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A COMPARATIVE STUDY BETWEEN CONVENTIONAL AND INTEREST-FREE BANKING SYSTEMS: A CASE OF TURKEY AND MOROCCO

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Abstract

The purpose of a financial system, whether conventional or Islamic, is the mobilization of financial resources and their allocation between different investment projects. Thus Interest-free banks have shown their resistance against the subprime crisis tthat hit conventional fincance.

This general study is made to find out the principles, risks and performances. This paper analyses the characteristics of Interest-free banks by comparing them with those of conventional banks. It shows also the different types of products between the two systems. The objective of this research has led us to develop four chapters. The first chapter will focus on conventional banking system. This chapter will allow us to define some concepts and revise the principles governing conventional banks. We will also present the different types of risks in the conventional banking system and describe the types of products. The second chapter will focus on interest-free banking system. First we will see the principles of Interest-free banks and the kinds of risks we encounter in this system. Then we will present the Interest-free banking financial products. The third and fourth chapter of this thesis will focus on a comparison of the two banking systems between Morocco and Turkey. These chapters will start with a general analysis of the economic and financial aspects of both countries. And then it will finish with a detailed analysis of the different products in Morocco and Turkey.

Özet

Katılım bankacılığı ya da geleneksel bankacılıkta bir finansal sistemin amacı mali kaynakların harekete geçirilmesi ve farklı yatırım projeleri arasında kendi tahsisi olmasıdır. Böylece faizsiz bankalar subprime krizinde dirençlerini geleneksel finansa göstermiş oldular.

Bu genel çalışma bankaların ilkelerini, risklerini ve performanslarını ortaya çıkarmak içindir. Bu çalışma faizsiz bankalar ile geleneksel bankaların özelliklerini karşılaştırarak analiz eder. Aynı zamanda bu iki sistemin ürünlerinin farkını da ortaya koyar. Bu araştırmanın konusu, bizi dört bölümde geliştirmeye yönlendirmektir. İlk bölüm geleneksel bankacılığın üstünde durur. Bu bölüm bize bazı kavramları tanımlamayı ve geleneksel bankacılığın yönetim ilkelerini gözden geçirmemizi sağlar. Ayrıca geleneksel bankacılık sistemindeki farklı tiplerdeki riskleri sunar ve ürünlerin tipini tanımlar. İkinci bölüm faizsiz bankacılığın üzerinde durur. İlk olarak faizsiz bankacılığın prensiplerini ve karşılaşılan çeşitli riskleri görürüz. Devamında faizsiz bankacılığın finansal ürünlerini sunarız. Bu tezin üçüncü ve dördüncü bölümü, bu iki bankacılık sisteminin Türkiye ve Fas arasında karşılaştırmasının üstünde durur. Bu bölümler iki ülkenin finansal ve ekonomik bakış açılarının genel analizleriyle başlar ve sonrasında Türkiye ve Fas'taki değişik ürünlerin detaylı analizi ile son bulur.

Abbreviations

AAOIFI – Accounting and Auditing Organization for Islamic Financial Institutions

BCBS – Basel Committee on Banking Supervision

CFI – Conventional Financial Institutions

DCR – Displaced Commercial Risk

GCC - Gulf Cooperation Council

GDP – Gross Domestic Product

IAH – Investment Account Holder

IFI – Islamic Financial Institutions

IFSB – Islamic Financial Services Board

IIFM – International Islamic Financial Market

IILM – International Islamic Liquidity Management

IIRA – Islamic International Rating Agency

IMF – International Monetary Fond

IRR – Investment Risk Reserve

IRTI - Islamic research and training institute

ISDA – International Swaps and Derivatives Association

LIBOR – London Inter Bank Offer Rate

M&As – Mergers and Acquisitions

OECD – Organization for Economic Co-operation and Development

OIC – Organization of Islamic Cooperation

PER – Profit Equalization Reserve

RIA – Restricted Account Holder

ROE – Return on equity

SPV – Special Purpose Vehicle

UIA – Unrestricted Investment Accounts

WP – Working Paper

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Introduction

According to Allen and Carletti, “banks perform various roles in the economy. First, they ameliorate the information problems between investors and borrowers by monitoring the latter and ensuring a proper use of the depositors’ funds. Second, they provide inter-temporal smoothing of risk that cannot be diversified at a given point in time as well as insurance to depositors against unexpected consumption shocks. Because of the maturity mismatch between their assets and liabilities, however, banks are subject to the possibility of runs and systemic risk. Third, banks contribute to the growth of the economy. Fourth, they perform an important role in corporate governance. The relative importance of the different roles of banks varies substantially across countries and times but, banks are always critical to the financial system.” (Franklin and Carletti 2008: 1)

So the banking system is a central element of the economic life of a country. It is also related to the stability of the financial environment. Banks play a major role in the daily lives of households and businesses for example to ensure the smooth flow of transactions by providing economic agents fast payment means, practical and safe, to finance the credit to purchase the housing, a car or a machine tool, and to enable households and businesses to invest and to grow their savings. There are so many circumstances that lead banks to intervene in economic life.

At a macroeconomic level, the banking system operates in conjunction with the Central Bank, the entire monetary circulation. However, because of some problems in the conventional banking system, a banking crisis occurs recently. The most recent crisis originated in the subprime mortgage market and due to the wrong interpretation and assumption of the market, the creed of fundamentalism became dominant since 1980s, which led to deregulation, globalization, and finally to crisis. The financial crisis has affected the whole world and Islamic finance has been introduced in some systems to reduce the financial crises. Many countries were seeking to reduce the impact of the crisis by introducing to their financial system alternatives. The Islamic finance can offer standardized Interest-free banking products with prudent regulations and supervisory arrangements. (Pyo Ryu, Zhen Piao, and Doowoo 2012: 48-54)

"This alternative banking proclaims that usury is prohibited while trading and surplus are permissible. Modern banking system deploys interests in performing its financial mediation roles. In return, Islamic scholars do not give any role to interests in its mediation; rather they recommend an alternative by profit and loss account." (Altan, 2010: 125-140)

Unlike conventional banks, the operations of Interest-free banks are not interest-based, which are primarily governed by the Sharia laws that prohibit interest transactions which are going to be detailed in my thesis.

This study is primarily concerned with the theoretical foundations of Interest-free banking and the practice in Morocco and Turkey, examines similarities and differences between the structures and practices of Interest-free banking and conventional banking.

Chapter 1 - Conventional Banking System

1.1. A Brief History of Conventional Banking

"Banking activities were sufficiently important in Babylonia in the second millennium b.c. that written standards of practice were considered necessary. These standards were part of the Code of Hammurabi – the earliest known formal laws. Obviously, these primitive banking transactions were very different in many ways to their modern-day counterparts. Deposits were not of money but of cattle, grain or other crops and eventually precious metals. Nevertheless, some of the basic concepts underlying today's banking system were present in these ancient arrangements. A wide range of deposits was accepted, loans were made, and borrowers paid interest to lenders." (Davies, G. 1994: 49)

"Similar banking type arrangements could also be found in ancient Egypt. These arrangements stemmed from the requirement that grain harvests be stored in centralized state warehouses. Depositors could use written orders for the withdrawal of a certain quantity of grain as a means of payment. This system worked so well that it continued to exist even after private banks dealing in coinage and precious metals were established." (Davies, G. 1994: 50)

"We can trace modern-day banking to practices in the Medieval Italian cities of Florence, Venice, and Genoa. The Italian bankers made loans to princes, both to finance wars and their lavish lifestyles, and to merchants engaged in international trade. In fact, these early banks tended to be set up by trading families as a part of their more general business activities. The Bardi and Peruzzi families were dominant in Florence in the 14th century and established branches in other parts of Europe to facilitate their trading activities. Both these banks extended substantial loans to Edward III of England to finance the 100 years war against France. But Edward defaulted, and the banks failed." (Hoggson, 1926: 1)

“Perhaps the most famous of the medieval Italian banks was the Medici bank, set up by Giovanni Medici in 1397. The Medici had a long history as money changers, but it was Giovanni who moved the business from a green-covered table in the market place into the hall of a palace he had built for himself. He expanded the scope of the business and established branches of the bank as far north as London. While the Medici bank extended the usual loans to merchants and royals, it also enjoyed the distinction of being the main banker for the Pope. Papal business earned higher profits for the bank than any of its other activities and was the main driving force behind the establishment of branches in other Italian cities and across Europe.” (Goldthwaite, 1995: 2)

“Much of the international business of the medieval banks was carried out through the use of bills of exchange. At the simplest level, this involved a creditor providing local currency to the debtor in return for a bill stating that a certain amount of another currency was payable at a future date – often at the next big international fair. Because of the church prohibition on directly charging interest, the connection between banking and trade was essential. The bankers would take deposits in one city, make a loan to someone transporting goods to another city, and then take repayment at the destination. The repayment was usually in a different currency, so it could easily incorporate what is essentially an interest payment, circumventing the church prohibitions. For example, a Florentine bank would lend 1000 florins in Florence requiring repayment of 40,000 pence in three months in the bank’s London office. In London, the bank would then loan out the 40,000 pence to be repaid in Florence at a rate of 36 pence per florin in three months. In six months, the bank makes 11.1 percent – that’s an annual rate of 23.4 percent.
It is also interesting to note that a double-entry bookkeeping system was used by these medieval bankers and that payments could be executed purely by book transfer.” (Goldthwaite, 1995: 2)

“During the 17th and 18th centuries the Dutch and British improved upon Italian banking techniques. A key development often credited to the London goldsmiths around this time was the adoption of fractional reserve banking. By the middle of the 17th century, the civil war had resulted in the demise of the goldsmiths' traditional business of making objects of gold and silver. Forced to find a way to make a living, and having the means to safely store precious metal, they turned to accepting deposits of precious metals for safekeeping. The goldsmith would then issue a receipt for the deposit. At first, these receipts circulated as a form of money. But eventually, the goldsmiths realized that since not all of the depositors would demand their gold and silver simultaneously, they could issue more receipts than they had metal in their vault." (Davies, G. 1994: 211)

"Banks became an integral part of the US economy from the beginning of the Republic. Five years after the Declaration of Independence, the first chartered bank was established in Philadelphia in 1781, and by 1794, there were seventeen more. At first, bank charters could only be obtained through an act of legislation. But, in 1838, New York adopted the Free Banking Act, which allowed anyone to engage in banking business as long as they met certain legal specifications. As free banking quickly spread to other states, problems associated with the system soon became apparent. For example, banks incorporated under these state laws had the right to issue their own bank notes. This led to a multiplicity of notes – many of which proved to be worthless in the all too common event of a bank failure." (Klebaner, 1974)

With the Civil War the legislation allowed national banks to issue notes. The federal guarantee the national bank notes and protected the note-holder. This new legislation also brought all banks under federal supervision. And this laid to the current system which we are part of.

1.2 Risks facing Conventional banking

Conventional banks are facing too many risks. The most important are market risk, liquidity risk, interest rate risk, forex risk, country risk, operational risk and credit risk.

1.2.1. Market risks

It corresponds to the decline in the value of the asset portfolio (duty, action, ...) held by the bank as a result of an unfavorable change in the value of the current market, in other words risk comes from the uncertainty of gains from changes in market condition. This type of risk is mainly due to the instability of the market parameters (interest rates, stock indexes and exchange rates), hence the effect of volatile markets, liberalization, and new technologies are accompanied by a remarkable increase in market risk. (Thirupathi, Manoj, 2013: 145-153)
The following are types of market risks :

1.2.1.1. Liquidity Risk:

This type of risk is the lack of bank liquidity to deal with these unexpected needs. Indeed, this risk can lead to bankruptcy of the bank after a panic of depositors, who can request their deposits at the same time. The recourse to massive withdrawals of funds by investors and their concerns about the solvency of the bank, can aggravate the situation. (Thirupathi, Manoj, 2013: 145-153)

1.2.1.2 Interest Rate Risk

This is a risk which mainly concerns credit transactions as well as that of the market, this type of risk concerns all categories of stakeholders whether financial or otherwise, as long as they are borrowers or lenders on the market. This risk is identified by the fact of seeing the results adversely affected by movements in interest rates. In addition, a bank carries a risk of higher rates if it lends at a fixed rate and the variable rate and refinance in the case of lower rates. Similarly any unexpected changes in the interest rates may negatively influence on banking activity, affecting the credibility of the bank and causing withdrawals of deposits from customers. (Thirupathi, Manoj, 2013: 145-153)

1.2.1.3 Forex Risk

This type of risk is born in the financial institutions from lending and borrowing more than a year in foreign currency. In other words the bank supports this risk category when it is facing an unfavorable exchange rate. In addition, it is also notable that there is an interaction between the risk rate and the adjustment. (Thirupathi, Manoj, 2013: 145-153)

1.2.1.4 Country Risk

Country risk is applied to different forms of debt that are non-marketable (bank or non-bank), or investment portfolio securities or trading and comes from the inability or refusal a country to provide the necessary foreign exchange to meet the financial obligations of the State or private economic agents operating in the country.

This risk is another aspect of banking risk, it is also known as sovereign risk and it is manifested as a result of the non-repayment of the foreign debt, which is due to economic conditions, political, social and financial debtor country. It originated in two main phenomena, disability payment and denial of reimbursement of debts, which are related to international operations. On other words this risk charectirazes all the elements of uncertainty that materialize through a specific volatility of international investment by contribution to domestic investment. (Thirupathi, Manoj, 2013: 145-153)

1.2.2 Operational Risk

“Operational risk, though defined as any risk that is not categorized as market or credit risk, is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events. In order to mitigate this, internal control and internal audit systems are used as the primary means. Risk education for familiarizing the complex operations at all levels of staff can also reduce operational risk. Insurance cover is one of the important mitigators of operational risk. Operational risk events are associated with weak links in internal control procedures." (Thirupathi, Manoj, 2013: 145-153)

This is not an unknown risk of banking supervisory authorities which, taken together, have built long in their analysis of the risk profile of credit institutions. Related to internal control, it requires from credit institutions and investment firms to set up a system for monitoring and control of operational risks, particularly those related to accounting and information systems.

1.2.3 Credit Risk

Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. Also called counterparty risk or default risk is the main risk that threatens the well being of credit institutions, where it refers to the default risk of customers as well as the deterioration of the financial situation of a borrower faces these obligations. (Thirupathi, Manoj, 2013: 145-153)

The management of credit risk includes:

- Measurement through credit rating/ scoring,
- Quantification through estimate of expected loan losses,
- Pricing on a scientific basis
- Controlling through effective Loan Review Mechanism and Portfolio Management.

1.3 Accounting and Auditing Standards

"Audit committees play an important role in the governance surrounding the finalisation of critical judgements, estimates and presentation affecting the accounts. The primary source of information for audit committees is the executive management. Good quality reporting from auditors to audit committees can add context to that and highlight gaps in management reporting.

Auditors have a duty to report matters of significance to those charged with governance. This normally happens through the audit committee, for whom auditors typically produce a report.
The findings, including key areas of the audit such as the critical accounting estimates are then discussed between the auditors and audit committees".(ICAEW, 2010: 4-23)

An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each of these bodies should have operational independence and adequate resources. An appropriate legal framework is also needed to cover include: the authorization of banking organizations and their ongoing monitoring, the powers of law enforcement and with regard to issues of security and stability, legal protection for supervisors . Provision should regulate further the exchange of information between them and protecting the confidentiality of such data.

"Auditors are expected to highlight in their reports to, and discussions with, audit committees any concerns or areas where estimates are towards the extreme end of ranges of acceptable outcomes. However, practice may vary as to how these issues are reported. Good practice is to use language that makes it clear whether, in the auditor's judgement, individual estimates fall within an acceptable range, whether there is consistency with estimates made in prior years and if the cumulative effect of, for example, moving from aggressive to conservative ranges of estimates, or vice-versa, could have a significant impact. Auditors can also indicate how comparable the definitions applied in financial statements, for example of particular types of financial instruments, are with those used elsewhere in the sector. Armed with this information, audit committees are more effective, for example because they are better able to challenge executive directors on the judgements, estimates and presentation used in the accounts." (ICAEW, 2010: 4-23)

Which means banking supervisors must ensure that banks have in place internal controls that are adequate to the nature and extent of their activities and covering several aspects: clear rules of delegation of powers and responsibilities, separation of duties involving the commitment of the bank, the payment of funds and accounting of assets and liabilities, cross-referencing of these processes, safeguarding of assets, appropriate independent audit, either internal or external; control functions for compliance with these provisions and applicable laws and regulations.

“As financial reporting standards have become increasingly complex, reflecting the growing complexity of financial markets and business generally, the perceived focus of preparation of true and fair financial statements may have shifted away from the big picture towards compliance with the requirements of standards. Financial reporting standards require various components of information which must be presented in order to provide a true and fair view in the financial statements. They do not and are not intended to cover every eventuality nor how information is put together. Compliance with financial reporting standards is only one part of providing a true and fair view. “(ICAEW, 2010: 4-23)

“Directors are already expected to consider the presentation of information in preparing financial statements as would auditors in providing an opinion on whether they provide a true and fair view. However, there is no framework for directors presenting information in the front half of annual reports. Such a framework could prevent key pieces of information from being lost in a surfeit of detail.
Auditors should assist directors in this process by considering more carefully the ordering and presentation of information in annual reports as a whole. This assessment could be clearly communicated to audit committees to ensure that the directors also consider this.” (ICAEW, 2010: 4-23)

It is necessary to consider the proposed operations and strategies. The operating plan should describe and analyze the scope of the market where the bank intends to carry the bulk of its business and establish a strategy for its current operations. The application for approval should clarify further how the facility will be organized and controlled internally. The authority issuing the approval should ensure the compliance of these provisions with respect to the proposed strategy, and verify the adequacy of internal policies and procedures as well as resources. This review should also demonstrate that appropriate corporate governance is in place.

"Banks could help to explain the important role that their auditors play by providing more information about the governance process over the financial statements and their discussions with auditors. Auditors should encourage such disclosures.
Audit committees could, for example, confirm that all of the matters highlighted in the critical accounting estimates section of the financial statements have been discussed with the auditors, and also that this section covers all of the main areas of discussion they have had with auditors over judgments in the financial statements." (ICAEW, 2010: 4-23)

1.4 Corporate governance for conventional banks

Good governance is an essential condition to support economic development. It notes a coherent approach. Indeed it prolongs and thorough upgrading of enterprises. The search for good governance also notes an integrated strategy. This is not the case of one company.

