



## THE DEVELOPMENT OF THE ISLAMIC BANKING IN THE CIS COUNTRIES: EXISTING BARRIERS AND EXPECTED OPPORTUNITIES

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Article history:	Abstract:
<b>Received:</b> June, 11 <sup>th</sup> 2021 <b>Accepted:</b> July, 7 <sup>th</sup> 2021 <b>Published:</b> August 20 <sup>th</sup> 2021	This article is devoted to a clear reflection and analysis of the factors that necessitate the introduction of Islamic banking as an alternative to the traditional banking system in overcoming the main problem indicators of the current situation of monetary policy in the CIS countries. The study examines the important steps for the introduction of Islamic banking in the countries of the region, attitudes towards them, as well as the obstacles encountered and their possible solutions. Almost all statistical tables and diagrams reflected in the article were prepared by the author based on the sources of international financial institutions and rating agencies.

**Keywords:** Commonwealth of Independent States (CIS), Islamic banking, Islamic Development Bank (IDB), Islamic Corporation for Development of the Private Sector (ICD), Islamic finance, macroeconomic indicators, money supply, inflation, monetary policy, liquidity.

### INTRODUCTION

Being home to most countries with a high share of Muslim population, the Commonwealth of Independent States (CIS) region is emerging as a region of opportunity for the development of the Islamic finance industry (Table 1), underpinned by low banking penetration and increased demand for financing. While progress has been slow for the most part, the region is now catching up and recognizing its vast potential. The region has witnessed an increase in Islamic finance activity in the past decade, although it remains largely fragmented. Even in countries without formal Islamic

finance regulations, there have been cases where Sharia'a compliant instruments and transactions were issued and executed while remaining applicable within the current legislative framework. In this respect, the Islamic Development Bank (IDB), along with its private sector arm, the Islamic Corporation for the Development of the Private Sector (ICD), has played an instrumental role in leading Islamic finance initiatives in the region. Since 2011, ICD heads its CIS countries' operations from the IDB Group Regional Office located in Almaty, Kazakhstan.

**Table 1. Muslim population growth by CIS countries (rounded to thousands)[1]**

Country	Estimated 2010 Muslim Population	Percentage of 2010 Population that is Muslim	Projected 2030 Muslim Population	Projected Percentage of 2030 Population that is Muslim*
Uzbekistan	26,833,000	96.5%	32,760,000	96.5%
Russia	16,379,000	11.7%	18,556,000	14.4%
Kazakhstan	8,887,000	56.4%	9,728,000	56.4%
Azerbaijan	8,795,000	98.4%	10,162,000	98.4%
Tajikistan	7,006,000	99.0%	9,525,000	99.0%
Kyrgyzstan	4,927,000	88.8%	6,140,000	93.8%
Turkmenistan	4,830,000	93.3%	5,855,000	93.3%
Georgia	442,000	10.5%	433,000	11.5%
Ukraine	393,000	0.9%	408,000	1.0%
Belarus	19,000	0.2%	17,000	0.2%
Moldova	15,000	0.4%	13,000	0.4%



## RESULT AND DISCUSSION

**Uzbekistan.** It would be more clear to define the necessity of introduction of Islamic banking services into the national economy of Uzbekistan through analyzing the one of the main current crucial problem faced by the commercial banks of the country, which is assessed as the "main risk" in the sources of interest risks allocated by the Basel Committee. This situation is mainly due to the risk of changes in interest rates on bank loans/credits and deposits as a result of a violation of the correlation between different financial instruments. In particular, according to the latest financial statements of the commercial banks, 70 percent of bank deposits have been short-term ones whereas 90 percent of credits/loans have been given for a long-term period. In some commercial banks, current

expenditures account for 60-70 percent of banks' revenues [2]. In this case, special attention should be paid to the fact that loans/credits are revalued on the basis of the refinancing rate while deposits are revalued depending on the level of yield on short-term government bonds. Indeed, the breakdown of the correlation between the refinancing rate and the level of profitability of short-term government bonds directly affects the bank's margin. The above indicators show that the most lagging factor in the banks of the country is the issue of long-term attraction of customers and financial resources. Based on a study conducted by Global Findex Data, the average level of savings of the population of Uzbekistan and European-Central Asian countries in financial institutions via comparative calculations are demonstrated below: (Table 2)

