

Banking Law and Implementation of Islamic Banking in Kazakhstan

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Abstract. Since 2009, the National Bank of Kazakhstan has been developing the legal framework for Islamic banks in the country. A set of amendments to the Civil Code, Banking Law, Tax Law and other laws and regulations were introduced to level the playing field both for Islamic and conventional banks. Despite the fact that the foundation for starting and operating of Islamic banks in the country has already been created, the development of the industry is characterized by extremely low indicators. High demand for foreign investments and Islamic financial services, and the purpose to become a regional hub for Islamic banking by 2020 in Central Asia make Kazakhstani authorities continue their active work over improving the environment for Islamic financial institutions. In 2015, an international law firm was invited into the country by the National Bank of Kazakhstan to work out a new set of legislative initiatives for Islamic financial institutions. This paper is an attempt to formulate and discuss recommendations for enhancing effectiveness of the regulatory framework for Islamic banking in Kazakhstan.

Keywords: Islamic finance, Kazakhstan, Islamic banking.

KAUJIE Classification: J33.

1. Introduction

In 2009, for the first time ever in the Commonwealth of Independent States (CIS) and Central Asia, the law of the Republic of Kazakhstan (RK) on organizing Islamic banks' activity and Islamic financing was adopted. Adoption of such a law became a starting point for Islamic finance development in RK. In 2012, the government of Kazakhstan approved a Road Map for Islamic Finance Development by 2020. In October 2014, during the 10th World Islamic

Economic Forum (WIEF), the President of Kazakhstan was awarded the Global Islamic Finance Award. This award is the international recognition of the great efforts made by the head of the state to promote Islamic finance and to make Kazakhstan a regional hub for Islamic banking in the CIS and Central Asia by 2020. Taking into account that the number of Muslims in this region is greater than 75 million, one may consider it as having great potential for the Islamic financial services market. Moreover,

as Islamic finance is equally accessible to everyone, regardless of faith, it is expected that the demand for Islamic banking products will grow substantially.

The National Bank of the Republic of Kazakhstan (henceforth National Bank) has identified three key objectives to ensure further development of Islamic finance in the country. The first one is human capital. Great attention needs to be given to educating people in the features of Islamic finance. The second relates to the improvement of legislation and the related development of the Islamic financial services industry. In 2014, Kazakhstan received a grant for technical assistance from the IDB Group in order to improve the legal framework for Islamic finance. It is expected that a new comprehensive law will be adopted in 2017. The third objective relates to attracting Islamic financial market participants to Kazakhstan. The attraction of foreign investor inflows is undoubtedly a driving force behind the latest reforms. As stated by the former governor of the National Bank: "Our aim is to attract financial institutions from the Middle East and Southeast Asia" (Kelimbetov, 2014).

In its concept for Financial Sector Development, the National Bank defined a targeted indicator for Islamic finance industry development: by 2020 the share of Islamic banks should reach 3-5 per cent of the total volume of the country's banking system assets. Eventually, this task requires significant joint efforts from all the participants: the regulator, the business and the scientific community. This article introduces some recommendations relating to enhancing the effectiveness of the legal, regulatory and core infrastructure to promote the development of Islamic financial institutions.

The structure of this paper is as follows: section two provides a literature review on Islamic finance developments in Kazakhstan, with special attention to Islamic banking challenges; section three discloses the approach of the Kazakh government towards regulation of Islamic banking as well as taxation of their basic bank products; section four researches the development of the Islamic finance industry in Kazakhstan; in the fifth section of the paper the analysis of the only Islamic bank operating in the country is undertaken. Finally, certain recommendations are drawn in the last section of the paper.

2. Literature Review

There are a number of studies dedicated to the investigation of the development of Islamic banking in Kazakhstan. Over the last two years, specialists in the National Bank have intensified their research on Islamic finance, for instance see, Alibekova (2015), Tukulova (2014), Shamshiyev (2014).

Alibekova (2015) investigates the support which the Islamic finance industry received from the UK and Dubai governments in the light of the legal framework, strategy and infrastructure, and proposed practical recommendations for Kazakhstan to boost the growth of the industry through establishing the Astana International Financial Centre (AIFC).

Tukulova (2014) raised the issue of Shari'ah governance in Islamic banking and the role of the National Bank in its regulation. She emphasized that due to the lack of Islamic scholars in the country, there was a risk of Shari'ah non-compliance for certain financial transactions. She argued that there was a need to study the international experience and standards of AAOIFI and IFSB, to adopt the principles of corporate and Shari'ah governance in Islamic financial institutions and to elaborate the requirements for Shari'ah board members in Kazakhstan.

Shamshiyev (2014) investigates the experience of deposit guarantees for Islamic deposits in Kazakhstan. He argues that the development of Islamic finance in the country depends on various factors including: the existence of an appropriate legal framework; market infrastructure, demand, human resources, and so on. Shamshiyev argues that the existence of a deposit guarantee system is one of the main factors for increasing people's confidence in Islamic banks. He studies the peculiarities of the Islamic deposit scheme protection in different countries with other dual banking systems and proposes to discuss this issue when the share of Islamic deposits from individuals and the number of Islamic banks in Kazakhstan increases significantly.

Baidalet (2011, 2014) describes historical aspects and the current situation of Islamic finance in Kazakhstan, including current and future prospects. He emphasizes that the most powerful supporter of Islamic finance is the president of the country, Nursultan Nazarbayev. Baidalet's studies are

critical in terms of the implementation of Islamic finance in the past. He identifies the main obstacles interfering with industry development relate to discrepancies in the current legislation and a lack of general understanding about Islam and its particular form of financing. On this basis he raises the issue of industry rebranding, emphasizing sustainability and ethical features.

Charman et al. (2013) examine the issues underlying the recent growth in Islamic finance in the Republic of Kazakhstan and assessed the prospects for future growth in the region and in particular, the extent to which Islamic banking can be merged with traditional lending.

Abduh et al. (2013) examine the level of awareness and willingness of Muslims to patronize Islamic banking in Kazakhstan based on survey evidence. They reveal that more than half of the respondents were aware of Islamic banking in Kazakhstan, but they were not aware of the variety of products and services on offer. They also identified that the willingness level for using Islamic banking products and services in Kazakhstan was high.

