GRATA INTERNATIONAL

ISLAMIC FINANCE IN THE POST-SOVIET SPACE, UNITED ARAB EMIRATES AND TURKEY

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The terms "Islamic finance" and "Islamic banking" have become increasingly common in recent times. A type of bank financing that has recently been actively developing worldwide, Islamic finance, with its growth potential and increasingly widespread adoption, makes a promising financing trend, yet not well known to quite a number of financial market participants.

This article is an effort to highlight a few specifics of Islamic finance and its legal regulation in Russia and other jurisdictions, with a brief overview of the practice and regulation of Islamic finance in the countries where GRATA International operates and where this viable financing option has developed.

Content

INTRODUCTION

Islamic finance, also known as Islamic banking or partner finance, is an alternative practice of banking and financing that follows the rules of Sharia law, gaining popularity not only in countries where Islam is practised, but also far beyond their borders. Islamic banking is one of the fastest growing financial trends worldwide. The Islamic finance industry robustly grew by 17 per cent. to reach USD 4 trillion of assets in 2021. [1] There is a clear tendency towards expansion in the post-Soviet space. For example, Uzbekistan and Azerbaijan are currently discussing draft legislation to introduce Islamic finance. In Russia, a recent federal law introduced Islamic finance in some of its constituent entities in August 2023.

1. FUNDAMENTALS OF ISLAMIC FINANCE

> Islamic finance is regulated by Sharia rules that prohibit any type of unethical, unfair, vague or onerous contract. Islamic banking focuses on movement of goods rather than money. Sharia also outlaws profits earned without reciprocal provision of wealth, or consideration.

Islam seeks to ensure fair financing by holding as haram (taboo):

- usury and interest (riba);
- transactions with excessive uncertainty, ambiguity and risk (gharar);
- gambling (maisir); and
- any business connected with the manufacture or sale of alcohol, tobacco, pork, arms and adult products, and gambling.

The restrictions rule out interest-bearing contracts, such as loan agreements or mortgages, or contracts that involve a high degree of uncertainty, e.g. futures contracts. Obeying Sharia, Islamic finance envisages alternative forms, the most important being:

- ***murabaha:*** an agreement by a bank to buy property and resell to the customer at a fixed price — consisting of the value of the property and the bank's arrangement fee — paid in installments, with the property remaining pledged to the bank until the debt is paid in full;
- ***card al-Hasan:*** an interest-free loan granted for the implementation of a socially important project, such as infrastructure and industrial development. The borrower can pay the bank an extra amount (hiba) as a token of gratitude;
- ***ijara:*** an alternative to financial lease (or hire-purchase) whereunder a bank takes ownership of property and leases it to a customer who pays rentals instead of interest, which include the value of the property and the bank's reward. Ijara can be structured to allow the customer to purchase the hired property;
- ***sukuk:***the Islamic equivalents of a bonds. Unlike conventional securities, sukuk are not debt instruments or parts of debt capital; rather, they entitle to ownership of shares in the assets of a company, as stock. Accordingly, sukuk entail shared risk and reward, as the return depends on

[1] ICD – Refinitiv Islamic Finance Development Report 2022 // Islamic Corporation for the development of the private sector. URL: [1] Code of the Republic of Kazakhstan «On taxes and other obligatory payments to the budget (Tax Code)» (25 December, 2017 № 120-VI) (accessed on 3 November 2023).

the value of the underlying assets, rather than the interest rate and therefore is not guaranteed. If the assets backing the sukuk increase in value, so does the price of the sukuk; and

- ***takaful:*** the Islamic form of insurance based on the idea of mutual social responsibility of the fund's contributors and distribution of surplus among them, rather than deriving an insurance company's corporate profit.

Islamic finance is also known as partner finance, fundamentally based on equitable distribution of returns and risks, reflected in two forms: musharaka and mudaraba.

Musharaka is a joint venture or partnership where a bank and other investors contribute capital and share profits and losses in proportion to their contributions, and jointly manage the venture.

Mudaraba is a partnership where a bank provides capital while the other party contributes skills, expertise, labour and management. The partners share profits in a pre-determined proportion, whereas the bank alone bears losses to the extent of its investment.

Islamic finance thus offers alternatives to conventional transactions to meet the needs of a wide range of customers. Despite the word "Islamic", this type of financing is available to any customer regardless of religion or nationality in all jurisdictions discussed in this article.

