



CIS REGION A GROWING OPPORTUNITY FOR ISLAMIC FINANCE

The Commonwealth of Independent States (CIS) countries are emerging as a region of opportunity for Islamic finance. The financial sectors in the frontier CIS countries are expected to record robust growth in the near term, further supported by CIS governments' moves towards re-integrating with the European Union. The region's growing wealth and supportive regulatory structures, combined with the need for infrastructure financing and access to financial services for the population, provide the ideal circumstances for Islamic finance to take root.

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MALAYSIA
WORLD'S ISLAMIC FINANCE
MARKETPLACE

CIS economic expansion to support Islamic finance

The rise of the Islamic finance industry thus far has been underpinned by strong interest from Muslim populations, growing wealth and supportive regulatory structures. Today, Islamic finance has accumulated assets worth more than USD2tn and is expected to surpass USD3tn by 2018¹. To date, expansion has been concentrated in parts of the Middle East, South East Asia and South Asia. Several African countries have also been actively involved in Islamic finance, through sukuk issuances and Islamic banking activity.

In this regard, the Commonwealth of Independent States (CIS) countries are a future source of growth for Islamic finance. The region is home to countries with a high share of Muslim population with relatively low rates of usage of banking services, suggesting room for growth in the financial

sector, including Shariah-compliant services. On the economy, the region's transition from the Soviet-era was initially marked by turbulence in the 1990s, but growth patterns in the early and mid-2000s were uniformly strong². Further supporting economic expansion, CIS governments have moved towards re-integrating with the European Union, which would benefit the economy through opening up more investment and trade channels. Today, the CIS economies (including Russia) account for 3.5% of global GDP³, tripling its share from 1.1% in 2000 (2019F: 4.4%).

Going forward, GDP growth in the CIS countries is expected to continue growing at firm rates. Excluding Russia, the frontier CIS economies are expected to grow by 2.4% in 2015, before accelerating to 4.4% in 2016 (2014: 1.5%)⁴.

¹ KFHR

² "25 Years of Transition: Post-Communist Europe and the IMF", IMF (October 2014)

³ Nominal figures. IMF estimate for 2014

⁴ "World Economic Outlook Update", IMF (January 2015)

Demographics and economic potential

Collectively, these countries have a 281m⁵ strong population, though half of this amount is accounted for by Russia. Of these, Islamic finance has made some nascent steps into the Muslim-dominated nations such as Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Azerbaijan. In addition, Uzbekistan may attract Islamic finance players, given that 98.4% of its 30.1m population is Muslim. Similarly, Russia has solid potential for Islamic finance as well, given its position as the ninth largest economy in the world⁶. In addition, the Muslim population in Russia is sizeable at more than 16m people.

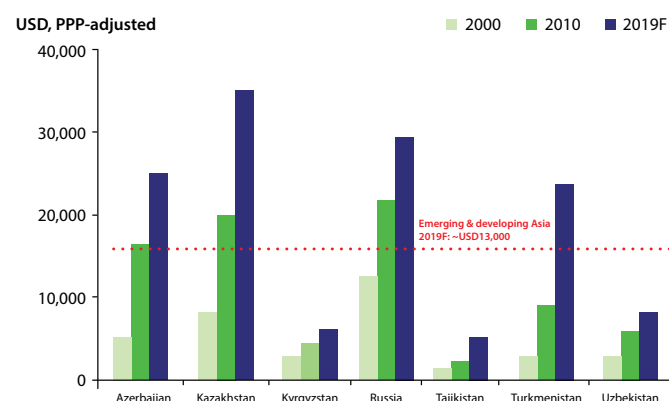
Individually, GDP per capita in the key CIS countries have increased at a Compounded Annual Growth Rate (CAGR) of between 5.1% and 15.4% in the period between 2000 and 2010. The strong growth rates were recorded in Azerbaijan (fuelled by an oil production boom), Turkmenistan (gas production) and Kazakhstan recording the strongest growth. By 2019, Kazakhstan's GDP per capita is expected to increase to almost USD32,000, higher than Russia's USD29,500. Meanwhile, both Azerbaijan and Turkmenistan are expected to record GDP per capita of USD22,000-23,000 by 2019⁷. This rise in income will likely fuel demand for retail financing and other basic financial services in this region.

