

Islamic Banking in Kazakhstan Law

Peter B. Maggs

Abstract

Kazakhstan has adopted legislation designed to facilitate Islamic banking, and at least one Islamic bank has started operations in Kazakhstan. Islamic banking is based upon traditional Islamic law, which forbids the taking of interest, the making of profit without risk, and profiting from “sinful” businesses such as pornography. The legislation in Kazakhstan forbids such activities for Islamic banks and also requires each Islamic bank to have an independent “Council on the principles of Islamic finance” to rule on bank policies and specific transactions. Islamic banking practices use complex combinations of transactions, each permitted by Islamic law, to mimic common conventional banking transactions, such as loans bearing fixed interest rates and repayable on a fixed date. Stable income and manageable principal obligations from credit-worthy borrowers can ensure that a bank will receive high ratings from leading international credit rating agencies and, thus, can satisfy the requirements of Kazakhstan’s bank regulators.

The formal difference between Islamic banking transactions and the conventional transactions that they mimic could lead to differing treatment for taxation. To provide a level playing field, Kazakhstan has amended its Tax Code to provide for equal treatment of economically equivalent Islamic and conventional banking transactions. Adjustments have also been made to bankruptcy legislation, reflecting the unavailability of deposit insurance for Islamic banks and the special nature of investment deposits in Islamic banks.

There are controversies among Islamic law scholars as to whether or not various practices used to mimic conventional banking transactions are unlawful because they violate the spirit of Islamic law. This creates what is called “Sharia risk”, the risk that a transaction will be found unlawful after it has been concluded, with consequences highly unfavorable for a party.

Key Words

banking, banks, finance, Islam, Islamic, Kazakhstan, Sharia, taxation

1. Introduction¹

Kazakhstan has joined the list of countries that have altered their legislation in order to facilitate Islamic banking and finance. Modern Islamic banking and finance legislation has originated not bottom up from the Islamic

¹ The author would like to thank Mr. Roustam Vakhitov for his careful reading of a draft of this article and his most helpful suggestions.

faithful, but top down from multinational businesses seeking a profitable market position.² Kazakhstan is no exception. About 65% of its population is at least nominally Muslim. However, it is a secular state with a generally good record on freedom of religion.³ Legislation on Islamic banking and finance was drafted with the cooperation of a leading international law firm⁴ and was passed in 2009.⁵ The country's powerful president has issued an edict calling for use of Islamic finance as a measure "for attracting resources for further development".⁶ One major Islamic bank has opened a subsidiary in Kazakhstan, which has begun project financing and has announced plans to offer retail financial services.⁷ Another bank is expected to offer Islamic financial services there.⁸ Important developments are also occurring in the area of non-bank related Islamic finance; however, such finance is beyond the scope of the present article.

There has been an immense amount of writing on Islamic banking and finance.⁹ Because Islam lacks a central authority, there are significant differences of opinion as to what financial transactions are permissible and

² Killiam Bälz, *Sharia Risk – How Islamic Finance has Transformed Islamic Contract Law* (Islamic Legal Studies Program, Harvard Law School, Cambridge, MA, 2008) <<http://www.law.harvard.edu/programs/ilsp/publications/balz.pdf>>. All Internet references in this article were last visited on 23 January 2011.

³ United States Department of State, "International Religious Freedom Report, 2010". <<http://www.state.gov/g/drl/rls/irf/2010/148793.htm>>.

⁴ "Salans assists in developing Islamic banking legislation in Kazakhstan" <<http://www.salans.com/en-gb/sitecore/Content/Salans/Global/Items/News/2009/20090708-Salans%20assists%20in%20developing%20Islamic%20banking%20legislation%20in%20Kazakhstan.aspx>>.

⁵ "O vnesenii izmenenii i dopolnenii v nekotorye zakonodatel'nye akty Respubliki Kazakhstan po voprosam organizatsii i deiatel'nosti islamskikh bankov i organizatsii islamskogo finansirovaniia" [On Making Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Matters of the Organization and Activities of Islamic Banks and Organizations of Islamic Banks], Law of 2 February 2009, No.133-4, available at <<http://www.pavlodar.com/zakon/>>. This is a good, free databank of the legislation of the Republic of Kazakhstan. All the laws cited in this article are available in this databank. The "Paragraf" databank, which provides better historical coverage of amended legislation and highly useful annotations, is available on a paid basis at <<http://online.prg.kz/>>.

⁶ "Kontseptsiia razvitiia finansovogo sektora Respubliki Kazakhstan v postkrisisnyi period" [Concept of the Development of the Financial Sector of the Republic of Kazakhstan in the Post-Crisis Period], approved by Edict of the President of the Republic of Kazakhstan of 1 February 2010, No.923 <<http://www.afn.kz/attachments/12/264/publish264-1633896258..pdf>>.

⁷ "Al-Hilal Bank financed 7 projects worth USD 23 mln in Kazakhstan" <<http://www.inform.kz/eng/article/2339299>>. "Islamskii bank 'Al' Khilal' planiruet nachat' rosnizchnoe finansirovanie k kontsu 2011 goda" [Al Hilal Islamic Bank Plans to Begin Retail Financing by the End of 2011] <<http://inform.kz/rus/article/2339235>>.

⁸ "Al Hilal Bank – Islamskii bank" [Al Hilal Bank – Islamic Bank] <http://www.lariba.kz/banks/all/442/?sphrase_id=715>. "V Kazakhstane otkroiut vtoroi islamskii bank" [A Second Islamic Bank is to be Opened in Kazakhstan] <<http://www.lariba.kz/news/finance/477/>>.

⁹ Two good guides are Mahmoud El-Gamal, *Islamic Finance, Law, Economics, and Practice* (Cambridge University Press, Cambridge, 2009); and Hans Visser, *Islamic Finance, Principles and Practice* (Edward Elgar, Cheltenham & Northampton, UK, 2009).

what are forbidden by Islamic religious law. The purpose of this article is not to take sides in these debates but, rather, to discuss the nature and implications of the regulation of Islamic banking in Kazakhstan. Despite the disagreements, there are, however, important areas of consensus on Islamic law as applied to finance. It is generally agreed that it is forbidden to charge interest and forbidden to make a profit without bearing a corresponding risk. It is clear that these principles would ban a high proportion of banking and financial transactions common in the world economy. The ban on interest would outlaw interest-bearing transactions such as saving deposits, bank loans, mortgages, conventional sales financing, and bonds. The ban on profit without risk would ban investments with guaranteed return of principal and would raise questions about deposit insurance. However, there also is general agreement that certain transactions which were accepted as lawful in the early days of Islam are still lawful, even if they may have strong economic similarity in economic terms to be economic equivalents to banned practices. These include sale of goods for time payments at a stated markup over the cash retail price, leasing of property, and the giving of gifts in connection with business transactions.

Major banking and financial institutions that claim to follow Islamic principles have, particularly in recent years, developed a variety of approaches by which they engage in transactions the economic effects of which are virtually indistinguishable from the many types of interest-bearing and principal-guaranteeing non-Islamic financial transactions. They have done this in a variety of ways, typically by structuring a combination of permissible transactions (such as time sales, leases, and gifts) to achieve a result that cannot be reached directly by a single impermissible transaction. Each transaction combination is given an Arabic name, for instance "*sukuk*" ("certificate") to symbolize their claimed compliance with Islamic law. Promoters of Islamic finance give the explanations such as the following:¹⁰

"Although theoretically a hybrid of debt and equity, *sukuk* can be structured to offer a fixed return similar to that of a conventional bond, making such investments attractive to Muslim investors seeking to diversify their portfolios. That said, it is not permissible for the return of a *sukuk* offering to be directly linked to a prime rate, such as the London Interbank Offered Rate (LIBOR) or similar market benchmarks, because such benchmarks are interest-based. However, a properly structured *sukuk* may generate a profit-based return that essentially replicates a prime rate or LIBOR. An argument often heard from investment bankers is that Shari'ah requirements achieve the same end result that conventional investment or finance products would achieve in a number of situations. The difference is the utilization of different

¹⁰ Ayman H. Abdel-Khaleq and Christopher F. Richardson, "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings", <<http://www.velaw.com/uploadedFiles/VEsite/Resources/IslamicSecurities.pdf>>, p. 5. Co-author Richardson is with Vincent and Elkins, a law firm that plays a leading role in Islamic finance.

mechanisms and finance techniques. While this is true in a number of ways, it is specific mechanisms and respecting the fact that the form by which investments are made is as important under Shari'ah as the substance."

Numerous leading scholars of Islamic law have opined that such transaction constructs are lawful. Islamic banking and finance is founded on the opinions of these scholars. There are differences of opinion among these scholars, with those from Malaysia approving some transactions that scholars from the Persian Gulf area disapprove.¹¹ There are some notable scholars of Islamic finance who do suggest that such roundabout approaches in fact exalt form over substance and, so, are unlawful as violating the basic spirit of Islamic law.¹² Scholars with these views are, not surprisingly, largely ignored by those involved in the growing system of Islamic banking finance.

