



FUNDAMENTAL PRINCIPLES AND MECHANISMS OF FUNCTIONING OF THE ISLAMIC FINANCIAL SYSTEM

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ABSTRACT

The article reveals the fundamental principles of the Islamic financial system — risk-sharing, asset-backing, and ethical-legal restrictions — and demonstrates the mechanisms through which they are implemented in practice: contractual structures (mudarabah, musharakah, murabahah, ijarah), Shariah governance, money-market infrastructure (including IILM), and capital markets (sukuk, including ESG-sukuk). Methodologically, the study employs qualitative analysis of secondary data and a comparative approach by aligning international standards (IFSB/AAOIFI) with the practices of leading jurisdictions. Particular emphasis is placed on implications for the Republic of Uzbekistan: institutional requirements, product line, and priorities for the development of the liquidity market.

KEYWORDS

Islamic finance; fundamental principles; risk-sharing; asset-backing; sukuk; ESG-sukuk; IILM; IFSB/AAOIFI; Shariah governance.

INTRODUCTION

The rapid institutionalization of Islamic finance (IF) in the 2010s–2020s has significantly increased its importance for international capital markets and economies with emerging financial infrastructure, including the Republic of Uzbekistan. According to dissertation research, in 2024 the total assets of the IF industry reached about USD 3.88 trillion (+14.9% y/y); the sukuk segment consolidated its position as the key channel of debt financing (issuances of about USD 180 billion in 2024, with the outstanding volume expected to approach USD 1 trillion). The niche of ESG-sukuk is developing at an accelerated pace, while the development of a Shariah-compliant money market (IILM short-term sukuk program up to USD 6 billion) is critical for banks' operational resilience. On the regulatory front, debate continues around AAOIFI Standard No. 62, which strengthens requirements for the “true” transfer of rights to underlying assets, affecting sukuk issuance and pricing.

The theoretical foundation of the Islamic financial system is described as a transition from a risk-transfer paradigm to a fundamentally different logic: joint sharing of risks and results (risk-sharing), priority of real assets (asset-backing), and ethical-legal restrictions (prohibition of riba, gharar, and maysir), institutionalized by IFSB and AAOIFI standards. This sets a distinctive mechanism for capital transmission and a supervisory framework (including Shariah governance), which differentiates IF from the conventional model not only at the level of contracts but also of institutions.

In the empirical dimension, the dissertation highlights key challenges shaping the research agenda of this article. First, differences between asset-based and asset-backed architectures exacerbate issues of legal enforceability and credit rating eligibility, while regulatory evolution

(AAOIFI-62) creates a natural “laboratory” for event analysis of regulatory premia. Second, the diversification benefits of sukuk and Islamic indices narrow under extreme states of return distribution, requiring consideration of “tail” connectedness and the regime-dependent nature of market integration.

For Uzbekistan, potential demand for IF instruments (including sukuk) has been recorded, which — given regulatory clarity and product line development — creates a window of opportunity for integration into global channels of Islamic capital.

The purpose of this article is to systematically reveal, based on dissertation research, the fundamental principles of the Islamic financial system and demonstrate the mechanisms through which they ensure the functioning and resilience of the financial environment: from contractual foundations (PLS models, trade-leasing and hybrid structures) and Shariah governance to market infrastructure (sukuk, Islamic indices, short-term liquidity via IILM, ESG-sukuk). At the same time, institutional implications are highlighted for the Republic of Uzbekistan as an emerging IF jurisdiction.

RESEARCH METHODOLOGY

The study was conducted using qualitative analysis of secondary data and a comparative approach. The main sources of information include specialized reports and standards of Islamic finance institutions: the annual ICD–LSEG Islamic Finance Development Report, the IIFM Sukuk Report, the IFSB Financial Stability Reports, the corpus of AAOIFI standards, as well as statistics from international organizations (World Bank, IMF, UN DESA) and market data on Islamic equity indices (MSCI/FTSE Islamic) and sukuk issuances (primary/secondary markets). Additional materials were drawn from liquidity management sources (the IILM program) and authoritative analytical reviews of Shariah-compliant contracts. Quantitative indicators collected from open sources (e.g., share of Islamic finance assets in GDP, volume and structure of sukuk issuances, liquidity and Shariah governance metrics) were organized into tables and charts for clear comparison.