Khaki et al. (2013) investigate Islamic banking and finance in Post-Soviet Central Asia with special reference to Kazakhstan. They examine the steps taken by the Kazakh authorities to advance Islamic finance in the country, covering: legislative developments; the Road-map, the debut *shukūk* issuance and the opening of the first Islamic financial institution.

Wolters (2013) describes the history of Islamic finance in Central Asian Republics with a focus on institutional development. He provides short overviews on selected Islamic finance initiatives including the establishment of the “Islamic Bank Al-Hilal” in Kazakhstan and the “EcoIslamikBank” in Kyrgyzstan.

Maggs (2011) investigates the legislation in Kazakhstan designed to facilitate the development of Islamic banking, namely: types of allowed activities for Islamic banks and prudential norms for their activity. Special attention is paid to liquidation and taxation issues.

Bekkin (2009) examines the development of Islamic finance in the former Soviet Union countries. He describes the first experience of

conventional banks to work with international Islamic financial institutions. He also investigates some peculiarities of the legal framework for Islamic banks in Kazakhstan.

Gresh (2007) examines the important role of the IDB and other Islamic banking and financial institutions in promoting socio-economic development across the Central Asia region. He argues that the Islamic banking and finance sector, supported by the IDB, will continue to thrive in the future because of Kazakhstan’s relatively stable political situation and flourishing economy.

This following, the paper investigates the legal and tax environment for Islamic banks operating in Kazakhstan. It also considers some practical issues for the industry development aimed at fulfilling the objective of making Kazakhstan a regional hub for Islamic banking in the CIS and Central Asia by 2020.

3. Regulatory Framework for Islamic Banking in Kazakhstan: Legal and Tax Perspective

The emergence of Islamic banking in Kazakhstan can be traced back to the start of its sovereign independency. In January 1992, the international bank ‘Al-Baraka Kazakhstan’ was established by decree No. 5 of the president of the Republic of Kazakhstan. The bank operated under this logo up to 1994, and Sheikh Saleh Kamel invested USD 100 million into the real sector of the Kazakhstani economy. However, due to the new state’s transition difficulties, problems among shareholders arose, and in 1995 Lukoil Company bought the controlling stake in the bank naming it ‘Caspian’ and restructured it into a conventional commercial financial bank (Wolters, 2013).

Later on during the economic boom when real estate prices (2005-2008) and credit inflows from outside boomed, various Kazakh banks (BTA, Alliance Bank, Temir Bank, Astana Finance) participated in several *murābahah* syndications with top Islamic banks from the Middle East and South East Asia. However, due to the sharp liquidity crisis of 2008-2009 all of them defaulted technically and those failures created doubts about the future of the industry. Nowadays this issue is being considered by the National Bank within their planned road map on Islamic finance development by 2020 (Baidaulat, 2014).

The first official attempt to institutionalize the Islamic finance industry was made in February 2009, when Kazakhstan enacted a number of amendments to establish an adequate legal framework for Islamic finance in the country. The adoption of the legislation covering Islamic banking, capital markets, and investment funds was based on international experience and the research program held by international experts “Zaid Ibrahim & Co” – the Malaysian consultancy, which acted as one of the main advisers on Islamic finance development

(Charman *et.al.*, 2013). New sets of amendments were adopted during 2011-2015 to facilitate the issuance of sovereign and corporate Islamic securities, harmonize tax treatment of some Islamic financial products, implement Islamic insurance and Islamic leasing in the financial system of the country, and to allow a conventional bank to be converted into an Islamic one.

Overall, the legislative framework for Islamic finance in Kazakhstan as of the first of December 2015 is shown in Table (1).

Table (1). Legislative Framework for Islamic Finance in Kazakhstan (December 2015).

Basic Laws	Amendments on Islamic financing issues
Civil Code of the Republic of Kazakhstan (General part) Civil Code of the Republic of Kazakhstan (Special Part) Tax Code of the Republic of Kazakhstan “On Banks and Banking Activity in the Republic of Kazakhstan” “On Limited Partnerships and Additional Liability” “On the Securities Market” “On Investment Funds” “On mandatory insurance of deposits placed with the second-tier banks of the Republic of Kazakhstan” “The Licensing Act” “On State Registration of Rights to Real Estate and Related Transactions”	Law of the Republic of Kazakhstan No.133-IV “On Introduction of Changes and Amendments to Some Legislative Acts of the Republic of Kazakhstan on Issues of Organization and Activity of Islamic Banks and Organizations of Islamic Financing” dated 12 February, 2009.
Budget Code of the Republic of Kazakhstan “On the Securities Market” “On Automobile Roads”	Law of the Republic of Kazakhstan No.475-IV “On Introduction of Amendments to Some Legislative Acts of the Republic of Kazakhstan on Organization of Islamic Finance” dated 22 July, 2011.
Civil Code of the Republic of Kazakhstan (Special Part) Tax Code of the Republic of Kazakhstan “On National Bank of the Republic of Kazakhstan” “On Banks and Banking Activity in the Republic of Kazakhstan” “On Financial Leasing” “On Insurance Activity”	Law of the Republic of Kazakhstan No. 311-V “On Introduction of Amendments to Certain Legislative Acts of the Republic of Kazakhstan on Insurance and Islamic Financing Issues” dated 27 April, 2015.
Civil Code of the Republic of Kazakhstan (General part) Land Code of the Republic of Kazakhstan Tax Code of the Republic of Kazakhstan Budget Code of the Republic of Kazakhstan “On National Bank of the Republic of Kazakhstan” “On Banks and Banking Activity in the Republic of Kazakhstan” “On the Securities Market” “On Accounting and Financial Reporting” “On State Property” “On Limited Partnerships and Additional Liability” “On Transport” “On Natural Monopolies and Regulated Markets” “On Automobile Roads” “On Currency Regulation and Currency Control” “On Public Procurement” “On State Registration of Rights to Real Estate and Related Transactions” “On Public Property” “On Enforcement Proceedings and Status of Court Bailiffs” “On permissions and notifications”	Law of the Republic of Kazakhstan No. 422-V “On Introduction of Changes and Amendments to Some Legislative Acts of the Republic of Kazakhstan on Issues of NPL and the second-tier bank assets, financial services offering, financial institutions and National Bank performance of the RK” dated 24 November, 2015.