Key Demographic Statistics of Selected CIS Countries

	Azerbaijan	Kazakhstan	Kyrgyzstan	Russia	Tajikistan	Turkmenistan	Uzbekistan
Population (million)	9.6	16.8	5.8	140.1	8.7	5.4	30.1
Median age (years)	30.3	29.6	25.4	38.8	22.2	26.2	25.8
% of Muslim population	98.4%	56.4%	88.8%	11.7%	99.0%	93.3%	96.5%

Source: UN Population (2015 estimates), Pew Research (2011 estimates), KFHR

GDP Per Capita of Selected CIS Countries (2000-2019F)



Source: IMF, KFHR

Key economic and trade activity

Economic activity in the region is driven mainly by commodity production and related industries, most notably oil and gas, coal, iron and other industrial and precious metals. The most prolific hydrocarbon exporters are Russia, Azerbaijan, Turkmenistan and Uzbekistan. The past decade has seen higher investment and capacity building in the production of hydrocarbons. Turkmenistan has benefitted from new gas pipelines to China and Iran. In the near future, the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline will further support natural gas exports; with an export capacity of 33billion cubic meters of natural gas a year from Turkmenistan to Afghanistan, Pakistan and India over 30 years⁸. Importantly, ongoing projects are expected to require major funding needs – Islamic finance may be utilised to fill this gap, especially infrastructure sukuk.

Historically, economic growth in Russia has had a large impact on the rest of the CIS countries, primarily via remittances, FDI and exports⁹. Today, trade links with Russia have declined as a share of total exports. China and emerging Asia are

⁵ CIS STAT (2014 estimate)

⁶ World Bank data (2013)

⁷ IMF (October 2014 forecast)

⁸ "Turkmenistan, Afghanistan, Pakistan and India Establish Landmark TAPI Pipeline Company", Asian Development Bank (November 2014)

⁹ "CIS frontier countries", Deutsche Bank (July 2013)

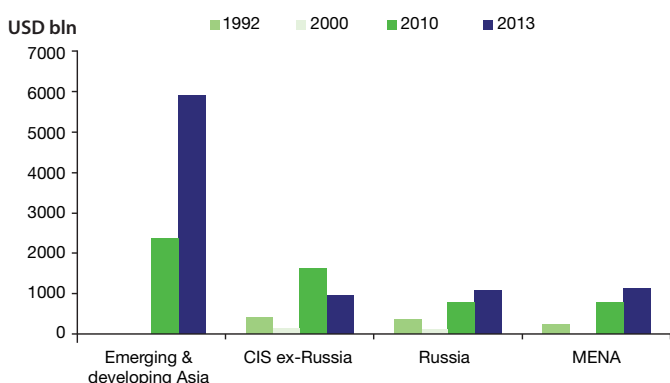
¹⁰ "Economic Performance and Trade in the CIS", IMF (May 2003)

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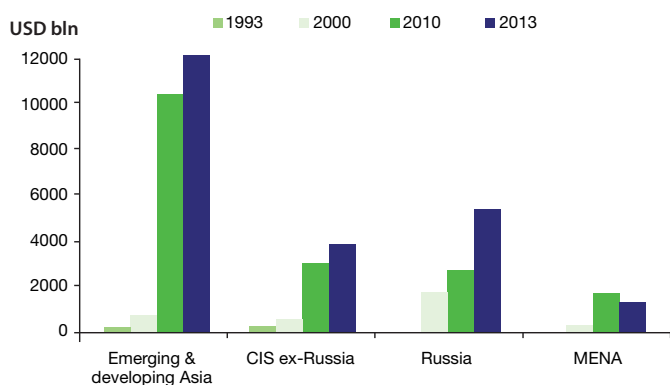
becoming increasingly important trade partners for the region, especially amongst the bigger CIS economies and hydrocarbon exporters. Broadly, intra-regional trade within the CIS has remained steady in leading economies such as Azerbaijan and Kazakhstan, while smaller nations such as Kyrgyzstan continue to depend on the region for export activity. Importantly, the full potential of intra-regional and global trade has not been fully harnessed; the expected further integration between the CIS countries and the European Union going forward¹⁰ will provide further impetus for export growth.

CIS Exports to Asia, MENA and within CIS (1990s-2013)

