Islamic Banking and Finance in Post-Soviet Central Asia with Special Reference to Kazakhstan

Prof. G.N. Khaki[1]

Bilal Ah. Malik[2]

Abstract

Since the collapse of the Soviet Union and rise of new nation-states in 1991, the Muslim republics of Central Asia and the southern Caucasus have witnessed the arrival of Islamic banking and finance to the region. In the mid-1990s, most Central Asian states joined the Organization of the Islamic Conference (OIC), allowing them to tap in to the resources of the OIC's Islamic Development Bank (IDB). Each country of the region has incorporated Islamic banking and financing instruments to varying degrees depending on the nature of its contemporary socio-political and economic structure. Particularly, the overview of Islamic finance industry in Kazakhstan and the steps taken by the Kazakh authorities, including the legislation framework, the Road-map, the debut sukuk issuance and opening of the first Islamic financial institutions, promise a good opportunity for Islamic banking in the country.

Key Words: Islamic banking, Islamic finance, Post-Soviet Central Asia, Emergence, Kazakhstan

Introduction

Islamic banking and finance, as viewed by most of the Islamic scholars, is an innovative way for the republics of Central Asia to strengthen the political and economic ties with other Islamic countries, ultimately leading the region to a greater market advantage in a competitive global economic scenario. Although Islamic financial institutions have existed since the 1960s and presently its working outlets are found in 75 countries of the world, investment in Central Asia did not take hold until after the fall of the Soviet Union. Since the collapse of the Soviet Union and rise of new nation-states in 1991, the Muslim republics of Central Asia and the southern Caucasus have witnessed the arrival of Islamic banking and finance to the region.[3]

The gradual inclusion of interest free banking, purely based on Shariah rulings, in the Muslim republics of Central Asia has succeed to generate a significant customer demand that will hopefully continue long into the future. Each country of the region has incorporated Islamic banking and financing instruments to varying degrees depending on the nature of its contemporary socio-political and economic structure. The purpose of the present paper is to take a general account of the emergence of Islamic banking and finance industry in Post-Soviet Central Asia and also to examine the actual demand for services and products offered by the industry to the majority Muslim populace of the whole region in general and Kazakhstan in particular.

[1] Islamic Studies, Centre for Central Asian Studies, Kashmir University

[2] Research Scholar, Islamic Studies, Centre for Central Asian Studies, Kashmir University

[3] Geoffrey F. Gresh, The Rise of Islamic Banking and Finance in Central Asia, The Fletcher School Online Journal for issues related to Southwest Asia and Islamic Civilization, June 2007.

The emphasis shall be given to discuss the theoretical and empirical aspects regarding, feasibility of the industry and the kind of structure it employs in building alliance and linkage with important Kazakh stakeholders. The paper will also investigate the role of Kazakh government in providing legal provision to the industry.

Background

Islamic banking and finance industry, moving ahead from its nascent phase, has now become an integral part of the global finance industry. It has not only taken its roots in almost all of the Muslim countries but has also been under discussion and penetration in Western and Far Eastern jurisdictions. In today's depressed financial scenario, investors, retail banking consumers and corporations are embracing Islamic finance as a viable alternative in investments, lending and corporate financing.[4]A similar kind of approach is appearing from the of Republics of Central Asia; the growth in the range of financial products and services, the increasing significance of the international dimension of Islamic finance, the growing economic and political relations between Central Asian countries and other money rich Arab countries are some of the essential factors which are believed to push-up the industry to become a dynamic and competitive form of financial intermediation in the region. With the rise in re-establishment of Muslim identity, a call, back to Islamic legacy, by some outer and regional Islamic forces, a good proportion of region's culturally Muslim population is looking for an ethical and value-based social setup envisaged by Islam. As a response, the local governments have moulded out some positive initiatives to suffice the growing public demand. In mid-1990s, most Central Asian states joined the Organization of the Islamic Conference (OIC), allowing them to tap into the resources of the OIC's Islamic Development Bank (IDB)and get linked to Shari'ah based financial instruments. Moreover, triggered not least by the recent global financial crisis, political decision makers and financial entrepreneurs in the region were eager to develop new sources for capital. The Middle East and the Arab states, less touched by the meltdown of Western banks, were welcoming partners for fresh capital investment in the region. The need for new and fresh cash-flows, the search for an alternative form of banking and the rising discourse about interest free banking has opened a new chapter for Islamic and finance industry in the region. [5]

Reality of Islamic Banking and Finance

Years ago, Islamic finance was considered a wishful thinking. However, serious research and development of Islamic products have shown that the Islamic finance is not only feasible and viable but it is also efficient and productive way of financial intermediation.[6]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 centers in Bahrain, Dubai, Kuala Lumpur and London. While still considered to be in its infancy as compared with the conventional 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[7].