"The importance of equity ownership by financial institutions in Japan and Germany, and the lack of a strong market for corporate control in these countries have led to the suggestion that the agency problem in these countries is solved by banks acting as outside monitors for large corporations. In Japan, this system of monitoring is known as the main bank system. The characteristics of this system are the long-term relationship between a bank and its client firm, the holding of both debt and equity by the bank, and the active intervention of the bank should its client become financially distressed. It has been widely argued that this main bank relationship ensures the bank acts as delegated monitor and helps to overcome the agency problem between managers and the firm. However, the empirical evidence on the effectiveness of the main bank system is mixed. Overall, the main bank system appears important in times of financial distress, but less important when a firm is doing well." (Franklin and Carletti 2008: 16)

"In Germany the counterpart of the main bank system is the hausbank system. Banks tend to have very close ties with industry and form long-run relationships with firms not only because of the loans they make and the shares they directly own but also because of the proxies they are able to exercise. A number of studies have provided evidence on the effectiveness of the outside monitoring of German banks." (Franklin and Carletti 2008: 17)

Good governance gives priority to good risk management. In recent years, many initiatives and regulations have been launched to encourage companies to adopt better governance and better manage their risk taking.

1.5 Types of product

The conventional bank has too many types of products. The most important are credit cards, short term loans, medium and long term loans, agricultural loans, house financing and finally investments.

1.5.1. Overdrafts/Credit Cards

The credit card can be used to pay in shops or to make withdrawals at ATMs. Overdrawing facility from account can be offered by the Conventional banks to the customer within interest. It can be also in form of credit card where the limit of overdrawing is set by the bank. Credit card provides a dual facility which includes financing and plastic money whereby customer's financial requirements can be met without having physical cash.

Interest-free banking systems only provide facility to customer in the form of Murabaha where they shall deliver the desired commodity and not exactly the cash. However facility to shop/meet requirement is provided by Islamic banks through debit card which allow the customer to use it if he has credit balance id his account.

In conventional banking system a customer is charged with interest once the facility is granted. He is also charged with interest for the extra period in case of default. But in Interest-free banking system and while using Murabaha only profit is due after the commodity is delivered to the customer and there is no extra charging because it is prohibited and not allowed. (Hanif, 2014: 166-175)

1.5.2. Short term loans

A company or individual regardless of its financial health is sometimes faced with cash flow requirements. These short-term needs allow bank customer's to meet these commitments with the manufacturers; suppliers; its staff for business or a monetary liquidity for personal needs for the individual.

According to Hannif, "one of the features of Murabaha is the case of delay in payment by customer. IFI cannot ask for extra amount as time value of money like conventional banks. However penalty is imposed on defaulter if stipulated in original contract of Murabaha duly signed by the customer but same cannot be included in the income of IFI. This penalty must be spent for charitable purposes. Under Murabaha scheme of financing facility is linked with assets which leads to economic stability and creates linkage between real and financial sector. It is not zero sum game because utility is created through services and products and not by mere building the blocks of wealth through dealing in paper money." (Hanif, 2014: 166-175)

Conventional banks provide to customers with short and medium term loans to meet their working capital requirements. For a company to invest and meet the expenses required it needs a working capital. Trough Murabaha Islamic banks provides inventory investment in order to meet the day to day expenses with participation term certificates whereby profit is shared on a prorata basis by IFIs. (Hanif, 2014: 166-175)

The immediate consequences are running out of cash to ensure the daily activity of your business and have a debtor's bank account without permission or beyond the authority granted by the bank. This particular leads to bank charges (commission intervention, bank charges a higher rate...) and a major risk :

• Discharges samples, checks or bills of exchange with consequences from your suppliers and the Bank of France (prohibition to issue checks, deteriorating its listing) • Legal proceedings for non-payment of credit installments, • Denunciation of bank lending after a notice for non-compliance with conditions of use, • Seizure or notice to holder's account in the event of non-payment of tax liabilities in particular. (Hanif, 2014: 166-175)

1.5.3. Medium and long term loans

To expand or change the existing assets, the firms need medium and long term loans.

There must be a link between the financing period and the life of the financed goods. Firms have to avoid that the financing period is longer than the duration of its use as the medium-term loan finance. It is applied to medium-term investments such as vehicles and machinery, and more generally, most equipment and production tools.

The granting of a medium and long term loan is subject to an extensive study because the risk comes from the duration and extent of the loan. The bank must study the market impact of the introduction of this equipment and provide the financial situation of the company, given its new production facilities and also taking into account its new charges. This requires drawing up a provisional financing plan that will clarify all charges and borrower resources to identify future opportunities for the company to meet its debts and thereby ensure a good outcome of the credit operation. (Hanif, 2014: 166-175)

In Interest-free banking system this requirements are fulfilled through Murabaha, Bai Muajjal, and Istisna'a. Hence the financing options often used for long-term are musharaka and Mudaraba which function under profit & loss. Financing under these two options is very challenging for IFIs and companies as well because firms needs to prove the profitability of the business or the project since risk of losing the amount is involved. (Hanif, 2014: 166-175)

1.5.4. Agricultural Loans

Agricultural loans include short-term as well as long-term loans. Short-term loans are required by farmers for seeds and fertilizers and long-term loans are required to develop extra lands and buy equipment.

Normally these loans will be returned after selling the finished crops by the farmers. Conventional banks provide credit facility by charging interest. In interest-free banking system there is the same facility to the farmers through Bai Salam, Bai Murabaha Musharaka and Mudaraba.

Bai Salam is a particular type of contract in Islam since it allows the cash payment of goods that are subsequently delivered. This is therefore a contract regarding non-existing products or goods at the time of drafting of the contract (or at the time of payment) which is an exception.

The bai-al-salam allows to share the risk between the two parties: this risk is the spot price of the goods delivered to the delivery day and can be lower than the price applied to the salam (loss for the buyer) or higher the price of salam (loss for the seller). The contract is only valid if the goods to be delivered, quantity, quality and delivery date are set in advance. (Hanif, 2014: 166-175)

1.5.5. House financing

Housing finance/Mortgages is the most protect form of financing for both conventional bank and interest-free bank. Under conventional system loan is given for interest but in alternative bank it is provided through diminishing Musharaka. Under diminishing Musharaka house is purchased by Islamic finance institution and customer.

As a Variant of Musharaka, diminishing Musharaka is a technique whereby the financial involvement in the partnership created with the investor decreases gradually as its participation in the Musharaka is transferred to the investor and his initial investment is repaid and also its eventual compensation. (Hanif, 2014: 166-175)

1.5.6. Investments

To maintain liquidity conventional banks have many avenues such as government securities, short term loans and money at call and short notices, leasing companies' bonds, and shares. They receive also interest from mandatory reserve maintenance with central banks. Conventional banks by issuing the bonds against their receivables can create liquidity. They are also protected by central banks. They can be rewarded in interest through interbank transactions and deposits.

For interest-free banks it is forbidden to have avenue in form of interest. So they created a new form for liquidity and it's called Sukuk (Islamic Bonds). To meet liquidity requirements of liquidity, alternative banks start issuing Sukuk (Bonds) to the investors in a equal value of asset, then the ownership of the asset is transferred to Sukuk-holders. There too many types of sukuk: Sukuks of Musharaka, sukuks of Murabaha, Sukuks of Ijara. (Hanif, 2014: 166-175)

Chapter 2 - Interest-free Banking System

2.1. A brief History of Interest-free banking:

"During the Islamic Golden Age, early forms of proto-capitalism and free markets were present in the Caliphate, where an early market economy and an early form of mercantilism were developed between the 8th–12th centuries, which some refer to as 'Islamic capitalism'.

A number of economic concepts and techniques were applied in early Islamic banking, including bills of exchange, the first forms of partnership (Mufawada), limited partnerships (Mudaraba), and the earliest forms of capital (al-mal), capital accumulation (nama al-mal), cheques, promissory notes, trusts (waqf), transactional accounts, ledgers and assignments. Business enterprises, independent from the state, also existed in the medieval Islamic world, and the institution of 'agency' was also introduced during that time. Many of these early capitalist concepts were adopted and further advanced in medieval Europe from the 13th century onwards."(Kettell, 2011: 24)

⇨ ***Modern Islamic Banking***

Modern Islamic finance is truly born in the 1960s. It has experienced two major steps in the evolution of the nature and objectives of Islamic finance.

Interest-free banking is of very recent origin. The earliest references to the reorganisation of banking on the basis of profit sharing rather than interest are found in academic work done in the 1940s and 1950s.

Modern Islamic finance is truly born in the 1960s. It has experienced two major steps in the evolution of the nature and objectives of Islamic finance.

The establishment of Islamic banking comes from the idea of a small number of scholars and Muslim scientists who have theorized since the 1950s the possibility of creating an alternative to the traditional financial system finance and consistent with “ Sharia “. Specifically, the first two experiments will be realized by the creation of 'Pilgrims' Administration and fund "(Tabung Haji) in Malaysia (1956) and the experience is " Mit Ghamr" in Egypt (1963). The goal sought through these two experiences is to set up financial circuits that reduce banking exclusion and promote the development of disadvantaged populations while respecting the philosophy of Sharia. Both experiences were of very different forms. Indeed, promoted and funded by public authorities Malaysian, the 'Tabung Haji was proposed to invest the resources collected from a large number of small investors in large industrial projects, agricultural and construction.

The Mit Ghamr which is completely private initiative was composed of small savings or investment cooperatives operating in the agricultural regions of northern Egypt. The objective of their founder, Ahmed al-Najjar, was to ensure the intermediation of financial resources between savers and small local investors. (Pastre 2008: 199-200)

“The early 1970s saw institutional involvement. The Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the First International Conference on Islamic Economics in Mecca in 1976 and the International Economic Conference in London in 1977 were the result of such involvement. The involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks.
The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process.” (Kettell, 2011: 24)

2.2. Principles of interest-free banking

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *Sharia'a*, known as *Fiqh al-Muamalat* (Islamic rules on prohibition of riba (usury). Common terms used in Islamic banking include profit sharing (*Mudaraba*), safekeeping (*Wadiah*), joint venture (*Musharaka*), cost plus (Murabaha) and leasing (*Ijara*). (Kettell, 2011: 24)

2.2.1. Prohibition of Riba

The term "Riba" means, in Muslim law, any benefit or surplus received by a Contracting without any acceptable and legitimate counterpart in terms of Sharia. Riba has two main forms:

• Riba-Al-fadl: This is any concrete surplus perceived in a direct exchange between two things of the same kind which are sold by weight or measure.
• Riba-Annassia: The surplus collected on payment of a due payment of which was made a condition expressed or implied in the contract, because the deadline for the deferred settlement. Riba-Annassia is the most common type in society, particularly through credits, loans and investments provided by banks and traditional funding agencies.

This differentiates Riba in its two forms of the sale of a good or a service, is that the perceived counterparty is considered acceptable in Muslim law, if it is intended to offset something legitimate, such as:

• the impairment loss related to the use of property (in the case of the lease of property)

• the effort for the realization of an object (in the case of the sale of goods produced by the seller)

• the work to obtain the material and the risk well into its management (in the case of the sale of goods purchased from others). (Austruy, 2006 : 52)

2.2.2. Prohibition of Gharar and Maysir

Sharia law also requires, in business and trade, it is not concluded transaction containing the Gharar. The Gharar can be defined as significant blur at a traded goods and / or has itself a risky and uncertain. This is the case:

•Where the contract relates to a commodity that is not precisely determined.
•When the transaction is concluded without the price of the commodity is determined clearly.
•When the transaction involves specific goods that the seller does not already own.
•When the transfer of ownership is subject to a hazardous event

This corresponds in conventional finance products or futures trading characterized by an obvious uncertainty as to their implementation, such as futures, swaps and other complex financial products like subprime.

Similarly, the Sharia prohibits based transactions Maysir. Etymologically the Maysir was a game of chance, in the economic field, it means any form of contract in which the right of contracting parties depends on a random event. Thus, each contract must have all the basic terms (such as the subject, Price, turnaround time and the identity of the parties) clearly defined the day of its conclusion. Muslim jurists also strongly encourage the satisfaction of all conditions before signing the contract. This clearly differentiates the Islamic banking institutions lending at interest, based on the principle that one can buy and sell without paying without holding, which constantly feeds speculation and prejudice the stability of the banking system.

The calculated risk of an investment is allowed by the Shari'a, however banning futures involving Gharar and Maysir is that the risk of false anticipation of market growth could jeopardize the realization of transactions based on uncertainty, speculation, or even tort detention of inside information in advance. Muslim jurists also justify the prohibition of such transactions by the need to direct available funds to finance the real economy, instead of leaving the empty fuel financial bubbles of all useful productivity and wealth. (Austruy, 2006 : 53)

2.2.3. Prohibition of illegal investments

Sharia law also requires that any Muslim can treat considered Haram or illegal goods. Indeed, there are requirements as to the nature of the activity in which an investment remains consistent with moral and religious imperatives as dictated by Islam. Thus, games of chance, in relation to alcohol activities, pig farming or with weapons, with the film industry eliciting or suggesting debauchery and especially pornography-related activities are sectors Investment of prohibited in Islam. We find this principle of exclusion in ethical finance for sustainable development and socially responsible investment.

From a financial standpoint, underlying all types of contracts should also comply with Sharia. Typically, in the framework of a shareholding in the form of shares, a number of sectors whose activities are considered illegal are to be excluded from the investment universe. (Austruy, 2006 : 54)

2.2.4. Principle of Profit and Loss Sharing

Islamic finance is often called "participatory", from the operation of participation contracts, it has established a system based on the sharing of profits and losses. This system allows combining financial capital to human capital and requires the participation must be secured in a proportion not by a profit at the contract signing.

More concretely, an investor must entrust their funds to a contractor with whom he will share the profits based on the performance of the underlying asset, he will also share any losses with this contractor if it is not due to negligence or gross negligence of the latter. So the client of an Islamic bank has almost a shareholder in investments related to its contracts and its income in the form of dividend. (Austruy, 2006 : 54-55)

2.2.5. The Asset Backing

Every financial transaction should be implied by an asset to be valid under Sharia. Tangibility of assets means that any operation must be necessarily backed by a tangible asset, real, material and especially Detainee. This principle of "Asset Backing" helps strengthen the potential for stability and risk management, particularly reassured about the disconnection issues in the financial sphere to the real economy. The principle of the tangibility of assets is also a way for Islamic finance to support the development of the real economy by creating economic activity in other areas. (Austruy, 2006 : 55)

2.3. Risks facing interest-free banking

“There are general factors that make the operation of Islamic financial institutions riskier than conventional counterparts do: **I**) fewer risk-hedging instruments and techniques, **II**) underdeveloped or non-existent of the inter-bank money markets and government securities, and **III**) the limited availability of and access to the lender-of-last-resort operated by central banks. By and large, Islamic financing contracts are exposed to market, liquidity, operational and credit risks, along with other risks resulting from the unique asset and liability structures of Islamic finance.” (Mounira and Anas 2008: 9)

Figure 2.1. Risk of Interest-free Banking

Source: Ahmad M.abu-Alkheil (2012), Ethical banking and finance: A theoretical and empirical frameworkfor the cross-country and inter-bank analysis of efficiency, Productivity, and Financial Performance, Thesis

2.3.1 Market risks

Like conventional banks, Islamic banks are also exposed to market risks. According to the IFSB, market risk refers to "*the potential impact of adverse price movements on the economic value of an asset" resulting in a "loss in on- and off-balance sheet positions*". In other words, market risk is the current and potential risk to earnings and stockholder's equity resulting from adverse movements in market rates or prices. (Ahmad M.abu-Alkheil 2012 : 26)

Market risks, however, generally consist of: interest rate risks, exchange rate risks, commodity risks and equity price risks.

By adjusting the returns to creditors accounts rate of conventional banks, IFIs use reference rates such as LIBOR (London Inter-Bank Offering Rate). In doing so, any changes in reference rates can have consequences for Islamic banks.

The IFIs bottom face the risk of margin also depends on changes in the LIBOR rate. Indeed, profits shared with depositors accounts include gains on sales with a margin as Murabaha, Ijara, the Istina, Salam, etc. The IFIs will determine a fixed margin to the initiation of the contract then they will periodically review the enabling them to protect themselves against this risk. If one period to the other references rates increased, the Islamic bank will increase its rate of profit distributed to compete with their conventional counterparts. Which causes the displaced commercial risk, above, with considerable smoothing PSIA accounts. We find that the risks in Islamic finance are closely linked to where the need for Islamic financial institutions to better understands the risk in business management.

And because of their heavy involvement in commercial transactions, Islamic banks are forced to store various goods on behalf of their client or to their personal needs. The bank may accumulate merchandise or for already established contracts or sales figures for provisions. For example if a bank acquires all of a housing stock that it hopes resell thereafter. The devaluation of the asset could be damaging to the IFIs. So IFIs are more vulnerable to the risk of price fluctuations than their conventional competitors.

These risks can be measured through VaR (Value at Risk) or the ALM (Asset Liability Management) for the Internal Rating-Based Approach (Internal Rating Based).

Also note that restrictions on the use of derivatives, particularly interest rate and currency swaps market make risk management a complicated task. Indeed swaps serve to minimize financing costs and are used as effective hedging instruments to reduce the costs of unwanted risks. Nevertheless, according to some experts, it is possible to today's date to design compliant rate swaps with Islamic law. (Ahmad M.abu-Alkheil 2012 : 28)

2.3.2 Liquidity Risks

This risk arises in the event of insufficient liquidity for the needs of current operations of banks, reducing their capacity to satisfy the demand of their customers. For Islamic banks, this risk is accentuated because the loans are interest prohibited by Shari'ah. Islamic finance does not allow the sale of debt outside of their nominal value. Therefore, it is excluded for Islamic financial institutions to feed into cash by selling financial assets.

