Research Article

Development of SME and increasing income of the population through Islamic financing

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ABSTRACT

The level of financial inclusion in Uzbekistan remains low: the majority of households and firms, rather than using formal finance, save and borrow informally, and few use digital finance products. Both indicate the high cost of finance as the top reason for not using it. Secondly, households, which are mostly Muslim, declare that religious reasons prevent them from using formal finance, as only conventional finance is available. Unlike households, firms report that complex application procedures and high collateral requirements are the second and third most important reasons for not using formal finance. The purpose of this paper is to examine the short-run and the long-run relationships between Islamic banking development and economic growth in the case of Uzbekistan.

Key words: Islamic financing, Islamic investment, takaful, mudarrabah, musharakah, small and medium enterprises, employment.

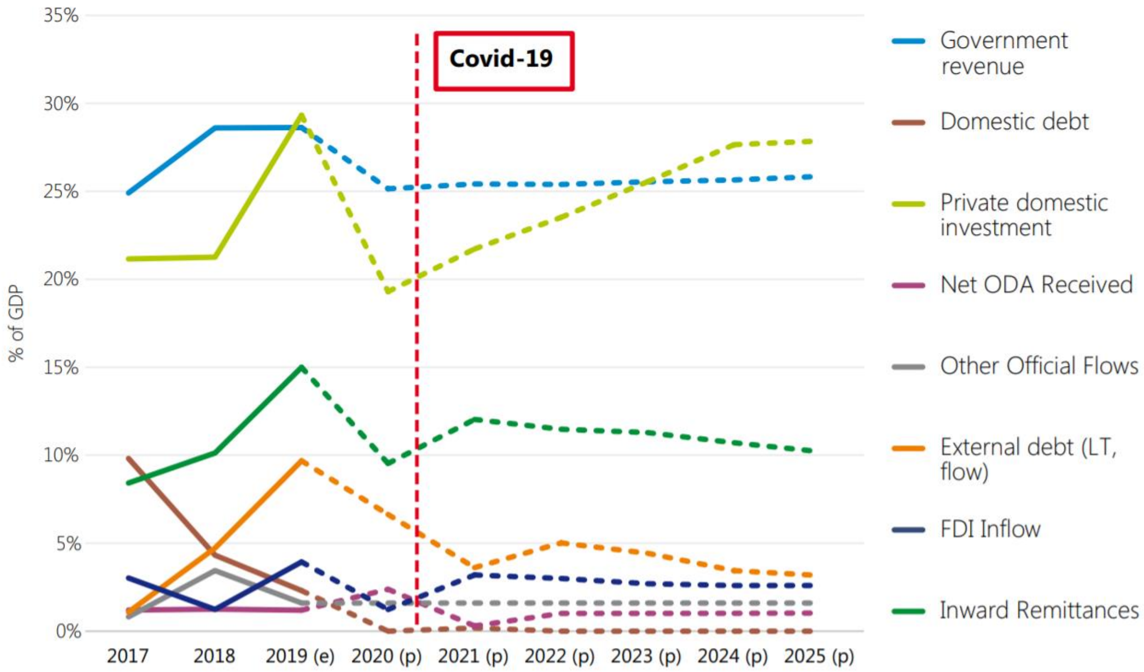
With its population of more than 34 million and traditional Islamic roots, Uzbekistan is probably one of the most promising markets for Islamic financing in Central Asia. But it is fair to say that, until recently, the banking and financial services sector and business in Uzbekistan have had limited exposure to and understanding of Islamic finance. Despite the active presence of the Islamic Development Bank (IDB) and investment, albeit limited in scope, from Islamic countries and investment institutions, Uzbekistan has not adopted a level playing field approach towards Islamic finance. Islamic finance has become a relatively recent trend across Central Asia, mainly through promotion of ties between central governments in the region, Islamic development agencies and Islamic investment funds. Uzbekistan has traditionally been selective in its approach to foreign borrowing with very low levels of reliance on world capital markets for funding its domestic economy. The state's attitude to Islamic finance is consistent with its overarching philosophy of cautious and gradual implementation of reforms. Natural and growing demand for Islamic finance instruments in Uzbekistan contrasts with the absence of a regulatory platform to accommodate Islamic finance and shariah-compliant investments. Uzbekistan is a secular state with a largely Islamic population and any legislative reform involving adoption of shariah-based principles must be a fine balancing act. The key laws such as the Civil Code, the Tax Code and laws on banking and investment do not refer to Islamic finance or to Islamic financial instruments. It is therefore important that Islamic finance and Islamic banking instruments are first recognized as a legislative concept before any regulatory mechanisms are put in place. In its lending policy, the IDB employs Islamic finance principles and it does so next to donors operating conventional financial instruments. In the absence of a specific regulatory regime, the IDB and Islamic investment and finance institutions rely on the use of existing conventional legislation to pursue their agenda in Uzbekistan.

