation of *Shariah*-compliant practices in the banking legal framework; restrictive eligibility criteria for acquiring a banking license; constraints on asset based financing and liquidity management; the lack of central *Shariah* Advisory Board; and double taxation on Islamic financial transactions. The study recommends for amendments of the existing laws to accommodate *Shariah*-compliant practices. The amendments are essential to creating conducive legal environment that supports Islamic banking and strengthens financial markets in Tanzania.

Keywords: Islamic Banking, Financial Markets, *Shariah* Compliance, Regulatory Framework, Tanzania.

JEL Classification: D53, E52

1. Introduction: Issue and Methodology

This study analyses banking legal framework with regard to Islamic banking in Tanzania. The study submits that, Islamic banking as a key player in financial markets operates in an adverse legal environment that derails their performance. Ordinarily, Islamic banking is to be regulated by a dual legal framework namely: laws of the land; and *Shariah*-compliant practices. Nevertheless, the banking legal framework does not accommodate *Shariah*-compliant practices. This amounts to adverse legal environment that needs revisiting. In order to achieve the main objective of this study, the study employed a qualitative research design that utilized a combination of doctrinal and empirical methodology, integrating black-letter and socio-legal approaches to analyze the existing banking legal framework. The analysis aims at identifying legal challenges impacting Islamic banking operations, and proposes legal reforms that can accommodate *Shariah*-compliant practices.

The study is informed by the data collected through documentary review, where various sources including statutes, regulations, and industry reports as well as scholarly books, journal articles, and research papers on Islamic banking and financial regulation were examined. In order to supplement doctrinal findings, empirical data were collected through interview method from 20 respondents in various Islamic banks in Tanzania, ensuring participation from key industry stakeholders. In reporting, the thematic analysis method is applied to develop themes and to examine key issues affecting Islamic banking under the current legal framework. The study therefore, identifies

legal challenges impacting Islamic banking operations and proposes best ways to improve the legal environment to support its growth and sustainability and ultimately enhance the financial markets.

2. Background

Financial markets in Tanzania through the banking sector plays an essential role in driving economic transformation, serving as the main channel for capital mobilization and financial intermediation [Epaphra, Kiwia 2021: 17]. The banks facilitate investments, savings, and credit access, thus, enhancing financial inclusion and economic stability for a significant proportion of the population [Cranston 2002: 29]. In Tanzania, the banking sector operates through different modes, including commercial banks, microfinance banks, community banks, and other specialized financial institutions [operating under interest-based modes and are herein referred to as Conventional banks], and each is tailored to meet diverse financial needs. These institutions operate under the supervisory authority of the Bank of Tanzania, ensuring compliance with national financial laws and monetary policies to create market transparency, financial stability, and consumer protection [Binamungu, Ngwilimi 2006: 26].

Over the past two decades, the banking sector in Tanzania witnessed the emergence of another distinct mode of banking, the Islamic banking. This banking model operates in adherence to Islamic law (*Shariah*), which governs not only religious practices but also the economic conduct of Muslims [Chau 2014: 114]. Islamic banking distinguishes itself by adhering to *Shariah* principles, which prohibits interest (*riba*), as emphasized in the *Qur'an*, as well as excessive speculation (*gharar*), and investments in prohibited (*haram*) industries such as gambling, alcohol, cigarettes and other unbecoming conducts [Vahed 2015: 21]. Unlike the conventional banks, which operate on an interest driven model, Islamic banks follow the principles of equity, mutual benefit, and risk sharing [Issa 2018: 8]. They offer financial services such as *Murabahah* (cost plus financing), *Mudarabah* [profit sharing], and *Musharakah* (joint ventures), where returns depend on the success of the investment [AAOIFI Shari'ah Standard on Islamic Finance Products 2010]. Depositors share in the bank's profits and bear potential losses, while deposits are safeguarded but do not yield returns. Islamic banks further strive to reinforce fairness and ethical financial practices [IFSB Standard on Islamic Financial Products

and Services, IFSB-17 2010]. According to the Government of Tanzania reports, Kenya Commercial Bank was the first institution to receive a licence to offer Islamic banking services in Tanzania through its Islamic window, *KCB Sahl Banking*, in 2008 [Bank of Tanzania 2019]. The Government's report further shows that, in the year 2011, Amana Bank was established, which now stands as the only fully-fledged Islamic bank, operating through ten branches nationwide [Bank of Tanzania 2021]. Recognizing the growing demand for *Shariah*-compliant financial services, several conventional banks, including the National Bank of Commerce, the People's Bank of Zanzibar, CRDB Bank PLC, and Azania Bank, have also ventured into Islamic banking through Islamic windows catering for diverse financial needs [Bank of Tanzania 2024].

