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Malaysia's Dual Banking System: Institutional, Legal and Strategic Prospects for Integrating Islamic Finance into the Conventional Banking System of Uzbekistan

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Abstract: This article examines whether Malaysia's experience with the "dual banking system" can be applied as an institutional, legal and strategic model for integrating Islamic finance into the conventional banking system of Uzbekistan. The study does not envisage replacing conventional banking activity; rather, it assesses the mechanisms through which Islamic banking can operate alongside conventional intermediation within a single financial stability framework. Malaysia's experience is analysed as a mature case that evolved from the Islamic Banking Act of 1983 into a developed system underpinned by the Islamic Financial Services Act of 2013, a national Shariah Advisory Council, institution-level Shariah governance, Islamic money market infrastructure, a sukuk market and a deep professional ecosystem. Uzbekistan, by contrast, is assessed as a reform-stage economy in which Islamic finance remains institutionally nascent while demand for it and interest in it continue to grow.

Keywords: Islamic banking, dual banking system, Islamic finance, Shariah governance, Bank Negara Malaysia, sukuk, Islamic money market, regulatory neutrality, tax neutrality, investment accounts, Islamic capital market, Shariah Advisory Council, Islamic windows, standalone Islamic banks, takaful, prudential supervision, ethical finance, liquidity management, financial literacy, human capital, banking reform, financing of the real economy.

Citation: Abduvohidovich, S. A. Malaysia's Dual Banking System: Institutional, Legal and Strategic Prospects for Integrating Islamic Finance into the Conventional Banking System of Uzbekistan. American Journal of Economics and Business Management 2026, 9(9), 1053-1059.

Received: 25th Jul 2026
Revised: 20th Aug 2026
Accepted: 5th Sep 2026
Published: 30th Sep 2026



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1. Introduction

The central question of this study is the extent to which Malaysia's dual banking system can serve as an institutional and regulatory model for the development of Islamic banking in Uzbekistan, and what adaptations are required for it to reflect Uzbekistan's legal, institutional, economic and financial conditions. The principal hypothesis is that Malaysia demonstrates how Islamic banking can be integrated into a predominantly conventional system through regulatory neutrality, dedicated Shariah governance, institutional diversification, appropriate liquidity instruments and sequenced market development. Uzbekistan, in turn, should introduce these mechanisms selectively and consistently rather than copying them mechanically from Malaysia [1].

The article gives particular attention to three aspects. First, Malaysia's experience is interpreted as an institutional model rather than as a mere catalogue of Islamic financial products. Second, the article identifies specific gaps in Shariah governance, liquidity management, capital market infrastructure and the legal and tax regime that could

constrain the emergence of a dual banking system in Uzbekistan [2]. Third, the existing banking reforms in Uzbekistan are examined through the prism of financial stability in the context of applying Malaysia's experience, and proposals and recommendations for its phased implementation are developed [3].

The relevance of the topic arises from the interaction between the reform of Uzbekistan's financial sector and the global expansion of Islamic finance. Uzbekistan is not beginning this process from an institutional vacuum. The country already has a central bank with strengthened supervisory powers, a developing private banking segment, expanding capital markets and steadily improving cooperation with international financial institutions. Introducing Islamic banking that is consistent with Shariah principles without weakening prudential standards is therefore a pressing task.

The topic is also important because of the institutional quality factor. Cross-country studies conducted in recent years show that the contribution of Islamic bank financing to raising the volume of private investment depends substantially on institutional conditions [4]. Consequently, simply permitting Islamic products does not in itself guarantee outcomes comparable to those achieved in Malaysia. Uzbekistan needs institutions that ensure the credibility of such products, their legal enforceability and their prudential manageability.

In the economic literature, Malaysia's experience is of key importance for understanding the parallel coexistence of two systems [5].