2. ISLAMIC FINANCE IN RUSSIA

Islamic banking in Russia has long been underdeveloped, particularly in the legal sphere, which hindered its widespread adoption and application. However, Federal Law No. 417-FZ On and Experiment to be Conducted in Certain Constituent Entities of the Russian Federation to Establish Special Regulation for the Purpose of Creating the Necessary Conditions for Partner Finance Activities Therein, and on Amendments to Certain Legislative Acts of the Russian Federation (the "Partner Finance Law") was adopted on 4 August 2023. The law is of interest because Russia has certain prerequisites for the development of Islamic banking:

- ***Firstly,*** a significant proportion of Russia's population are Muslims whoare a majority in the ethnic republics of Bashkortostan, Dagestan, Ingushetia, Kabarda-Balkaria, Karachay-Cherkessia, Tatarstan and Chechnya;
- ***Secondly,*** Islamic finance could become an additional tool for interacting and cooperating with the Islamic nations in the Middle East and South East Asia; and
- ***Thirdly,*** participants in Russia's financial market show interest in Islamic finance, as is evidenced by projects that have already been implemented.

2.1. HISTORICAL BACKGROUND

Several Russian banks piloted some Islamic banking products well before the Partner Finance Law was adopted. Sberbank and AK Bars Bank led the trend in introducing of Sharia-compliant financing.

Sberbank used elements of Islamic finance in a large transaction in 2019, confirming an export letter of credit issued by the State Bank for Foreign Economic Affairs of Turkmenistan backed up by the Islamic Development Bank's reimbursement undertaking, to secure the supply of the Chelyabinsk Pipe-Rolling Plant's products to Turkmenistan. In 2020, Sberbank discounted an export letter of credit in a transaction for the supply of grain to Egypt, with the participation of the Finance Company.[2] Later that year, Sberbank established a centre for partner financing and special projects to develop Islamic banking products. In 2022, the bank opened an office in Kazan, Tatarstan, offering some Islamic financial services, such as murabaha, halal investments, bank accounts, along with corporate and retail payment and cash services.[3]

Tatar AK Bars Bank arranged USD 60,000,000 of syndicated murabaha financing for a service and transport infrastructure development project in Tatarstan in 2011. The bank also offers Islamic mortgages in the land, single-family and existing home markets.

Sukuk-Invest, a Tatarstan company, issued bonds in accordance with the sukuk rules of Islamic finance in 2017. The Bank of Russia approved the issuance of floating rate bonds, where bondholders share the profits from the placement of the funds raised, instead of haram fixed interest.

Investment funds and finance houses offering Sharia-compliant financing are widespread in Russia's other constituent entities with large Islamic populations, such as Chechnya and Dagestan.

Russian banking law prohibits banks and credit institutions from buying and reselling for profit; therefore, prior to the adoption of the Partner Finance Law, banks offered Islamic products through exempt intermediaries who used the banks' funds to purchase real estate and then resold it at a premium to clients paying in instalments. Intermediaries made Islamic finance products more expensive and less competitive.

2.2. SUBSTANCE OF THE PARTNER FINANCE LAW

The Partner Finance Law authorised piloting some of the Islamic banking products in Bashkortostan, Dagestan, Tatarstan and Chechnya from 1 September 2023 to 1 September 2025. An Expert Council constituted under the Government of the Russian Federation will assess the practicability of introducing Islamic finance throughout Russia at the end of the pilot period.

[2] Sberbank Discounts Export Letter of Credit under Deal on Grain Supply to Egypt // Sber Pro. URL: https://sber.pro/publication (accessed on 25 October 2023).
[3] Sberbank Opens an Islamic Finance Office // Sber Pro. URL: https://sber.pro/publication (accessed on 25.10.2023).

THE LAW REFLECTS THE BASIC PRINCIPLES OF SHARIA:

(a) it outlaws interest (riba), allowing instead variable remuneration depending on results of transactions; and

(b) it prohibits financing the manufacture of tobacco, alcohol, arms, ammunition, and gambling.

The law is non-discriminatory and makes partner financing available to all customers regardless of their social, racial, national, linguistic or religious affiliations of backgrounds.