The use of multiple transactions, each permissible under Islamic law, to mimic unlawful conventional transactions is facilitated by the ability of an Islamic bank to act as an agent of its client. The client can sign a single agency agreement, and the bank can then conclude multiple transactions each in the appropriate order. For instance, if Islamic law requires that a bank take title to goods and hence bear the risk of price fluctuation in the interval between buying goods and selling them to a client on credit, the bank, by acting as agent of the customer, can conclude successive transactions within minutes (or even in milliseconds on electronic exchanges), thus virtually eliminating the window of risk for the bank and providing speedy service for the client. The Emirates website of Al Hilal Bank, the first Islamic bank to enter the market in Kazakhstan, advertises on its Abu Dhabi website:¹³

"WALK IN. DRIVE OUT.

It sounds radical, we know, but that's exactly what happens when you come into our Auto Mall within our Mall Branch at Al Sahel Tower, Abu Dhabi.

In the time it takes to sip on a cup of freshly brewed coffee in our café, we can arrange all the finance and legal documents, so you can just drive away in your new vehicle."

Article 52-II of the amended 1995 Law of Kazakhstan on Banks and Banking provides the legal basis for the bank to act as the client's agent:

¹¹ Beng Soon Chong and Ming-Hua Liu, *Islamic Banking: Interest-Free or Interest-Based?* <<http://www.efmaefm.org/efmameetings/efma%20annual%20meetings/2007-vienna/papers/0019.pdf>>; Abel-Khaleq and Richardson, *op.cit.* note 10, 4.

¹² E.g., Mahmoud A. El-Gamal, "Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering", 25 *Wisconsin International Law Journal* (2008), 605-623.

¹³ <<http://www.alhilalbank.ae/alhilalauto/index.php>>.

“Article 52-II. Conduct of Agency Activity in the Conduct of Banking Operations of an Islamic Bank

1. An Islamic bank in conducting banking operations of the Islamic bank shall have the right to conduct agency activity in accordance with which the Islamic bank acts as agent of its client or names a third person as its agent.
2. In accordance with the agency agreement, the agent in the name of and on delegation by the client either in the agent's own name, but on delegation from and at the expense of the client undertakes the obligation on the basis of its own experience and knowledge to take for compensation specific legal actions aimed at the receipt of income.
3. The rules on the contract of delegation or commission, with the peculiarities provided by the present Article shall be applied to the agency agreement of an Islamic bank.
4. Physical and legal persons including banks and other financial organizations can act as parties under an agency agreement (as client or agent).
5. The terms of the agency agreement must provide for the manner of determining and paying compensation to the agent. The terms of an agency agreement may not provide for a guaranteed measure of income to the client.
6. The agent shall retain the right to receipt of compensation without regard to the results of performing the agency agreement.
7. The risk of losses as the result of the activity of the agent shall be borne by the client of the agency agreement with the exception of the arising of losses due to the fault of the agent.”

In addition to prohibiting certain kinds of transactions, such as interest-bearing loans, Islamic law also prohibits certain types of business activities. It is generally agreed that it is unlawful to make money by directly engaging in businesses forbidden by Islamic law, such as sale of liquor, pork, or pornography. There are differences of opinion, however, on the question of indirect profit from unlawful business or practices. A very wide variety of criteria are used in practice by Islamic mutual funds to determine what businesses are suitable for investment in terms of borderline products (such as tobacco), borderline practices, such as leaving small amounts of cash in interest bearing accounts, and permissible ratios of debt financing.¹⁴ In some cases, such improper income can be sanitized by giving it to charity.

When Kazakhstan adopted comprehensive legislation to form the basis for the introduction of Islamic banking and finance to the country, the legislation also attempted to create a “level playing field” in which Islamic products could operate in a clearly-defined legal framework, without advantages or disadvantages in such key areas as civil, banking,

¹⁴ “A Universal Platform for Shari’a-Compliant Equity Screening” (2009) <<http://www.daralistithmar.com/files/OIF-DI%20Equity%20Screening.pdf>>.

tax, and securities law. Islamic banking legislation has also been adopted in Kyrgyzstan,¹⁵ and it could spread to other Central Asian countries. Although, in the short run, Islamic banking and finance may play a small role, Kazakhstan's legislation may serve as a model for legislation of neighboring countries. In particular, if there appear to be profits to be made from Islamic banking, there will be pressure to adopt enabling legislation in Russia.

During the course of an Islamic bank's operation, specific questions of Islamic law may arise. Is a new type bank account or a new form of lending compliant with Islamic law? Is it permissible to invest in or finance a wholesale grocery dealer, one (or ten or fifty) percent of whose sales are liquor? What if, after making a long-term financial arrangement with an Islamic bank, the wholesale grocer starts selling liquor? What if a rogue bank officer knowingly entered, on behalf of the bank, into a financial arrangement with a liquor distributor? To answer such issues, laws on Islamic banking and finances typically provide that each Islamic banking or financial institution must have an independent board of scholars of Islamic law to provide opinions. In Kazakhstan's legislation this board is called a "Council on the Principles of Islamic Finance". If the Council has given a negative opinion about a certain type of transactions, the bank may not conclude transactions of this time. Likewise, if the Council disapproves a contemplated transaction, the bank may not enter into the transaction. The legal situation becomes more difficult if a contract has been signed or performance has already begun at the time a negative opinion is rendered.

The present article will examine how the legislation in Kazakhstan deals with the many issues involved in Islamic banking and finance. The 2009 law authorized Islamic banks but—unlike similar legislation in other countries—did not authorize "Islamic windows" in conventional banks.¹⁶ The absence of a provision for Islamic windows may be explained by the fact that the driving force behind the legislation was a leading Islamic bank from the United Arab Emirates, which naturally would be more willing to invest in Kazakhstan if it did not face competition from Islamic windows at conventional banks. It is quite likely that there will be further legislation expanding opportunities for Islamic finance in Kazakhstan and, perhaps, also dealing with problems that may arise in implementation of the 2009 law.

¹⁵ "Islamskii banking v Kyrgyzstane tverdo stoit na nogakh" [Islamic Banking in Kyrgyzstan is Standing Firmly on its Feet] <http://www.ecobank.kg/index.html?subaction=showfull&cid=1259219391&archive=&start_from=&ucat=6&>.

¹⁶ A conventional bank's "Islamic window" is a subdivision or subsidiary that follows Islamic principles, thus allowing both conventional and Islamic banking services to be offered within a single corporate structure from the same physical location or locations.

2. Islamic Banks

The 2009 law that authorized Islamic banks contains both a list of activities prohibited for Islamic banks (Article 52-1 of the amended Law on Banks and Banking) and a list of activities permitted for Islamic banks (Article 52-5). The article on prohibited activities is very short, but it also gives each bank's council on the principles of Islamic finance the power to make further limitations:

“Article 52-1. Requirements for the Activity of an Islamic Bank

An Islamic bank shall not have the right to take compensation in the form of interest, to guaranty the return of an investment deposit or income on an investment deposit, to finance (or to provide credit for) activity connected with the production and/or trade in tobacco, alcohol production, arms and ammunition, the gambling business, and also other types of entrepreneurial activity the financing of which (or the providing credit for which) is forbidden by the council on the principles of Islamic finance.

The council on the principles of Islamic finance shall have the right to additionally determine other requirements for the activity of an Islamic bank that shall be obligatory for observance by the Islamic bank.”

The list in the first paragraph of Article 52-1 is entirely negative. One distinguished author has argued that there should also be positive screening, rewarding Islamic financial activities that contribute to development, education, and alleviation of poverty.¹⁷ The second paragraph gives great discretion to the bank's council on the principles of Islamic finance, the role of which will be discussed below. Article 52-5 gives a broad list of permitted activities:

“Article 52-5. Banking and Other Operations of an Islamic Bank

1. The following are banking operations of an Islamic bank:

- 1) accepting non-interest-bearing demand deposits of physical and legal persons, opening and servicing bank accounts of physical and legal persons;
- 2) accepting investment deposits of physical and legal persons;
- 3) bank loan operations: granting by the Islamic bank of credit in monetary form on terms of time limit, repayment, and without the taking of compensation;
- 4) financing entrepreneurial activity in the form:
 - of financing trade activity as a trade intermediary with the granting of commercial credit;
 - financing production and trade activity by way of participation in the charter capital of legal persons and/or on terms of partnership;

¹⁷ El-Gamal, *op.cit.* note 9, 188-189.

