

Comparative analysis of Islamic banking regulation in Kyrgyzstan and Central Asian countries

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Abstract. The Islamic banking regulation plays a key role in ensuring the development of this type of financial activity, especially for countries with a predominantly Muslim population, such as the Kyrgyz Republic and other Central Asian countries, in particular the Republic of Kazakhstan and the Republic of Tajikistan. Therefore, the study aims to analyse and compare the peculiarities of the legal framework that regulates the activities of Islamic banks. Legal analysis, statistical analysis, grouping, generalisation, comparison, and abstract and logical thinking methods were used in the article. The information basis for this study included the current laws and regulations of Kyrgyzstan, Kazakhstan, and Tajikistan in the field of Islamic banking regulation. The study analyses the laws that establish the principles of operating and regulation of Islamic banks, as well as the regulatory documents of the Central banks of the Kyrgyz Republic, Kazakhstan, and Tajikistan. The study identifies and analyses the key requirements established for the establishment of Islamic banks, Shariah boards operating within such banks, as well as prudential standards for financial institutions operating on the principles of Islamic finance. A comparative analysis of regulatory and legal documents has made it possible to formulate both common and different approaches used to ensure and regulate the activities of Islamic banks. It is established that the key difference between the legal regulation of Islamic banks in Kazakhstan, as compared to Kyrgyzstan and Tajikistan, is the lack of possibility for banking structures to combine traditional banking activities with activities based on the principles of Islamic Finance. The study results can be used by the authorities that form the legislative framework and regulate the activities of Islamic banks, and entities operating in the banking system, as well as by the scientific community interested in ensuring the Islamic banking regulation in Kyrgyzstan and other Central Asian countries

Keywords: principles of Islamic Finance; Islamic financial institutions; Islamic banking regulation; Islamic financial system; management; state control

Introduction

The Islamic banking is a system of financial services that is based on the principles of Shariah (Islamic law). This type of banking activity aims to provide financial services that comply with the principles of Islamic Finance. Islamic banking

is of growing interest in Kyrgyzstan and other Central Asian countries. The study of legal regulation of Islamic financial and credit institutions is particularly relevant for countries that are forming a financial system based on the parallel

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functioning of traditional banking structures with institutions using principles of Islamic Finance, and more importantly, organisations that combine these two models by introducing Islamic financial products into their classical operational portfolio.

As E. Djeentaeva (2022) notes, the financial sector in Kyrgyzstan shows a trend of development, as total assets and liabilities are increasing from year to year and the client base is growing. This implies the use of a wide range of different financial instruments, including a fundamentally new approach to investing in projects based on Islamic rules and moral and ethical norms. These rules and regulations reject the use of interest on loans, exclude usury, and the relationship between the borrower and the lender is based on mutual trust and shared responsibility (Kostruba & Hylilaka, 2020). There is therefore a need to harmonise the legal framework that regulates traditional finance with this type of financial activity. For this purpose, it is necessary to incorporate the practices of other countries, highlighting the features of regulatory mechanisms aimed at Islamic banking, which will be done in this study.

Considering the Islamic Development Bank as an opportunity to obtain investment capital in the real sector of the Kyrgyz economy, A. Mirzakhmedova (2023) notes that the integration of the Kyrgyz Republic into the international community as a result of social, financial, economic, and political reforms at the end of the last century, led to an understanding of the need for comprehensive interaction with international financial and credit structures. As a result, Kyrgyzstan joined the Islamic Bank Group, which became an impetus for the development of Islamic banking in the country and the need to ensure the regulation of this activity through the formation of new and improvement of the existing legal framework (Abykeeva-Sultanalieva *et al.*, 2022).

A. Zhoraev and A. Yükses (2021) conclude in their study that despite the modest market volumes of Islamic banking in Central Asian countries. In general, the Islamic finance in Kyrgyzstan has subsequent prospects for development, which is due to the emergence of international Islamic banking structures that offer innovative financial market products. However, the study does not focus on the problem of legal regulation of Islamic financial institutions as a fundamental factor in the development of this financial activity.

A detailed study of the characteristics of the banking system, and Islamic banking in particular, is carried out in the study by S. Kairdenov *et al.* (2021). The authors conclude that it is necessary to develop optimal solutions to the pressing problems of the banking sector of Kazakhstan and other Central Asian countries, one of which may be Islamic banking. The authors note that the effectiveness of Islamic banks depends on the regulatory policy, which, in turn, affects the mechanism and features of Islamic bank management.

Despite the existing scientific research, the problem of peculiarities of modern legal regulation of Islamic banking in the countries of Central Asia, especially through comparative analysis, is poorly covered in the scientific literature. Given this, as well as the growing popularity of financial operations carried out on the principles of Islamic finance, the purpose of the article is to study modern approaches, mechanisms, and principles of legal regulation of Islamic banking in the Republic of Kyrgyzstan and to compare this process with other countries, in particular with some Central Asian states.

Materials and methods

The legal and regulatory framework of Kyrgyzstan, Tajikistan and Kazakhstan became the information basis for conducting a comparative analysis of the peculiarities of regulatory and legal support and regulation of financial institutions in the banking sector operating on the principles of Islamic finance.

To study the fundamental principles and peculiarities of regulation of the Islamic banking in Kyrgyzstan, the article analyses the Law of the Kyrgyz Republic No. 93 “On Banks and Banking Activities” (2022). To assess the peculiarities of deposit activity of Islamic banks, the Law of the Kyrgyz Republic No. 78 “On the Protection of Bank Deposits” (2008) was analysed. To identify specific mechanisms of legal regulation of Islamic banking in Kyrgyzstan, related regulatory and legal documents of the National Bank of the Kyrgyz Republic (NBKR) were also selected. In particular, these are Resolution of the Board of the National Bank of the Kyrgyz Republic No. 32/2 “On the Implementation of Islamic Principles of Financing in the Kyrgyz Republic within the Framework of a Pilot Project” (2006), Resolution of the Board of the National Bank of the Kyrgyz Republic No. 38/8 “On Approval of the Regulations “On Operations Carried out Following Islamic Principles of Banking and Financing” (2009), to study the specifics of the implementation of banks, including those that have opened Islamic windows, certain types of operations that comply with the norms of Islamic finance.

To assess the requirements for risk management in banks that use Islamic principles of activity, the Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2018-P-12/30-3-(BS) “On Approval of the Regulations “On the Minimum Requirements for Risk Management in Banks Carrying out Operations Following the Islamic Principles of Banking and Finance” (2018). To determine the key requirements that must be met to obtain a licence and further implementation of Islamic banking operations, the Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2017-P-12/23/1-(NPA) “On Approval of the Regulations “On Licensing the Activities of Banks” (2017), as well as Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2022-P-12/78-7-(NPA) “On Approval of the Regulations “On Economic Standards and Requirements Mandatory for Compliance by Commercial Banks of the Kyrgyz Republic” (2022).