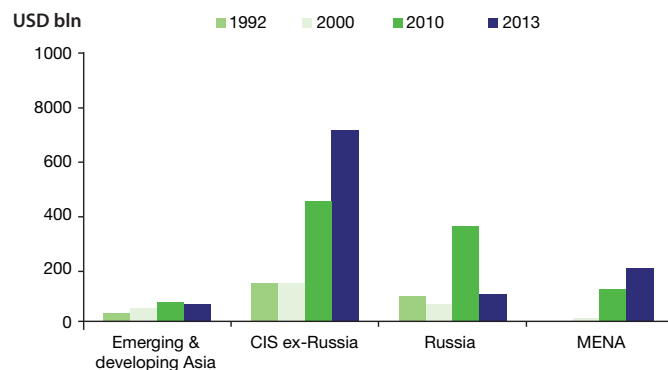
Azerbaijjan



Kazakhstan



Kyrgyzstan



Source: IMF Department of Trade Statistics, KFHR

Financial sector

Broadly, the financial sector in the frontier CIS countries are expanding in line with economic activity and growing wealth; demand for consumer credit, especially for housing, has seen robust growth in the past few years¹¹. Azerbaijan's banking sector, for example, has maintained stable growth in the post-crisis period, with banks benefitting from oil production-related activity and public spending¹². Meanwhile, Uzbekistan's banking sector is supported by demand for industrial projects, backed by the government¹³. Risks in the CIS banking sector generally arise from the possible effects of lower oil prices, as well as the reliance on a few big corporate players or public sector deposits¹⁴.

Beyond the banking sector, capital markets in the region have attracted landmark issuances in recent years, while tackling challenges such as the lack of liquid secondary markets and underdeveloped infrastructure¹⁵. Kazakhstan's local currency bond market, for example, has grown at a rapid pace from only USD15.8bln at end-2006 to USD55.2bln at end-March 2014¹⁶. In October 2014, Kazakhstan's government raised USD2.5bln through 10- and 30-year dollar-denominated bonds, after a 14 year

¹¹ IMF assessments on Kazakhstan, Moody's reports on Kazakhstan and Azerbaijan, Fitch report on Uzbekistan (2014)
¹² "Moody's maintains stable outlook on Azerbaijan's banking system", Moody's (April 2014)
¹³ "Uzbekistan's Banking Sector Stable; Structural Weaknesses Remain", Fitch (July 2014)
¹⁴ Moody's reports on Kazakhstan and Azerbaijan (2014)
¹⁵ "Overview of Tajikistan's Financial Sector", IMF presentation (February 2013), "Asia Bond Monitor", Asian Development Bank (June 2014)
¹⁶ "Asia Bond Monitor", Asian Development Bank (June 2014)

absence from the bond market. Demand for the bond was strong, with an order book exceeding USD11bn¹⁷; more than four times oversubscribed. The bond issuance was expected to form a benchmark for Kazakh companies to attract foreign capital¹⁸. Elsewhere, Azerbaijan launched its first international bond sale in March 2014, with a USD1.25bn issuance. Despite its low investment grade ratings¹⁹, the order book was nearly USD4bn, with investors citing diversification as the main appeal of the bond. Overall, the strong demand for these landmark issuances in 2014 signal potential issuances in the near future, especially in light of improving growth forecasts and various infrastructure projects.

Islamic finance potential and recent progress in CIS

In light of economic growth prospects of the region, favourable demographics and a budding financial sector, Islamic finance players may look to the frontier CIS countries for future growth – in particular Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. Broadly, potential growth for Islamic finance will stem mainly from the Islamic capital markets for both infrastructure and corporate financing, while enhancing access to Shariah-compliant financial services for the population. Meanwhile, the potential of Islamic finance in Russia arises from the need for diversified sources of funding.

Key Islamic finance developments in CIS countries

Throughout the last five years, Islamic finance developments in the CIS nations include both regulatory changes to support Islamic finance, as well as sukuk issuances. In 2012, the state-owned Development Bank of Kazakhstan issued a RM240m ringgit-denominated sukuk (USD76m), marking the first sukuk issuance from a former Soviet state. Following the success of the bond issuance in 2014, the Kazakh government announced plans to issue sukuk in 2015.

On the banking side, Kazakhstan has one full-fledged Islamic bank. Al Hilal Bank, which started operations in 2010, serves mainly corporate clients. A second Islamic bank is in the works, as the Islamic Development Bank had announced in end-2013 that it would invest in local player Zaman Bank, to convert the bank into a Shariah-compliant financial institution. Going forward, the growth of Islamic banking in Kazakhstan will be supported by an improved regulatory structure for the industry. Kazakhstan was the first CIS nation to roll out Islamic finance legislation in 2009; in 2014, the country announced that it will start drafting a unified set of laws for Islamic banking, focusing on a certain set of financial instruments, a clear tax regime and product structures. In addition, the central bank is seeking to join international standard-setting bodies such as the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM). On another note, in May 2015, Kazakhstan will be the host for the annual Islamic Financial Services Board (IFSB) summit – the first to be held in the Central Asia region.