- 5) investment activity on terms of leasing (or lease);
- 6) acting as agent in the conducting of banking operations of the Islamic bank.
2. The banking operations provided for by subparagraphs 4) and 5) of Paragraph 1 of the present Article shall be conducted by the Islamic bank at the expense of its own money and/or money attracted as investment deposits. The Islamic bank and/or investment deposit clients shall get the right of common share ownership to property obtained with its money and the bank shall act as participant in general shared ownership and or as entrusted manager. An Investment bank as entrusted manager must ensure state registration of rights to immovable property and transactions with it and the registration of means of transport and other moveable property in accordance with the requirements of the legislation of the Republic of Kazakhstan. The Islamic bank shall keep records of the participants in common share ownership to property that has been obtained.
3. The Islamic bank shall have the right, if this is provided by the charter, to conduct individual types of banking and other operations provided for by Article 30 of the present Law, with the observance of the requirements indicated in Article 52-1 of the present Law, with the exception of the following operations:
- 1) factoring operations: obtaining the right of demanding payment from a buyer of goods (or work or services) with the taking of the risk of nonpayment;
 - 2) forfeit operation (forfeiting): payment of the debt operations of a buyer of goods (or work or services) by purchase of a promissory note without recourse against the seller.
- The council on the principles of Islamic finance shall have the right to recognize individual banking and other operations provided by Article 30 of the present Law as not corresponding to the requirements indicated in Article 52-1 of the present Law.”

The last subparagraph of this article refers to Article 30 of the Kazakhstan’s Law on Banks and Banking. Article 30, in turn, lists a broad and unsurprising range of activities permissible for ordinary banks.

2.1. Types of Bank Accounts

Chapter 38 of the Civil Code of the Republic of Kazakhstan deals with “Banking Service” and envisions two types of bank accounts, a regular bank account and a savings account. A regular bank account is designed to be used for current banking needs, such as payments and withdrawals upon demand by the account-holder. The bank and the account-holder may determine by contract if any interest is to be paid and if so, how much. In fact, the ordinary bank account terms and conditions of non-Islamic banks in Kazakhstan that I have found online do not provide for payment of interest on accounts meant for current deposits and payments but, rather, envision significant charges for bank services.¹⁸ The 1994 Civil

¹⁸ The two largest banks in Kazakhstan are Kazkommertsbank and Halyk Bank. Their terms for current accounts and for deposit accounts are available at <<http://ru.kkb.kz>> and <<http://www.halykbank.kz>>.

Code of Kazakhstan—before the Islamic banking amendments—required payment of compensation, *i.e.*, interest, on savings accounts. The Civil Code also required the return of principal on request for demand savings accounts and upon expiration of the agreed time for time savings accounts. Non-Islamic banks in Kazakhstan offer both demand savings accounts and time savings accounts, at interest rates that are higher the longer the agreed time.¹⁹ The Islamic banking amendments amended the Civil Code to exempt Islamic banks from the compensation requirement for savings accounts. (A guaranty of return of principal for an account which pays no compensation does not violate the rule of Islamic law forbidding a profit without risk, since there is no profit on a non-interest bearing savings account.)

Unfortunately, the Law on Banks and Banking uses terminology different from that of the Civil Code. There are two Russian words related to banking that are commonly translated as “deposit”. One word, *vkład*, is based on a Slavic root and is the word used in the Civil Code for a savings account. The other word, *depozit*, is based on a Latin root and is not used in the chapter of the Civil Code on Banking Services but is used in the Law on Banks and Banking. To avoid confusion, I will use the English word “deposit” as a translation for *depozit* and the English word “savings account” as a translation for *vkład*. Article (2)(8) of the Law on Banking defines a deposit as follows:

“[...] money transferred by one person (a depositor) to another person – a bank, including the National Bank of the Republic of Kazakhstan (hereinafter the “National Bank”) or to the national operator of the post on condition of its return in the same amount (with the exception of an investment deposit in an Islamic bank) regardless of whether the money must be returned on demand or after some time period, in full or in part, with a previously agreed addition or without such, directly to the depositor, or transferred on order to third parties.”

Article 52-6 (“Deposit Accounts in Islamic Banks”) of the amended Law on Banks and Banking envisages two basic types of customer deposit accounts in an Islamic bank: (1) non-interest bearing demand deposit accounts; and (2) investment deposit accounts.

2.2. Demand Deposit Accounts

Non-interest-bearing demand deposit accounts are governed by Article 52-6(1):

“Article 52-6. Deposit Accounts in Islamic Banks

1. Under the contract of non-interest-bearing demand deposit account, an Islamic bank has the duty to accept money from a client on a demand bank deposit not providing for payment or guaranty of payment of compensation as interest and to return the deposit account amount or part of it on receipt of demands from the

¹⁹ *Ibid.*

client. The rules of the contract of bank savings account shall be applied to the contract of non-interest-bearing demand deposit account, with the exception of the provisions on the payment of compensation on the account.”

Different countries have different approaches to the question of deposit insurance for accounts in Islamic banks. Deposit insurance, of course, serves an important public purpose, that of creating public confidence so as to prevent runs on banks. On the other hand, such insurance, if applied to accounts that produced income, could be seen as contrary to the principle that there should be no profit without risk. Some countries, such as Malaysia, have included accounts in Islamic banks in their standard deposit insurance scheme.²⁰ Kazakhstan, however, specifically exempts Islamic banks from its deposit insurance system.²¹ Surprisingly, deposit insurance is unavailable even for demand deposit accounts that pay no incentives to depositors. Two different methods used to protect depositors will be discussed below: (1) minimum capital requirements; and (2) placing risks on holders of profit-and-loss-sharing accounts.

2.3. *Investment Deposit Accounts*

Investment deposit accounts are governed by Article 52-6(2):

“2. Under the contract of investment deposit account, an Islamic bank has the duty to accept money of a client for a defined time period without a guaranty of its return as a fixed sum, to pay income on it depending upon the results of use of the money transferred as provided by the contract of investment deposit. The rules of the contract on entrusted administration of property shall be applied to the contract of investment deposit account with the peculiarities provided by the present Article for the manner of use and return of money, the rights and duties of the client and the Islamic bank, the manner of determining and payment of compensation of the entrusted administrator – the Islamic bank.

Upon conclusion of a contract of investment deposit account, a settlements account may be opened.

3. The terms of the contract of investment deposit account must define the measure of compensation of the entrusted administrator, the Islamic bank, for managing the money of the client, the founder of entrusted administration, the time periods for and the manner of return of money, the risks of losses from the use of money and other terms.

4. Compensation of the Islamic bank shall be determined as part of the income received from the use of money acquired on investment deposit account, on the condition that compensation may be paid only from income from the use of money under the investment deposit. The Islamic bank shall lose the right to compensation in case there is a loss on the investment deposit (or in case of absence of income as

²⁰ <<http://www.pidm.gov.my/About-Deposit-Insurance/Member-Institution-List.aspx>>.

²¹ Art.3(5-1) of the amended banking law provides:
“An Islamic bank is not a participant in the system of obligatorily guaranteed deposits, and deposits in an Islamic bank are not guaranteed by the system of obligatory guaranty of bank deposits.”

the result of use of the money acquired on investment deposit). The terms of the contract of investment deposit account may not provide for a guaranteed measure of income under the investment deposit account nor of compensation for the Islamic bank.

5. The client shall lose the right to receipt of income in case of early return of the investment deposit account amount on his demand, unless otherwise provided by the contract of investment deposit account.

6. The contract of investment deposit account may provide terms on the determination by the client of the manners of use of the money, the list of the kinds of assets or objects of investment of money or the terms of use of the money of the client separately from the money of other clients without the right of combining them.

7. As Islamic bank shall have the duty to keep accounts of the sum of money on individual investment deposit accounts with the purpose of determining the manner and results of the use of the money, including determining the manners of use of the money, the list of the types of assets or objects of investment of money, the amount of income or loss from such use, and the amount of compensation of the Islamic bank.

8. On demand by the client, the Islamic bank shall have the duty to provide a report on the use of money on the investment deposit account.

9. Unless otherwise provided by contract, the client, who has put money on an investment deposit account shall not answer for the obligations of the Islamic bank arising in connection with the placement of money, but shall bear the risk of losses connected with the reduction of the value of assets in which the money was invested within the limits of the amount of money put on the investment deposit account.

10. The Islamic bank shall not bear liability for losses connected with reduction of the value of the assets in which the money of the investment deposit account was invested with the exception of cases when such losses arose due to its fault.

In the case that losses connected with reduction of the cost of assets in which the money of the investment account arose due to the fault of the Islamic bank, then the Islamic bank is obligated to inform the client of the occurrence of such losses.”

Investment deposit accounts do not violate the principle of no profit without risk, because the depositor gets profit but bears the risk. They are not protected by deposit insurance, and indeed, since they could be used to finance high-risk investments, deposit insurance would be highly inappropriate.

2.4. Lending

The new legislation made only one substantive amendment to the Civil Code. Paragraph 1 of Article 727 of the Civil Code provides: “Under the contract of bank loan, the lender has the duty to transfer money to the borrower on terms of compensation, duration, and repayment.” The amendment added a new Paragraph 1-1 that omitted the requirement of compensation, so as to comply with the Islamic prohibition on interest.

