

Guide to Islamic Finance in Russia

Part I: Infrastructure

2009

About the Guide

- ✪ This Islamic Finance Guide in Russia is the result of research work by specialists of IFC Linova, corroborated in practice and expressed for the first time during the International Islamic Business and Finance Summit held in June 25-26, 2009. The work is based on the experience gained by the Company's staff at the Islamic Development Bank, international banks, Bank of Russia, other major Russian telecommunications and manufacturing companies.
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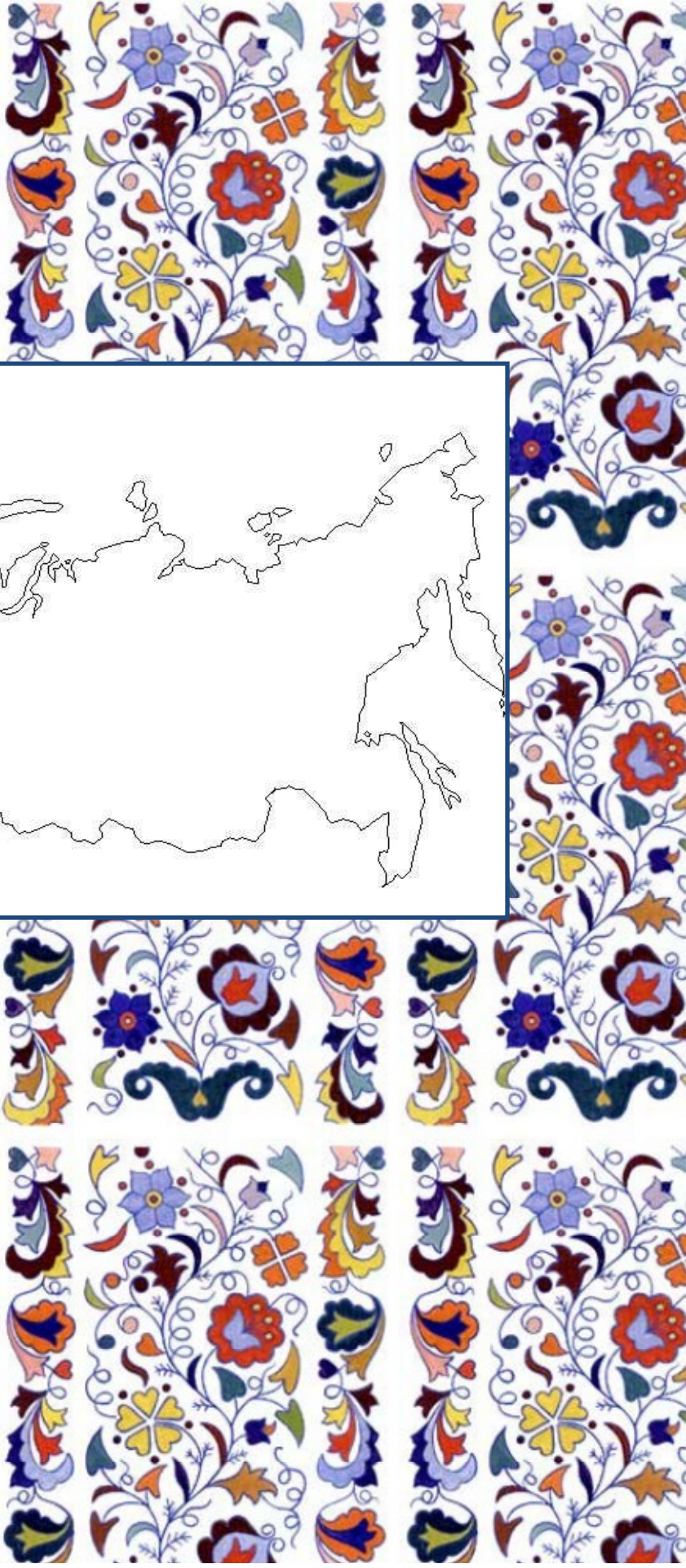
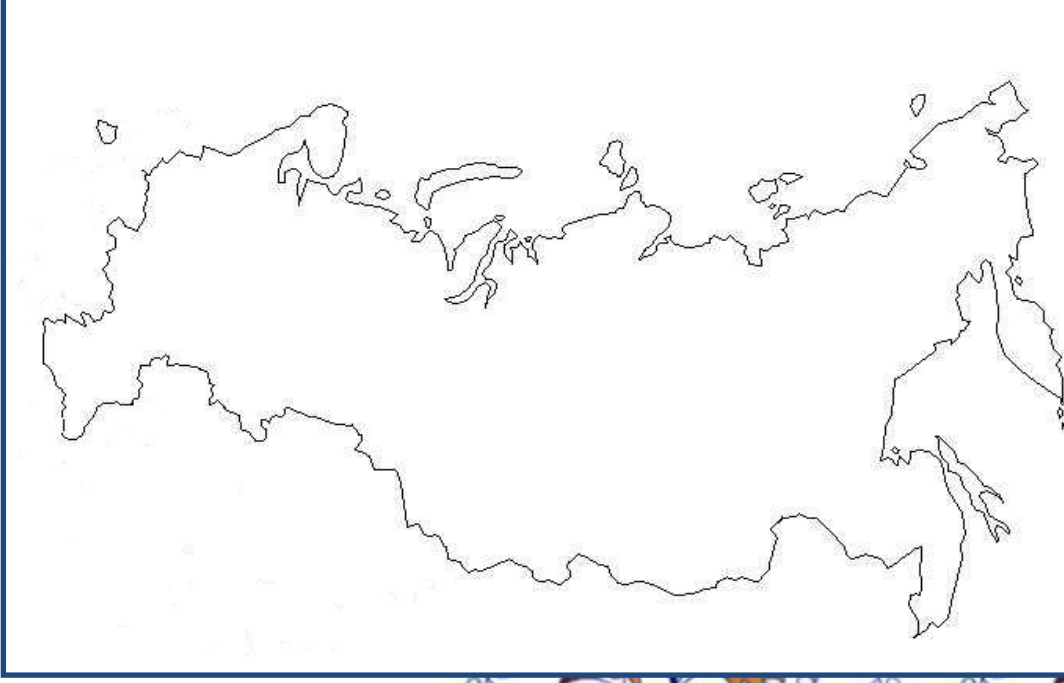


