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Uzbekistan's Relations with the Islamic Bank and Prospects for their Development

Nazarov Nodirjon Namoz o'g'li
Scientific researcher, Teacher Tashkent institute of finance

Annotation: This article reveals Uzbekistan's relations with the Islamic Bank and prospects for their development. We have done some statistical analysis on this theme and contemplated some concepts about implementation of Islamic financing in the economy of Uzbekistan.

Main body: The Islamic prohibitions, nominate contracts, and promises are closely related features of Islamic finance. Here, we use a few examples to explain their fundamental role in shaping Islamic finance in commercial banking (the largest sector in Islamic finance), capital, takaful, and microfinance. These examples are also intended to advance understanding of the most fundamental debate in Islamic finance: the form versus substance debate, to which we turn later.

Commercial Banking. In its early days of conceptualization, Islamic banking was intended to work as two-tiered investment management (mudaraba). Individuals were supposed to invest with the bank on a profit sharing basis, and the bank, in turn, was expected to invest in businesses on a profit-sharing basis. Contemporary practice is very different, however, from that early conceptualization.

Redistribution of Wealth. Although legitimate acquisition of wealth is permissible, Islam discourages hoarding and accumulation of wealth for the love of money. Redistributive justice is a core feature of Islamic economic thought. It aims to strike a balance between private property rights and distributional concerns. In addition to risk-sharing contracts, some of the key instruments of wealth distribution in Islam are: zakah (social welfare tax), sadaqa (charitable giving), waqf (charitable trusts), qard hasan (interest-free loans), and inheritance. These welfare instruments, together with the promotion of risk-sharing contracts in Islamic finance, can enhance financial access. In the following subsections, we briefly describe these instruments.

Uzbekistan, a nation at the crossroads of Central Asia, has embarked on a journey to diversify its financial sector by introducing Islamic banking. This move reflects a global trend toward embracing ethical and interest-free financial practices rooted in Sharia principles. While the market share of Islamic banks in Uzbekistan is currently modest, the nation's commitment to fostering a conducive regulatory environment signals the potential for significant growth in the Islamic finance sector.

The introduction of Islamic finance in Uzbekistan is part of a broader strategy to create a more inclusive and diverse financial landscape. The government has taken proactive steps to establish a regulatory framework that accommodates Sharia-compliant financial products. This framework not only caters to the needs of the Muslim population but also opens up new avenues for financial services that align with ethical and sustainable practices.

Islamic banking in Uzbekistan encompasses various financial instruments and services adhering to Sharia principles. Among these are Islamic bonds, known as Sukuk, which offer an alternative investment option for both individuals and businesses. These instruments are structured to comply with Islamic finance principles, emphasizing asset-backed financing and profit-and-loss sharing arrangements.

One of the key drivers behind the adoption of Islamic finance in Uzbekistan is the aim to promote financial inclusion. By offering Sharia-compliant services, Islamic banks cater to individuals and businesses that may have religious or ethical preferences for interest-free banking. This inclusivity contributes to a more diverse and accessible financial sector, ensuring that a broader segment of the population can participate in economic activities.

While the market share of Islamic banks in Uzbekistan is currently limited compared to conventional banks, there is a notable potential for growth. As awareness of Islamic finance increases and the regulatory framework matures, more individuals and businesses may opt for Sharia-compliant financial services. The growth of Islamic banking in Uzbekistan could be spurred by a combination of factors, including the appeal of ethical and socially responsible financial practices.

Furthermore, the potential for Islamic banking to contribute to economic development in Uzbekistan should not be overlooked. By adhering to principles that prioritize transparency, risk-sharing, and socially responsible investing, Islamic banks can play a role in supporting projects that have a positive impact on society. This aligns with the broader goals of sustainable development and economic well-being for the Uzbekistan community.

In conclusion, the role of Islamic banking in Uzbekistan is emerging as a catalyst for financial diversity and inclusion. The government's commitment to creating a regulatory framework that accommodates Sharia-compliant financial products reflects a strategic vision for a more resilient and ethical financial sector. While the market share of Islamic banks is currently in its early stages, the potential for growth is substantial. As Uzbekistan continues to navigate this path, Islamic banking is poised to become an integral component of the nation's financial landscape, contributing to economic development and fostering financial inclusion for all.

Conventional banking is based upon financing profitable projects with interest lending. Islamic banks avoid interest or riba, and instead invest on a profit or loss basis. Typical types of transactions include leasing, purchase and resale transactions (murabaha and ijara) or profit and loss sharing (mudaraba, trust financing or limited partnership and musharaka, joint venture (investment not required to be paid back).