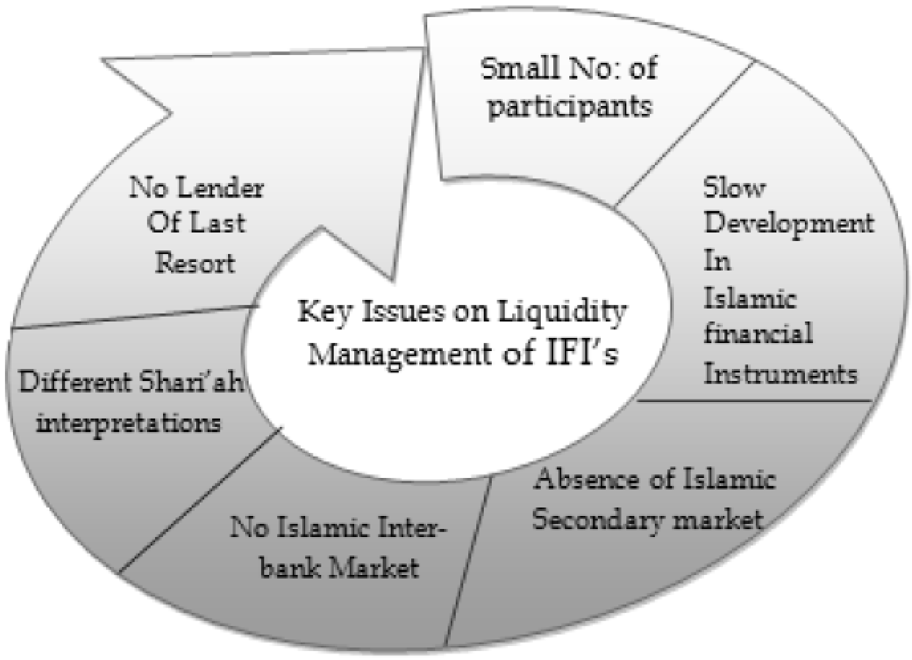


Figure 2.2. The causes of liquidity problems in Islamic financial institutions

Source: Abdul Majid, International Conference on Islamic Banking: Risk Management, Regulation and Supervision -2003

Conventional banks use several methods to guard against this kind of risk. First, they can appeal to the interbank market where they borrow the funds needed to repay deposits. Second, they can use their cash on the balance sheet and thirdly, sell assets they have.

For the IFIs, it is very difficult to manage this risk through lack of lender of last resorts or an interbank market for refinancing. Indeed IFIs have a lot of assets that are short and medium terms for deposit accounts are the majority. And to reduce the risk of maturity of assets, they developed capabilities for financing and investment, increasing the average maturity of assets but refinancing remains essentially short term. (Mohammed Ali Chatti 2013: 9)

2.3.3 Operational risks

This risk arises as a result of accidents or human error and / or techniques. It is a risk of direct or indirect loss arising from inappropriate or defective internal processes (inaccurate execution of transactions, specification errors models), human faults staff (incompetence, malevolence), and technological errors (system of failed communication, inadequate programs ...) in view of recent institutions, Islamic banks incur an operational risk mainly from the lack of qualified personnel to effectively conduct Islamic financial transactions. The special character of Islamic banks that computer software available on the market are not very suited to them (because they are designed for conventional banks). This therefore increases the risk associated with the use of information technology. (Mohammed Ali Chatti 2013: 10)

2.3.4 Credit Risk

This risk appears when the debtor fails to meet its liabilities when due, that is to say when the counterparty is unable to fully meet its obligations on time. For Islamic financial techniques, this credit risk is real and very present. Indeed, Mourabahah, a margin sales contract, Al Istisna, which is a contract with the aim of manufacturing or construction (construction order contract becomes installment sale) and / or Al bay 'bitaqsit, meaning installment sales, all these contracts are forward sales that create a debt on the books of the bank; it bears the risk that customers can not repay their debts.

The contract of Ijarah (rental and leasing) also faces the risk of credit when the owner do not manage to pay the rent. As for Salam, a sales contract with deferred delivery, there may also be subject to this risk when the client fails to deliver to the bank the contract subject merchandise. On the other hand, contracts of participations and investments may also be exposed to this risk, even if the advance of capital is based on a participation in the profits and losses and not on a base credit; risks in this group of contracts occur when one partner is the cause of damage or negligence of assets it manages; it becomes the guarantor of those losses but his partner also bear the risk of not being repaid capital. On the other hand, an entrepreneur-partner can refuse to share the profits, which can also be part of credit risks. (Mohammed Ali Chatti 2013: 8)

2.4. Shari'ah Supervision and auditing of interest-free banks

The term "Sharia", which literally means in Arabic "The way forward" means a legal system based on Islamic ethics. This system figure of legal reference and indicates the course of action in all areas of the lives of Muslims, including the economic sphere. Sharia includes invariant elements that are immutable canonical rules in time and space elements and variants that Muslim jurists are able to enact, according to analysis of specific and changing situations.

The two main sources of Sharia are:

- The Quran: The holy book of Islam reflects the message of God as revealed to Prophet Muhammad (SAWS), it is the primary source in terms of law. Any items taken from other legal sources must always be in full compliance with the speaking of God in the Qur'an.

- Sunna: This term encompasses all the teachings transmitted by the Prophet Muhammad (SAWS) through his words, his expressions, his deeds, and his tacit approval. (Kettell, 2011 : 30)

These two sources are the essential bases for determining compliance of any action with the rules and the purpose of the Sharia. However, Sharia remains open to possible interpretations and development. So we can add two other sources of Sharia:

- The Ijmaa: In its technical dimension, Ijmaa means the consensus of Muslim jurists on a point of law. In practice, the Ijmaa serves as evidence if any part of the Koran or the Sunnah is dispositive in a case.
- The Qiyass (reasoning by analogy): this technique is to assign, based on a common underlying characteristic, the legal rule to an existing case found in the texts of the Qur'an, the Sunnah and / or the Ijmaa a new case whose legal rule could not be clearly identified. This while remaining faithful to the spirit of traditional sources of Islamic law. (Kettell, 2011 : 30)

Islamic banks, like conventional banks will tend to enjoy a fairly large power with respect to depositors and to play an important role in the stability of the financial economic system. It is therefore necessary to protect the interests of investors and depositors against any possible abuse of power, fraud, mismanagement, and excessive risk. Hence the importance of establishing an appropriate regulatory framework, to ensure the proper functioning and development of capital market and guarantee the interests of different stakeholders.

Islamic banks are generally controlled under international surveillance systems of commercial banks. However, only two countries were in line with standards established by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). As part of its adaptation to several standards changes must be made as creating depots participatory investments for example.

However, many international organizations have been created to harmonize all the Islamic banks:

- The Accounting and auditing Organization of Islamic Financial Institution (AAOIFI) in Bahrain located and whose role is to monitor the accounting rules of Islamic banks.
- The Islamic Financial Services Board (IFSB) its aim is to seek ways of integration of Islamic finance into the international financial system.
- The International Islamic Financial Market: with the aim of creating new mechanisms compatible with both Sharia but also allow rapid development of Islamic banking.
- The International Islamic Rating Agency (IIRA) rating agency established in 2002 in Bahrain, which aims to promote the entry of Islamic institutions in the international markets, however, the Western investment is still limited. (Kettel, 2011: 31)

⇨ ***External Auditor***

"One of the unique roles played by the external auditor of an IFI, besides performing the financial statements audit, is to conduct a test of *shariah* compliance. The audit process involves a structured, documented plan involving a series of steps beginning with planning the audit and ending with expressing an opinion in an external audit report as to whether the financial statements are prepared in accordance with the fatawa (religious opinions), rulings and guidelines issued by the SSB of the IFI, the accounting standards of the AAOIFI, and relevant national accounting standards and practices in the country in which the IFI operates.

In order to provide reasonable assurance that the IFI has complied with *shariah* rules and principles as determined by the SSB, the auditor needs to obtain sufficient and appropriate audit evidence. In order to guide the auditor in making judgment as to whether the financial statements of the IFI have been prepared in accordance with *shariah* rules and principles, the auditor will rely on the fatawa, and rulings and guidance issued by the SSB. However, the auditor is not expected to provide interpretation of the *shariah* rules and principles." (Haniffa R and Hubaib M, 2002, 47-48)

2.5. Corporate Governance for interest-free banks

Each Islamic bank or window has an obligation to mandate an independent committee to validate the transactions of the institution with the principles of 'Shari'ah'. The Committee of the 'Sharia' is composed of four to seven members all lawyers in the 'Fiqh Al mouamalat ''. Each member of the Committee is selected by the Board of Directors and at the end of each year, the Committee submits a report on the adequacy of the bank's practices with Islamic law. To monitor the actions of the bank more frequently, the Committee of the 'Sharia' executive committee appoints a responsible, sometimes monthly, to check the operations of the IFIs. In addition, a member of the internal control is designated to be the bridge between the Committee of the 'Sharia' and the bank.

This person must have knowledge of Islamic law because it is responsible for conducting audits of all transactions and check their compliance with the fatwas. It can give its approval to new operations which have already been approved by the board and validate some minor operations not yet approved by the Committee. (Hossein askari, Zamir Iqbal, Noureddine Krichene and Abbas Mirakhor, 2010, 101)

However, all transactions are controlled by the Committee of 'the' Sharia 'year-end. Finally, the Committee of the 'Sharia' supervises the actions taken by the bank to meet the Islamic code of conduct. This includes all ethical and religious values which the concepts of integrity, sincerity, piety and righteousness. Ethics is particularly important in the Islamic economic environment because it is the foundation of the financial system with the concept of sharing profits and losses resulting. Compliance with these values allows all IFIs to strengthen its differentiating factor compared to conventional banks. It allows the same time sustain its reputation and renown.

➔ The board

Islamic banking is governed by a Board of Directors, the latter is appointed by the General Meeting of Shareholders and consists of directors. It should be noted that in Muslim law, the management function is always paid. Admission requirements to the Board are threefold:

• Be Muslim society more Islamic law is the legal basis for exchange of services, the economic instrument of capitalist exploitation.

• Hold a number of action required by the bylaws, the shares in question must be registered, inalienable, they guarantee good management by the Board of Directors.

• Do not fall foul of inconsistency, this condition is not common to all Islamic banks

The control of Islamic banks jointly by censors accountants and members of the religious council.

➔ The accounting Censors

They are appointed by the general meeting of shareholders to fix their remuneration and the term of their office. The accounting censors must prepare a report to the general meeting of shareholders on the bank's balance sheet. All this in order that decisions relating to the management are taken knowingly. The accounting censors have the right to physical acts of verification and control, so they can examine the bank's books.(Hossein askari, Zamir Iqbal, Noureddine Krichene and Abbas Mirakhor, 2010: 102)

2.6. Ethical governance

Islamic finance advocates ethical finance and is built on many pillars.

First, the money invested should always be backed by tangible assets; Islam encourages economic activity, but considers that the production of goods and services, trade, the realization of investments must be accomplished as part of the real economy, creator of actual value. Money can not create money, is the provision of human effort which enshrines the creation of the value allowed by money.

Secondly, the contracts must be concluded on equity and balance principles. Relative to an investment contract must appeal to the equitable sharing of risks, losses and gains that may result. In Islamic law are deemed void contracts where one party would exploit an unfair way or the other party perceives a gain to its detriment. A Muslim can make a profit only from transactions or activities conducted on a transparent basis as to risk sharing. For example it is forbidden to make a financial gain such as a late fee on a debtor default.

Thirdly, contracts should seek to remove uncertainties, and loyalty is built through contracts the most comprehensive eradication possible uncertainty. A contract whose object is the uncertainty is deemed to be zero.
Also the financial speculation is systematically banished; its prohibition is in line with the inability to decouple the financial activity of the obligation of genuine economic value creation. The refusal of speculation is stated by the assertion that we can’t sell what we do not possess. This doctrine therefore prohibits any investor access to the derivatives market.

Investments must meet ethical criteria, avoiding illicit assets and reprehensible activities of the moral point of view. The list of prohibited activities is public, but is capable of modifications related to the evolution of our societies; its content is mainly investments in prohibited sectors such as gambling, alcohol, pornography, weapons.

And finally a sharing obligation should apply on realized gains. Islamic finance practice the finance sharing, of reserving a portion of profits to non-governmental organizations, humanitarian organizations or simply poor people.

The mentioned principles reflect the extreme vigilance that attaches to the loyalty of financial practices. These should give investors the certainty that they are in full compliance practices with the demands of faith. This is the advice of compliance with the Sharia (the Shari'a Compliant Board) responsibility to monitor the activities of Islamic financial institutions they support each direction and interact with it in total independence. These boards may object to management. (Bari Imane and Radi Bouchra, 2011: 19)

2.7. Type of products

There are too many types of products in interest-free banking system. The most important of them are: Murabaha, Mudaraba, Musharaka, Ijara, Istisna'a and Salam.

2.7.1 The Murabaha Contract and risks

This is a procedure by which the client requests the bank to buy a certain commodity and agrees to buy it, with a pre-agreed profit, by repaying the installment financing bank.

It is the instrument most used by current Islamic banks. It is essential, in this formula, the initiative is taken by the customer. In practice, a bank buys the goods on behalf of a client and is responsible for reselling it at cost plus a "margin agreed". If the first two analyzed financial instruments are generally medium to long term Murabaha is an investment vehicle for the short term. The form in which this instrument is the most used, is cash and carry operation on goods, which consists of the cash purchase by the Islamic bank capital goods or goods of various (usually raw materials and energy) and simultaneous resale ultimately friends, their client against receipt of commission. The term is generally between 6 and 18 months. For repayment, the debtor open in most cases, an Islamic account (usually a documentary credit) to the bank account that caters according to a formula established in the contract so doing, the debtor will become the sole owner the goods as soon as the amount of the provision is equal to the loan amount plus a commission.

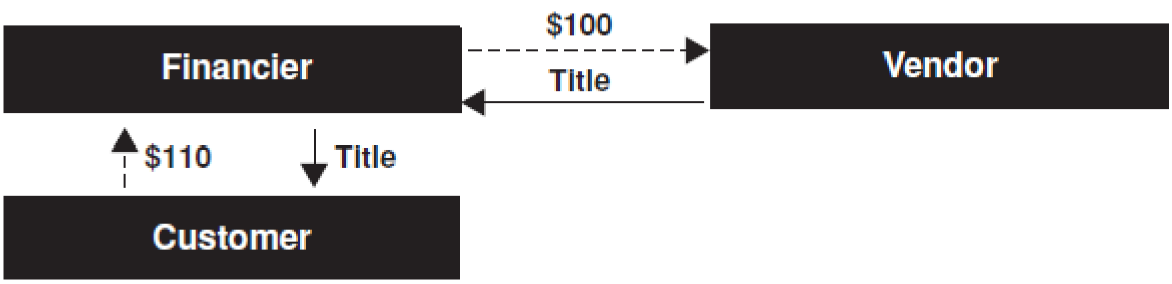


Figure 2.3. The Murabaha Flow Chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

⇨ **Critics**

Murabaha is the instrument most used in transactions between the Islamic bank and entrepreneurs on the one hand, and between the Islamic bank and Western banks on the other. The commission that the bank key is treated as interest by certain schools, which has led to differences of opinion as to the legitimacy of Murabaha. Indeed, in the Murabaha contract, the amount of the bank's profit is fixed in advance, which is not the case in previous instruments, this poses the problem of Islamic or otherwise of the operation.

In the general opinion of Western banks, this commission is nothing but a disguised interest. This criticism is not entirely justified, if the price increase that represents the commission does not exceed the deserved compensation for services rendered.

In addition, although the bank verifies the validity of the transaction and the creditworthiness of the client, the risk remains ever present until the customer has completely fulfilled its commitments.

If the purchase by the bank must be secured by a guarantee, it seems to us that from the Islamic point of view, the justification for Murabaha becomes clear as the risk and liability of the bank decreased considerably.

Murabaha, combined with the use of letters of credit, is useful in the international Business. It is currently vital for Islamic banks, given the extent of its scope and quality of flexibility.

The Risks with the Murabaha contract are:

Risk 1 Credit Risk: Customer may not be able to honour the payment obligation.
Risk 2 Market Risk: If it is a nonbinding Murabaha, the customer can cancel the agreement. The bank then has to sell the goods in the open market. (Kettell, 2011: 37-48)

2.7.2 The Mudaraba Contract and risks

Al-Mudaraba is, without doubt, the most important instrument that relies on capital and labor. It is made by those who own capital, but does not have provisions nor the technical abilities to invest. It is the basis of all the PLS system. Its origin dates back to pre-Islamic period and it is Islam which instituted. The Mudarab could be defined as "an association between two parties according to which one of the two parts, the agent (Al-Mudarib), applies fully to fruition the full capital advanced by the other party, the owner (Rabb Al-Maal) and whose benefits are shared in defined proportions ". This association is based on the capital, labor, trust, risk and fidelity.

In other words, Mudaraba is a contract whereby the bank provides capital that another party (the Mudarib) invests. Note that all the funding is through a single match. The Mudarib, meanwhile, provides expertise and management.

There are four conditions for a joint venture or a Mudaraba:

• The capital must be liquid. However, some banks authorized capital in the form of goods in circumstances well accurate, especially when it facilitates trade and development;
• The capital must be in cash and not in the form of debt incurred by the Mudarib. Its amount must be known;

• Partners must share not only the benefits but also the losses in proportion to their stakes in the case. If profits, they will be shared according to a share, agreed in advance. As for the losses, they are assumed by the bank; Mudarib loses the whole part of its contribution, namely his time and energy:

• The capital cannot remain with the owner, or be handed over to a third person, either entirely or partially. Note that the owner of fund may impose conditions in Mudarib over decisions in investment management.

The different types of Murabaha are:

• The Mudaraba general nature: it is not subject to any time limitation stress of work or trade or business for the manager.

• Conditional Mudaraba: It concerns very specific cases on which the two parties have to agree in advance. Note that when the bank is Mudarib, it promotes Mudaraba in general to have a free hand, but when Aabb-Al-Maal (financial) or his representative, she opts for Mudaraba specific to object to safeguard the interests of its clients.

This kind of contract is quite risky for the bank, which is why this instrument is too rarely applied in relation to its theoretical importance. In the case of import operation: very common in this type of contract, the contractor enters into Mudaraba transaction with the bank to finance imports.

The bank extends credit to the contractor and will participate in profit from the sale, according to a formula stipulated in the contract. Islamic banks have been very flexible in the application of the Mudaraba to adapt to practical needs. In this system the bank plays the pivotal role as an intermediary between contractors and depositors. In this light, the double relationship "bank-depositor" and "banque entrepreneurs" based each time on a Mudaraba contract:

- Depositor-bank: this relationship is based on Mudaraba which applicants are the owners of capital (Rabb Al-Maal) and where the bank is the agent (Al-Mudarib), which is both confidant, since any responsibility for the Capital investment is delegated;

- Bank-entrepreneur: this relationship is based on Mudaraba where, this time, the bank assumes the role of Rabb al-Maal, while that of the entrepreneurs assume Mudarib.

The risks with Mudaraba contract are:

Risk 1 Displaced Commercial Risk: The risk that the bank may retain investment account holder’s funds by increasing the rate of return thus giving away its share of the profit.

Risk 2 Credit Risk: The risk that the entrepreneur/partner defaults and goes bankrupt. (Kettell, 2011: 49-63)

2.7.3 The Musharaka Contract and risks

The contract of Mousharaka is considered as the second alternative instrument for loans with interest. It is similar to Mudaraba contract, insofar as there is also collaboration between labor and capital and the risk and trust are always decisive.

Musharaka is a contract between two or more people who trade with a common capital whose profits are divided among them, as agreed.

Therefore, each partner contributes to capital and labor. Unlike the Mudaraba, capital belongs to all partners. It follows that everyone can participate in the capital to grow and that none of them can make a decision without first consulting the other.