Welcoming Address



- This is the first part of the introduction into Islamic business and finance in Russia - a brief description of the infrastructure, within the framework of which we see the further development of Islamic business in the Russian Federation. It is a practical manual on basics of Islamic financial system with focus on legal, taxation and financial infrastructure issues (investment, banking, waqf, leasing and insurance).
- This Guide to Islamic Finance in Russia is the result of two-year research work by IFC Linova, expressed for the first time during the International Islamic Business and Finance Summit held in June 25-26, 2009.
- The work is aimed at specialists in Islamic economics, companies interested in alternative investments, and those wishing to diversify their investments. It can also be interesting for university lecturers, economics, law and theology students, and for many others who are involved in this field.
- IFC Linova wishes you to enjoy the Guide and make use of it in the process of developing new lines of your business, implementation of commercial projects, and building long-term relationships with representatives of Islamic businesses.
- This Guide will give you some answers on the possibility of developing Islamic business and finance in the territory of Russia, help you to see in a new light the alternative economic system, understand methods of Islamic finance and start using them in practice.

Linar Yakupov
General Director
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Russia - General Information

- The growing interest of foreign investors in Russia, which is among the world's 10 largest economies, appears to be reasonable, as Russia, being the 3d trade partner of the European Union and its main energy provider, also plays a leading role in the international arena.
- Russia has investment grade ratings, which are supported by its strong and liquid state balance sheet. At the end of 2008 its national debt made up less than 10% of GDP, and the sovereign wealth funds had about USD 225 billion. Gold and foreign currency reserves of Russia are the world's third largest.
- Russia has a good external liquidity level, which according to Fitch Ratings, stands at 284% in 2009. At the end of 2008 Russia's position as a net external creditor accounted for 39% of current earnings in foreign currency. GDP per capita was over the median level for countries having "BBB" rating.
- Russia's gold and foreign currency reserves have considerably decreased - by 35% (USD 210 billion), from the highest level of USD 596.6 billion at the end of July 2008 to 386.5 billion as of January 23, 2009. However, Russia's gold and foreign currency reserves are the third largest in the world, coming after China (with A+ rating) and Japan (with AA rating).
- Around 200 shares are being rated on the main two trading platforms of the Russian Federation - MICEX and RTS. There is a sector of innovative and developing companies on MICEX, and new companies segment on RTS (RTS START). Mutual investment funds assets make up 2.5% of GDP, assets of non-government pension funds - 1.2% of GDP, and assets of insurance companies - 0.9% of GDP.
- Actively involved in financial markets are less than 1 million people. Three major international agencies and several national rating agencies operate in Russia. There are some limits on the use of foreign currency in the territory of Russia. IFRS are obligatory to all the banks.
- In general the Russian economy continues to diversify its sector's structure, relying less and less on raw materials sector. One of the most dynamic is the financial sector, which takes advantages of the real sector's growing demand on financial services. And the financial sector growth results, in its turn, in a more effective attraction of investments and economic growth.