Specifically, the Partner Finance Law authorises:

1. raising money and attracting other assets from individuals and companies by borrowing, issuing bonds, establishing trusts and/or accepting contributions to the authorised capital (sukuk equivalent);
2. lending money to individual and corporate borrowers;
3. financing retail and corporate purchases by buying and reselling in instalments for a fee (murabaha equivalent);
4. corporate financing through contributions to the authorised/share capital and joint conduct of business under simple and investment partnership agreements (mudaraba and musharaka equivalents respectively);
5. financing retail and corporate customers under financial leases (ijara equivalent); and
6. providing guarantees.

Enabling these transactions required amending banking law to exempt partner-financing banks and companies from the prohibition on manufacturing, income-bearing buying and reselling, and insurance [4], and allow them to buy, resell and hold stakes in joint ventures directly.

The Partner Finance Law allows a wide range of entities to participate, including credit and non-credit financial institutions, consumer cooperatives, public benefit foundations, autonomous non-profit organisations, commercial companies and partnerships, but all must meet a number of requirements to be eligible:

(a) each must be resident of the Russian Federation;

(b) financial institutions or their subsidiaries must be located in the designated area;

(c) non-credit institutions must have minimum equity of RUB 10,000,000 each from 1 September 2023 and RUB 15,000,000 from 1 January 2024;

(d) their authorised (or share/unit) capital must not be borrowed or consist of pledged property; and

(e) each must be entered in the register of participants prior to commencing operations.

4] These restrictions are imposed by Article 5 of Federal Law No. 395-1 On Banks and Banking Activities dated 2 December 1990 andArticle 12 (2)(3) of the Federal Law No. 151-Ф3 On Microfinance Activities and Microfinance Organisations dated 2 July 2010.

Financial institutions may combine Islamic finance with their core business, but they must keep assets they raise for or through partner financing separate.

The Central Bank of Russia which oversees partnership financing, maintains the participant register, and enters and strikes off participants. As of 1 February 2024 there 8 registered participants, including AK Bars Bank and Sberbank.

3. ISLAMIC FINANCE IN OTHER JURISDICTIONS

3.1. UNITED ARAB EMIRATES

The United Arab Emirates (UAE) is one of the world's largest markets for Islamic banking services. The Emirates was among the first to legalise Islamic banking by creating a comprehensive legislative framework, specifically, Federal Law No. (6) of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies, relevant amendments to the Civil Code, Commercial Code which sets forth the fundamentals of Sharia-compliant transactions, and Federal Law No. (14) of 2018 Regarding the Central Bank and the Organisation of Financial Institutions and Banking.

The Emirates' Central Bank created a Supreme Sharia Authority, a group of competent Islamic scholars, to draft legislation and provide expert opinions on the compliance of banks and credit organisations with Sharia law.

Emirati law authorises Islamic financial services to be provided by various types of entities: Islamic banks, "Islamic windows" in conventional banks, and investment and insurance companies, all of which require a licence. They are also required to establish Sharia supervisory boards.

The largest Islamic bank, Dubai Islamic Bank, was established in 1975. There are seven other Islamic banks and fifteen "Islamic windows" in conventional banks, nine Islamic finance companies and twelve Islamic insurance companies.

Emirati banks and credit institutions offer a full range of services in the Islamic finance sector.

3.2. TURKEY

Islamic finance in Turkey began to develop in the 1980s with the establishment of specialised finance houses offering interest-free loans. Islamic finance is now regulated by Banking Law No. 5411 dated 19 October 2005. The Banking Regulation and Supervision Agency and the Participation Banks Association have issued a number of binding communiqués regulating certain aspects of Islamic finance.

Only "participation banks" (katılım bankası) can provide Islamic finance. Conventional banks cannot engage in Islamic banking directly, but they can use participation banks as intermediaries.

Turkey established a governmental Central Sharia Advisory Board in 2018 to oversee participation banks' compliance with Sharia principles. Each participation bank is required to establish an advisory board for this purpose.

According to the Banking Regulation and Supervision Agency of Turkey, 9 participation banks offer various Islamic banking products.

3.3. POST-SOVIET AREA

The prerequisites for the development of Islamic banking in the post-Soviet space are the presence of a significant number of professing Muslims and their active economic relations with Arab countries.

