Mazin FAHAD

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Mazin FAHAD

Fatih University

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Student **:** Mazin FAHAD

Institute **:** Institute of Social Sciences

Department **:** Economy

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I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Arts.

Prof.Dr. Mehmet ORHAN

Head of Department

This is to certify that I have read this thesis and that in my opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Arts.

Prof.Dr. İsmail ÖZSOY

Supervisor

Examining Committee Members

Prof.Dr. İsmail ÖZSOY ……………………….

Prof.Dr. Mehmet ORHAN ……………………….

Assoc.Prof.Dr. Osman Nuri ARAS ……………………….

It is approved that this thesis has been written in compliance with the formatting rules laid down by the Graduate Institute of Social Sciences.

Assoc. Prof. Mehmet KARAKUYU

Director

AUTHOR DECLARATIONS

1. The material included in this thesis has not been submitted wholly or in part for any academic award or qualification other than that for which it is now submitted.

2. The program of advanced study of which this thesis is part has consisted of:

i) Research Methods course during the undergraduate study

ii) Examination of several thesis guides of particular universities both in Turkey and abroad as well as a professional book on this subject.

Mazin FAHAD

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ABSTRACT

Mazin FAHAD **APRIL 2013**

THE EVOLVEMENT OF PARTICIPATORY BANKS IN TURKEY OVER 1985AND 2010

Participation Banks having a history of a relatively short when compared to the banking sector entered a period of rapid growth in recent years depending on the developments in the financial sector. Instead of money trade, investigating characteristics of the customer is important transactions based on the expression of these institutions, the development of the historical, legal structures, sources and uses of funds, contribution to the economy, the size of Turkey, as well as the activities. Due to the globalization of capital, the international financial market, a closer examination of these institutions provides new opportunities for developing countries, and the anxiety of the interest savings sectors of the economy that do not offer the service of the economy on the other gaining the investors and investment funds that could be obtained by seeing the functioning of institutions as intermediaries between savers fulfil. In this study, the concept of participation banking, basic principles, practices, activities and developments of participatory banks in Turkey between 1985 to 2010 to work to put forward progress and financial development and growth in Turkey will be discussed.

Keywords: Development, Participation Banking, participatory Banking, Interest-free Banking

KISA ÖZET

Mazin FAHAD **NISAN 2013**

TÜRKİYE'DE KATILIM BANKALARININ 1985-2010 DÖNEMİNDE GELİŞİMİ

Bankacılık sektörüyle karşılaştırıldığında oldukça kısa bir geçmişe sahip olan Katılım Bankaları, mali sektördeki gelişmelere bağlı olarak son yıllarda hızlı bir büyüme sürecine girmiştir.

Para ticareti yerine mal ticaretine dayalı işlemlerin esas alındığı bu kurumların kavram olarak ifade edilmesinin, tarihsel gelişiminin, hukuki yapılarının, fon kaynakları ve kullanımlarının, ekonomiye katkılarının, Türkiye'deki faaliyet ve büyüklüklerinin yanı sıra Türkiye'deki kriz süreçlerinde alınan önlemler önem arz etmektedir. Sermayenin küreselleşmesinin de etkisiyle, uluslararası mali piyasada daha yakından incelemeye alınan bu kurumlar kalkınmakta olan ülkelere yeni imkanlar sunmakta ve bir yandan faiz kaygısıyla tasarruflarını ekonominin hizmetine sunmayan kesimlerin tasarruflarını ekonomiye kazandırırken diğer yandan da yatırımcıların fon temin edebilecekleri kurumlar işlevini görerek yatırım ve tasarruf sahipleri arasında aracılık görevini yerine getirmektedirler.

Bu çalışma ile Katılım Bankacılığı kavramı, temel ilkeleri, uygulamaları, faaliyetleri ve Türkiye'de yaşanan kriz dönemlerindeki gidişatları ortaya konulmaya çalışılacak ve Türkiye'deki finansal gelişimleri irdelenecektir.