Social Environment

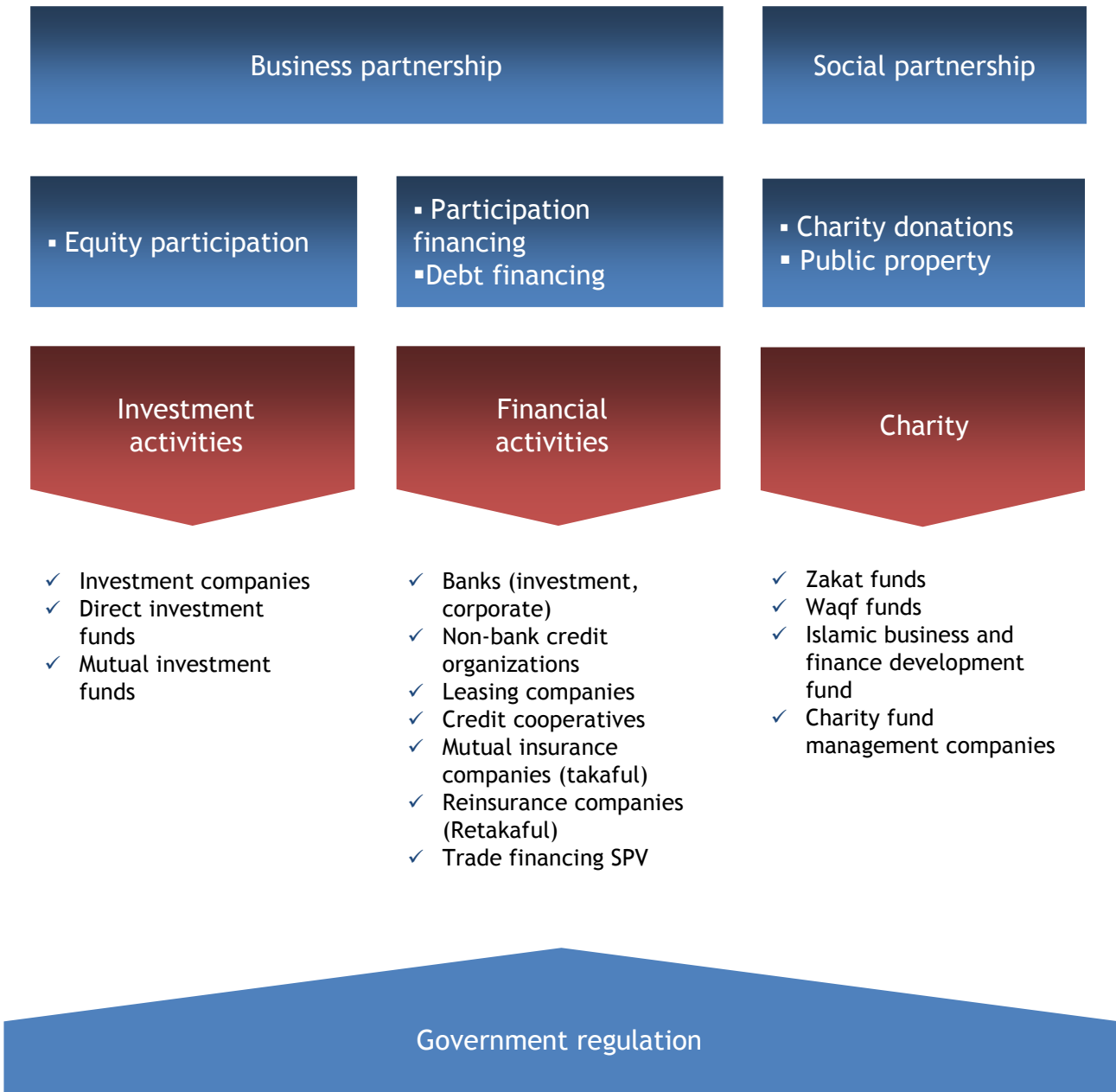
- Observer status in the Organization of Islamic Conference (OIC), granted to Russia in 2005, allowed to improve its position on the international, political, cultural and economic arenas. To date the main partners of Russia in the OIC are Malaysia, Turkey, Kazakhstan, Uzbekistan, Azerbaijan, Egypt and Kyrgyzstan. Russia's share in the total foreign trade turnover of OIC member states accounts for 2.4%, which shows active development of contacts between Russia and the Islamic world.
- Muslims, as the main users of Islamic financial services, make up 15% of the Russian population, that means 22 million citizens who are interested in the Islamic industry because of their inner beliefs. However, the number of halal producers is small to meet the needs of all the Muslims. For example, according to www.halalpages.ru, there are only 12 halal producers of different meat and bakery products for almost 2 million Muslims in Tatarstan (10% of total meat products produced here, with 10-15% growth), 25 cafes, 80 grocery stores, 13 clothing stores, 5 beauty salons and 1 clinic.
- The growing Russian halal market needs Sharia-compliant financial and investment institutions. Return of the Muslim population to their traditions and the growing desire to live and work in compliance with Islam, growth of the number of Muslims who are actively practicing their religion, interest of the traditional financial business in Islamic finance, rationality and attractiveness of the classic forms of financing for business - all give momentum to the development of Islamic finance.
- In addition to publications of "Doing business in Russia" series, the following issues are considered to be important for foreign investors interested in establishing Islamic financial institutions.



- Russian legislation facilitates investments by non-residents and introduces considerable benefits and guarantees for foreign investors.
- Russian corporate law provides for the development of equity finance institute. Equity agreements, participation agreements, and agreements on company's legal incapacity and operating period facilitate the effective use of special purpose vehicles (SPV) in commerce.
- Along with generally recognized rules of making international deals, Sharia compliance should be stipulated in contracts with Russian contractors as an obligatory condition of doing business.
- Contractual jurisdiction makes it possible for foreign companies to reduce their risks choosing an optimal jurisdiction. A legal case can be considered by the International commercial arbitration at the Chamber of Commerce and Industry of Russia, if there is an appropriate stipulation in the contract.
- Another advantage of corporate, financial and contractual laws of Russia is their regulation character, which is mainly optional and allows parties to structure most effective forms of interaction.