Source: Author

The main set of amendments pertaining to the implementation of Islamic banking was made to the Act “On Banks and Banking Activity” in 2009. The most important amendments to the Act were directed at:

- (i) Establishing basic requirements for Islamic banking activity based on Islamic financing principles (prohibition of interest, guarantee return of investment deposits or any income thereon, and financing activity that contradicts with the norms of Islam);
- (ii) Prohibiting an Islamic branch or window in a commercial bank. According to the legal provisions, an Islamic bank has to operate as a fully-fledged Islamic financial institution and has to contain the word combination “Islamic Bank” in its name;
- (iii) Appointing the Council on Islamic Finance Principles by the General Shareholders Meeting of an Islamic bank, which is analogous to establishing a Shari‘ah Supervisory Board (SBB). This body shall determine the compliance of operations and transactions of an Islamic bank to Shari‘ah principles;
- (iv) Specifying the list of Islamic banking operations. It should be pointed out that in the Bank Law of 2009, commodity *murābahah* was not recognized as one of the operations of Islamic banks.

However, in 2015, due to the high demand for liquidity from clients of the only Islamic bank in the country, commodity *murābahah*, with certain conditions, was included in the Bank Law and Tax Law as well;

- (v) Excluding Islamic banks from the Compulsory Deposit Guarantee System. This provision was included due to the nature of investment deposits in Islamic banks. However, due to the disadvantageous position of Islamic banks compared with the conventional ones, a new set of amendments in 2015 stipulate that Islamic banks have the right to establish a non-profit organization in the form of joint stock company (JSC) with the aim of guaranteeing the return of deposits, attracted by Islamic banks.

It is worth noting that Kazakhstan bank law does not include any traditional Arabic terminology of Islamic finance such as *ribā*, *mushārahah*, *ijārah*, *takāful*, Shari‘ah, etc. Only the term “Islamic” together with the descriptions of Islamic financial products are used in the law to identify such types of financing. This is a unique case within secular conventional law which keeps connections with the nature and principles of Islamic finance, and at the same time, this approach puts emphasis on the substance of the products through their definitions. Basic transactions of Islamic banks are illustrated in Table (2).

Table (2). Basic Transactions of Islamic Banks in Kazakhstan Law.

Traditional Terminology	Definition in Kazakhstan Law
Accounts based on <i>qard ḥasan</i> principles	Accepting interest-free demand deposits from individuals and entities, opening and maintaining their bank accounts
Accounts based on <i>muḍārabah</i> principles	Accepting investment deposits from individuals and entities
Financing based on <i>qard ḥasan</i> principles	Bank borrowing: providing interest-free cash loans repayable within specified periods
Financing based on: - <i>murābahah</i> principles - commodity <i>murābahah</i> principles	Financing of individuals and entities as a commercial agent by providing a commercial credit; - without the right to resell the commodity to a third party; - with the right to resell the commodity to a third party
Financing based on <i>private equity</i> , <i>muḍārabah</i> and <i>mushārahah</i> principles	Financing manufacturing and trading activities through equity participation and/or on partnership conditions
Financing based on <i>ijārah</i> principles	Investment activities on leasing/renting conditions
Transactions based on <i>wakālah</i> principles	Agency for Islamic bank’s banking transactions

Source: Author

Islamic banks in Kazakhstan have the right to carry out the above mentioned operations together with some other types such as currency exchange, transfer transactions etc., which do not contradict Islamic banking requirements.

It should be pointed out that *istiṣnāʿ* and *salam* are also recognized as Islamic banking operations. The bank law describes that an agreement between an Islamic bank, as a commercial agent, and a seller, as a producer or manufacturer of goods, may provide immediate partial or full prepayment of goods purchased under the condition of delivery of the goods within the period stipulated by the parties. To regulate the relationship between an Islamic bank and a manufacturer or producer, the rules of a construction agreement or agricultural procurement contract are applied.

In 2015, to ensure compliance of leasing operations of Islamic banks to Sharīʿah principles, the Act on Financial Leasing was amended. In particular, there is a special clause which stipulates that the transfer of title ownership of the subject of leasing is carried to a lessee through a separate agreement after fulfilling all contractual obligations by the lessee.

In November 2015, the Parliament of the Republic of Kazakhstan approved a new set of amendments that regulate the issues of converting conventional banks into Islamic ones and issuing Islamic securities. It will allow the local “Zaman Bank” to be converted into a full-fledged Islamic bank that in its turn will give an access to Islamic banking services for both the population and SME. Moreover, new changes will provide a legal basis for the Government of the Republic of Kazakhstan to issue sovereign *ṣukūk* in 2017. On the one hand, it will serve as a good benchmark for corporate entities; on the other hand, it will provide local Islamic financial institutions with liquid instruments.

Another positive example of the Kazakhstani authorities’ activity towards Islamic banking is the RK Government Decree dated 31 July, 2015, No.599: “The Rules of subsidizing the part of mark-ups on products and part of rental payment that make the profit of Islamic bank while financing private business in the framework of *unified program* for *business support and development* “*Business Road*

Map 2020”. Thus, we can state that the policy of the National Bank and Government is directed towards providing Islamic banks with equal conditions to the ones that conventional banks have.

In an attempt to level the playing field for Islamic banks with conventional banks, in 2009 and 2015 two sets of amendments to the Tax Code of the Republic of Kazakhstan were adopted. The main changes were directed at a number of exemptions for some Islamic banking operations from VAT and relief from income tax on investment deposits.

Value-added Tax (VAT)

Most financial transactions of conventional banks in Kazakhstan are VAT free. With Islamic banks coming to Kazakhstan, it was necessary to regulate the levying of VAT of specific Islamic transactions. According to the tax code, the following bank transactions of Islamic banks which operate on the basis of a received license are VAT exempt:

- (i) Acceptance of interest-free demand deposits, opening, and maintenance of bank accounts of individuals and legal entities;
- (ii) Acceptance of investment deposits of individuals and legal entities;
- (iii) Banking borrowing transactions: provision by an Islamic bank of credits in cash on terms of maturity, repayment and without charging of interest.