In case of loss, all participants bear a pro rata share of the sums involved. As for profit, they are to be shared in the same proportion as the financial activities of each partner, is distributed according to the concluded contract, given that the work as it plays its role.

There is different types of Musharaka:

➔ Musharaka general nature:

Musharaka or Anane company is the general form of "partnership" which is a cooperation between the bank and its customers (retailers, manufacturers, farmers, ...). The bank finances part of a viable economic project, submitted by a creditworthy customer, which provides the remaining funding.

Such participation is commonly used by Islamic banks because the potential risk is lower compared to that of the Mudaraba; Moreover, the bank supports, in case of loss, a portion on the part put into the project.

The banks' preference to this form of association is also explained by the fact that the bank can monitor and participate in the operation.

➔ Dereasing partnership:

It is an association that allows the bank to replace the partner as the owner, in stages or all at once, according to the agreed terms and nature of the transaction, provided that steps are taken to retain part of income to repay the bank's participation. The central idea of this participation is decreasing the possibility for the partner to gradually repay the bank its share to become the sole owners of the company.

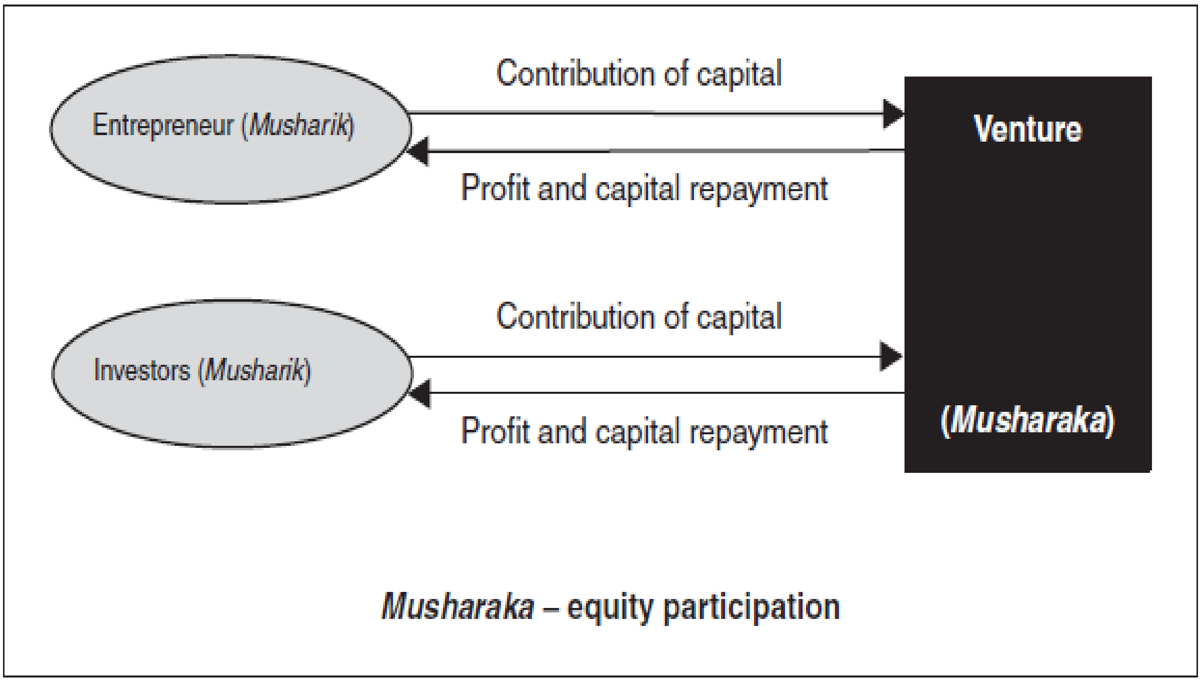


Figure 2.4. Musharaka flow chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

Musharaka is often applied in the field of transport and construction. In Pakistan, House Building Finance Corporation (HBFC) specializes in housing construction; the bank buys the house under construction and is selling the property by payment installments, against payment of rent for 15 years. In this way, the tenant ends up owning the house.

The Faisal Islamic Bank of Sudan (FIBS) practice very often lower participation, introducing a slight technical change: the bank withdraws progressively profits according to agreed terms. Thus, it eliminates the As the participation agreement until the other partner's ownership of the entire company.

The FIBS apply any form of participation, namely:

• Participating interest of a project: shares are issued covering the value of the project and are divided between the parties according to their shareholding.

• Participation in any case: it is a series of short-term Musharaka and affects all economic sectors, which allows the bank to diversify its operations to minimize losses.

• In the case of financing, the FIBS provides 80% of the required capital and partner the remaining 20%. The bank pays the contractor 20% or 30% in net profit for its management. Typically, the bank is satisfied with the project supervision and grants his client a net profit higher than its contribution to the capital.

The Risks with the Musharaka contract are:

Risk 1 Credit Risk: The risk that the entrepreneur/partner defaults and goes bankrupt.

Risk 2 Operational Risk: The risk that the partner lacks technical expertise and the project fails. (Kettell, 2011: 65-75)

2.7.4 The Ijara Contract and risks

This is a variant of the Ijara, a leasing contract, but where the customer agrees in addition to regular pay an agreed amount in an account Musharaka (participation) of the bank.

The reinvestment of profits from this account and the paid up capital, allows customers to buy at a price fixed in advance, the equipment he becomes owner at the end of the leasing contract.

Greater customer involvement is noted again in the activities of Islamic banking, as among conventional banks. This technique is often used in the medium or long term by the bank for financing consumer durables.

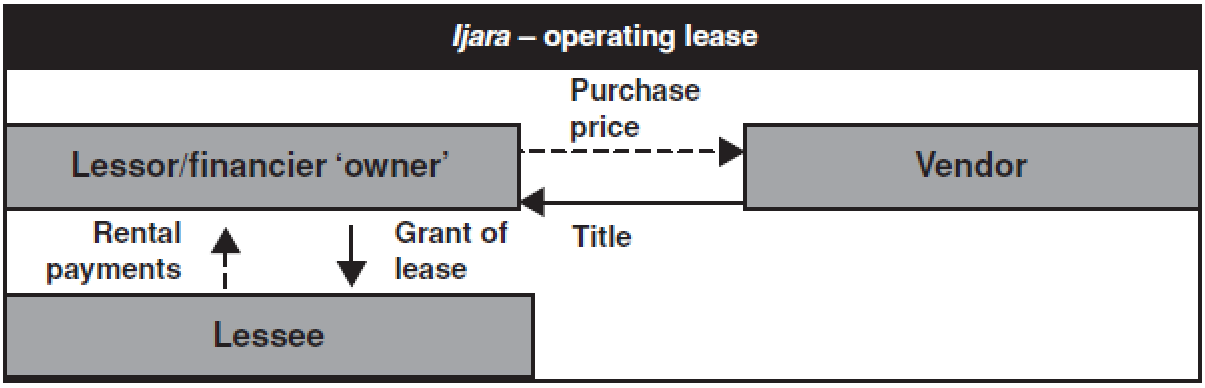


Figure 2.5. The Ijara Flow Chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

The bank purchases the asset and makes it available to the contractor for use in return for payment of rent (leasing contract). The finalization of this contract also request a purchase order expressed by the final customer. Except that the latter agrees to rent and not buy the property as is the case in the murabaha. This formula is therefore seeking three types of commitments: a purchase order, a promise to lease and leasing agreement. It can be with or without promise to purchase (Ijara-wa-Iqtina).

Renting leading to the purchase is to transfer ownership of the property to the tenant at the end of the leasing contract. This transfer can be done by way of gift or sale contract. The document on the second option can not be signed until the end of the lease period.

A third variant is the Ijara with diminishing Musharaka. The share of the financial institution in the leased property decreases with principal payments that the customer makes over and above the payment of rent. The goal is to eventually transfer ownership of the property (usually real estate) to the client.

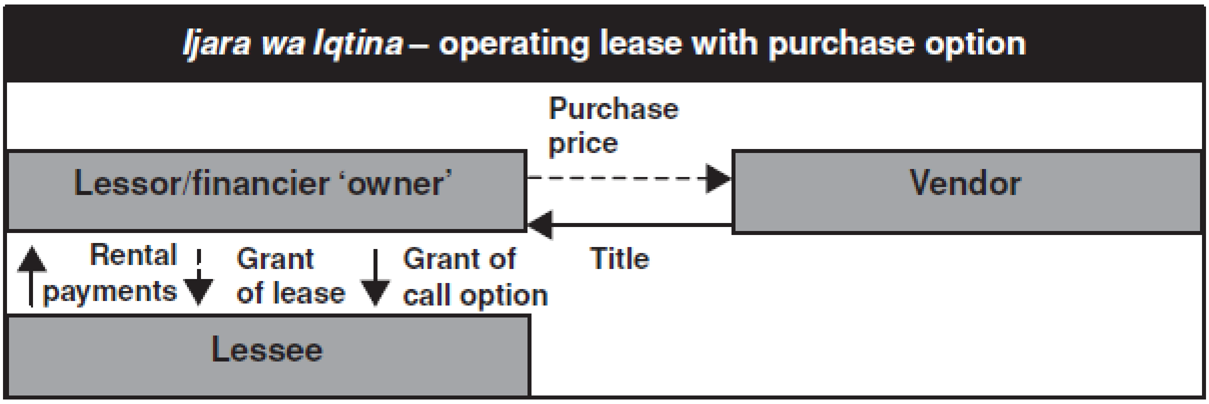


Figure 2.6. The Ijara wa Iqtina Flow Chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

The Risks with the Ijara contract are:

Risk 1 *Credit Risk*: The risk that the lessee is unable to service the lease rental as and when it is due.

Risk 2 *Market Risk*: The risk that if default occurs, the bank has to re-rent the property on the open market at a lower price than agreed. (Brian Kettell, 2011: 77-89)

2.7.5 The Istisna'a Contract and risks

The Istisna'a is a contract under which one party (Moustasni'i) asks another (Sani'i) to make him a book or build upon remuneration payable in advance, fractionally or term. The majority of jurists consider the Istisna'a a variant which is similar to the Salam contract unlike the object of the transaction is for the delivery, not goods purchased in the state, but of finished products that have undergone a process of transformation.

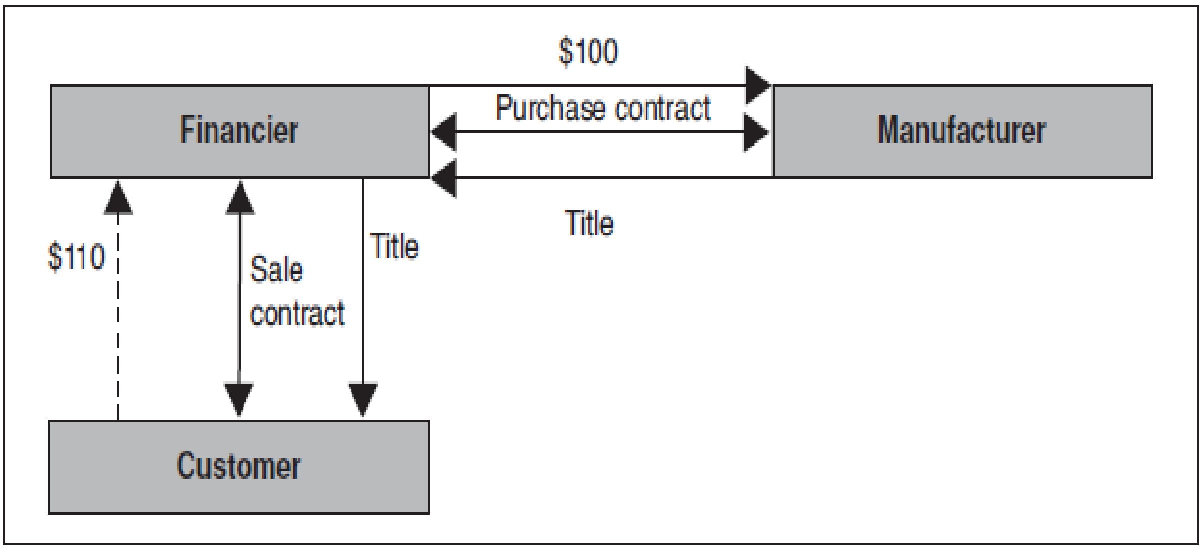


Figure 2.7. The Istisna'a Flow Chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

The bank may use the Istisna'a contract in two ways:

a / The bank may buy convenience istisna'a by a contract and the sale by means of fractional payments or deferred payments, it is a Istisna'a contract of sale.

b / The bank may enter in two parallel Istisna'a contracts, as a seller to buyers of a particular convenience, and the other as a buyer with the convenience of the manufacturer, it is a contract Istisna has parallel. The formula of Istisna'a, placing in this case has the appearance of a triangular operation involving alongside the Bank, the project owner and the contractor as part of a double Istisna'a .

In Istisna'a, contracts between the Islamic bank and the buyer and between it and the manufacturer or subcontractor may be separate and independent, but the bank can not intervene if the two parties reach ' agreement on a project to fund only since this would be treated as a loan with interest. The bank does here is to lend money in return for a certain profit.

The basic principle is that the remuneration of the Bank in connection with the Istisna'a is justified by its intervention as a contractor responsible for the execution of works relating to the construction of the work covered by the contract, that Intervention takes place directly or through subcontractors.

The Istisna'a contract must necessarily relate to a manufacturing process, specifying all the characteristics of the property to produce. The Istisna'a is applicable in various industries, it can be used in food industries, in the construction sector, in the technology industry in the financing of imports of goods needed for different projects.

The Risks with the Istisna’a contract are:

Risk 1 *Credit Risk*: The risk that the customer is unable to honour the payment obligations for deferred installments when the work is already in progress.

Risk 2 *Operational Risk*: The risk that the partner lacks technical expertise and the project fails. (Kettell, 2011: 91-99)

2.7.6 The Salam Contract and risks

This is a short-term agreement whereby a financial institution pays, in advance, the corresponding amounts for the future delivery of a specified quantity of goods. Mainly used for the financing of goods, it is like a forward.
There are seven requirements to validate the salam:

1- The information must be given on the category of the product to deliver (jins).

2. The information must be given on its variety;

3- On the quantity (quadr);

4- On the quality (sifa)

5- On the delivery date (ajal)

6- At the place (Makan), with transportation costs and other expenses;

7- On the exact amount to be paid (ra's al-mal)

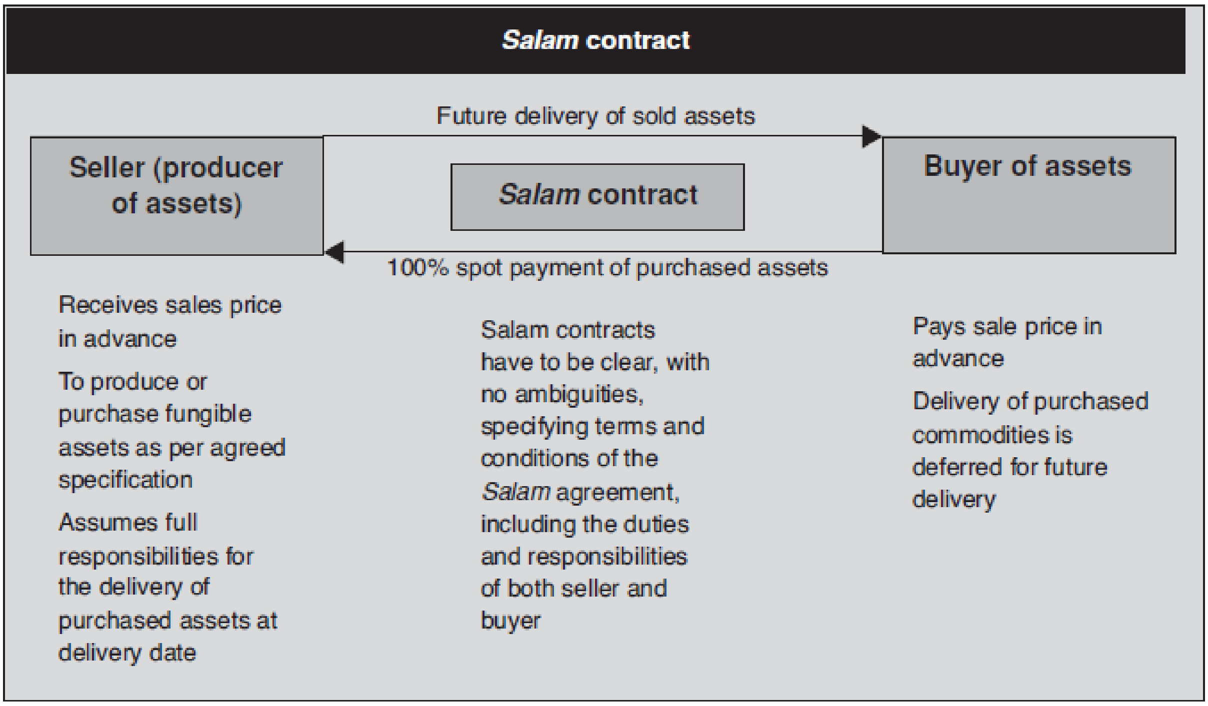


Figure 2.8. The Salam Flow Chart

Source: Kettell, Brian (2011), The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance

Salam contract allows the seller to get his money upfront in exchange for the obligation to deliver the convenience later. The bank buys the convenience in which it wants to trade, benefits of price opportunities available and protects against fluctuations.

The bank may sell parallel convenience questioned by another independent Salam contract, as it can expect receipt of convenience and sell cash or deferred payment.

The delivery and receipt of convenience is a specific date, and the bank has several options. The bank may receive convenience on time and sell for cash or on credit. It may allow the seller to sell the convenience of place for a fee or no fee. It can also ask the seller to deliver convenience to a third party's prior agreement.

Risks with the Salam Contract are:

Risk 1 *Credit Risk*: Settlement/delivery risk where the goods are not delivered or not delivered on time.

Risk 2 *Market Risk*: The risk that if there is a default then the bank has to purchase the goods on the open market at a higher price than the agreed price in the Parallel *Salam* contract. (Kettell, 2011: 101-110)

2.8. The performance of interest-free banking products

"The performance of Islamic financial institutions can be considered good, especially in light of the fact that Islamic institutions are part of an emerging and developing market that is trying to overcome many challenges and obstacles. The returns to Islamic banks have been comparable to those of conventional banks. No Islamic bank has failed as a result of the subprime crisis. The risk - adjusted returns of some Islamic capital market products are higher than comparable ones in conventional markets. These are, however, preliminary results and may change with time." (Hossein askari, Zamir Iqbal, Noureddine Krichene and Abbas Mirakhor, 2010: 206)

2.9. A perspective on interest-free banking

The Evolution of Islamic finance has big changes in the financial industry, as evidence from today increasing numbers of new participants in the Islamic bank. The ultimate justification for the new entrant interested to join in this industry is mainly due to its unique financing structures that provide relatively more flexible procedure compare to the strict sentence imposed by conventional bank. Islamic financial institution is established to operate commercial banking activities that release of any item prohibited in Shariah Islamic jurisprudence as riba, maisir, Jahala and gharar. The replacement of the interest share of profits and losses is intended to promote fairness and helps when just in terms of risk and return.