AZERBAIJAN does not have a legal framework to regulate of Islamic finance, but discussions on a draft Islamic finance law are underway at various levels. However, this republic has a history of applying Islamic finance. The International Bank of Azerbaijan established an Islamic banking branch in 2012 as part of the "Islamic window" project, which operated until 2015, offering ijara, issuing Islamic bank cards, and opening customer card al-Hasan accounts.

KAZAKHSTAN introduced Islamic finance through Law No. 133-IV On Amendments and Additions to Some Legislative Acts of the Republic of Kazakhstan on the Organisation and Activities of Islamic Banks and Islamic Finance Institutions dated 12 February 2009, which added an Islamic banking chapter to Law No. 2444 On Banks and Banking Activities in the Republic of Kazakhstan dated 31 August 1995, to legalise a long list of Islamic products, including murabaha, ijara, musharaka, mudaraba, sukuk and others. The 2015 legislation added takaful to the list of insurance products.

Two fully-fledged Islamic banks are currently operating in Kazakhstan: Al Hilal Bank and Zaman Bank; an Islamic finance lessor, Kazakhstan Ijara Company; an Islamic insurer, Mutual Insurance Company Takaful; and a multifunctional Islamic finance institution, Al Saqr Finance.

The general meetings of shareholders of the financial institutions establish Islamic finance principles boards, appointed on the recommendation of the boards of directors, to determine the compliance of the institutions' financial activities with Sharia requirements.

The Astana International Financial Centre (AIFC) is Kazakhstan's special economic zone that offers special legal treatment to facilitate business and encourage investment. Islamic finance is one of the focus areas of the AIFC. The Centre has created a legal framework for the operation of financial organisations according to Sharia rules. The main regulatory instruments are the AIFC Islamic Finance Rules and the AIFC Islamic Finance Prudential Rules.

All Islamic financial products, including Islamic securities and insurance, are available in the AIFC. To offer Islamic financial services, a company must be an Islamic financial institution registered in the AIFC and hold a Sharia-compliant banking licence. Islamic institutions can only offer Islamic finance.

Other non-Islamic institutions may offer halal services through "Islamic windows". Each Islamic institution must establish an independent Sharia supervisory board to ensure its Sharia compliance. Islamic investment funds may also be established in the AIFC.

Islamic financial institutions already offering services in the AIFC include Al Saqr Islamic Bank Ltd, Alif Islamic Bank Ltd, and Kazakhstan Islamic Finance Company Ltd.

KYRGYZSTAN began introducing Islamic finance in 2006 when its National Bank adopted the Regulation for Implementing the Principles of Islamic Banking and Finance in the Kyrgyz Republic within the Pilot Project. Islamic finance rules are incorporated in the Law of the Kyrgyz Republic No. 93 On Banks and Banking Activities dated 11 August 2022 and in the Kyrgyz civil code. The National Bank is actively adopting new regulations to set standards for the provision of Islamic services, including such comprehensive and detailed regulations as the Regulation on the Requirements to the Standard Agreements Concluded under the Principles of Islamic Banking and Finance adopted in 2009 and amended in 2022.

Kyrgyzstan has one bank (the Eco-Islamic Bank), four conventional banks with "Islamic windows", and several microcredit companies operating under Sharia rules. Intercascade Islamic Special Financial Company LLC issued Kyrgyzstan's first sukuk al mudaraba for 750,000,000 Kyrgyz Som in May 2023 [5].

Each Kyrgyz commercial bank has a Sharia board, an independent body responsible for ensuring bank's compliance with Sharia standards. The chairmen and members of the boards must have knowledge of Sharia and the principles of Islamic finance. The republic has adopted a Concept for the Development of the Islamic Economic Platform in Kyrgyzstan for 2022 - 2027 to develop Islamic finance, which, among other things, provides for the establishment of a Sharia Supervisory Board at the state level.

TAJIKISTAN began developing Islamic banking in 2010 when its National Bank joined the Islamic Financial Services Board (IFCB) as an observer. Tajikistan adopted its Islamic Banking Law № 1108 on 26 July 2014 and introduced a new tax code on 1 January 2022, which abolished double taxation on murabaha purchases and sales by Islamic banks. These measures were favourable for the further development of Islamic finance.

The National Bank of Tajikistan has established an Advisory Council on Islamic Banking Services to regulate the operations of Islamic banks and other credit organisations.

