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## TO BE OR NOT TO BE? ISLAMIC BANKING IN KAZAKHSTAN



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Unlike conventional finance, Islamic finance builds and regulates its activities based on the principles and philosophy of Islamic legal jurisprudence, and its development[1] in Kazakhstan dates back to the end of the 1990s. At that time, Arab banks showed interest in investing in *shariah*[2]-compliant private and state projects in the country, with Saudi billionaire businessman, Sheikh Saleh Kamel, founder of Dallah al Baraka Group, being the first foreign investor in Kazakhstan's economy following independence.

Encouraged by promising early indications, the Kazakh government took steps to improve the infrastructure for the development of Islamic finance in the country. Despite this, Islamic finance in Kazakhstan remains in its infancy.

State regulators defined four key components of the national financial ecosystem:

**Figure 1: Four key components of the national financial ecosystem**



Figure 2. Development of Islamic finance in Kazakhstan



Source: Alfiya R. Salikhova, head of research committee, Association for Development of Islamic Finance.

## 1. INTERNATIONAL RELATIONS

While Kazakhstan organised several international banking forums and conferences, the National Bank of Kazakhstan acquired several memberships in international financial bodies, becoming a full-fledged member of the Islamic Development Bank (IDB) in 1995. In 1998, the IDB opened a regional office in Almaty. Remarkably, it was, and remains, the first and only branch in Central Asia and the Commonwealth of Independent States (CIS). The inauguration of IDB's branch in Almaty was a key step in linking Kazakhstan with international Islamic finance markets and institutions. Today, IDB is one of Kazakhstan's key and strategic partners in the development of the Islamic finance and banking industry.

In 2012, the government and IDB Group agreed to and signed a country partnership strategy aimed at strengthening interaction within the state programme of mandatory industrial and innovative development. On June 1, 2014, the National Bank of Kazakhstan signed the Memorandum of Cooperation and Interaction with IDB Group, as well as an Agreement for Technical Assistance (grant) on enhancing Kazakhstan's laws concerning Islamic financing. The personal involvement and support of President Nazarbayev accelerated the international initiatives.

Prior to the 2008 financial crisis, several large Kazakh banks approached the international market for Islamic finance. Between 2005 and 2008, Islamic banks provided a number of loan packages totalling US\$238 million to Kazakh banks. At that time, all international transactions and agreements between foreign and Kazakh financial institutions were processed under traditional and international banking regulations. Although the Kazakh legislation was then in force, it did not specify an option to use Islamic banking or prohibit it.

## 2. LEGISLATION AND REGULATION OF ISLAMIC FINANCE

In a discussion among the representatives of local banks during a 2006 conference held in Almaty, the banks stated there were no obstacles to the conclusion of deals with Islamic banking partners. Moreover, local regulators visited Islamic banks in Malaysia to learn from their experience. They claimed that it was a matter of time before special 'Islamic Windows'[3] were opened at traditional banks for Islamic banking transactions. In the autumn of 2007, the conference that followed became the forum for heated discussions on Islamic finance. At that time, the subprime mortgage crisis was erupting in the United States, with Western banks suffering from diminished liquidity ratios, resulting in expensive external borrowing for Kazakh banks. This conference became a platform for discussions on the future of Islamic finance in Kazakhstan.

Having determined the necessity of introducing an official basis for Islamic banking, President Nazarbayev, on February 12, 2009, signed off on a specific legal framework for Islamic finance. As a result of this historic step, Kazakhstan became the first government in the CIS to adopt legal measures for Islamic finance. The act created the legal infrastructure necessary to introduce and develop Islamic financial instruments in Kazakhstan. The main amendments to the laws on banks were as follows:

- Basic requirements for Islamic banking transactions, based on the principles of Islamic financing (prohibition on interest-based lending, or investment in businesses considered unlawful or *haram* – contrary to the norms of Islam);
- The removal of restrictions on the participation of Islamic banks in the share capital of legal entities, as well as restrictions prohibiting Islamic banks from engaging in other activities in addition to personal banking, for example the financing of production and trading activities. Thus, Islamic banks are allowed to engage in commercial operations and share profits and losses with their clients;
- The introduction of Councils on Islamic Finance Principles, which are equivalent to *Shariah* advisory councils in Islamic banks located overseas.

Despite the amendments made to the legislation allowing Islamic banking[4] activities, the regulators did not adequately analyse the specifics of Islamic banking instruments. This led to ambiguities in the interpretation and application of the laws. The main problems relating to the ongoing development of Islamic finance are as follows:

### Regulatory issues

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Initially, Islamic banks managed transactions in accordance with Article 52 (11) – ‘Conduct of Agency Activity in the Conduct of Banking Operations of an Islamic Bank’. However, the regulatory agency considered such Islamic finance transactions to be an ‘investment activity’, according to Article 52 (6), ‘Deposit Accounts in Islamic Banks’.

### Taxation

Currently, there are no specific tax regimes for Islamic financial instruments. All income taxes from Islamic finance are regulated according to general taxation, with certain qualifications and amendments. According to the Kazakhstan Tax Code, any transactions of a bank, including trading mechanisms (the purchase and sale of stocks, fixed assets, etc.), i.e. all basic instruments, are subject to value-added tax (VAT). At the same time, the margin earned by a banking product is treated as the income of the Islamic bank, which is exempted from income tax. Thus, according to the current tax code, although the margin earned from products is exempt from tax, the main sum of the loan is subject to VAT. This makes the financial instruments of Islamic banking unattractive for both clients and the banks.