The transfer of property by Islamic banks is VAT exempt in the part of the income (a mark-up sum) which Islamic banks receive in the framework of financing individuals and legal entities as a trade mediator through providing commercial loans:

- (i) Without a condition for further selling the property to a third party;
- (ii) With conditions for further selling the property to a third party.

The first condition implies that transactions are to be based on *murābaḥah to the purchase order*. The second condition was introduced into the tax law in 2015 and is designed for transactions that are based on commodity *murābaḥah (tawarruq)*. The rationale of these amendments is based on the high demand for such facilities from Islamic bank’s clients and strong

intentions of the Kazakhstani authorities to provide equal tax treatment for Islamic and conventional banking transactions.

Corporate income tax

According to the tax code, the income obtained by an Islamic bank within the process of managing funds received in the form of investment deposits or transferring to depositors these investment deposits are tax exempt. The given norm allows protecting the part of the profit the bank earns for investment account holders from being levied with corporate income tax.

Individual income tax

In Kazakhstan, interest on deposits held in conventional banks do not incur income tax. To level the playing field, the income on investment deposits placed in Islamic banks is not to be levied with individual income tax.

Overall, the amendments to the legal acts establish the foundations for opening and operating Islamic banks in Kazakhstan. Based on this framework, in June 2009, President Nazarbayev signed the Act ‘On Ratification of the Agreement between the Government of the RK and the Government of the United Arab Emirates on opening an Islamic Bank in Kazakhstan’, and the first Islamic bank, namely Al Hilal Bank was opened in the country.

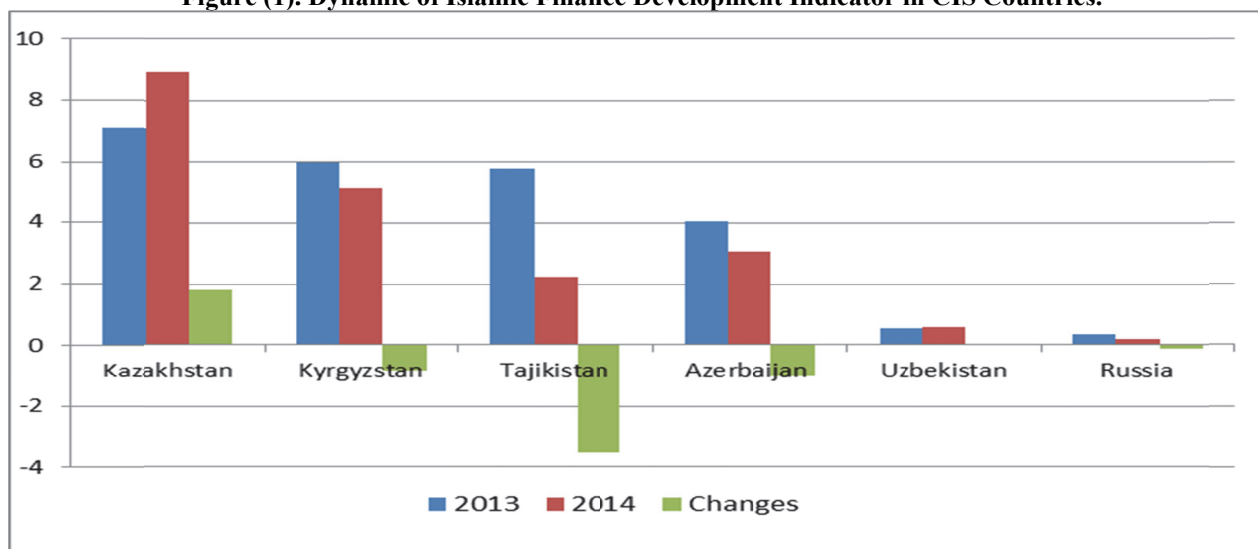
4. Development of the Islamic Finance Industry

The existence of an Islamic finance regulatory framework in Kazakhstan and the positive attitude of government and regulator means that developments in the country are well regarded by international organizations. For instance, according to Thomson Reuters, the indicator of development of Islamic finance in Kazakhstan during 2014 increased from 7.11 to 8.931 and remains the highest among the CIS countries with Muslim populations (Figure 1). Table 3 shows the indexes and sub-indexes of the given indicator for Kazakhstan in 2013-2014.

Despite the fact that Kazakhstan is the first country among the CIS to have adopted Islamic finance laws the quantitative development of the industry, while positive, is somewhat modest – 0.38 points. For comparison, in 2014, in such countries as Azerbaijan and the Kyrgyz Republic, the development of Islamic finance was rated as 1.40 and 0.49, respectively.

The Islamic finance industry in Kazakhstan is represented by four sectors: Islamic banking (0.86), plus the operation of non-banking Islamic financial institutions (0.55), *shukūk* issuance (0.07), and *takāful*.

Figure (1). Dynamic of Islamic Finance Development Indicator in CIS Countries.



Source: <https://www.zawya.com/islamic-finance-development-indicator/#>

Islamic Banking

Both regulators and business consider Islamic banking as the mainstay of the Islamic finance industry. Over the last seven years, the share of Islamic banking in the total assets of the banking sector remained at only 0.08% by 2014. Islamic is represented by the only bank Al Hilal Bank Kazakhstan. The bank does not finance the general population or SME's (for details, see part 5 of the paper). Thus, an extremely small volume of financing together with a relatively narrow business focus makes Islamic banking invisible to the majority of the country's population. It is not rare to hear the business accusing the regulator of lack of access to Islamic banking services in spite of constant claims of the authorities about the development of Islamic finance in the country.