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[4]Zeti Akhtar Aziz, "Islamic Finance: Global Trends and Challenges", The National Bureau of Asian Research (NBR), volume 18, number 4, March 2008.

[5]Mahmud Mohieldin, "Realizing The Potential Of Islamic Finance", The World Bank Economic Premise, Number 77, March 2012.

[6]MohamadZaidMohdZin, NadiyahHashim, NurulKhairiah Khalid, HajarOpir,RohayaSulaiman, The Implementation of Sukuk in Islamic Finance, International Conference on Sociality and Economics Development Singapore, 2011.

[7]Ernst and Young, Challenges and Opportunities for Islamic finance in Kazakhstan, Ernst and Young, Report 2011.

In contrast to conventional banks, during the international financial crisis of 2008—2009, no Islamic bank failed or required government recapitalization. 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 industry has established its own regulatory authorities and standard-setting bodies. Being based on the religious lines, Islamic banking has the ethical and moral principles ingrained in its core and its high level goals aim for social justice and distributional equity. To achieve this fundamental objective, the industry stimulates all sorts of economic activities in a just and fair way and increases financial inclusion of all members of community. The principal 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 (*gharar*) in transactions is strictly prohibited.
- *Riba*, making money from money (i.e. interest) is similarly prohibited.
- Certain activities like gambling (*maisir*) and game of chance (*qimar*), not beneficial to society, are banned.
- Transactions must be asset-based or asset-backed.
- Prohibition of finance for illegal and void (*haram*)businesses.

Emergence of the Islamic banking and Finance Industry in Post-Soviet Central Asia

In the late 1980s most Central Asians were still deeply secular in outlook, a legacy of 70 years of communist rule. Yet from the bottom up, as well as from the top down, there was an impetus for enhancing the role of Islam in society. In the 1990s, after the collapse of the Soviet Union, these pressures increased, stimulated by internal as well as external developments. Since the collapse of Soviet Union, end of Iron-curtain phase ascertaining limited access to the outer world and beginning of Velvet-curtain phase, letting the people peep-in and peep-out, the central Asian epaulets have seen a revival of Islamic values. The process moved on very quickly as Islam always had deep roots in the region and moreover the Muslim missionaries and funds started to arrive from other Muslim countries to help in rebuilding the religious schools, mosques and other socio-religious institutions. Increasingly, as the Central Asian states became integrated into the international community, so their responses to Islam began to resemble those that are found in other parts of the world, particularly in the Middle East. With Islam's growing importance across Central Asia, a majority of the countries in the region view the presence of an international Islamic financial institution like the IDB positively because of its ability to help respective governments promote both Islam and socio-economic development.

Islamic banking and finance, where no usury or riba is permitted, has only just begun to take root across the region and could be used as an instrument to channel the energy of Muslims who desire greater inclusion of Islam in government. Since the breakup of the Soviet Union, each of the Central Asian Republics has joined the IDB: Azerbaijan (1992); Kyrgyzstan (1993); Turkmenistan (1994); Kazakhstan (1995); Tajikistan (1996); and Uzbekistan (2003). By 1997, the IDB established a regional office in Almaty, Kazakhstan, to foster the Bank's efforts in social and economic development of the countries in the region. The regional office in Almaty (ROA) has effectively become the hub for IDB group operations in the area. The regional decision makers and private bankers are gradually opening up to Islamic financial products. The local governments like Kazakhstan, Kyrgyzstan and Azerbaijan (the countries under study) in response to the growing demand, have made some amendments in their respective state constitutions with the intention to provide some legal space for the industry where it could facilitate its Shariah based financial instruments and has an opportunity to rise its influence and boost its market share. Also, a healthy group of economic experts and finance analysts are of the opinion that the continuity of financial crisis, firstly hitting U.S and now rocking the Euro-Zone has encouraged the demand for some robust and risk-mitigated alternative.