The emergence of Islamic banks has created a new frontier in the industry of financial intermediation, where the nature of Islamic banking alternative that provides more banking services based on equity based, debt-based and based on expenses. Islamic banking is expanding its alternative way of financing in line with the financing needs of its customers needs today. New participants in Islamic banks should be aware that to become fully involved in the banking scheme uninteresting bankers need to be educated in the field of Sharia in particular in its Fiqh related to financial matters before engaged in the Islamic banking industry.

Very often criticized Islamic banks in particular classical secularism in terms of similarities of Islamic banks to traditional bank-based interest, this question arises when is the practice of Islamic banking activities are not carefully exercised the principle of Sharia law which regulated each type of financing before it concluded. Although the growth of Islamic finance to date has proved that Islamic banking is feasible and capable of working side by side to the traditional bank with a wide range of products able to respond to households and businesses. (Waeibrorheem Waemustafa, 2013: 67)

Chapter 3 - Conventional and interest-free banking systems in Morocco:

The introduction of Islamic finance in Morocco has been start-stop at best; the first attempt at introducing Islamic financial products, or alternative financial products as they are called in the country, was in 1991 when Wafa Bank took the lead but the bank's offering of alternative financial products was short-lived due to legal issues.

In 2007 there was a more concerted national-level introduction of sharia-compliant financial products within conventional financial institutions but this has not made significant impact. Following these first experiments and increasing investment opportunities particularly from Gulf countries and the plans for the Casablanca Finance City to propel Morocco as a regional financial hub, the kingdom is now ready to more fully embrace Islamic finance.

Morocco is viewed as an exciting emerging Islamic finance market with vast opportunities for investment, and the country's current government is keen to develop the industry both for its citizens as well as to attract foreign investment.

Islamic finance in Morocco is set to take root and bloom with the establishment of Islamic banks, or participatory banks as they are called locally, and other Islamic financial institutions that will come onto the financial landscape once all relevant legislation is put in place. As of this writing a bill regulating participatory banks and sukuk has been adopted by government, paving the way for a final vote by parliament. Approval of the law is expected before the end of 2014. The draft laws for takaful and mutual funds are set to follow. (Morocco Islamic Finance Report 2014)

3.1. Politics

Morocco has a fundamentally stable political environment relative to its North African Arab Spring neighbours. In June 2011 King Mohamed VI responded to the growing demands for more democracy and introduced a wide range of political and social reforms including the drafting of a new constitution accepted by a large margin in a popular referendum in July 2011. Early Parliamentary elections were held in November 2011 which ushered in a coalition made up primarily of the Justice and Development Party (official name — Parti de la justice et du développement, PJD), the Istiqlal party, and the National Rally of Independents. In July 2013 the Istiqlal party quit the coalition government, forcing the PJD to form a new coalition with the National Rally of Independents (NRI) in October. (Morocco Islamic Finance Report 2014)

3.2. Economy

Morocco has been on a steady path of economic recovery since the stagnation of the 1990s, with sound macroeconomic management and sustained growth in non-agricultural sectors. The country's Haut Commissariat au Plan reported GDP growth of 4.8% in the first quarter of 2013, rising to 5.1% for the second quarter and dipping to 4.5% in the third quarter. All signs point to an improved GDP performance in 2013 from sluggish growth of 2.7% in 2012. (Morocco Islamic Finance Report 2014)

Morocco's economy has grown an average of 4.7% since 2000, which is almost double that of the average of 2.6% per year from 1990 to 1999. The International Monetary Fund (IMF) projects growth of 5.1% for the whole of 2013 and 3.8% for 2014, attributing the slowdown in 2014 to the normalization of rain-dependent agricultural production after an exceptional harvest in 2013. (IMF World Economic Outlook October 2013).

GDP growth of 4.3% in 2015F is due to:

- Agricultural GDP growth rate of 13.2% in 2015F thanks to a higher cereal harvest (115 million quintals in 2015) compared to 2014 (68 million quintals)

- Non agricultural GDP growth rate of 2.5% in 2015F vs 3.1% in 2014

- Growth of Moroccan domestic consumption stable at 3.2% in 2015F

- Increase of external demand to Morocco growth rate due to the rebound of European economy (especially France and Spain)

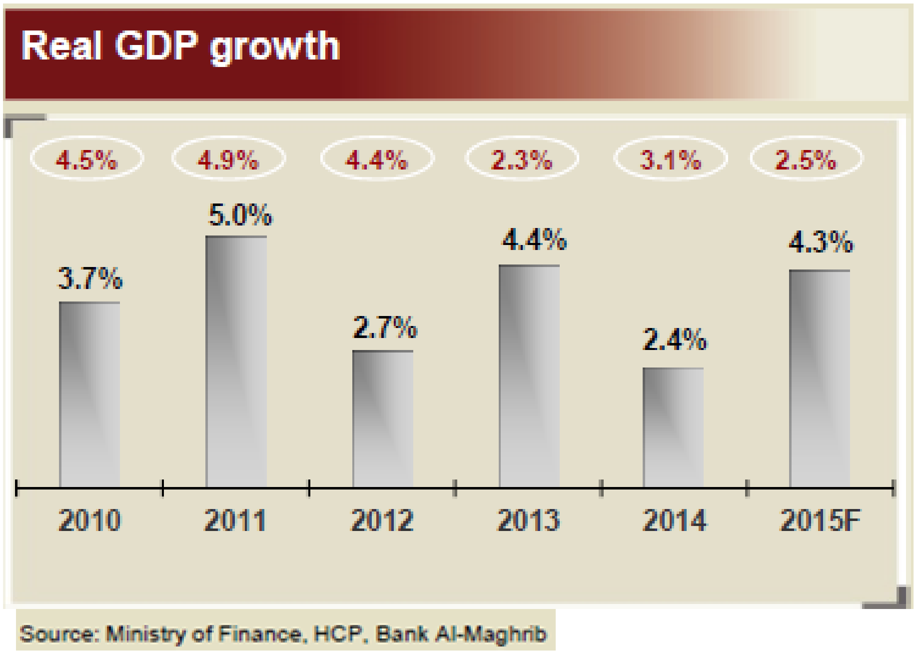


Figure 3.1. Morocco's GDP Growth

Inflation, Monetary and Exchange rate policies are as follow:

-Slight increase of inflation rate to 1.7% in 1H-2015 :+2.3% in food items and +1.2% in non-food items.

-Stable central bank key interest rate at 2.50% after a cut of 50 basis points in September 2014 and December 2014

-April 2015: Evolution of the mix of the Dirham's basket of currencies to 60% Euro and 40% US dollar (80% and 20% previously)

-USD/MAD exchange rate up 20% between June 2014 and June 2015

-EUR/MAD exchange rate down 3% between June 2014 and June 2015

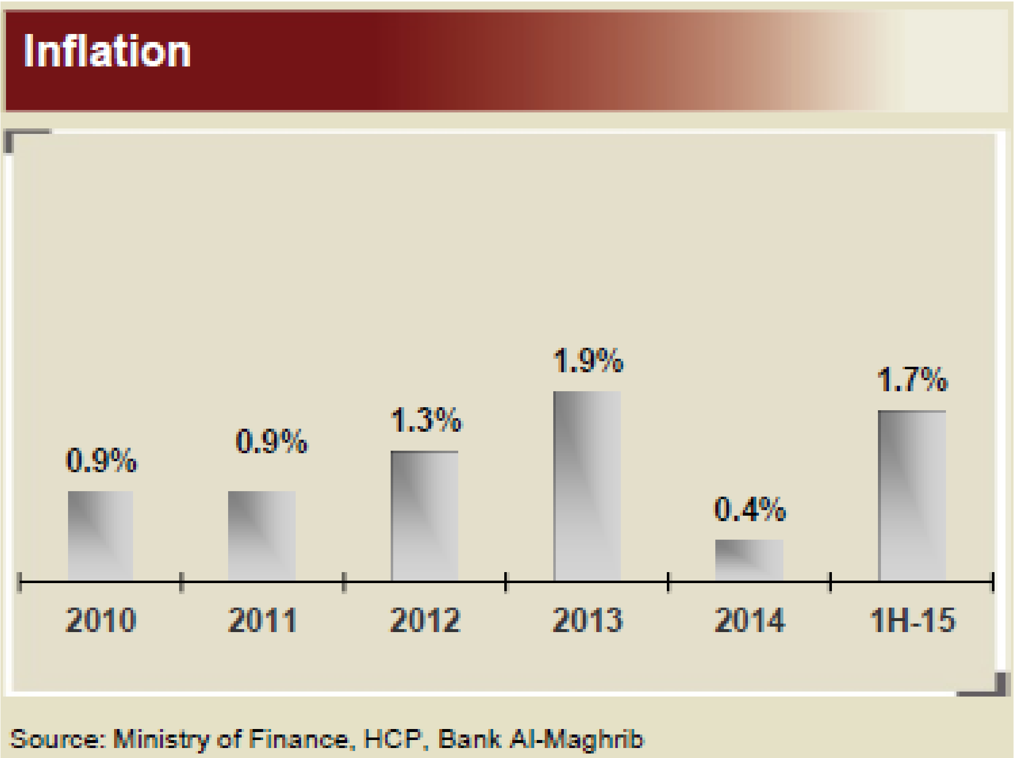


Figure 3.2. Morocco's Inflation

3.3. Financial Industry Structure

The financial sector comprises 86 financial institutions including 19 commercial banks (among which 6 are listed), 36 finance companies, 6 offshore banks, 10 funds transfer companies and 13 microcredit associations, in addition to the Central Guarantee Fund and the Caisse de Dépôts et de Gestion (a state-owned holding company).

Table 3.1. Evolution of the number of Credit Institutions and similar organizations

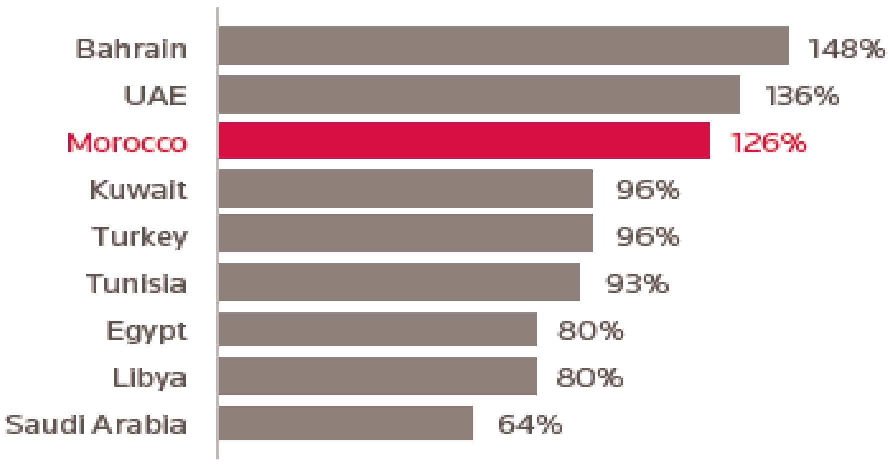
	2008	2009	2010	2011	2012
Banks	18	19	19	19	19
Financing Companies	37	36	36	35	36
Offshore banks	6	6	6	6	6
Microcredit associations	13	12	12	13	13
Funds Transfer companies	7	9	8	10	10
Other Institutions	3	2	2	2	2
TOTAL	84	84	83	85	86

Source: Bank Al-Maghrib.

Table 3.2. Breakdown of Moroccan Credit Institutions by Asset Share in 2012

i. Commercial Banks	88.76%
ii. Offshore banks	2.78%
iii. Leasing, Factoring and other financing institutions	8.02%
iv. Microfinance Institutions	0.44%
TOTAL ASSETS	100%

Source: Bank Al-Maghrib – 2012, on the Control, Activity and Results of the Credit Institutions.



Source: Thomson Reuters Eikon & IMF World Economic Outlook, October 2013.

Figure 3.3. Banking Assets/GDP(2012)

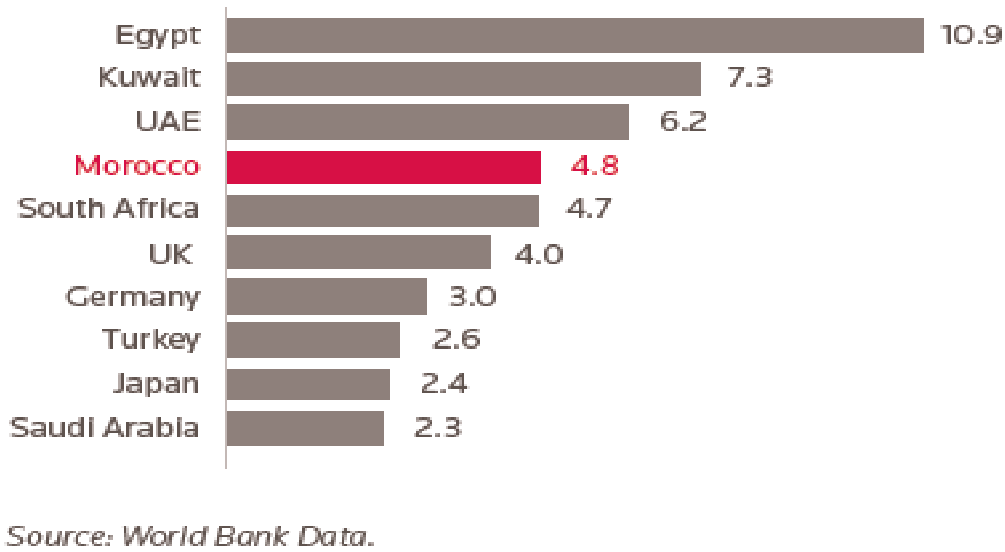
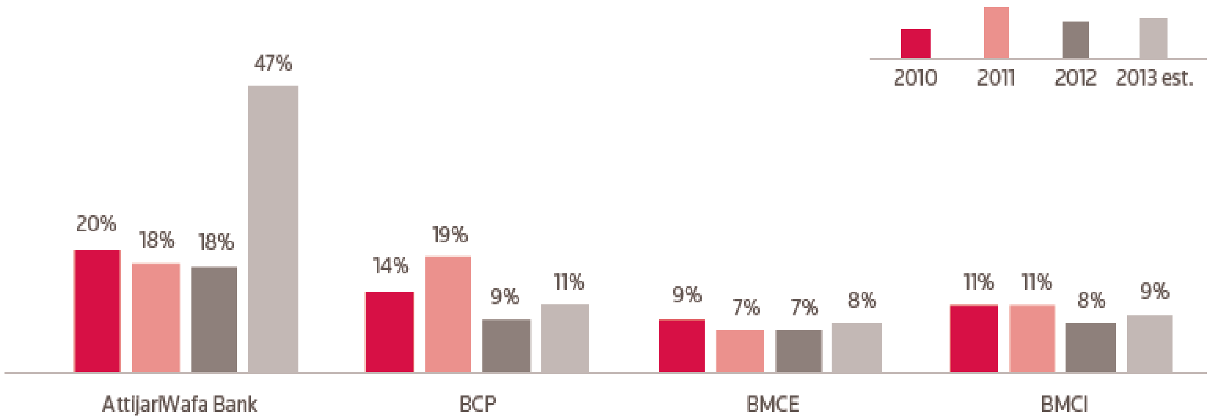


Figure 3.4. Banking nonperforming loans to total gross loans (%), 2011

The banking sector is dominated by the three largest banks, which control approximately 65.6% of the banking sector's total assets. This is a very clear warning for new entrants as to how well established these three banks are in the kingdom.

AttijariWafa, the largest bank in Morocco and Africa's sixth largest by balance sheet, announced in 2012 its plan to expand its presence mostly in francophone African countries as bank penetration in Morocco reached over 50% in 2011, a sign for the bank that its domestic growth may be nearing saturation point. (Morocco Islamic Finance Report 2014)



Souce: Thomson Reuters Elkon.

Figure 3.5. Return on Equity (ROE)

Morocco has one of the **highest banking assets / GDP** in comparison to its neighbours. Banking assets stood at US $ 127 billion in 2012, compared to Tunisia's US $ 42 billion but much lower than Egypt's US $ 206 billion.

Non-performing loans (NPL) ratio is considered the most fundamental indicator in relation to asset quality. Morocco's NPLs stood at 5% in 2012 compared to 4.8% in 2011. In comparison, South Africa's NPL was 4.6% and UAE's was 6.2% in 2012. Since the financial crisis in 2008, Morocco's banks have managed to keep very low NPL levels. The ratio showed remarkable improvement for the period from 2008-2011, decreasing to 4.8% in 2011 compared to 6% in 2008.

Return On Equity (ROE) eased for all four big banks except BCP for the period 2010 to 2012. Moroccan banks' ROE is expected to recover and reach as high as 46% for AttijariWafa bank, according to forecasts. (Morocco Islamic Finance Report 2014)

3.4. The banking Sector

The banking sector can be divided into three categories in terms of ownership:

• Private banks (7),

• Public banks (5), and

• Subsidiaries and branches of foreign banks (7)

According to Bank Al-Maghrib statistics released in June 2012, private banks with dominant Moroccan ownership represent 65.8% of total banking assets, 65.6% of total deposits and 64.5% of total loans. In June 2012, 58.2% of deposits were current accounts, 23% were term deposits and 15.7% saving accounts.

Table 3.3. Structure Indicators of the Moroccan Banking Sector (Activities in Morocco)

	2008	2009	2010	2011	2012
Banks with dominant public ownership	5	6	6	5	5
Banks with dominant private ownership	6	7	7	7	7
Banks with dominant foreign ownership	7	7	7	7	7
Employees	29,412	30,845	35,766	37,245	38,262
Foreign presence: Numbers of branches, subsidiaries and representative offices	NA	NA	86	88	94
Bank Accounts/Population	43%	47%	50%	54%	57%
Banking cards (in millions)	5.2	6.3	7.1	8	9.3
Assets' concentration *	65%	66%	63.60%	64.60%	65.60%
Deposits' concentration *	68%	67.90%	64.70%	65.70%	65.40%
Credits' concentration *	60.90%	61.40%	62.70%	64.10%	64.50%

** share of the 3 major banks*

Source: Bank Al-Maghrib Reports – 2008, 2010 and 2012, on the Control, Activity and Results of the Credit Institutions.