As noted above, Islamic finance has seen a gradual rise from being an almost non-existent concept in the early days of Uzbekistan's independence to becoming a popular trend in recent times. Although the history of Uzbekistan's engagement with the IDB dates back to 1992 and the financing of pilot infrastructure projects, it was not until the government of Uzbekistan approved a programme of cooperation between Uzbekistan and the IDB in 2004 that Islamic finance became available for private and public sector development on a large scale in Uzbekistan. In 2003, Uzbekistan joined the IDB with full membership in the Islamic Corporation for the Development of the Private Sector (ICD) from 2004. In accordance with the 2011-2013 cooperation programme approved at the IDB's

36th annual board meeting, the main focus of the IDB's operation is in infrastructure development and financing of structural reforms. Total financing available under this cooperation programme is US$655.5 million. The total amount of credit funds and investments of the bank in 38 projects in Uzbekistan's economy is over US$1 billion. As an example, the IDB provided financing to the government of Uzbekistan in 2013 for the purchase of two Boeing aircraft for the national air carrier, a deal worth US$270 million according to the IDB press release.[1] In May 2017, the IDB approved US$300 million for the construction of rural residential housing and supporting water and transport infrastructure across Uzbekistan. It is expected that almost 30,000 rural households will benefit from the project. The Saudi Fund for Development and Kuwait Fund for Arab Economic Development are among key Islamic lending institutions in the Arab world with which Uzbekistan has an established track record of cooperation in financing infrastructure development projects. Typically, such projects are assigned to state-owned companies or banks with state shareholding. Analysis of recent trends suggests a steady increase in lending volumes attracted through Islamic finance institutions.

Already prior to COVID-19, Uzbekistan's available Sustainable Development Goals financing was increasing too slowly to meet the country's financing needs. Estimates from 2019 revealed Uzbekistan needs at least an additional, annual investment of USD 6 billion to meet the nationalized Sustainable Development Goals. Now, in 2020, the IMF estimates addressing the external shock and the domestic impact of COVID-19 will require an additional external financing of about USD 4 billion, or 7 percent of GDP.

Figure 1. Shifting composition of development finance in Uzbekistan



The country's Sustainable Development Goals financing gap is projected to further widen in the immediate future. This Development Finance Assessment's projects development finance flows to decrease from USD 55.1 billion (94 percent of GDP) in 2019 to USD 45.1 billion (74 percent of GDP) in 2020. From 2021 onwards, total available development finance is projected to hover around 77 percent of GDP. The composition of available development finance in Uzbekistan has changed since 2017. Government revenue and spending dominated development finance flows prior to the COVID-19 crisis, but their share in total development finance is stagnating. Private domestic investment is projected to become the largest flow in the immediate future, pointing to the importance of more effectively engaging the private sector for financing sustainable development in Uzbekistan. Remittances have kept growing and became an increasingly critical source of external international development finance, significantly larger than Foreign Direct Investment and Official Development Assistance combined.

Private sector initiatives launched by the Islamic Corporation for the Development of the Private Sector (ICD), a private-sector lending arm of the IDB, include interventions with private banks and SMEs. Its approach to

[1] https://mift.uz/en/news/theislamic-development-bank-approved-financing-of-projects-in-uzbekistan-for-usd-5092-million

lending is based on shariah-compliant principles that are adapted to the requirements of the existing conventional regulatory environment. Upward trends registered in private sector lending in recent years suggest there is a growing demand for Islamic finance and Islamic banking products. However, local banks have not yet been permitted to operate Islamic windows given that such a step would require a policy change and adjustments to the regulatory environment. Meanwhile, Uzbekistan's banking sector is supported by demand for industrial projects, backed by the government.

The International Islamic Trade Finance Corporation (ITFC) is a new actor that entered the market in 2018-2019. ITFC intends to engage closely with local commercial banks to build partnerships with and reach out to the private sector in Uzbekistan.

The theory of Islamic banking is based on the concept that interest is strictly forbidden in Islam, and that Islamic teachings provide the required guidance on which to base the working of banks. The basic principle that has guided all theoretical work on Islamic banking is that although interest is forbidden in Islam, trade and profit is encouraged.[2]

Islamic banking is a financial system whose key aim is to fulfill the teachings of the Holy Quran. Islamic law reflects the commands of God and this law regulates all the aspects of a Muslim's life and hence Islamic finance is directly involved with spiritual values and social justice (Gudarzi Farahani and Dastan, 2013).

The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible. Under Islamic banking, all partners involved in financial transactions share the risk and profit or loss of a venture and no one gets a predetermined return. This direct correlation between investment and profit is the key difference between Islamic and conventional banking which its main objective is maximizing shareholders' wealth (Dar and Presley, 2000).