Islamic law specialists consider non-interest bearing loans permissible as a form of charity.²² Since Islamic banks, like other banks, are in business to make money, it seems unlikely that they would make commercial loans without compensation. However, as noted above, conventional transactions that would violate Islamic law are often constructed from a group of transactions that comply with Islamic law. Interest-free loans have a place in such a group of transactions, since the profit may come from other transactions in the group.

2.5. Commercial Credit

A simple example of commercial credit would be financing the purchasing of goods. Suppose a business wanted to buy a truck costing \$30,000 with no down payment. In a typical conventional transaction, a bank would finance this purchase over five years at 8% interest. The bank would be protected by a security interest in the truck. If my calculations are correct, there would be 60 monthly payments of \$608.29 each. The total amount paid over the term of the loan would be \$36,497.40, of which \$6,497.40 would be interest. If the same truck were financed by an Islamic bank, the bank would buy the truck from the dealer for \$30,000 cash and agree to sell the truck to the business at a 0% interest rate, with title to pass upon making of the last payment. The sale price to the business would be \$36,497.40, to be paid in 60 monthly payments of \$608.29 each. Thus the number and amount of monthly payments under conventional and Islamic financing would be identical. (In practice, there may be additional charges in the Islamic finance situation, because of the extra cost of the more elaborate formalities, of different tax treatment, or of lack of competitors.) Not surprisingly, scholars debate whether or not such financing—which complies with the letter, but not the spirit, of the prohibition on interest—really complies with Islamic law. In particular, Professor Mahmoud El-Gamal argues that “Islamic” financing actually results in the borrower paying more (because of the additional transaction costs) effective interest rather than less, so that conventional financing is actual more compliant with the spirit of Islamic law.²³

²² The other three amendments to the Civil Code merely contained a reference to matters that would be covered by banking legislation. These amendments were made necessary by provisions of the 1998 Law on Normative Acts and of the Civil Code under which codes in general and the Civil Code in particular prevail over other legislation. The amendments provided that provisions of banking legislation on sales, bank deposits, and entrusted administration relating to Islamic banking would prevail over the provisions of the Civil Code.

²³ El-Gamal, *op.cit.* note 12.

Article 52-8 of the amended Law on Banks and Banking provides the legal basis for the granting of Islamic commercial credit including not only relatively simple situations of the type described above but, also, various other common types of commercial credit.

“Article 52-8. Financing Trade Activity as a Trade Intermediary with the Granting of Commercial Credit

1. An Islamic bank shall have the right to participate in trade activity as a trade intermediary by granting commercial credit to a buyer or seller on the basis of a contract of Islamic bank commercial credit (hereinafter: contract of commercial credit).
2. The contract of commercial credit shall be concluded on the basis of a proposal by the buyer of goods on the conclusion of a contract of commercial credit (the offer), which must provide a time period for its adoption by the Islamic bank (the acceptance). During the time period of effectiveness of the offer, the Islamic bank shall have the right to conclude a contract of purchase and sale with the seller of the goods. Acceptance by the bank shall be given after it has obtained the right of ownership to the goods. Upon receipt by the buyer of the acceptance of the Islamic bank during the time period of effectiveness of the offer, the performance of the contract on commercial credit shall be obligatory for the buyer. In case of refusal to perform the contract of commercial credit, the buyer shall compensate the Islamic bank for the out-of-pocket loss caused by such refusal, and the Islamic bank shall sell the goods to a third person or return them to the seller.
3. The rules of the contract of purchase and sale of goods on credit (with delayed or installment payment) shall be applied to the contract of commercial credit, taking into account the peculiarities provided by the present Article and the requirements indicated in Article 52-1 of the present Law.
4. The contract of commercial credit must contain terms on the designation and quantity of goods, the price at which the buyer will obtain the goods from the Islamic bank, with an indication of the amount of markup on the goods, and also the terms of commercial credit (delayed or installment payment)
5. Unless otherwise provided by the contract of commercial credit, the price of sale of goods by the Islamic bank to the buyer shall be made up of the price of purchase of the goods from the seller and a markup on the goods. The markup may be established as a fixed amount or a percentage of the price of purchase of goods from the seller.
6. In obtaining goods on the basis of an offer by a buyer, the Islamic bank shall have the duty in the contract of purchase and sale with the seller to indicate that the goods are being obtained for the conclusion of a contract of commercial credit.
7. It is not allowed to obtain goods from a seller that is simultaneously the buyer under a contract of commercial credit. The contract of commercial credit of the Islamic bank with the seller of the goods may provide conditions on preliminary payment for goods, the possibility of returning, within a defined time period, the goods bought and the return of the purchase price of the goods.
8. The contract of commercial credit may provide terms for ensuring the performance of the obligations of the buyer for payment by pledge of money or other property.

9. In case in which the object of the contract of commercial credit is obtaining goods needing preparation (products of reprocessing, a new movable thing, newly created immovable property), goods obtained as the result of use of property, performance or work or rendering services (in the form of separable fruits from the use of property, produced by agricultural, animal husbandry or other analogous production) there is required to be a conclusion of the council on the principles of Islamic finance on the correspondence of the contract to the requirements indicated in Article 52-1 of the present Law.

10. A contract of commercial credit concluded between an Islamic bank and a seller that is the producer (or manufacturer) of goods indicated in Paragraph 9 of the present Article may provide for the immediate partial or full preliminary payment for the goods to be obtained (commercial credit in the form of an advance) on the condition of supply of the goods within a time period determined by agreement of the parties (delay of supply). In case of provision of commercial credit to the producer (or manufacturer) of the goods, the contract of the Islamic bank with the direct buyer of the goods may provide terms on immediate partial or full payment for the goods on condition of supply of the goods within the time period determined by agreement of the parties (delay of supply).

11. In case of conclusion of the contract of commercial credit provided for in Paragraph 9 of the present Article, the rules on the work, supply, procurement, compensated rendering services or other rules provided by the civil legislation of the Republic of Kazakhstan on the obligation corresponding to these relations shall be applied.”

2.6. Leasing

Leasing provides the possibility for duplicating secured interest-based sales transactions without explicitly violating the prohibitions against interest or absence of risk.²⁴ Leasing is enabled by Article 52-10 of the amended Law on Banks and Banking.

“Article 52-10. Conduct of Investment Activity on the Bases of Leasing (or Lease)

1. Islamic banks shall have the right to conduct investment activity on the bases of leasing (or lease) of property.

2. The rules on finance leasing or on lease of property, with the peculiarities provided by the present Article, shall be applied to relations of an Islamic bank for the conduct of investment activity on the basis of leasing (or lease) of property.

3. The terms of a contract of leasing (or lease) with an Islamic bank may not provide the right of purchase of the leased property. The right of ownership to the leased property may pass to the leasing recipient (or lessee) on the basis of a separate agreement.

4. Unless otherwise provided by the charter or the internal rules of the Islamic bank, transactions for leasing or lease of property shall be included with the Rules on the General Conditions of the Operation of the Islamic Bank approved in accordance

²⁴ Mohammad Hashim Kamali, “Shariah Issues of Islamic Leasing: Perspective of the Lessor” <<http://www.financeinislam.com/article/10/1/553>>.

with the requirements of Article 52-2 of the present Law and shall not require separate approval by the council on the principles of Islamic finance.

5. A contract may provide a term on securing obligations for making leasing payments (or lease payments) by a pledge of property.”

2.7. “Investment”

A business investment in which the investor shares in both the risks and profits clearly conforms to Islamic law. However, by manipulating the terms on how profit sharing is done, it is possible to create a structure in which one investor essentially is a lender receiving a fixed income, while the other bears the risks. Article 52-9 allows such transactions by the repeated use of the language “unless otherwise provided by contract”.

“Article 52-9. Financing Production and Trade Activity by Way of Participation in the Charter Capital of Legal Persons and/or on Bases of Partnership

1. An Islamic bank shall have the right finance production and trade activity on the basis of a contract of partnership with the purpose of receipt of income or the attaining of another goal not contrary to the legislation of the Republic of Kazakhstan. The contract of partnership may provide a term on the creation of a legal entity (contract of partnership with the formation of a legal entity).

2. The contract on partnership may be concluded after obtaining a positive conclusion from the council on the principles of Islamic finance. Violation of the requirements indicated in Article 152-1 of the present Law shall be the basis for the early rescission of the contract of partnership and/or liquidation of the legal person created on the basis of the contract of partnership and or alienation of the share of the Islamic bank including shares of stock and investment shares in the charter capital of legal persons and direction of the income received to charity.

3. The rules of the contract of joint activity with the peculiarities provided by the present Article shall be applied to the contract of partnership without a term on the creation of a legal person (the contract of simple partnership with the participation of an Islamic bank).