One of the drawbacks of regulatory activity has been the relatively slow legal developments. Amendments to Islamic financial and tax laws initiated by the National Bank in 2012 were adopted only in the mid of 2015. Another drawback is the lack of a cohesive approach to adopt resolutions. In 2013, a local bank "Zaman Bank" and the *Islamic Corporation for the Development of the Private Sector* (ICD) announced their intention to transform Zaman Bank into a fully-fledged retail Islamic bank. However, up to November 2015, bank law of the RK did not regulate the process of transformation of a conventional bank into an Islamic one. To be licensed to perform Islamic banking operations, a

conventional bank is to return its present banking license, close its activities and to reapply for an Islamic banking license. For Zaman Bank, which has been operating in the banking sphere since 1991 and being one of few regional banks in Kazakhstan with a substantial client base, this was not feasible. Moreover, it is not a secret that the process of bank winding up in Kazakhstan may can take over 3 years. The adoption of a special provision for licensing of banking and other activities introduced at the end of 2015 now will allow Zaman Bank to apply for a license and to convert into a fully-fledged Islamic financial institution. As expected, in 2017 the first retail Islamic bank will be established in Kazakhstan.

Shukūk

In 2014, the development of the *shukūk* market in Kazakhstan was rated by international experts at 0.07 points. Such a low indicator can be explained by the fact that after the debut placement of *shukūk* made by the Development Bank of Kazakhstan on the Malay-sian market in 2012, new issuance of corporate *shukūk* did not follow. The Ministry of Finance in Kazakhstan intended to issue sovereign *shukūk* in 2012, but did not need to as they had a budget surplus. Thus, for now, there is only one precedent of attracting assets through issuance of Islamic securities.

Table (3). Sub-components of Islamic Finance Development Indicator for Kazakhstan.

Sub-Indexes	2013	2014
IFDI Kazakhstan	7.11	8.931
Quantitative Development	0.3	0.375
Islamic Banking	0.86	0.86
<i>Takāful</i>	0	0
Other Islamic Financial Institutions	0.55	0.55
<i>Shukūk</i>	0.07	0.07
Funds	0	0
Knowledge	4.3	4.084
CSR	0	0
Governance	28.51	23.106
Regulation	83.33	83.33
Sharī'ah Governance	2.19	2.19
Corporate Governance	0	0
Awareness	2.47	17.087

Source: <https://www.zawya.com/islamic-finance-development-indicator/#>

Non-banking Islamic financial institutions

Non-banking Islamic financial institutions in Kazakhstan include an Islamic leasing company “Ijara” that has been providing services of operational and financial leasing since 2014, and by the “Fund of Financial Support for Agriculture” which has been providing financing under *murābahah* program since 2012. The Fund offers funds to the rural population in the framework of an agreement concluded with the Islamic Development Bank (IDB).

Over 2012 – 2015 on the bases of the principles of Islamic finance, JSC “Fund of Financial Support for Agriculture” granted 3 billion Tenge as loans for the rural population. A positive moment in the activity of the fund was that it used not only Islamic Development Bank funds but also its own due to the high demand for “*murābahah*” program financing.

Takāful

Despite the fact that the “Takaful Halal Insurance” company started its activity in Kazakhstan in 2009, there is no assessment data on *takāful* in the report made by Thomson Reuters.

Perhaps it is connected with the lack of special legislation on Islamic insurance in the country. However, the Mutual Insurance Society (MIS) “Takaful Halal Insurance” is the only institution in the territory of the CIS which provides Islamic insurance services. MIS “Takaful Halal Insurance” operates on a modified model of *wakālah* (underwriting) and *muḍārabah* (investment activity). It provides medical insurance services, accident insurance, and automobile insurance. The number of insured and the volumes of collected commission are not high. In April 2015, legislation was passed aimed at promoting this sector.

Further developments of Islamic finance in Kazakhstan depend primarily on Islamic banking industry and conditioned by the following factors. Firstly, its development relates to the success of the industry realizing the government’s plan to achieve the 3-5% assets market share by 2020. Secondly, a well-developed Islamic banking industry is able to become an accelerator for the *takāful* segment and for the Islamic securities market. Thirdly, due to developments elsewhere there is an increased interest in conventional banks operating special Islamic banking units.

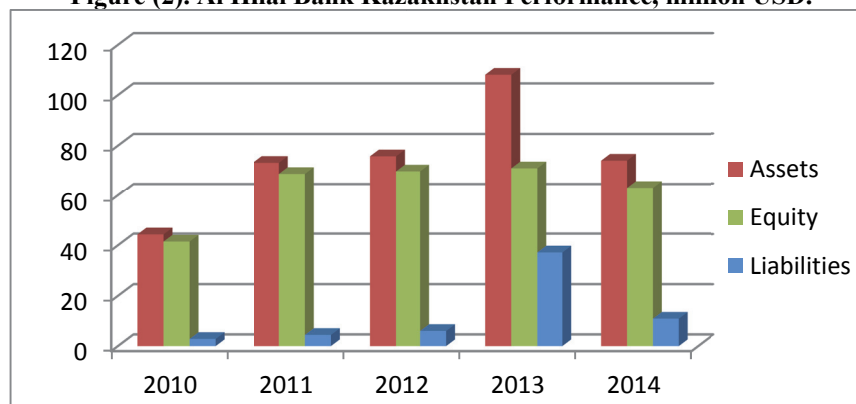
5. Al Hilal Bank Kazakhstan

Al Hilal Bank is the first Islamic bank established in Kazakhstan and the CIS. Al Hilal Islamic bank is a 100% subsidiary of Al Hilal bank of the UAE, which is the only bank fully owned by the Government of Abu Dhabi.

According to the development strategy, the bank positions itself as a corporate financing institution, and also takes deposits from individuals. It pays special focus on governmental, quasi-governmental companies and corporate clients. Nowadays, the bank offers to clients the following products for business financing: corporate *murābahah*, commodity *murābahah* and *ijārah muntahiyah bi al-tamlīk* facilities.

As shown in Figure 2, in 2013 the assets of Al Hilal Bank Kazakhstan amounted to 110 million USD and in comparison with 2010 their size increased about 2.5 times. However, in 2014, the Bank saw a decline in its assets and liabilities. This can be explained by two basic factors, namely the devaluation of the local currency by almost 20 percent during 2014 and the resulting significant deposit outflows.

