

IDENTIFICATION AND MANAGEMENT OF RISKS IN ISLAMIC FINANCE IN THE REPUBLIC OF UZBEKISTAN

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Abstract. *The importance of developing Islamic finance in the Republic of Uzbekistan is increasing in the context of international economic integration and globalization. The creation and development of financial institutions based on the principles of Islamic finance in our country, including Islamic banks and investment funds, play a crucial role in ensuring the stability and development of the national economy. In 2021, the total value of assets in global Islamic finance markets reached approximately \$3.95 trillion. By 2026, the total value of assets in these markets is projected to reach \$5.9 trillion, with an annual growth rate of 10-20%. The emergence of Islamic finance as a decisive component of economic changes in Uzbekistan is explained by the government's efforts to modernize the financial sector and integrate advanced global experiences. The principles of Islamic finance, including the prohibition of interest (riba), risk-sharing, and the requirement to back transactions with real assets, distinguish it from traditional finance. However, these unique characteristics give rise to specific risks that need to be identified and managed effectively. These include compliance, operational, market, and liquidity risks. This thesis examines the identification and effective management methods of these risks.*

Key words: *Islamic Finance; Risk Management Sharia Compliance; Legal Risk; Liquidity risk; Operational risk.*

The emergence and development of Islamic finance in Uzbekistan represents a dynamic opportunity for diversifying the country's financial sector, in line with ethical financial principles derived from Sharia law. Islamic finance not only promises to attract significant international investments but also fulfills the needs of the country's predominantly Muslim population, ensuring inclusive economic growth. In Uzbekistan, Islamic finance has become a crucial component of the ongoing economic changes, closely linked to the government's efforts to modernize the financial sector and integrate advanced global practices. The principles of Islamic finance, such as the

prohibition of interest (riba), risk-sharing, and the requirement to back transactions with real assets, distinguish it from traditional finance. However, these unique features introduce specific risks that need to be identified and managed effectively. This thesis explores the identification and management of risks in Islamic finance within the context of Uzbekistan's developing legal and institutional framework. By analyzing international practices and Uzbekistan's recent efforts, the study proposes strategies for mitigating these risks to encourage sector growth. Integrating Islamic financial practices into Uzbekistan's evolving financial landscape brings with it various challenges, such as addressing regulatory uncertainties, mitigating market-specific risks, ensuring operational efficiency, maintaining liquidity, and strict adherence to Sharia principles. These risks are compounded by Uzbekistan's relatively limited experience in Islamic finance and the unique dynamics of its financial ecosystem. This thesis aims to comprehensively analyze these risks by drawing on international research, Uzbekistan's legal and financial foundations, and globally recognized risk mitigation strategies. Through identifying potential pitfalls and offering effective solutions, this study strives to contribute to the establishment of a stable and sustainable Islamic finance sector in Uzbekistan, enhancing its role as a driver of economic development and serving as a model for other emerging markets.

While Islamic finance offers numerous advantages, particularly in promoting ethical and sustainable business practices, it also presents unique risks:

1-table.

Risks in Islamic Finance and Their Implications¹

Risk Type	Causes of Risk	Likelihood	Consequences	Management strategy
Legal risk	<ul style="list-style-type: none"> - Lack of specific legislation - Unclear regulator framework 	High	<ul style="list-style-type: none"> - Financial disputes - Misinterpretation of contracts - Weak investor confidence 	<ul style="list-style-type: none"> - Develop specific laws for Islamic finance - Study and adapt international legal practices - Organize training for lawyers specializing in Islamic finance
Liquidity risk	<ul style="list-style-type: none"> - Limited financial products and services 	Medium	<ul style="list-style-type: none"> - Financial instability - Difficulty in fulfilling obligations 	<ul style="list-style-type: none"> - Introduce innovative financial products - Promote diversification of assets and funding sources