Anahtar Kelimeler: Katılım Bankacılığı, Faizsiz Bankacılık, İslami Bankacılık

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CHAPTER ONE

1. RESEARCH METHODOLOGY

1.1. Introduction

Since the beginning of the new millennium it has become clear that change is inevitable. The last few years have witnessed tremendous change in the banking arena on regional and international levels. The purpose is to keep up with international economic and political developments to initiate the process of globalizing financial markets after full enforcement of GATT, especially in the field of financial services. This has necessitated a number of developments in the structures, operations and performance levels of local, regional and international financial institutions. It has also marked a tendency towards formulating economic blocs and large banking merges. Such tendency manifests itself in the appearance of a number of large banking entities which aim to prevail over smaller institutions that are still working as isolated individual organizations.

It's expected that they are going to face strong competition. This necessitates are developing a new work strategy that is suitable to challenge this new phase in an attempt to maintain the success they have achieved, and secure a bright future, based on the expertise they have gained over the years. This is main thing in the fact that there is not a single participatory bank enlisted among the top 100 banks of the world. In fact, the size of participatory banks is one of the major obstacles of their ability to interact efficiently in international markets, and keep up with increasing developments in providing modern banking services. It is indeed inevitable for those

In charge of the participatory banking industry to explore future horizons with the aim of having a clearer vision, predicting both obstacles and challenges and dealing with them effectively (Abdallah, 1987).

It is well-known that most participatory banks and financial institutions operate within certain environments and communities that encompass both types of conventional and participatory banking systems. participatory banking then should deal and coexist with conventional banking as well as benefit from its huge technological, organizational and financial potential without violating the principles of participatory banking operations.

participatory banks operate in over 60 countries in the Muslim world, most of them in the Middle East and Asia. Recently, participatory banks have been opened in Europe and also in the United States. In three countries, Iran, Pakistan, and Sudan, the operations of the entire banking system have been converted to the participatory mode of finance.

Today, participatory banking is estimated to be managing funds to the tune of US$ 250 billion. Its clientele are not confined to Muslim countries but are spread over Europe, United States of America and the Far East.

participatory banking continues to grow at a rapid pace because of its value orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike. participatory bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but also ethically motivated.

Now at these days more than 261 participatory financial institutions are operating worldwide.

As a response to the success of participatory banks in attracting depositors in their early years of establishment, many conventional banks formed participatory branches.

1.2. Aim

The aim of this study is to measure and compare the performances of the Participation Banks in Turkey that are operating as participatory Banks to conventional banks and to research the development of participation banks from 1985 to 2010.

1.3. Objectives

One of the objectives of this study is empirically investigate how the Participation banks in Turkey are performing. In addition, this study conducts a performance comparison of Participation banks and possible answers to differences in their performance experiences. In the process of achieving the objectives and ultimate aim, this study also looks at the history and current development of Participation banks in Turkey.

1.4. Research Question

The research topic is mainly about the development and expansion of interest free banks in Turkey and especially the period between 1985-2010 will be questioned. In that respect, there will be two main questions that establish the general framework of this paper. The first question is the motives behind the rapid growth of interest free banks. The reason will be figured out to understand the growth of interest free banks (IFBs).

CHAPTER TWO

2. LITTERATURE REVIEW

2.1. What is participatory Banking?

participatory banking is not a negligible or merely temporary phenomenon. participatory banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the participatory injunction against the institution of interest, one may find in participatory banking some innovative ideas which could add more variety to the existing financial network. participatory banking has been defined in a number of ways.

The definition of participatory bank, as approved by the General Secretariat of the OIC, is stated in the following manner. "An participatory bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of participatory Shariah and to the banning of the receipt and payment of interest on any of its operations.

The concept from the perspective of an participatory economy and the prospective role to be played by an participatory bank therein opines: "It is, therefore, natural and, indeed, imperative for an participatory bank to incorporate in its functions and practices commercial investment and social activities, as an institution designed to promote the civilized mission of an participatory economy" (Ibid). Ziauddin Ahmed says. "participatory banking is essentially a normative

Concept and could be defined as conduct of banking in consonance with the ethos of the value system of Islam" (Abdeen and Shook, 1984).

