

29 May 2009

Introduction of Islamic Finance in Kazakhstan

In line with Baker & McKenzie's practice of keeping clients informed of important legal developments that might influence your business, we would like to draw your attention to the following recent changes in Kazakhstani legislation.

Overview

Kazakhstan has promulgated a new law, the Islamic Finance Law,¹ intended to broaden the range of finance options available to Kazakhstani companies and to provide a legal framework for Islamic finance in Kazakhstan. While some Islamic financing transactions had occurred prior to adoption of this new law, their number was small and the legal basis for them was unclear. The Islamic Finance Law primarily addresses domestic finance operations, i.e., the operations between Kazakhstan residents, but also may be applicable to Islamic finance operations originated in Kazakhstan or financing partnerships in Kazakhstan with funds raised abroad.

The Islamic Finance Law is basically a set of amendments to various other laws, including the Civil Code, the Tax Code and the banking, securities market, investment funds, corporate and other laws.² Several sets of implementing resolutions and regulations have subsequently been promulgated to address specifics of Islamic banking and Islamic finance and further ones are expected.³ Some of the most important changes of the new law and the regulations are outlined below.

¹ Law *On Making Changes and Amendments to Certain Legal Acts of the Republic of Kazakhstan Concerning Organization and Activity of Islamic Banks and Organization of Islamic Financing* dated 12 February 2009.

² The Islamic Finance Law makes amendments to the following laws:

- (i) *Civil Code of Kazakhstan (General Part)* dated 27 December 1994 (the "Civil Code - GP");
- (ii) *Civil Code of Kazakhstan (Special Part)* dated 1 July 1999 (the "Civil Code - SP" and, together with the Civil Code – GP, the "Civil Code");
- (iii) *Tax Code of Kazakhstan* dated 10 December 2008 (the "Tax Code");
- (iv) *Law On Banks and Banking Activity in the Republic of Kazakhstan* dated 31 August 1995 (the "Banking Law");
- (v) *Law On Partnerships with Limited and Additional Liability* dated 22 April 1998;
- (vi) *Law On the Securities Market* dated 2 July 2003 (the "Securities Market Law");
- (vii) *Law On Investment Funds* dated 7 July 2004;
- (viii) *Law On Mandatory Guaranteeing of Deposits in the Second-Tier Banks of the Republic of Kazakhstan* dated 7 July 2006;
- (ix) *Law On Licensing* dated 11 January 2007; and
- (x) *Law On State Registration of Rights to Immovable Property and Transactions Therewith* dated 26 July 2007.

³ On 14 March 2009 the Prime Minister issued an order (No. 40-r) directing that 11 sets of implementing normative legal acts be adopted. To date, the following have been adopted:

- (i) amendments and changes to certain resolutions on bookkeeping and financial reporting by Islamic special finance companies (the "ISFC") (National Bank of Kazakhstan (the "NBK") Resolution No. 24 dated 20 March 2009);
- (ii) instruction on bookkeeping by Islamic special finance companies (NBK Resolution No. 25 dated 20 March 2009);
- (iii) rules governing transfer of property and liabilities under investment deposits of liquidated Islamic banks to another selected Islamic bank (FMSA Resolution No. 51 dated 27 March 2009);
- (iv) extension of rules for issuance of bank establishment permits and for licensing of banking and other operations to cover Islamic banks (FMSA Resolution No. 53 dated 27 March 2009);
- (v) requirements for the establishment and operation of ISFCs (FMSA Resolution No. 54 dated 27 March 2009);

Islamic Finance Concepts

The concept of the Islamic finance is based on profit and loss sharing and on a prohibition of interest payments, usury and investment in businesses whose operations are inconsistent with Islamic principles.

The most popular Islamic instruments are ijara, musharaka, murabaha and sukuk. **Ijara** is an Islamic lease, where a financial institution purchases an asset and then leases it to a client for a fixed monthly rent. The asset may be repurchased at the end of the lease period. **Musharaka** is a partnership to which parties contribute working capital and share the profit according to a pre-agreed ratio. The losses of each partner will depend on the amount of contributed assets. In a **murabaha** transaction, a financial institution purchases goods upon a client's request from a third party and sells it to the client at an agreed-upon profit margin on a deferred payment basis. **Sukuk** is an Islamic equivalent of a bond; it is a certificate of the right to receive income on a pro-rata basis or a participation security that grants investors shares in ownership of the assets of a particular project or a special investment activity. The Islamic finance concepts introduced in the Islamic Finance Law do not contain references to ijara, musharaka, murabaha, sukuk or any other specific instrument. But the main concepts of Islamic finance appear to be established, albeit in a basic form.

