

# Islamic finance in Russia: Recent developments

Western markets are effectively closed for most Russian companies because of the European and American sanctions imposed due to the Ukrainian crisis, so the Russian government and Russian companies have been actively exploring alternative methods of accessing financing. GRIGORY MARINICHEV and ALEXEY CHERTOV provide an overview of recent developments in the Russian Islamic finance space.



## RUSSIA

By Grigory Marinichev  
& Alexey Chertov

The Islamic finance market is considered by Russian financial institutions as one of the most attractive options to obtain finance, both locally and globally, largely for the following reasons:

- The global Islamic finance market is reportedly growing at nearly 20% yearly, and according to the IMF's calculations, by 2020 the global volume of the Islamic finance market is expected to reach US\$6.1 trillion.
- According to the official census, Russia's Muslim population exceeds 15 million, which evidences the high potential for the development of the internal Islamic finance market in Russia.

“ *The development of an Islamic finance market could have the potential to develop the Russian economy, by increasing investments from both local and international Islamic and other investors* ”

## The Russian Islamic finance market

Admittedly, the Russian Islamic finance market is still in its infancy. In the absence of a regulatory framework and clear political support, the Russian Islamic finance market comprises the activity of a very limited number of investment companies and Shariah compliant transactions undertaken by regional banks and other companies (mostly in Tatarstan and Bashkortostan, the regions of Russia with the highest Muslim populations).

Highlights from the Russian Islamic finance market include:

- Murabahah facilities of US\$100 million (2013) and US\$60 million (2011) received by AK BARS Bank for Shariah compliant assets and investment projects in the Republic of Tatarstan. The US\$100 million facility was arranged by Citi, Commerzbank Aktiengesellschaft and Emirates NBD Capital.
- The issuance of Islamic insurance policies by the Information Insurance Company Euro-Policy.
- The provision of Shariah compliant financial services to Russian customers by IBA–Moscow, the Russian unit of the International Bank of Azerbaijan and Asia Bank (Moscow).
- Shariah compliant investment services being rendered by Amal Financial House, Tatarstan International Investment Company, Open Mutual Investment Fund BKS – Halal Fund (Kazan) and LaRiba Finance.
- The signing in July 2015 of a memorandum of cooperation for Islamic finance services in Tatarstan between Sberbank of Russia and the Republic of Tatarstan.

These examples clearly indicate a solid foundation for the development of the Islamic finance market in Russia.

## Draft law

In March 2015, a draft law to amend Russian law No. 395-1 ‘On Banks and Banking Activities’ dated the 2<sup>nd</sup> December 1990 (the Banking Law) was introduced to the Russian State Duma. The proposed amendments were aimed at allowing banks to carry out trade operations which are fundamental to Islamic financing that are not currently possible under the Banking Law. However, the State Duma rejected the draft law, following which a working group was created to prepare a revised draft of changes to the Banking Law to permit the functioning of Islamic finance in Russia.

Although this legislative initiative is a positive step towards developing the Islamic finance market, there are complex issues involved and a comprehensive reform of the Russian finance system is required for the proper development of the Islamic finance market. The following major obstacles will have to be resolved by this reform.

## Excessive tax burden

- Unlike a conventional bank, Islamic financial institutions are entering into transactions with real assets rather than with funds. Under Russian law, transactions with assets are usually subject to VAT (18%).
- In an Islamic trade finance (Murabahah) transaction, a financial institution purchases assets and sells them to a client (borrower) with a margin, subject to deferred installment payments. In this situation, Russian law would require the seller to pay income tax on the margin, as soon as the transaction is made, regardless of when the margin is ultimately received by the seller (and regardless of whether the margin will in fact be received). On the contrary, under Russian law, conventional banks are only required to pay income tax upon the actual receipt of income (being the interest on the loan).

*Continued*

- Bank depositors have to pay tax on the interest income only when the interest rate exceeds 18.5%, while investors in Islamic (and any other) investment companies have to pay income tax on any income.
- Many Russian companies which provide Islamic finance services function through several legal entities: an investment company, such as a limited partnership, which can attract and use investments with fewer restrictions than conventional banks; a bank or a branch of a bank, which provides payment and cash services; and a separate trade or leasing company. The use of these structures creates various administrative and tax issues. For instance, income tax may be payable by one company even if the group of companies as a whole is not profitable.

The excessive tax burden on these transactions, which are typical in the Islamic finance market, increases the cost of funding provided by Islamic finance companies, and makes these structures less attractive compared to standard banks. The development of the Islamic finance market would require Islamic finance operations to be given similar tax treatment to standard banking operations.

## Banking law and regulatory issues

- The key feature of Islamic finance funds is that income and risk are shared by the finance institution and its investors (depositors). Because of this, Islamic finance institutions are not in a position to guarantee the return of the principal amount of investments. However, the Banking Law requires that the principal amount of a bank's deposit should be returned to an individual depositor in any event (subject to Russian insolvency laws).
- Russian law provides that the payment of interest is an essential element of loan and deposit transactions. This conflicts with one of the fundamental principles of Islamic finance, being the prohibition of interest payments (Riba).
- Because Islamic finance institutions are dealing with real assets, these

assets must be shown on their balance sheets. The Bank of Russia regards these assets to be non-core assets, which in turn negatively affects a bank's own capital requirements and creates regulatory risks.

To promote the development of the Islamic finance market, the current regulatory framework would need to be substantially amended to exempt Islamic finance institutions from the aforementioned restrictions.

## Conclusion

In the current political and economic environment in Russia, the development of an Islamic finance market could have

the potential to develop the Russian economy, by increasing investments from both local and international Islamic and other investors.

However, a comprehensive reform of Russian banking, civil, tax and other laws and regulations would be required in order to remove the existing legal barriers to the development of the Islamic finance market.<sup>(2)</sup>

*Grigory Marinichev is a partner and Alexey Chertov is the associate of global law firm Morgan Lewis's Moscow office. They can be contacted at gmarinichev@morganlewis.com and achertov@morganlewis.com respectively.*



**MAPLES**

Unrivalled knowledge. Unique solutions.

Recognised as the leading law firm on Cayman Islands, British Virgin Islands and Irish law, Maples and Calder has been ranked Best Law Firm of the year in Offshore Finance for three consecutive years by Islamic Finance News.

In the Middle East, Maples and Calder offers clients a wide range of legal services including advising on offshore fund formation and Sharia compliant finance structures.

MaplesFS brings deep industry leadership for fiduciary, corporate governance and fund administration services that meet the demanding standards you expect.

Our highly qualified professionals have been involved in many of the most innovative Islamic finance transactions and are here to help you achieve your objectives.

maplesandcalder.com  
maplesfs.com

Tahir Jawed  
+971 4 360 4070  
tahir.jawed@maplesandcalder.com