

## Azerbaijan: emerging market

With a long history of secularism, Azerbaijan has not been prominent in the Islamic world, despite being essentially a Muslim state, with around 95 per cent of the 8.5 million population Muslim. Can this oil-rich state on the shores of the Caspian Sea be put on the map of Islamic finance? Renat Bekkin, PhD in Law, senior researcher at the Institute for African Studies of the Russian Academy of Sciences, reports from the country's capital, Baku.

Like many other former republics of the USSR, for a few years after the October (Soviet) Revolution of 1917 Azerbaijan was an independent state. Azerbaijanis are proud that the Azerbaijani Democratic Republic (ADR), declared in 1918, became the first secular state in the region, a few years prior to abolition of the caliphate in Turkey. At that time, the ADR was a classic parliamentary republic.

Furthermore, Azerbaijani historians emphasise that all reforms in the country were carried out in a democratic way, unlike, for example, in neighbouring Turkey at the time of conversion to a republican system (based on the Kemalist ideology) and Atatürk's Reforms under the leadership of Mustafa Kemal Atatürk.

The modern Republic of Azerbaijan, which gained independence in 1991 after the demise of the USSR, adopted ADR's flag, the national emblem and the anthem, as well as the policy of secularism, which meant minimisation of Islamic influence in the public and political life of the country. ADR's ideology was based on the views of the founders of the Musavat Party ('musavat' is translated as 'equality'), who believed that religion should be separate from the state. Interestingly, today's Musavat Party, which considers itself the successor of original Musavat movement of early 1900s, is in the opposition to the current Azerbaijani government, despite the mutual support of secularism.

Analysing the role of Islam in Azerbaijan today, it is important to remember that at

the time of ADR's emergence, Musavat's opposition, an Islamist party called Ittihad (Arabic word for 'alliance, union'), was against the creation of ADR. The ideologists of Ittihad were true pan-Islamists and therefore were calling for the unification of all Muslim nations of the Russian Empire and against the concept of the nation state of Azerbaijanis, or 'Transcaucasian Tatars', as they were often referred to in those days. So, the leaders of Ittihad felt there was no other option but to support the Soviet regime as the only power, in their opinion, capable of uniting the Muslims of the fallen apart Russian Empire.

So, the idea of national statehood in Azerbaijan is closely connected with secularism and anti-clericalism rather than with Islam and religious values. The religious observance of Muslims residing in the country is relatively low and Muslim identity tends to be based more on culture and ethnicity rather than religion. Even hardcore Azerbaijani nationalists admit that over 70 years of imposed atheism during the Soviet era strengthened the foundation of the country's national identity.

Nevertheless, starting from the early 1990s the number of mosques across Azerbaijan has risen dramatically. Many were built with the support of other Muslim states, such as Iran, Oman and Saudi Arabia. A Muslim seminary was also established during that period. In the last five years or so, local imams have reported increased attendance at mosques, especially among the younger generation. However, Islam does not yet play a major role in the

country's social and political life. The key partner of modern Azerbaijan is Turkey, which advocates the principles of secularism, and not its other neighbour, Iran, despite the fact that the overwhelming majority of Azerbaijani and Iranian Muslims share the same denomination of Islam – Shia.

A handful of initiatives to amend Azerbaijan's banking legislation to accommodate Islamic banks and facilitate their development are still by and large blocked by the regulatory bodies on the grounds of the constitution that proclaims Azerbaijan a 'democratic, constitutional, secular and unitary republic', and asserts the separation of religion and state as well as the equality of all religions before the law.

However, with the forthcoming sweeping reforms of Azerbaijan's financial sector and the need for investment in the economy, there are expectations of the shift in the regulators' politics (particularly of the central bank, National Bank of Azerbaijan) towards Shari'ah-compliant banking and finance.

The banking sector of Azerbaijan is characterised, above all, by a low level of transparency and a lack of capital (although the current economic upturn has spurred notable growth of the banking market, quadrupling the assets of domestic banks in the last three years). State-owned financial institutions dominate the market, but are gradually losing ground to the emerging commercial banking segment.