In the year 2019, the sector saw further innovations as Vodacom PLC, in collaboration with Amana Bank, introduced *Halal Pesa*, a microfinance product tailored for *Shariah*-compliant savings and investments, reflecting the growing demand for ethical financial solutions [The Citizen 2019]. This momentum continued in the year 2022 when Kenya Commercial Bank launched the country's first public Islamic bond, the *Fursa Sukuk*, to finance *KCB Sahl Banking*. The bond received an overwhelming response, surpassing its subscription target by 10 per-cent [KCB Bank Tanzania, 2022]. *Fursa Sukuk* is listed in the Dar es Salaam Stock Exchange, thus enhances market liquidity and expands participation in *Shariah*-compliant financial activities [The Citizen 2022]. Despite its evident progress, Islamic banking faces significant challenges due to the adverse legal environment. The banking legal framework in Tanzania is not fully supportive of *Shariah*-compliant practices. Islamic banks currently operate under a framework primarily designed for conventional banking, offering inadequate accommodation for the distinct principles of Islamic finance [Suddy 2021: 4]. Inadequate accommodation of Islamic banking creates substantial compliance difficulties; as financial institutions must align their *Shariah*-compliant services with regulations that do not consider the unique nature of Islamic finance [Habiba, 2017:17]. The study therefore, identifies legal challenges impacting Islamic banking and recommend for a way forward.

3. Conceptual Framework

Conceptual framework presents concepts of the key variables and their relationship in the context of this study. It aims at enhancing understanding of the concepts as they are applicable in this study. Accordingly, the conceptual

framework herein conceptualizes financial markets, Islamic banking, Islamic Banking Products and Services [Financing Modes], and Islamic Banking Structures.

3.1. Financial Markets

Financial markets are platforms or systems that facilitate the exchange of financial instruments, such as bonds, credits, equities, currencies, and derivatives, enabling interactions between financial buyers and sellers [Epaphra, Kiwia 2021: 8]. As such financial markets include: capital market; credit market; and currency market as per Section 3 of the Bank of Tanzania Act, No. 4 of 2006; Section 3 of the Banking and Financial Institutions Act, No. 5 of 2006; Section 2 of the Capital Markets and Securities Act [Cap. 79 RE 2002]; and Section 4 of the Foreign Exchange Act [Cap. 271 RE 2002]. Financial markets play a crucial role in capitalist economies by allowing the raising of capital, transfer of risks, and the promotion of commerce [Mishkin & Fredrick: 2015:24 – 25]. Within these markets, the banking sector serves as a fundamental intermediary, connecting surplus units [savers] with deficit units [borrowers], thus ensuring efficient capital allocation and liquidity provision [Mishkin, 2019:64]. The function of banks as fundamental intermediaries can be exemplified in the case of *The M & Five B Hotels and Tours Limited v. Exim Bank Tanzania Limited*, Commercial Case No. 104 of 2017, *The High Court of Tanzania Commercial Division at Dar es Salaam [Unreported]*.

In this case, the court's records indicate that, in the year 2011, the Plaintiff commenced the construction of a five star hotel project in its landed property on Plot No. 47 Block EE Ngarenaro, Arusha Municipality. In the course of the construction, the Plaintiff experienced a budget deficit derailing the project. Since, the project was at an advanced stage and because, equity financing and the finance generated from third party related companies could not cope with the construction speed and objectives, the Plaintiff resolved to seek loan from Exim Bank Tanzania Limited, the Defendant in this case. In the course of adjudicating the case, the High Court of Tanzania narrated that, the project operates within certain constraints of time, money, quality and functionality. It needs to have a clear beginning and a definite end. By granting the project loan, the Defendant impliedly assumed the role of a co-owner and beneficiary of the project. The project loan is provided to corporate borrowers for the purposes of capital expenditure and it is

a loan structure that relies primarily on the project's cash flow for repayment with the project's assets, rights and interests held as secondary collaterals. It is for this reason, among others, that before committing and extending credit to a project, lenders reviews the credit worthiness of the borrowers, credit risk appraisals, and seeks to ascertain the risks associated with the extension of the credit facility. By so doing, the lender is showing great financial interest and actually is a partner in the success of the project. Thus, this case clearly shows that banks are vital in financial markets to service both entities with budget surplus and budget deficits.

In Tanzania, the Bank of Tanzania is the highest organ mandated to play a central role in fostering the development of financial markets by providing an enabling environment as per Section 5 of the Bank of Tanzania Act, No. 4 of 2006; and Section 4 of the Banking and Financial Institutions Act, No. 5 of 2006. The Bank of Tanzania is further mandated to facilitate financial markets infrastructure, participate in making and the enactment of appropriate legislation, and oversees and designs market instruments as per Section 5 and Section 70 of the Bank of Tanzania Act, No. 4 of 2006; and Section 4 and Section 71 of the Banking and Financial Institutions Act, No. 5 of 2006. The effectiveness of financial markets, therefore, relies significantly on the strength and stability of banking institutions, as they influence monetary policies, investment flows, and the general economic growth [World Bank 2021]. At this juncture therefore, it suffices to assert that, banks and financial institutions are vital players in the financial markets. Accordingly, Islamic banking is among the major platforms for trading financial instruments.