The banking sector plays a major role in the Moroccan economy and has withstood the global financial crisis in large part because it is not highly integrated into the international financial architecture.

Table 3.4. Indicators of the Moroccan Banking Sector Operations

%	2008	2009	2010	2011	2012
Total Assets/GDP	110.8	113.0	115.9	121	125.7
Deposits/GDP	83.1	82.1	81.4	84.4	84.1
Loans/GDP	79.5	82.9	85.4	91.1	92.6
Domestic Credit to Private Sector	63.0	65.0	69.0	72.0	73.0
Securities / Total Asset	16.4	17.9	15.8	17.6	19.9
Fixed Assets / Total Assets	2.0	2.0	2.0	2.0	2.0
Liabilities / Total Liability	86.7	84.6	82.4	85.5	84.9
Deposit / Total Liability	75.0	72.6	70.2	69.8	66.9
Loans / Deposit	95.7	101.1	104.8	108.0	110.1
Liabilities / Total Asset	86.7	84.6	82.4	85.5	84.9
Off-Balance Sheet Transactions / Total Assets	28.7	26.5	25.8	24.9	23.9

Source: Bank Al-Maghrib reports –2008, 2010 and 2012, on the Control, Activity and Results of the Credit Institutions.

Bank assets to GDP ratio

This has been gradually increasing, reaching 125.7% in 2012 from 110.8% in 2008.

Deposits to GDP ratio

Deposit growth is very slow and marginally dipped from 84.4% in 2011 to 84.1% in 2012.

M2 to GDP ratio

Between 2000 and 2012, this rose 71% to 113%, indicating that the size of the Moroccan financial intermediary sector has increased rapidly.

Loans to GDP ratio

This has increased gradually from 79.5% in 2008 to 92.6% in 2012 although growth slowed from 2011 to 2012.

Extension of credit to the private sector

Increased to 73% of GDP in 2012, up from 63% in 2008. This ratio is higher than Turkey's (54%) but below the 118% of GDP in Malaysia. While loans granted by banks to the public sector represent only 5.8% of total loans in January 2013, the allocation of loans among the private sub-sectors reveals the predominance of real estate loans (31.25%) relative to equipment loans (19.51%), financial facilities loans (25.36%), and financial transaction loans (11.65%). The maturity structure of the loans in June 2012 matches with the above breakdown of the loans since 40.8% of the total loans are of short term maturity, 27.6% are mid-term and 26.6% are long term loans, with the remaining 5% as non-performing loans.

Securities portfolio to total assets

Increased to 19.9% in 2012 from 16.4% in 2008. Looking at the sector's asset composition,

Fixed Assets represent only 2% of total assets and 84.9% of the sector's assets are financed by liabilities. Off-balance sheet transaction to total assets ratio has been decreasing since 2008, reaching 23.9% in 2012.

Loans to deposits ratio

Increased from 95.7% in 2008 to 110.1% at the end of 2012. This signals increased pressure on banks' liquidity which is also reflected by the drop in bank liquid reserves to bank assets ratio which passed from 10% in 2008 to 3.2% in 2012, a level which is much lower than that of Turkey (16.1%) and Malaysia (19.4%). (Morocco Islamic Finance Report 2014)

3.5. Swot Analysis

Strengths:

- Government support for the development of Islamic finance and its willingness to issue its first sovereign sukuk.
- A population which is highly interested in Islamic financial services.
- Morocco aims to be a regional financial hub through Casablanca Finance City, a unique opportunity to attract Islamic finance players.
- The presence of conventional Moroccan banks in sub-Saharan Africa will enable future Islamic banking subsidiaries to gain economies of scale.
- Current advances in the legal framework of the Islamic financial system (ongoing — draft banking law introducing the participatory banks, sukuk law, takaful law) are likely to be pursued by more specific and detailed application circulars.
- Creation of a Central Sharia Board.
- Morocco has a deeply rooted culture of awqaf.
- Microfinance services are developed in Morocco.
- Many associations are active in the field of Islamic finance and economics.

Weakness

- Lack of awareness of Islamic finance products and services amongst the public.
- Lack of specialised human capital.
- Alternative products were not attractive in the past and the population was suspicious about their Islamic authenticity and compliance to sharia.
- Fiscal neutrality is still not completely resolved except for murabaha products.

Opportunities

- The three largest banks are interested in offering Islamic financial products and services.

- More than 90% of the population expressed interest in Islamic financial products, according to the IFAAS survey.
- With 42% of its population between 25 and 54 years old, Morocco could gain remarkable progress in promoting family takaful. (Islamic Finance News, May 2012)
- Good political and economic relationship with GCC countries would encourage inflows and direct investment into Islamic financial institutions and related sharia-compliant sectors.
- The richness of awqaf and their coupling with microfinance institutions will enable the rapid development of the Islamic microfinance industry.
- The stock exchange of Morocco is ready for the listing of sovereign and corporate sukuk with the possibility of listing foreign companies' sukuk.
- Many universities have recently launched diploma, masters and PhD programmes in Islamic finance and economics.
- Existing programmes for the promotion of SMEs (e.g. Emtyaz are endowed with the flexibility to receive line of financing in the form of mudaraba or musharaka).

Threats

- Delays in enacting the new laws and the issuance of detailed application circulars will trigger uncertainty and possible lack of confidence towards direction of the development of the Islamic financial services ecosystem.
- A market structure which does not favour competition between the suppliers of Islamic financial services will dampen the demand from the population and may have a chronic effect.
- Huge expectations on the benefits of the development of the Islamic financial services industry could turn to disappointment rapidly if the services are offered in the absence of a well-designed ecosystem. (Morocco Islamic Finance Report 2014)

3.6. Current use of Islamic Finance

The Moroccan government has been carrying out some of its infrastructure, real estate and energy-based national projects using Islamic finance. Most of the funding have consisted of istisna where the financier pays for the tools, employment and contractors for the project and receives the profit of the capital advanced plus a pre-arranged profit mark-up when the project is completed and revenue flows in.

Bank Al-Maghrib approved a licence for Attijariwafa Bank, the country's largest bank and the third largest in Africa, to open the first participatory financial institution in the country, Dar Assafaa Litamwil, as one of its subsidiaries. The central bank's announcement was published in the Official Bulletin No. 5852 of 18 Rajab 1431 (1 July 2010). Dar Assafaa Litamwil has been marketing a range of alternative financial products (i.e. Islamic financial products) in Morocco since its establishment. All its products are based on murabaha contracts and target individuals:

- ✓ Safaa Immo: Financing Real Estate Projects
- ✓ Safaa Auto: Financing Vehicles
- ✓ Safaa Cons: Purchasing Products and Services
- ✓ Safaa Tajhiz: Purchasing Home Furniture

Table 3.5. Project Financed Islamically

DATE	PROJECT	SECTOR	TYPE	$USM
2011	National Roads Support Program	Infrastructure	Istisna (IDB)	11.0
2011	Port Expansion	Infrastructure	Istisna	150.0
2010	Rural Electrification	Energy	Istisna	65.6
2009	Al-Quneitrah Housing	Real Estate	Islamic Finance	53.5
2009	Al-Quneitrah Power Station	Energy	Islamic Finance	200.0
2007	Mohammedia Gas Turbine Plant	Energy	Istisna	189.0
2005	Marrakash – Agadir Highway	Infrastructure	Istisna	106.2

Source: Islamic Finance Information Service

Table 3.6. Key Highlights of Dar Assafaa Litamwil

Number of Branches	9
Commenced Operations	May 13, 2010
Capital	$5.7 million
Ownership	Attijariwafa Bank

Source: Dar Assafaa Litamwil

The country's parliament approved a law "N°119-12" in September 2013 that will permit the sovereign and corporate bodies to issue sukuk.

The current securitization law was enacted in 2002 and was later amended in 2010 to widen the range of eligible assets and to permit institutions other than banks to use securitization. At the end of 2012, the government passed another amendment to the law to pave the way for sukuk issuance.

The new law “N°119-12” for securitization which relates to sukuk will allow issuers to target both domestic and international investors. It also allows the government to use any government or government related entities’ tangible assets to back any sovereign sukuk issuances.

In Aug 2013, three banks — Attijariwafa Bank, Banque Centrale Populaire (BCP) and BMCE Bank — indicated their intentions to issue foreign-currency bonds to boost their liquidity levels. The banks are more likely to issue conventional bonds instead of sukuk, given that the sukuk law is yet to be approved by the parliament.

One of the reasons for these banks to bolster liquidity is the expansion of their operations in Africa. Expansion is in line with government vision for Morocco’s development as a regional financial hub. BMCE Bank sold $300 million in conventional bonds at the end of November 2013, which it said it would use to fund expansion across Africa beyond the francophone countries of West and Central Africa where it already has a presence.(Reuters, “Morocco’s BMCE bank to use bond sale $300 mln to fund expansion”, Nov 29, 2013) Their intention is to increase the company’s presence on the continent from 12 to 20 countries by 2015.(Morocco Islamic Finance Report 2014).

Chapter 4 - Conventional and interest-free banking systems in Turkey:

From economic crisis in 2000/1 to an annual average real GDP growth of 4.26% between 2000 and 2010 Turkey is projected to keep on growing. The International Monetary Fund (IMF) estimates higher growth for 2013 (3.4%) and 2014 (3.7%) as compared with 2012's real GDP growth of 2.6%.

Turkey's growth projections are the second highest for Europe (Latvia leads), and are comparable with the IMF's estimates for South Korea (2.8%, 2013 and 3.9%, 2014) and Brazil (3%, 2013 and 4%, 2014). Turkey's sustained growth during the last decade was driven by its SMEs, and this growth is reflected in the large increase of per capita GD P. Driven by geo-political developments, and with a variety of initiatives in financial sector development, one area that stands as a successful growth story is the Islamic finance sector. (Turkey Islamic Finance Report, 2014, IRTI)

4.1. Economy

An upper middle-income country, Turkey's economy grew at an average annual rate of 4.25% (% change of GD P constant prices) over the period 2000-2010, pushing up per capita GD P (current prices) to an estimated $10,456.886 in 2012 from $4,146.781 in 20044.

Despite the recession due to the global economic crisis, the country achieved an estimated growth (% change of GD P constant prices) of 9.15% in 2010, (IMF World Economic Outlook, October 2012) facilitated by enabling macroeconomic and structural policies which encouraged the private sector to realign its activities towards sectors with higher comparative advantage and to export to new fast-growing markets. It is the seventeenth biggest economy in the world with an estimated GD P (current prices) of $783.064 billion in 2012. (IMF World Economic Outlook, October 2012.)

The IMF estimates real GDP growth moving on a positive trend reaching 3.7% in 2014, the second highest growth projection in Europe behind Latvia (4.2%), and comparable with the 2014 estimates for South Korea (3.9%) and Brazil (4%). (Turkey Islamic Finance Report, 2014, IRTI)

Turkey has a diverse economy dominated by the Services sector which accounted for 62.98% (2011) of the value added % in GD P while industry and agriculture accounted for 27.88% and 9.14% respectively. Within the Services sector, trade, transportation, and communications are major contributors. Turkey also has a vibrant manufacturing sector which accounted for 29.7% of total Gross Capital Formation in 2010. Textiles and clothes and automotive are the leading export sectors.

Travel and Tourism contributed 10.9% to GD P in 2011 and this figure is forecasted to rise by 3% per annum from 2012 to 2022. In 2011 Travel and Tourism generated 1,939,000 jobs (8.1% of total employment) and visitor exports generated 15% of total exports. (Travel & Tourism Economic Impact, Turkey, 2012.)

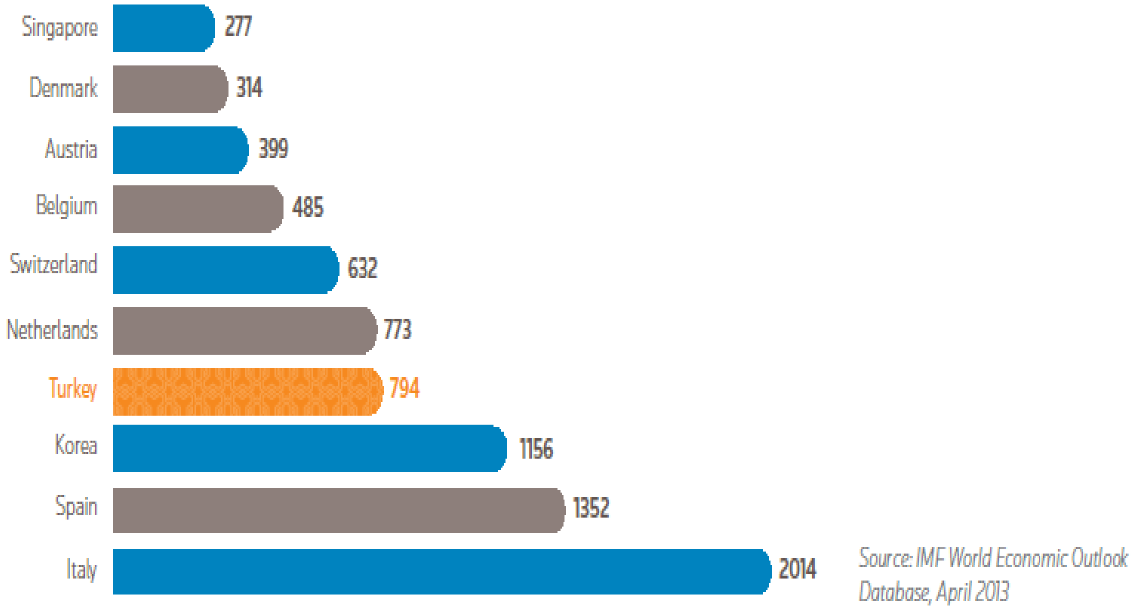


Figure 4.1. GDP Growth: 2012 GDP, current prices USD billions (Comparison with advanced economics)

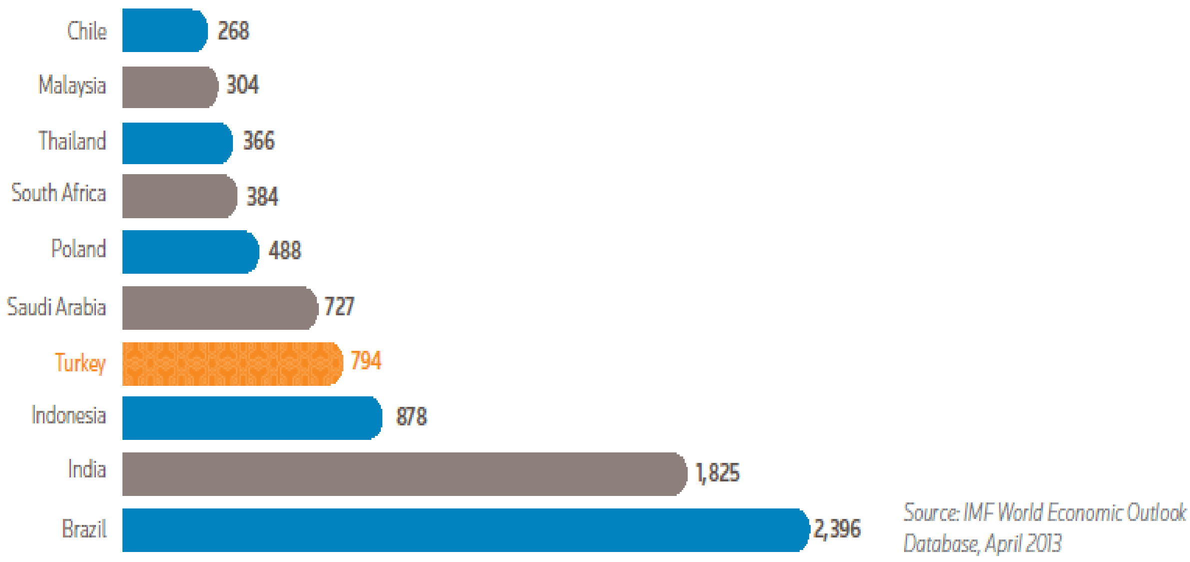
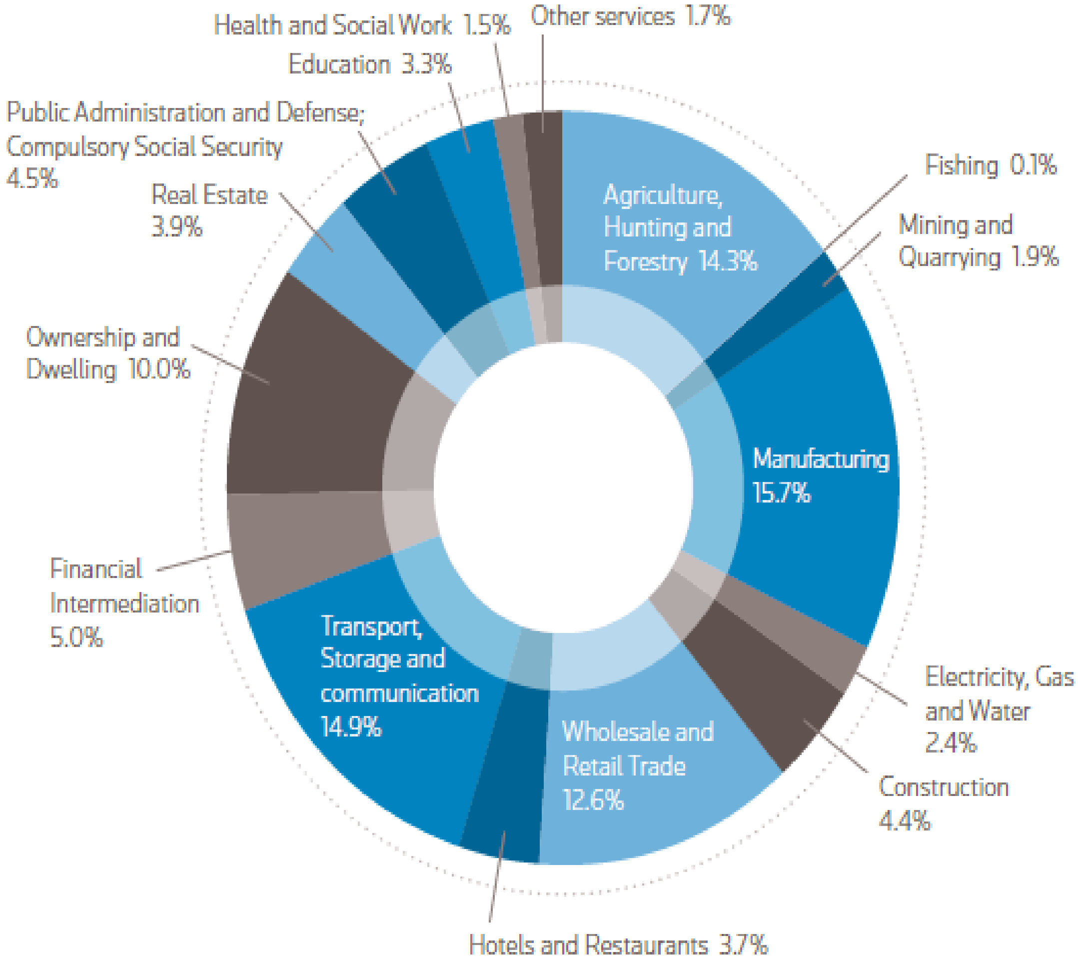