For example, in spite of the crisis, the Islamic financial market in Kazakhstan grew by 15% last year and in the last two years, Kazakhstan's trade turnover with the Arab world reached 500 million dollars per year - more than any other Central Asian state, but less than Russia system of banking and financing. Although Kazakhstan and its neighbors are considered fertile ground for future successful Islamic business, yet they also demand new debates and efforts, like the establishment of Shari'ah councils for instance, to define appropriate understandings of Islamic practices within their own societal contexts. For the most part, such considerations seem to be only in their initiation phase in all countries today, where first institutional developments have been set off only in the last years.[8]

Banking in Kazakhstan

Since its independence in 1991 Kazakhstan, a transitional economy has been carrying out a lot of reforms and innovatory fiscal trends towards a market-oriented economy and macroeconomic stabilization. The FDI inflow into oil and gas industry was enhanced, public sector was restructured, financial sector was liberalized, Soviet era Kazakhstan Republic's *Gosbank* was transformed to the National Bank of the Republic of Kazakhstan in 1993 and Russian ruble was replaced by Kazakh *Tenge* (KZT), the national currency.[9] The two-tier banking system was introduced with the National Bank as its first tier and all other commercial banks as the second one. The National Bank was empowered to fulfill traditional central bank's functions including money issue, currency control, monetary policy and banking regulation and supervision.[10]Among all Central Asian countries, the banking system of Kazakhstan continues to be one of the strongest and comparatively stable since independence. The total banking assets cover around 10% of total GDP, and the National Bank of Kazakhstan commands sufficient resources to support the country's commercial banks. Consolidation in the banking sector continues, with liquidation of insolvent banks, privatization and mergers of others. Currently, NBK oversees 38 commercial banks, including one Islamic bank opened in 2010.[11]

NBK facilitated growth by strategies aimed towards international banking and finance standards in terms of accounting and reporting, information technologies and risk management, infrastructure and regulation. Over the past decade, Kazakhstan's banking industry has experienced a pronounced boom and bust cycle. After several years of rapid expansion in mid-2000s, the banking industry collapsed in 2008, since then the role of the banking sector in the economy decreased significantly. The total Assets-to-GDP ratio fell down as much as twice to 47% at the end of 2011. Overall, despite economic recovery of the country and structural changes in the banks' balance sheet during last few years, the banking sector is still fragile. Already high NPL (non-paying loans) ratio may be even higher than official number, as indicated by 2012 IMF Kazakhstan banking sector report. At the same time the decreased Assets-to-GDP ratio designates a low penetration of the banking sector, promising a high potential for growth. It also reflects the possibility of new banking approach in contemporary Kazakh economy.[12]

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[8] Alexander Wolters, Islamic Finance in the States of Central Asia: Strategies, Institutions, First Experiences, Forschungspapiere Research Papers, January 2013, p. 6.

[9]OECD Global Forum on International Investment, "Foreign Direct Investment In Kazakhstan", 26-27, November, Mexico.

[10] National Bank of Kazakhstan (NBK 2012) *Information about the National Bank* [Online] Available from: http://www.nationalbank.kz/?docid=164 [Accessed 10 December 2013].

[11] FMSA) *Banking Sector Statistics* [Online] Available from: http://www.afn.kz/?switch=eng&docid=441, 2012, [Accessed 14 December 2013].

[12] Madi Akmambet, How Attractive is Setting up an Islamic Bank in Kazakhstan?, Cass Business School, City University London, 14 October 2012.

Kazakhstan: A Growing Market for Interest-Free Banking and Finance Industry

Kazakhstan holds a unique position among the countries that gained sovereignty after the collapse of the USSR. Kazakhstan, the ninth largest state in the world in terms of area, occupies more than 2.7 million square kilometers (over one million square miles). More than 70 percent of the residents of Kazakhstan are Muslims. For centuries, Islam has been the main religion for the whole region. However, during the period of Soviet regime, Kazakhstan faced a vehement wave of modernization along with its root linked secularization. The country where thousands of Islamic state figures and scientists lived and worked was subjected to violent elimination of religious values and potential abolishment of religious institution and as a result Islam was saved for domestic aspects of life only. Once Kazakhstan has gained sovereignty in the early 1990s after the demise of the Soviet Union, the process of the revival of Islamic values started with a vengeance.[13]Although, Kazakhstan does not have Islam as the state religion and according to Article 1 of the 1995 constitution Kazakhstan is a secular state but still one can witness the increase in growth of the process of Islamization and rapid increase of religious feeling in the population of Kazakhstan.