**Table 2. Level of savings of the population in financial institutions, % [3]**

	Uzbekistan			Europe and Central Asia		
	2011	2014	2017	2011	2014	2017
<b>Female</b>	<b>0,5</b>	<b>1,6</b>	<b>1,6</b>	<b>23,2</b>	<b>28,2</b>	<b>31,7</b>
<b>Male</b>	<b>1,1</b>	<b>2,1</b>	<b>3,1</b>	<b>26,3</b>	<b>33,7</b>	<b>37,1</b>
<b>Youth (between the ages of 15-25)</b>	<b>0</b>	<b>0,6</b>	<b>1,1</b>	<b>19,4</b>	<b>25</b>	<b>22,1</b>
<b>Middle-aged and elderly people (25+)</b>	<b>1,2</b>	<b>2,4</b>	<b>2,8</b>	<b>25,9</b>	<b>31,9</b>	<b>36,6</b>
<b>People with primary education</b>	<b>0,6</b>	<b>0,8</b>	<b>1,2</b>	<b>10</b>	<b>13,4</b>	<b>21,9</b>
<b>People with secondary education</b>	<b>0,9</b>	<b>2,3</b>	<b>2,8</b>	<b>29,2</b>	<b>34,7</b>	<b>37,7</b>

It can be concluded from the above indicators that in 2011-2017s, the average growth rate of savings in Uzbekistan compared to the general population was 8.3 percent, of which 1.1 percent for women, 2 percent for men, 1.1 percent for youth aged 15–25, 1.6 percent for people over 25 years of age, 0.6 percent for those with primary education and 1.9 percent for the others with secondary education. But unfortunately, these

figures is lagging significantly behind those in Europe and other countries of Central Asia, with an average of 29.1%. The main factors for this issue have been analyzed by the Asian Development Bank through researches of the level of financial activity of the population in member countries, including Uzbekistan: (Table 3)

**Table 3. Analysis of the main reasons for the non-use of financial services and the lack of bank accounts of Uzbek citizens [4]**

		Reasons for not using financial services,%	Reasons for not having a bank account,%
<b>1</b>	<b>The high cost of financial services</b>	<b>44</b>	<b>11.2</b>
<b>2</b>	<b>Religious views</b>	<b>30</b>	<b>2.0</b>
<b>3</b>	<b>Use by other family members</b>	<b>30</b>	<b>16.6</b>
<b>4</b>	<b>Lack of necessary documents</b>	<b>21</b>	<b>17.6</b>
<b>5</b>	<b>The remoteness of financial institutions</b>	<b>12</b>	<b>11.8</b>
<b>6</b>	<b>Lack of confidence in financial institutions</b>	<b>10</b>	<b>9.8</b>



<b>7</b>	<b>Lack of funds for the use of services in financial institutions</b>	<b>0.4</b>	<b>35.9</b>
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Based on the data in the Table 3, it can be concluded that all of the above factors have a significant impact on the lack of access to financial services and bank accounts among the population, and this explanation indicates a strong correlation between them. More precisely, when the indicators of these factors change, the level of population savings in financial institutions also changes inversely. The largest share among these factors are the cost of financial services - 44% and religious views - 30%, both of which, on the one hand, require an increase in financial literacy of the population, on the other hand, demand commercial banks to introduce competitive financial products that provide affordable and alternative choices for customers. Indeed, the active movement of free money in the hands of the population in the economy, the use of it to finance targeted investment projects could prevent the factors leading to the economic crisis, such as the deterioration of the country's macroeconomic indicators, including an increase in the money supply due to a decrease in the velocity of money and, as a result, an increase in inflation rate, and so on. In addition to overcoming these problems, in order to increase the investment activity of banks, as in the practice of developed countries, it is necessary to study bank deposit products offered by the Islamic banking sector, which have indicators of sustainable development in the global economy, and accordingly, it can be assumed that the implementation of this process will have a positive impact on the future prospects of the country's banking system. Conducted researches in recent years show that the development and growth of the Islamic financial industry in the region is more likely to enable the majority of citizens, in particular, those who follow Islamic rules and avoid traditional financial services, to participate on a large scale in the country's economy.