The regulatory and legal framework of Kazakhstan, which regulates Islamic banking, was analysed based on the study of the Law of the Republic of Kazakhstan No. 2444 “On Banks and Banking Activities in the Republic of Kazakhstan” (1995), as well as Resolution of the Board of the National Bank of the Republic of Kazakhstan No. 144 “On the Establishment of Prudential Standards and other Mandatory Standards and Limits for Islamic Banks, their Regulatory Values and Methods for Calculating Prudential Standards and Other Mandatory Standards and Limits for Islamic banks” (2016), to determine the key prudential indicators required, their normative values, calculation methodology and other binding norms for Islamic banks set by the central bank of the country.

The study of the peculiarities of regulation of Islamic banks in Tajikistan was carried out based on the Law of the Republic of Tajikistan No. 1108 “On Islamic Banking” (2014). Analysis of Resolution of the Board of the National Bank of Tajikistan No. 87 “On Approval of the

Instruction “On the Procedure for Regulating the Activities of Islamic Credit Organisations” (2019), which details the regulatory mechanism in the above-mentioned law, made it possible to assess the procedure for regulating the activities of credit organisations using the basics of Islamic banking. To identify the requirements for services and products of Islamic banks and other credit institutions, Instruction No. 224 “On Operations Carried out Following Islamic Principles of Financing in Islamic Credit Institutions” (2017) was analysed. The procedure for creating the Committee on Islamic Financial Services, powers, and requirements for its members (2017) were analysed to assess the requirements for the committees on Islamic financial services, as well as their powers.

The use of generalisation and systematisation methods allowed us to identify both similar and different approaches to the regulation of Islamic banking in the above-mentioned countries. The statistical method of dynamics series was also used to assess the intensity of Islamic banking development in Kyrgyzstan and other Central Asian countries. In particular, deviations and growth rates of indicators characterising banking activity were calculated. In addition, the method of calculating the specific weight of indicators was used to calculate the share of Islamic banking in the overall structure of indicators of financial institutions in the banking systems of the countries studied.

Results

The Islamic banking is a banking system that is based on the principles of financial activities related to Islam and Shariah (Rahmayati, 2021). The main idea of Islamic banking is that all banking operations and services are carried out follow-

ing Islamic morality. The important distinguishing features of the Islamic banking sector are the prohibition of interest (riba) and adherence to the laws of justice and morality in financial transactions.

Also, one of main instruments of the Islamic banking is Mudaraba, a type of interaction between the bank and the entrepreneur, where the bank provides funds and the entrepreneur manages these funds. Profits are shared between them in pre-determined portions while losses are borne by the bank. Another important transaction in the Islamic banking is Murabaha, which is a buying and selling agreement with a pre-determined profit for the bank. This type of transaction provides the opportunity to do away with the application of interest rates. Islamic finance also provides other innovative Shariah-compliant financial products such as Ijarah (leasing), Sukuk (Islamic bonds), and Islamic investment funds. The principles and products of Islamic banking have made it attractive to all those who seek to comply with Islamic norms in their financial transactions. However, as with any financial system, Islamic banking must be subject to regulation and require careful risk management.

The last few decades have been characterised by the expansion of Islamic finance in many countries, including the Caucasus and Central Asia, where the majority of the population is Muslim. It should be noted that many Central Asian countries, like Kyrgyzstan, have built a traditional financial model. The banking system of Kyrgyzstan has been actively developing in recent years and demonstrates positive dynamics in terms of the main indicators characterising this sphere, in particular, the total assets of banking institutions, loan portfolio and deposit base (Fig. 1, 2).

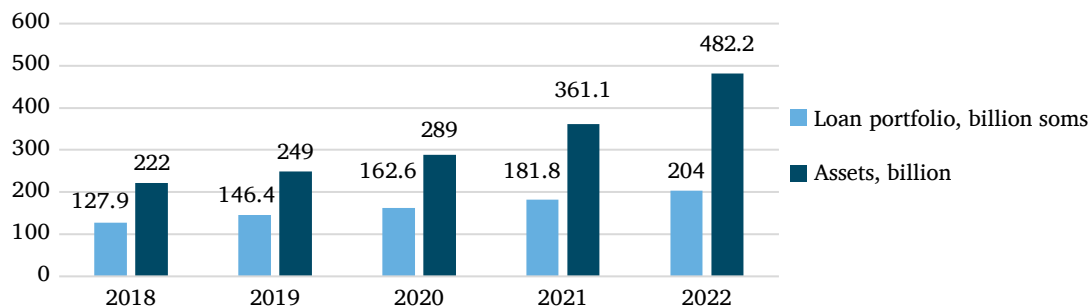


Figure 1. Assets and loan portfolio of banks in Kyrgyzstan for the period 2018-2022 (end of period)

Source: Annual report of the National Bank of the Kyrgyz Republic for 2022 (2022)

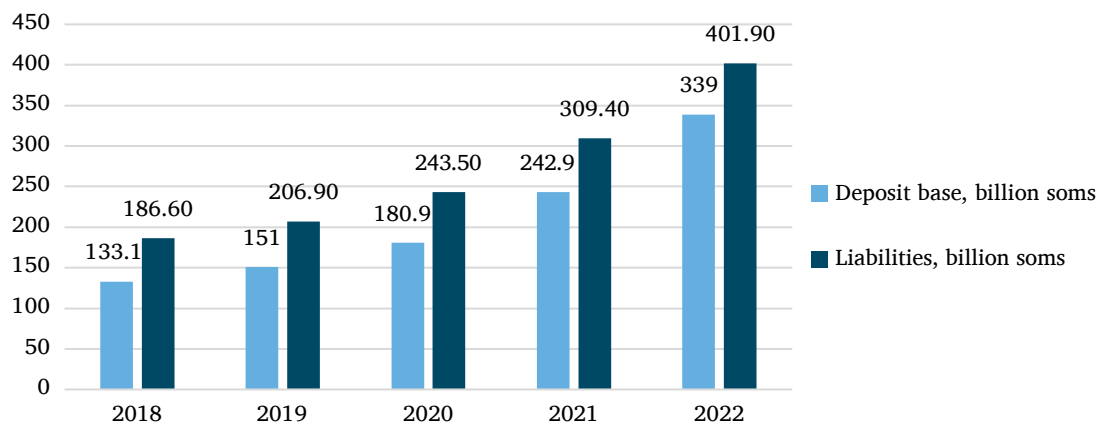


Figure 2. Deposit base and liabilities of banks for the period 2018-2022 (end of period)

Source: Annual report of the National Bank of the Kyrgyz Republic for 2022 (2022)

Over 2018-2022, the loan portfolio of banks increased by 59.5%. The growth of the loan portfolio in 2022 was due to the increase in the size of lending in the national currency by 19%, up to 156 billion soms. At the same time, the size of loans in foreign currency decreased by 5.3% and reached 48 billion soms. Assets of banking institutions increased by more than 117% during the period under study. Moreover, it should be noted that in 2022, relative to 2021, the increase in assets of the banking system was more than 33.5%, which exceeds the average annual growth rate by almost 12%.