Islamic banking has introduced itself as an emerging alternative to conventional banking system and has grown rapidly over the last two decades both in Muslim and non-Muslim countries. Islamic banks have recorded high growth rates in both size and number and have operated in over 60 countries worldwide and bankers predict that Islamic banking would control over 50% of savings in the Islamic countries within the next decade (Ahmad, 2004 and Muhamad. A and Azmi Omar. M, 2012).

The development of the Islamic finance sector is at its very early stages in Uzbekistan and Islamic securities, whether listed on the local exchange or as banking instruments, are yet to be recognised at the policy and legislative levels. However, the intensifying public debate around the matter and recently announced plans to create an infrastructure for Islamic banking and finance suggest the authorities are taking a radical U-turn regarding the sector.

Any transactions performed on the basis of or using Islamic finance principles shall be subject to conventional laws of Uzbekistan. Islamic finance or Islamic banking and similar practices have not yet been afforded a specific treatment or legislative framework in Uzbekistan. Islamic finance-based transactions are governed by governmental and presidential decrees and resolutions to the extent such investments or projects are agreed and coordinated by the state and its authorised agencies.

Uzbekistan legislation applicable to the financial services industry is complex and constantly evolving to embrace challenges and to cope with competing development priorities. Apart from the Constitution, Civil Code and Tax Code, which provide the major principles and set the legislative framework, the operation of the financial services industry is subject to regulatory requirements and sector-specific by-laws issued in the form of presidential decrees and government resolutions. As a result, all currency restrictions with respect to the export and import of products and services, the buying and selling of hard currency valuables (precious metals, jewellery, etc), interest transfers, dividend payments from investments abroad, dividends and revenue payments abroad for investments in Uzbekistan, as well as certain other currency conversion restrictions, have been abolished. However, the country faces certain foreign exchange challenges and pressures to protect its national interests from the effects of the world economic downturn. The introduction of the Foreign Exchange Law in 2003 represents the government's effort to outline the rules governing the operation of business in Uzbekistan under the applicable foreign exchange regime. For example, under the Uzbek foreign exchange regime resident exporters must ensure that 50 per cent of their export sales proceeds in foreign currency is converted to local currency at the prevailing exchange rate fixed by the Central Bank of the Republic of Uzbekistan (CBU). Certain operations related to the movement of capital are

[2] Gudarzi Farahani, Yazdan1 and Sadr, Seyed Mohammad Hossein Analysis of Islamic Bank's Financing and Economic Growth: Case Study Iran and Indonesia Journal of Economic Cooperation and Development, 33, 4 (2012), 1-24

subject to notice and the procedure prescribed by the CBU in accordance with Regulation 2536 issued on 17 December 2013. General guarantees of equal national treatment and further assurances of rights and protections on matters such as expropriation and profits repatriation, which are of specific interest to the foreign investor, are encapsulated in the Law on Foreign Investments and the Law on Guarantees and Measures for Protection of Rights of Foreign Investors. The Law on Foreign Borrowings and Procedure for Provision of Sovereign Guarantee, as approved by the Cabinet of Ministers of the Republic of Uzbekistan Resolution No. 534, dated 28 November 2003, further sets the scene for general lending and sovereign guarantee transactions. The 2012 Law on Private Banking and Financial Institutions and Guarantees of Their Operations provides important safeguards against discrimination and unlawful intervention from state and authorised state agencies. In 2004 Uzbekistan enacted the Law on Anti-Money Laundering and Combating the Financing of Terrorism, which contained a range of anti-money laundering and counter-terrorism provisions, including record keeping, reporting and the establishment of financial intelligence units. All financial services sector organisations must comply with a specific anti-money laundering checklist approved by the Ministry of Justice's 2013 Regulation on Monitoring Currency.

The CBU is the principal national regulator and the licensing authority with responsibility for oversight of the banking and financial services sector. Foreign lending transactions other than those backed by sovereign guarantee of the government of Uzbekistan are subject to registration by the CBU. The Centre for Coordination and Control of the Functioning of the Securities Market performs licensing for capital markets participants and acts as a registering authority for transactions involving depositories and joint-stock companies including banking institutions. Licensing of insurance and auditing companies falls within the remit of the Ministry of Finance. Filing of any government acts affecting the operation of the industry, and state registration and maintenance of the register of companies, will fall within the authority of the Ministry of Justice. The State Tax Committee has overall responsibility for regular supervision and spot-checking of compliance with statutory requirements applicable to the entire financial services industry.

Foreign banks, including Islamic banks, may open representative offices or set up subsidiary outlets in Uzbekistan provided they comply with minimum criteria and qualify under requirements imposed by the CBU[3]. Foreign banks may also become shareholders in existing banks subject to minimum statutory requirements as set out above. Corporate entities registered or individual's resident in offshore jurisdictions, and religious organisations, are prohibited from becoming shareholders or acting as founders of banks in Uzbekistan.

