New markets and challenges in Islamic banking for Russia

Islamic finance has been developing rapidly over the past two decades. The number of Islamic banks and financial services firms is growing even as market growth slows down. Today, such banks operate in over 75 countries with up to 70 million clients all over the world. The total volume of Islamic finance assets has already exceeded US$2 trillion and it is expected to reach US$3 trillion by 2021 according to the International Association of Islamic Business, a non-commercial organization based in Moscow. VLADISLAV ZABRODIN and VALENTINA ALIKOVA explore.


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In a time when businesses and banks are experiencing financing difficulties, the ideas of Islamic banking tend to become more and more favored by investors. Credit agencies working under Islamic finance principles proved to be more stable and this is one of the main reasons why Islamic banking is steadily expanding to new countries and new markets. Russia, with its multinational population and dynamically developing economy, is no doubt one of the most attractive places for putting the ideas of Islamic finance into action.

Russia has over 25 million Muslims in its population and there are many more in countries of the Islamic world that are interested in developing economic relations with Russia. Due to US and European sanctions, Russian banks and companies now face difficulties working with western financial markets, and so alternative markets are being actively sought.

It seems clear that Islamic banking being introduced in Russia can have considerable benefits for the Russian economy. This could provide the opportunity to attract additional investments from countries in Southeast Asia and the Middle East and thus the opportunity to enlarge and diversify the funding base. Energy and infrastructure projects, as well as retail and real estate, are just some of the areas where Islamic financing has good potential to thrive. Experts also think that it can be successfully used not only in major infrastructure projects but in medium and small businesses as well. Even microfinancing is considered to be a worthwhile option. And these are the areas that have been actively developed in Russia lately.

However, Russian legislation is still not adapted for Islamic banking. Although much has already been done in that direction, there is still a number of significant gaps between Russian civil law and Islamic finance principles that need to be taken care of.

> ***"Islamic investors are willing to invest in Russia. What they need are the appropriate means that would make their investments more convenient and cost-efficient"***

Firstly, Russian credit organizations are banned from working with real assets. This is crucial for institutions trying to work under Islamic finance principles because under Russian law, any deal with real assets is subjected to an 18% value-added tax (VAT), and starting the 1st January 2019 it will be 20%. This raises the issue of multiple VAT taxation in transactions that involve a number of resale operations, such as, for instance, Murabahah. A Russian credit organization using Murabahah has tax obligations that are different from traditional ones. In a sale and purchase operation, tax must be paid on the entire contractual amount, irrespective of whether the buyer fulfills his payment obligations. Such a system imposes significant limitations and makes transactions like Murabahah inexpedient.

Russian banking law also forbids banks to engage in trade. A bank working under Islamic financing principles must accept assets on its balance, which is deemed a non-core activity for a credit institution.

Another disputed point concerns deposits. When a person makes a bank deposit, income tax is paid only when the deposit rate exceeds a certain value (12.25% at the moment), whereas in Islamic companies income tax must be paid irrespective of the rate. This also puts Islamic banks in unequal conditions compared to traditional banks, and makes them uncompetitive.

Finally, the key feature of Islamic financing – profit and risk being shared between the financial organization and its investor – makes Islamic financial institutions incapable of guaranteeing return of the principal investment amount. Yet banking law requires the bank to return the principal in full in any event.

So these are the main barriers that prevent Islamic financing from being instituted in Russia. At the moment, Russian legislation does not provide banks with a possibility to fully comply in their operations with Islamic financing principles.

At the same time, we can see a number of deals in which investment funds from countries of the Islamic world become

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equity investors in major projects in Russia. For example, in 2016, global trade enabler DP World (UAE) and the Russian Direct Investment Fund launched a joint venture company targeting ports, transportation and logistics infrastructure in Russia with the total amount of investment at about US$2 billion. Another US$2 billion deal was made in 2017 in collaboration with Qatar Investment Authority, the sovereign wealth fund of Qatar, and many more deals in smaller amounts are being made regularly.

Based on this, we can conclude that Islamic investors are willing to invest in Russia. What they need are the appropriate means that would make their investments more convenient and cost-efficient.

There have already been attempts to make the relevant adjustments to Russian legislation. Two legislative bills were introduced to the Russian State Duma, one in 2015 and another in 2017. The bills were meant to make it possible to conduct banking operations based on Islamic law; however, Russian authorities considered that they needed further improvement and so neither of the bills were accepted.

In addition to that, a work group was formed in the Bank of Russia to study the possible ways Islamic banking could be developed in Russia. In 2016, the group prepared a roadmap to introduce partner banking. Based on this roadmap, the first Islamic bank in Russia, the Partner Banking Center, was created in the city of Kazan in Tatarstan. However, in less than a year, it ceased its activity because its parent bank, Tatagroprombank, had license issues.

At the moment, the work group is preparing a new legislative bill. Perhaps, it would be reasonable to study the experience of neighboring countries such as Kazakhstan, Kyrgyzstan and Azerbaijan. So far, Kazakhstan is the first post-Soviet country that was able to successfully adjust its legislation for Islamic banking by making changes to their law on banks and banking activity. Once the proper regulatory changes are made in Russia, this will likewise create favorable conditions to work under in the Islamic financing system, for both local and foreign investors.