2. Materials and Methods

This study applies a qualitative comparative research design to examine the extent to which Malaysia's dual banking system can serve as an institutional and regulatory model for the development of Islamic finance in Uzbekistan. The main methods used are comparative analysis, systematic analysis, chronological analysis, legal and regulatory analysis, and secondary data analysis.

Comparative analysis is used to identify similarities and differences between Malaysia and Uzbekistan in terms of banking structure, regulatory architecture, Shariah governance, liquidity management, capital market development, and institutional readiness. Particular attention is paid to identifying which elements of the Malaysian model can be adapted to Uzbekistan and which require modification due to differences in financial market maturity and institutional conditions.

Chronological analysis is applied to trace the development of Islamic banking in Malaysia from the adoption of the Islamic Banking Act in 1983 to the establishment of the modern regulatory framework under the Islamic Financial Services Act 2013. This makes it possible to assess Islamic finance as a gradual institutional development process rather than a single policy intervention.

Legal and regulatory analysis is used to examine the role of legislation, prudential supervision, Shariah governance, taxation, Islamic liquidity instruments, and sukuk market infrastructure. These mechanisms are compared with the current institutional framework of Uzbekistan in order to identify major regulatory and infrastructural gaps.

Secondary data are drawn from official sources, including Bank Negara Malaysia, the Central Bank of the Republic of Uzbekistan, the International Monetary Fund, and relevant academic studies. The analysis focuses on indicators such as the share of Islamic financing, Islamic money market activity, banking sector structure, and the role of state-owned banks.

The study also employs gap analysis to identify the main institutional constraints in Uzbekistan, including limited Shariah governance, insufficient liquidity instruments, underdeveloped Islamic capital markets, and a shortage of specialised human capital.

Based on these findings, the study develops policy recommendations for the phased and selective adaptation of Malaysia's experience to Uzbekistan's financial system.

3. Results

Malaysia's experience is best understood not as a single regulatory intervention but as a cumulative, stage-by-stage process of institutional development. The first important step was the legal recognition of Islamic banking activity in 1983. The next significant direction consisted in broadening the range of providers and financial instruments, by creating the opportunity for conventional financial institutions to participate in Islamic banking [6]. This in turn established an important competitive framework: Islamic finance did not have to develop solely through the establishment of entirely new banks. As a result, banks were able to develop Islamic subsidiaries and Islamic operations while drawing on their existing infrastructure, technology and customer base [7].

The adoption in 2013 of the Financial Services Act and the Islamic Financial Services Act was decisive in securing the institutional transition. These two statutes created separate but mutually complementary legislative foundations for conventional and Islamic activity, while preserving Bank Negara Malaysia, the central bank and regulator, as the single prudential supervisory authority. This architecture avoids two opposite errors. The first is treating Islamic finance as conventional banking under a different name; the second is building an entirely separate regulatory regime that generates excessive systemic fragmentation. Instead, Malaysia established differentiated rules within a common supervisory and monetary framework [8].

The effectiveness of this framework is clearly reflected in the scale of Islamic banking. According to the statistics, approximately 40 per cent of total financing in 2015, and 46 per cent in 2025, was accounted for by Islamic financial services (*Figure 1*).