- ✪ Taxation is an important issue, concerning the implementation of Sharia-compliant deals. It is about convenient operation of Islamic finance system within a certain jurisdiction in accordance with laws of the countries, where the deals are made.
- ✪ On the microeconomic level, relevance of taxation issues consists in the ability to implement Sharia-compliant deals and having positive socio-economic effect.
- ✪ Financial experts examine taxation issues according to advantages and disadvantages of two types of deals: compliant and not compliant with Sharia.
- ✪ In practice, an Islamic financing deal is made between the parties, where at least one of them can not disregard Sharia norms. Therefore these parties do not consider advantages and disadvantages between traditional and Islamic forms of financing, including taxation issues, as this is not relevant.
- ✪ Russia supports international agreements on avoidance of double taxation (77 countries), allowing to select a country with an appropriate tax regime for closing a deal.
- ✪ Depending on the structure of a deal and amount of tax payments, either the Russian partner's jurisdiction or that of a foreign partner can be chosen, including of a subsidiary company registered in the territory with preferential taxation.
- ✪ In the process of taxation optimization it is advisable to take into account not only interests of the parties of a deal, but interests of the state of principal place of business, which consist in expected budget receipts from certain business activities. This does not necessarily mean the regulator's loyalty but does contribute to a positive business reputation.

Financial Infrastructure





- ✧ An Investment Company can play a role of the basis of the Islamic finance group. Its activities are aimed at establishing a fund, bank, trade financing company, microfinance institution, leasing and insurance companies, as well as making direct investments in infrastructure projects in the territory of Russia.
- ✧ Like the Investment Company, the mutual investment fund accumulates funds of individuals and legal entities, in order to co-finance business projects organized by the Investment Company.
- ✧ Sharia-compliant investing is realized in the form of Musharaka and Mudaraba contracts. This is actually project financing, i.e. direct participation of an investor in the capital -preparation of feasibility studies, attraction of investors, support and implementation of investment projects.
- ✧ Essential part of investing in infrastructure projects is an institute of private and public partnership, and mutual investment funds. The Law “On the order of foreign investments having strategic importance for the national security of the Russian Federation” restricts foreign investments to 42 “strategic” sectors.
- ✧ Except for direct investing, Sharia-compliant equity financing is also possible via securities market of Russia - primarily Sukuk (state, municipal, corporate), and foreign securities (Sukuk), interest-free bills, which are in the aggregate investment-attractive financial instruments.
- ✧ The securities legislation allows the generation of returns on bonds, like a shareholder return, i.e. acquisition of a property right to share profits with the issuer according to results of its activities.
- ✧ Taking into account the fact that Russian banks do not have proper experience in issuing sukuk, it makes sense to use this financing instrument, as a temporary measure, with participation of foreign banks.

- ⦿ The Russian banking system is based on interest, mitigation of risks through insurance of deposits and establishment of reserves to secure loans, and high risk deals.
- ⦿ According to the Civil Code of Russia, the Law on banks, and Acts of the Bank of Russia, a borrower, who has received a bank loan, has to not only return the debt, but also pay interest on it. Deposits are made with banks in order to save money and generate profits in the form of interest. A bank has to charge interest on loans and pay interest on deposits.
- ⦿ The regulator does not divide Russian banks clearly into commercial, savings, investment, mortgage or corporate, but introduces universal requirements. Bank owners choose a bank type they want, including mixed.
- ⦿ Russian legislation enables the establishment of an Islamic bank, which, excluding credit and deposit functions, can also perform the following banking operations:
 - Bank account services;
 - Encashment and cash services;
 - Foreign currency exchange;
 - Bank guarantees;
 - Money transfer services to individuals;
 - Fiduciary management of cash and other property;
 - Operations with precious metals/stones;
 - Storage of documents and valuables;
 - Professional activities on securities market.
- ⦿ Taking into account regulatory restrictions, an Islamic bank can operate without deposits and loans, but with project financing and investment accounts as an investment and clearing bank.
- ⦿ The fact that non-cash payments make up no more than 75% of all cash transactions, shows the commercial attractiveness of clearing and settlement transactions.
- ⦿ Prohibition of direct participation of banks in production, trading, and insurance activities makes it possible for them to focus on musharaka, mudaraba and wadiah contracts, leaving murabaha and salam transactions to trade financing companies, including subsidiary companies, as the banking law does not introduce any quantity restrictions in terms of participation