4. The contract of simple partnership with the participation of an Islamic bank must contain the purpose of the joint activity, the period of effectiveness of the contract or the conditions upon the occurrence of which the contract shall be terminated the manner and periodicity of distribution of income from joint activity, the liability of the participant for breach of the terms of the contract, information on the list, types, and price of property contributed by each of the participants for the conduct of joint activity. Unless otherwise provided by contract, the amount of the share of each of the participants in the common property shall be determined in proportion to the value of the property contributed for the conduct of joint activity. The contract may provide terms on the use of part of the income received from joint activity for charitable purposes.

5. Income from joint activity, general expenditures and losses of the participants in a contract of simple partnership with the participation of an Islamic bank shall be distributed in proportion to the share in the common property, unless otherwise provided by contract. The income of a simple partnership with the participation of an Islamic bank must be distributed on the basis of actual results without taking into account expected income. The income of a participant in a simple partnership may not be established in the form of a fixed amount of money.

6. In case of insufficiency of the common property of a simple partnership, its participants shall bear responsibility for the obligations connected with the contract of simple partnership in proportion to shares in the common property.

7. The rules on the founding contract of a legal person of the corresponding organizational-legal form shall be applied to a partnership with the formation of a legal person, unless otherwise provided by contract or the rules of the present Article.

8. In addition to the information provided by the legislation of the Republic of Kazakhstan for the founding contract of a legal person on a determined organizational-legal form, the contract on partnership with the formation of a legal person must contain information on the purposes and time periods of the partnership and a term on the distribution of the income of the legal person in proportion to the contributed share of each participants.

9. The rules of the contract on partnership with the formation of a legal person shall be applied also to cases of partnership the terms of which are the obtaining of shares of stock of (or investment shares in) a legal person if the condition exists that the purpose of the partnership is financing the production or trade activity of this legal person.”

The possibility of structuring transactions using Article 52-9 so as to provide a bank with low-risk investments can allow it to maintain an asset structure that will meet the prudential requirements of banking regulation.

3. Bank Regulation

Kazakhstan’s Financial Supervision Agency is responsible for bank regulation. Effective 1 January 2006, the Agency adopted an “Instruction on Normative Values and the Methodology of Calculation of Prudential Norms for Banks of the Second Level”.²⁵ (The National Bank of the Republic of Kazakhstan is the “bank of the first level”. Other banks are “banks of the second level”.) These standards were inspired by widely-followed the Basel-2 international standards. However, because they envisioned

²⁵ Resolution of the Board of the Agency of the Republic of Kazakhstan for the Regulation and Supervision of the Financial Market and Financial Organizations, of 20 September 2005, No.358 (as amended), “Ob utverzhdanii Instuktsii o normativnykh znacheniakh i metodike raschetov prudentsial’nykh normativov dlia bankov vtorogo urovnia” [On Approval of an Instruction on Normative Values and the Methodology of Calculation of Prudential Norms for Banks of the Second Level], available at <<http://www.afn.kz/ru/legislation/2009-11-19-05-29-09/2009-11-19-05-31-55/2010-01-12-06-00-21/2010-01-12-09-19-48>>.

that a substantial portion of bank reserves would be in interest-bearing, principal-guaranteed investments, the standards clearly were unsuitable for Islamic banks. In 2009, shortly after the passage of Islamic banking legislation, the Agency promulgated an “Instruction on Prudential Norms for Islamic Banks, their Normative Levels and Methods of Calculation”.²⁶ The 2009 Instruction for Islamic banks reproduces many parts of the 2005 Instruction (as amended through 2009) verbatim, omits parts of the Instruction that deal with transactions impermissible under Islamic law—such as interest-bearing loans—and adds provisions dealing with transactions (such as sale at a markup with time payments) that Islamic banks typically use to achieve the same economic effects as impermissible transactions. A number of the special provisions appear to be compatible with the Islamic Financial Services Board’s²⁷ “Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services”.²⁸ Like the prudential norms for ordinary banks, the prudential norms for Islamic banks require that a substantial portion of bank investments have high ratings with internationally recognized rating agencies, such as Standard and Poors. However, in order to obtain a high rating, an investment must effectively guaranty the return of capital.²⁹ This, would seem to violate the spirit of Islamic law; however, as mentioned above, there are ways to do this that—in the opinion of a number of leading scholars—do not violate the letter of Islamic law.

Chapter 6 of the norms for Islamic banks,³⁰ like Chapter 6 of the prudential norms for conventional banks,³¹ provides that the ratio of basic and other nonfinancial assets to own capital should not exceed 50%. However, for Islamic banks, basic assets do not include those “obtained

²⁶ Resolution of the Agency of the Republic of Kazakhstan for the Regulation and Supervision of the Financial Market and Financial Organizations, 27 March 2009, No.66, “Ob utverzhenii Instruktsii o prudential’nyikh normativakh dlia islamskikh bankakh, ikh normativnykh znacheniikh i metodike raschetov” [On Approval of an Instruction on Prudential Norms for Islamic Banks, their Normative Values and the Methodology of Calculations], available at <<http://www.afn.kz/ru/legislation/2009-11-19-05-29-09/2009-11-19-05-31-55/2010-01-12-06-00-21/2010-01-12-09-19-48>>.

²⁷ As indicated on its website, <<http://www.ifsb.org>>: “The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders.”

²⁸ December 2005, available at <<http://www.ifsb.org/published.php>>.

²⁹ <http://gcc.standardandpoors.com/islamic_finance/index.html>.

³⁰ *Op.cit.* note 26.

³¹ *Op.cit.* note 25.

in the framework of financing trade activity as a trade intermediary”. Amounts in investment deposit accounts are not counted in the bank’s asset base. This is because, as will be explained below, the risk of loss of principal is in investment accounts borne by the account-holders, not by the bank. Article 27 of the Islamic bank standards provides:

“27. Assets obtained under a contract of investment deposit are not guaranteed by the bank and any losses from investments are to be borne by the holders of investment deposits, with the exception of cases when such losses have arisen due to the fault of the bank. The commercial risk for such assets does not require the creation of normative capital for the bank. Assets financed at the expense of assets acquired by a contract of investment deposit shall be excluded from the calculation of assets weighed by degree of risk.”

Since the bank shares in the profits, but not in the losses on such accounts, it would appear to be very much to the bank’s advantage to engage in high-risk investing on such accounts.

4. Liquidation and Bankruptcy of Islamic Banks

Because Islamic banks in Kazakhstan combine the functions of ordinary banks and investment intermediaries, and because they lack deposit insurance, special legal provisions are necessary to deal with liquidation and bankruptcy. If an ordinary bank fails, private individuals are reimbursed by deposit insurance up to a certain amount. The deposit insurance fund then has a high priority claim for reimbursement from the bank’s liquidation estate. Amounts in bank accounts above the deposit insurance reimbursement limit have priority below that of the deposit insurance fund, but above the claims of general creditors.³² As mentioned above, for Islamic banks, there is no deposit insurance. Article 74-2(3)(4) of the Law on Banks and Banking provides for high priority for claims related to “non-interest-bearing demand deposit accounts placed an Islamic bank undergoing liquidation”. Investment deposits are given a very different treatment:

“3. The liquidation estate of an Islamic bank shall not include property obtained at the expense of money acquired under a contract of investment deposit of the Islamic bank. This property and also the obligations under investment deposits shall be subject to transfer by the liquidation commission to another Islamic bank.

The procedure for selection of an Islamic bank and transfer to it of property obtained at the expense of money acquired under a contract of investment deposit and obligations on investment deposits of the Islamic bank undergoing liquidation shall be established by a legal act of the authorized body.”

This provision assumes that there will be another Islamic bank operating in Kazakhstan that will be willing to take over the investment deposit

³² Law on Banks and Banking, Art.74-2.

accounts. Whether or not this will be the case will, of course, depend upon the development of Islamic banking in Kazakhstan and the attractiveness or unattractiveness of the investment deposit accounts of a failed Islamic bank.

5. Taxation

A number of articles of Kazakhstan's Tax Code were amended so that the substance of Islamic banking and finance transactions would be subject to the same tax treatment as other transactions with the same economic content.

The Islamic version of credit sales—a time sale with a markup economically equivalent to interest—may have an economic effect identical to an immediate sale financed by an interest bearing loan. Despite their identical economic effects, the two may have quite different treatment under typical legal rules. Consider, for instance, a value-added tax as applied to the truck sales financing transaction discussed above. If there is a value-added tax, for instance of 20%, then the tax on a sale by a dealer of a truck direct to a customer would be 20% of \$30,000 or \$6,000, if the customer used conventional bank financing. However under Islamic financing, the customer would be paying more, for instance, \$36,497.40, for the truck. The value added tax on this amount would be \$7,299.48, *i.e.*, \$1,299.48 more. In order to create a “level playing field”, legislation must exempt the additional amount of the price from tax, just as interest on conventional financing is not subject from value-added tax. In addition, if there is differing tax treatment of capital expenditures and interest expenditures, it would be necessary to classify the \$36,497.40 price as really being a purchase of an income-producing asset for \$30,000 and payment of \$6,497.40 in interest.