For the reasons outlined above, no foreign institutions offering Islamic banking and capital markets services other than the IDB and ICD are currently registered in Uzbekistan. However, foreign institutions are not prevented from engaging in the market without being registered in Uzbekistan provided they satisfy requirements contained in CBU Regulation 2536. In accordance with the Regulation, any currency transactions involving movement of capital are subject to registration with a local bank and notice to the CBU. Uzbekistan law allows foreign banks to set up subsidiaries and become shareholders in Uzbek banks. Foreign insurers may establish in Uzbekistan by way of registering a subsidiary or acquiring shares in existing businesses. Establishing an in-country presence triggers licensing requirements. Similar registration and licensing requirements apply in respect of auditing and broker companies. Sector-specific minimum requirements (including capitalisation) will vary depending on the business segment and regulator.

Takaful and retakaful operators. As foreign insurers, takaful and retakaful operators will be required to register a branch and obtain a licence to conduct business in Uzbekistan. Registration shall be performed by the Ministry of Justice and licensing by the Ministry of Finance. A minimum charter capital requirement applicable to insurers specialising in general insurance is US$500,000. Applicants seeking to obtain a licence must have established branches in all provinces and the capital city of Tashkent.

Admission can be achieved via establishing in Uzbekistan or by merger with the existing operator and subject to minimum requirements including capitalisation. No foreign operators may engage in business in Uzbekistan without being admitted. A fronting arrangement is not an option.

Islamic finance disputes are not subject to any specific treatment under Uzbek law. Parties to agreements contemplating transactions based on Islamic finance principles or using Islamic banking instruments are not restricted as to their choice of governing law and dispute resolution. The choice of arbitration as the form of dispute resolution shall be valid, binding and enforceable under the laws of Uzbekistan. Uzbekistan is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (the New York

[3] in accordance with the Regulation on the Procedure for Registration and Licensing of Banking Operations approved by CBU Resolution No. 2014 of 8 October 2009 as most recently updated on 20 May 2014.

Convention). Accordingly, a foreign arbitral award shall be recognised and enforced by an Uzbek court in accordance with the provisions of the New York Convention unless such award is in contravention with public policy considerations. Arbitration courts under the Chamber of Commerce and Industry provide a cost-effective and viable dispute resolution alternative in Uzbekistan.

Mudarabah - profit sharing partnership separating responsibility for capital investment and management. The Civil Code does not expressly prohibit the mudarabah type of arrangement. The principle of freedom of contract under article 354 of the Civil Code allows the parties to choose this arrangement and various provisions of the Code allow parties to a transaction to share risks and liabilities (for example, concepts of joint and secondary liability).[4] It is also an observed practice in Uzbekistan for banks to share profits and risks with entrepreneurs; however, this occurs more often in foreign borrowing transactions and by allowing a financing institution to become a shareholder in a business entity.

No restrictions shall apply in respect of a foreign financing institution in terms of risk levels it can accept in any particular financing transaction.

However, limitations apply to Uzbek banks. These limitations are introduced by CBU Regulation No. 557 on maximum risk levels applicable to any one borrower or a group of affiliated borrowers issued on 2 December 1998. In accordance with Regulation No. 557, commercial banks may not assume risks amounting to 25 per cent of the bank's Tier 1 capital (equivalent to at least 50 per cent of the bank's authorised capital) per one borrower or a group of affiliated borrowers. This rule applies in relation to secured loan facilities. The maximum level of risks that can be borne by an Uzbek commercial bank in unsecured financing arrangements constitutes 5 per cent of the bank's Tier 1 capital. Also, the aggregate amount of Uzbek bank's large-scale loans cannot exceed eight times the bank's Tier 1 capital. In the case of leasing transactions, the value of all leasing services provided by an Uzbek bank (apart from aircraft lease operations) may not exceed 25 per cent of the bank's Tier 1 capital.

Murabahah - cost plus profit agreement. Mudarabah transactions are commonly practised by the ICD and local commercial banks. Where such transactions are financed by the ICD, the local commercial bank issues a guarantee as security for the performance by the borrower of its obligations to the ICD. Mudarabah-based transactions are subject to conventional sale and purchase rules specified in the Civil Code, which defines a sale and purchase agreement as an agreement 'whereby a seller undertakes to transfer a commodity into the ownership of another party (buyer), and the buyer undertakes to accept such commodity and pay for it'.

