

# Unveiling Russia's new Islamic finance regulation

Islamic banking in Russia has long been underdeveloped, particularly in the legal sphere, which hindered its widespread adoption and application. Meanwhile, there are prerequisites for the introduction of Islamic banking in Russia. In line with the general trends in the growth of Islamic finance worldwide, in 2023 a law introducing some Islamic finance products in certain regions was adopted in Russia. In this article, VYACHESLAV KHOROVSKIY and IRINA LISINSKAYA highlight a few specifics of legal regulation of Islamic finance in Russia, with a brief overview of the practice of Islamic finance.



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## Prerequisites for the adoption of the legal regulation

Federal Law No 417-FZ On the 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 the 4<sup>th</sup> August 2023.

The law is of interest because Russia has certain prerequisites for the development of Islamic banking:

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

## 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 Shariah 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 IsDB'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. Later that year, Sberbank established a center 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 Murabahah, Halal investments, bank accounts, along with corporate and retail payment and cash services.

Tatarstan AK Bars Bank arranged US\$60 million of syndicated Murabahah 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 Shariah 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 which used the banks' funds to purchase real estate and then resold it at a premium to clients paying in installments. Intermediaries made Islamic finance products more expensive and less competitive.

## Substance of the Partner Finance Law

The Partner Finance Law authorized piloting some of the Islamic banking products in Bashkortostan, Dagestan, Tatarstan and Chechnya from the 1<sup>st</sup> September 2023 to the 1<sup>st</sup> September 2025. The 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. The law reflects the basic principles of Shariah:

- prohibits interest (Riba), allowing instead variable remuneration

- depending on results of transactions, and
- (b) 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, race, national, linguistic or religious affiliations of backgrounds.

Specifically, the Partner Finance Law authorizes:

- (i) raising money and attracting other assets from individuals and companies by borrowing, issuing bonds, establishing trusts and/or accepting contributions to the authorized capital (Sukuk equivalent)
- (ii) lending money to individual and corporate borrowers
- (iii) financing retail and corporate purchases by buying and reselling in installments for a fee (Murabahah equivalent)
- (iv) corporate financing through contributions to the authorized/share capital and joint conduct of business under simple and investment partnership agreements (Mudarabah and Musharakah equivalents respectively)
- (v) financing retail and corporate customers under financial leases (Ijarah equivalent), and
- (vi) 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, and allow them to buy, resell and hold stakes in joint ventures directly.

These restrictions are imposed by Article 5 of Federal Law No 395-1 on Banks and Banking Activities dated the 2nd December 1990 and Article 12 (2)(3) of the Federal Law No 151-Φ3 On Microfinance Activities and Microfinance Organizations dated the 2nd July 2010.

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 organizations, commercial companies and partnerships, but must meet a number of requirements to be eligible:

- (a) each must be a resident of the Russian Federation
- (b) financial institutions or their subsidiaries must be located in the designated area
- (c) non-credit institutions must have a minimum equity of RUB10 million (US\$106,341) each from the 1<sup>st</sup> September 2023 and RUB15 million (US\$159,512) from the 1st January 2024
- (d) their authorized (or share/unit) capital must not be borrowed or consist of pledged property, and
- (e) each must be entered in the register of participants of the experiment (the Register of Participants) prior to commencing operations.

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

The Central Bank of Russia which oversees partnership financing, maintains the Register of Participants, and namely enters data on banks and financial organizations providing Islamic finance services into the Register of Participants and excludes the organizations from it if their activities do not comply with the Partner Finance Law. As of the 1<sup>st</sup> April 2024, there are 15 registered participants, including AK Bars Bank, Sberbank and Public Joint Stock Company Metallurgical Investment Bank.

## Advantages and deficiencies of the legal regulation

Based on the foregoing review of the status and development of Islamic finance in various jurisdictions, a trend toward 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 favorable terms and competitive services (no need for intermediaries), and
- (d) the law requires non-discrimination in financing.

It seems it is 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 just 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:

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

Excessive authorized capital requirements (RUB10 million initially and RUB15 million from the 1<sup>st</sup> January 2024) may be too high for microfinance and non-financial organizations providing Islamic finance in the republics and may inhibit the spread of partner finance.

## Conclusion

The Partner Finance Law is only a few months old and it is still difficult to assess its impact. 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 operationalize will encourage further development of Islamic banking in Russia. ☺