3.2. Islamic Banking

Islamic banking represents a unique financial system that operates in accordance with *Shariah* (Islamic law) while also adhering to the legal framework of the jurisdiction in which it operates [Mzee 2016: 11]. This dual compliance ensures that Islamic banking maintains ethical integrity while also fulfilling regulatory requirements such as financial reporting, consumer protection, and anti-money laundering measures [Lewis 2022: 71]. To qualify as an Islamic financial institution, banks must integrate religious principles into their operations, ensuring that all financial activities, including deposit taking,

investment, financing, and asset management, comply with *Shariah* principles [AAOIFI Shari'ah Standard No. 1: Trading in Currencies 2004].

These principles prevent any form of exploitation in financial transactions. *Shariah* strictly prohibits *riba* [interest] in lending and borrowing, as it creates financial imbalances and contributes to social inequality [Iqbal, Mirakhor 2017]. The *Qur'an*, which serves as the primary source of Islamic law, states: “*Allah has permitted trade and has forbidden interest (riba)*” [Qur'an 2: 275]. The *Qur'an* also cautions against *gharar* (excessive uncertainty), forbidding transactions involving speculation, deception, or ambiguity. Investments in sectors such as alcohol, gambling, and other activities considered immoral or harmful to individuals and society, are prohibited [Al-Dhareer 2007: 41]. Instead of deriving income through interest-bearing transactions, Islamic banking relies on risk sharing arrangements, whereby financial returns depend on the performance of the underlying investment [IFSB Revised Standard on Disclosures, IFSB-22 2023]. Under this model, depositors participate in both the profits and possible losses of the bank's ventures, whereas demand deposits are protected but do not earn any returns. This approach promotes equity and upholds ethical standards in financial dealings [AAOIFI Shari'ah Standard on Islamic Finance Products 2010].

Internationally, Islamic banking is governed by a growing body of standards and guidelines developed by regulatory and standard-setting bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The IFSB sets prudential and supervisory standards to enhance financial stability within the Islamic finance sector, offering frameworks on capital adequacy, risk management, liquidity, and corporate governance in line with *Shariah* principles [IFSB 2021]. AAOIFI, on the other hand, provides globally recognized standards for accounting, auditing, *Shariah* governance, and ethics for Islamic financial institutions, helping to ensure transparency, consistency, and credibility in Islamic banking operations [AAOIFI 2024]. Together, these institutions play a vital role in harmonizing Islamic banking practices across jurisdictions, addressing challenges arising from diverse interpretations of *Shariah*, and fostering the development of a robust and resilient Islamic financial ecosystem [Sulayman 2015].

3.3. Islamic Banking Products and Services

Some of Islamic banking products and services (financing modes) are similar to financial products and services offered by conventional banking such as savings accounts, investment accounts, and currency exchange. What sets Islamic banking apart from conventional banking is their strict adherence to *Shariah* principles. *Shariah* principles prohibit the charging of *riba* and *gharar* [Sulayman 2015: 32]. Beyond these fundamental services, Islamic banks primarily focus on more advanced financing structures such as *Murabahah* (cost plus financing), *Tawarruq* (commodity based financing), *Ijarah* (leasing), *Musharakah* (joint venture), *Mudarabah* (profit sharing investment), and *Sukuk* (Islamic bonds), among others. These financing modes provide ethical and risk sharing financial solutions that distinguish Islamic banking from conventional banking [Jabir 2017].

In a *Murabahah* transaction, the bank purchases an asset and sells it to the bank-customer at a profit, with the cost and profit margin clearly disclosed, the customer then pays for the asset in instalments [AAOIFI Shari'ah Standard on Islamic Finance Products 2010]. *Tawarruq* on the other hand, is used to provide liquidity by facilitating a series of *Murabahah* transactions involving commodities, ultimately converting goods into cash without involving payment of interest [Jassat 2014: 23]. Under *Ijarah* however, the bank buys and leases out an asset to the customer for a fixed period and price. The bank retains ownership of the asset, and the customer pays rent [AAOIFI Shari'ah Standard No. 1: Trading in Currencies 2004]. In a *Mudarabah* arrangement, the bank provides capital to an entrepreneur or business-owner, and profits are shared according to a pre-agreed ratio. The loss is borne entirely by the provider of the capital, while the entrepreneur loses only their effort and time [IFSB Standard on Islamic Financial Products and Services, IFSB-17, 2010]. On the part of *Musharakah*, a partnership is formed, where all parties contribute capital and share profits and losses according to their equity-stake. *Sukuk*, on the other hand, is similar to bonds but is asset backed and provide returns to investors without the payment of interest [TanzaniaInvest 2024].