It appears from the above definitions that participatory banking is a system of financial intermediation that avoids receipt and payment of interest in its transactions and conducts its operations in a way that it helps achieve the objectives of an participatory economy Alternatively, this is a banking system whose operation is based on participatory principles of transactions of which profit and loss sharing (PLS) is a major feature, ensuring justice and equity in the economy. That is why participatory banks are often known as PLS-banks (Abdel-Fadil, 1989).

participatory bankers do not expect to advance money and receive a predetermined sum on a fixed date in the future. Under the Shariah, the bedrock of the participatory faith, they are instead responsible for ensuring that money is invested in viable projects, with reliable borrowers. If the project succeeds the banker shares in the profit. If it fails he suffers the losses (Abdel-Magib, 1981).

Just as an "participatory Bank" is defined with reference to its mandate requiring that it Complies with two sets of law: (1) the "law of the land" and (2) participatory Sharia law. participatory bank was "owned by its shareholders, established to conduct banking and investment activities in accordance with the participatory Shariah and its (own) articles of association (Abdel-Magid, 1981).

The guiding principles for an participatory financial system is a set of rules and laws, collectively referred to as shariah, guiding economic, social, political, and cultural aspects of participatory

Societies. Shariah originates from the rules dictated by the Quran and its practices, and explanations rendered (mare commonly known as Sunnah) by the Prophet Muhammad. Further

elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the Q"uran and Sunnah. In a sense, the combination of law and finance in Islam is inevitable.

2.2. History of participatory banking.

It is difficult to say with accuracy which was the first such company or bank, that pioneered this concept in practice. Some analysts and experts in the field are of the opinion that, participatory banking and finance, in the modern context, first emerged in 1963, when Mit-Ghamr Saving Bank began an experimental project offering interest free banking in Egypt. The project was a success and lead to the bank opening four new branches by 1967. In the same year, eight new banks mushroomed offering interest free banking. Due to the political climate prevailing in Egypt during that period, the success of these participatory banks was seen as a threat, and they were forced to close down in 1971. Some observers are of the opinion that the concept of an "participatory bank" was born at the Islamic Summit of Lahore, Pakistan in 1974 which recommended the creation of an participatory Development Bank. Since then participatory banking and financial institutions have grown rapidly.

American Muslim individuals and groups have been running many Islamic financial institutions from over a decade now. The Amana Fund, the LARIBA bank, and a host of smaller organizations dot the North American landscape. (See other items in our section on participatory Banking, to learn about the attempts to consolidate and strengthen the institution of participatory

Banking and the institutions that practice the concept). The launching of the multi-million dollar Halal investment company in London is another indicator of the growing salience of participatory banking institutions not just in Muslim countries, but in the West as well. Countries where vibrant financial institutions are functioning include: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan.

The first modern participatory bank, established in Egypt in 1970, was called Nasser's Social Bank. Islamic accounting, an essential tool for the success of participatory banks, is said to have been developed contemporaneously at the University of Cairo (Abdel-Magib, 1981).

The desirability of abolishing fixed interest rates and the Islamization of financial systems were discussed at the first meeting of the Islamic Organization Conference (IOC) in Jeddah in 1973. Subsequently, many participatory banks were founded under the profit-and-loss sharing system (PLS), which all transactions are based on this principle.

Returns are variable, dependent on bank performance and not guaranteed. But the risks are managed to ensure better returns than deposit accounts.

Consumers can participate in the profit upside i.e. in a more equitable way than receiving a predetermined return. Several Muslim countries, Indonesia, Iran, Malaysia, Pakistan, Sudan and Turkey, in recent years have been taking systematic steps to establish an participatory banking and financial sector.

