

Challenges and Opportunities for Islamic Finance in Kazakhstan

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The reality of Islamic finance

Islamic finance is a generally used term for financial and commercial transactions that are in compliance with Shari'ah (Islamic law).

Islamic finance is one of the fastest growing areas of the global financial services industry. Since its relatively recent appearance nearly forty years ago, Islamic finance has increasingly become a mainstream banking activity with financial centres in Bahrain, Dubai, Kuala Lumpur and London. While still considered to be in its infancy as compared with the global financial industry, Islamic finance accounts for assets conservatively valued at over US\$750 billion across 450 financial institutions based in 75 countries, all operating according to Islamic principles.

In contrast to conventional banks, during the international financial crisis of 2008 - 2009, no Islamic bank failed or required government recapitalisation. The spread of Islamic finance into Western markets demonstrates that it is now being viewed by regulators and financial institutions as a viable alternative to conventional banking products.

The principle differentiators between Islamic finance and conventional finance include the following:

- Risk and profit must be shared equally between parties to a transaction
- Speculation and uncertainty in transactions are strictly prohibited
- Making money from money (i.e. interest) is similarly prohibited
- Certain activities not beneficial to society are banned
- Transactions must be asset-based or asset-backed.

It is widely known that the legislation of the Middle East and Gulf countries is based on Shari'ah. Legislative acts creating favourable tax and legal conditions for the development of Islamic finance have also been approved in such European countries as Great Britain, France and Germany. While in Asian countries Islamic finance is

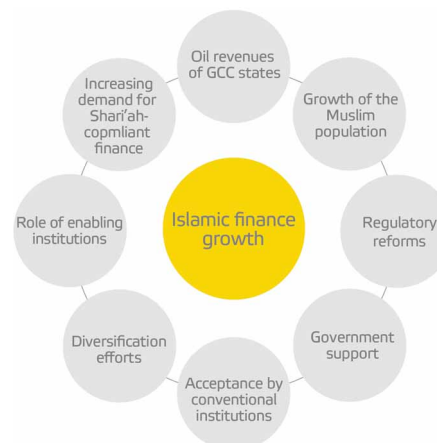
well developed, with its main centre in Malaysia, other regions (e.g. Singapore, Hong Kong) are also competing for their share of the Islamic finance market.

Kazakhstan has extensive trade relations with countries in Europe, Asia and the Middle East, and further development of the regulatory framework for Islamic finance would facilitate trade relations with countries that adhere primarily to Shari'ah principles. It would also generate greater interest on the part of these countries in investing in Kazakhstan.

It should also be noted that Islamic financial products are available to the general public and not only to Muslims. Overall, Islamic financial products are regarded as a direct alternative to conventional financial products offered to the population and business by conventional financial institutions.

The Government's commitment to make Kazakhstan an Islamic finance centre, coupled with the country's current leadership in the CIS in making legislative changes to allow the operation of Islamic finance institutions, should give Kazakhstan a unique competitive advantage in attracting Islamic finance investments and help the country achieve its goal of becoming a leading financial centre for the region.

Islamic finance has demonstrated a growth rate of over 20% over the past decade, fuelled by a number of factors:



Development of Islamic finance in Kazakhstan

In 2009 the Republic of Kazakhstan became the first country in the Commonwealth of Independent States to introduce fundamental legislative amendments for purposes of Islamic finance. Such amendments were made to a number of Kazakhstan's legislative acts (the Civil Code, the Tax Code, the Law on Banks and Banking Activities, the Law on Financial Markets and others).

To develop these amendments, a group of specialists was formed that actively cooperated and continues to cooperate with government bodies on issues related to the development of Islamic finance in Kazakhstan.

The main principles used in developing the amendments to Kazakhstan's legislation were the following:

- Equalisation of the taxation of Islamic financial products with the taxation of conventional financial products
- Expansion of existing concepts to include specific definitions of Islamic financial instruments
- Extension of tax benefits applied to traditional financial products to Islamic financial products
- For tax purposes, Islamic financial products are classified as such only for the purposes of transactions carried out by Islamic banks.

As a result of the work done in developing amendments, Chapter 4-1 on requirements and procedures for establishing and activity of Islamic banks as well as defining certain Islamic bank products was added to Law No. 2444 of the Republic of Kazakhstan on Banks and Banking Activities of 31 August 1995.

The following main amendments to the Tax Code were also introduced:

- The list of types of income received by residents and non-residents was expanded to include income received from an investment deposit placed in an Islamic bank. Such an amendment allows

the taxation of such income to be defined and makes the tax consequences of investing in Kazakhstan, including foreign investments, more transparent.