Some of the Islamic banking products and services were explained in the case of *Shymaa Commission Agent Co. Ltd v. KCB Bank Tanzania Limited and Another, Land Case No. 103 of 2022, The High Court of Tanzania Land Division at Dar es Salaam (Unreported)*. In the said case, *Murabahah* and *Tawarruq* were explained

as follows: *Murabahah* is derived from the Arabic word *ribh*, which means profit. It is a contract in which Islamic banks, finance the bank-customer by providing an asset in exchange for money as a profit. The purpose is to finance purchases without involving payments of interest. *Tawarruq* is the process of purchasing a commodity for a deferred price determined through *Musawamah* (bargaining) or *Murabahah* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash. Thus, Islamic banking products and services reinforce the ethical foundation of Islamic banking by promoting risk sharing, ensuring asset backed transactions, and fostering a fair and transparent Islamic financial system.

3.4. Islamic Banking Structures

Islamic banking in Tanzania operates through three main structures: fully-fledged Islamic banks, Islamic windows, and Islamic branches. A fully-fledged Islamic bank is an independent financial institution that strictly adheres to *Shariah* principles, ensuring that all transactions comply with Islamic law and prohibiting income from *Shariah* non-compliant sources [Mussa 2024: 8]. Amana bank is the only fully-fledged Islamic bank in Tanzania, operating ten branches across the country, including five in Dar es Salaam and others in Mwanza, Arusha, Tanga, Pemba, and Zanzibar [Bank of Tanzania 2024]. Its governance structure includes a *Shariah* Board, along with various committees that ensure compliance with Islamic principles while maintaining operational efficiency [Amana Bank 2023].

Islamic windows and Islamic branches, on the other hand, function within conventional banks but offer distinct *Shariah*-compliant services. Islamic windows are specialized units within conventional banks that provide *Shariah*-compliant financial products. For example in Tanzania, conventional banks hosting Islamic windows identified in brackets include: KCB Bank Tanzania Ltd (*KCB Sahl Banking*); CRDB Bank PLC (*CRDB Al-Barakah Banking*); National Bank of Commerce (*NBC La-Riba*); and Peoples' Bank of Zanzibar (*PBZ Ikhlas Banking*) [Bank of Tanzania 2024]. These windows ensure Islamic compliance while benefiting from their parent banks' infrastructure and distribution networks [Vahed 2015: 23]. Islamic branches, in contrast, operate separately from their conventional counterparts, maintaining dedicated sales teams and service channels. For example, *PBZ Ikhlas Banking* has fully Islamic branches staffed by professionals exclusively focused on Islamic banking

services while still leveraging the administrative and technical support of its parent bank [Mapeyo et al. 2022: 27]. These structures ensure that bank-customers have access to Islamic financial products and services through a range of banking models tailored to meet their religious and financial needs [Ginting et al. 2019].

4. Findings and Discussion

This section presents the findings that provides an insight in response to the objective of this study that aimed at identifying legal challenges impacting Islamic banking operations, and proposing legal reforms that can adequately accommodate Islamic banking. The discussed legal challenges include; inadequate accommodation of *Shariah*-compliant practices in the banking legal framework, restrictive eligibility criteria to acquire a banking license, problems associated with maintenance of liquidity ratio, exclusion from central bank facilities, lack of a central *Shariah* Advisory Board, constraints on asset-based financing, and double taxation.

4.1. Inadequate Accommodation of *Shariah*-Compliant Practices

Inadequate accommodation of *Shariah*-compliant practices can be seen in multiple spectrums. Primarily, the findings reveal a notable absence of a dedicated legal framework governing Islamic banking in Tanzania. At present, there exists neither specific legislation nor regulation tailored to the operational and structural particularities of *Shariah*-compliant financial institutions. As a result, Islamic banks are compelled to operate within a legal environment originally formulated for conventional banking models [Acting Director of Financial Sector Supervision, the Bank of Tanzania 2024]. According to the study findings, key laws, such as, the Bank of Tanzania Act No. 4 of 2006, and the Banking and Financial Institutions Act No. 5 of 2006, were enacted prior to the advent of Islamic banking in the country. As such, they fail to incorporate or address the distinctive principles and financing instruments central to Islamic banking. For example, Section 3 of both Acts provides a general definition of “banking business,” which does not explicitly accommodate *Shariah*-compliant mechanisms such as *Murabahah* and *Sukuk*. This regulatory omission subjects Islamic banks to legal uncertainty and hinders them from fully aligning with both domestic legal standards and *Shariah*

principles. In an interview with stakeholders from Islamic banking institutions, one of the Bank Managers emphasized the regulatory challenge, stating:

Islamic banking in Tanzania started without any legal adjustments, and to date, there has been no financial Act amendment, regulation, or guideline to accommodate its unique structure. This regulatory vacuum remains the biggest challenge, as it forces Islamic banks to operate under laws that do not recognize their distinct financing principles [Corporate Relationship Manager, KCB *Sahl* Banking 2025].