**Kazakhstan.** The Republic of Kazakhstan was the first founding country to introduce Islamic finance and become a member of the International Islamic Financial Institutions in the CIS region (including the IDB in 1995, the Islamic Financial Services Board (IFSB) in 2011, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM) in 2014), which is still continuing to actively cooperate. In 2009, Kazakhstan became the first in the region to alter its legislation in order to facilitate Islamic banking and finance. In

particular, it relaxed the conventional taxation system, which was too burdensome for banking mechanisms that do not operate through interest rates. However, despite active steps taken to improve the legislation, Kazakhstan still lacks a systematic approach to the introduction of Islamic finance. The ongoing practice of amending and modifying various legal regulations confirms that the country does not have the necessary legal infrastructure to develop the Islamic financial services industry. According to the Law of the Republic of Kazakhstan "On Banks and Banking", the Islamic bank is a second-tier bank that carries out banking activities on the basis of a license of the competent authority. The Islamic Bank is not a member of the Compulsory Deposit Insurance System and deposits in the Islamic Bank are not guaranteed by the Compulsory Deposit Insurance System. In accordance with the legislation of the country, as part of the financing of trade activities by the Islamic Bank, as a trade intermediary through the issuance of commercial loans, the transfer of property that is part of the income to be received by the Islamic Bank is exempt from value added tax (VAT). Unfortunately, any transactions of banks with a trading mechanism (sale and purchase of reserves, fixed assets, etc.) are subject to VAT. Despite the fact that the current legislation exempts VAT on Islamic finance, the main amount of the loan is taxed, which makes the financial products offered by Islamic banks unprofitable for both the bank and the customer. At present, there are two actively proceeding full-fledged Islamic banks in Kazakhstan: Abu-Dhabi based Al-Hilal Bank established in 2010, under an agreement between Kazakhstan and UAE, and Zaman Bank, which was previously established as a conventional bank, then was completely converted into Islamic banking sector. Within the CIS region, the Islamic banking sector in Kazakhstan constitutes 70% of the total Islamic finance assets; however, domestically, Islamic banking assets still account for less than 1% of the total Kazakhstan banking industry, which is worth USD 1 billion. Digitalisation and strong government support are providing a major boost to Islamic banking. To date, Kazakhstan's government aims to boost the share of Islamic banking assets to 3% of total banking assets in the country by 2025 from the current 0.2%. [5]

**Kyrgyzstan.** Attention to the development of a regulatory framework for Islamic banking has also been a key focus in the Kyrgyz Republic. Improvement of the legal and regulatory framework has been initiated to



support the growth of Islamic banking assets, among other risk management and corporate governance measures. Such developments contribute to a positive outlook for stable growth of the Islamic banking sector there to improve on its existing 1.5% market share and Kyrgyzstan aims to expand it to 5% by 2021. [6] As one of the main factors for Kyrgyzstan to achieve its own priority position on Islamic finance industry in CIS region, can be provided its initial path on the issuance of a license for OJSC "EcoIslamicBank" for the right to carry out transactions according to Islamic principles of financing in accordance with the Regulation "On the implementation of Islamic principles of financing in the Kyrgyz Republic within the framework of a pilot project" approved by the Resolution Of the Board of the National Bank of Kyrgyz Republic in 2006. The bank, in accordance with the obtained license, have been able to carry out the financial transactions under the contracts such as *mudaraba*, *murabaha*, *ijara* and *ijara muntahiya bittamlik*, *qard-hasan*, *istisna*, *wadia yad damana* as well as *warranty operations*. It is noteworthy that in Mudaraba transactions, the bank acts not as a creditor, but as a partner, who shares profits and losses with the borrower. On April 28<sup>th</sup>, 2008, the first meeting of the Sharia Council in the CIS region was held at OJSC "EcoIslamicBank". At the meeting of the Sharia Council, the normative documents which includes questions about dividing the bank's balance sheet into Islamic and traditional, and the methodology for distributing profits between depositors were considered and approved. At the current time, the bank is achieving the trust of many residents by supporting the Islamic position of financing and providing a comprehensive range of financial services to customers across Kyrgyzstan over 120 branches. It has been operating according to international accounting and reporting standards and its financial results are steadily profitable. [7] All in all, the long history of EcoIslamicBank addresses will be a great example for many other young financial institutions in CIS countries, which are at the initial stage of their successful development.

