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CREDIT RISK TRANSFORMATION IN ISLAMIC FINANCING CONTRACTS: IMPLICATIONS FOR THE FINANCING POLICY OF COMMERCIAL BANKS IN UZBEKISTAN

Azimov Obidjon Toymuratovich

Independent researcher, Tashkent State University of Economics

Abstract. The thesis examines how Islamic financing contracts change the credit risk of commercial banks. On the basis of AAOIFI Shariah standards, IFSB prudential standards and recent empirical studies, it is shown that Islamic contracts do not reduce credit risk but transform it: profit-and-loss-sharing contracts convert credit risk into equity investment risk borne largely by the bank, whereas sales- and lease-based contracts retain credit risk while restricting the bank's enforcement tools. Empirical evidence indicates that credit risk peaks when *mushāraka* financing reaches about 37–39 per cent of a bank's portfolio. For Uzbekistan, where Islamic banking was legalised by Law No. ЎПҚ-1126 in 2026, the findings imply that contract-specific risk weights, provisioning rules, recognition of Shariah-compliant collateral and a ceiling on the share of participatory financing should become elements of banks' financing policy.

Keywords: Islamic finance; credit risk; equity investment risk; *murābaḥa*; *mushāraka*; *muḍāraba*; *ijāra*; financing policy; commercial banks; Uzbekistan.

Introduction

Credit risk — the possibility that a counterparty fails to meet its contractual obligations — is the dominant risk of commercial banks, and non-performing financing reduces profitability, raises provisioning, weakens capital adequacy and, in the extreme, threatens financial stability. The question of how Islamic financing contracts affect this risk has become practically relevant for Uzbekistan. Law No. ЎПҚ-1126 of 27 March 2026, in force since 29 June 2026, introduced Islamic banking into the Law on Banks and Banking (new Articles 5¹ and 5²), created a five-member Islamic Finance Council of the Central Bank and added Chapter 71² to the Tax Code [1]; Central Bank Board Resolution No. 19/2 of 23 June 2026 established the licensing procedure and requires each bank to form an Islamic finance council of at least three members [2]. In July 2026 the Central Bank extended its regulations on risk-management systems, large exposures, corporate governance and deposit-guarantee contributions to Islamic banking [3]. What

CONFERENCE ON FRONTIERS OF SCIENCE AND ENGINEERING • QATAR •

the published register does not yet contain is a contract-specific prudential treatment of Islamic financing exposures — risk weights, asset classification and provisioning by type of contract. This gap is the subject of the present thesis.

The thesis argues that the widespread claim that Islamic instruments «reduce» credit risk is imprecise. Islamic contracts *transform* credit risk: they change who bears the loss, when the loss is recognised and which enforcement tools remain available to the bank. The financing policy of a bank must therefore be built around the structure of its contract portfolio rather than around the Islamic label as such.

Risk transformation by type of contract

The IFSB Guiding Principles of Risk Management (IFSB-1, 2005) distinguish six risk categories for Islamic financial institutions — credit, equity investment, market, liquidity, rate-of-return and operational risk [4]. Participatory contracts belong largely to the second category. Under *muḍāraba* the financial loss is borne by the capital provider alone, while the entrepreneur loses only his effort, unless negligence or breach of contract is proved (AAOIFI Shariah Standard No. 13); when the bank acts as capital provider, this contract concentrates rather than shares financial loss. Under *mushāraka* profits are distributed in the agreed ratio, but losses are borne strictly in proportion to capital contributions (Standard No. 12) [5]. In both cases the bank's exposure is to the performance of the enterprise, which requires monitoring capacity that conventional lending does not.

Sales- and lease-based contracts remain credit exposures. In *murābaḥa* the debt becomes fixed at the moment of sale; the bank may not increase it in exchange for an extension, and a penalty for late payment may be stipulated only if its proceeds are directed to charity (Standard No. 3), so the enforcement incentive that interest on arrears provides in conventional banking is absent. In *ijāra* the bank retains ownership of the asset, which strengthens recovery, but it also bears ownership risks — major maintenance, insurance (*takāful*) and residual value (Standard No. 9). *Salam* and *istiṣnāʿ* add delivery, price and completion risk to counterparty risk. The prudential consequence of this transformation is visible in IFSB-based capital rules: under the Central Bank of Bahrain rulebook, a *mushāraka* exposure in a private commercial enterprise carries a 400 per cent risk weight under the simple method or 90–270 per cent under supervisory slotting, whereas *murābaḥa* receivables are weighted according

CONFERENCE ON FRONTIERS OF SCIENCE AND ENGINEERING QATAR

to the counterparty, as conventional loans are [6, 7]. Table 1 summarises the transformation.