The absence of a dedicated legal framework has even made Tanzanian courts to refer to international standards when adjudicating disputes originated from Islamic banking. In the case of *Shymaa Commission Agent Co. Ltd v KCB Bank Tanzania Limited & Another Land Case No. 103 of 2022, The High Court of Tanzania Land Division at Dar es Salaam (Unreported)*. The court relied on the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Guidelines to determine whether *Tawarruq* was a valid Islamic financial instrument. The court noted that AAOIFI recognizes *Tawarruq* as a lawful method for structuring financial transactions within Islamic law, provided it does not involve prohibited elements such as interest for an advanced credit. Furthermore, the court identified that the defendant's *Shariah* Board had affirmed the restructuring of the loan under *Tawarruq*, thereby validating its compliance with Islamic banking principles. This case underscores the legal uncertainty surrounding Islamic finance in Tanzania and highlights the pressing need for a dedicated regulatory framework to ensure consistency, legal clarity, and the sustainable growth of Islamic banking in the country. It is high time for Tanzania to create a legal framework that accommodate *Shariah*-compliant practices. It may even borrow a leaf from other countries such as Malaysia and the United Kingdom, which have established robust legal frameworks to accommodate Islamic banking compliant practices. To date, inadequate accommodation of *Shariah*-compliant practices in the banking legal framework in Tanzania remains a challenge, limiting its broader participation in the financial markets.

4.2. Restrictive Eligibility Criteria to Acquire a Banking License

The findings confirm that Islamic banks in Tanzania face significant structural and operational challenges due to licensing requirements that do not accommodate their distinct governance models. Section 7 (1) of the Banking

and Financial Institutions Act No. 5 of 2006, requires any entity seeking a banking license from the Bank of Tanzania to be registered either as a company or as a cooperative society. From this observation, it is clear that Islamic banks are confined to these two legal forms. However, the only feasible option under Islamic law is to register as a cooperative society, since the concept of a company is fundamentally inconsistent with *Shariah* principles. *Shariah* principles maintain that financial responsibility and accountability are inherently personal, borne by natural persons who are answerable to God for their actions. This doctrine reflects the Islamic worldview that moral and legal obligations cannot be transferred to artificial legal entities, such as corporations. Rather, each individual is accountable for their conduct, particularly in financial transactions and in the fulfilment of contractual duties. One respondent observed this during the data collection exercise, noting Qur'an 2:286, which stipulates: "*God does not burden any soul with more than it can bear. Each soul will be (held) accountable for what it has earned...*" This verse reinforces the principle of individual accountability central to Islamic finance, contrasting sharply with the existing laws, which recognize a company as a distinct legal personality capable of owning property, entering into contracts, and being liable in its own name [Section 15 (2) of the Companies Act, Cap. 212 of 2002].

The respondent emphasized that, while the cooperative society model offers a possible alternative, it is not viable for institutions seeking to attract large scale investors, as it lacks the governance and capital raising mechanisms associated with conventional corporate structures [Bank Manager, Amana Bank 2024]. This regulatory rigidity leads to limited capital mobilization, constrained growth potential, and uncertainty in the governance and risk management. Benchmarking from other countries may offer instructive lessons. For example, Malaysia, through the Islamic Financial Services Act No. 759 of 2013, has established a separate licensing regime for Islamic banks, independent of conventional banking regulations. This includes provisions for *Shariah* governance, licensing, risk management, and supervision by dedicated regulatory units. Islamic banks in Malaysia operate either as full-fledged institutions or as Islamic windows of conventional banks, but always under strict *Shariah* oversight. Such a framework ensures both compliance with Islamic legal doctrine and operational clarity within a national legal system. This assurance is what is needed to facilitate Islamic banking and enhancement of its participation in the Tanzania's financial markets.

4.3. Problems Associated with Maintenance of Liquidity Ratio

The findings reveal that Islamic banks in Tanzania face significant challenges in meeting the liquidity ratio requirements mandated by the Bank of Tanzania. Section 46 [1] of the Bank of Tanzania Act No. 4 of 2006 requires all banks and financial institutions to maintain liquid assets at levels prescribed by the Bank of Tanzania. These liquid assets typically include cash, balances with the Bank of Tanzania, and short term government securities. However, Islamic banks, adhering to *Shariah* principles, avoid interest-bearing instruments which are commonly used to satisfy these liquidity requirements. Instead, they focus on asset-based financing, such as *Murabahah* and *Ijarah*, which are not readily convertible to cash. This structural difference places Islamic banks at a disadvantage, as they struggle to comply with liquidity ratio requirements designed around conventional banking models. A respondent from an Islamic bank highlighted this issue:

Our liquidity management is constrained because we cannot invest in interest-based instruments. The current regulations do not accommodate our *Shariah*-compliant products, making it challenging to meet the prescribed liquidity ratio [Branch Manager, PBZ *Ikhlās* 2025].