It is believed that in contemporary Kazakhstan Islam is emerging as an important factor in shaping the self-identification and spiritual identity. The process of Islamic revival in Kazakhstan was followed by the process of revitalization of Islam. The increase in number of Mosques (2.5 thousand compared to 63 during Soviet era), Madrasas, Muslim schools and Islamic institutions of higher education, Islamic publications, and well educated ministers of religion come as evidence of reactivation and revitalization of religious life in Kazakhstan.[14]Meeting the public demand, in 2001, the Halal standard was introduced in Kazakhstan, resulting in a growing number of cafes and restaurants offering Halal food, and stores selling clothes that meet Shari'ah requirements[15].The impact of recent global financial crisis on the banking industry of Kazakhstan together with the potential customer demand for an ethical and value based banking and finance, paved way for the evolution and expansion of Islamic banking and finance industry in Kazakhstan.

The statistical observations reflect that PLS (profit and loss share) industry in Kazakhstan is coming out from nascent evolutionary stage and is gradually towering to produce a better alternative in terms of customer motivated policies and services in the near future. Kazakhstan's effort to develop Islamic finance has a short history and is closely intertwined with the effects of the global financial crisis starting in 2007. First initiatives for Islamic banking, however, were undertaken as early as 1990 in the republic. Still part of the Soviet Union the Council of Ministers of the Kazakh SSR passed a resolution to found the "Al'baraka Kazakhstan Bank" as an international project in cooperation with Saudi-Arabian partners (Sovet Ministrov KSSR, 30.11.1990). Al'baraka Kazakhstan Bank opened on January 1, 1991 and survived the difficult years of the dismantling of the Soviet economy only to be renamed "Kaspi Bank" and re-structured into a conventional commercial finance institute in 1997. A similar fate was suffered by an initiative from "La riba", a riba-free operating US-based Bank that tried to enter the Kazakhstan market in the 1990s.[16] Kazakhstan was the first country in Central Asia to experience PLS system of banking and finance when in 1996 IDB opened its representative office in Almaty, then capital of the Russia, which is now covering the whole Central Asia, Azerbaijan and Albania. Since operations began the IDB has spent almost 700 Mill.US-Dollar in Kazakhstan, which puts the republic ahead of its Central Asian neighbors in terms of received funding.

[13] Kuralay Yeldesbay, Kazakhstan: On the Path of Development, New Horizon, Issue No. 165, Jan-March, 2008, p. 25.
[14]Prof. Dr. Saniya Edelbay,Traditional Kazakh Culture and Islam, International Journal of Business and Social Science, Vol. 3 No. 11; June 2012.
[15] Ibid, p. 26
[16]Alexander Wolters, *Op. cit.*, p. 7.

As a player in the development aid market in Central Asia, the IDB follows the standards of operation provided for in this particular game. For its investments in Kazakhstan such standards demand a close cooperation with the state structures as the point of entrance to the market and it results in a predominance of funding and loans to state organized infrastructural projects. The money used for such activities stems from contributions generated in the member states of the IDB group. It is important to mention that for most of its engagement the bank employs conventional instruments, even if Shari'ah conformity is being observed on a case-by-case basis. As an important engine for the further development of Islamic finance in Kazakhstan the IDB has emerged, nonetheless, during the unfolding of the global financial crisis when it supported first attempts to launch reforms.[17]Taking a move forward, Kazakhstan became the only IDB member country in the Central Asia Region which joined the Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) in 2002. During the Member Country Partnership Strategy (MCPS) Technical Mission, potential opportunities in the provision of Shariah-compliant export credit and investment insurance in Kazakhstan were identified. In order to enhance Islamic banking finance in the country the MCPS Work Program proposed the following programs and capacity development activities:

a. Technical Assistance to develop the Enabling Environment (regulatory and supervisory frameworks) for Islamic finance;
b. Technical Assistance for developing the Takaful sector;
c. Equity investment in an Islamic bank to expand the sector, as well as joint initiatives and programs with key institutions, including the Development Bank of Kazakhstan; and
d. Assistance to build capacity of the Zakat Fund.[18]