## COUNTRY FOCUS

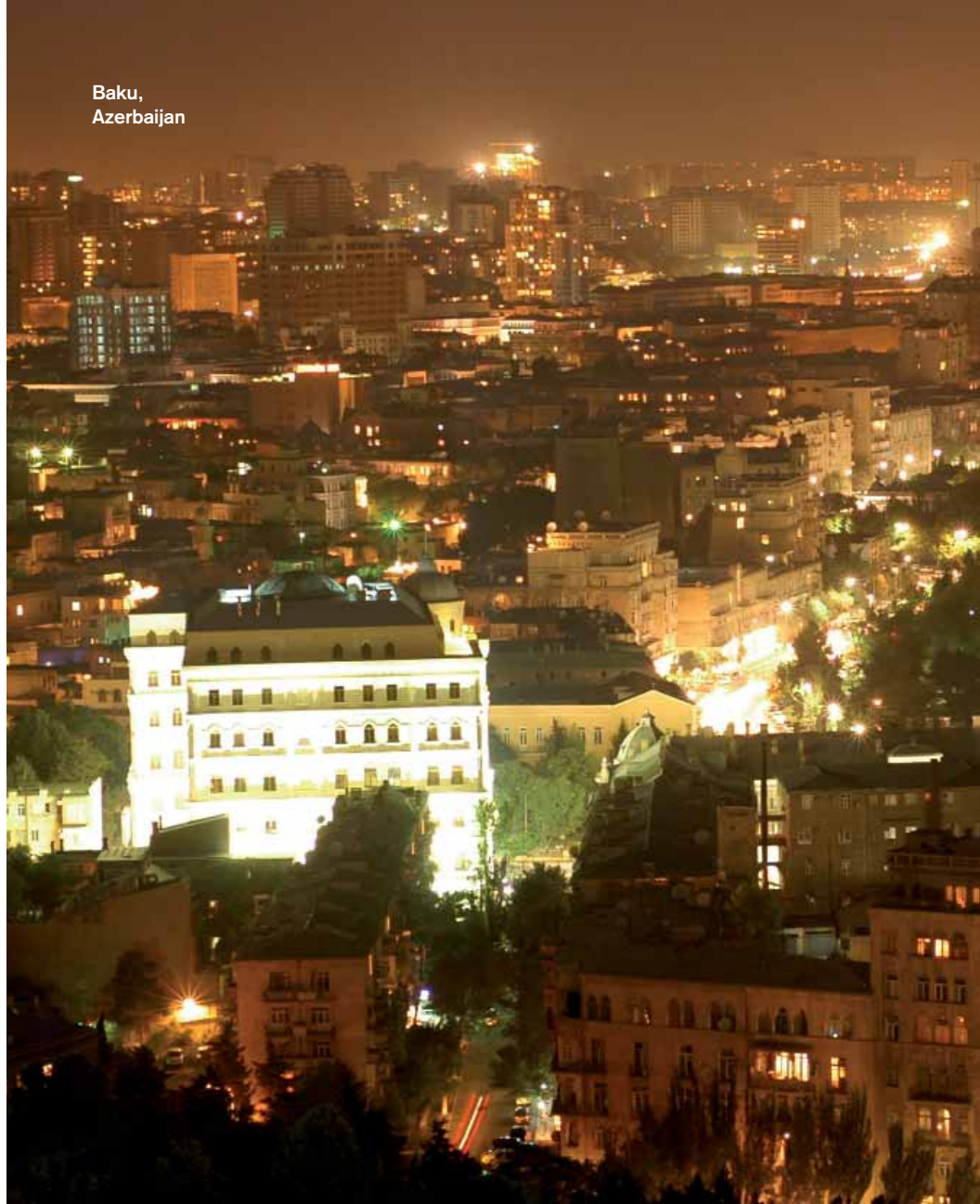
Since Azerbaijan is a country with a traditional banking system, Islamic banks do not have a special status or fall under a separate category. The first and only Shari'ah-compliant bank in the country, Kauthar Bank, is considered to be a conventional bank according to the official documents. Nevertheless, it is probably safe to say that Kauthar is the only fully-fledged Islamic bank in the post-Soviet space, though Ekobank in Kyrgyzstan has an Islamic window (*NewHorizon*, April–June 2007 issue) and in Kazakhstan, a standalone Islamic bank is currently a work in progress (*NewHorizon*, January–March 2008 issue).

Kauthar is one of the first non-state banks in Azerbaijan. It obtained a licence back in 1988 and until September 2001 was known as Universal Bank. A year later the bank obtained a new banking licence to carry out the full range of banking operations, and around the same time, it started to cleanse its loan and debt portfolios of *riba*. It also ceased participating in all transactions that involved usury. All interest-accruing loans that had been issued prior to the bank going Islamic were sold off to a specialist company.

It is worth noting that Kauthar is regarded as a Shari'ah-compliant bank by the worldwide community. At the same time, it is still too early to state that the bank offers a complete range of Islamic banking products and services. At the moment, it has only four offerings – investment accounts based on *mudarabah* (profit-and-loss sharing), loans to businesses based on *musharakah* (joint venture), loans for retail and corporate clients by purchase and sale of bills of exchange analogous to *sukuk* (Islamic bonds), and consumer loans based on *ijara wa iqtina* (leasing and subsequent purchase). Due to restrictions on banks' trading activity stipulated in the Azerbaijani legislation, Kauthar cannot base any of its operations on the *murabaha* principle (the bank buys and sells the items required by the customer).