This challenge is compounded by the limited availability of *Shariah*-compliant liquidity instruments in Tanzania. Unlike conventional banks, Islamic banks cannot access traditional interbank markets or interest-based government securities, leading to higher liquidity risks and operational inefficiencies. In addition, Section 21 (1) of the Banking and Financial Institutions Act No. 5 of 2006, allows the Bank of Tanzania to set a minimum level of capital reserves that banks must deposit to maintain liquidity and protect depositors. This provision is also problematic to Islamic banks, because unlike conventional banks, which generally trade in money, Islamic banks are mainly assets and equity based. Consequently, Islamic banks may be financially stable but have low liquidity, making it difficult for them to meet the liquidity requirements set by the Bank of Tanzania. This situation not only impedes the operational efficacy of Islamic banks in Tanzania, but also forces them to navigate a framework that inadvertently contradicts the ethical principles of *Shariah*. And therefore positioned as vulnerable and marginalized players in the Tanzania's financial markets.

4.4. Exclusion from Central Bank Facilities

Islamic banks in Tanzania face a significant regulatory challenge due to their exclusion from the Bank of Tanzania's liquidity support mechanisms, a systemic inequity embedded within the country's financial regulatory framework. Section 41 of the Bank of Tanzania Act No. 4 of 2006, grants the Bank of Tanzania the authority to act as a lender of last resort, providing liquidity support to financial institutions in times of distress. However, this facility is structured on interest based terms, making it inherently incompatible with the *Shariah* prohibition of *riba* [interest]. Islamic banks which operates in adherence to *Shariah* principles are prohibited in engaging in any activity involving interest, either lending or receiving with interest. As a result, Islamic banks are unable to access this critical financial safety net, solely due to their adherence to *Shariah* principles. A respondent from an Islamic bank highlighted this challenge, explaining that:

When liquidity shortages arise, Islamic banks cannot rely on the Bank of Tanzania's support, as doing so would mean engaging in interest based transactions. Unlike conventional banks who can access emergency funding instantly, Islamic banks must depend on internal reserves or seek alternative financing arrangements, which can be both costly and time consuming [Shariah Compliant Manager, KCB Sahl Banking 2025].

This exclusion creates a legal and operational imbalance, disproportionately favouring conventional banks while placing Islamic financial institutions in a precarious position. This, in turn, forces them to adopt a more cautious approach to liquidity management, as they lack the financial safety-net available to conventional banks. The inability to access the Bank of Tanzania's liquidity support not only places Islamic banks at a competitive disadvantage but also introduces systemic risks in the financial markets by creating financial exclusion within the broader banking sector.

4.5. Lack of a Central *Shariah* Advisory Board

The findings reveal that Islamic banking in Tanzania faces a significant challenge due to the lack of a central *Shariah* Advisory Board to oversee and standardize Islamic banking operations. As a result, individual Islamic banks rely on their internal *Shariah* boards for compliance, leading to inconsistencies

in the interpretation and application of *Shariah* principles. With each bank developing its own guidelines, this lack of uniformity creates regulatory uncertainty and hinders the establishment of consistent practices within the sector. The decentralized approach further complicates the development of universal guidelines, leading to operational inefficiencies and confusion among stakeholders.

A notable example is the case of *Shymaa Commission Agent Co. Ltd v. KCB Bank Tanzania Limited & Another*, Land Case No. 103 of 2022, The High Court of Tanzania Land Division at Dar es Salaam (Unreported), where a dispute arose regarding an additional charge of TZS 76,000,000/= following the restructuring of two *Murabahah* contracts. The plaintiff contested the legality of the charge, arguing that it constituted interest, which is prohibited under Islamic law, and denied having consented to it. The defendant bank, however, justified the charge as a profit derived from a restructuring agreement based on the *Tawarruq* contract, as permitted by its internal *Shariah* Advisory Board. The court ultimately ruled in favour of the bank, accepting the interpretation of the bank's own *Shariah* Advisory Board that *Tawarruq* does not amount to interest but it is a profit-based mechanism sanctioned by Islamic jurisprudence. This case underscores a critical flaw in the current regulatory environment: that is, the reliance on internal *Shariah* Boards of individual banks to interpret and validate complex Islamic financial contracts. Such practice not only raises concern about impartiality and conflict of interest especially when the same board serves as both an advisor and a validator in disputes involving its institution but also fosters legal uncertainty and inconsistency across the financial markets industry. In the absence of a central *Shariah* Advisory Board, there is no authoritative body of providing uniform interpretations or resolving divergent views on *Shariah*-compliant practices.