**Azerbaijan.** Kauthar Bank was the first Islamic bank in Azerbaijan, which had been founded in 1996 and began its transformation to work on Islamic financial principles in 2001. According to the analysis of the bank's audit statements, the bank was marked as a small sized since its assets amounted to only 17 billion USD as of 2009 [8], and as well was owned by individuals, including non-residents from countries as Japan, Saudi Arabia and Canada. Majority of bank's clients were individuals, small and medium-sized businesses. As a result of successful economic activities, the bank has been recognized as the best Islamic bank in Azerbaijan by

financial publications such as World Finance and Global Finance in 2013-2014s. Even though the bank had also signed a cooperation agreement with Islamic Development Bank for further expansion and progress of his proceeding services by that period, in 2006, it never advertised its work and did not announce itself loudly.

In 2007, International Investment Bank (belong to Bahrain) acquired 49% stake in the Amrahbank (belong to Azerbaijan) with 46,8 million USD for its complete transformation into an Islamic bank. Amrahbank has existed in market since 2003 and was privately owned. The owners expected Amrahbank to become a pioneer in Azerbaijan in providing financial services based on Sharia as a result of a contribution of rapid economic growth and development of the banking sector into this investment project. International consulting companies such as Deloitte, E&Y, Baker & McKenzie acted as consultants on these dealings. The acquisition of Amrahbank by the Bahraini investor allowed the first to establish cooperation with a number of well-known Middle Eastern financial structures as Gulf Finance House, Islamic Trade Finance Corporation (IDB group), Turkapital Holding. Furthermore, the bank attracted additional financing from the Saudi Fund for Development, Islamic Corporation for the Development of the Private Sector (IDB group) and OPEC Fund for International Development. Despite these achievements, the new owners did not succeed in converting Amrahbank into an Islamic bank owing to the absence of proper legislation, accordingly, the bank has still been operating as a traditional financial institution. In 2013, the Bahraini investor initiated a partial withdrawal (sale) from Amrahbank, but in 2018, the bank was still in the investor's portfolio despite the recommendation of the Sharia Committee on the complete withdrawal of their asset as indicated in the annual report.

While working with the corporate sector, Islamic financial standards were used by many traditional banks of Azerbaijan, which attracted financing from the IDB for the development of small and medium-sized businesses: Turan Bank (13.8 million USD), and Rabita Bank (2.6 million USD), and Unibank (21.7 million USD), and Standard Bank (3 million USD), and Azerdemiryol Bank (3 million USD). It should be noted that such financing is provided by international development banks without government guarantees. At the end of 2010, one of the recipients of capital from the IDB, the Turan Bank, announced its intention to apply Islamic financial standards not only in the corporate, but also in the retail sector. In the same year, the IDB also claimed that it is ready to participate in the establishment of an Islamic bank in Azerbaijan, but for