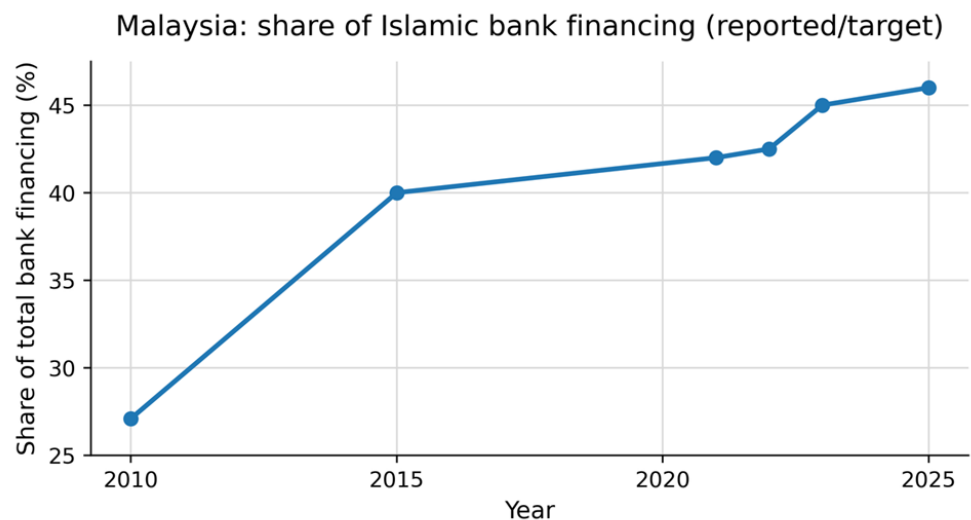


Figure 1. Source: prepared by the author on the basis of the annual reports of Bank Negara Malaysia.

This growth is significant, because the national strategy set a 40 per cent target for financing by 2020; already in 2015 Islamic banking services had exceeded the initial target and had become a structural component of the banking system. By 2025 the indicator stood at 46 per cent.

A second important conclusion concerns market infrastructure. Bacha's¹ empirical study of the Malaysian case shows that Islamic interbank markets remain closely linked

¹ Bacha O.I. The Islamic Inter Bank Money Market and a Dual Banking System: The Malaysian Experience. *International Journal of Islamic and Middle Eastern Finance and Management*, Vol. 1 (3), 2008. -pp. 210–226.

to conventional monetary conditions, and that the availability of Islamic financial instruments does not eliminate macro-financial transmission mechanisms. For this reason, Malaysia's financial system developed, alongside Islamic banking activity, Islamic money market instruments, settlement mechanisms and liquidity-provision facilities.

The scale of the Islamic money market is substantial. According to data published by Bank Negara Malaysia, the volume of Islamic money market operations amounted to 5.98 trillion ringgit in 2024 and reached 6.31 trillion ringgit in 2025, with more than 90 per cent of it accounted for by commodity murabahah. The key implication for Uzbekistan is not that the commodity murabahah model should be transplanted mechanically, but that Islamic banks require a liquid short-term market with standardised contracts, reliable settlement mechanisms, eligible counterparties and financial instruments capable of interacting with central bank operations.

A third important aspect concerns Shariah governance. In Malaysia this framework does not rest on individual Shariah scholars engaged by banks in isolation. The Shariah Advisory Council attached to Bank Negara Malaysia operates at the national level, while Islamic financial institutions form their own Shariah committees. The national Council is institutionally significant in determining the essential features of contracts, taking into account Shariah opinions, academic research, legislation and market practice. The Shariah Governance policy document adopted by Bank Negara Malaysia in 2019 further strengthened the integration of Shariah requirements into business and risk management strategies [9].

This institutional structure addresses a problem that may also arise in Uzbekistan: divergent interpretation and fragmentation of Shariah rules. If each bank develops its own independent interpretation of murabahah, ijarah, musharakah, sukuk or investment accounts, comparison across products becomes difficult, litigation risk increases and consumer confidence may decline. A national-level Shariah body serves to ensure consistency in Shariah requirements and their interpretation while preserving institutional responsibility at the level of individual banks [10].

The governance framework also has a prudential dimension. Corporate governance research conducted in Malaysia from the perspective of financial stability has shown that independent directors can contribute positively to the stability of Islamic banks. Shariah governance should therefore not be assessed as a purely ceremonial religious function. It is an integral part of the system for managing financial products and operational risk, ensuring compliance and protecting consumer rights.