Not being able to use some of the Islamic finance instruments, Kauthar fulfils its

Baku,  
Azerbaijan



potential in financing halal sectors of economy, although not always with a desired outcome. A good example is a multi-million dollar project of constructing several skyscrapers in Baku. In 2004, the bank signed an agreement with ICD (Corporation for the Development of the Private Sector, a member of Islamic Development Bank (IDB) group). According to this agreement, ICD was going to finance the bulk of the project. Kauthar's assets and one of the multi-storey buildings was the guarantee. The same year, ICD purchased a shareholding stake in the bank.

The project remained at a standstill for a long time due to the developers' main stipulation requiring financing of the entire construction project. In due course, a number of significant changes were made to the plans, such as building four 24-storey structures instead of two 45-storey ones.



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Then it was decided to create a complex of two 39-storey buildings with a gross floor area of 170 thousand square metres. The last option attracted \$300 million from some Korean investors (conventional banks). In the end, the participation of Kauthar in the project was minimised and there was no longer a need for ICD's investment.

The entire complex is going to be rented out as offices and apartments. The project is managed by a local firm, Baku Pride, set up by the Korean investors with minimal input from the Azerbaijani partner (close to Kauthar's management).

Nevertheless, it seems that at present it is precisely the Shari'ah-compliant investment business that is the best option for unlocking the Islamic finance potential in Azerbaijan (as opposed to expanding the range of Islamic banking products and services). And the recent flurry of activity in this area seems to substantiate the point. One of the notable ventures is the launch of Caspian International Investment Corporation (CIIC), which operates according to Shari'ah principles. CIIC was established in June this year as a result of an agreement signed at the International Investment Conference in Baku in 2006, a high profile event organised by the IDB.

ICD has a 75 per cent stake in the company, with the remaining 25 per cent owned by a domestic investment firm, Azerbaijan Investment Company (AIC). The main objective of the CIIC is to attract foreign investment to Azerbaijan and gain a strong foothold in the international market. It is expected that in the next two years the capital of the CIIC will increase many fold to reach \$70 million from a current \$4 million.

The corporation's investment activity will kick off with financing logistics projects, although other favourable spheres are also being analysed. The priority segments include agriculture, the pharmaceutical industry, the building materials industry and the services sector.



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Renat Bekkin,  
Russian Academy of Sciences

Overall, ICD and its parent, IDB, show a great deal of interest in Azerbaijan. In addition to partnerships with AIC and Kauthar, the group has issued a number of credit lines for SME financing to another domestic bank, Rabitabank. International Bank of Azerbaijan and Unibank also received loans from ICD. Most recently, in September, a similar agreement was signed with Azerdemiryolbank, securing a \$3 million credit line for SME development in agricultural, bio-technology, multimedia, telecommunications and transport sectors. Both parties emphasise that none of the financing will be directed at spheres prohibited by Shari'ah. Two other domestic banks, Bank Standard and TuranBank, also held talks with ICD about possible cooperation.

IDB group is not the only Islamic financial institution investing in Azerbaijan (although to date, it is the largest Shari'ah-compliant investor, having contributed around \$300 million). In May last year, Kuwait Finance House (KFH) and AIC signed a memorandum of understanding, according to which a company similar to CIIC is to be established. KFH will have a majority shareholding of 75 per cent in the new entity and AIC a 25 per cent stake.

Despite not being able to set up an Islamic bank in Azerbaijan so far, IDB is not abandoning this idea. Nik Zeinal Abidin, director of IDB's regional office in Almaty, Kazakhstan, has noted on numerous occasions that IDB is ready to provide support in establishing an Islamic bank in Azerbaijan, but the initiative has to come from the country's government.

The lack of dedicated legislation and somewhat disapproving attitude towards the industry from the regulators, without doubt, hinder the development of the country's Islamic banking sector. In October 2007, Bahrain-based International Investment Bank (IIB) purchased a 49 per cent stake in Amrahbank. IIB, which is a shareholder of European Islamic Investment Bank (EIIB) in the UK, is actively supporting the development of Islamic finance in both Muslim and non-Muslim countries.

Amrahbank was to be converted to a fully-fledged Shari'ah-compliant bank to seize the benefits of Azerbaijan's 'untapped demand for Islamic banking products and services', according to the IIB's CEO, Aabed Al-Zeera. However, this initiative has never been put into practice due to regulatory and legislative uncertainty. To date, the Islamic banking section of Amrahbank's website states that this type of products and services will be introduced in near future.