Part of the social significance of an Islamic bank, relative to a conventional bank, is its social objectives. Conventional banks usually require a person with a business idea also to have some collateral or capital before finance will be granted. Regardless of whether the project is profitable or not, interest will always be levied. The aim of a conventional bank is to fund the most efficient and productive projects. Obviously, from the viewpoint of building “relationship banking”, the banker would like the project to succeed. However, even if it does not, the interest and principal has some chance of being recovered. Islamic bank funding, however, can be structured so the bank’s success can be tied directly to that of the client. They can share in the profits, but also in any losses, hence taking on a more active role. Amongst conventional banks a variety of off-balance sheet activities have assumed considerable importance over the years (Lewis, 1988, 1992). As with conventional banks Islamic banks can run a banking book and a trading book (Hassan and Choudhury, 2004). This means that they can also deal with off balance sheet contracts such as letters of credits, foreign exchange and financial advising. Sources of funds for Islamic banks include deposits. Islamic current accounts do not pay any reward and are only used for liquidity purposes hence there are no profits to share. Savings accounts holders may be able to receive a return called hiba for their investments. An investment account attracts a higher return for depositors, but they also share in the risk of losing money if the bank makes a loss. Money must be deposited for a minimum period of time also. Also for large investors or institutions further investment accounts may exist.

These are usually for a specified large project. In contrast to conventional banks, Islamic banks have an ethical investment charter. Unethical investments in gambling, alcohol or pornography are avoided in line with the Qur'an. As part of their social responsibility, Islamic banks will arrange the payment of zakat, or donations to charitable purposes, which is often listed on their financial statements. This may motivate further supportive zakat payments by other parties when the Islamic bank clearly nominates charitable donations. Muslim consumers are able to gain comfort from investing/borrowing via principles that follow the Qur'an and therefore can help consumers ensure their religious. Typically Islamic banks have a shari'a board to ensure that practices comply with the Qur'an.

Comparing the operational performance analysis of islamic Banking versus conventional banking. The two main sources of funds for a bank are equity and debt. Banks usually operate with a high leverage ratio (in relation to other non-financial businesses) meaning that they borrow high levels of funds, in relation to equity, to then be able to lend out more funds and to therefore increase returns to equity holders. Results indicate that the Islamic banks had a conservative level of equity in relation to liabilities and equity over the period. From the figures for 2003, it would seem that the Islamic banks' structure was converging or reducing to conventional bank levels. However a 4,5 percent difference in equity to total assets ratio remained. Perhaps the conservative structure relates to the social standing of Islamic banks and could also relate to fact that Islamic banks are more exposed to business risks than conventional banks. Given the higher equity levels it might be expected that returns or profitability will also be lower for Islamic banks.

Financial institutions need access to funds for net new investment (new financing less repayments of existing finance) and net withdrawals by depositors (when withdrawals exceed new deposits). And as with any other business form, banks require funds for day-to-day expenses. Liquidity risk is the possibility that the bank will not have enough funds on hand to be able to meet obligations as they fall due. Returns on liquid assets are generally much lower than returns from funds invested in long-term assets such as loans. The conundrum a bank faces is that holding smaller levels of liquidity increases liquidity risk whereas if the bank holds a higher proportion of liquid assets, then liquidity risk is minimised but returns such as return on assets (ROA) are likely to be much lower. Liquidity is proxied by liquid assets to customer and short term funding. Conventional bank operations had a higher level of liquidity. Given that Islamic banks have limited access to Islamic products to use for liquidity purposes, such as Islamic securities, it may have been expected that Islamic banks would have had higher liquidity levels than conventional banks.

The mainstay business of a bank is providing new financing. Nevertheless banks are able to balance their asset portfolio with other investments such as in securities or bonds. Government bonds are commonly purchased due to lower credit risk (risk of default of repayment) and liquidity or ability to sell in the secondary markets (conversion to cash when the banks are short on cash). It could be reasonably expected that Islamic banks would provide finance to customers at similar levels to conventional banks. The ratio results of net loans or financing (referred to as "loans" in the tables) to total assets show that Islamic banks have higher levels of financing provided in all years. The other measurement of loan or financing levels is net loans or financing to customer and short term funding; Islamic banks obtained higher results in all years but the level fluctuated from 66 percent to 111 percent. The conventional banks had a much more stable loan portfolio at about 55 percent of customer and short term funding or 42 percent of total assets. Perhaps this highlights more consistent management practices of conventional banks which may stem from the fact that conventional banks have been in existence for a longer period and have more competition than Islamic banks. Islamic banks had a much more consistent result for net financing to total assets at around 51 percent for all years. Islamic banks therefore provided financing at about a 9 percent higher rate than conventional banks when compared to total assets. Part of this could be due to equity financing where Islamic banks take a position in the project as a joint partner or perhaps in the purchase and resale types of transactions. If the Islamic banks had higher risk equity, it would be expected to be offset by lower risk assets low risk loans or government securities.