Malaysia and Pakistan first to Institutionalize participatory Banking For example, Malaysia in 1983 passed an participatory Banking Act to facilitate the growth of indigenous participatory

Banks and finance companies. In conjunction with this Act, it became the first Muslim economy to issue bonds on an Islamic basis. Since then, some 50-60 institutions have been established,

and are now in the process of forming an Islamic inter-bank market (i.e. in which banks borrow or lend to each other). Within 10 years of introducing the participatory Banking Act, the Malaysian government has taken further steps to popularize participatory banking and finance, by allowing conventional banks to offer Shariah compliant instruments, Western Banks embrace participatory Banking Instruments These trends in Malaysia and elsewhere are having a profound effect on the banking and financial world as a whole. For example, America's Citibank was the first major conventional bank to establish an participatory bank in Bahrain, with an operating capital of $20 million (The Economist, August, 24, 96). It may be a puny sum, but, it does suggest to some degree that conventional banks have begun to embrace participatory banking on a moderate scale.

A number of other Western financial institutions have followed suit by offering Islamic mutual funds and other investment products in an attempt to attract liquidity from this growing market. For example, non- participatory banks such as Goldman Sachs, Kleinwort Benson and ANZ Grindlays are now offering financial products that meet an Islamic criteria. Germany's fourth largest bank, Commerzbank, started offering Islamic mutual funds from December 1999.

In February 1999, Dow Jones introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with the Shariah laws.

2.3. Principles of participatory Banking.

An participatory bank is based on the Islamic faith and must stay within the limits of Islamic Law or the sharia in all of its actions and deeds. The original meaning of the Arabic word sharia was 'the way to the source of life' and it is now used to refer to legal system in keeping with the code of behaviour called for by the Holly Qur'an (Koran). Four rules govern investment behaviour:

a. the absence of interest-based (riba) transactions;

b. the avoidance of economic activities involving speculation (ghirar).

c. the introduction of an Islamic tax, Zakat.

d. the discouragement of the production of goods and services which contradict the value pattern of Islamic (Haram)

In the following part we will explain these four elements give participatory banking its distinctive religious identity.

2.3.1. Riba .

Perhaps the most far reaching of these is the prohibition of interest (riba). The payment of riba and the taking as occurs in a conventional banking system is explicitly prohibited by the Holy Qur'an, and thus investors must be compensated by other means. Technically, riba refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. While earlier there was a debate as to whether riba relates to interest or

Usury, there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest (Al- Omar).

In banning riba, Islamic seeks to establish a society based upon fairness and justice (Alfab, 1986). A loan provides the lender with a fixed return irrespective of the outcome of the borrower's venture. It is much fairer to have a sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and thus be governed by the return on the individual project for which funds are supplied.

Hence, what is forbidden in Islamic is a predetermined return. The sharing of profit is legitimate and that practice has provided the foundation for participatory banking (Ahmad, A., 1987).

Table.1 : Difference Between Usury and Profit.

Usury	**Profit**
1- When money is "charged" its imposed positive and define result is Riba.	1- When money is used in trading (for e.g.) it's uncertain result is profit.
2- By definition, Riba is the premium paid by the borrower to the lender along with principle amount as a condition for the loan.	2- By definition , profit is the difference between the value of production and the cost of production.
3- Riba is prefixed, and hence there is no uncertainty on the part of either the givers or the takers of loans.	3- Profits is post-determined, and hence its amount is not known until the activity is done.
4- Riba cannot be negative, it can at best be very low or zero.	4- Profit can be positive, zero or even negative.
5. From Islamic Shariah point of view, it is Haram.	5- From Islamic Shariah point of view, it is Halal.

2.3.2. Ghirar .

Another feature condemned by Islamic is economic transactions involving elements of speculation, ghirar. Buying goods or shares at low and selling them for higher price in the future is considered to be illicit. Similarly an immediate sale in order to avoid a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large.

2.3.3. Zakat.

A mechanism for the redistribution of income and wealth is inherent is Islam, so that every Muslim is guaranteed a fair standard of living, nisab. An Islamic tax, Zakat (a term derived from the Arabic zaka, meaning "pure") is the most important instrument for the redistribution of wealth. This tax is a compulsory levy, one of the five basic tenets of Islam and the generally accepted amount of the zakat is one fortieth (2.5 per cent) of Muslim's annual income in cash or kind from all forms of assessed wealth exceeding nisab.