Methodologically, the work is based on comparative analysis of the fundamental principles and mechanisms of IF: principles of risk-sharing and asset-backing are compared with conventional financial practices; key contractual forms (mudarabah, musharakah, murabahah, ijarah, and hybrid structures), Shariah governance mechanisms, and capital market infrastructure (sukuk, including ESG-sukuk, and short-term liquidity instruments) are analyzed. To interpret institutional specificities, content analysis was applied to IFSB/AAOIFI standards, relevant Shariah board clarifications, and expert commentaries from leading jurisdictions (Malaysia, GCC countries, Indonesia, Turkey). The results are systematized into thematic blocks: (1) principles and contracts, (2) Shariah governance and compliance, (3) money-market infrastructure and liquidity, (4) capital markets and borrowing costs.

For the context of the Republic of Uzbekistan, a targeted comparison of global trends with national initiatives was undertaken: analysis of draft regulatory acts and publicly available statistics from regulators (Central Bank of Uzbekistan, Ministry of Finance/Capital Market Agency), reviews of pilot steps in takaful and sukuk, as well as practices in corporate finance. This design allows for consideration of both the universal identifying features of the Islamic finance model and the specificities of Uzbekistan’s emerging market.

It should be noted that the methodological limitations include: (i) insufficient detailed statistics for certain segments of IF in Uzbekistan, (ii) heterogeneity of definitions (asset-based vs. asset-backed) in cross-country sources, and (iii) limited depth of public data series on new products (e.g., ESG-sukuk). To mitigate these limitations, cross-validation of data from multiple authoritative sources, unification of indicator definitions, and careful interpretation of results in light of jurisdictional legal specificities were applied.

The adopted research design — qualitative analysis of secondary data combined with comparative approach and content analysis of regulatory standards — is optimal for achieving the purpose of the article: a systematic disclosure of the fundamental principles of the Islamic financial system and demonstration of the mechanisms through which these principles ensure the functioning and resilience of the financial environment at both global and national levels. The results are presented in the section Analysis and Results, structured by the identified thematic categories and with sources indicated for each table and chart.

ANALYSIS AND RESEARCH RESULTS

The Islamic financial system represents a distinct model of banking and investment organization, founded on the religious and ethical norms of Shariah. Over the past decades, this sector has demonstrated rapid growth (15–20% annually), and by 2025 the global volume of Islamic financial assets is projected to reach USD 3.4 trillion. Islamic banks successfully operate not only in countries with predominantly Muslim populations but also in the United Kingdom, the United States, Germany, and other states, drawing attention due to their resilience and ethical orientation. Islamic finance is increasingly viewed as an alternative to conventional finance, combining modern financial technologies with the principles of justice and partnership.

In 2024, the total assets of the Islamic finance industry increased by 10.6% compared to 2023, driven by the expansion of banking assets and the sukuk industry.