¹ Table created by the author

	- Low market participation			- Encourage participation of institutional investors
Operational risk	- Lack of experienced staff - Weak internal controls	High	- Errors in processes - Operational inefficiency - Increased costs	Automate and digitize operational processes - Conduct regular training and certification programs for staff - Implement strong internal control systems
Shariah compliance risk	- Weak performance of Shariah boards - Inconsistent Shariah standards	High	- Social unrest - Loss of trust among investors - Non-compliance penalties	- Strengthen the capacity of Shariah boards through training - Apply internationally recognized Shariah standards - Conduct periodic Shariah audits
Uncertainty risk	- Uncertainty in profit and loss sharing - Lack of clarity in contracts	High	- Unexpected losses - Investor dissatisfaction - Reduced market confidence	- Develop risk-sharing mechanisms such as takaful (Islamic insurance) - Ensure transparency in profit and loss sharing contracts - Educate investors on risks

The economic conditions of the Republic of Uzbekistan and the inherent characteristics of Islamic finance give rise to a number of risks. The following analysis presents these risks and their management strategies in the form of a table: The analysis shows that:

- **Legal Risk:** In the context of Uzbekistan, legal risk is the most pressing issue, and to address it, special laws and regulatory documents need to be developed.
- **Operational Risk:** To reduce operational risks, it is necessary to train qualified personnel and study international practices.
- **Sharia Compliance Risk:** Strengthening the activities of the advisory boards is crucial for eliminating this risk.
- Strategic management of these risks not only ensures financial stability but also helps to increase confidence in Islamic finance. To assess the risks in Islamic finance in the context of Uzbekistan and their scale, quantitative indicators will be used. These indicators are of significant importance in analyzing the real-life impact of these risks and developing effective strategies to address them.

2-table.

SWOT analysis Risks in Islamic Finance in the Republic of Uzbekistan ².

SWOT Category	Description
Strengths	<ol style="list-style-type: none"> 1. Risk-sharing mechanism (based on Sharia principles). 2. Stable financing foundations (real assets). 3. Government focus on developing Islamic finance. 4. Social responsibility-based approach. 5. Principles of honesty and transparency.
Weaknesses	<ol style="list-style-type: none"> 1. Lack of skilled personnel. 2. Underdeveloped legal framework. 3. Limited risk management tools. 4. Low financial literacy. 5. Weak risk assessment methods.
Opportunities	<ol style="list-style-type: none"> 1. Learning from international experiences (Saudi Arabia, Malaysia, Indonesia). 2. Implementation of innovative technologies (Fintech). 3. Improvement of the legal framework. 4. Accessing international financial markets (Sukuk). 5. Diversification of the financial sector.
Threats	<ol style="list-style-type: none"> 1. Non-compliance with international standards. 2. Risks related to Sharia compliance. 3. Resistance from market participants. 4. Geopolitical instability. 5. Lagging technological advancement.

The SWOT analysis highlights both the potential and challenges faced by Islamic finance in Uzbekistan. While there are strong foundations in terms of social responsibility, transparency, and the risk-sharing model, the sector still faces several challenges, particularly in terms of legal infrastructure, skilled personnel, and risk management tools. By leveraging international best practices, embracing technological advancements, and strengthening its legal and regulatory framework, Uzbekistan has significant opportunities to develop its Islamic finance sector.

² Table created by the author

However, it must also address the risks of non-compliance with global standards and the resistance from traditional market participants to realize its full potential.

In conclusion, this analysis identifies key risks in the Islamic finance sector in Uzbekistan, including legal, liquidity, operational, Sharia compliance, and uncertainty risks. Legal risk is the most critical, requiring immediate legal reforms due to its high impact. Operational risk, linked to the shortage of skilled professionals, demands enhanced training programs. Liquidity risk, arising from limited financial products, highlights the need for diversification to ensure market stability. Sharia compliance risk requires strengthening Sharia boards to ensure legitimacy and prevent financial instability. Lastly, uncertainty in profit-sharing mechanisms emphasizes the importance of clear guidelines. Addressing these risks through targeted strategies will foster the growth of Islamic finance in Uzbekistan.

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