Figure (2). Al Hilal Bank Kazakhstan Performance, million USD.



Data source: Annual Report

In the structure of the bank's liabilities, 90 percent are current accounts. In 2013, their volume comprised 5.6 billion Tenge (36.2 million USD). However, during 2014, current accounts decreased 3 times to 1.8 billion Tenge (9.9 million USD). One of the reasons for such a fall was also the lack of deposit protection for Islamic bank clients. This is an unequal condition for Islamic banks' operations in the country. Current accounts structured on the basis of *qard* or *wadi'ah* principles are similar to current account deposits in conventional banks in terms of the commitment to return the full deposit on demand. In these circumstances, the exclusion of Islamic bank current accounts in from the Compulsory Deposit Guarantee System in Kazakhstan, made them less attractive and impede their growth.

As for investment accounts, Al Hilal Bank Kazakhstan considers them off-balance sheet liabilities. In the annual report (2014) it is noted that "The bank bears no risks and is not responsible for the losses resulted from the investment activity on *mudaraba* and *wakala* products; except for the cases when they happen as a result of gross negligence or wilful misconduct of the bank." As of the end of 2014, the volume of funds attracted on *wakalah* deposits grew nearly 2.5 times from 30.8 billion Tenge (199.9 million USD) to 74.6 billion Tenge (409.3 million USD). The Bank uses these funds for debt financing of the clients under *murabahah* contracts. Such high dynamics of investment deposit growth indicates three important outputs: (i) there is a high demand for Islamic investment deposits in Kazakhstan; (ii) off-balance activities are the main operations of Al Hilal Bank Kazakhstan. In 2014, off-balance sheet liabilities exceeded total assets by 5.5 times: 409.2 million USD against 74 million USD, and therefore (iii) there is an acute need for the development of a special protection scheme for investment accountholders.

It is worth noting that in the practice of leading countries in Islamic finance such as Malaysia and Bahrain, different deposit protection schemes cover investment accounts. We assume that the Kazakhstani regulator should thoroughly investigate these schemes to level conditions for both Islamic and conventional banks.

The asset structure of Al Hilal Bank Kazakhstan shows that in 2014 the operational portfolio amounted to 60.9 million USD and nearly 90 percent of all these funds were invested through commodity *murabahah* and investment deposit *wakalah* mechanisms. The share of *ijarah* financing in the bank was only 9 percent due to the lack of Islamic leasing legislation over those years. It should be pointed out that the main financing was made from off-balance sheet liabilities, namely *wakalah* deposits. In 2014, the off-balance *murabahah* portfolio amounted to 407 million USD.

Such a high disproportion between on-balance and off-balance sheet financing can be interpreted in two ways. On the one hand, this could mean that the bank does not want to take risks inherent in local borrowers and shifts them to local investors (*wakalah* accountholders). On the other hand, this could help the bank to avoid some compulsory regulatory requirements such as minimum reserve requirement and others. In both cases, accountholders are at a greater risk than their peers in conventional banks which in turn requires from the National Bank to continue developing the legal and regulatory environment for Islamic banks. In connection we set out a range of proposals that are aimed at enhancing the effectiveness of the legal, regulatory and core infrastructure for Islamic financial institutions operating in the country.

6. Recommendations

To support the development of the Islamic banking industry, it is important to continue providing Islamic banks with the same conditions in the sphere of law, "supporting" (infrastructural) institutions, liquidity instruments, and taxation of Islamic products that are provided nowadays to conventional banks. To create these equal conditions, it is necessary to introduce some amendments and changes to the basic laws which regulate the activity and operation of Islamic banks.

The Law "On National Bank of the Republic of Kazakhstan"

On the basis of recommendations made by Khan (1998) we consider that it is necessary to revise some provisions to make monetary policy operations acceptable for Islamic banks, in particular:

(i) *Reserve Requirements article*. As is stated in the Law “On Banks and Banking Activity in the Republic of Kazakhstan”: “according to the investment deposit contract Islamic bank shall accept money for a certain period of time without guaranteeing its return in nominal value, pay out the return depending on the results of received funds application in the order stipulated by the investment deposit contract”. Thus, Islamic investment deposits cannot be considered as balance sheet liabilities materially. In accordance with AAOIFI Accounting Standard No.1, investment deposits may be considered as the capital of unrestricted investment account holders (URIA) or off- balance-sheet liabilities (restricted investment account, *wakālah* deposits) of an Islamic bank. As Khan (2015) points out, the profit-sharing investment accounts (PSIA) are perceived to be more unstable as compared to interest-based term deposits. Therefore, additional capital preservation reserves, transparency infrastructure and regulatory oversight is needed in order for the PSIAs not to destabilize the funding structures of Islamic banks;

(ii) *Loans article*. Receiving loans on interest rate is not acceptable for Islamic banks; so it is necessary to work out other refinancing mechanisms for them. The National Bank at the initial stages of Islamic banking development may offer such funding on conditions of maturity, repayment and without charging interest. In the process of further development of Islamic institutions, the National Bank may implement a Points Account System mechanism to them;

(iii) *Deposits article*. Keeping funds on the condition of charging interest is not acceptable for Islamic banks, so launching a Points Account System mechanism can urge Islamic banks to keep funds with the National Bank on its non-interest-bearing deposits. Moreover, the National Bank shall provide an alternative way for Islamic banks to get fair profits on their funds. A *wakālah* mechanism launched by Central Bank of Bahrain for opening deposits for Islamic banks in May 2015 may serve as a vivid example of such sound practice. The given mechanism allows Islamic banks to place excessive liquidity with the bank with one-week maturity. In this connection, we consider it possible to keep Islamic banks’ funds with the National Bank on the condition that they are interest-free and investment deposits;

(iv) *Short-term Notes of National Bank of Kazakhstan article*. Islamic banks are not allowed to participate in such operations as they involve interest based securities. Thus, they are limited in their operation by not having access to highly liquid financial assets.. Paying attention to Bahrain’s experience, it is necessary to indicate that the government and central bank of this country, apart from conventional bonds, issue *ṣukūk al-ijārah* and *ṣukūk al-salam* to support Islamic financial institutions with liquidity instruments. Going further, on the basis of *ṣukūk al-ijārah*, the central bank of Bahrain developed another mechanism to provide short-term liquidity for Islamic banks. In connection with this, we consider it necessary for the regulator to stipulate in law the issuance of short-term securities for Islamic financial institutions.