Every participatory bank has to establish a zakat fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions. This tax is imposed on the initial capital of the bank, on the reserves, and on the profits as described in the Handbook of participatory Banking.

2.3.4. Haram .

A strict code of ethical investment' operates. Hence it is forbidden for participatory banks to finance activities or items forbidden in Islam, haram, such as trade of alcoholic beverage and pork meat.

Furthermore, as the fulfillment or materials needs assures a religious freedom for Muslims, participatory banks are required to give priority to the production of essential goods which satisfy the needs of the majority of the Muslim community, while the production and marketing of luxury activities, Israf wa Traf is considered as unacceptable from a religious viewpoint. In order to ensure that the practices and activities of participatory banks do not contradict the Islamic ethical standards, participatory banks are expected to establish a Sharia Supervisory Board, consisting of Muslim jurisprudence, who act as advisers to the banks.

2.4. Activities of participatory Banks.

Individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following , we will describe the salient features common to all banks.

All the participatory banks have three kinds of deposit accounts: current, savings and investment.

2.4.1.Current accounts:

Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

2.4.2. Savings accounts:

Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands (Ahmad, S.M., 1952).

2.4.3. Investment account:

Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed. Banks adopt several modes of acquiring assets or financing projects. But they can be broadly categorized into three areas: investment, trade and lending.

2.4.3.1. Investment financing .

This is done in different ways:

1st) Musharaka where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period. Musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-detemined basis, and any losses shared in proportion to the capital contribution. In this case, the bank enters into a partnership with a client in which both share the equity capital and may be even the management-of a project or deal, and both share in the profits or losses according to their equity shareholding.

b) Mudarabha where the bank contributes the finance and the client provides the expertise, management and labor. Profits are shared by both the partners in a pre- Arranged proportion, but when a loss occurs the total loss is borne by the bank.

The following rules must govern all Mudaraba transactions:

The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return. The investor is not liable for losses beyond the capital he has contributed.

The mudarib does not share the losses except for the loss of his time and efforts.

c) Murabaha Murabaha was originally an exchange transaction in which a trader purchases items required by an end user. The trader then sells those items to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the trader. To be in consonance with the principles of Islamic finance governing exchange transactions every Murabaha transaction must meet the following conditions:

Murbaha transactions may be undertaken only where the client of a bank, or financial institution, wants to purchase a commodity. This type If transaction cannot be effected in cases where the client wants to get funds for a purpose other than purchasing a commodity, like payment of salaries, settlement of bills or other liabilities.

To make it a valid transaction it is necessary that the commodity is really purchased by the bank and it comes into the ownership and possession (physical or constructive) of the bank so that it may assume the risk of the commodity so far as it remains under its ownership and possession.

After acquiring the ownership and possession of the commodity it should be sold to the client through a valid sale.

D) Ijarah In the context of participatory banking Ijarah can be defined as a process by which " usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her ". In many respects, Ijarah resembles leasing as it is practiced in today's commercial world.

The distinguishing feature of this mode is that the assets remain the property of the participatory bank to put them up for rent every time the lease period terminates so as not to remain unutilized for long periods of time under Ijarah the bank or the leasing company assumes the risk of recession or diminishing demand for these assets.

Literally, Ijarah means to give something on rent. As a term of Islamic Fiqh, Ijarah can also refer to wages paid to a person in consideration of the services rendered by him/her. In the above discussion, the term Ijarah is used to represent the usufructs of assets and properties, and not to the services of human being.

E) Istisna is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him, the transaction of (Istisna comes into existence, but it is necessary for the validity of Istisna that that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of Istisna creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving notice to the other. But after the manufacturer has started the work, the contract cannot be cancelled Unilaterally. However, the party placing the order has the right to retract if the commodity does not conform to the specifications demanded.

F) Salam or Bay-Salaam as it s also called, is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advanced price fully paid on the spot.

Here the price is paid in cash, but the supply of the purchased goods is deferred, The buyer is called " Rabb-US-Salam ", the seller is " Muslam ilaih ", the cash price is " ra'sul-mal ", and the purchased commodity is termed as " Moslem fih ".

