

# Challenges and opportunities for Islamic finance in Kazakhstan



# The reality of Islamic finance



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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 global financial industry, Islamic finance accounts for assets conservatively valued at over US\$750 billion across 450 financial institutions based in 75 countries, all operating according to Islamic principles.

In contrast to conventional banks, during the international financial crisis of 2008–2009, no Islamic bank failed or required government 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 principle differentiators between Islamic finance and conventional finance include the following:

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

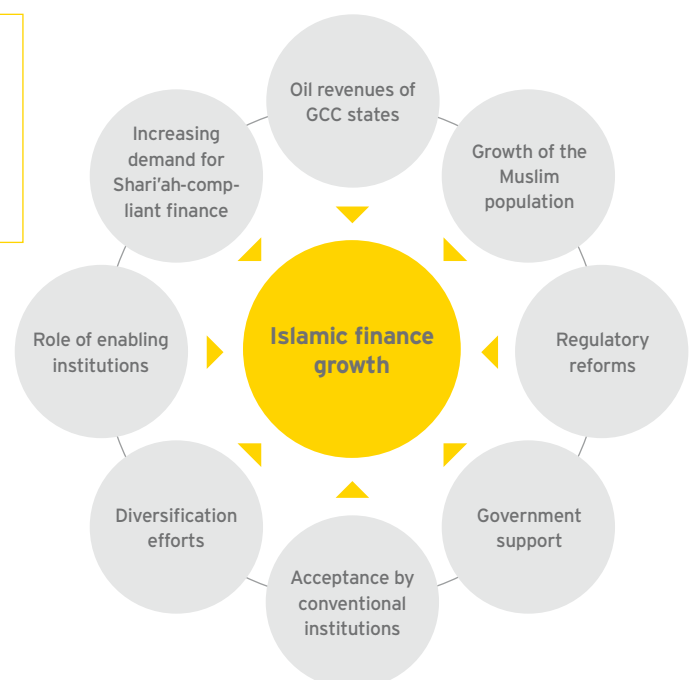
It is widely known that the legislation of the Middle East and Gulf countries is based on Shari'ah. Legislative acts creating favorable tax and legal conditions for the development of Islamic finance have also been approved in such European countries as Great Britain, France and Germany. While in Asian countries Islamic finance is well developed, with its main center in Malaysia, other regions (e.g. Singapore, Hong Kong) are also competing for their share of the Islamic finance market.

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

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

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

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



# Development of Islamic finance in Kazakhstan

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

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

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

- ▶ 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.

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

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

- ▶ The list of types of income received by residents and non-residents was expanded to include income received from an investment deposit placed in an Islamic bank. Such an amendment allows the taxation of such income to be defined and makes the tax consequences of investing in Kazakhstan, including foreign investments, more transparent.
- ▶ The provision of Islamic financial products was generally exempted from value added tax, which is a significant achievement in equalizing the taxation of Islamic and traditional financial products.

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




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# Further development of Islamic finance in Kazakhstan

Kazakhstan to move forward  
without delay in order to fully  
utilize its pioneer status in the  
area of Islamic finance



Despite the work that has been done, Kazakhstan's legislation regulating Islamic finance is not perfect and requires further development. It is essential to ensure a strong legislative base for the establishment of other Islamic financial institutions in Kazakhstan (e.g. insurance companies, investment funds) and the coverage of all Islamic financial products as well as to enable conventional banks and other financial organizations to provide Islamic financial products in the course of their regular activities.

In particular, the following main aspects must be considered:

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

Despite the amendments to Kazakhstan's tax legislation, the tax treatment of certain Islamic financial products remains unclear and unfavorable as compared with their conventional counterparts. Based on today's experience with Islamic financial products in Kazakhstan, certain changes for the improvement of tax law are currently being considered. These include, among others, changes to the VAT treatment for an asset's cost when a commercial agent finances trading activities by providing a commercial loan (Commodity Murabaha) and exemption from VAT on the markup of an Islamic bank that renders agency services in the process of banking transactions (Wakala). Other amendments that should accelerate the implementation and development of Islamic finance in Kazakhstan are also being considered.

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

# Ernst & Young is a leader in Islamic financial advisory services

Responding to the dynamic development of the Islamic financial market, Ernst & Young established a group of experts (the Islamic Financial Services Group) which specializes in rendering Islamic financial advisory services to participants of Islamic and conventional financial organizations.