The Law “On Banks and Banking Activity in the Republic of Kazakhstan”

(i) *Banking system of the RK article*: Islamic banks may establish non-commercial organization in the form of joint-stock company to guarantee deposit returns attracted by Islamic banks. The deposit guarantee system is a significant element for enhancing a deposit base of a banking sector. In 1999, Kazakhstan Deposit Insurance Fund was founded with 100 per cent participation of the National Bank in the authorized capital of the fund (1 billion Tenge). To strengthen the financial position of the fund in implementing its basic mission “to insure the rights and interests of depositors”, the National Bank decided to enlarge authorized capital of the fund up to 16 billion Tenge in 2007 and up to 100 billion Tenge in 2008. Thus, the National Bank plays a significant role in establishing the deposit guarantee system for conventional commercial banks of the Republic of Kazakhstan. We consider that it is necessary to make a provision in the Law for establishing an organization that, with the participation of the National Bank, will insure deposits attracted by Islamic banks. It will help to form a required authorized capital with little number of participants and strengthen the confidence of the depositors in the system due to NBRK participation;

(ii) *Banking and other operations of Islamic banks article*. Among other operations, Islamic banks may “finance industrial and trade activities through

participation in authorized capitals of legal entities and/or on partnership basis". The given statement prohibits financing of individuals on terms of partnership. But according to Shirazi (2012), home financing of citizens on the basis of diminishing partnership (diminishing *mushārah* that is a combination of *ijārah* and *mushārah* contract) is one of the most popular products for retail Islamic banks (UK, Middle East, Malaysia). Here we find it necessary to change the wording describing this operation in the law or set this operation aside into a separate operation on financing individuals on terms of partnership.

(iii) In the attempt to create favorable conditions for the development of Islamic banking in the country, the National Bank shall allow the opening of Islamic "windows" in conventional banks. Initially the Regulator believed that combining conventional and Islamic banking in one institution may undermine the credibility of the whole Islamic finance industry. This conservative approach at the initial stage of development was justified; however, after seven years have passed, the industry is still tiny and the majority of Kazakhstani citizens do not have access to Islamic banking products. As such, to give the sector a kick start conventional banks should be permitted to open Islamic windows.

It should be pointed out that the development of Islamic banking in many countries was initially based on opening of Islamic "windows". For example, in the UK, in 2013, there were 22 conventional banks with Islamic "windows", 5 investment Islamic banks and only one fully-fledged retail Islamic bank. Another example is Malaysia where Islamic banking has about 25 % market share of the total retail business and 20 % out of this is held by Islamic windows and subsidiaries of conventional banks (Rizvi, 2013). Islamic "windows" are allowed in practically all conventional banks operating in the Middle East apart from in Qatar. Islamic industry leaders such as Bahrain, UAE, Saudi Arabia and Oman all allow for the opening of Islamic "window" subdivisions in conventional banks.

(iv) The issues of Sharī'ah board activity, defined in Kazakhstani Law as the Islamic Finance Principles Board (IFPB), are being studied at the present time by the National Bank. The new legislation is some

what complex and problematic. Partially resulting from the fact that despite the dominant number of Muslims living in the country, Kaza-khstan is a secular state with a lack of Sharī'ah scholars. And the problem is that all the members of Sharī'ah boards should be both Sharī'ah legal experts and practitioners, should have experience working for financial institutions and be highly esteemed in the international arena. Other issues of the Islamic Finance Principle Board activity are in defining its authority in Islamic banks and also in the character of their relations with the National Bank of the Republic of Kazakhstan.

As Tukulova (2014) noted, the Republic of Kazakhstan is a secular state and this means that the state is separated from religion. Taking into consideration all the above mentioned points, in Kazakhstan it is impossible to form such an Islamic board as a state authority. So the National Bank proposes that in the process of further development of Islamic finance, to establish such a board in the form of a public association such as Association for Islamic Finance Development or any other non-state organization.

As for IFPB members, the National Bank is planning to set the following minimal requirements:

(a) To have a diploma of higher education in Economics or Law. The chairperson of the IFPB should have a diploma of higher education in Sharī'ah Law including specializations in Islamic finance operations/commercial law;

(b) To be certified in finance and Islamic finance;

(c) To have experience (not less than a year) in carrying out resolutions on Sharī'ah compliances or at least 2 year experience in teaching Islamic finance either in researching Islamic finance, or 2 years' experience in Islamic banking and finance.

The appointment of IFPB members should be approved by the National Bank. All these measures will decrease the risks of Sharī'ah non-compliance for financial products and services and will demonstrate the readiness of Kazakhstan to offer Islamic finance services in accordance with international Islamic finance standards (Tukulova, 2015).

Tax Code of the Republic of Kazakhstan

To follow the principle of tax neutrality towards Islamic banking operations, it is necessary to take into consideration the following requirements:

(i) *Interest deduction article*. To calculate the amount of taxable income a legal entity may refer loan interest payments received from conventional banks to deductions. It allows business subjects to lessen corporate income tax expenses. At the same time, according to tax law, the term “interest” does not include mark-up pay-off while getting finance under *murābahah* contracts. It makes the financing received from Islamic banks less attractive for business in comparison with conventional lending as it does not allow them to lessen the corporate income tax expense. So we believe that it is necessary, only for tax purposes, to refer mark-up pay-off of Islamic banks as equivalent to interest;

(ii) Article: “Transferring property in financial lease is VAT free in the part of lease fee which is paid to a lessor if the following terms are observed: (a) this transfer conforms with the requirements set for financial lease; (b) the lessee acquires the property as a fixed assets, investment property, biological asset.”