Table 1. Transformation of credit risk in the main Islamic financing contracts

Contract	Risk category (IFSB-1)	Who bears financial loss	Enforcement and mitigation under Shariah standards
<i>Murābaḥa</i> (cost-plus sale)	Credit risk	Customer; debt fixed at sale	No increase of debt on extension; penalty only to charity; <i>rahn</i> , <i>kafāla</i> , <i>hāmish jiddiyya</i>
<i>Ijāra</i> (lease)	Credit risk; residual asset risk	Customer (rentals); bank (ownership risks)	Ownership retained by the bank; <i>takāful</i> of the asset; major maintenance on the lessor
<i>Salam</i> / <i>istiṣnāʿ</i>	Credit risk; market and completion risk	Customer (delivery); bank (price, completion)	Parallel contracts; performance guarantees; delivery security
<i>Mushāraka</i> (partnership)	Equity investment risk	Partners, strictly in proportion to capital	Monitoring, covenants, diminishing structure; 400 % risk weight (simple method) in IFSB-based rules
<i>Muḍāraba</i> (capital–entrepreneur)	Equity investment risk	Capital provider alone (bank), except for negligence	Monitoring, restricted <i>muḍāraba</i> , entrepreneur's liability for breach

Source: compiled by the author on the basis of IFSB-1, AAOIFI Shariah Standards No. 3, 5, 8, 9, 12 and 13, and the Central Bank of Bahrain rulebook (CA-3.6.11) [4–7].

The mitigation instruments available to an Islamic bank are also specific. The Shariah standards permit pledge (*rahn*), third-party guarantee (*kafāla*), a security deposit against a binding promise to purchase (*hāmish jiddiyya*), an earnest-money deposit (*urbūn*) and *takāful* cover of the financed asset (Standards No. 5 and No. 8) [5];

CONFERENCE ON FRONTIERS OF SCIENCE AND ENGINEERING QATAR

what they do not permit is the transfer of credit risk through interest-bearing instruments or conventional credit derivatives. Credit risk management in an Islamic bank is therefore a matter of contract selection, collateral structuring and monitoring rather than of pricing alone.

Empirical evidence

Empirical research confirms that the contracts differ in their effect on credit risk. Warninda, Ekaputra and Rokhim, using ten-year panel data on 63 Islamic banks in the Middle East, South Asia and South-East Asia, find that *muḍāraba* financing affects credit risk linearly, whereas *mushāraka* financing has an inverted-U-shaped effect: credit risk rises with the share of *mushāraka* until that share reaches approximately 37–39 per cent of total financing and declines thereafter, and *muḍāraba* is not riskier than *mushāraka* [8]. Khandelwal and Aljifri, classifying 72 Islamic banks as conservative, moderate or liberal by their reliance on profit-and-loss sharing, find that moderate banks achieve the best balance between participatory and other contracts, while both conservative and liberal banks rely heavily on risk-shifting structures [9]. Trad, Trabelsi and Goux show that the risk profile and profitability of Islamic banks depend on bank-specific factors such as size and capitalisation rather than on the Islamic label as such [10]. In practice, Islamic banks therefore prefer sales-based *murābaḥa* and lease-based *ijāra* because participatory contracts generate information asymmetry, moral hazard and monitoring costs [11]. The optimal solution is not the replacement of all financing with participatory contracts but a portfolio whose contract mix corresponds to the risk characteristics of customers and projects and to the bank's monitoring capacity.

Implications for Uzbekistan

Three implications follow for the financing policy of Uzbek banks entering Islamic banking. First, the prudential framework should distinguish contracts. Risk weights, asset classification and provisioning for *murābaḥa* and *ijāra* receivables can follow the existing conventional categories, whereas *mushāraka* and *muḍāraba* exposures require the equity-investment treatment of IFSB-23 [7]; until such rules are issued, a bank's internal financing policy should apply equivalent internal limits. Second, the share of participatory financing is a policy parameter. The empirical peak of credit risk at 37–39 per cent suggests an internal ceiling on *mushāraka* financing below this range — about one third of the portfolio — during the first years, with sales- and lease-based contracts

CONFERENCE ON FRONTIERS OF SCIENCE AND ENGINEERING • QATAR •

forming the core and participatory contracts expanding as monitoring capacity and Shariah governance mature. Third, Shariah-compliant mitigants — *rahn*, *kafāla*, *hāmish jiddiyya*, *takāful* — should be recognised in the Central Bank's collateral and provisioning rules for Islamic windows, and the charitable treatment of late-payment penalties should be reflected in accounting and reporting. In the author's broader research, compliance with these Shariah requirements enters the Islamic Financing Policy Effectiveness Index (IFPEI) as a gate condition rather than as a weighted criterion: a contract portfolio that fails the Shariah gate is not scored, however favourable its risk indicators.

Conclusion

Islamic financing contracts do not remove credit risk from the balance sheet of a commercial bank; they redistribute it between the bank, the customer and the underlying asset and replace price-based enforcement with contract-based protection. Participatory contracts convert credit risk into equity investment risk that is largely borne by the bank; sales- and lease-based contracts retain credit risk while limiting the bank's enforcement tools. For Uzbekistan, where the legal basis of Islamic banking was created in 2026 but the contract-specific prudential treatment has not yet been issued, the financing policy of a bank should rest on three elements: differentiated risk weights and provisioning by contract, a ceiling on the share of participatory financing informed by empirical thresholds, and the recognition of Shariah-compliant collateral and guarantees. Under these conditions Islamic financing becomes an instrument of risk allocation and diversification rather than a source of concentrated, unmeasured exposure.

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CONFERENCE ON FRONTIERS OF SCIENCE AND ENGINEERING QATAR

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