Figure 4.2. GDP Growth: 2013 GDP, current prices USD billions (Comparison with advanced economics)



Source: Central Bank of Turkey – EDDS

Figure 4.3. Diverse Economy -2012Q3- % of GDP By Branch Of Economic Activity

4.2. Capital Market

The market capitalization of Borsa Istanbul Stock Exchange increased by 45% in 2012 to TR Y 550 billion compared to TR Y 381 billion in 2011. In May 2013, the BIST-100 index reached a record high of 93,179 points as investors rushed for bank shares on historically low benchmark bond yields and rising expectations for a second credit rating. Asset and capitalization size has decreased by 1.6% in Sec. (Turkey Islamic Finance Report, 2014, IRTI)

Table 4.1. Table of Asset Size Changes

Turkish Lira (TRY) Billion	2008	2009	2010	2011	2012
CBRT	113.5	110.0	128.5	146.2	203.6
ISE (Capitalisation)	182.0	350.8	472.6	381.2	550.1
VOB (Capitalisation)	208.0	334.2	431.7	439.8	–
IGE (Capitalisation)	14.6	10.7	7.8	23.3	–
Banks	733	834	1,006	1,218	1,371
Conventional Banks	707	800	963	1,162	1,300
Participation Banks	25.8	33.6	43.3	56.1	70.3
Fin. Leasing Comp.	17.1	14.6	15.7	18.6	20.3
Factoring Comp.	7.8	10.4	14.5	15.7	18.2
Consumer Fin. Comp.	4.7	4.5	6.0	8.9	11.6
Asset Management Comp.	0.4	0.4	0.7	0.9	1.4
Fin. Holding Comp.	5.0	4.9	5.1	5.5	5.6
GGF	0.1	0.1	0.1	0.2	–
Insurance Comp.	26.5	31.8	35.1	39.9	50.8*

Reassurance Comp.	1.4	1.6	1.6	1.6	1.8
Intermediary Ins.	4.2	5.2	7.5	9.6	11.4
Sec. Investment Trusts	0.6	0.7	0.8	0.7	0.7
REIT	4.3	4.7	17.2	18.7	24.1
VCT	0.1	0.2	0.2	0.6	0.7
Portfolio Mangement Comp.	0.3	0.3	0.3	0.3	–
Sec. Investment Funds	24.0	29.6	33.2	32.2	30.7
Pension Investment Funds	6.0	9.1	12.0	14.3	20.3
Total	2,085.6	2,591.8	3,203.3	3,593.3	3,604

Source: Banking Regulation and Supervision Agency (BRSA)
** Source: Annual report about insurance and private pension activities, Republic of Turkey Prime Ministry Undersecretariat of Treasury*

4.3. Banking Sector

The Turkish banking sector's asset base increased by 15.1% YoY to reach TL 1,994 billion in 2014.The volume of securities issued by the banking sector reached TL 89.3 billion in 2014, an increase of 47.4% when compared to its level at the end of 2013. Thus, the share of non-deposit sources in liabilities increased, reaching 35.6% at the end of the year.

Although there have been significant fluctuations in the international markets during the year, the sector did not experience any difficulty in obtaining funds from abroad, and Turkish banks renewed their syndicated loans with high demand.

Table 4.2. Turkish Banking Sector Branches and Personal Indicators (2014)

	Number of Banks	Number of Branches	Number of Personnel
Public Banks	9	3,523	59,943
Private Banks	17	5,668	100,250
Foreign Banks	25	3,020	56,687
Total	51	12,211	216,880

Source: BRSA

Table 4.3. Turkish Banking Sector Selected Balance Sheet Indicators (2014)

Assets	TL billion	Change (%)
Cash and Cash Equivalents*	124	10.9
Reserves	172	10.3
Loans	1,241	18.5
NPL (Gross)	36	22.9
Securities	302	5.4
Other Assets	119	17.6
Total Assets	1,994	15.1
Liabilities	TL billion	Change (%)
Deposits	1,053	11.3
Debt to Banks	293	15.3
Repo Transactions	137	15.3
Securities Issued	89	47.4
Shareholders' Equity	232	19.8
Other Liabilities	190	19.3
Total Liabilities	1,994	15.1

*Includes the total amount of cash, CBRT, and receivables from money markets and banks.

Source: BRSA

18.5% growth in the Turkish banking sector's loan stock in 2014. Loans which continue to be the most important item in sector's balance sheet increased by 18.5% and reached TL 1,241 billion in 2014. Loans have been decisive in the growth of the assets of the sector and despite the suppressive effect of the decline in domestic demand, share of loans in total assets increased to historically high levels, with 62 % in 2014.

At the end of December 2014, the total loans item stood at TL 1.24 trillion, of which TL 881 billion consists of Turkish Lira loans and TL 360 billion consists of foreign currency loans. In other words, at the end of the year, the share of foreign currency loans in total loans stood at 29%. The amount of credit was TL 1.1 trillion in the third quarter, while deposits amounted to TL 1 trillion with the loans to deposits ratio standing at 1.18 as of December 2014.

Strong growth in corporate loans, but a softer trend in the retail portfolio. Most of the growth in the sector's loan portfolio was realized in corporate lending, where competition is intense.

4.4. Ratios related to Banking Operations

Analyzing Turkish banking activities, the share of loans to total assets increased to 58% in 2012 from 56.1% in 2011. The securities portfolio to total assets dipped to 19.7% in 2012 from 23.4% in 2011, with the increased expectation in interest rates. Annual credit growth ratio decreased to 16.4% in 2012 compared to 29.9% from the previous year. Looking at the sector's asset composition, Fixed Assets represent only 3.4% of total assets, which reflects a high liquidity that mitigates risks in this sector. 86.7% of the sector's assets are financed by liabilities.

The ratio of liquid and semi — liquid asset to liabilities increased to 195.6% in 2012 compared to 182.3% in 2011. This increase reflects the ability of the sector to repay all its liabilities which is a positive marker for liquidity risk. Liquid and semi-liquid FX assets to FX liabilities also increased to 121.8% in 2012 from 117.9% in 2011. Off-balance sheet transaction to total assets ratio has been increasing since 2009, reaching 143.1% in 2012. (Turkey Islamic Finance Report, 2014, IRTI)

Table 4.4. Turkish Banking Operations Ratios

%	2007	2008	2009	2010	2011	2012
Loans / Total Asset	49.1	50.1	47.1	52.2	56.1	58.0
Credit Growth Rate	30.4	28.6	6.8	33.9	29.9	16.4
Securities / Total Asset	28.3	26.5	31.5	28.6	23.4	19.7
Fixed Assets / Total Assets	4	4	4	3	3	3.4
Liabilities / Total Liability	87	88.2	86.7	86.6	88.1	86.7
Own Funds / Total Liability	13	11.8	13.3	13.4	11.9	13.3
Deposit / Total Liability	61.4	62.1	61.7	61.3	57.1	56.3
Loans / Deposit	80	80.8	76.3	85.2	98.2	103.0
Liabilities / Total Asset	87	88.2	86.7	86.6	88.1	86.7
Liabilities / Own Funds	667	748	652	648.2	742	653.4
Liquid and Semi-Liquid Asset / Liability	198.9	194.8	203.5	198.3	182.3	195.6
Liquid and Semi-Liquid Asset (FX) / Liability (FX)	126.4	124.7	141.2	128.1	117.9	121.8
FX Loans / Total Loans	24	28.7	26.6	27	29	26.0
FX Deposit / Total Deposit	35.4	35.3	33.7	29.7	33.9	32.6
FX Assets / Total Assets	28.3	30.3	26.7	25.6	30.3	30.3
Off-Balance Sheet Transactions / Total Assets	66.3	65	69.5	103.1	134.9	143.1
Derivative Transactions / Off-Balance Sheet Transactions	41.6	41.2	43.3	37.6	35	31.7

Source: Banking Regulation and Supervision Agency (BRSA)

4.5. Development of Ratios related to Asset Quality

NPL Ratio is considered the most fundamental indicator in relation to asset quality. The ratio increased to 2.9% in 2012, compared to 2.7% in 2011. The NPL Provision / NPL ratio decreased to 75.2% in 2012 from 81.4% in 2011. The loans which are larger than TR Y 1 million ($0.57 million) to total loans ratio decreased marginally in 2012 to reach 46.5% from 47.4% in 2011. The decrease in this ratio indicates lower risks within the banking sector as large loans have the potential to cause deterioration in cases of default. Individual loans and credit cards to loans ratio rose to 34.2% in 2012 compared to 33.2% in 2011.

This follows the trend in recent years, reflecting a reduction in credit risk concentration that will have a positive effect on the sector's asset quality. But this ratio is also seen as an indicator of household indebtedness, which means that a limited increase in these loans can be considered a positive sign for household indebtedness. Housing loans to cash loans ratio dipped slightly to 10.5% in 2012 compared to 10.6% in 2011. Unsecured loans dropped to 45% of the sector's non-performing loans compared to 48.9% in 2011. The decrease in the ratio will contribute to the banking sector's financial strength as it indicates improvement in collateralization during the credit allocation process. (Turkey Islamic Finance Report, 2014, IRTI)

Table 4.5. Development Ratios

%	2007	2008	2009	2010	2011	2012
NPL (Gross) / Loans	3.5	3.7	5.3	3.7	2.7	2.9
NPL Provisions / NPL	86.8	79.8	83.6	83.8	81.4	75.2
Cash Loans Larger than TRY1 million / Loans	39.2	44.6	45.8	47.8	47.4	46.5
(Individual Loans + Credit Cards) / Loans	33.3	32	33.3	33.1	33.2	34.2
Housing Loans / Cash Loans	11	10.3	11	11.2	10.6	10.5
Unsecured NPL / NPL	42.7	44.4	49.3	48.7	48.9	45.01

Source: Banking Regulation and Supervision Agency (BRSA)

4.6. Islamic Finance development

In Turkey, the specificity of Interest-free banks was recognized when they are created through specific legislation. The government felt that their methods and products offered differed from those of other banks. Special finance companies were governed by the Commerce Code and, therefore, subject to specific obligations and exercise conditions often deemed more favorable than those of the banks themselves.

4.6.1. Turkey's Islamic Finance Milestones

- ✓ 1983 Aug, "Special Finance Houses" decree was passed
- ✓ 1984 Nov, Al Baraka Türk was established
- ✓ 1985 Saudi-based Faisal Finans Kurumu was established
- ✓ 1989 Kuveyt Türk was established
- ✓ 1991 Anadolu Finans was established
- ✓ 1995 Ihlas Finans was established
- ✓ 1996 Bank Asya was established
- ✓ 2000 Ülker acquired Faisal Finans, changing its name to Family Finance House
- ✓ 2001 Feb, Turkish Lira moved from a crawling peg to a free floating regime
- ✓ 2001 Turkey Financial Crisis
- ✓ 2001 Ihlas finance filed for bankruptcy
- ✓ 2002 Justice and Development Party (AKPART i) came into power
- ✓ 2005 Family Finans and Anadolu Finans merged to form Türkiye Finans Katilim Bankasi
- ✓ 2005 Banking Law officially replaced the "Special Finance Houses" term with "participation banking"
- ✓ 2007 Saudi National Commercial Bank (NCB) acquired 60% of Türkiye Finans Katilim Bankasi for $1 billion
- ✓ 2008 Global Financial Crisis
- ✓ 2010 Framework for corporate sukuk was set up

- ✓ 2010 Aug, Kuveyt Türk issued Turkey’s first sukuk ($100 million)
- ✓ 2011 First participation index was launched by the Istanbul Stock Exchange
- ✓ 2011 The parliament passed legislation to promote “Islamic Finance”
- ✓ 2012 Sep, First dollar denominated sovereign sukuk issuance ($1.5 billion)
- ✓ 2012 Oct, First Lira denominated sovereign sukuk issuance ($904 million)
- ✓ 2013 Amendment to the sukuk law was enacted on June 7,2013
- ✓ 2013 Mar, Announcement by Deputy Prime Minister Ali Babacan to establish two new state-owned participation banks
- ✓ 2013 Mar, Bank Asya issues the first Turkish lira sukuk out of Turkey
- ✓ 2014 July, Newly adapted mutual fund regulation, “Participation umbrella fund” (katılım şemsiye fonu) will include funds with no interest bearing securities. (Turkey Islamic Finance Report, 2014, IRTI)

4.6.2. Overview of Participation of Banks

One of the most important developments in the sector in 2014 was the statement by Turkey’s leading bank, Ziraat Bank, that a participation company which would operate in the field of participation banking had been established.

Participation banks are expected to maintain their healthy growth and increase their share in the banking sector in 2015 and beyond. In the coming period, with the increase in number of banks and therefore the increase in the nationwide access to participation banks, the development in participation fund accounts is expected to gather pace.

By the end of 2014, four participation banks had a total of 990 branches operating in Turkey. Participation banks have opened a total of 25 new branches during the year. Participation banks operating in the 4 locations abroad and did not open new points of service abroad in 2014. (Participation Banks Report, TKBB, 2014)

Table 4.6. Participation Banks: Key Financial Indicators (December 2014)

Financial Highlights		Albaraka Türk		Bank Asya		Kuveyt Türk		Türkiye Finans		Grand Total	Grand Total	
		2014	2014/2013 (Change %)	2014	2014/2013 (Change %)	2014	2014/2013 (Change %)	2014	2014/2013 (Change %)	2014	2013	2014/2013 (Change %)
Funds Collected	TP	9,782,163	30	4,865,894	-54	12,147,375	30	12,443,928	29	39,239,360	36,984,083	6
	FC	6,861,055	37	4,021,059	-50	9,997,339	30	6,668,832	21	27,548,285	26,226,112	5
	TOTAL	16,643,218	33	8,886,953	-52	22,144,614	30	19,112,760	26	66,787,545	63,210,195	6
Funds Allocated		16,143,978	34	8,544,306	-59	21,213,691	28	24,063,493	32	69,965,468	67,415,970	4
Non-Performing Loans (Net)		39,714	51	1,387,416	116	71,977	58	228,470	73	1,727,577	847,119	104
Non-Performing Loans (Gross) / Loans		2,0	-	20,9	-	2,3	-	2,5	-	4,6	3,4	-
Total Assets		23,046,424	34	13,523,387	-51	34,008,175	31	33,494,790	33	104,072,776	96,021,671	8
Shareholders' Equity		1,790,927	20	1,641,990	-35	3,022,870	31	2,809,287	11	9,265,074	8,832,644	5
Net Profit		252,631	5	(876,872)	-586	370,450	23	334,228	2	80,437	1,051,633	-92
Number of Employees		3,510	15	3,200	-37	5,082	9	4,478	12	16,270	16,763	-3
Number of Branches		202	21	200	-29	308	15	280	12	990	966	2

Source: PBAT, BRSA

Table 4.7. Participation Banks in Turkey: Branches and Employees (2003-2014)

Year	Number of Branches	Growth (%)	Number of Employees	Growth (%)
2003	188	71	3,520	61
2004	255	36	4,789	36
2005	290	14	5,740	20
2006	355	22	7,114	24
2007	422	19	9,215	30
2008	530	26	11,022	20
2009	569	7	11,802	7
2010	607	7	12,677	7
2011	685	13	13,851	9
2012	828	21	15,356	11
2013	966	17	16,763	9
2014	990	2	16,270	-3.1

Source: PBAT, BRSA

The achievements under the influence of the monetary policy and the macro prudential measures taken by the BRSA and the tightening the Central Bank's monetary policy throughout 2014 affected the Turkish banking sector and participation banking sector, leading to a loss of momentum.

As a result of the arrangements made by the authorities in the second half of 2013, general reserves increased, risk weightings have been raised, credit card limits have been restricted and maturities of consumer loans have been limited. These regulations have had significantly limiting effects on the composition of sector loans, the direction of the growth and profitability performances in 2014. (Participation Banks Report, TKBB, 2014)

Table 4.8. Participation Banks in Turkey: Key Indicators

	2013	2014	Change %
Funds Collected TL	36,984	39,239	6
Funds Collected FC (including precious metals)	26,226	27,548	5
Total	63,210	66,788	6
Funds Allocated	67,416	69,965	4
Total Assets	96,022	104,073	8
Shareholders' Equity	8,833	9,265	5
Net Profit	1,052	80	-92

Source: PBAT, BRSA, CBRT

Table 4.9. Participation Banks in Turkey: Total Assets and Position in the Banking Sector (2011-2014)

	Total Assets	Change %	Share %
2011	56,077	29.4	4.6
2012	70,245	25.3	5.1
2013	96,022	36.7	5.5
2014	104,073	8	5.2

Source: PBAT, BRSA

Table 4.10. Turkish Banking Sector's Indicators by Segments

Bank	Number of Institutions	Assets 2014-TL million	Assets 2014-share (%)	Assets 2013-share (%)	Deposits 2014-TL million	Deposits 2014-share (%)	Deposits 2013-share (%)	Loans 2014-TL million	Loans 2014-share (%)	Loans 2013-share (%)
Participation Banks	4	104,163	5.2	5.5	65,405	6.2	6.5	69,639	5.4	6.2
Savings Banks	32	1,805,427	90.5	90.5	991,223	93.8	93.5	1,151,639	90.0	89.5
Development and Investment Banks	13	84,571	4.3	4.0	0	0.0	0.0	58,859	4.6	4.3
Total	49	1,994,161	100	100	1,056,628	100	100	1,280,137	100	100

Source: BRSA

4.6.3. Current Participation Banks

- *AlBaraka Türk*

AlBaraka Türk Participation Bank was established in 1984 and began its operations in the beginning of 1985 as the first finance house adhering to Islamic principles in Turkey. AlBaraka Türk was founded by Al Baraka Banking Group (AGB), Islamic Development Bank and a local industrial group. The partnership structure of the bank is composed of 66% foreign partners, 11.06% local partners and 22.7% is held by IPO. AlBaraka Türk currently operates with a total of 137 branches, with 136 branches in Turkey and 1 branch in Iraq as of December 2012. The local 129 branches are spread all over the country with 54 branches in Istanbul and 75 branches in the major trade centers of the republic.