In the context of Uzbekistan law, this type of transaction falls within the above definition of sale and purchase agreement and is therefore legal, binding and enforceable, while the principle of freedom of contract will govern the contract price and the profit disclosure requirements. Mudarabah implies that the title to the commodity passes to and remains with the buyer. As such, mudarabah is in compliance with Uzbekistan law regulating conventional sale and purchase in terms of title to a commodity of a transaction. Under Uzbekistan law and unless otherwise provided by the contract, the risk of loss passes to the buyer upon delivery by the seller of the goods sold. Import-export rules, as set forth in Government Resolution No. 416, require that delivery of goods or services under import contracts occur no later than 180 days following due payment. The buyer's deferred payment under mudarabah is in compliance with Uzbekistan law, namely article 244 of the Civil Code, which allows for deferred performance of a contractual obligation, provided this is explicitly agreed by the parties in the contract. Further, articles 421 and 422 of the Civil Code regulate the issue of deferred and instalment payments in sale and purchase agreements. In particular, unless otherwise provided in the agreement, the seller may terminate the agreement and demand return of the sold item if the buyer fails to make at least one scheduled payment, except where the amount already paid by the buyer for the item exceeds two-thirds of the contract price. In addition, under sale and purchase agreements with a deferred-payment mechanism, an item sold is deemed pledged to the seller to secure the seller's obligation to pay. A seller in a mudarabah-based transaction shall be subject to applicable customs duties, VAT and profit tax levied in accordance with the Tax Code unless granted preferential status and treatment in Uzbekistan under relevant treaties. The IDB's and ICD's assets are exempt from generally applicable customs duties when entering Uzbekistan. We note, however, that such exemption will only apply where assets are imported for the IDB's and ICD's personal use.

We note that the concept of mudarabah is typically used in transactions involving ICD lending and the IDB employs a mixture of Islamic finance tools such as mudarabah and ijarah. Most recent examples of private sector

[4] Civil Code Republic of Uzbekistan. December 21, 1995 No. 163-I. Article 354.

initiatives include mudarabah-based facilities to finance working capital and equipment purchase for private production companies Leading Force LLC and Magnus Industrial Group LLC.

Musharakah - profit sharing joint venture partnership agreement. Profit-sharing joint venture partnership agreements can be entered into in two ways: by establishing a separate company that will be treated as a legal entity; or by establishing a simple partnership by separate legal entities. If a legal company is established, all shareholders should have rights and obligations arising from the quantity of shares they hold. If a simple partnership is arranged, then no new legal entity emerges and all partners must choose one managing partner, which will represent the partnership before third parties. Owing to lack of regulation and excessive taxation, simple partnership arrangements have not achieved popularity in Uzbekistan.

As regards floating interest rates, the banking laws of Uzbekistan do not forbid use of floating rates of return and linking them to the borrower's profits. CBU Regulation on requirements for the credit policy of commercial banks No. 905 of 2 March 2000 requires that Uzbek banks approve an internal credit policy with a detailed description of types of loans, security issues, interests and others. CBU Regulation No. 905 allows Uzbek commercial banks to determine their lending policies independently. Nevertheless this has not become a widespread practice in Uzbekistan and all banks tend to issue loans with the interest rated fixed throughout the whole loan period. The applicable interest rate must not exceed 20 per cent.

Ijarah - lease to own agreement. Under Uzbekistan law an arrangement whereby one party buys a commodity for the sole purpose of leasing it back to a seller cannot be framed into a single contract (except for reversionary leasing, as discussed below) and must be split into two separate agreements: sale and purchase, and a lease-type contract.

If a commodity is procured from a foreign (non-Uzbek resident company or individual) third-party supplier then this transaction falls outside the reach of Uzbekistan legislation and, therefore, will not be discussed herein. Conversely, if the commodity is purchased from a resident company, then such transaction will be treated as an export of goods, and, similarly to import contracts (see question 16), it will be subject to registration with Uzbek customs authorities and the local Uzbek bank. In Uzbekistan all export contracts are subject to a minimum 15 per cent advance payment requirement (to be included in the contract), in the absence of which the contract would not be registered by the authorities and the bank. In addition, 50 per cent of export proceeds credited to a resident company from such sale will be subject to mandatory sale (conversion into Uzbek soms) at the prevailing exchange rate fixed by the CBU. Following the purchase of a commodity from a resident company the foreign entity may lease it back to the resident under a conventional lease agreement in accordance with provisions of the Law on Leasing and the Civil Code. A lease agreement may provide for an unconditional transfer of ownership of the leased item from the lessor to the lessee upon the expiry of the lease agreement, thus avoiding execution of separate undertakings to sell and to buy.