The regulatory gap was also highlighted in the case of *Lulua Investment Co. Ltd & Another v. The Peoples' Bank of Zanzibar Ltd [Islamic Banking Division]*, Civil Case No. 48 of 2019, The High Court of Zanzibar [Unreported]. In this case, the plaintiffs entered into a financing agreement with the defendant bank under Islamic banking principles. However, disputes arose regarding the calculation and application of charges, which the plaintiffs contended were not in compliance with *Shariah*. The court had to rely on expert testimonies and international standards to resolve the dispute, which exemplifies the challenges of operating without a standardized institutional framework.

While this remains a crucial challenge in Tanzania, countries with advanced Islamic banking have established centralized frameworks to ensure *Shariah* compliance. For example, Malaysia's *Shariah* Advisory Council of Bank Negara Malaysia, established under Section 51 of the Central Bank of Malaysia Act No. 701 of 2009, serves as the highest authority on *Shariah* matters in Islamic finance in Malaysia. The Malaysia's *Shariah* Advisory Council issues binding rulings that ensures Islamic banks operate in accordance with Islamic principles. Establishing a similar central *Shariah* Advisory Board in Tanzania would assist the Bank of Tanzania to provide clearer guidance, would ensure consistency across banking institutions, and would significantly improve the regulatory clarity and operational efficiency of Islamic banks in Tanzania, hence, facilitating financial markets.

4.6. Constraints on Asset-Based Financing

The study reveals constraints on asset-based financing as another challenge impacting Islamic banking in Tanzania, reflecting contradictions between the existing regulations and the *Shariah*-compliant banking model. Section 29 of the Banking and Financial Institutions Act No. 5 of 2006, restricts banks from investing in fixed assets beyond those directly related to their operations, effectively preventing them from acquiring or leasing assets for broader financial transactions. Unlike conventional banks that rely on interest based lending, Islamic banks operate on an asset based model, where financing is directly tied to tangible assets. This regulatory constraint severely limits their ability to engage in *Shariah*-compliant mortgage financing, which typically involves the bank purchasing an asset such as property and reselling it to the customer at a profit under *Murabahah* or leasing it under *Ijarah*. A Bank Manager highlighted:

Islamic banks rely on assets for financing, but the law limits asset ownership. For instance, in *Ijarah*, we should buy a building and lease it out, but regulations prevent this [Bank Manager, Amana Bank 2025].

This regulatory constraint not only stifles innovation in Islamic banking but also places Islamic financial institutions at a disadvantage compared to their conventional counterparts, discouraging financial inclusion among *Shariah*-sensitive populations. The lack of regulatory clarity on Islamic financing modes in Tanzania intensifies these challenges, as the existing laws do not adequately accommodate the unique operational structures

and requirements of Islamic banking. As a result, Islamic banks face hurdles in offering competitive asset-based financing products, limiting their growth and contribution to financial markets in Tanzania.

4.7. Double Taxation

Islamic banks in Tanzania face a significant financial burden due to double taxation, primarily arising from the Stamp Duty Act [Cap 189 R.E 2019], and the Value Added Tax Act [Cap 148 R.E 2019], which impose taxes in a manner that disproportionately affects their *Shariah*-compliant financial products. Section 5 of the Stamp Duty Act requires stamp duty on all instruments executed in Tanzania or relating to Tanzanian property. This provision results in double taxation on certain Islamic financing structures. For instance, in *Murabahah* financing, where an Islamic bank purchases an asset and resale it to a customer at a markup price, a stamp duty applies at both stages; first on the bank's purchase and then on the resale to the customer. Moreover, since Islamic banks do not charge interest, their profit margin is classified as a sale of goods rather than a financing transaction, making it subject to value added tax on the profit margin alongside corporate tax on the bank's income from the transaction. A Compliance Officer from an Islamic bank observed that while conventional banks offer loans without value added tax obligations, Islamic banks struggle with double taxation, increasing costs for both the institution and its customers [*Shariah Compliant Manager, KCB Sahl Banking 2025*].

Further complications arise in the taxation of *Sukuk* due to regulatory uncertainty. Unlike conventional bonds, which generate interest income and have a clear tax framework, *Sukuk* represent ownership in tangible assets or projects, generating returns based on asset performance. Tanzanian tax laws lack a clear classification for these returns, leading to ambiguity over whether they should be taxed as capital gains, rental income, or business income. This legal uncertainty discourages the issuance and adoption of *Sukuk*, further hindering an effective participation of Islamic banks in financial markets in Tanzania. Drawing on foreign experiences, the study found that countries such as Kenya and Malaysia have addressed similar challenges through legal reforms. For example, Kenya amended its Stamp Duty Act, Cap. 480 and Public Finance Management Act No. 18 in 2017 to eliminate double taxation in Islamic banking transactions. In Malaysia, the Stamp

Act No. 378 provides tax incentives by limiting stamp duty to the principal document in Islamic banking transactions and ensuring taxes are applied to the financing amount rather than the resale price. A Bank Manager interviewed on the issue emphasized the need for Tanzania to consider similar amendments, arguing that tax neutrality would not only strengthen the Islamic banking but also promote financial inclusion and economic fairness in financial markets in Tanzania [Branch Manager, PBZ *Ikhlas* 2025].