this, the ministries of economic development and finance should first apply with such an initiative. However, no attempts were made to establish a full-fledged Islamic bank in Azerbaijan, but the initiative to create an Islamic window was implemented within the framework of the largest state bank - the International Bank of Azerbaijan (IBA). Then, in 2009, a special group was created in the IBA to organize an Islamic banking window, and a year earlier the bank opened representative offices in Qatar and Dubai (now closed). The Islamic banking window at the IBA was opened in September 2012, but was later reorganized as an Islamic Banking Subsidiary. In creating such a structure, IBA was assisted by a consortium of international consultants as Salans, KPMG, Pinsent Masons and Daral Sharia, and it was expected to make the country a regional leader in Islamic finance by the formers. In 2013, the new department began serving clients, and the list of services offered, included *ijara*, *wakala* deposit, *Islamic bank cards* and *qard hasan accounts*. In 2014, the IBA took the 219th place (out of 360 possible) in the rating of the top Islamic Financial Institutions by the British magazine "The Banker". "At the end of 2013, the assets of the Islamic Banking Department of the bank amounted to USD 180 million, which amounted to approximately 1.8% of the total assets of the IBA. The net income from Islamic operations of the bank at the end of last year amounted to 7.69% of the total income of the bank. In the rating, which includes only commercial banks, the IBA took the 156th line out of 214 possible. Nevertheless, the transparency of the banking system in Azerbaijan is low: the majority of the banks in Azerbaijan, including the IBA, do not publish financial statements, therefore it is almost impossible to carry out an objective analysis of the results of their activities. But according to the management of this department, the successes were very impressive: "for 9 months of 2014, the total volume of deposits of the population in Baku increased almost 10 times: if as of January 1 of this year, the total volume of deposits amounted to 1.69 million manats, then by the beginning of October, this figure increased to 10.1 million manats, and the investment portfolio of the department increased 1.5 times, and amounted to 175.7 million manats. The total amount of funds attracted from international financial markets as of October 2014 amounted to \$ 218.7 million [9]; a quote from another interview informs us that "the IBA's portfolio in Islamic banking amounted to about 172-173 million manats. Of these, about 130 million manats, where 45% were allocated for financing mortgages, falls on leasing. The remaining 42-43 million manats fall on corporate and consumer financing [10]. On this wave, it was planned that by the end of 2014, Islamic

banking will be presented by the IBA outside Baku: the corresponding departments were planned to open in the countries: Ganja, Lankaran and Sumgait. The banking market regulator was also satisfied with the results of the pilot project. At the peak of its popularity, the IBA's Islamic finance portfolio amounted to \$ 526 million [11]. A unique model on alternative banking has been tested in Azerbaijan, which was able to achieve success without a legislative base, starting from servicing retail clients, issuing plastic cards within the framework of Islamic finance and ending with documentary operations for large corporate clients. However, despite these results, in October 2015, the IBA's Islamic Banking Department was abolished due to the international banking scandal associated with the former Chairman of the IBA Board and his family, as well as the actual declaration of default on the bank's external liabilities [12;13].

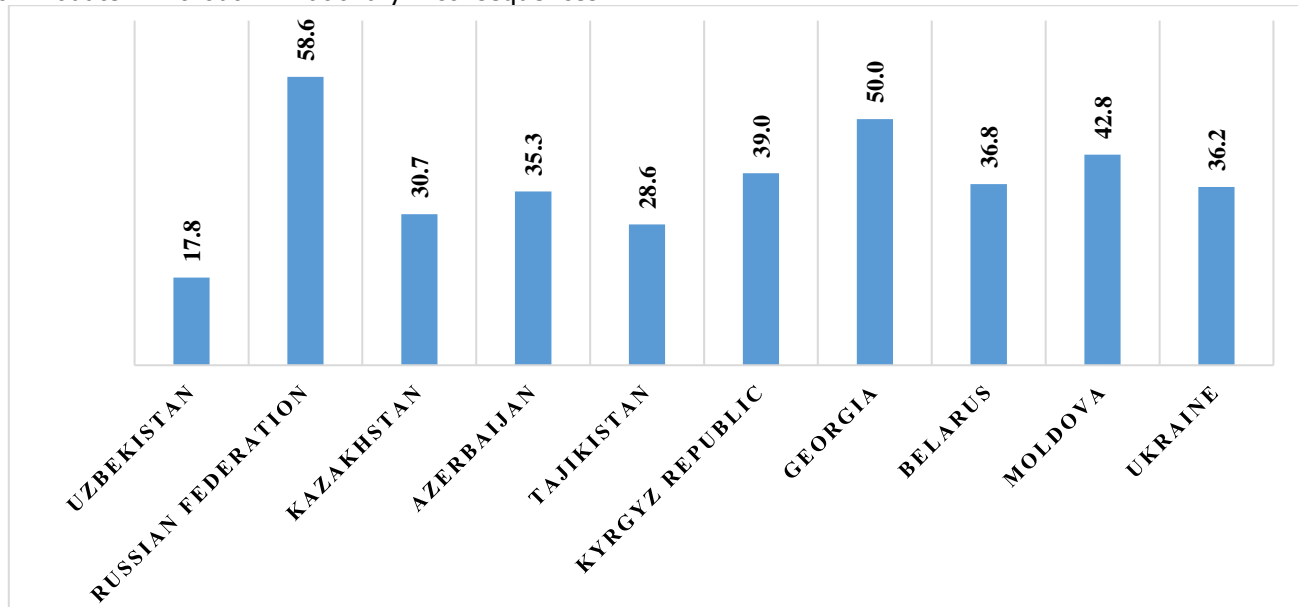
Despite further attempts to use a grant allocated by the IDB for the development of legislation and discussions about opening an independent Islamic bank with branchless services, this topic came to naught, and accordingly, in 2019, the international rating agency Moody's assessed the development potential of Islamic banking in Azerbaijan as low. According to the agency's analysts, the government is currently not planning to progress the Islamic banking because its focus is on creating a secular state and economy. In addition, they explained the situation with notes: "Without decisive government intervention in the development of the sector, its growth will be limited" [14].