The Law on Leasing allows for a lease transaction in which the lessee and the third party that sells the item to the lessor is the same person; the lessor purchases an item from the lessee only to lease it back to the lessee on such terms prescribed by the lease agreement and in accordance with applicable laws on leasing. One of the advantages of this arrangement is that it does not require execution of separate irrevocable undertakings to buy and to sell, which are otherwise not available under Uzbekistan law, as both such undertakings are implied. In addition, it is up to the parties to a such a lease to agree on maintenance and insurance obligations (ie, it can be agreed to be an obligation of either a lessor or lessee), thus avoiding execution of an agency service agreement. Article 590 of the Civil Code and article 20 of the Law on Leasing expressly provide that a payment under a lease agreement must comprise the actual price of the leased item and the lessor's profit interest (interest payment). In other words, Uzbekistan law prohibits lease agreements without an express reference to the lessor's interest payments.

The most recent example of an ijarah-based (lease-back) transaction includes financing in 2013 by the IDB of two aircraft for the national air carrier of Uzbekistan. This was the IDB's first experience of aircraft financing using an Islamic finance tool.

Wadiah - safekeeping agreement. Wadiah may be enforceable in Uzbekistan only if a financing institution does not sue a debtor in economic courts or arbitration courts. Taking into account that transfer of title in relation to any type of property requires consent of the owner, the debtor shall have quite a strong legitimate protection against seizure by a financial institution of the property, including bank accounts, real estate, movable property and others.

However, entering into wadiah will not protect debtors if a financing institution files a lawsuit with a competent court and receives an enforcement decision. In accordance with the Law on Enforcement of Court Decisions and Decisions of Other Competent Authorities of Uzbekistan, law enforcement agencies shall be required to execute an enforcement decision, and through law enforcement agents a financing institution will be able to recover funds from bank accounts (deposits) and other property of the debtor.

In accordance with Uzbekistan contract and banking rules, gifts cannot be offered to depositors in lieu of interest. The banking laws of Uzbekistan require banks to pay interest to depositors on all deposits made.

Should a breach of fiduciary duty or misuse of funds occur, financing institutions will be entitled to sue corresponding employees for abuse of power in the criminal courts of Uzbekistan. The burden of proof will rest with the suing party.

The principal law governing the insurance industry in Uzbekistan is the Law on Insurance Activities. Insurance rules are rather strict and, in general terms, the fundamental principles of Uzbekistan's insurance system do not greatly differ from that of takaful. However, the approach to certain aspects differs to some degree. The main difference is that under Uzbekistan law, insurance activities are treated as commercial activities and an insurance company's profits are distributed among its shareholders, whereas under takaful, insurance is not treated as a commercial activity of its shareholders.

The following table highlights the differences in approach.

Table 1. The differences between fundamental principles of Uzbekistan's insurance system and takaful.

Principle under takaful	Principle under Uzbekistan law
Policyholders cooperate among themselves for their common good.	Insurance companies are registered by shareholders, licensed and operate for the benefit of the insured and shareholders.
Policyholders' contributions are treated as donations to the pool.	Insurance premiums are paid by the insured as consideration for insurance of their risks.
Each policyholder pays a subscription to help those who require assistance.	Insurance payments to the insured are paid by the insurance company financed by its shareholders and insurance premiums paid by other insured.
Losses and liabilities are shared according to the community pooling system.	All losses and liabilities are assumed by the insurance company.
Uncertainty is eliminated concerning subscription and compensation.	Uncertainty is eliminated by signing a written detailed insurance contract.
No advantage is gained at the expense of others.	Overall advantage received from insurance activities is paid to the insurance company's shareholders in the form of dividends.

From a historical perspective Uzbekistan has already made significant steps towards recognition of Islamic finance via membership in the IDB and ICD, which it joined in 2003 and 2004, respectively. Stable relations between these institutions and the government have enabled Islamic finance to gain an entry point into the market. However, for Islamic finance to gain an institutional foothold it must be recognised at the legislative level. Forming an initiative group within parliament to develop a road map with clear milestones towards reform of existing conventional law to create a level playing field for Islamic finance might be a starting point. Alternatively, a similar government blueprint would signal a policy shift at the top executive level. Any proposed regulatory reform must include an awareness campaign to promote the perception of Islamic finance and Islamic banking as interest-free alternatives to conventional banking and financial services. As the next step, amendments would be required to the Civil Code, the Tax Code and the major banking and investment laws to address the matter systemically. Whether commercial banks should be allowed to open Islamic windows or Islamic banking institutes set up independently from conventional banking will inform public and expert debate on the shape and scope of regulatory reform. To introduce Islamic banking and Islamic finance instruments, new rules must be formulated or existing ones adapted for Islamic book-keeping procedures. National accounting standards are IFRS-based and any reform to introduce shariah principles must include compatibility analysis. Embedding the success stories of IDB and ICD project interventions in the regulatory reform will pave the way for Islamic banking products and sukuk. In fact, the launch of sukuk bonds could be a point at which market response and readiness of the domestic stock exchange system will be tested. Bringing taxation of Islamic products into the equation will prove another challenge. Insurance laws in Uzbekistan do not contemplate principles of community insurance typical for takaful. Potential establishment of takaful-governed insurance will require a further reform of insurance laws and the regulatory environment as a whole.