- A bank can place funds raised in compliance with Sharia through investments - buying shares or Islamic bonds (sukuk).
- Banks can both buy and sell securities. Additional income can be generated through intermediary financing - assistance by issuance and placement of securities.
- Banks can use the following forms of equity and debt financing in compliance with Sharia:
 - Share acquisition in the authorized capital of the SPV;
 - Encouragement of purchasing by customers stocks or equity shares in the authorized capital of the SPV;
 - Origination and issuance of Islamic bonds (full or partial);
 - Encouragement of purchasing by customers securities (shares and sukuk) of Russian or foreign issuers, including through a bank-managed mutual fund;
- Participants of the Russian Islamic financial system, special purpose vehicles or other legal entities, individuals, foreign companies interested in receiving Islamic banking services in the territory of the Russian Federation are expected to be clients of the Bank.
- The idea of establishing an Islamic bank is supported by statistics - income of credit organizations managed by non-residents amounted to 37.8 billion roubles in the 1st half of 2009, while income of all Russian credit organizations to 6.8 billion roubles only.
- Among the factors having positive implications on activities of banks managed by non-residents are worth mentioning: availability of western sources of financing, quality risk management, banking technology and corporate governance.
- On the 1st of July 2009, 12.1% of the Russian banking sector assets were concentrated in banks with foreign participation? but they had 21.4% of all loans, deposits and other funds placed, with 6.3% in deposits.

- Waqf is a constituent part of public finance, the system that consists in voluntary and equitable distribution of profits and invests in social projects.
- Waqf fund uses charity donations - assets transferred to the fund by Muslims or Islamic companies on a voluntary basis - to meet the needs of the Ummah.
- Thus, the idea of Waqf consists in attracting and accumulating assets in a specialized fund, for commercial use in the interests of the Muslim community.
- That is, instead of one-time direct charity, a business entity is created that multiplies its profits on a continuous basis - this appears to be preferential in the long-term period.
- Among other things, there can be established interaction between the Waqf fund, the Investment Company and the bank, for the fund to purchase a share in a socially important project consistent with its aims within a Musharaka contract.