Kazakhstan banks demonstrated a strong interest in Islamic financial services since early 2000's. In 2003, Kazakhstan's largest bank, BTA, became the first Central Asian financial institution to draw on an Islamic-backed line of credit when it borrowed 250 million dollars from Arab, UK and Malaysian Islamic lenders. Since 2006, other Kazakh banks such as Centre Credit and Alliance have started using Islamic financial practices.[19] The current instability in the international financial markets (e.g. the recent subprime mortgage crisis in the US) has had animpact on the local economy, and Kazakhstan's banks and regulatory authorities are increasingly turning their attention to financing based on Shari'ah guidelines. With respect to the present domestic business environment and local clients' capabilities, *murabaha,* which is the simplest type of Islamic financing, is also being practiced in Kazakhstan today. Other forms, specifically *musharakah* (joint venture), *Ijarah* (leasing) *sukuk* (Islamic bonds) and *mudarabah* (profit/loss sharing) are currently under examination, and their introduction is being planned.[20] Islamic banking guidelines were first approved in 2003 by one of the major banks in Kazakhstan, Bank Turan Alem JSC (BTA Bank). From 2006, these were acceded to other leading domestic banks, Center Credit Bank, Alliance Bank and Kazcommertzbank. In the spring of 2007, BTA Bank signed a memorandum of understanding with Dubai-based Emirates Islamic Bank to promote Shari'ah-compliant banking in Kazakhstan and other CIS states, where BTA has a number of subsidiaries.[21] Initiatives for the development of Islamic finance in Kazakhstan in 2007 did not only result in new legislation, but also led to new corporations and agencies being formed and established. First to appear was "Fattah Finance", a consultancy and financial broker for Islamic investment and securities. Fattah Finance and its staff were behind the establishment of the "Association for the Development of Islamic Finances" (ARIF) in 2009.

[17]*Ibid.*
[18]Islamic Development Bank Group, Member Country Partnership Strategy for the Republic of Kazakhstan (2012-2014) Strengthening Competitiveness for Growth & Diversification, September, 2012, pp. 30-35.
[19] Oxford Analytica Ltd., Central Asia: Islamic Finance Shows Promise, May 08, 2009, p. 2.
[20]KuralayYeldesbay,*Op. cit.*, p. 26.
[21] New horizon, April-June 2007,

A clear lobby group, ARIF tries to develop contacts with state institutions in Kazakhstan to ease the reform of legislation and work on behalf of its members' interests. In 2012 seven members join ARIF, among them the only Islamic bank operating in the republic to this day, the Islamic Bank Al-Hilal. The bank was founded in 2009 based on an agreement between the governments of the Republic of Kazakhstan and the United Arab Emirates. In line with this agreement, Al-Hilal bank from Abu Dhabi owns 100% of the JSC Islamic Bank Al Hilal which has its headquarters in Almaty, with branches in Astana and Shymkent and each branch is targeting to offer a wide range of products for both retail and corporate customers. Al Hilal bank in Abu Dhabi in turn is 100% owned by the UAE government. The young bank, founded in 2008, has become a major player on the UAE financial market, with 97% of its activities in retail and only 3% in corporate financing. Quite to the contrary, Islamic Bank Al Hilal in Kazakhstan operates solely in corporate financing, with state holdings being the main recipient of investment and service, and big infrastructure projects as the target market segment for loans. Furthermore, having considered the need of an independent Shari'ah Panel as specified in the «Al Hilal» Islamic Bank» JSC charter and the Banking Law of RK (Article No. 52-2), the Bank's Shareholder has appointed the Islamic Finance Principles Board of scholarly qualified individuals to issue opinions (Fatwa) according to Shari'ah Principles with specialized and comprehensive knowledge in Islamic Jurisprudence, Finance, Banking and Laws.

It has been put at the helm of the bank to ensure all the activities are carried out in strict compliance with Shari'ah rules and principles.[22] The Bank's mission is to raise the profile of Islamic banking in the CIS countries whilst contributing to Kazakhstan's national growth and prosperity and also strives to understand its Customers needs and provide the right Islamic finance solutions to meet these needs. The bank plays an insignificant role in the financial market in the republic ranked 33 out of 39 Kazakh banks in 2011.[23]According to the bank's annual report (Al Hilal bank, 2012) the main products offered to the corporate clients are commodity *Murabaha (58%)* and *Ijara (42%)*. The retail banking presents a current account based on *Qard-Hassan* and a deposit based on *Mudaraba* contracts.