The experience of the IDB's engagement in Uzbekistan suggests that the CBU in its regulatory capacity does not oppose shariah-compliant lending to Uzbek borrowers.

An important issue to bear in mind when choosing shariah law with Uzbek debtors is arbitration. We note that parties to a commercial contract are not restricted in their choice of foreign arbitration forum to resolve disputes.

Where contractual terms of a shariah-governed agreement do not contradict imperative rules of Uzbekistan law it would be possible to enforce in Uzbekistan a foreign arbitral award issued in accordance with shariah. Uzbekistan is a party to the New York Convention. If the decision is made by a state court then enforcement shall be made under bilateral or multilateral treaties to which Uzbekistan is a party. In the following cases a foreign judicial or arbitration decision may be refused recognition and enforcement:

- ❖ the parties to a contract have not explicitly chosen shariah law in their contract or the provision choosing shariah law is insufficiently clear;
- ❖ the party to a contract relying upon a certain provision of shariah law has not proved the existence of this law to an Uzbek court. Please note that, in accordance with the Economic Procedure Code and the Civil Code, if the parties choose foreign law as the governing law of the contract and the matter is brought before an Uzbek court, the burden of proof of the existence of the foreign law lies with the party relying upon this law. Typically, the foreign law can be proved either by receiving a certified copy of the law from the competent state authorities of the respective country, or by providing original publication of the law, or by certifying a copy of the law with an Uzbek consular department. In rare cases, courts tend to accept original publications or explore publicly available internet databases;
- ❖ if Uzbek laws require satisfaction of certain procedural or legal requirements, for example registration of a contract with certain authorities or providing certain provisions in the text of a contract, and these requirements have not been fulfilled owing to their not being necessary under a foreign law chosen by the parties, then the courts will refuse application of such foreign law and will give preference to existing Uzbek laws; and
- ❖ if the matter is related to enforcement of a foreign arbitration decision then the court may refuse application of a foreign law if this law contradicts the public order of Uzbekistan. This ground is provided by the New York Convention. Through public policy considerations, Uzbekistan courts tend to understand existing Uzbekistan legislation enacted by the Parliament, the President and the Cabinet of Ministers of Uzbekistan.

Assuming that further expansion of Islamic finance in Uzbekistan has become a fait accompli, we believe the concept of Islamic boards will be difficult to apply in the conventional legislative framework.

The most populous nation in the predominantly Muslim part of the Soviet Union, Uzbekistan has for the last few years sought to attract fresh foreign investment in order to jumpstart its economy which had stagnated under the previous government.

The draft regulations published for public discussion cover various types of sukuk and their legal and tax treatment.

Under a pilot project, Uzbekistan plans to allow local companies to issue sukuk both domestically and abroad using elements of English law and enjoying some tax breaks.

The nation of 34 million people issued its first sovereign Eurobond last year which has been followed by bonds from several state-owned companies, the most recent one announced on Monday by the National Bank for Foreign Economic Affairs (NBU), Uzbekistan's largest bank by assets.

Islamic Finance is one of the fastest growing industries in the world. Legislation on Islamic finance has been introduced in about 50 countries around the world, including three Central Asian states: Kazakhstan, Kyrgyzstan and Tajikistan. Total assets of more than 1500 Islamic financial institutions operating around the world exceed 2.5 trillion US Dollars.

There has always been demand for Shariah compliant finance in Uzbekistan. Considering beliefs of businessmen and individuals, as well as providing inclusive financial opportunities for all people and fostering economic development, this research examines the potential of Islamic finance and opportunities in Uzbekistan.

The total volume of Islamic Banking and Finance assets grew to US$ 2.6 trillion globally. Iran, Saudi Arabia and Malaysia were the largest markets of the 61 countries that reported Islamic financial assets, with all three recording more than US$ 500 billion in assets.

The growth of Islamic finance industry in CIS countries is slower than other but it is attracting the attention of the global international banking industry due to the rising opportunities in this region. Islamic banking will grow substantially in CIS countries in the next five years from a low base, if their governments took initiatives to boost this sector. Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan can be main players to lead this expansion of Islamic banking & finance in CIS.

The interest for Islamic finance is gradually growing in Uzbekistan. In 2003 and 2004, Uzbekistan has made significant steps towards recognition of Islamic finance via membership in the IDB and ICD. Stable relations between these institutions and the government have enabled Islamic finance to gain an entry point into this market.

93% of Uzbekistan's population is Muslims but no local bank nor any foreign institutions offering Islamic banking and capital markets services other than the IDB and ICD. Although more than 9 banks get grant from ICD on Mudarabah base to start Islamic Banking but still waiting for legislation to be passed which allow them to work under Shariah. Foreign institutions are not prevented from engaging in the market without being registered in Uzbekistan provided they satisfy requirements contained in CBU Regulation.