According to the law, financial leases transfer property under the leasing agreement with the maturity more than 3 years in case it complies with one of the terms:

(a) Transferring the property to lessee ownership and/or granting the right to lessee for acquiring the property at fixed price, are stipulated by the leasing agreement;

(b) Financial lease maturity exceeds 75 percent of the useful lifetime of the equipment which is transferred under the financial lease contract;

(c) Current (discounted) value of lease payments for the whole time of the financial lease exceeds 90 percent of the value transferred under financial lease on property.

Together with that, according to the law “On financial leasing”: “Islamic leasing contract cannot provide the transfer of the leasing subject to lessee ownership. The title to the leasing subject may be transferred to a lessee on the basis of a separate agreement.”

Let’s suppose that in the framework of *ijārah* financing, the client of the Islamic bank receives the real property on lease with the maturity of 10 years, but the useful lifetime of the property is more than 30 years; moreover, the current value of leasing payments within the whole leasing term equals less than 90 percent of the property value. Given these conditions, the transfer of property on lease for the Islamic bank customer will be subject to VAT that will increase the financing value for the borrower. So, in this concern, we believe that it is necessary to indicate in tax law the peculiarities of Islamic leasing on the part of the necessity to conclude a separate agreement. It is also important to indicate that taking the peculiarities of Islamic leasing into account will allow business entities to refer payments to commission deductions while calculating corporate income tax.

It is worth mentioning that the proposed recommendations in the part of taxation are oriented toward “tax neutrality” for Islamic finance as has been done by the UK government. From a tax perspective, UK tax legislation includes certain provisions covering most commonly used structures in the field of Islamic finance so as to ensure that Shari’ah compliant investors are afforded similar tax treatment to that of conventional investors when using specific Islamic finance products (PWC, 2012).

HM Revenue and Customs (HMRC) introduced enabling tax legislation through various Finance Acts and its policy had been based on the following key principles:

- (a) The tax treatment should follow the economic substance of the transaction;
- (b) The tax treatment should be on the same basis as equivalent financial products that bear interest;
- (c) The existing tax rules should be applied where possible;
- (d) The rules that give undesirable or unpredictable results should be amended (Eisenberg, 2012).

Tax legislation in the UK creates a freestanding set of definitions for use in tax law which are entirely neutral regarding religion. For transactions which fall within these definitions, the legislation specifies how

to determine the finance cost and how that finance cost is treated by both the payer and the recipient. Broadly speaking, the finance cost is brought within the same tax rules as those that apply to interest. The legislation does not change the nature of the financial arrangements, nor does it in any way impute interest, or deem interest to arise where there is none. It simply sets out a code for the tax treatment of transactions that fall within its definitions (Amin, 2010).

Therefore, to ensure further development of Islamic banking in Kazakhstan, the regulator and the government should continue their efforts in the formation of an appropriate legal and regulatory environment for Islamic banking operations. In 2014, the CEO of Al Hilal Bank Kazakhstan, Mr. Abraham noted: “We have been operating in this country for four years, and during this period we have developed a continuous dialogue with local regulators. We find full support here, even under the circumstances when the existing legal system does not fully cover the principles of Islamic banking. The National Bank provides us all necessary support to enable our progress in the country.” (Abraham, 2014). This gives hope that in the near future, a comprehensive legal and regulatory environment for Islamic banks in Kazakhstan will be developed.

7. Conclusion

The promising perspectives of Kazakhstan to become a hub for the Islamic banking industry in the CIS and Central Asia by 2020 is connected with the idea to establish an Astana International Financial Center (AIFC), where the development of Islamic finance

will be a key driver. To accommodate AIFC, the National Bank initiated a constitutional law with the following purposes:

- (i) Establishment of a special financial zone.
- (ii) Introduction of English law on the territory of the AIFC.
- (iii) Establishment of a court of eminent foreign judges.
- (iv) Introduction of the dollar as the currency of the AIFC.
- (v) Introduction of English as the official language of the AIFC.
- (vi) Establishment of a special visa regime for AIFC participants, their families and employees.

As is expected, the AIFC will start its operation in 2018 on the basis of infrastructure prepared for the international exhibition, Kazakhstan Expo 2017.

Given the tough competition for attracting foreign investment, it would not be right to rely only on creating favorable conditions for foreign investors in the territory of the AIFC. Islamic banks from the Middle East, South East Asia and other regions will come to the country when they see that Islamic financial institutions in the region show sustainable development and there is a demand for Islamic financial products and services. In this regard, the proposed recommendations are of the highest importance in the part to improve the regulatory, legal and tax environment for Islamic banks operating in Kazakhstan.

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القانون المصرفي وتطبيق الصيرفة الإسلامية في كازاخستان

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المستخلص: منذ عام ٢٠٠٩م، يقوم البنك المركزي لجمهورية كازاخستان على تهيئة الظروف المناسبة للمصارف الإسلامية في الدولة. فقد تم وضع وتعديل عدد من القوانين الرئيسية منها القانون المدني، قانون البنوك، قانون الضرائب والقوانين والأنظمة الأخرى حيث أتاحت للمصارف الإسلامية إمكانية اتخاذ دورا هاما في اقتصاد الدولة علي نفس المستوى مع البنوك التقليدية. وعلى الرغم من وجود إمكانية فتح وإدارة المصارف الإسلامية في الدولة إلا أن تنمية هذه الصناعة لم تتميز بمؤشرات مرتفعة بعد. ووجود طلب مرتفع للاستثمارات الأجنبية والخدمات المالية الإسلامية، والعزم على جعل كازاخستان مركزا إقليميا للصيرفة الإسلامية في منطقة آسيا الوسطى بحلول عام ٢٠٢٠م، تجعل البنك المركزي لكازاخستان تستمر جهوده بنشاط لتحسين البيئة للمؤسسات المالية الإسلامية. وفي عام ٢٠١٥م، دُعيت شركة المحاماة الدولية "فولبرايت نورتن روز" من قبل البنك المركزي الكازاخستاني للعمل على مجموعة جديدة من المبادرات التشريعية للمؤسسات المالية الإسلامية. وهذه المبادرة هي محاولة لإعادة صياغة ومناقشة توصيات المتخصصين بشأن تعزيز فعالية الإطار التنظيمي للقطاع المصرفي الإسلامي وإدراجها في التشريع الكازاخستاني.

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