Ernst & Young's Islamic Financial Services Group, established in 1998 in Bahrain, currently includes more than 50 professionals working in countries in the Middle East and Asia, Great Britain, Luxembourg and the CIS.

The Islamic Financial Services Group has won a number of awards for market leadership, professionalism and contributions to the development of services in the Islamic finance sector, including:



**Best Advisory Firm 2009**  
Islamic Business & Finance Awards



**Best Islamic Finance Advisory Firm for 2008**  
Islamic Finance News Awards



**Most Outstanding Business Advisory & Consulting Firm for 2006 and 2007**  
Kuala Lumpur Islamic Finance Forum Award



**Best Islamic Finance Advisory Firm for 2006**  
Islamic Finance News Awards



**Best Islamic Consulting Firm 2006**  
Sheikh Mohammed Bin Rashid Al Maktoum Award



**Best Islamic Finance Advisory Firm 2005**  
Banker Middle East Award



**Euromoney Islamic Finance Award 2005**





## Islamic financial services provided by Ernst & Young in the CIS

As mentioned above, Kazakhstan was the first region in the CIS to take action in implementing Islamic finance legislation.

Our specialists actively collaborated with government institutions in Kazakhstan in developing, analyzing and lobbying legislative changes for purposes of Islamic finance as well as on issues related to the creation of Al Hilal Bank, the first Islamic bank in Kazakhstan. Currently we are establishing relations with government institutions in Russia and Azerbaijan.

In connection with the growing demand for advisory services in the Islamic financial sector, Ernst & Young is hiring experienced specialists in this sector to expand its services and consolidate its status as a leader in providing Islamic financial services in the CIS and worldwide.

We have successful experience in rendering Islamic financial services. Our specialists render services to various financial organizations in the CIS region, including:

- ▶ Cooperation with BTA Bank in implementing Islamic financial services in Kazakhstan
- ▶ Assistance in opening Al Hilal Bank, the first Islamic bank, and advice to the bank on various issues
- ▶ Advice on the treatment of Islamic banking products under current Kazakhstan tax law
- ▶ Analysis of the tax consequences for Amrahbank of implementing Islamic banking products in Azerbaijan
- ▶ Analysis of the Russian tax implications of Sukuk, assistance in developing a tax-efficient structure for one of the largest Russian leasing companies
- ▶ Structuring a trade financing operation, including analysis of the Russian tax implications of Murabaha for a Turkish trading company
- ▶ Advising a large investment group on the tax aspects of establishing an Islamic Investment Fund and on raising funds
- ▶ Acting as professionals and speakers on Islamic finance issues at various international Islamic finance conferences in Astana, Almaty, Moscow and Kazan.