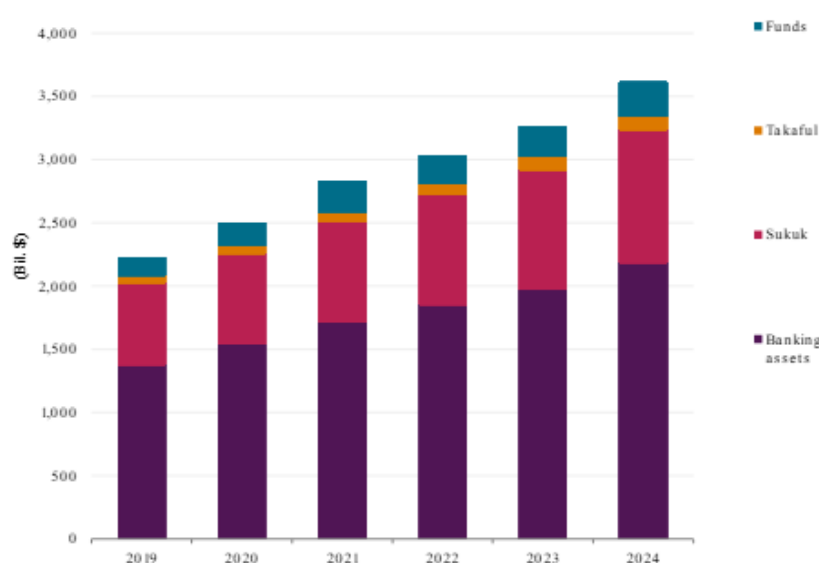


Fig. 1. Assets of the Islamic Financial Industry

Source: IFSB – Islamic Financial Services Industry Stability Report



Banking assets contributed 60% of the industry's growth in 2024 compared to 54% in 2023. The Gulf Cooperation Council (GCC) accounted for 81% of this growth, with Saudi Arabia responsible for two-thirds of the increase. These strong results stem from opportunities created by the Saudi government's Vision 2030 program and the deep integration of the Islamic banking industry in Saudi Arabia, which represented about three-quarters of the banking system's assets at the end of 2024. Bahrain also demonstrated significant growth in the Islamic finance industry, particularly due to the conversion of Ahli United Bank (BBB+/Stable/--) from conventional to Islamic banking. The United Arab Emirates (UAE) also contributed to this growth through strong performance of the non-oil economy. Other countries showed moderate expansion, particularly Malaysia and Turkey.

The main distinction of the Islamic financial system lies in adherence to a set of fundamental principles derived from Shariah. These principles aim to ensure fairness, transparency, and equitable distribution of risks in financial relationships. The core Shariah prohibitions and requirements shaping the functioning of Islamic finance include:

Prohibition of riba (usury/interest): Shariah strictly prohibits charging a predetermined interest rate on monetary loans. Any guaranteed return on capital, independent of business performance, is considered usury (riba) and impermissible. Islam encourages profit-making, but only when linked to shared entrepreneurial risk; compensation to the investor is acceptable only as a share of actual profits earned, not as a fixed return unrelated to project outcomes. Thus, conventional interest is absent in the Islamic model — the investor's return is generated through participation in the profits of the financed venture.

Prohibition of gharar (excessive uncertainty in contracts): Islamic law requires clarity and certainty in transaction terms. Contracts with a high degree of uncertainty, hidden information, or asymmetric knowledge between parties are disapproved. Prohibited examples include agreements involving deliberate risk and outcomes unknown to one of the parties. Shariah bans excessive speculative risk, holding that transactions should not resemble gambling. The concept of gharar encompasses any speculative operations where the outcome is uncertain or left to chance.

Prohibition of maysir (gambling and speculation): Any activity based on chance or gambling is prohibited. This excludes transactions resembling lotteries or betting, as well as operations with derivative instruments that involve speculation on future prices. Due to the existence of maysir, the use of classical derivatives and short-selling is limited in the Islamic system, since they inherently carry elements of uncertainty and speculation.

Prohibition of investment in haram sectors: Islamic finance imposes ethical restrictions on investment targets. Financing the production or trade of goods and services that contradict Islamic values (alcohol, pork, gambling, pornography, weapons, etc.) is forbidden. Capital must be directed toward halal (permissible) sectors of the economy — predominantly the real sector — thereby fostering material production and social benefit.

Money as potential, not self-sufficient capital: From the perspective of Shariah, money should not serve as a commodity or an independent source of profit. It is viewed only as a medium of exchange and a means of acquiring real value. This implies that every financial operation must be linked to a tangible asset or product. The principle of asset-backing requires that every transaction reflect real economic activity rather than mere speculative manipulation of figures. Consequently, Islamic banks generally finance real projects — trade in goods, construction,

production — rather than provide simple monetary loans without a specific purpose. Furthermore, the imposition of penalty interest for late payments is forbidden, ensuring that money itself does not generate additional income purely by the passage of time.

Beyond prohibitions, the Islamic financial system is based on principles of partnership and risk-sharing. Since fixed interest is prohibited, the capital provider and entrepreneur agree in advance to share the project's outcome — both profits and potential losses are distributed between the parties in proportion to their contributions. This mechanism ensures fair distribution of risks and rewards: the investor's return is justified as compensation for bearing the risk inherent in any business venture. In Islamic banking, the principle of Profit-and-Loss Sharing (PLS) underpins the relationships between depositors, the bank, and borrowers. This aligns the investment nature of deposits with direct participation in the real economy. According to Islamic ethics, only income earned through work and entrepreneurial activity involving risk is considered righteous, while guaranteed interest “out of thin air” is deemed unjust. This concept is designed to strengthen social justice: wealth should be created through effort and equitably shared, preventing the concentration of capital in the hands of creditors at the expense of debtors.