**Tadjikistan.** In spite of high rates of economic growth within last years, the economy of Tadjikistan lacks financial resources, which is being clearly evidenced by a number of financial indicators. The lack of financial resources is most clearly demonstrated by the indicators of the financial depth of Tadjikistan, calculated by the World Bank. The financial depth of an economy shows the extent to which businesses, households, and governments finance their activities through capital markets, banks, and other financial intermediaries. This concept was originally used by experts of the World Bank to assess the level of financial resources of the economy of a state, region, group of countries. The main indicators of the financial depth of the economy are the monetization coefficient and an indicator of the credit depth of the economy for countries with a dominant banking sector in the financial system. The above provided view on the lack of financial sources in Tadjik economy can be proved through conducting a brief comparative analysis of these two indicators



between their level in Tajikistan and the level of other CIS countries. The monetization coefficient of the economy expresses the volume of liquidity that the national economy can accommodate without inflationary consequences.

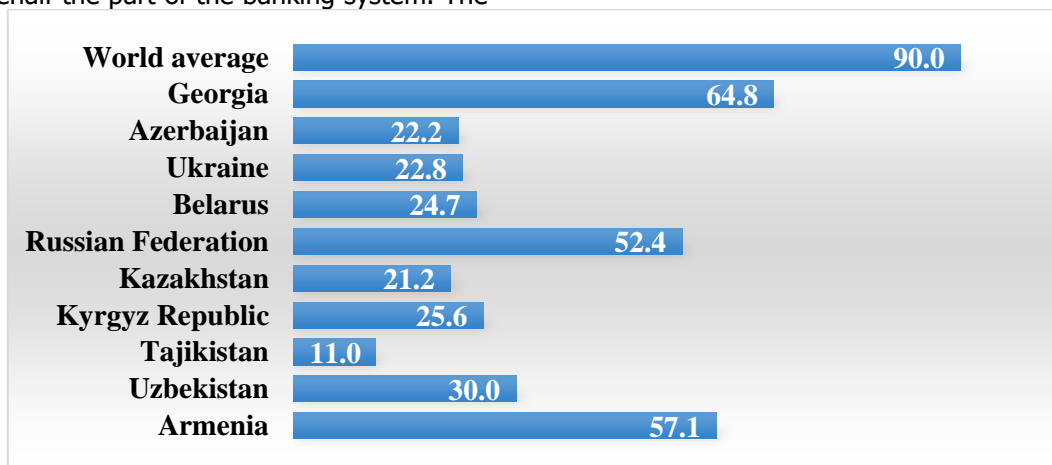
Monetization of the economy is an integral indicator reflecting public confidence in the national currency, the policy of the monetary authorities, as well as the level of credit activity. (Figure 1)