# Who we are



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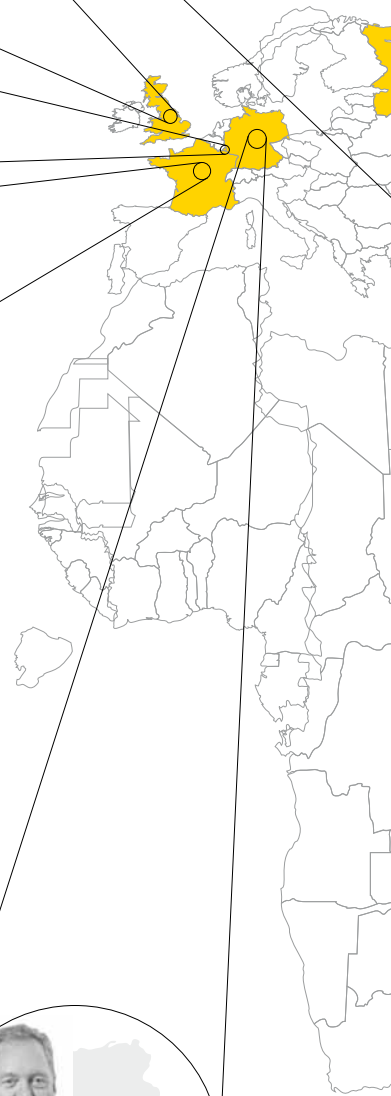
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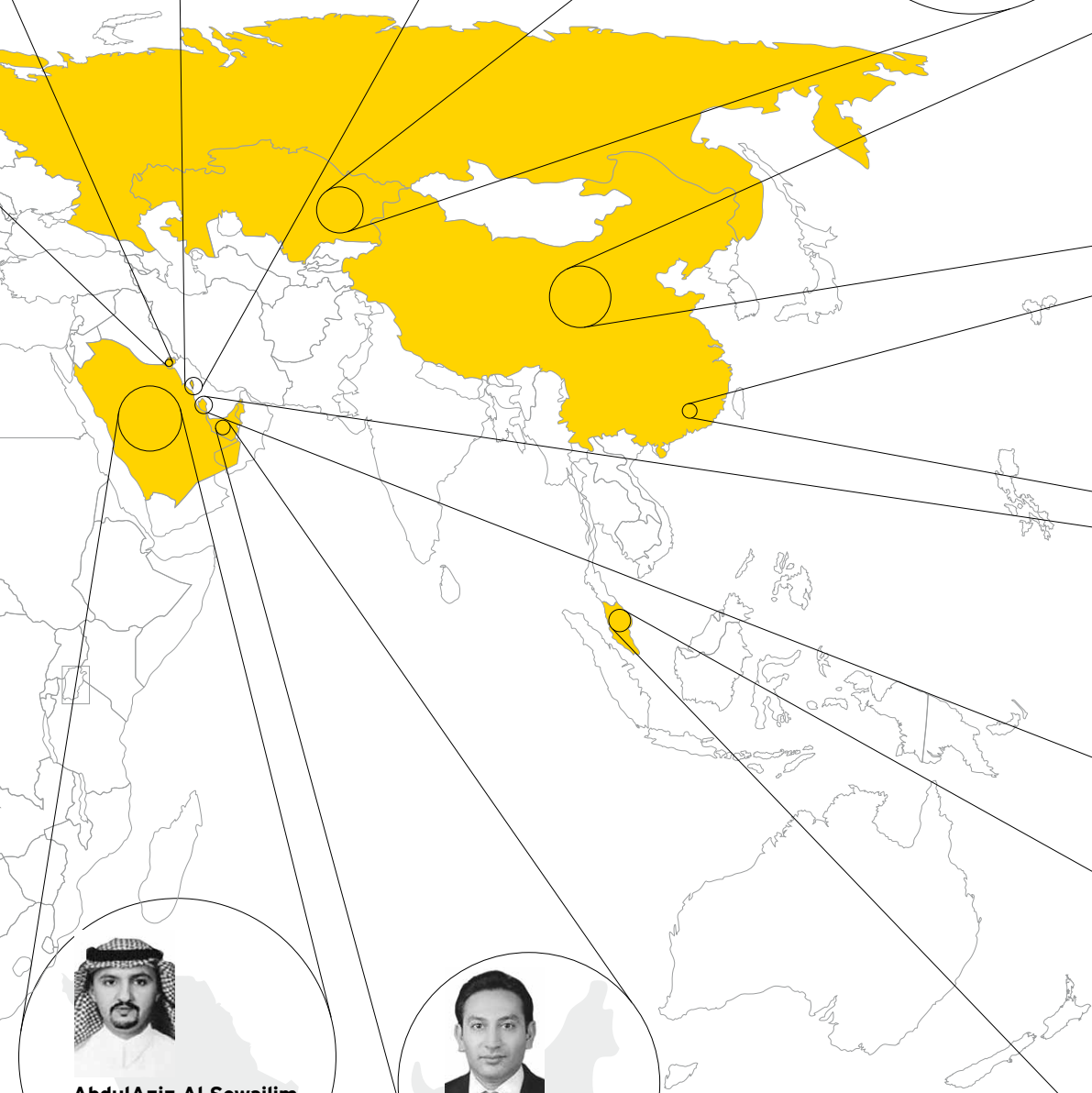
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**About Ernst & Young**

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Ernst & Young expands its services and resources in accordance with clients' needs throughout the CIS. 3,500 professionals work at 18 offices in Moscow, St. Petersburg, Novosibirsk, Ekaterinburg, Kazan, Krasnodar, Togliatti, Yuzhno-Sakhalinsk, Almaty, Astana, Atyrau, Baku, Kyiv, Donetsk, Tashkent, Tbilisi, Yerevan, and Minsk.

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