5. Conclusion and Recommendations

This section concludes and recommends for the improvement of the legal framework in Tanzania that adequately caters for participation of Islamic banks in the Tanzania's financial markets.

5.1. Conclusion

Based on the above discussion, the existing regulatory framework governing Islamic banking in Tanzania remains inadequate to support sustainable growth and competitiveness of Islamic banking. The lack of a dedicated legal framework has led to uncertainty; as Islamic banks are forced to operate under conventional banking laws that fail to address the unique nature of *Shariah*-compliant financial services. This regulatory gap, coupled with challenges such as double taxation and the lack of a central regulatory authority, creates significant barriers to the realization of full potential of Islamic banks. Although these institutions have adapted to international standards and rely on internal governance, the existing legal and institutional deficiencies continue to hinder the development and participation of Islamic banking in Tanzania's financial markets. Addressing these challenges is crucial in fostering a stable and conducive environment for Islamic banking and financial markets in Tanzania.

5.2. Recommendations

This study recommends the following:

- a) The amendment of principal legislation to fully integrate Islamic banking into Tanzania's financial regulatory framework.
 - i. The amendment of Section 3 of the Banking and Financial Institutions Act, No. 5 of 2006 to explicitly recognize *Shariah*-compliant financial instruments. As such the amendment shall broaden the definition

- of “banking business” to include *Sukuk* bonds and other Islamic financing models. And to introduce definitions of key terms such as *Shariah* Advisory Board and the provision of Islamic financing so as to ensure a clear regulatory guidance.
- ii. The amendment of Section 29 (1) of the Banking and Financial Institutions Act, No. 5 of 2006 to allow Islamic banks to acquire fixed assets in asset-based financing arrangements such as *Ijarah* [leasing] which is a fundamental Islamic finance practice.
 - iii. The amendment of Section 40 (1) of the Bank of Tanzania Act, No. 4 of 2006 to allow the central bank to provide *Shariah*-compliant financing mechanisms alongside conventional loans.
 - iv. The amendment of Section 41 of the Bank of Tanzania Act, No. 4 of 2006 to recognize Islamic financial facilities under the lender of last resort function, ensuring Islamic banks can access liquidity support without engaging in interest based arrangements.
- b) The amendments of subsidiary legislation to ensure equitable treatment of Islamic banking within Tanzania’s financial sector.
- i. The amendment of the Liquidity Management Regulations, GN. No. 724 of 2023, to include *Sovereign Sukuk Bonds* under the definition of liquid assets, allowing Islamic banks to meet liquidity requirements without relying on interest bearing instruments.
 - ii. The amendment of the Management of Risk Assets Regulations, GN. No. 287 of 2014, to explicitly include Islamic financing structures within the definition of credit accommodation, ensuring appropriate risk assessment mechanisms for *Shariah*-compliant transactions.
- c) The enactment of Islamic banking regulations to address the existing regulatory gaps and provide a clear legal framework for licensing, supervision, and dispute resolution while ensuring uniform compliance under the Bank of Tanzania. Such regulations would standardize Islamic banking practices, enhance consumer confidence, and attract foreign investment into the sector. Without such reforms, Tanzania risks lagging behind other economies that have successfully integrated Islamic finance, thereby missing a significant opportunity to enhance financial inclusion and economic development.
- d) The establishment of a central *Shariah* Advisory Board to oversee Islamic banking and financial transactions. A unified regulatory body would provide consistent oversight, ensuring standardized interpretation

and application of *Shariah* principles. This approach would strengthen public confidence in Islamic banking, reduce regulatory fragmentation, and create a more structured environment for *Shariah*-compliant practices in Tanzania.

- e) Tax reforms for Islamic financial transactions are needed as neutrality measures to eliminate double taxation on Islamic financial transactions such as *Murabahah* and *Ijarah*. Reforming these tax laws to allow tax neutrality would create a level playing field, encourage investment, and promote the growth of Islamic finance in Tanzania.
- f) The engagement in capacity building and awareness initiatives through specialized training on Islamic financial principles to effectively regulate and develop the Islamic banking sector, financial regulators, policy-makers, and other stakeholders. This would enhance capacity of these sectors to oversee and implement regulations that align with *Shariah* principles. Additionally, public awareness campaigns should be conducted to educate consumers about Islamic banking as a viable alternative to conventional finance. Such initiatives would promote wider acceptance and foster greater participation in the Islamic finance industry.

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