Salam sale is suitable for the finance of agriculture operation, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest either from their own crops or crops of others, which they can buy and deliver incase their crops fail. Thus the bank renders great services to the farmers in their way to achieve their production targets.

Salam sale is also used to finance commercial and industrial activities, especially phases prior to production and export of commodities and that is by purchasing them on Salam and marketing them for lucrative prices.

2.4.3.2. Trade financing .

This is also done in several ways. The main ones are:

One) Mark-up where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on.

b) Leasing where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning an becomes the owner of the item.

c) Hire -purchase where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item.

d) Sell-and-buy-back where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price.

e) Letters of credit where the bank guarantees the import of an item using its own funds for a client on the basis of sharing the profit from the sale of this item or on for mark-up basis.

2.4.3.3. Lending .

Main forms of Lending are:

One) Loans with a service charge where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities.

b) No-cost loans where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers.

c) Overdrafts also are to be provided, subject to a certain maximum, free of charge.

Other banking services such as money transfers, bill collections, trade in foreign currencies at spot rate etc. where the bank's own money is not involved are provided on a commission or charges basis. participatory banks financing is granted on the basis of either of three modes:- sharing, sale and leasing.

2.4.3.3.1. Sharing Modes

There are two forms of applications of this principle: full equity sharing and nonvoting equity financing. In full equity sharing, the bank sits on the board of directors and participates in formulating policies and managerial decisions, while in non-voting financing, the bank fully entrusts managerial decision-making to the fund user. Both forms of sharing modes may be formulated to share net income or gross output. They may also be permanent, declining or timed.

2.4.3.3.2. Sale Modes.

In this group of modes, the bank is asked to buy goods and sell them to users (producers/ consumers) against future payment. participatory banks also practice two other forms: construction/ manufacturing contract and deferred delivery contract. The construction/ manufacturing is usually employed to finance land development, infrastructure, and industrial and residential construction; while deferred delivery is generally an agricultural financing contract that provides farmers with funds needed for their operations against delivery of grain at the season.

2.4.3.3.3. Leasing Modes.

As practiced by leasing companies and recently in many traditional banks, leasing modes may have a variety of forms with fixed or variable rents, declining or fixed ownership, operational or financial, along with different conditions regarding the status of leased assets at the end of the lease period.

2.5. Contribution of participatory banking.

The actual practice of participatory banking over the past three decades and the rise of participatory banks as a new species of banks reveal three innovations in banking traditions:

(1) a new kind of relationship between banks and depositors.

(2) integration of financial and real market in financing.

(3) incorporation of ethics and moral values in investment decisions.

1-Relations with Depositors: Returns paid to depositors as well as the bank's own income from financing represent distribution of net profit at the closing of a financial period.

The early practices of the money exchangers in the 15t" century and over the past five centuries, the relationship between depositors and bankers was based on a lending contract.

Example: The experience of the Pakistani banks (in which all deposits were turned into profit sharing basis since the early 1980s) indicates that the principle of profit sharing offers an important cushion for banks to lean on at times of recession. When the Pakistani Monetary Authority was putting pressure on banks to reduce their credit facilities through different policies including credit rationing, ceilings and other contractionary policies, banks were able to absorb this pressure by passing substantial part of it in terms of reduced returns to depositors.

2- Closing the financing Gap: The second contribution of participatory banks, as witnessed over the last part of the 20th century, is the bridging of gap between financial and real markets. Since participatory banks limit their financing to the three aforementioned modes or principles as: (1) the establishment of new productive projects, (2) purchase of producer/consumer goods, or, (3) lease of productive machinery and equipment and consumer durable. Two main categories of traditional financing are totally excluded from the arena of participatory banking practices: (a) general purpose financing that aims at simply supplementing government and corporate budgets, whether for seasonal or non-seasonal purposes. (b) increase in indebtedness as a result of debts rescheduling (Ahmad, S. M., 1952b).

Table.2: The Characteristics between participatory & Conventional banking.