As for Kauthar's Shari'ah-compliant activity, it is not being widely advertised and the information about it is mainly spread by word of mouth. Furthermore, the bank's official documents contain hardly any Arabic terminology relating to Islamic finance. There is hardly any mention of Shari'ah principles the bank adheres to in the published information about Kauthar. For example, in the English version of Kauthar's promotional literature its activity is described as 'Islamic banking', while in Azeri language version the phrase used is 'faizsiz qazanc', which is translated as 'non-interest banking'.

Such discrepancy in terminology is not a conspiracy, but rather a sensible precaution, says Heydar Ibrahimov, chairman of Kauthar. 'Shari'ah-compliant banking in Azerbaijan has its foes, including in the National Bank,' says Ibrahimov. 'But nevertheless, compared to Russian Badr-Forte Bank, we are in a more favourable environment.' Badr-Forte, the only Islamic bank in Russia, had its licence revoked in late 2006 on the grounds of money laundering activity and terrorism financing (for more details on Badr-Forte's story and Islamic finance in Russia, see *NewHorizon*, January–March 2007 issue). Badr-Forte and its chairman, Adalet Dzhabiev, are well known to Kauthar and Ibrahimov. Back in 2002, when nothing seemed to threaten Badr-Forte's existence, Dzhabiev consulted Kauthar's management on applying Islamic finance methods. The two banks have, indeed, a lot in common. Similar to Kauthar, Badr-Forte was restricted in applying Islamic principles. The central bank not only refused to make any concessions for Badr-Forte's specifics (for

example, a mandatory deposit insurance scheme introduced by the Central Bank of Russia was a huge stumbling-block for the bank), but also demonstrated excessive regulatory pressure towards every aspect of the bank's activity. All this resulted in Badr-Forte eventually losing its licence.

In their reluctance to accommodate Islamic finance, both Russian and Azerbaijani regulators consistently refer to the constitution and the secular foundation of the state, as well as absence of the necessary regulatory control over banking activity based on Shari'ah principles.

However, to be fair, Kauthar's management is in no rush to advertise its Shari'ah-compliant products, and not just for political reasons. 'The information about our bank gets about through the system of social networks,' observes Ibrahimov. 'In other words, Kauthar Bank adheres to Know Your Customer (KYC) principles by more than 100 per cent. Our clients are religious people and understand that according to Shari'ah, we cannot guarantee them fixed profit. Our customers know and trust us and we, in our turn, know that they are prepared to accept profit as well as loss. They realise that mudarabah is not a guaranteed income. But if we advertise widely in the mass media, we'll gain clients that we don't know and who might not be aware of the specifics of Islamic banking. And we won't feel comfortable if we can't provide them with the same level of profit as a conventional bank.'

As a result of such caution within Kauthar's management, many Muslims in Baku have no idea that an Islamic bank has been operating in the country for over five years now.

And what about Islamic insurance (takaful), is there a market for it in Azerbaijan? The potential is there. However, at present, the country's overall insurance sector is underdeveloped, constituting only one per cent of the GDP (gross domestic product). There are 28 insurance companies and seven insurance brokers, as well as one reinsurance firm operating in Azerbaijan

today, but so far none of them have expressed interest in takaful.

The issue is complicated by the new insurance legislation (compliant with the key principles of the International Association of Insurance Supervisors, IAIS) that came into effect in Azerbaijan in March 2008. This regulatory act does not cater for the specifics of takaful, and it seems that the same omission has been made in preparing another law on compulsory insurance, drawn up by the Ministry of Finance with the assistance from Lawrie Savage & Associates, a Canadian law firm. Development of takaful is also hampered by the deficiency of effective instruments that would enable Shari'ah-compliant investment of actuarial reserves.

A lack of an insurance culture in Azerbaijan is not to the benefit of takaful either. There

is widespread mistrust from the population towards long term investments such as insurance and as a result life insurance represents just over one per cent of insurance premiums. Nevertheless, Ibrahimov states that despite the obstacles takaful is a high priority task for Kauthar.

Needless to say that the future of Islamic banking and insurance in Azerbaijan depends not only on the politicians and regulators, but on the country's Muslims as a whole. And the word of mouth spreading by the system of social networks that Kauthar extensively relies on is clearly not enough. The demand for Shari'ah-compliant products and services can appear and flourish only when the population of Azerbaijan has access to comprehensive information about the industry. 🌱

The Mausoleum of the Shirvanshahs, Baku, Azerbaijan