Two provisions have been added to the 2008 Tax Code so as prevent the imposition of value-added tax on the markup that an Islamic bank takes in lieu of interest: A new Paragraph 4 of Article 250 provides:³³

“4. Transfer of property by Islamic banks shall be freed from value-added tax with respect to the part of the income subject to receipt by the Islamic Bank in the framework of financing trade activity as a trade intermediary with the provision of commercial credit in accordance with the banking legislation of the republic of Kazakhstan

For the purposes of the present paragraph the amount of the markup on goods sold to a buyer, which markup is determined by the terms of a contract of an Islamic bank on commercial credit concluded in accordance with the banking legislation of the Republic of Kazakhstan.

³³ The amendments were introduced by the Law of 2 February 2009, *op.cit.* note 5.

The provisions of the present paragraph shall not extend to cases of sale by an Islamic bank of goods to a third person in case of refusal of a buyer to perform a contract on commercial credit.”

Under the provisions of the Tax Code, value-added tax on purchases normally can be deducted from value-added tax on sales.³⁴ There are, however, important exceptions. In particular, value-added tax is not deductible when paid in connection of various types of goods not bought for resale.³⁵ The Tax Code allows taxpayers to choose between two methods of dealing with deductible and non-deductible tax paid.³⁶ Under the separate method, the tax is calculated item-by-item, so that if a certain item is purchased for resale, the tax paid on the purchase of the item is deducted when the item is resold. Under the proportional method, tax credit is given for purchases in accordance with the proportion of the value of goods subject to tax deduction on resale. A new Paragraph 5 of Article 262 allows an Islamic bank that has opted for the proportional method nevertheless to use the separate method for goods purchased for Islamic trade financing:

“5. Islamic banks using the proportional method of allocation for report shall have the right to use the separate method for reporting the amount of value-added tax on turnover connected with the obtaining and transfer of property in the framework of trade activity as a trade intermediary with the provision of commercial credit in accordance with the banking legislation of the Republic of Kazakhstan.”

By using the separate method for such goods, the bank can apply the privilege given for Islamic trade financing markups in Paragraph 4 of Article 250 of the Tax Code (quoted above).

Another set of changes in the Tax Code is designed to treat income from investment deposit accounts as income of the investor, not the bank. New subparagraphs Article 99(1)(13) exclude from income:

“13) income received by an Islamic bank in the process of managing money received as investment deposits if the income is directed to the accounts of the depositors of the given investment deposits and is held on these accounts. Such income does not include the compensation of the Islamic bank; [...]”

Amended Article 85(22-5) includes in the income of a depositor “income on an investment deposit placed in an Islamic bank”.

6. Council on Principles of Islamic Finance

The system for compliance with principles of Islamic finance is—in contrast to the prudential norm system—completely decentralized.

³⁴ Art.256.

³⁵ Art.257.

³⁶ Arts.260-262.

Kazakhstan's legislation provides that each Islamic bank must appoint a council on the principles of Islamic finance and that this council will have the final word on compliance issues. Article 52-2 of the amended Law on Banks and Banking describes the role of the council:

“Article 52-2. Activity of the Council on the Principles of Islamic Finance

1. For the determination of the correspondence of activity, operations and transactions of an Islamic bank to the requirements indicated in Article 52-1 of the present Law, in an Islamic bank there must obligatorily be created a council on the principles of Islamic finance.
2. The council on the principles of Islamic finance shall be an independent body named by the general meeting of shareholders of the Islamic bank on recommendation by the board of directors.
3. The rules on the general conditions of the conduct of operations of the Islamic bank and the rules on internal credit policy of the Islamic bank shall be subject to approval by the board of directors of the Islamic bank on the condition of the existence of a positive conclusion of the council on the principles of Islamic finance.
4. Unless otherwise provided by the present Law, the charter, or the internal rules of the Islamic bank, the decisions of the credit committee of the Islamic bank adopted in accordance with the Rules on Internal Credit Policy of the Islamic Bank and transactions concluded in accordance with the Rules on the General Conditions of the Conduct of Operations of the Islamic Bank shall not require separate approval by the council on the principles of Islamic finance. However, the council on the principles of Islamic finance shall have the right to verify at its discretion any transaction with respect to its correspondence to the requirements indicated in Article 52-1 of the present Law.”

This approach of using an independent council is by no means unique to Kazakhstan. Similar requirements are found in legislation on Islamic finance in many other countries. And, in countries, such as the United States—where Islamic finance institutions operate in the absence of specific enabling legislation—the institutions typically also have such councils. Nevertheless, provisions such as those of Article 52-2 severely compromise the independence of the bank's council on the principles of Islamic finance, since the members of the council are appointed by the bank itself. Presumably, members of the council also are paid by the bank and are subject to removal by the bank. For countries like Kazakhstan, in which Islam is not an established religion, the establishment of a government agency to engage in detailed regulation of what banking activities were “Islamic” and what were not, would raise serious constitutional questions. It is true that the amendments to the banking legislation did set up certain restrictions on what an “Islamic bank” could do. However, these restrictions could be viewed more as a matter of “truth in marketing” than a regulation of religious doctrine. Essentially, all the restrictions do

is to require banks that advertise themselves as “Islamic” to refrain from practices that consumers would not expect to find in an “Islamic bank” and, also, to engage in self-regulation.

Kazakhstan lacks local experts in Islamic finance law.³⁷ Nothing in the legislation of Kazakhstan forbids staffing the council with scholars from other countries. In particular, a bank with headquarters in the United Arab Emirates that wished to replicate its business plan in Kazakhstan could invite the same scholars that serve on its board in the Emirates. Likewise, a Malaysian bank that wished to follow the much more permissive Malaysian approach could invite the same scholars that approved its operations in Malaysia. A bank that used the same experts for its Kazakhstan operations as it had used for its main enterprise would have little reason to fear that practices already approved for the main enterprise would be disapproved for the subsidiary in Kazakhstan. The councils on principles of Islamic finances are not only formally independent of the banks; they are also independent of government regulation. Thus, it is possible that a bank with a more flexible council might be able to provide attractive terms that other banks could not provide.

7. Sharia Risk

The essence of “Sharia risk” is that a transaction may turn out to be non-compliant with Islamic law and, hence, unenforceable (or worse, as will be explained below). There are three types of Sharia risk in Kazakhstan: (1) that a transaction will violate principles of Islamic law embodied in legislation on Islamic banks, (2) that a transaction will be found to violate rules adopted by a bank’s council on Islamic finance, or (3) that a specific transaction will be found by a bank’s council on Islamic finance to be in violation of the law or of the rules it has adopted. The first two types of risk are created by Article 52-1 of amended Law on Banks and Banking:

“Article 52-1. Requirements for the Activity of an Islamic Bank

An Islamic bank shall not have the right to take compensation in the form of interest, to guaranty the return of an investment deposit or income on an investment deposit interest, to guaranty the return of an investment deposit or income on an investment deposit, to finance (or to provide credit for) activity connected with the production and/or trade in tobacco, alcohol production, arms and ammunition, the gambling business, and also other types of entrepreneurial activity the financing of which (or the providing credit for which) is forbidden by the council on the principles of Islamic finance.

³⁷ Dauren Mukhatev, “Islamskie finansy v Kazakhstane - iuridicheskie voprosy” [Islamic Finance in Kazakhstan - Legal Issues] <http://prodengi.kz/publikacii/islamskie_finansy_v_kazakhstane_yuridicheskie_voprosy/>.

The council on the principles of Islamic finance shall have the right to additionally determine other requirements for the activity of an Islamic bank that shall be obligatory for observance by the Islamic bank.”

7.1. Violation of Statutory Rules Embodying Islamic Law

It is unlikely that an Islamic bank would explicitly lend money at interest or directly invest in a liquor distillery. A number of commentators on Islamic law contend that many of the transactions used in Islamic banking are ruses to disguise prohibited transactions, such a loan to be repaid in a fixed amount with interest.³⁸ The law of Kazakhstan has a specific provision designed to deal with transactions made to hide “real” underlying transactions. Article 160 of the Civil Code provides:

“Article 160. Mock and Sham Transactions

1. A mock transaction made only for appearances without the intent to create the legal consequences corresponding to it, is invalid.
2. If a transaction made for the purpose of hiding another transaction (a sham transaction) then the rules relating to the transaction that the parties actually had in mind shall be applied.”

These rules are not surprising; they were taken by Soviet code drafters from the German Civil Code and are repeated in the civil codes of various post-Soviet countries. However, they present a potential threat to Islamic banking transactions. Suppose a party that has borrowed money from a bank under a disguised interest-bearing loan transaction wishes to escape the obligation to pay interest to the bank. The party may argue, under Paragraph 2 of Article 160 that the transaction really is an interest-bearing loan. It would then use the language of Article 52-1—“An Islamic bank shall not have the right to take compensation in the form of interest [...]”—to argue that the bank did not have the right to enforce the interest clause of the loan.