These principles fundamentally transform the operating mechanism of financial institutions. In a conventional bank, relationships follow a “creditor–debtor” model, while in an Islamic bank they follow an “investor–partner” model. An Islamic bank does not simply issue loans at interest but invests depositors' funds into clients' projects under partnership contracts. In essence, the bank acts as a joint participant in the project: its profit directly depends on the success of the financed enterprise, while losses are also borne by both the bank and its depositors. As a result, an Islamic bank is far more deeply engaged in the analysis and monitoring of projects, since it shares the risk of capital alongside the entrepreneur.

CONCLUSIONS AND PROPOSALS

Following the principles outlined, Islamic banks have developed a wide range of financial instruments that are equivalent in purpose to traditional loans but are implemented in forms permissible under Shariah. All instruments in use can be divided into several categories: equity (investment) contracts, trade-sale transactions, and service operations. Equity financing implies the bank's participation in the capital or profits of an enterprise: classic examples include mudarabah (a contract in which one party provides capital while the other manages the project; profits are shared according to agreement, while losses are borne by the investor) and musharakah (joint capital investment by several parties with profits and losses distributed proportionally to shares).

Trade and leasing schemes make it possible to replace interest-bearing loans with the sale of goods at a markup or with leasing. For example, murabahah is the sale of goods to a client with a markup: the bank purchases the necessary asset and resells it to the borrower in installments at a higher price, with the profit taken as markup. Ijarah is analogous to leasing, where the bank acquires property and leases it to the client with an option to purchase. Salam represents advance payment for agricultural products to be delivered in the future (advance purchase of harvest), while istisna finances production or construction with staged payments as the product becomes ready. The issuance of corporate and government bonds is replaced by Islamic securities (sukuk), where income is tied not to interest but to profits from the



underlying asset or project. Additionally, qard al-hasan—interest-free loans on a charitable basis—are also applied. Finally, commission-based products include services such as wakalah (an agency/mandate contract for managing funds in exchange for a fee) and kafalah (guarantee obligations). These instruments provide bank profits through trade markup, rental payments, or profit-sharing, while remaining within Shariah restrictions. Figure X presents a classification of the main types of Islamic financial products.

It is important to note that all operations of Islamic financial institutions undergo strict compliance checks with Shariah. Each Islamic bank operates a Shariah Supervisory Board—a group of independent Islamic law experts that approve new products, review contracts, and ensure that the bank's activities comply with religious norms. Moreover, banks calculate and pay the charitable tax zakat, contributing to the redistribution of wealth in favor of disadvantaged social groups. In many countries (Malaysia, Bahrain, the UAE, etc.), national Shariah councils have been established, and standardized reporting requirements for Islamic banks have been introduced, enhancing the system's reliability. Thus, the Islamic financial system forms an integrated environment combining ethical principles with financial technologies. Its fundamental principles—prohibition of interest (riba), fair risk-sharing, support of real production, and adherence to moral standards—ensure stability and societal trust in Islamic financial institutions. This is confirmed by practice: Islamic banks do not seek to act as charities, but they also do not contradict market principles, showing competitiveness and, in many cases, greater stability compared to traditional banks. Such results highlight the potential of the Islamic financing model in strengthening the systemic resilience of the financial environment, which will be further examined in the subsequent sections of this study.

The principles of Islamic finance—prohibition of riba, limitation of gharar/maisir, mandatory asset-backing of transactions, and profit-and-loss sharing (PLS)—shape a distinct mechanism of financial intermediation in which the lender's/investor's returns are closely tied to the outcomes of real economic activity. This linkage reduces the system's tendency toward excessive debt accumulation and restrains procyclical “credit-debt” bubbles. At the aggregate (country) level, this manifests itself in higher capital and liquidity buffers in banking systems with a significant share of Islamic institutions and in a lower amplitude of responses to external shocks. At the meso-level (individual banks), the business models of Islamic banks demonstrate consistent advantages in asset quality and capital adequacy, with comparable—and in some cases slightly lower—operational efficiency (higher cost-to-income ratio due to the complex legal-transactional nature of products and Shariah supervision). Integrated resilience indicators (including the Z-score) are not universally higher for all Islamic banks but are statistically significantly stronger than those of comparable traditional banks in jurisdictions with a developed ecosystem (IFSB/AAOIFI standards, liquidity instruments, national Shariah councils). Therefore, the resilience effect of the Islamic model is contingent on the quality of institutions and infrastructure.

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