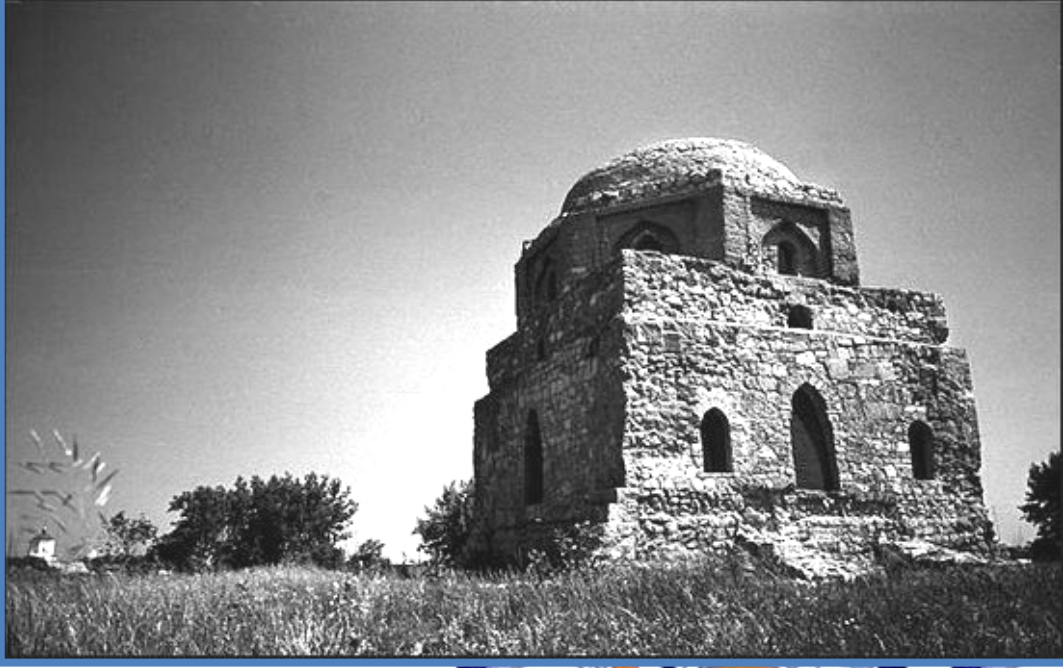
- A leasing Company provides financial services leasing assets to legal entities in compliance with Islamic law.
- The leasing legislation allows to develop financing business model in compliance with Sharia. Developing Russian economy and its industrial and construction potential contribute to the profitability of an Islamic leasing company, being even more attractive for clients-entrepreneurs, than traditional leasing services based on bank loans.
- One of the key issues should be appropriate financing of the leasing company, which can be done through the investment Company, the bank, or sukuk issuance. The leasing company can also cooperate with a Waqf company, credit and insurance organizations.
- Leasing is essential for successful operation of the Investment Company in implementing infrastructure projects, where equipment and special technology can be required purchased through Ijara contract.

- Due to specificities of the Russian Law, traditional insurers can not provide takaful services to their customers. However, considering the importance of insurance as a financial institution, it is possible for interested companies to establish mutual insurance companies, which are subject to licensing but are less regulated - this allows to develop takaful in Russia even now.
- According to the Russian law mutual insurance companies can reinsure their risks (claim payment risks) through a reinsurance company, including international companies having portfolios of developed takaful solutions.
- This makes it possible to create a two-level insurance system, where a mutual insurance company acts as a front office of a retakaful company and issues insurance policies and other documentation, pays insurance claims, ensures there are no violations and fraudulent actions in the process.
- For example, the retakaful company searches for entrepreneurs interested in establishing mutual insurance companies, provides them with documentation and teaching staff, coordinates their work, handles funds attracted by the mutual insurance company and increases them, pays insurance claims, determines general insurance conditions, and develops a business model. Reward of the retakaful Company is its share in insurance premiums (as a fee) and the profit generated from the performance of its funds (collected money).
- Development of takaful industry in Russia appears to be attractive not only to insurers but also to large international takaful players accounting for about 20, which is more than enough.

Trade Financing

- A trade financing house (trade financing company) is a networking platform for Russian and foreign entrepreneurs to implement joint Sharia-compliant business projects.
- The trade financing house is an instrument of non-bank financing of manufacturing, agricultural, trade, distribution and logistic projects, mainly, but not exclusively, through salama and murabaha contracts
- The mechanism of interaction where an investor establishes a SPV (trade financing house) for implementation of commercial projects appears to be optimal for participants of trade financing.
- A trade company (initiator), interested in doing business without using credit resources, is invited to take part in the establishment of a trade financing house as a shareholder or a fiduciary.
- In this case, the relations between the SPV and the trade company can be structured as a murabaha contract, where the trade financing house (rabb-ul mal) finances trade deals, and the fiduciary (mudarib) fulfills them for a fee, in accordance with the Civil Code of Russia.
- Manufacturing financing consists in consecutive implementation of salam and murabaha deals to finance the whole production cycle.
- For example, the trade financing house pays for and buys produced feedstock (corn, metal, oil products), transfers or sells it to a plant, and then buys back finished goods to sells them to a trading chain.
- As this activity turns quick and is highly demanded, and returns on trade financing account for 20% on average, Islamic trade financing house appears to be a relevant and investment attractive financial instrument.