Islamic Banking

The Islamic Finance Law amends the Banking Law to provide for the new concept of an "Islamic bank" and the operations such a bank can undertake.

Islamic Bank

An **Islamic bank** is a second tier (i.e., commercial) bank created as such and having an Islamic banking license issued by the FMSA,⁴ Kazakhstan's principal bank regulator. (A regular commercial bank is ineligible for an Islamic banking license.) Its name should contain the words 'Islamic bank.' Except as otherwise described herein, an Islamic bank is subject to the same requirements as to the shareholders, operations, control, establishment procedures, and liquidation/rehabilitation procedures as a regular commercial bank.

An Islamic banking license authorizes an Islamic bank to conduct the following operations: a) accepting interest-free demand deposits; b) accepting investment deposits; c) issuing interest-free loans; d) financing of commercial operations through purchase/sale of goods or by way of participation in projects; e) leasing; and f) agency activity when undertaking Islamic banking operations. The law⁵ further says that only an Islamic bank, and not regular commercial banks, may undertake such operations.⁶ An Islamic bank also may undertake banking operations generally licensed to regular commercial banks, except for factoring and forfeiting operations, provided that such operations are: y) stipulated in the bank's charter; and z) not recognized by the bank's Islamic Bank Council as being inconsistent with Islamic finance principles.

Like other Kazakhstani banks, Islamic banks are subject to the supervision of the FMSA. Islamic banks are subject to specific capital adequacy rules (different from the ones applicable to regular commercial banks). Also, significant changes to certain of Kazakhstan's existing banking regulations (e.g., accounting rules) are necessary to address specifics of Islamic banking. As noted above, some (but not all) of these changes have recently been adopted.

(vi) rules on voluntary reorganization or liquidation of Islamic special finance companies (FMSA Resolution No. 55 dated 27 March 2009);

(vii) requirements for content of an agreement between the issuer and the representative of holders of Islamic securities and the functions and duties of the representative (FMSA Resolution No. 56 dated 27 March 2009); and

(viii) instruction on prudential standards for Islamic banks (FMSA Resolution No. 66 dated 27 March 2009).

⁴ The Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations.

⁵ Article 26.1 of the Banking Law.

⁶ This is somewhat confusing as operations a), e), f) and, in certain circumstances c), are permitted for the regular commercial banks (Article 30 of the Banking Law). We understand, however, that the intention of the legislation is to separate, to the maximum extent, Islamic finance compliant activities from non-Islamic finance compliant activities, even if they appear substantially similar. Accordingly, we believe this contradiction should be interpreted such that regular commercial banks may proceed with operations a), c), e) and f) but may not claim to do so in accordance with Islamic finance principles.

Islamic Banking Principles

The Banking Law (as amended by the Islamic Finance Law)⁷ prohibits an Islamic bank from:

- charge interest or guarantee return/income on investment deposits; and
- finance activities related to production and/or trade in tobacco, alcohol, weapons, ammunition, gambling, and other businesses prohibited for financing by the Islamic Bank Council.

Islamic Bank Council

With one notable exception, the bodies of an Islamic bank are the same as any other Kazakhstani bank. All Islamic banks must have a Council on Islamic Finance Principles (the “**Islamic Bank Council**”). This is an independent body appointed by the general meeting of shareholders upon recommendation of the bank’s Board of Directors. Except for transactions executed in accordance with the model terms approved by the Islamic Bank Council, all banking transactions of an Islamic bank should be approved by its Islamic Bank Council. Further, the Islamic Bank Council has the right to review any transaction (even one entered in accordance with the approved model terms) for its compliance with Islamic finance principles. Should the Islamic Bank Council deem a given transaction to be inconsistent with such principles, the transaction shall not be executed and, if already executed, it shall be terminated early at the request of the bank in court (or in out-of-court proceedings, where applicable). It is unclear from the legislation whether the court will be obligated to terminate such a transaction and, if it does so, whether (and how) it may order restitution.