It is supervised in its activities by the Islamic Finance Principles Board which consists of three members that are specialists in Shari'ah law and that yearly issue a fatwa on the bank's performances.[24] The Government also plans to develop and promote Almaty as a Central Asia regional financial center, and mandated the Regional Financial Center Almaty, or RFCA, for achieving this goal. More recently, in November 2011, the National Bank of Kazakhstan was admitted as an Associate Member of the Islamic Financial Services Board, based in Kuala Lumpur, Malaysia. Furthermore, in July 2011, the President signed into law the amendment "On alteration and addition to some legislative acts of the Republic of Kazakhstan on the organization of Islamic finance", paving the way for issuance of *Sukuk*.[25]In July 2012 the Development Bank of Kazakhstan became the first in the region to issue *Sukuk*. In May 2013, the ICD announced its initiative to convert Zaman Bank into Islamic bank with an investment of up to 35% of capital. The local bank will be the second Islamic bank in the country. The ICD along with Zaman Group and other investors established the first *Ijarah* Company in the Republic with an authorized capital of US$36 million. A US$ 76 million debut Murabahah program carrying a 5.5% yield will mature in August 2017.[26]Since independence, the government of Kazakhstan has been paying special attention towards the development of Islamic financial services sector but from the past few years, there has been a kind of drift in its policy.

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[22] Al Hilal Audit Report, 26.3.2012)

[23] Al Hilal has 90 Mill. US$ invested in mid-2012 in Kazakhstan, including a "wakalah" contract worth 10 Mill. US$ with the Kazakh Post (NBC News, 2.7.2012).

[24] Alexander Wolters, *Op. cit.*, p.10.

[25]***, Islamic Development Bank Group,*** *Op. cit.*, p. 28.

[26] Kazakhstan: The Golden Ticket to Islamic Finance in Central Asia, Online Islamic Finance News, Accessed on 20.10.2013.

The industry is being supported through;

(a) promulgation of specific legislation,
(b) Development of ambitious strategies,
(c) Setting up of special purpose departments,
(d) Hosting of events to deliberate on core issues in a transparent environment, and
(e) Reaching out to IDB and other institutions and experts for assistance.

Law of Kazakhstan and Government Road Map: A beginning to potentialise the Islamic banking and finance Industry in the Country

The economic researches convey that the market of Islamic banking and finance industry is growing 15-20% annually. The traditional global banking and financial system is changing. People are looking for new ways of managing their finances. Kazakhstan cannot stay away from these trends. Kazakhstan has joined the list of countries that have altered their legislation in order to facilitate Islamic banking and finance. Modern Islamic banking and finance legislation has originated not bottom up from the Islamic faithful, but top down from multinational businesses seeking a profitable market position.[27] The Republic of Kazakhstan became the first country in the Commonwealth of Independent States to introduce fundamental legislative amendments after indentifying the volume and future prospectus of Islamic finance. In 2009, after President Nursultan Nazarbayev ordered a bill on Islamic financing, the government revised existing laws on banks and the securities market and several other laws pertinent to Islamic financing.[28]

The country's powerful president has issued an edict calling for use of Islamic finance as a measure "for attracting resources for further development".[29] 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). An amendment to the Kazakhstan Banking Law in 2009 allowed Islamic banking activities, established a separate license for Islamic banks and stipulated the Islamic financing products. However, the law does not recognize Islamic 'window' operations. The main differentiating factor between conventional and Islamic banks is the accounting procedures for Islamic banks.[30]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:

- Equalization 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.
- 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.

[27]Peter B. Maggs, Islamic Banking in Kazakhstan Law in Review of Central and East European Law,Martinus Nijhoff Publishers, 2011, p. 369.
[28] On Making Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Matters of the Organization and Activities of Islamic Banks and Organizations of Islamic Banks], Law of 2 February 2009, No.133-4, available at <http://www.pavlodar.com/zakon/>
[29]Peter B. Maggs,*Op. cit.*, p. 370.
[30]***Islamic Development Bank Group,*** Op. cit., p. 27.

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 equalizing the taxation of Islamic and traditional financial products.