The legal issues are more complex if the bank seeks to invalidate a transaction as unlawful. The bank, for instance might have made a loan commitment that involved the economic equivalent of a promise to pay interest by the borrower. If interest rates rose sharply, the bank might want to get out of the loan commitment and, thus, might argue that the envisioned loan really involved interest and so was *ultra vires* in view of Article 52-1 and the charter of the bank. (The charter of an Islamic bank would almost certainly repeat the restrictions of Article 52-1 verbatim.) An *ultra vires* transaction indeed might violate Article 158 of the Civil Code, which provides:

³⁸ E.g., Muhammad Taqi Usmani, “Sukuk and their Contemporary Applications” <<http://www.muftitaqiusmani.com/images/stories/downloads/pdf/sukuk.pdf>>.

“Article 158. Invalidity of a Transaction, the Content of Which Does Not Correspond to the Requirements of Legislation

1. A transaction is invalid whose content does not correspond to the requirements of legislation or is made with a purpose clearly contrary to the fundamentals of the legal order or morality.

2. A person who has intentionally concluded a transaction that violates the a requirement of legislation, the charter of a legal person or the competence of its bodies shall not have the right to demand declaration of the transaction as invalid if such a demand is caused by selfish motives or the intent to avoid responsibility.

3. In the case if one of the parties to a transaction has made it with the intent to avoid performance of an obligation or responsibility to a third person or to the state, and the other participant knew or should have known of this intent, the interested person (or the state) shall have the right to demand declaration of the transaction as invalid.”

However even if the transaction were *ultra vires*, and so were in violation of Paragraph 1 of Article 158, the bank might be estopped to assert its invalidity by Paragraph 2 of Article 158. This paragraph is a specific application of broader principles found in Paragraphs 4 and 5 of Article 8 of the Civil Code:

“4. Citizens and legal persons must act in the exercise of rights belonging to them in good faith, reasonably, and justly, observing the requirements contained in legislation, the moral principles of society, and entrepreneurs – observing also the rules of business ethics. This obligation may not be excluded or limited by contract. Good faith, reasonableness, and justice of participants in civil-law relations shall be presumed.

5. Actions of citizens and legal persons directed at causing harm to another person, abuse of right allowed in other forms, and exercise of a right contrary to its purpose are not allowed.

In case of failure to observe the requirements provided by Paragraph 3-5 of the present Article, the court may refuse the person protection of the right belonging to him.”

Even if the bank could assert the invalidity of the provision on interest in a loan commitment contract, it still might have a problem using the invalidity of the interest provision to invalidate the whole loan commitment. Article 161 of the Civil Code provides:

“Article 161. Consequences of the Invalidity of Part of a Transaction

The invalidity of part of a transaction shall not entail the invalidity of its other parts if it is possible to suppose that the transaction would have been made even without the inclusion of its invalid part.”

A non-Islamic bank would make a loan commitment if the borrower was not to pay interest. Thus, in the case of a loan commitment by a non-Islamic bank, if the interest clause were for some reason invalid, the rest of the loan commitment agreement would also fail. On the other hand,

the only kind of loan that is legal for an Islamic bank is one that does not bear interest. Thus the removal of a clause that called for interest would make the contract valid under Islamic law, *i.e.*, the kind of contract that it would be supposed that the bank would make. Article 161 refers only to “part of a *transaction*”. The terms “transaction” and “contract” are defined in the Articles 147 and 148(1) of the Civil Code:

“Article 147. Definition of a Transaction

Transactions are acts of citizens or legal persons directed at the establishment, change or termination of civil-law rights and duties.”

“Article 148. Unilateral Transactions and Contracts

1. Transactions may be unilateral or may be bilateral or multilateral (contracts).”

In many cases, an overall commercial deal negotiated by an Islamic bank consists of a number of contracts and, hence, of a number of transactions. This is because, as noted above, scholars of Islamic law used by the bank approve accomplishing by a package of separate contracts that would clearly be unlawful if done by a single contract. If one of the contracts in such a package were invalid, then Article 161 would have no application, since, with respects to contracts, it applies only to one contract at a time.

Another way that either the bank or the borrower might seek to get out of an unfavorable transaction would be by arguing that the transaction was not authorized by the bank’s license. Under Article 32(2-1) of the amended Law on Licensing, Islamic banks are not licensed, for instance, to engage in transactions involving paying or receiving interest:

“2-1) banking operations conducted by Islamic banks:
 acceptance of non-interest-bearing demand deposits of physical and legal persons,
 opening and operating bank accounts of physical and legal persons;
 acceptance of investment deposits of physical and legal persons;
 bank loan operations: provision by an Islamic bank of credit in monetary form on conditions of time period, repayment, and without taking compensation;
 financing entrepreneurial activity in the form:
 of financing trade activity as a trade intermediary with the granting of commercial credit;
 of financing production and trade activity by participation in the charter capital of legal persons and/or on terms of partnership;
 investment activity on terms of leasing (or lease);
 agent activity in conduct of banking operations of an Islamic bank.”

Article 159(1) of the Civil Code provides:

“1. A transaction concluded without obtaining the necessary license or after the end of the period of effectiveness of the license is invalid.”

Thus, even if a transaction had been approved by the bank’s council on the principles of Islamic finance, the counterparty still would be free to

argue that the transaction was in fact, for instance, an interest-bearing loan, and thus in violation of the bank's license.

If a transaction is found invalid, remedies available under Article 157 of the Civil Code include:

“Article 157. Invalid Transactions and Consequences of Invalidity

[...]

In case of the invalidity of a transaction, each of the parties shall have the duty to return to the other party everything obtained under the transaction and if it is impossible to return in kind, to compensate for the value in money.

[...]

9. The invalidity of a transaction shall not entail legal consequences with the exception of those that are connected with its invalidity and shall be invalid from the time of its conclusion.

10. In declaring a transaction invalid, the court shall have the right, taking specific circumstances in account, to limit itself to a prohibition of the further performance of the transaction.”

7.2. Violation of Rules Set by the Council on Principles of Islamic Finance

The second paragraph of Article 52-1 appears to equate the effect of requirements set by a bank's council on Islamic finance with the requirements set by law in the first Paragraph of Article 52-1. Thus, issues related to requirements set by the council would be decided in the same way as the issues (discussed above) that are raised by the legal restrictions in the first paragraph.

7.3. Finding of Non-Compliance by the Council on Principles of Islamic Finance

A more serious threat is posed by Paragraph 2 of Article 52-3, which applies to already existing transactions.

“2. In case of a finding by the council on the principles of Islamic finance that a concluded but not performed or a partially performed transaction does not correspond to the requirements indicated in Article 52-1 of the present Law, such a transaction on demand by the Islamic bank shall be rescinded early as provided by the civil legislation of the Republic of Kazakhstan.”

A similar risk is posed by Paragraph 3 of Article 32-5 of the amended Law on the Securities Market:

“3. In case of recognition by the council on the principles of Islamic finance that a concluded but not performed or a partially performed transaction for financing at the expense of funds obtained from the placement of Islamic securities as not corresponding to the principles of Islamic finance indicated in Article 32-1 of the present Law, such a transaction, on demand of the originator or the management company of the Islamic investment fund, may be rescinded early in the manner established by the Civil Code of the Republic of Kazakhstan.”

Essentially, what these provisions do is to give the Islamic bank, the originator, or the management company, but not the counterparty to a transaction, the option of applying the provisions of the Civil Code on rescission of a transaction subsequently found by the council to be unlawful. This one-sided option seems contrary to a key purpose of Islamic banking and finance, namely to provide customers and counterparties with the assurance that transactions entered into with the banks will comply with Islamic principles, an assurance that is heavily advertised on the websites of Islamic banks. There are several possible situations. The transaction may have been of a type never approved by the bank's council or of a type specifically disapproved by the council, or may be a transaction subsequently specifically disapproved by the council. In such cases, if the counterparty was intentionally misled into the belief that the transaction was compliant, the counterparty might have the right under Paragraph 9 of Article 159 of the Civil Code to have the transaction declared invalid. Paragraph 9 provides:

“9. A transaction made under the influence of deceit [...] may be declared invalid by the court on suit by the victim.”

If the bank and the counterparty acted in good faith in reliance on an opinion of its council, only to have the council later change its mind on the legality of the transaction, then the counterparty might be able to have the transaction declared invalid under Paragraph 8 of Article 159 of the Civil Code, which provides:

“8. A transaction made as the result of a mistake having substantial significance may be declared invalid by a court on suit by a party that acted under the influence of the mistake. A mistake has substantial significance if it is a mistake concerning the nature of the transaction, or the identity or other qualities of its object that significantly reduces the possibility of its use for its intended purpose. A mistake as to motives may serve as the basis for the invalidity of a transaction only in case of inclusion of such motive in its content as a suspending or dissolving condition (Article 150 of the present Code).