Islamic Banking Products

The Islamic Finance Law introduces products that are new to the Kazakhstani banking sector: a) investment deposits, b) finance of business activities (by way of participation in projects) and c) trade finance (through sale/purchase of goods).

Under an investment deposit agreement an Islamic bank accepts a client’s money for a specific term and promises to pay income on such deposit depending on investment returns. Money contributed to an investment deposit may be invested jointly with money contributed by other investors or separately, as may be set out in the investment deposit agreement. Investment deposit clients exercise the right of common shared ownership⁸ to the property acquired with the money deposited, and the Islamic bank serves as trust manager (and co-owner, if it contributes its own funds, along with the clients’ money, in relation to such property). The Banking Law (as amended by the Islamic Finance Law) specifically excludes Islamic banks from participation in the deposit insurance organization that insures deposits (subject to certain limits/conditions) of individuals in regular commercial banks. Accordingly, neither investment deposits nor interest-free deposits made with an Islamic bank are insured by such deposit insurance organization.

An Islamic bank may finance business activities on the basis of a partnership contract or by way of acquiring shares in legal entities. In the case of a partnership contract, the share of participants in common property, income and losses, or in the project company, as the case may be, are proportional to their contributions unless the contract provides otherwise.

To facilitate trade finance, an Islamic bank may enter into a commercial credit agreement with either a buyer or a seller of goods. In both cases, the bank becomes the owner of the goods as a matter of regular business; this contrasts with the legal regime and business practice for regular commercial banks.

⁷ Article 52-1 of the Banking Law.

⁸ Under the Civil Code, co-owners may have either a right of common shared ownership or a right of common joint ownership over a given property. In both types of common ownership, co-owners operate the property jointly by an agreement. However, in common shared ownership the respective shares of the co-owners are expressly defined (as percentage or otherwise) while in joint ownership the owners’ respective shares are not quantified.

A buyer should send to the Islamic bank an offer to enter into a commercial credit agreement (similar to an application to grant loan/issue letter of credit in regular trade finance). The bank may accept the offer only after the bank becomes the owner of the goods to be sold by it to the buyer.⁹ The commercial credit agreement should specify the type and quantity of the goods, the price the buyer should pay to the bank, the margin and the payment terms. The margin is the difference between the buyer's price and the seller's price (unless otherwise is provided by the agreement) and may be expressed as a definite amount or as a percentage of the seller's price.

Alternatively, the Islamic bank may enter into a commercial credit agreement with the seller of the goods. Subject to the Islamic Bank Council's conclusion, such agreement could be executed in relation to goods that will be created in the future (effectively, to finance the production of such goods) or goods that will be produced as a result of using property, performing work or providing services.

Islamic Securities

The Islamic Finance Law amends the Securities Market Law to provide for the new concepts of Islamic securities and several new market players.

Islamic Securities

Under the Securities Market Law (as amended by the Islamic Finance Law),¹⁰ **Islamic securities** are emission securities, which are issued in accordance with principles of Islamic finance and which certify common shared ownership rights of the holders in tangible assets and/or the right of disposal of assets and income received from an investment project. The Securities Market Law provides for the following types of Islamic securities: a) stocks and shares in Islamic investment funds; b) Islamic rent certificates; c) Islamic participation certificates; and d) other securities recognized as Islamic securities according to Kazakhstani legislation. Islamic rent certificates and Islamic participation certificates are particularly novel to Kazakhstan's securities market.

Islamic rent certificates are issued by an Islamic special finance company ("ISFC") and have a fixed maturity. Holders of Islamic rent certificates are entitled to income from underlying rent agreement(s) (financial leasing). Islamic participation certificates also are issued by an ISFC and have a fixed maturity. The funds raised are used for purposes of establishing a new investment project, developing an existing investment project or financing a business activity either on the basis of a partnership contract or through a project company (created in the form of a joint stock company or a limited liability partnership). Holders of Islamic participation certificates will have the right of common ownership over the project's assets.

Apart from peculiarities discussed below, Islamic securities remain subject to all general rules and regulations applicable to securities in Kazakhstan.