Both Islamic and conventional banks with "Islamic windows", as well as non-bank credit institutions and microfinance organisations, may provide Islamic financial services in Tajikistan. The chairmen and members of the management boards and chief accountants of the banks must be qualified in Islamic banking. Providers are also required to establish Islamic financial services boards responsible for ensuring that their financial activities comply with Islamic banking standards.

[5] Asadov A, Turaboev I, Mohd Zakhiri Md. Nor (2023) Legal Challenges in Establishing the Islamic Capital Market in Uzbekistan // ISRA International Journal of Islamic Finance, 15, 45-63. URL:4] These restrictions are imposed by Article 5 of Federal Law No. 395-1 On Banks and Banking Activities dated 2 December 1990 andArticle 12 (2)(3) of the Federal Law No. 151-ФЗ On Microfinance Activities and Microfinance Organisations dated 2 July 2010 (accessed on 20 January 2024).

So far, one fully Islamic bank, Tawhidbank, is operating in Tajikistan, and another, Alif Bank, is in the process of being converted into an Islamic institution. A micro-credit fund, Imon, and a micro-deposit organisation, Humo, were licensed in 2020 to operate according to Islamic finance principles through Islamic banking windows.

In **UZBEKISTAN,** the Islamic finance industry is still a work in progress. The country still has no special law on Islamic finance and no comprehensive legal regulation in this area. Article 4 of the Law № ЗРУ-765 On Non-Bank Credit Institutions and Microfinance Activities dated 20 April 2022 allows only microfinance institutions to operate in Islamic finance. Nevertheless, Uzbekistan is currently drafting legislation on Islamic finance, while the republic's president and government are issuing decrees and regulatory acts to promote Islamic banking. Uzbekistan joined the International Islamic Trade Finance Corporation (ITFC) by the president's Ordinance No. ПП-4147 dated 1 February 2019. Presidential Decree No. УП-6207 On Measures for Further Development of the Capital Market dated 13 April 2021 sets out measures to conduct an experiment on the introduction of securities based on the principles of Islamic finance. Pending the adoption of a comprehensive law on Islamic finance, banks are developing necessary infrastructure to open "Islamic windows".

SUMMARY

From the above review of the status and development of Islamic finance in various jurisdictions, a trend towards the spread of Islamic finance in the post-Soviet space, including Russia, emerges.

A comparison of the regulation of partner financing in Russia with other jurisdictions reveals the following positive points:

(a) the Partner Finance Law provides for the core transactions applicable in Islamic finance, in line with global practice;

(b) the law sets out a broad range list of pilot participants, including eligible conventional banks that can participate through "Islamic windows";

(c) the law has removed the restriction on banks' buying and reselling activities, as well as manufacturing and insurance, allowing them to offer more favourable terms and competitive services (no need for intermediaries); and

(d) the law requires non-discrimination in financing.

It seems a good idea to give partner financing a neutral name that reflects the nature of the method rather than its religious affiliation or origin. This measure could increase the popularity of the new alternative not only among the country's Muslims.

However, the Partner Finance Law does not reflect a number of other Islamic finance instruments available in other jurisdictions:

- the law leaves out Sharia-compliant takaful insurance;
- the amendments part of the law has left the Russian Tax Code unchanged and has not exempted the participant institutions from double VAT, paid once on the purchase of real estate in their own name, and then again on resale to the customers (murabaha) for instalments; and
- the law does not require either the pilot participants or the Bank of Russia to establish bodies to assess, ensure and enforce Sharia compliance, either at central or local level, as is the case in other jurisdictions, which may put off potential Muslim customers.

Excessive authorised capital requirements (RUB 10,000,000 initially and RUB 15,000,000 from 1 January 2024) may be too high for microfinance and non-financial organisations providing Islamic finance in the republics and may inhibit the spread of partner finance.

The Partner Finance Law is only a few months old and it is still difficult to assess its impact. A survey by the Bank of Russia identified fourteen companies planning to participate in the experiment, including twelve non-financial institutions. [6] It appears that the new law may increase pilot participants' revenues by tapping into individuals' savings. The law may also improve inclusiveness and equality in the provision of financial and banking services to Muslims. The law and the steps taken to operationalise it will encourage the further development of Islamic banking in Russia.