The implementation of Islamic finance at a legislative level in Kazakhstan played 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.[31]The Government and NBK continue to demonstrate a political will to support the new industry. The 41-point government road map "Road Map for Development of Islamic Finance by 2020", released on March 2012 (extending up to the year 2020), speaks about the concern of Kazakh government towards expansion of Islamic banking finance industry in the country. The Road-map includes main actions to be taken, responsible parties and time-frame for the following directions:

1. Legislation Improvement;
2. Educating Market;
3. Islamic Finance Infrastructure Development.
4. Public Sector Development.
5. Islamic Financial Services Development;
6. Science and Education;
8. Investors Relations.[32]

Growth of Sukuk and Takaful** Market and Some Other Activities*

In the medium term and in the context of favorable market conditions, the Government of Kazakhstan is considering the issuance of Sovereign *Sukuk* to finance fiscal deficit of the country and set the benchmark for local issuers. According to the estimates, the coupon rate of the *Sukuk* will be formed taking into account some risk premium. Overall, expected markup will be comparable to ones with traditional sovereign securities, as one of the key factors of price formation is the credit risk of the issuer. Issuance of *Sukuk* is being promoted by the Government, however, for this to materialize the pricing of the *Sukuk* will need to be competitive with the conventional bonds.[33] On 3 August 2012 the Development Bank Of Kazakhstan, a government owned financial investment institute with assets worth more than 6 Bill. US$, issued a sukuk, an Islamic bond in the size of 75 Mill US$. This was the first time an Islamic bond was issued in the former Soviet Union. For a market new to Islamic finance, the issuance by the Development Bank is believed to provide a good starting point for opening the market for other sukuk issuers because of the bank's ties with the government of Kazakhstan.

To shed light on some of the conditions for this operation allows to better follow the debut of Islamic finance products on the Kazakh and, for that matter, entire Central Asian market. To begin with, the issuer, the Development Bank of Kazakhstan (DBK), was operating under uncertain legal conditions. The *sukuk* was issued as a commodity murabahah, yet laws in Kazakhstan specified only *sukuk* of the *Ijarah* and *musharakah* type. In addition, according to representatives from the DBK, neither issuance procedures for Islamic bonds nor their listing procedures were clearly regulated. The launching of this bond was a test for all parties involved to examine the reaction of the market.

[31]Ernst & Young,*Op. cit.*
[32]MadiAkmambet,*Op. cit.*, p. 43.
[33] Ernst & Young, *Op. cit*.

To smooth the process, the *sukuk* was issued in Malaysian ringgit, using the Malaysian law and corresponding supervisory capacities in the Kingdom, namely approval from the Malaysian Central Bank and the Shari'ah Advisory Council of the Securities Commission of Malaysia for Shari'ah conformity. Listed at the Kazakh stock exchange and with a profit rate of 5,5% p.a. the *sukuk* was aimed at investors from Malaysia to whom 62% of the bond were allocated, the remaining 38 to investors in Kazakhstan.[34] There is a need to facilitate a local currency *sukuk* to invest in local projects and for the local investors. Promotion activities related to *Sukuk* is continuing. Thanks to the state support and adoption of the new law on Islamic Finance in Kazakhstan, some Islamic financial institutions have been established and are operating in the country. Thus, a number of legal entities has been registered and some companies are already providing consultancy services on Islamic finance.

In order to coordinate activities of public entities involved in development of Islamic finance, the Government of Kazakhstan approved Road Map for Development of Islamic Finance in Kazakhstan by 2020, and its implementation will contribute to the creation of stable environment for development of Islamic financial industry, attracting the investors and market players. Definitely, to ensure efficient implementation of the Islamic finance in Kazakhstan further amendments and changes will be required to adapt the current legislation to the needs of this sector. Currently National Bank of Kazakhstan prepare a draft law "On the introduction of changes and amendments into the legal acts of the Republic of Kazakhstan related to insurance and Islamic finance", to further develop the Islamic finance in Kazakhstan through introducing principles of Islamic insurance, improving environment for Islamic banks, and developing infrastructure of the Islamic finance.

The *Takaful* sector shows potential in Kazakhstan. The *Takaful* Association is busy in promoting the sector. Currently, it only offers health and accident coverage for *Hajj* and *Ummrah* travelers. The Financial Services Industry (FSA) has adopted a document which entails acceptance of necessary legislation of *Takaful* by 2012. The Hajj Fund (a 50:50 joint venture of Fattah Finance and Amana Raya) was launched at the WIEF in June 2011. The Ministry of Finance is keen to develop the Islamic microfinance sector, and has allocated funds for developing the microfinance in the country. It is proposing changes to national legislation for microfinance with a focus on rural areas. Kazakhstan's priorities are to strengthen the existing 800-1,000 microfinance institutions.