- The provision of Islamic financial products was generally exempted from value added tax, which is a significant achievement in equalising the taxation of Islamic and traditional financial products.

The implementation of Islamic finance at a legislative level in Kazakhstan plays an important role in the development of the country's economy and infrastructure. In particular, it extends the range of financial services, which makes Kazakhstan's financial market more competitive, and is a means of attracting investment capital and major players from the worldwide Islamic financial industry to Kazakhstan.

Further development of Islamic finance in Kazakhstan

Despite the work that has been done, Kazakhstan's legislation regulating Islamic finance is not perfect and requires further development. It is essential to ensure a strong legislative

base for the establishment of other Islamic financial institutions in Kazakhstan (e.g. insurance companies, investment funds) and the coverage of all Islamic financial products as well as to enable conventional banks and other financial organisations to provide Islamic financial products in the course of their regular activities.

In particular, the following main aspects must be considered:

- Legal and tax issues with respect to transactions involving assets that must be owned by an Islamic bank (e.g. transfer and registration of ownership rights);
- Improvement of accounting principles with respect to Islamic financial products in Kazakhstan;
- The possibility and procedures for the licensing of activities related to the provision of other Islamic financial products (e.g. insurance, investment funds);
- Efforts to improve government and public understanding of the principles and specifics of Islamic financial products as well as a focus on the practical implementation of legislation.

Despite the amendments to Kazakhstan's tax legislation, the tax treatment of certain Islamic financial products remains unclear and unfavourable as compared with their conventional counterparts. Based on today's experience with Islamic financial products in Kazakhstan, certain changes for the improvement of tax law are currently being considered

These include, among others, changes to the VAT treatment for an asset's cost when a commercial agent finances trading activities by providing a commercial loan (Commodity Murabaha) and exemption from VAT on the markup of an Islamic bank that renders agency services in the process of banking transactions (Wakala). Other amendments that should accelerate the implementation and development of Islamic finance in Kazakhstan are also being considered.

All in all, given the rapid development of other countries and ever-growing competition for foreign investments globally, it is vital that Kazakhstan move forward without delay in order to fully utilise its pioneer status in the area of Islamic finance and become a regional hub for Islamic finance investments.

Second Islamic Finance Forum in Astana Raises Business Awareness

The development of the Islamic finance in Kazakhstan will be one of the strategic tasks supported by the Government within the Islamic finance development road map. Holding relevant forums and conferences is considered a way to boost public and business' awareness of the Islamic finance in Kazakhstan. They play a role of platforms for exchanging information and pursuing dialogue where the current problems are discussed and resolved.

The Second Islamic finance forum held in the Kazakh capital at Rixos President Astana hotel on 20 September 2011 is one of the notable examples of such platforms.

Forum participants discussed the prospects of attracting foreign investments by means of Islamic financing, its basic tools and mechanism such as sukuk for corporative and public sectors at the Forum.

Islamic finance is set to play a major role in the development of the financial

system in Kazakhstan. It can introduce new financial instruments, bring investors into contact with potentially lucrative projects in need of financing, and strengthen relationships between Islamic investors and financial institutions.

According to experts, the world has been increasing its interest in Islamic finance, and primarily due to the fact that it does not include speculative capital. Islamic finance is one of the fastest growing trends with the average annual growth of 15%. The annual turnover of Islamic banking, according to estimates, is around US\$ 750 billion, more than 300 financial institutions worldwide practicing it, operating not only in Muslim countries, but in the U.S., Europe and Southeast Asia. According to unofficial estimates, the assets related to Islamic finance have exceeded US\$ 1 trillion.

"Global trends suggest the need for development and support of Islamic finance in Kazakhstan. Here it is seen as an alternative and long-term model

of funding, aimed at projects in the real sector of economy. It would be interesting to discuss the possibility of issuing Islamic securities for specific industrial and innovative projects in Kazakhstan," Head of Centre for Strategic Research and Analysis of the Presidential Administration Darmen Sadvakassov said at the Forum.

Vice Minister of Finance Berik Sholpankulov highlighted that Kazakhstan has already created a legal framework for the development of Islamic finance. And country has the possibility to become a "hub" for Islamic investments in the post-Soviet realm.

The development of Islamic finance in Kazakhstan is gaining momentum as the country has embarked on a one-year chairmanship of Council of Foreign Ministers of the Organization of the Islamic Cooperation (OIC). As part of it, the state is paying additional attention to the issues related to the development of the economic cooperation within the Ummah.

Source: The Ministry of Foreign Affairs of the Republic of Kazakhstan