In Azerbaijan, the International Bank of Azerbaijan (IBA), is preparing to launch a Shariah-compliant unit, citing latent demand as a factor. The Minister of Finance noted that Islamic financing by IBA could quadruple through the formation of the Islamic unit. At present, IBA provided USD180m of Islamic financing in the country, and this amount could increase to as much as USD750m²⁰. The bank has engaged a Saudi Arabian Shariah advisory firm to support the development of new products.

In other frontier CIS nations, developments are mainly on the regulatory side, such as in Tajikistan, Turkmenistan and Kyrgyzstan. Meanwhile, Russia may witness nascent Islamic finance developments in the future, following interest from the domestic

¹⁷ Halyk Finance

¹⁸ "Investors snap up Kazakhstan dollar bond", Financial Times (October 2014)

¹⁹ Moody's and Fitch

²⁰ "Azerbaijan's IBA plans stand-alone Islamic banking unit", Reuters (August 2014)

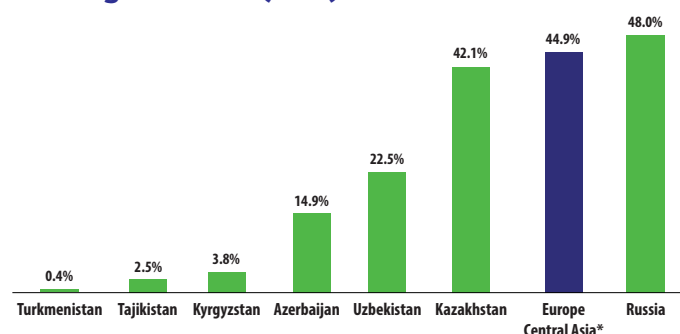
banking industry itself. In August 2014, the Association of Russian Banks (ARB) sent a letter to the central bank, suggesting that the promotion of Islamic finance would support economic activity and attract investment from the Middle East and Southeast Asia²¹. At present, the lack of regulation on Islamic finance is a constraint for banks and potential issuers.

CIS is a region of emerging important to Islamic finance. The frontier CIS countries of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Azerbaijan and Uzbekistan are expected to record robust growth in the near term, underpinned by a strong hydrocarbon and metals base, amid more investment in supporting infrastructure. Going forward, the region is forecasted to have a relatively high GDP per capita in 2019 compared to the average in emerging and developing Asia of around USD13,000; selected countries CIS countries' GDP per capita is forecasted at above USD20,000²².

The vast region is an important producer of hydrocarbons, and will thus need significant infrastructure investments in the near future. Several key projects are in the works, for example the TAPI natural gas pipeline which would stretch across Turkmenistan, Afghanistan, Pakistan and India; as well as the Trans Anatolia Natural Gas pipeline, a USD11bln project²³ which will deliver gas from Azerbaijan to Turkey and parts of Europe. Beyond oil and gas projects, basic infrastructure such as transport, telecommunications and power and utilities will require financing. In Azerbaijan, for instance, transportation spending including on roads and airports is forecasted to more than double to USD7bln by 2025²⁴. These projects will likely require substantial financing, including from

international capital markets – given the move towards Islamic finance in these regions, the sukuk market is a potential avenue to raise funds.

Share of Population Aged 15 and Above with Banking Accounts (2011)



* Developing economies only
Source: World Bank

Meanwhile, Islamic banking potential lies in the households sector, which is predominantly Muslim, fairly young and increasingly wealthy. With the exception of Kazakhstan, banking penetration rates in frontier CIS economies are low relative to the average for developing Europe and Central Asia countries. These data suggest ample opportunity for Islamic banks and takaful companies to set up base in the countries, to offer basic financial services as a start. In this regard, ongoing efforts to draft Islamic finance regulations and increase participation in standard setting bodies will also set the stage for future industry growth in the region.

Going forward, Islamic finance is likely to take root in the CIS region, supported by the need for infrastructure financing and access to financial services for the population. Risks to growth include a slowdown in oil prices, as well as risks linked to the Russian economy, which may be

²¹ "Russian banks lobby central bank to draft Islamic finance law", Reuters (August 2014)

²² IMF

²³ "Trans Anatolian Gas Pipeline indispensable", Anadolu Agency (January 2015)

²⁴ Oxford Economics (2014)



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affected by geopolitical tensions. Nevertheless, future growth will increasingly depend on emerging Asia which has become a major trade partner for the bigger CIS countries. In the financial sector, efforts to improve regulatory clarity for Shariah-compliant financial activity, as well as the depth of capital markets are also important to support the growth of Islamic finance. Overall, the CIS region represents untapped potential for Islamic finance; the industry needs to position itself to benefit from the region's bright growth prospects and latent demand for Islamic financial products and services.

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