Banking system some money may be hoarded in a household, for instance, which is then not invested for the good of the economy. Hence banks are able to assist in economic output and growth by collecting funds and then financing suitable projects. To gain the most potential economic output, however, banks must be working efficiently. A traditional ratio measurement of efficiency for banks is cost to income. Hence the emphasis is on minimising costs to maximise efficiency. Although this is a reasonable assumption, it must also be noted that a more profit efficient bank may incur higher costs to look after their high-end customers, but meanwhile make a higher margin. From 2001 to 2003 Islamic banks had higher cost to income ratios at around 70 percent, but still in line with worldwide conventional bank average figures. Given the different arrangements with Islamic finance which often require more "work" on the part of the bank, such as with purchase-and-resale or mark-up transactions, it would be expected that Islamic banks incur higher costs as compared to conventional banks. When Islamic banks take equity investments in a new project it is reasonable to consider that costs in the initial years would be high. With time however the expected return would hopefully be higher and associated costs lower. Conventional banks obtained a measure around 55 - 60 percent, which is considered quite low. Nevertheless, many of the countries used in our sample are from the Middle East region and that region is noted for the lowest cost efficiency levels worldwide for most financial institutions, the ultimate aim is to maximise shareholder wealth.

Islamic banks have a broader covenant, and they may be willing to sacrifice profitability for utilitarian aspects of social lending. Nevertheless, the continued financial health and existence of a bank requires that the capital be maintained. Equity investors will also be concerned that returns are adequate to cover the risks they are taking in their investment in the bank. Interestingly, for both profitability measures the Islamic banks outperformed conventional banks, although note that the results were calculated on specific country data only and not on a worldwide asis.

Equity levels are much smaller than total asset because on the source of funds side of a bank's balance sheet is also the debt. Hence profitability figures in relation to equity will always be higher than to total assets.

Next the specific country data are examined. These are set out in the Appendix to this chapter for eleven countries, Bahrain, Egypt, Iran, Jordan, Lebanon, Oman, Qatar, Saudi Arabia, Tunisia, Turkey and Yemen. Although both the conventional and Islamic banks within a particular country will have similar economic, social and financial conditions they may work within different banking regulations. The very nature of Islamic banking with purchase and resale and profit sharing contracts, is different to lending in conventional banks. Hence the applicable regulation in regards to Islamic banks may be different. Some Islamic banks have been previously able to operate outside the conventional bank regulatory boundaries.

ICD's primary mission is to complement IsDB's role as a leader by promoting private sector economic growth and development. ICD's vision is to be a leading multifaceted Islamic financial institution for private sector development.

Objectives of ICD:

- to identify opportunities of the private sector that can act as an engine of growth and provide them with effective financial products and services on a large scale;
- mobilization of additional funds for private sector projects;

➢ To support the development of Islamic financing and the capital market.

Table 1 Projects financed in Uzbekistan by IsDB and ICD, 2022[1]

Uzbekistan (member of IsDB, ICD)		
	IsDB	ICD
Joining date:	27.08.2003	14.09.2004
Capital subscription (million):	ID 13.44	USD 0.24
Capital subscription (percent):	0,03	0,01
Total projects and financing:	116 projects (USD 2 602,8 m)	
Completed:	55 projects (USD 1 077,7 m)	
On-going:	61 projects (USD 1 525,1 m)	
New commitments:	USD 427,2 m	
Business insured:	USD 381,5 m	
Agriculture	9 projects	USD 702,4 million
Education	11 projects	USD 78,4 million
Energy	5 projects	USD 203,1 million
Finance	54 projects	USD 653,5 million
Health	15 projects	USD 413,2 million
Industry	9 projects	USD 59,9 million
IT	1 projects	USD 0,1 million
Real estate	0 projects	USD 0,0 million
Transport	4 projects	USD 348,1 million
Water, sanitation and urban services	3 projects	USD 93,1 million
Others	5 projects	USD 51.0 million

Uzbekistan has been a member of IsDB since August 2003 and ICD since September 2004, respectively. IsDB and ICD have provided a total of USD 2 602,8 million in financing for 116 projects in Uzbekistan. Out of these projects, 55 have been completed with a financing of USD 1 077,7 million while 61 are on-going with a financing of USD 1 525,1 million. The sectors that received the most funding are agriculture, finance, and health, respectively USD 702,4 million, USD 653,5 million, and USD 413,2 million in financing. However, the other sectors such as education, energy, transport, water, sanitation and urban services also received significant funding from IsDB and ICD.