If the mistake is the result of gross negligence by a participant in the transaction or is comprised in his entrepreneurial risk, the court shall have the right, taking into account the specific circumstances and interests of the other participant in the transaction to reject the suit for declaration of the transaction as invalid.”

Normally, the bank would have entered into the contract with the intended purpose of making a business deal complying with Islamic law. The counterparty, on the other hand, might be interested in compliance with Islamic law or might merely find the financial terms of the deal attractive. (There is absolutely no legal requirement that the counterparty be a Muslim or be owned by Muslims.) Where compliance with Islamic

law was important for a party, Paragraph 8 (quoted above) would apply in accordance with its terms. If Paragraph 8 applied, then the consequences of invalidity would be determined by Article 157 of the Civil Code, Paragraphs 3 and 9 of which provide:

“3. In case of declaration of a transaction as invalid, each of the parties shall be obligated to return to the other party everything received under the transaction and in case of the impossibility of return in kind to compensate for the value in money.

[...]

9. In declaring a transaction invalid, a court shall have the right, taking into account the specific circumstances, to limit itself to forbidding the future performance of the transaction.”

Rescission of the contract would have rather surprising results, which are quite different from those of a declaration of invalidity. Subparagraph 2 of Paragraph 2 of Article 401 of the Civil Code provides:

“Article 401. Bases for Amending and Rescinding a Contract

[...]

2. Upon demand by one of the parties a contract may be amended or rescinded by decision of a court only:

[...]

2) in other cases provided by the present Code, other legislative acts or the contract.”

Article 403 of the Civil Code indicates the effects of rescission:

“Article 403. Consequences of Rescission or Alteration of a Contract

1. In case of rescission of a contract, the obligations of the parties shall be terminated.

[...].

4. The parties shall not have the right to demand the return of that which was performed by them under the obligation until the time of rescission or change of the contract, unless otherwise provided by legislative acts or agreement of the parties.

5. If the basis for rescission or change of the contract was a significant breach of the contract by one of the parties, the other party shall have the right to demand compensation for losses caused by the rescission or change of the contract.”

Such a rescission might be very advantageous or very disadvantageous to a bank. If the bank had released substantial funds to a borrower under a contract that the bank’s council on the principles of Islamic finance later found to be impermissible—for instance, because the council found that the contract involved paying interest—the borrower could keep the money. On the other hand, if a purchaser financed a building in a contract in which

title was to pass with the last payment, the bank could keep the building if—just before the last payment—the council found that the transaction was impermissible.

A prudent counterparty would wish to include a clause of the type permitted by Paragraph 4, of Article 403, namely a provision for the return of its performance. However, in some situations such a return would not fully compensate the counterparty to the bank. Consider, for instance, the situation where a buyer has financed a building worth \$1,000,000 and has paid a total of \$1,500,000 in time payments, but has not yet received title to the building. Assume that, at the time of rescission, the building is worth \$2,000,000. In case of return of performance, the buyer would receive back the \$1,500,000 it paid, while the bank would retain title to the building. Thus, the buyer would be worse off than if it had been able to obtain specific performance of the bank's promise to convey title to the building.

The scholars used by banks in Malaysia and the Persian Gulf area are generally men of high integrity. Unfortunately, not everyone in the post-Soviet space is of the same high integrity. Further, even persons of high integrity might yield to threats of violence to themselves and their family. Several worrisome possible scenarios arise. In one, a bank might staff its council with scholars of dubious background, who could rule for or against transactions depending upon the bank's interests. A party doing business with a bank might in some way pressure the bank's council to find a transaction impermissible, so that the party could keep what it had obtained under the transaction. Some of these problems could be solved by creating a centralized Sharia council with the power to supervise individual banks' councils. However, such centralization would potentially be in conflict both with the secular nature of the Republic of Kazakhstan and, also, with the Muslim tradition of free debate on religious law.

8. Avoiding Sharia Risk by Contractual Choice of Law Clauses

As mentioned above, risks connected with rescission under the law of Kazakhstan could be reduced, but not eliminated, by an appropriate contractual clause. For further protection a party might want include a choice-of-law clause pointing to the law of a country that did not allow rescission in case a contract violated rules such as the Islamic law rules incorporated in the amended Law on Banks and Banking or that permitted payment in full for losses in case of such rescission. Would the courts of Kazakhstan recognize such a choice of law clause? The courts would

apply the conflicts rules of the Civil Code of the Republic of Kazakhstan. Paragraph 1 of Article 1112 of the Civil Code provides:

“1. A contract shall be regulated by the law of the country chosen by agreement of the parties, unless otherwise provided by legislative acts of the Republic of Kazakhstan.”

This provision is limited to the choice of the law of a “country” and, so, would appear to rule out a choice of “Islamic law”. However, this freedom of choice of law is subject to two major exceptions.

“Article 1090. Public Policy Exception

1. Foreign law shall not be applied in cases when its application would contradict the fundamentals of the legal order of the Republic of Kazakhstan (the public order of the Republic of Kazakhstan). In such cases, the law of the Republic of Kazakhstan shall be applied.

2. A refusal to apply foreign law may not be based merely on the difference of the political or economic system of the respective foreign state from the political or economic system of the Republic of Kazakhstan.”

“Article 1091. Application of Imperative Norms

1. The rules of the present division do to affect the effect of imperative norms of the legislation of the Republic of Kazakhstan that as the result of an indication in the norm itself or in view of their particular significance for ensuring the rights and the interests protected by law of participants in civil commerce regulate the respective relations regardless of the law subject to application.

2. In applying the law of any country according to the rules of the present Division, the court may apply the imperative norms of law of another country having a close connection with the relations if according to the law of this other country such norms must regulate the corresponding relations regardless of the law subject to application. In such a case, the court must take into account the purpose and nature of such norms and also the consequences of their application.”

It may be even more difficult to avoid the risk of an *ultra vires* argument in view of the English decision in *The Investment Dar Company KSCC v. Blom Developments Bank Sal* [2009] EWHC 3545 (Ch).³⁹ In this case, the defendant, a Lebanese company, cited provisions of its corporate charter that forbade engaging in transactions in violation of Sharia law, hoping thereby to avoid performing a contract that allegedly violated Sharia law. The plaintiff contended it had a right, under the contract, to the economic equivalent of repayment of a deposit plus fixed interest. There was no doubt that the contract, which contained an express choice of English law, would have been valid under English law, if the defendant had the

³⁹ <<http://www.bailii.org/ew/cases/EWHC/Ch/2009/3545.html>>.

power to make the contract. Nevertheless, the court held that defendant's argument that making the contract was *ultra vires* raised a triable issue.

“Article 1100. Law of a Legal Person

The law of a legal person is the law of the country where this legal person is founded.”

“Article 1101. Legal Capacity of a Legal Person

1. The civil legal capacity of a legal person shall be determined by the law of the legal person.

[...]”

9. Conclusion

Kazakhstan has adopted legislation adequate to allow the wide range of Islamic banking and financial transactions. It is too early to answer a number of important questions. Two questions arise. *First*, is there some way that such accounts can compete for the business of those who want the features of conventional interest-bear savings accounts? *Second*, could such accounts be attractive to some categories of investors who were willing to take risks?

Major conventional banks in Kazakhstan offer a variety of savings accounts with guaranteed return of 100% of principal, deposit insurance, and substantial interest payments.⁴⁰ An Islamic bank in Kazakhstan would face serious problems in competing with these terms. In some countries, an Islamic bank may have a substantial advantage if a large percentage of the population adheres to Islamic values and believes that Islamic banks, but not conventional banks, conform to these values. Only about 70% of the population of Kazakhstan are Kazakhs, Uzbeks, and others of traditionally Muslim religion,⁴¹ while the remainder is of Russian, Ukrainian, or German ethnicity, *i.e.*, of traditional Christian background. As is apparent from the patterns of alcohol consumption in Kazakhstan, adherence to even the most widely-accepted Islamic values is not strong. A somewhat outdated report from the World Health Organization lists only 10% of the male population of Kazakhstan as lifetime abstainers from alcohol.⁴² Thus, Islamic banks in Kazakhstan may have difficulty in attracting invest-

⁴⁰ <<http://www.kkb.kz/>>; <<http://www.halykbank.kz/>>; <<http://www.btabank.kz/>>.

⁴¹ <<http://www.kazakhembus.com/index.php?page=ethnic-groups>>.

⁴² “Country profiles: Kazakhstan”, available at <http://www.who.int/substance_abuse/publications/statusreportalcohol/euro/en/index.html>.

ment deposits from citizens of Kazakhstan, unless, perhaps, men decide to atone for their sins in some areas by compliance in other areas.

On the on the other hand, wealthy Muslims from other countries may find it attractive to use an Islamic bank as an intermediary for investment in oil-rich Kazakhstan. The analysis above shows that there are serious issues of Sharia risk in major Islamic financial transactions.