Islamic Securities Principles

Similar to the Banking Law, the Securities Market Law (as amended by the Islamic Finance Law)¹¹ contains the following limitations intended to comply with principles of Islamic finance:

- both consideration in the form of interest "from the value"¹² of Islamic securities and a guaranteed income from Islamic securities are prohibited; and
- funds received from the issuance and placement of Islamic securities should not be directed to finance activities related to production and/or trade in tobacco, alcohol, weapons, ammunition, gambling, and other businesses prohibited for financing by the Islamic Securities Council.

⁹ When the bank buys goods with the purpose of selling them to the buyer under a commercial credit agreement, the bank should stipulate so in its agreement with the seller of the goods.

¹⁰ Article 1.34-3) of the Securities Market Law.

¹¹ Article 32-1 of the Securities Market Law.

¹² The Russian word 'stoimost' used in the law may mean both face value and price of securities.

Islamic Securities Council

As with Islamic banking transactions, Islamic securities transactions should be reviewed by a council on principles of Islamic finance (the “**Islamic Securities Council**”). The Islamic Securities Council is responsible for ensuring that the projects being financed comply with Islamic finance principles. When the Originator is an Islamic bank, the respective Islamic Bank Council serves as the Islamic Securities Council. In other cases, an outside council on Islamic finance principles may be hired on the basis of a contract to act as the Islamic Securities Council. The Islamic Securities Council has the right to review any transaction for compliance with Islamic finance principles. Should a given transaction be deemed by the Council as inconsistent with such principles, the securities transaction shall not be executed and, if already executed, shall be terminated early at the request of the Originator and/or the management company (for Islamic investment funds) in court (or in out-of-court proceedings where applicable). As with banking transactions, it is unclear from the legislation whether the court will be obligated to terminate such a transaction and, if it does so, whether (and how) it may order restitution.

Originator

One of the new securities market players introduced by the Islamic Finance law is the “**Originator**.” An Originator of Islamic securities may be an Islamic bank, a national holding,¹³ a national managing holding¹⁴ and legal entities where 100% of the voting interest belongs to national managing holding. An Originator also serves as the founder of an ISFC and transfers assets to the ISFC on the basis on a sale and purchase agreement. Please note that privately-owned companies (except for Islamic banks) may not serve as Originators. Such limitation appears to reflect the recent trend of enhancing the role of the state rather than any fundamental legal or business reason.

Changes to the Tax Legislation

The Islamic Finance Law amends the Tax Code to introduce several of the above-described Islamic finance instruments, including investment deposits, Islamic rent certificates and Islamic participation certificates, and to set out applicable tax rates.

Most notably, the amendments introduce a number of tax incentives for Islamic financing in Kazakhstan. For example:

- (i) income under an investment deposit placed with an Islamic bank is exempt from income taxes for individuals, both resident and foreign (however, legal entities are not exempt);
- (ii) income of a Kazakhstani-incorporated ISFC received from assigning debt receivables is exempt from corporate income tax; and
- (iii) a number of operations of an Islamic bank (including the taking of investment deposits and granting interest-free loans) are exempt from value added tax (this is similar to VAT treatment of regular commercial banks in Kazakhstan); the VAT exemption also applies to the markup charged an Islamic bank in the course of trade financing activities.

* * * *

This LEGAL ALERT is issued to inform clients and other interested parties of time-sensitive legal developments which may affect or otherwise be of special interest to them. The comments above do not constitute legal advice or opinion and should not be regarded as a substitute for detailed legal advice in individual cases.

Questions regarding the matters herein may be addressed to:

Curtis B. Masters, Partner
+7 727 3300 500
curtis.b.masters@bakernet.com

Maxim Grekov, Counsel
+7 727 3300 500
maxim.grekov@bakernet.com

¹³ The term ‘national holding’ is used in Kazakhstani legislation but is not expressly defined. Any entity having ‘national holding’ as the part of its legal name is commonly understood to be a ‘national holding’ for the purposes of the Securities Market Law.

¹⁴ Currently, this is JSC “National Wealth Fund ‘Samruk-Kazyna.” (For more details on this entity, please see Baker & McKenzie’s Legal Alert *Kazakhstan Adopts Law Clarifying Powers of its National Wealth Fund* dated 17 March 2009).