Deposit activity of the banking system of Kyrgyzstan for the period 2018-2022 showed positive dynamics. Thus,

during this period, the deposit base of banks increased more than 2 times. At the end of 2022, the volume of this indicator increased by 39.5%, relative to the previous year. Deposits increased both in national (by 29%) and foreign (by 54.6%) currencies. Liabilities also increased significantly in 2022, relative to 2021, by almost 30%. At the same time, the total value of the Islamic finance loan portfolio exceeded USD 3.3 billion, in the total banking sector (Fig. 3). On the other hand, the deposit base based on Islamic finance principles is less than USD 3.2 billion and corresponds to about 1.1% of the banking sector's deposit portfolio.

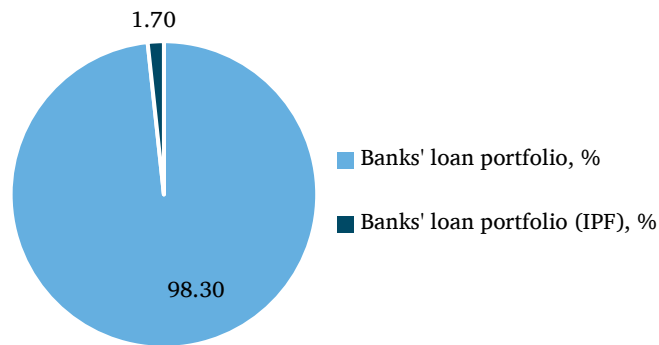


Figure 3. Share of loan portfolio of conventional banks and banks operating according to the principles of Islamic finance in Kyrgyzstan in 2022

Note: IPF – Islamic Principles of Finance

Source: compiled by the author based on the Concept for the development of the Islamic economic platform in the Kyrgyz Republic for 2023-2027 (2023)

As for non-bank credit financial institutions (NBCFIs), their total assets in 2022 compared to the previous period increased by 4.2 billion soms, which is 12.3%. The attracted volume of deposits of NBCFIs as of the end of 2022 totalled 3.4 billion soms, increasing by 1.8 billion soms compared

to the figures of 2021. The loan portfolio of these institutions grew by 11.2% (by 3.1 billion soms) to reach 31.2 billion soms, with the share accounted for by PIF operations in 2022 accounting for 4.9% of the total loan portfolio of NBCFIs (Fig. 4).

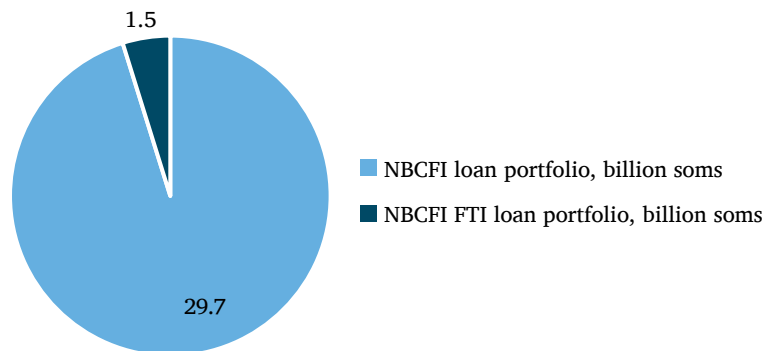


Figure 4. Structure of the loan portfolio of non-banking credit financial organisations operating under Islamic financing principles in 2022

Source: compiled by the author based on the Annual report of the National Bank of the Kyrgyz Republic for 2022 (2022)

Currently, the Kyrgyz Republic is a member of the Islamic Development Bank (IsDB), an international financial institution that aims to assist the socio-economic and financial development of states belonging to the Muslim world. The main mission of this institution is to raise the level of socio-economic development in the IsDB member states through involvement in the process of financing various projects and programmes.

The first Islamic bank in the Kyrgyz Republic started its operations in May 2006 after the IsDB, the Kyrgyz Republic and Eco-Islamic Bank signed a Memorandum of Understanding. From that moment, the process of introducing Islamic banking and Islamic finance in the Kyrgyz Republic began (Resolution of the Board of the National Bank..., 2006). It should be noted that Eco-Islamic Bank became the first bank not only in Kyrgyzstan but also a pioneer in Central Asia,

providing financial products based on Islamic principles of financing. Thus, the first goal and stage of the introduction of Islamic banking in the Kyrgyz Republic was the launch of a pilot project and the development of appropriate legislation for the functioning and further development of this sphere. The second step in the development of the principles of Islamic finance in the Kyrgyz Republic was the formation of a legal framework aimed at creating equal conditions for both classical and Islamic banking. This stage envisaged the harmonisation of legal acts regulating banking activity, civil law, and taxation.

In general, the second stage of development of the Islamic banking system has ended with the formation of a favourable legislative framework, which creates conditions for further increase in the number of financial institutions operating on the principles of Islamic finance. As part of the promotion of Islamic finance, the National Bank of the Republic is currently implementing a project to establish full-fledged Islamic banking in the Kyrgyz Republic with the

support of the IsDB (Islamic Development Bank, 2022). The regulation of Islamic banking varies from country to country depending on legal, financial, and religious aspects. However, in most Muslim countries and countries with an Islamic banking sector, regulation is carried out within the framework of the relevant Shariah-compliant financial authorities. Thus, Law of the Kyrgyz Republic No. 93 “On Banks and Banking Activities” (2022) defines that together with classical banking, Islamic banking principles are applied. Islamic banking principles imply that banking activities and transactions should be carried out following Shariah standards, which are a set of rules for conducting financial and economic activities, following the principles developed and approved by international organisations that set standards for Islamic banking. The above-mentioned law and Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2017-P-12/23/1-(NPA) “On Approval of the Regulations “On Licensing the Activities of Banks” (2017), define the possibility of Islamic banking in two forms (Fig. 5).