A further important conclusion is that Islamic banking activity can coexist with a competitive environment. The study conducted by Ibrahim, Salim, Abojeib and Lau found that consolidation of the banking system and the expansion of Islamic banking services in Malaysia did not lead to a straightforward elimination of competition. The empirical results indicate differences in the "competition–stability" relationship between conventional and Islamic banks, as well as interaction between the two segments. Šeho, Bacha and Smolo reach a broadly similar conclusion, namely that diversification and concentration affect conventional and Islamic financial institutions differently, while the expansion of Islamic banking services is associated with an improvement in the overall stability of the banking system. For Uzbekistan this indicates the need to move away from a regulatory approach that treats Islamic and conventional banks as entities with identical characteristics [11].

The starting position in Uzbekistan differs substantially from that of Malaysia. The country's banking sector is considerably more concentrated in institutions with a state shareholding. As of July 2026, 34 banks were operating in Uzbekistan, of which nine have a state shareholding and together account for 62 per cent of banking system assets (*Figure 2*).

Structure of the assets of the banking system of Uzbekistan

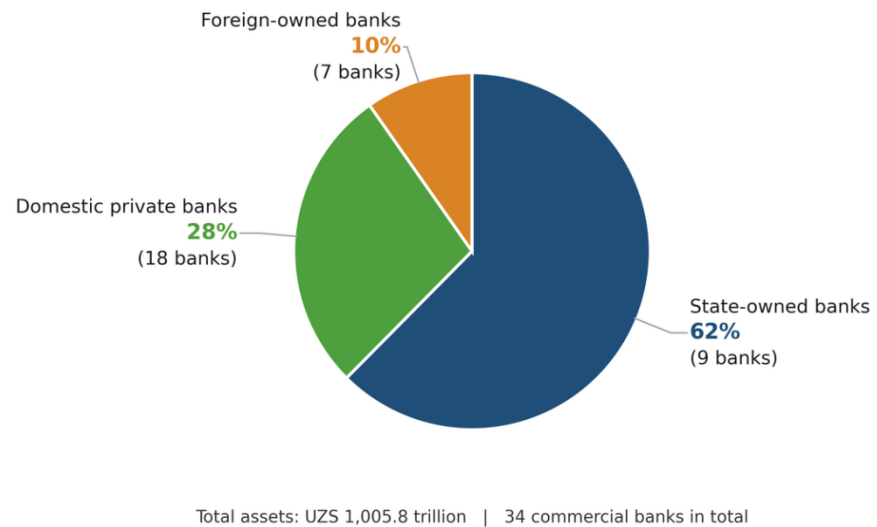


Figure 2. Source: author's calculations based on data of the Central Bank of the Republic of Uzbekistan (cbu.uz) as of 1 July 2026.

The ownership structure is material for Islamic banking, because the effective functioning of a dual banking model requires a competitive environment and incentives grounded in commercial interest. If Islamic banking is introduced within a system dominated by preferential and directed lending, there is a risk that Islamic financial products will become yet another channel for the administrative allocation of financial resources rather than a competitive market-based financing alternative [12]. The International Monetary Fund has repeatedly identified preferential and directed lending practices as a source of concern from the standpoint of efficiency and financial stability. As of end-2024, preferential loans accounted for 25–302 per cent of total loans extended by banks [13].

In the conditions of Uzbekistan, a practical institutional approach inspired by Malaysia's experience should rest on five main pillars. First, regulatory neutrality must be ensured in Uzbekistan. Islamic financial products should not be placed at a disadvantage by tax rules designed for conventional interest-based financing mechanisms [14]. Second, a national Shariah governance architecture needs to be established in Uzbekistan. Third, a two-tier market entry strategy should be adopted, under which the possibility of operating through Islamic windows or specialised subsidiaries is combined with licensing opportunities for fully fledged Islamic banks. Fourth, Islamic liquidity infrastructure must be developed before bank balance sheets are allowed to expand rapidly. Fifth, the integration of Islamic finance with the capital market should be secured by establishing a credible sukuk mechanism [15].

The policy transfer matrix indicates that institutional mechanisms are more transferable than quantitative targets (*Figure 3*).