According to the decision of the Cabinet of Ministers No. 428 of May 23, 2019, a few investment projects have been planned to implement with the help of IsDB.

For 2020, three (3) investment projects have been planned to be launched in the amount of 682,0 million USD, 623 million USD out of this cost is loan amount. For 2021, 5 investment projects:

➢ reconstruction of the highway A-380 "Guzor-Bukhara-Nukus-Beinov" in the section 581 — 698 km – 257,0 million USD;

➢ improvement of water supply in Kogon district of Bukhara region – 71,9 million USD;

➢ improvement of the perinatal service of the Republic of Uzbekistan – 40,0 million USD;

➢ equipping healthcare facilities with modern equipment for medical oxygen supply – 15,0 million USD;

➢ improvement of water supply, road transport and engineering-communication infrastructure in the villages of Bukhara, Navoi and Samarkand regions as part of the "Prosperous Village" program – 200,0 million USD.

[1] https://www.isdb.org/sites/default/files/media/documents/2022-08/IsDBG_Brief_2022_Q2.pdf
IsDB (Islamic Development Bank) Group Brief for 2022 Q2

According to decree of the ex-President of the Republic of Uzbekistan, No. PQ-4147 dated 02.01.2019 named as “On the membership of the republic of Uzbekistan in The International Islamic Trade and Financial Corporation and The Islamic Corporation of Investment and Export Credit Insurance”, Financial cooperation was implemented in order to further expand cooperation with international financial institutions, diversify sources of external financing, and implement advanced international experience in developing the country's export potential.

Table 2 Payment of contributions of the Republic of Uzbekistan to the authorized capital of IITFC and IECIIC (1 ID=1,39 USD)[2]

№	Year	Payment of contributions for IECIIC shares			Payment of contributions for IITFC shares			Payment for shares in USD during years
		Amount of shares	Payment		Amount of shares	Payment		
			in islamic dinaar	in USD		in islamic dinaar	in USD	
1.	2019	62	62 000,00	86 180,00	16	160 000,00	222 400,00	**308 580,00**
2.	2020	63	63 000,00	87 570,00	17	170 000,00	236 300,00	**323 870,00**
3.	2021	-	-	-	17	170 000,00	236 300,00	**236 300,00**
TOTAL:		125	**125 000,00**	**173 750,00**	**50**	**500 000,00**	**695 000,00**	**868 750,00**

According to the approved schedule of payments, the Ministry of Finance has allocated to the Ministry of Investments and Foreign Trade of the Republic of Uzbekistan funds in the amount of 500 000 Islamic dinars equivalent to pay the subscription fee for the shares of IITFC at the expense of additional sources of the republican budget of the Republic of Uzbekistan during 2019-2021 years.

When it comes to introduction of Islamic banking and finance products in economy of Uzbekistan prospects are broad and numerous. Uzbekistan’s economy is still strongly dependent on its agriculture industry and contract of Salam can become very handy to finance farmers at times of planning and growing of agriculture products. Financier can also benefit by making advance purchase of the harvest at attractive prices. Similarly, contract of istisna could be widely used in financing of many production, manufacturing and construction projects. Flexibility of financing according to phases of production in the project makes this contract handy in many instances. Especially, financing of new housing and office real estate could be done in very smooth manner if istisna mode of Islamic finance is used in the process. Both construction firm and its financiers could agree on stages of financing and renegotiate on price if there are any changes in cost of construction material and due to other unforeseen circumstances. On the other hand, success of small and micro enterprises (SMEs) could substantially increase in the country which Islamic modes of equity-based partnership such as mudarabah and musharakah are introduced. It can be compared to important role that venture capitalists are playing in modern western business sectors. Without such intervention by equity investors many of the modern high-tech companies such as Apple would not exist at all. This means similar equity based Islamic finance contracts could significantly contribute to development of innovation by Uzbekistan growing SMEs.

[2] Decree of the President of the Republic of Uzbekistan, “On the membership of the republic of Uzbekistan in The International Islamic Trade and Financial Corporation and The Islamic Corporation of Investment and Export Credit Insurance” No. PQ-4147 dated 02.01.2019

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