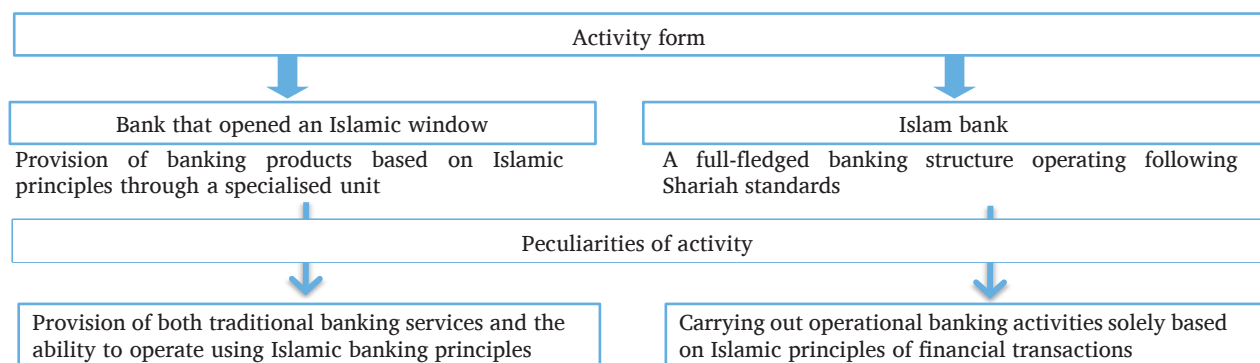


Figure 5. Specifics of Islamic banking activity organisation in Kyrgyzstan

Source: compiled by the author based on Law of the Kyrgyz Republic No. 93 “On Banks and Banking Activities” (2022) and Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2017-P-12/23/1-(NPA) “On Approval of the Regulations “On Licensing the Activities of Banks” (2017)

In addition to the standard procedures and requirements for conventional banks, an Islamic financial institution must elect the members of the Shariah Council and its chairman. This body is responsible for aligning the bank’s policies and standard contracts to the existing Shariah standards. The procedure for establishing the Shariah Council, its powers, functional features, tasks (as well as the body that appoints the members of the Council and determines their term of office) and the requirements for the members of the Council based on the principles of Islamic finance are specified in the bank’s charter and confirmed by the minutes of the bank’s constituent assembly on the election of the members of the Shariah Council and its chairman.

To obtain a licence to establish an Islamic bank it is also necessary to submit original or duly certified copies of the relevant documents to the National Bank. In addition to the standard information, these documents contain mechanisms to identify, calculate, control, and monitor all types of risks to which the bank may be exposed in the course of its activities, which involves the use of Islamic bases for financial transactions. It is also necessary to form guidelines for controlling and consistently minimising all risks that may arise from banking activities within Islamic standards. Members of the Shariah Board of an Islamic bank, as well as a commercial bank that has an Islamic window, members of the Management Board, chief accountant, and heads of structural units of the bank must meet certain requirements (Table 1).

Table 1. Special regulatory requirements to be met by members of the Shariah Council, members of the Board, chief accountant, and heads of structural subdivisions of an Islamic bank and a bank with an Islamic window in the Republic of Kyrgyzstan

Distribution	Requirements
Members of the Shariah Council	Diploma of higher education, knowledge, and skills in the field of banking law of Kyrgyzstan concerning Islamic principles of banking business. Documents confirming knowledge in the field of Islamic finance, one year of study experience in financial and credit institutions, or more than two years of experience in educational institutions or religious organisations with the skills to develop Shariah opinions. At least 1 member of the Board must be a resident of Kyrgyzstan and speak the state (or official) language.

Table 1, Continued

Distribution	Requirements
Chairman of the Shariah Council	In addition to the requirements for members of the Board, it is necessary to have a diploma of higher education in the field of Shariah in a profile that includes legal and/or commercial issues, as well as to have more than one year of work experience as a member of the Shariah Board or more than five years of study in banking structures, from one year of experience in a management position.
Managing director, head of structural subdivisions	Study experience of more than 2 years in the financial and credit system. A managing director who is not a member of the Management Board and only supervises the activities of the bank's structural units in highly specialised areas (IT, information security, legal support) should have at least two years of experience in the financial and credit system and/or have worked in institutions that specialise in the above-mentioned specifics for at least three years.
Deputy Chairman/ Member of the Management Board in charge of financing carried out based on Islamic banking	Documents or certificates that demonstrate knowledge of banking based on Islamic finance principles are required.
Chief Accountant	Knowledge of Accounting Standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) specific accounting standards and relevant documents to prove the completion of a course or refresher training in the above areas at an educational institution with relevant permission/licence from a recognised national body within five years before applying for approval of the nomination.
Head of Internal Audit Service	Possess information, and knowledge of the principles of Islamic banking and finance, know the standards (AAOIFI), and provide a document proving training in the principles of Islamic banking and finance.

Source: compiled by the author based on Law of the Kyrgyz Republic No. 93 “On Banks and Banking Activities” (2022) and Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2017-P-12/23/1-(NPA) “On Approval of the Regulations “On Licensing the Activities of Banks” (2017)

Any commercial bank is authorised to establish an Islamic window to conduct business by the principles of Islamic banking and to provide necessary financing following the existing requirements. To carry out banking activities through the Islamic window. The Bank is required to obtain approval in the form of a licence to conduct business using

Islamic banking principles and to provide financial products through an Islamic window. During the period from 2017 to 2022, the National Bank of Kyrgyzstan issued 5 licences to conduct financial operations on the principles of Islamic finance through the “Islamic window”, one licence was returned in 2020 (Table 2).

Table 2. Statistics on the issuance of licences to conduct financial transactions on the principles of Islamic finance through the “Islamic window”

Year	Licence activity
2017	One license issued
2018	One license issued
2019	No operations
2020	One license revoked
2021	One license issued
2022	Two licenses issued

Source: compiled by the author based on the Annual report of the National Bank of the Kyrgyz Republic for 2022 (2022), Annual report of the National Bank of the Kyrgyz Republic for 2017 (2017), Annual report of the National Bank of the Kyrgyz Republic for 2018 (2018), Annual report of the National Bank of the Kyrgyz Republic for 2019 (2019), Annual report of the National Bank of the Kyrgyz Republic for 2020 (2020), Annual report of the National Bank of the Kyrgyz Republic for 2021 (2021)

As of March 2023, five commercial banks (one pilot bank, four classical banks that have opened an Islamic window) and 8 microcredit companies provide services on Islamic financing principles in Kyrgyzstan (Kyrgyzstan allowed the issuance..., 2023). To open an Islamic window, a bank must submit the required list of documents, and be adequately capitalised, according to the established requirements of the National Bank. It must also comply with economic and financial regulations and other requirements set by the National Bank of Kyrgyzstan. For Islamic banks following the instruction, which establishes the limits of financing, based on the principles of Islamic banking business, the norm of the maximum amount of risk per client is provided. Thus, the acceptable level of risk per borrower,

which is not related to an Islamic bank, cannot be more than 20% for a non-bank customer and 30% for a bank (Resolution of the Board of the National Bank ..., 2012).