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## 3. MARKET PLAYERS

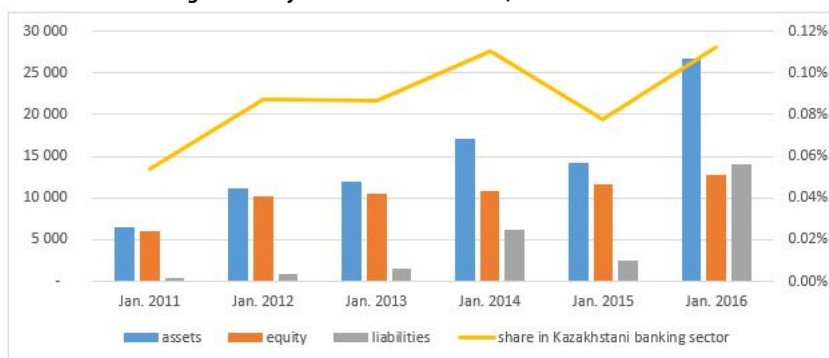
Market players in the Islamic banking sector of Kazakhstan make up less than 1 percent in the country. There are also few Islamic finance institutions. As a major bank, Al Hilal Bank, for example, demonstrates the real development of Islamic banking in Kazakhstan.

In 2010, Al Hilal Bank JSC was a pioneer in Kazakhstan, being the first financial institution to operate as a fully-fledged Islamic bank under intergovernmental agreements between Kazakhstan and the United Arab Emirates (UAE). The bank opened branches in Almaty, Astana and Shymkent. While all traditional banks were headquartered in Almaty, Astana had become the new national capital with infrastructure projects co-financed by Arab bankers, including those offering Islamic finance. Al Hilal Bank opened a branch in Shymkent because the majority of that city's citizens are Muslim; ethnic Kazakhs who tend to follow Kazakh/Muslim traditions more closely than those living in other regions. They are also considered to be entrepreneurial. By contrast, other traditional banks opened regional branches in resource producing cities, particularly in oil and gas producing areas.

Al Hilal Bank defined its main target market as large corporate clients. It paid special attention to state and national companies, which account for half the country's gross domestic product. The bank also looked to VIP clients for deposits. The bank took three years to grow from its incorporation through to the commencement of commercial activities. The main challenges faced by the bank were:

- The differences between the legislative acts regulating the activities of Islamic banking and the situation currently in force
- The inadequacy of regulations relating to the accounting and regulatory reporting of Islamic finance
- Unfavourable differences in tax regimes between Islamic and non-Islamic banks
- Issues related to the simplification of procedures for the registration of real estate transactions for Islamic banks.

**Figure 3: Major financial indicators, JSC Al Hilal Bank**



Source: National bank of the Republic of Kazakhstan.

## 4. PUBLIC AWARENESS

The National Bank of Kazakhstan reports that 40 percent of surveyed participants do not understand the difference between Islamic and conventional financial services products, but would like to have more information. However, 39 percent of respondents said that they have no knowledge of the differences and do not need to find out more.

According to a SWOT analysis of Islamic Finance in Kazakhstan conducted by the National Bank of Kazakhstan, factors such as low financial literacy, a lack of product information available to businesses and the general population, as well as the lack of professional and experienced specialists, are defined as weaknesses in the development of Islamic banking. Moreover, there are potential threats to the nascent industry due to 'Islamophobia', as there is a pervasive misconception that the industry could have potential connections with terrorist organisations and extremism.

## CONCLUSION

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Experts confirm there is evidence of a growing general interest in alternative finance, particularly resulting from the unattractive offerings currently available from conventional banks and the generally poor reputation of the traditional, global financial sector. However, there is no financial institution serving this demand and stimulating its growth, which also depends on the effectiveness of regulatory institutions.

The financial sector is as dependent on human factors as any other commercial sector. The lack of professional and experienced banking specialists and the generally low level of understanding of Islamic finance among the population are key obstacles to the development of Islamic finance in Kazakhstan. However, according to analysts at S&P, Islamic finance activity is expected to gradually expand over the coming years and will eventually complement conventional bank offerings by providing an accepted alternative route to domestic financing needs.

One of the prerequisites for the development of Islamic finance in Kazakhstan is the establishment of the Astana International Financial Centre, where a special legal and regulatory framework based on English common law and in accordance with Islamic finance principles will be implemented.[5] Moreover, the memorandum signed on March 14, 2017 for Islamic finance development during the Islamic Finance News CIS Forum, is one of the steps for growing Islamic finance activities in Kazakhstan, the analysis of which should be done in further studies.

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[1] A conventional bank's 'Islamic window' is a subdivision or subsidiary that follows Islamic principles, thus allowing both conventional and Islamic banking services to be offered within a corporate structure from the same physical location or locations.

[2] Financial services that comply with the requirements of the Shariah. <http://www.islamic-banking.com>

[3] Defined as financial services that comply with shariah requirements: <http://www.islamic-banking.com>

[4] Often referred to as Islamic law, shariah as a legal form did not exist at the time the *Qur'an* was revealed. <http://www.islamic-banking.com>

[5] <http://astanatimes.com/2017/03/astana-to-be-positioned-as-one-of-leading-platforms-for-islamic-finance-says-aifc-governor/>  
(<http://astanatimes.com/2017/03/astana-to-be-positioned-as-one-of-leading-platforms-for-islamic-finance-says-aifc-governor/>)

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