- ✪ Microfinance is represented by a credit cooperative, which pools funds in order to provide financial and investment services to its members - individuals and legal entities.
- ✪ Economic activities of a credit cooperative, as in case of other financial institutions, have 2 lines: raising of funds (contributions of members, external borrowings, sponsorship, etc.) and placement of the funds (loans to members, external investments).
- ✪ According to the prohibitions under Sharia, members of a cooperative - shareholders and borrowers - are actually parties of its investment activities, who share both profits and losses with it.
- ✪ Taking into account restrictions on types of activities of a credit cooperative, which may not extend loans, but to members of the cooperative, may not have a share in the authorized capital of business companies or partnerships, issue or buy emissive securities, trade or produce - the main Islamic finance instruments used by a cooperative would be mudaraba, salam, wadiah yad damanah, ijara, and sukuk.
- ✪ According to the aims of a cooperative, contributions of the members can be structured in the way of raising funds into their personal accounts within the cooperative (wadiah) and subsequent fiduciary management of the funds by the cooperative (mudaraba). External borrowing is processed as mudaraba or waqf contracts.
- ✪ The cooperative uses funds virtually placed under its management to provide interest-free social loans (qard ul hassan) to its members, invest and finance activities of its members - legal entities (murabaha, salam, ijara).
- ✪ Participation of a cooperative in economically advantageous projects of external companies can be done through issuance of state or municipal bonds (sukuk) under specific projects of an issuer.
- ✪ The way out is outsourcing of the greater part of cooperative's functions, which is encouraged by the current legislation, making it possible for nonmembers to perform functions of executive, credit, investment, and supervising bodies.



Regulators

- A Sharia board can be established in the form of an independent non-profit organization or partnership, which examines Sharia compliance of commercial projects, business solutions, and financial instruments being developed. The Sharia board includes a Sharia arbitration court and an auditing unit supervising compliance of current activities of the Company with the adopted business model.
- Sharia arbitration court is required to settle economic disputes between entrepreneurs who participate in implementation of Sharia-compliant business projects. Establishment of a Sharia arbitration court and the contractual character of commercial relationships enables the integration of Sharia in the Russian legal system as a universally recognized practice of business intercourse.
- Educational Centers provide assistance to regulators, in particular the Russian Centre of Islamic Economics and Finance, which was established in 2008 and operates under the Russian Islamic University. It organizes monthly courses on basics of Islamic finance, international thematic seminars on certain aspects of Islamic finance based on models of Middle East and Southeast Asia countries, also conducts researches on theoretical issues of Islamic economics.

Cooperation

- The team of IFC Linova consists of professionals with skills and experience in attracting strategic/financial investors via establishment of joint companies, as well as in structuring such deals.
- IFC Linova staff has experience of working at international and Russian financial and government institutions, and understands clearly the process of decision-making by regulators and investors in establishing financial companies with a foreign capital.
- IFC Linova has contacts with a range of major Islamic financial institutions, such as IDB, ICD, IFSB, international consulting companies, making it possible to solve additional issues connected with implementation of projects on optimal terms and conditions.
- IFC Linova uses integrated approach to implemented projects, including conduct of pre-investment investigations, consultation on organizational and legal issues, taxation, appraisal, management consulting and financial engineering .

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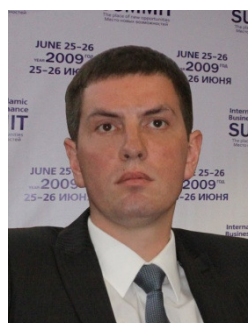


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