There are also requirements to limit concentration risk. The risk for an Islamic bank is considered large if the total debt of one customer exceeds 10% of its net total capital. In this case, the aggregate amount of all large risks of an Islamic bank cannot be more than five times the size of the net total capital. For a bank that conducts operations through the Islamic window, the maximum exposure per customer is defined as the ratio of total liabilities per borrower to the bank's net total capital within the framework of conventional and Islamic banking and financing principles. In addition, Resolution of the Board of the National Bank of the

Kyrgyz Republic No. 2022-P-12/78-7-(NPA) “On Approval of the Regulations “On Economic Standards and Requirements Mandatory for Compliance by Commercial Banks of the Kyrgyz Republic” (2022) regulates the sufficiency (adequacy) of total capital, should be at least 12%, and 14% for systemically important banks, liquidity ratio should be at least 45%, and the limit of currency risk 15-20% of the bank’s capital.

Although the first steps towards the introduction of Islamic principles of financing in the Republic of Kyrgyzstan were made back in 2006, after signing a memorandum with the IDB and the launch of the first Islamic bank in the country, the formation of the legal and regulatory framework for the regulation and regulation of this type of business is still underway. The National Bank continues to detail the regulatory mechanisms, supplementing the legal framework with its resolutions aimed at creating a transparent and efficient environment conducive to the development of Islamic banking. The country’s banking system demonstrates positive dynamics of key indicators from year to year, but the share of operations based on Islamic principles of financing is still insignificant compared to the activities of other banking structures.

Law of the Republic of Kazakhstan No. 2444 “On Banks and Banking Activities in the Republic of Kazakhstan” (1995) defines that Islam is a structure of the banking system, carrying out banking activities following the licence issued by the authorised institution. Islamic banks are not members of the system of compulsory insurance (guaranteeing the return) of deposits, and accordingly, deposits of individuals in Islamic banks are not guaranteed by the system of compulsory deposit insurance. Islamic banks have the right to establish

non-profit organisations in the form of joint stock companies, which can guarantee the return of deposits in case of bankruptcy of the financial institution.

The name of the banking institution must necessarily contain the phrase “Islamic bank”. Conventional commercial institutions of the banking system according to the current regulatory framework cannot work with Islamic financial instruments (Shirazi *et al.*, 2022). In addition to the information specified by conventional banks, the charter of an Islamic credit organisation must have information regarding the purpose of the bank’s activities, the functions of the tasks and powers of the council that controls compliance with Islamic principles of financing, as well as the mechanism of its formation and requirements for representatives of such a council. An Islamic bank is obliged to establish such a council, but the requirements for its members are not regulated by the legislation but are determined by the banking institution itself.

The legislation specifically provides requirements for the activities of an Islamic bank. In particular, the Islamic bank has no right to establish interest as a form of payment for services, to guarantee that the client will receive income on the investment deposit or will have the opportunity to return it, to finance (lending) activities that are aimed at the production or sale of tobacco, alcoholic beverages, weapons, armaments, ammunition, gambling business. Moreover, other areas of business, do not allow to finance the Islamic model of financial activity. An important factor in ensuring the development of Islamic banking in Kazakhstan is that the regulatory burden is about the same as for conventional banks, a very important step was the establishment of equivalence of the prudential standard of the current liquidity ratio in 2021 (Table 3).

Table 3. Comparison of the main prudential requirements for conventional and Islamic banks in Kazakhstan

Values	Ratio for traditional banks	Ratio for Islamic banks
Requirement for conservation buffer	2%	2%
Currency risk ratio	8%	8%
Operational risk ratio	8%	8%
Overall risk ratio	8%	8%
Bank’s current liquidity ratio (k4)	30%	30%

Source: compiled by the author based on the Resolution of the Board of the National Bank of the Republic of Kazakhstan No. 144 “On the Establishment of Prudential Standards and Other Mandatory Standards and Limits for Islamic Banks, their Regulatory Values and Methods for Calculating Prudential Standards and other Mandatory Standards and Limits for Islamic Banks” (2016)

In addition, the ratio of the risk level for a bank per borrower on its liabilities to the bank’s equity capital cannot be more than 25%. The total aggregate risk exposure of a financial institution per borrower, with a share of more than 10% of the bank’s equity, cannot be more than five times the bank’s equity. For borrowers who are persons related to the bank by certain relations, may not be greater than the amount of the bank’s equity capital. As of 2023, 2 full-fledged Islamic banks are operating in Kazakhstan: JSC Islamic Bank “Al Hilal” and JSC Islamic Bank “Zaman Bank”. Al Hilal is one of the first Islamic banks in the CIS, it was established in 2010 and is a subsidiary of an international financial institution of the same name. Over the past few years, the average annual growth rate of Islamic banks in the Republic of Kazakhstan has been 18%, in contrast to the industry’s average annual growth rate of 12%. Even though

Islamic banks are developing intensively, their share in the segment does not exceed 0.2% (Alieva, 2023).

The formation of Islamic banking in Kazakhstan began in 2009, which is somewhat later than in Kyrgyzstan. A significant circumstance concerning the development of Islamic banking in Kazakhstan is the virtually identical regulatory and legal burden concerning classical financial institutions. However, even though the country is home to a significant number of people who profess Islam, and the financial products and services of Islamic banks adequately meet the actual needs of both the business sector and the majority of individuals, the share of Islamic banking operations remains insignificant.

The main legal act that determines the functioning and regulation of Islamic banks in Tajikistan is Law of the Republic of Tajikistan No. 1108 “On Islamic Banking” (2014). In

addition, other regulatory legal acts of the National Bank of Tajikistan supplement the regulatory mechanisms of Islamic banking in the country, in particular Resolution of the Board of the National Bank of Tajikistan No. 87 “On Approval of the Instruction “On the Procedure for Regulating the Activities of Islamic Credit Organisations” (2019), which defines the regulatory mechanism of Islamic credit organisations.

Thus, the law that establishes the organisational and legal conditions of Islamic banking business in the Republic of Tajikistan states that an Islamic bank is an Islamic credit institution operating following the licence of the National Bank of Tajikistan and carrying out banking activities on the principles of Islam. In addition, it also provides for the possibility of classical banks to provide services on the principles of Islamic finance through an Islamic banking window – a subdivision of a traditional banking institution, carrying out the whole range or a separate part of banking

activities on Islamic principles (Law of the Republic of Tajikistan No. 1108, 2014).