Bank Information		
Postal Address: Saray Mahallesi Dr.Adnan Buyukdeniz Caddesi No:6 34768 Ümraniye/ Istanbul **Telecommunication:** Phone: +90216 6660101 Fax: +902166661600 Website: albarakaturk@albarakaturk.com.tr	**Incorporation:** Year: 1984 Type: Public Joint Stock Company No. of Branches: 137 No. of Employees: 2175	
Financial Highlights (USD 000'S)		
	2011	**2012**
Cash and Balances with Central Bank	557,962	730,001
Loans and Receivables	3,856,056	5,084,135
Total Assets	5,552,487	6,919,040
Funds Collected	4,270,036	5,177,649
Total Equities	533,042	683,804
Total Liabilities	5,019,445	6,235,237
Profit Share Income	408,560	559,481
Profit Share Expense	203,864	286,765
Net Profit	204,696	272,716
Exchange Rate:	**1.884**	**1.7817**

Figure 4.4. AlBaraka Türk

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuters

- *Bank Asya*

Bank Asya began its operations on the 24th of October 1996 in Altunizade. It was the sixth private finance house in Turkey. The bank's name was changed in 2005 from "Asya Finans Kurumu Anonim Şirketi" to "Asya Katılım Bankası Anonim Şirketi". Bank Asya, was established with initial capital of TR Y 2 million and current paid up capital is TR Y 900 million. The institution has a multipartnered structure based on domestic capital. As of November 2012, the bank had 251 branches.

Bank Information		
Postal Address: Küçüksu Cad. Akçakoca Sk. No. 6 34768 Ümraniye/ Istanbul **Telecommunication:** Phone: +902166335000 Fax: - Website: www.bankasya.com.tr	**Incorporation:** Year: 1996 Type: Privately Held Company No. of Branches: 251 No. of Employees: 5,100	
Financial Highlights (USD 000'S)		
	2011	**2012**
Cash and Balances with Central Bank	891,535	1,509,567
Loans & Receivables	6,981,832	8,994,511
Total Assets	9,208,331	12,108,662
Funds Collected	6,524,905	8,774,400
Total Equities	1,192,553	1,369,936
Total Liabilities	8,015,778	10,738,726
Profit Share Income	679,861	943,022
Profit Share Expense	342,082	441,644
Net Profit	337,779	501,378
Exchange Rate:	**1.884**	**1.7817**

Figure 4.5. Bank Asya

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuter

- *Kuveyt Türk*

Established in 1989, Kuveyt Türk was first licensed as a Private Financial Institution operating in accordance with the principles set by the Cabinet Decree No. 831/7506 of December 1983. Operations were carried out by Cabinet Decrees on the one hand and communiqués of the Central Bank and the Under-secretariat of Treasury on the other until such operations were included within the spectrum of the Banking Law in 1999. Starting from December 1999, Kuveyt Türk became subject to the Banking Law No. 4389, adhering to the same rules for other Financial Institutions. The title of the institution was changed to Kuveyt Türk Participation Bank Inc. in May 2006. Kuveyt Türk is 62% owned by Kuwait Finance House, 9% by the Public Institution for Social Security, 9% by the Islamic Development Bank, 18% by General Directorate for Foundations and 2% by other shareholders.

Bank Information	
Postal Address: Bukudere Cad. No: 129 34394 Esentepe, Sisli, Istanbul – Turkey **Telecommunication:** Phone: +902 12 354 1111 Fax: +902 12 354 1212 Website: www.kuveytturk.com.tr	**Incorporation:** Year: 1989 Type: Participation Bank No. of Branches: 89 No. of Employees: 1692

Financial Highlights (USD 000'S)	2011	2012
Cash and Balances with Central Bank	282,014	268,359
Loans & Receivables	5,569,600	6,773,533
Total Assets	7,717,973	10,437,250
Funds Collected	2,066,618	2,908,874
Total Equities	781,166	970,049
Total Liabilities	6,936,807	9,467,201
Profit Share Income	468,234	663,544
Profit Share Expense	232,148	342,685
Net Profit	120,977	147,179
Exchange Rate:	**1.884**	**1.7817**

Figure 4.6. Kuveyt Türk

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuters

- *Türkiye Finans Katılım Bankası*

Türkiye Finans Katılım Bankası was founded in December 2005 following permission by the Banking Regulation and Supervisory Agency (BR SA) for the merger of Anadolu Finans Kurumu, owned by Boydak Group, and Family Finans, owned by Ülker Group, the giant Turkish food producer. In 2007, National Commercial Bank acquired 60% stake in the bank for $1 billion, the largest acquisition in the Islamic banking world. The bank currently has 211 branches with over 3,600 employees that serve over 1 million customers. (Turkey Islamic Finance Report, 2014, IRTI)

Bank Information	
Postal Address: Yakacik Mevkii Adnan Kahveci Cad. No. 139 -34876 Kartal/ Istanbul **Telecommunication:** Phone: +902 165867000 Fax: +902 165866326 Website: www.turkiyefinans.com.tr	**Incorporation:** Year: 2005 Type: Privately Held Company No. of Branches: 211 No. of Employees: 3600

Financial Highlights (USD 000'S)	2011	2012
Cash and Balances with Central Bank	1,017,960	1,581,730
Loans & Receivables	5,491,797	7,163,608
Total Assets	7,180,654	9,887,469
Funds Collected	5,047,327	6,414,961
Total Equities	856,507	1,192,772
Total Liabilities	6,324,148	8,694,697
Profit Share Income	556,901	791,579
Profit Share Expense	251,986	346,997
Net Profit	122,923	159,159
Exchange Rate:	1.884	1.7817

Figure 4.7. Türkiye Finans

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuters

4.7. Swot Analysis

Strenghts:

• Government supporting Islamic finance growth by announcing aim to raise participation banking market share to 15% by 2023

• Government set the benchmark for sukuk issuances with its debut sovereign issuance in 2012

• Two large state-owned banks are planning to start Islamic operations in 2014

• Retail Islamic finance is well-established with 4 participation banks already operating

• Participation banks market share stands at only 5% of total banking sector

• Banking market is controlled by a few big banks, a concentration that is comparable to many emerging markets

• No dedicated regulations for Islamic finance

• A big gap in understanding of Islamic finance

Weakness:

• Participation banks market share stands at only 5% of total banking sector

• Banking market is controlled by a few big banks, a concentration that is comparable to many emerging markets

• No dedicated regulations for Islamic finance

• A big gap in understanding of Islamic finance

Opportunities:

• Recent Islamic finance activities can accelerate the growth of the participation banking sector

• With the establishment of two state-owned banks, public awareness will gradually increase

• Middle Eastern investors' growing interest to enter Turkey's participation banking sector

• Sizeable numbers open to Participation banking 'windows'

• Home financing is the most desired financial service among existing and potential customers, indicating an area of opportunity

• Turkey's (and especially Istanbul's) overall improving stature and reputation as an emerging financial centre will benefit the domestic Islamic finance sector

Threats:

• Instability of international capital market a potential source of external financing problems

• The Kurdish issue continues to be a source of potential instability

• Worsening of the EU economic crisis (Turkey Islamic Finance Report, 2014, IRTI)

4.8. Participation Banking Industry Performance

The growth of the participation banking industry has always hovered above national growth rates, despite small business volumes. The participation banking industry has been developing very rapidly, with assets rising from \$3.7 billion in 2004 to \$29.8 billion in 2011. Growth rate has been approximately 38% annually. This is well above the annual growth rate of the country's banking industry which is approximately 17%. (Turkey Islamic Finance Report, 2014, IRTI)

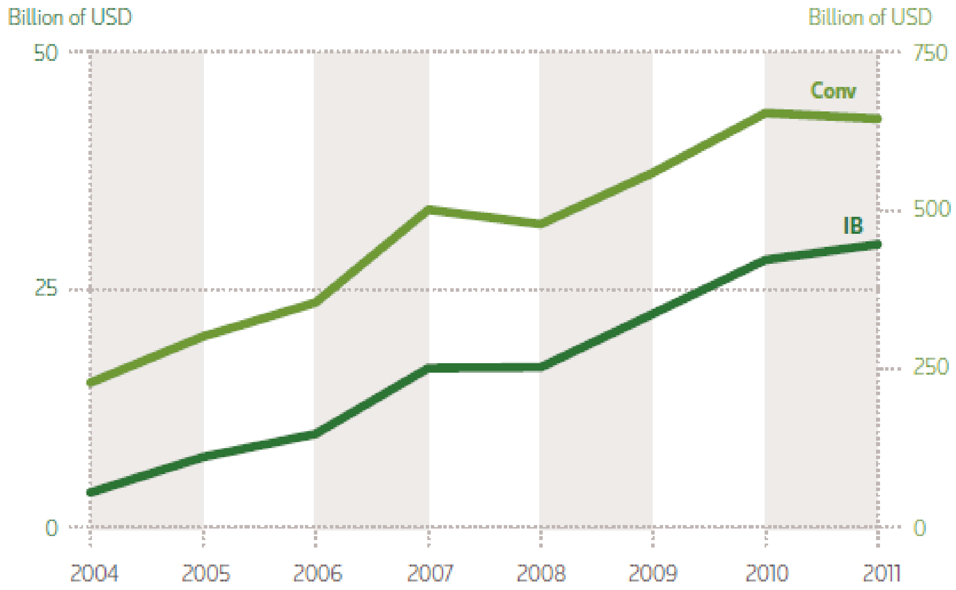


Figure 4.8. Participation banking assets in Turkey

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuters

Number of branches and employees

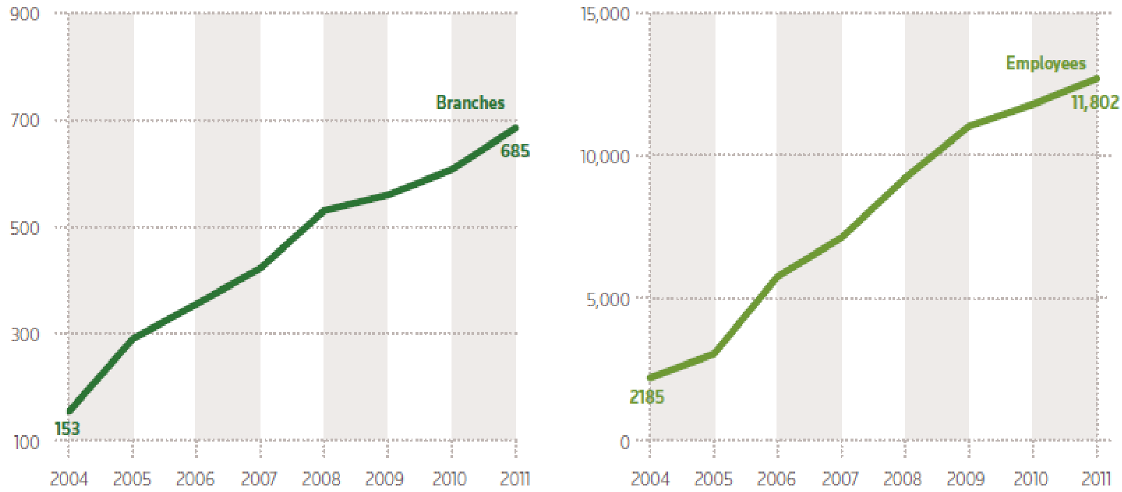


Figure 4.9. Number of branches and employees

Source : Turkey Islamic Finance Report 2014: Fundamentals and the Promise of Growth (2014), IRTI, Thomson Reuters

Branch offices and numbers employed by the sector have increased in tandem with the rise of participation banking assets and market share. Across the country, the industry was supported by 685 branch offices (growing at 26% annually) and 12,703 employees (growing at 31% annually) at the end of 2011.

4.9. Participation Banking Industry Market Share

The Turkish participation banking industry is shared almost evenly among the four market players. Asya Bank holds the biggest share with 30.8% of the market, followed by Kuveyt Türk, Türkiye Finans and AlBaraka Türk on 26.5%, 24.1%, and 18.6% respectively.

Kuveyt Türk led growth (27.4%) and maintained the quality of exposures (NPF/TA of 1.4%). AlBaraka, Asya and Türkiye Finans have been growing at 14.8%, 13.9%, and 9.8 %respectively. In general, the participation banks in Turkey maintain high growth rates with low problem financing. (Turkey Islamic Finance Report, 2014, IRTI)

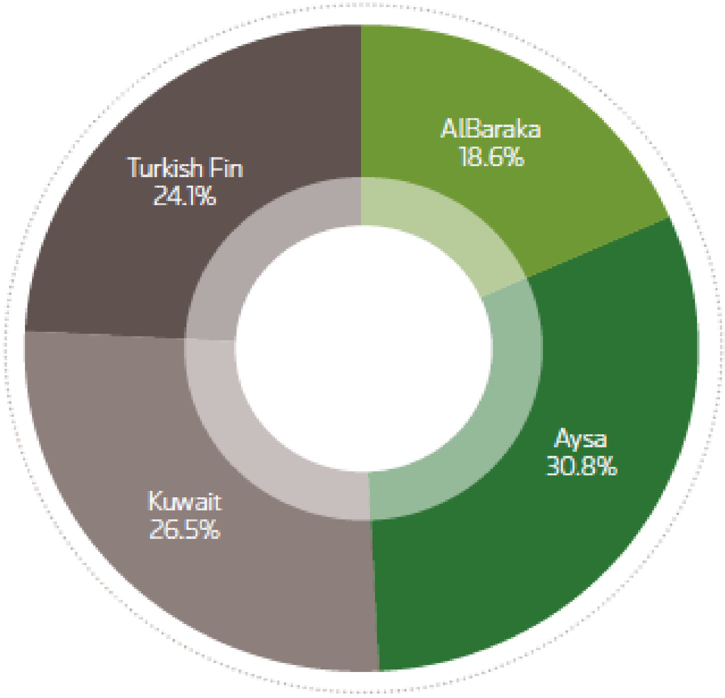


Figure 4.10. Participation Banking Market Share in Turkey
Source: Turkey Islamic Finance Report 2014 (Database)

4.10. Sukuk Issuance

Sukuk hold considerable potential for Turkish participation banks for a number of reasons. These lenders have historically depended on retail deposits and syndicated short-term murabaha loan facilities for their funding. This narrow funding base has created challenges in terms of mismatches between assets and liabilities as well as in terms of cost — especially the cost of murabaha facilities. The growth of the banks’ asset portfolios has made sukuk issuance an increasingly realistic prospect of late. This opportunity, importantly, offers longer maturities and lower costs. (Turkey Islamic Finance Report, 2014, IRTI)

Table 4.11. Sukuk Issuance in Turkish Participation Banking

Sukuk name	Kuveyt Türk Katılım Bankası	Kuveyt Türk Katılım Bankası	Turkey sovereign sukuk	Turkey sovereign sukuk	Bank Asya Katılım Bankası	Bank Asya Katılım Bankası	Türkiye Finans Katılım Bankası	Albaraka Türk Katılım Bankası	Turkey sovereign sukuk
Structure	wakala	Ijara-wakala	ijara	ijara	ijara	murabaha	murabaha	murabaha	ijara
Currency	USD	USD	USD	TRY	TRY	USD	USD	USD	TRY
Tenor (years)	3	5	5.5	2	1	10	5	10	2
Closing date	24 Aug 2010	30 Oct 2011	17 Sept 2012	20 Feb 2013	26 Feb 2013	21 Mar 2013	24 Apr 2013	30 Apr 2013	21 Aug 2013
Issue size	$100mn	$350mn	$1.5bn	TRY1,520mn	TRY125mn	$250mn	$500mn	$200mn	TRY1,82mn
Issuer name	KT SPV	KT SPV	Treasury SPV	Republic of Turkey	Asya SPV	Asya SPV	TF SPV	ABT Sukuk	Republic of Turkey

Source: Turkey Islamic Finance Report 2014 (Database)

4.11. Sukuk Legislation: Timeline in brief

⇨ **2010 – April 1**, Communiqué Serial III no: 43 on Principles regarding Lease Certificates and Asset Leasing Companies. This regulated ijara sukuk, and the structure of financial institutions, Special PurposeVehicles (SPVs), and their principles of incorporation and activities. (Tax incentives on sukuk in Turkey can be found in Communiqué Serial: Iii, No: 4141)

⇨ **2011 – February**, Law No 6111 (known as "Tax Amnesty Law") — Turkish National Assembly passed tax and other measures to facilitate issuances of ijara sukuk, reducing the withholding tax on such sukuk to 10% and exempting sales from value-added, stamp and corporate taxes. This facilitates the sale and transfer of tangible real estate to an onshore SPV combined with asset-based ijara characteristics. Further legislation includes the exemption from taxes on revenue for sukuk certificates with a minimum tenor of five years. Certificates with shorter tenors would still be subject to tax ranging from 3% to 10%. But since most corporate sukuk issuance meet the shorter tenor profile, further adjustment would be needed to open the market.

⇨ **2013 – June 7**, Communiqué III-61.1 no: 28670, allowing istisna', murabaha, mudaraba, musharaka and wakala sukuk. (Turkey Islamic Finance Report, 2014, IRTI)

Conclusion

In conclusion it is clear that participation banking is developing and getting accessible to more individuals in Turkey as participation banking makes progress every year and integrates conventional banking products that could be adapted to interest free banking system.

While participation banks started their activities in Turkey they had only 7-8 interest free banking products which made them reach to very narrow customer groups, they have made progress every year, developed interest free banking products and has started to strike their customer's need within interest free system in every aspect. Today their product number is over 30 and they access to wide customer groups. They have started to reach up to date conventional banking system customer groups as well.

On the other hand, Morocco's Islamic finance industry potential is to become a regional hub. With an established and stable banking system, stable economy and political environment, and initiatives including the Casablanca Finance City, Morocco is well positioned to become a regional hub.

Morocco should aim to attract Islamic finance investment and banking flows from developed countries led by Turkey. Morocco can attract more emerging markets in Interest-free banking flows from the GCC and Malaysia by 2018 and develop a revenue pool to facilitate Interest-free banking flows by 2018.

In a statement to the Moroccan press last year, Youssef Baghdadi, CEO of Dar Assafaa had already announced that with the amendment of the Banking Act and the establishment of the legal and regulatory framework to govern the activities of participatory banks, Dar Assafaa Litamwil was about to change its status from a finance company to become a full participatory bank. A request for approval was filed to that effect to the supervisory authorities.

In this context, the Turkish experience leads us to draw the right lessons for the future of alternative banks in Morocco.

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