The on-going political transition and economic liberalization underpins a slow uptake of Foreign Direct Investment and Official Development Assistance, albeit below their potential. Large infrastructure deficits and persistent perception of high levels of corruption, combined with ineffective dispute settlement mechanisms, limit potential foreign direct investment inflows. There remain significant knowledge gaps regarding the Sustainable Development Goals alignment of non-commercial private flows, including remittances, philanthropy and faith-based finance. The COVID-19 crisis has significantly impacted the medium-term prospects of these critical international financial inflows to Uzbekistan. The below table summarizes the Development Finance Assessment's main recommendations for harnessing private sustainable development goals finance:

Table 2. The Development Finance Assessment's main recommendations for harnessing private sustainable development goals finance[5]

MEASURES FOR A JOB-RICH RECOVERY	• Harmonize the COVID-19 SME support measures with an upgraded SME finance policy framework.
BOOSTING PRIVATE SECTOR INVESTMENTS IN INFRASTRUCTURE	• Diversify available bond offerings: green bonds and sukuk. • Develop innovative risk-sharing tools, such as credit guarantee schemes.
MAINSTREAM SDGs ACROSS INVESTMENT PROMOTION	• Mainstream the SDGs across the recently adopted PPP framework > People-first SDGs • Review the SDG alignment and coherence of the BITs and free trade agreements. • Integrate sustainable development criteria across the Investment promotion agency. • Set up a UN Global Compact Local Network
HARNESSING NEW SOURCES OF PRIVATE FINANCE	• Establish or expand initiatives to leverage remittances and the diaspora. • Explore the potential of philanthropy to fund SDG targets related to human development. • Access untapped sources of faith-based finance: Zakat.

In May 2019 the Government of Uzbekistan issued a draft resolution to create infrastructure for Islamic banking and finance in order to foster alternative financing opportunities, expand the range of banking, financial services and to open the doors for Islamic investors from the Middle East. The Government. of Uzbekistan is also planning to introduce the issuance of different tenure Sukuk (Islamic Bonds) to address the long-term and short-term liquidity and investment requirements of Islamic finance industry. Many educational institutions start offering

[5] Mr. Gregory De Paepe, The Analytical report "Development Finance Assessment for the Republic of Uzbekistan". UNDP Project on "Financing for Sustainable Development in Uzbekistan. Uzbekistan 2021.

Islamic Finance education to its senior students. Many Insurance and leasing companies are also working to start Takaful and Ijarah operations to meet the need of the Islamic financial market in the country.

The country needs to improve its financial consumer protection. The current institutional structure, which pools financial and general consumer protection together, may not provide adequate safeguards. Rutledge (2010), based on six transition economies, explained that the financial crises of 2008 and 2009 demonstrated that the sustainability of financial systems is highly dependent on the existence of adequate consumer protection. Rutledge also explained that such protection should put systems in place that ensure that consumers make fully informed decisions when deciding to buy financial services and while using them along with easy and provide less costly mechanisms for settling conflicts with financial institutions. Finally, consumers need to have access to resources that enable them to gain financial education in any form and at the most convenient time. To achieve this, the Government needs to adjust the Law on "Consumer Protection" to fit the specific needs of financial services. Moreover, institution wise, the country needs specific institutions that focus on financial consumer protection. The evidence on the level of financial literacy in Uzbekistan remains limited. The available sources imply that the level of financial literacy is low. The existing studies, like that by Klapper, Lusardi, and Panos (2013), have suggested, based on the Russian Federation, that financially literate people are more likely to use formal finance rather than informal finance compared with financially illiterate people; the ability of individuals to avoid negative income shocks and have higher spending capacity increases with their level of financial literacy. Thus, to promote financial inclusion, the country needs to promote financial literacy.[6]

The promotion of Islamic finance industry in Uzbekistan will also attract the Foreign Direct Investment (FDI) in the country which will strengthen the economic growth of the country and will reduce the headcounts living under the poverty line.

For Islamic finance to gain an institutional position following actions need to be taken:

An awareness campaign among people to promote the perception of Islamic finance and Islamic banking as interest-free alternatives to conventional banking and financial services must be started.

Amendments would also be required to the Civil Code, the Tax Code and the major banking and investment laws to address this matter systemically.

Commercial banks should be allowed to open Islamic windows or Islamic banking institutes should be allowed to set up independently from conventional banking

To introduce Islamic banking and Islamic finance instruments, new rules must be formulated or amendments in existing ones should be done to accept the Islamic laws and procedures.

Some Islamic Finance education and training courses at national level should be introduced to increase the basic and practical knowledge of people so that they can adopt this new change.

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