Credit institutions operating following the principles of Islamic finance are authorised to use the term “Islamic” in their name. The names and symbols of credit institutions utilising the principles of Islamic finance may only be used for Islamic banking activities. In addition to the traditional governing bodies, an Islamic credit institution is also managed by an Islamic financial services committee (The Procedure for creating the Committee..., 2017). Such committee regularly forms and sends information regarding the compliance of Islamic finance principles in an Islamic bank, to the Supervisory Board of the bank. The same regulation and the aforementioned Law on Islamic Banking, in addition to the Islamic Financial Services Committee, define the requirements for the personnel responsible for the management of the Islamic bank and the Islamic window (Table 4).

Table 4. Summary of the requirements for members and executives of the Islamic bank, according to the legal acts of Tajikistan

Distribution	Requirements
Member of the Islamic Financial Services Committee	Availability of higher education (economic or legal). Knowledge of banking (Islamic) legislation and Islamic finance (certificate, diploma, certificate). Experience of study on a speciality in the banking system for 3 years. Absence of debts to the Islamic bank more than 2% of the size of its regulatory capital. Cannot supervise legal entities with interests related to the Islamic bank. Must not be a relative of a member of the Supervisory Board. Cannot work in a conventional credit organisation or another Islamic credit organisation.
Members of the Board of the Islamic bank, chairman, deputies, chief accountant	Higher economic education, training in Islamic banking and at least five years of study experience in the banking system, of which at least three years in the position of the head or deputy head of the economic structural unit. It is prohibited to be an employee of other traditional credit institutions or Islamic credit organisations, to hold the same position, to reside in the Republic of Tajikistan
Branch manager and chief accountant, head of Islamic banking window, chief accountant of Islamic banking window	Higher education in economics, education in Islamic banking and three years of study in financial and economic organisations of the banking system or other higher education with 10 years of experience in banking. It is prohibited to be an employee of other commercial credit institutions or Islamic credit institutions. It is necessary to have an employment relationship only with this Islamic credit institution, as well as reside in the Republic of Tajikistan.

Source: compiled by the author based on the Law of the Republic of Tajikistan No. 1108 “On Islamic Banking” (2014) and The procedure for creating the Committee on Islamic Financial Services, powers and requirements for its members (2017)

The National Bank of Tajikistan has established eight prudential standards for Islamic credit institutions, which are detailed in Instruction No. 224 “On Operations Carried out in Accordance with Islamic Principles of Financing in Islamic Credit Institutions” (2017). These include regulation of the minimum amount of share capital, limitation of the amount of share capital in a form other than cash, limitation of the level of risk per customer, regulation of capital adequacy, regulation of current liquidity, limitation of the level of risk associated with foreign exchange transactions, regulation of the use of funds belonging to Islamic credit institutions for the acquisition of shares in companies, limitation of the volume of Islamic credit lines. According to this instruction, the minimum authorised capital for new Islamic banks must be 5 times higher than the minimum authorised capital for conventional banks using Islamic windows.

The regulations regarding capital consist of the capital adequacy ratio, which should be at least 12% and the ratio of the Islamic credit institution’s regulatory capital to total

assets, which should be at least 10%. The current liquidity ratio should be at least 40%. In terms of risk, the upper limit of risk per customer or aggregate of customers is set at 20%. The maximum exposure per borrower/related party customer is set at up to 2% of regulatory capital and the total exposure to related parties cannot exceed 10% (The Procedure for creating the Committee..., 2017).

Compared to 2022, in 2023 (as of September), the number of banking institutions operating under the principles of Islamic finance in Tajikistan has not changed. There were 1 full-fledged Islamic bank and 2 traditional banks with Islamic windows (State of the banking system..., 2022). The assets of Islamic credit institutions accounted for just over 1% (1.034%) of the total assets of the country’s banking sector (Fig. 6). The share of the loan portfolio of Islamic credit institutions in the Republic of Tajikistan is less than 0.97%, and the share of Islamic banking in terms of deposit activity is only 0.56% of the total deposits of the banking system of the country.

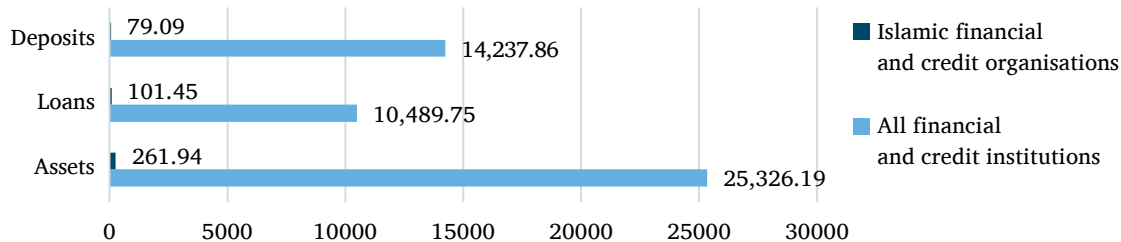


Figure 6. Ratio of the performance of Islamic credit organisations in Tajikistan to the banking system as a whole, at the beginning of 2023

Source: compiled by the author based on the Banking Statistics Bulletin (2022)

Based on the above, it is possible to note that the formation of legislative and regulatory support for the fundamental principles of regulation aimed at the activities of Islamic banking in the country began relatively recently after the adoption of a law specifically aimed at this area. The regulatory documents of the central bank of the country detail the regulatory mechanisms and procedures for banks to operate according to the principles of Islamic finance. As in the other above-mentioned countries, the volume of Islamic banking operations is significantly less than the volume of activities of traditional commercial banks in the country.

Discussion

The results of the study show that the regulatory policies for Islamic banking are designed to ensure compliance with Shariah (Islamic law), by financial institutions operating according to Islamic principles. Therefore, the opinion of A. Louhichi *et al.* (2020), who investigated the risks of Islamic banking regulation that these rules are set by the regulators in the respective jurisdictions and play a crucial role in regulating Islamic banks, is valid.

As E. Aslam and R. Haron (2020) argue in analysing the impact of governance on the performance of Islamic banks, the formation and adaptation of a legal framework specifically to regulate Islamic banking is of great importance. Regulatory policy provides a legal framework for the activities of Islamic banks, including the recognition of Shariah contracts and dispute resolution mechanisms, all these assertions are also supported by the findings of the study, which also shows that the legal regulation of Islamic banking by the state is based on the relevant law. For example, in Kyrgyzstan and Kazakhstan, Islamic banking is regulated by separate provisions of the laws on banking activities, while Tajikistan has adopted a special law that is aimed exclusively at the sphere of Islamic banking in the country (Mishchenko *et al.*, 2022).