[6] The Central Bank: Fourteen Companies Ready to Participate in Islamic Banking Experiment // TASS News Agency. URL: 4] These restrictions are imposed by Article 5 of Federal Law No. 395-1 On Banks and Banking Activities dated 2 December 1990 andArticle 12 (2)(3) of the Federal Law No. 151-Ф3 On Microfinance Activities and Microfinance Organisations dated 2 July 2010. (last accessed on 26 November 2023).

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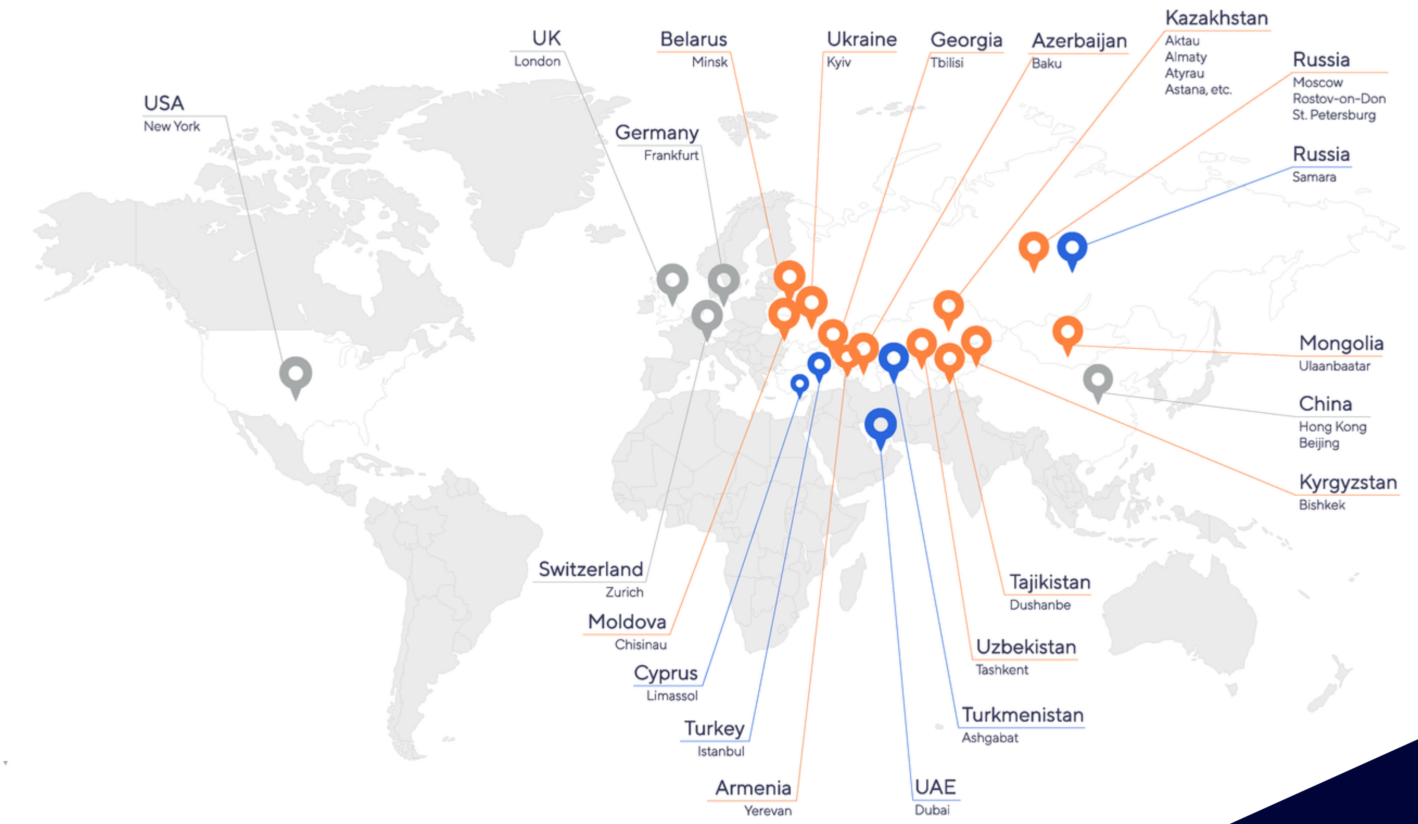

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