Applying Islamic financing instruments in Agri sector is a new market exposure for the Islamic finance industry in Kazakhstan. The country is among the world's top 10 exporters of wheat which is by far the country's most important agricultural commodity, well- known for its modernization of harvesting techniques. The International Islamic trade Finance Corporation (ITCF), a member of the Islamic development Group, put together an Islamic structured deal of US$40 million for financing exports of wheat in a Shariah-compliant manner. The deal in the form of a *murabaha*- based financing structure serves as a model for future agricultural and supply chain transactions with a substantial reduction of the total pricing charged to the beneficiary and thereby rendering the financing structure more competitive.[35]

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[34] Alexander Wolters, *Op. cit*., p. 10.

**Sukuk* is a plural of *Sakk*, which means "legal documents, deed, and check". It is an Arabic name for financial certificate but it can be seen as an Islamic equivalent of the conventional bonds.

***Takaful* is an Arabic word that means mutual protection and indemnity: one party, while providing help to others is also identified by them and this idea of mutual protection is in clear contrast to the profit motive which underlines conventional proprietary insurance.

[35] Islamic Research & Training Institute, Islamic Finance in Practice Financing Agri-Business, Vol.1, No.2, Feb. 2012.

Recommendations

Nevertheless, Islamic banking and finance in Kazakhstan has been gradually evolving from its nascent stage in terms of regulation, infrastructure and number of market participants, the overview shows that Islamic banking and finance in Kazakhstan is quite far from a full readiness of the market. Here are some recommendations and suggestion, if followed, maybe helpful for the industry to perform better in the current Kazakh banking scenario.

1. Islamic investments in Kazakhstan must be weighted from the viewpoint of its better socio-economic goals. Thus a ‘Socio-Economic Better-Off Test’ for each and every transaction needs to be introduced in order to have a risk controlled *Shariah* compliant business venture.
2. Despite of low market penetration, banking sector has high potential market in Kazakhstan. The industry (Islamic banking and finance industry) should revisit its business strategy so that awareness must be created at a better level among the population of the country. This will increase the potential market for Islamic products.
3. Ensuring microfinance, the industry should enhance the channelization of funds to rural population and the agro-sector.
4. The largest Islamic banking unit IDB should utilize its experience and also should act as a major investing agent in the country.
4. Not only Islamic banks, but also the regulators should take actions in informing and educating the market on Islamic finance goals and mission, principles and mechanisms.
5. The bank and the regulators must ensure that the Islamic finance legislation framework is being improved as it is planned in the Road-map of the Government of the RK and the recent draft law.

Conclusion

The banking and financial pundits are of the opinion that the chances for Islamic banking are higher in Kazakhstan because of declining customer trust in years old conventional banking industry due to the impact of global financial and debt crisis on the local Kazakh banks. While the majority of Kazakhstan's citizens are Muslim, the country is largely secular, and Nazarbayev's policy has been to build good relations with all religions. However, he has been very much the driving force behind efforts to establish Islamic finance in Kazakhstan. The country of Kazakhstan has a lot to offer for Islamic banking and finance. The banking and business sector of country shows a promising potential for the industry. Taken alone by the numbers of international conferences and forums dedicated to Islamic finance and business, Kazakhstan has indisputably become the regional leader in promoting Islamic ideas of banking and doing business in the region. Among others the “Seventh World Islamic Economic Forum” was held in June 2011, the “Second Islamic Finance Forum” took place in September 2011, the “Kazakhstan International Halal Expo '2012” and the “Third Kazakhstan Islamic Finance Conference” were both organized in October 2012. These events underline Kazakhstan's declared goal to develop the country into the regional center for Islamic finance in the former Soviet Union. The government is currently implementing a program of industrial and innovative development and to give this framework a practical shape, it needs foreign investment. The Muslim world, including Malaysia and the countries of the Middle East, has a huge amount of capital ready to flow into Kazakhstan once the right conditions are in place, and that is what the roadmap is for. The roadmap, primarily set out to provide all possibilities of regulating the Islamic banking and finance activities until 2020, is expected to enhance the market share of Islamic banking and finance industry in the coming years.

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