It is worth noting that almost all aspects of the regulation of Islamic banks in Kazakhstan are provided for in the relevant section of the law “On Banks and Banking Activities in the Republic of Kazakhstan”, which is supplemented by resolutions of the Central Bank of Kazakhstan, which establishes prudential standards for Islamic banks, methodology of calculations and other mandatory requirements for Islamic banks. In the Republic of Kyrgyzstan, the law establishes only basic principles and mechanisms for regulating Islamic banking in the country, and specific regulatory mechanisms are supplemented by many regulatory documents in the form of resolutions of the National Bank of the Kyrgyz Republic (Mostovenko, 2023). The same approach operates in Tajikistan, where in addition to a separate law, the activities of Islamic banks (credit organisations) are regulated by

instructions and procedures approved by resolutions of the National Bank of Tajikistan.

An analysis of the regulatory and legal framework of the above-mentioned countries allows us to conclude that the possibility of Islamic banking in Kyrgyzstan and Tajikistan is provided in two forms – it is directly the establishment of an Islamic bank or the opening of an Islamic window by conventional banks. Unlike these countries, in Kazakhstan, the legislation does not provide for the possibility for classical banking structures to open such windows. That is, the legislation does not provide for the possibility for traditional banking structures to use Islamic financial instruments in their activities (Poyda-Nosyk & Markush, 2023).

Accordingly, Islamic banking is carried out exclusively by specially established banks according to the principles of Islamic finance. However, the law provides for the possibility of reformatting a conventional bank into an Islamic bank and establishes a mechanism for granting and reasons for refusal to issue a licence by an authorised state body to conduct a voluntary reorganisation of a financial institution in the form of transformation into an Islamic bank. Comparing these results with the study of N.S. Shirazi *et al.* (2022), it is possible to agree that this feature is one of the key factors that hinder the development and spread of Islamic banking in Kazakhstan.

Furthermore, it is possible to conclude that this regulatory component also affects the fact that Islamic banks in Kazakhstan are not members of the mandatory deposit guarantee system. Therefore, deposits of individuals in Islamic banks are not guaranteed by such a system, although such financial institutions have the right to establish non-profit organisations that can guarantee the return of deposits in case of bankruptcy of the bank. The same approach is provided for in the legal framework of Tajikistan. In contrast to Kazakhstan and Tajikistan, in the Kyrgyz Republic, conventional banks that have opened Islamic windows and operate according to the principles of Islamic finance are participants in the deposit protection system, which is provided for in the Law “On Protection of Bank Deposits”. To obtain a licence, following Chapter 4, paragraph 37, subparagraph 21 of the regulation, Islamic banks are obliged to submit documents for participation in the Deposit Protection Fund (Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2018-P-12/30-3-(BS), 2018).

As the results of the study show, the legislation of all the above-mentioned countries regulates the specifics of using the phrase “Islamic bank” in the names of banking institutions. In Kyrgyzstan, as well as in Tajikistan, only financial institutions that provide services based on the principles of Islamic finance have the right to use this phrase in their names. However, in Kazakhstan, financial institutions of the

banking system that provide Islamic banking are required to include the phrase “Islamic bank” in their names.

The results of a study obtained by S. Meslier *et al.* (2020) indicate that regulators often require Islamic banks to have Shariah supervisory or advisory boards. Such boards are composed of Islamic scholars and experts in Islamic finance who make recommendations on the compliance of financial products and operations with Shariah law. This is also confirmed by the results of the conducted research on the countries of Central Asia. Thus, in the Kyrgyz Republic, Kazakhstan and the Republic of Tajikistan, the legal and regulatory framework governing the specifics of the activities of institutions related to Islamic banking obliges the establishment of the Shariah Board (Kyrgyzstan), the Board on the principles of Islamic Finance (Kazakhstan) and the Committee on Islamic financial services (Tajikistan).

These structures are based on ensuring that the financial products and services provided by the banking institution comply with Islamic principles and Shariah law. However, the analysis of regulatory and legal documents shows that in Kazakhstan the requirements for candidates to the members of such councils are set by the Islamic bank itself and specified in the charter of the organisation, which differs from the norms of regulation of this aspect in Kyrgyzstan and Tajikistan. Thus, in Kyrgyzstan, based on Chapter 18, Section 4, the regulations defining licensing requirements for Islamic banks, regulate the requirements for representatives of the Shariah Board of the Islamic bank, as well as the chairman of such a council (Resolution of the Board of the National Bank of the Kyrgyz Republic No. 2022-P-12/78-7-(NPA), 2022). In Tajikistan, the regulations regulate the requirements for the members of the committee on Islamic financial services, in particular, Law of the Republic of Tajikistan No. 1108 “On Islamic Banking” (2014) and Resolution of the Board of the National Bank of Tajikistan No. 87 “On Approval of the Instruction “On the Procedure for Regulating the Activities of Islamic Credit Organizations” (2019).

As the analysis has shown, the general requirement for members of such bodies is higher education and knowledge necessary for study in the field. The requirements for work experience are also regulated, however, in Kyrgyzstan the requirements for this aspect are somewhat simpler, it is necessary to have one year of study experience in financial and credit organisations, or in educational institutions for more than two years, while in Tajikistan the required work experience in the banking system is at least 3 years.

It should be noted that the Kyrgyz Republic also has additional, more severe requirements for the Chairman of the Shariah Board, while in Tajikistan the requirements for such a position are not regulated. Compared to other countries, more demanding regulations are set for the management staff of Islamic banks in Tajikistan. In particular, the head of the bank and the chief accountant must have a higher economic education, working experience in the Islamic banking, work more than five years in banking structures, and it is necessary to work in a managerial position for 3 years. The legal documents of Kyrgyzstan provide only the need for two years of study in the banking system.

Besides the above-mentioned, as the comparative analysis shows, the legal and regulatory frameworks of Kyrgyzstan, Tajikistan and Kazakhstan provide prudential norms to which Islamic banks must comply, and in the case of Tajikistan and the Kyrgyz Republic also conventional

banks with Islamic windows. The common and main prudential requirement is the rationing of the amount of authorised capital of Islamic banks and banks with Islamic windows. Also, concerning capital, Kyrgyzstan has additionally established requirements for the amount of the bank’s equity capital. A common feature of prudential regulation is the establishment of capital adequacy parameters.

Thus, in Kazakhstan and Kyrgyzstan, the level of adequacy is set both by type of capital (core, Tier 1, Tier 2 capital) and depending on whether the bank is systemically important or not (Ikra *et al.*, 2021; Junaidi *et al.*, 2022; Abasimel, 2023). It should be noted that Kyrgyzstan has slightly more demanding regulations, but not significantly so, the difference is 1-2%. In Tajikistan, the capital adequacy of an Islamic bank is normalised by two indicators, the capital adequacy ratio and the ratio of regulatory capital to total assets.