Characteristics	participatory Banking System	Conventional Banking System (interest based system)
Business Framework	Based on Sharia laws Sharia scholars ensure adherence to Islamic laws and provide guidance.	Not based on religious laws or guidelines-only secular banking laws.
Balance between moral and material requirement	The requirement to finance physical assets which banks usually take ownership of before resale reduced over extension of credit.	Excessive use of credit and debt financing can lead to financial problems.
Equity financing with risk to capital	Available. Enables several parties, including the participatory bank to provide equity capital to a project or venture. Losses are shared venture. Losses are shared on the basis of equity participation while profits are shared on a pre-agreed ratio. Management of the enterprise can be in one of several forms depending on whether the financing is through Mudarabah, Musharaks , etc.	Not generally through commercial banks , but through venture capital companies and investment banks which typically take equity stakes and take equity stakes and management control of an enterprise for providing start-up finance.
Prohibition of Gharar	Transactions deemed Gharar are prohibited. Gharar demotes varying degrees of deception pertaining to the price and quality of goods received by a party at the expense of the other. Derivatives trading e.g. options are considered as having elements of Gharar.	Trading and dealing in derivatives of various forms is allowed.
Profit and Loss Sharing	All transactions are based on this principle. Returns are variable, dependent on bank performance and not guaranteed. But the risks are managed to ensure better returns than deposit accounts. Consumers can participate in the profit upside i.e. in a more	This principle is not applied. Returns to depositors are irrespective of bank performance and profitability. The customer as depositor is like a lender and does not share in the success of the enterprise beyond receiving a fixed rate of predetermined

	equitable way than receiving a predetermined return.	interest. Unlike the Islamic system the depositor cannot theoretically gain subject to improved bank performance.

2.6. Difference between participatory Banks and Conventional Banks.

The conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work ethic, wealth distribution, social and economic justice, and the role of the state.

2.6.1. Some of the differences between the participatory Banks and the Conventional Banks .

The following is a brief discussion in which we list the fundamental differences in the nature of work between the participatory and conventional or commercial banks:

First, traditional or commercial banks are intermediate financial institutions which stand between the savers and the investors (Al-Arabi, 1966). On the other hand, participatory banks are a mixture of internationally known traditional financial institutions for they not only operate like saving banks but are also similar to finance companies in so far as they can offer financial support to high risk projects. Furthermore, they can operate as open or closed investment funds [or banks].

Second, the form of the participatory bank and the form of the conventional bank: The participatory bank is more than the conventional bank for it works like any other specialized bank, (such as industrial banks, agricultural banks or building societies). It finances projects in all the above mentioned fields in addition to the fact that it can work like any investment bank because it is interested in the establishment of long-term projects.

Third, conventional banks do not get involved in the buying and selling or even the keeping of commodities, only within certain conditions. Also these banks, in accordance with their charters, cannot buy capital assets or fixed assets unless they are used by the bank itself (Al-Ashker, 1990). As for participatory banks, they can trade with all types of commodities and can keep capital assets and establish limited companies or other types of companies.

Fourth, the conventional bank promises to pay fixed rates on its deposits, regardless of whether it makes profits or losses. The participatory bank however, does not promise profits; if it made any profits during the financial year it would give the depositors the agreed rates; conversely, if the bank made losses, the depositors would share the burden together with the bank.

Fifth, any conventional or commercial bank can issue excellence share, which has fixed rate from the profits, but the participatory bank cannot do that because they are of limited interests (Al-Qaradaway, 1990).

Sixth, all reserves in the commercial or conventional banks are deducted from the net profit, but in the participatory bank they are deducted only from the net profit ear-marked for the share-holders (Al-Salous, 1987).

Seventh, a considerable part of the conventional or commercial bank's funds are directed towards commercial (business) loans , but the majority of the funds in the participatory bank are directed toward Al-Musharaka finance (shared finance or partnership companies), Mudarabah finance (speculative finance) or resale with specification of gain or other .

Eighth, regardless of their rate of profits, the participatory banks prohibit the production of trading with certain prohibited goods and services in Islam (Al-Salous, 1991b) such as:

- The finance of breweries or meat processing companies dealing with pigs.
- The finance of gambling casinos.