2 <https://www.gazeta.uz/uz/2025/10/24/direktiv-kreditlar/>

Institutional readiness: comparative analytical assessment

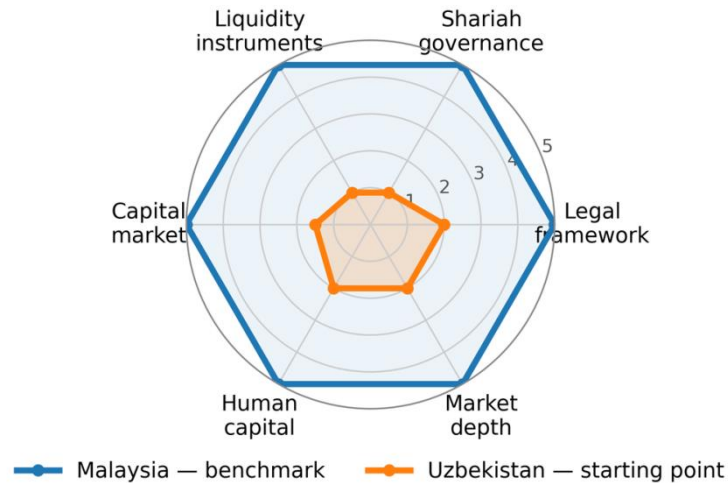


Figure 3. Institutional readiness matrix. Author's assessment.

At the initial stage Uzbekistan should not set a market share target of 40 or 46 per cent of the kind characteristic of the Malaysian model. A quantitative target set prematurely may encourage banks to relabel conventional financing instruments or to prioritise volume growth over sound risk management. Instead, it would be appropriate for Uzbekistan to set measurable institutional targets. These include the introduction of a national Shariah governance framework, the number of licensed Islamic financial service providers, the availability of liquidity instruments, the number and value of sukuk issued, the share of Islamic financial assets covered by independent Shariah audit, and indicators relating to the protection of consumer rights.

4. Conclusions

As a recommendation, the priority principle to be implemented immediately is to ensure regulatory and tax neutrality. Economically comparable and equal conditions should be created for Islamic and conventional forms of financing. To this end, Uzbekistan needs to review value added tax (VAT), transfer taxes, the corporate taxation regime, collateral rules, the norms governing leasing relations, insolvency provisions and accounting procedures. The principal purpose of these measures is to prevent Islamic finance contracts from being subjected to artificial additional tax or regulatory burdens, and equally to prevent them from being granted unwarranted privileges.

Second, it would be appropriate to introduce Islamic banking in Uzbekistan through several institutional forms. At the initial stage, Islamic windows and subsidiaries should be permitted within existing banks, since such an approach can accelerate market formation and lower barriers to entry. At the same time, the establishment of fully fledged Islamic banks should also be permitted where investors and supervisory authorities possess sufficient institutional capacity. The regulatory framework should be technologically and institutionally neutral. This will create the conditions necessary for digital Islamic finance to develop freely alongside branch-based conventional banking services.

Third, the Central Bank needs to develop Islamic liquidity management instruments before allowing Islamic banks to expand their balance sheets rapidly. This is probably one of the most important lessons to be drawn from Malaysia's experience. In the absence of an effectively functioning liquidity market, Islamic banks may end up with inefficient balance sheet structures or become dependent on foreign sources of liquidity. The introduction of liquidity instruments available to the Central Bank, of Wakalah-based placement mechanisms, of Qard-based mechanisms where appropriate,

and subsequently of sovereign sukuk instruments, should therefore be regarded as part of the core financial infrastructure.

Fourth, human capital should be treated as a component of infrastructure. Malaysia's experience shows that a complex and developed Islamic finance system requires qualified specialists with simultaneous in-depth knowledge of Shariah principles, banking regulation, accounting, risk management and financial markets. In this connection, Uzbekistan needs to develop certification programmes, establish cooperation between higher education institutions and industry, organise specialised professional training programmes for law enforcement officers and judges, and build dedicated research capacity in the field of Islamic finance.

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