Liquidity is also a common financial and economic indicator regulated by central banks (Makarchuk *et al.*, 2022). The Kyrgyz Republic and the Republic of Kazakhstan have set several liquidity ratios. In Kyrgyzstan, these are the general liquidity ratio, instantaneous liquidity ratio, short-term liquidity ratio, and in Kazakhstan, current liquidity ratio and term liquidity ratios (5 ratios). At the same time, Tajikistan’s regulations regulate only one indicator – the current liquidity ratio for Islamic banks. Comparing this norm with identical norms of other countries, it is possible to conclude that Kyrgyzstan has a less demanding level of this indicator – 35%, while in other countries – 40% (Karim *et al.*, 2022; Riaz *et al.*, 2023; Hanic & Smolo, 2023).

In addition, the regulations of all three countries pay considerable attention to regulating the maximum amount of risk that can be allowed per borrower of an Islamic bank (Mishchenko *et al.*, 2022). In Kyrgyzstan it is 20% or 30%, depending on the type of borrower, in Kazakhstan, it is 10% or 25%, and in Tajikistan, it is 20% (Čihák & Hesse, 2010; Kettell, 2011; Beck *et al.*, 2013). Large exposures can also be defined and regulated. In addition to general prudential norms, specific requirements are also applied, such as the procedure for provisioning (Kyrgyzstan), capitalisation of banks to liabilities to non-residents (Kazakhstan), financial instruments based on Islamic principles, maximum permissible size of credit lines, guarantees and sureties provided by Islamic banks to their shareholders (Tajikistan).

To summarise the aforementioned information, it is possible to state that, as in the case of conventional banking, the regulation of Islamic banking has several general principles and approaches, which consider the principles of Shariah and are reflected in the regulatory and legal documents of Kyrgyzstan and other Central Asian countries, in particular Kazakhstan and Tajikistan. The specifics of the economy and the sphere of finance determine some differences in the legal regulation and, accordingly, the functioning of Islamic banking, but it should be noted that it is the legal and regulatory support and regulatory policy are the basis for the development and spread of Islamic banking within the financial system of the state.

Conclusions

The Islamic banking, as a type of banking activity, is based on the principles of Islamic Finance, formed on the foundations of Islamic law, which prohibits the use of interest and requires fairness and ethics in financial transactions. Since the Islamic banking operates based on Shariah law,

governments are seeking to develop specific standards and regulations to ensure compliance with these principles, especially in countries where the traditional banking system operates in parallel, such as Kyrgyzstan and other Central Asian countries.

A comparative analysis of legal and regulatory documents of Kyrgyzstan, Kazakhstan and Tajikistan shows the existence of both common and different approaches to legal support and regulation of Islamic banking. The common feature of legal regulation is the presence of law and complementary legal acts, by which the central banks of the countries detail the features of regulatory policy.

A Shariah Board (or a similar governing body) is a mandatory requirement for the establishment of Islamic financial institutions in Kyrgyzstan, Kazakhstan, and Tajikistan. Despite the existing differences in prudential regulations for Islamic banks in Kyrgyzstan, Tajikistan, and Kazakhstan, for the most part, they are both in essence and quantitatively quite similar. The key economic requirements in all the above-mentioned countries are to ensure a certain level of capital adequacy, liquidity, and maximum risk per borrower. A key distinguishing characteristic of the regulation of Islamic banks between Kazakhstan on the one hand, Kyrgyzstan, and Tajikistan on the other hand, is the lack of possibility for conventional banks in Kazakhstan to operate according

to Islamic finance principles by opening Islamic windows. In addition, in Kazakhstan and Tajikistan, unlike Kyrgyzstan, where it is obligatory, Islamic banks are not participants in the mechanism of protection and guaranteeing of deposits.

Since the legal regulation of banks' activities following the principles of Shariah in Kyrgyzstan, Kazakhstan and Tajikistan has been formed relatively recently, Islamic banking is still at the beginning of its development, which is also evidenced by the insignificant volume of activities of banks operating on the principles of Islamic finance. Therefore, it is recommended to consider the possibility of expanding the range of competition, compared to classical banks, services and products provided to both enterprises and individuals, which will increase the level of demand and popularity of Islamic banking. Further research should be aimed at developing a legal mechanism for the practical implementation of this recommendation by making appropriate amendments to the current legislation of Kyrgyzstan, which regulates the Islamic banking.

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Conflict of interest

None.

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Анотація. Правове регулювання ісламського банкіngu відіграє ключову роль у забезпеченні розвитку цього виду фінансової діяльності, особливо це актуально для країн, де переважає населення, що сповідує іслам, до яких належить Киргизька Республіка та інші країни Центральної Азії, зокрема Республіка Казахстан та Республіка Таджикистан. Тому мета дослідження полягає в тому, щоб проаналізувати та зіставити особливості нормативно-правової бази, яка забезпечує регулювання діяльності ісламських банків. У статті були використані методи правового аналізу, статистичного аналізу, групування, узагальнення, порівняння та абстрактно-логічного мислення. Інформаційною основою для здійснення цього дослідження послужили чинні закони та нормативно-правові акти Киргизстану, Казахстану та Таджикистану у сфері регулювання ісламського банкіngu. У дослідженні проаналізовано закони, що встановлюють засади функціонування та регулювання діяльності ісламських банків, а також нормативно-правові документи національних банків Киргизької Республіки, Казахстану та Таджикистану. У дослідженні виділено та проаналізовано ключові вимоги, встановлені до створення ісламських банків, ісламських рад, що діють при таких банках, а також до пруденційних нормативів для фінансових установ, які діють за принципами ісламських фінансів. Порівняльний аналіз нормативно-правових документів дав можливість сформулювати як загальні, так і різні підходи, які використовуються для забезпечення та регулювання діяльності ісламських банків. Встановлено, що ключовою відмінністю правового регулювання діяльності ісламських банків у Казахстані, порівняно з Киргизстаном і Таджикистаном, є відсутність можливості для банківських структур поєднання традиційної банківської діяльності з діяльністю, заснованою на основах ісламської фінансової справи. Результати дослідження можуть бути використані органами, що формують законодавчу базу та здійснюють регулювання діяльності ісламських банків, суб'єктами, що функціонують у банківській системі, а також науковою спільнотою, що цікавиться забезпеченням правового регулювання ісламського банкіngu в Киргизстані та інших країнах Центральної Азії

Ключові слова: шариатські засади фінансування; кредитні організації; фінансове законодавство; фінансова система; керування; державний контроль