**Figure 1. Monetization coefficient of the economy (broad money (% of GDP)) in the context of CIS countries [15]**

As can be seen by Figure 1, the values of this indicator for Tajikistan and Uzbekistan is perceptibly low in comparison with other CIS countries and the world average according to the World Bank classification. The indicator of the credit depth of the economy is defined as the ratio of domestic loans provided by the banking system to the private sector to GDP. At its core, this indicator reflects the confidence in the private sector of the country behalf the part of the banking system. The

low level of trust leads to a rather significant scale of foreign exchange in the country, which is a special form of capital outflow, and also entails a high interest rate on loans. For Tajikistan as well as other Central Asian countries such as Uzbekistan, Kazakhstan, and Kyrgyz Republic, as countries with a bank-oriented financial system, this indicator is the main one in the list of indicators of financial depth. (Figure 2)



**Figure 2. Domestic credit to private sector by banks (% of GDP) [16]**



As follows from the diagram data, the credit depth indicators of all CIS countries, including Central Asian countries are perceptibly lower than the world average. Accordingly, all analyzed indicators are proving the fact- a low level of saturation of the Tajik economy with money. The level of provision of the economy with financial resources in the country is one of the lowest in the CIS region. The main limiting factor for the expansion of monetary policy is the underdevelopment of the financial market in the country, which could offer alternative forms of bank deposits and investments in foreign currency for the population and business entities. In the context of an underdeveloped financial market, any increase in the money supply will lead to an increase in prices. Moreover, banks are reluctant to finance small and medium-sized enterprises, since they are small in size, poorly diversified, and have problems with providing collateral for loans. Their weak side is also financial management: in most enterprises, not qualified specialists, but the owners themselves are engaged in finances, and accordingly, assessing all these risks, banks voluntarily are reluctant to lend to SMEs. In addition, operations for servicing SMEs are less profitable for banks in comparison with large business operations. All the above issues related to the financial situation of Tajikistan have made the introduction of alternative banking services to the economy emergent, and accordingly, the offer of Islamic banking products has become not only an opportunity but also a necessity for the country.

The central idea of Islamic banking is that money itself has no intrinsic value and cannot increase on its own. In order to increase the money supply, it need to be used productively, which is explained to be a real capital when it is invested in production activities. The most important difference between Islamic and conventional financial system is that it is based on the movement of goods, not money. Making a profit without mutual provision of material values is contrary to the ethical norms of Sharia. Unlike traditional commercial banks, which receive interest on funds provided on a loan, regardless of the result of the borrower's activities, in Islamic banking all participants in commercial activities are jointly and severally responsible for its results. The bank shares with the borrower both profit and risks. The unique principle of distribution of profits and losses allows Islamic banks to invest in projects with a long payback period. Islamic banks are more careful in choosing a client, since in case of failure they incur greater losses than traditional commercial banks. Thus, Islamic banking is focused on the development of the real sector and in its operations connects money with real production. Thus, Islamic banking contributes to the non-inflationary development of production. On

the territory of the Republic of Tajikistan, in accordance with the law "On Islamic Banking" in 2019, the first bank, "Tavhidbank", received a license to conduct operations on the principles of Islamic finance. The bank has encouraged other lending institutions to use this alternative to traditional banking, and as a result, credit institutions MFR "Humo" and MCF "Imon" opened Islamic banking windows. At the same time, it should be noted that the Islamic banking market in Tajikistan is still in its infancy. The set of operations is extremely narrow yet and often comes down to the purchase and sale of goods in installments.

### CONCLUSION

In conclusion, although Islamic finance is still in its infancy stage in CIS countries, there is no doubt that there is room to grow if all challenges are addressed and appropriate measures are undertaken. Indeed, all of the above represent obstacles to success, but not complete barriers to growth. The benefits of Islamic banking system are manifold: it has the potential to significantly contribute to higher and more inclusive growth while reducing economic disparity, and it promotes macroeconomic and financial stability. Choosing to accept it as a financial discipline will only reap in rewards and foster prosperity in CIS region. The only one necessary requirement should be met- the benefits of Islamic banking can only be achieved if its transparent nature and purpose are matched by existing practice in the relative countries.

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