Ninth, one of the characteristic features of the participatory banks is the existence of what is called `Al-zakat fund'. This seeks to establish social equality. Such funds are found in the Kuwaiti Finance House (KFH), the participatory Bank of Jordan (IBJ) and various other participatory banks. This fund is financed by taking 2.5% of the bank's capital every year, with the bank's customers are given the option of paying their Zakat to the bank.

Finally, the importance of the 5Cs (capital, capacity, collateral, character, and condition): The participatory banks attach varying degrees of importance to the elements of the 5Cs from that of the conventional or commercial banks. The commercial bank may give prior to the collateral, whereas the participatory bank gives priority to character of customer. The commercial bank is perhaps more interested in the capital and capacity, but the participatory bank is found to be more interested in capacity than in capital. On the other hand, there may be some similarity between the commercial bank and the participatory bank on the issue of priority attached to the security and soundness of any project submitted to the bank for the purpose of financing (Blitz and Long, 1965).

Table.3: **Difference between participatory & Conventional banking**

Conventional Banks	participatory Banks
1- The functions and operating modes of conventional banks are based on manmade principles.	1- The functions and operating modes of participatory banks are based on the principles of Islamic Shariah.
2- The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk sharing between provider of capital (investor) and the use of funds (entrepreneur).
3- It aims at maxmizing profit without any restriction.	3. it also aims at maximizing profit but subject to Shariah restrictions.
4. It does not deal with Zakat.	4. In the modern participatory banking it has become one of the service-oriented functions of the participatory banks to collect and distribute Zakat.
5. Leading money and getting it back with interest is the fundamental function of the conventional banks.	5. Participation in partnership business is the fundamental function of the participatory banks.
6. Its scope of activities is narrower when compared with an participatory bank.	6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.
7. It can charge additional money (compound rate of interest) in case of defaulters.	7. the participatory banks have no provision to charge any extra money from the defaulters.
8. In it very often, banks own interest becomes prominent, it makes no effort to ensure growth with equity.	8. it gives due importance to the public interest. Its ultimate aim is to ensure growth with Equity.
9. For interest based commercial banks, borrowings from the money market is relatively easier.	9. For the participatory banks, it is comparatively difficult to borrow money from the money market.
10. since income from the advance is fixed, it gives little importance to developing expertise in project appraisal and evaluation.	10. Since it shares profit and loss, the participatory banks pay greater attention to developing project appraisal and evaluations.
11. The conventional banks give greater emphasis on credit-worthiness of the clients.	11. the participatory banks, on the other hand, give greater emphasis on the viability of the projects.
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtor.	12. The status of participatory bank in relation to its clients, is that of partners, investors and trader.
13. A conventional bank has to guarantee all its deposits.	13. Strictly speaking, and participatory bank cannot do that

2.7. The Relationship Between Central Banks And participatory Banks .

Central Banks plays the major role in supervisory activities applied on banks in different parts of the world. Central bank activities in that respect include supervisory operations which are administered on banking units operating within the boundaries of their governing states. They cover checking registers and books for the purpose of validating sound assets and operations. They are also involved in developing rules and principles related to bank operations in general, and establishing the range of dealing with specific activities and clients. The role of central banks is not merely limited to such activities; they are also authorized to determine credit and debit interest rates, set tariffs for banking services which would apply to all banks that are subject to their authority.

The relationship between Central Banks and participatory Banks Since participatory Banks have been initiated in the mid 1970s they have always adhered to the rules, regulations and decisions issued by central banks. It has been observed recently that the nature of the relationship between participatory banks and central banks differs from one country to another. This depends on the legal framework which regulates the status of participatory banks within these countries.

Based on this, there are three types which represent such relationship:

1- This type is found in Pakistan and Iran. Within this type the relationship between participatory banks and central banks is determined by specific rules and regulations. In that case the central participatory bank undertakes the supervision of participatory banking units, and makes sure that they follow such rules and regulations properly without any contradiction in objectives or policies.

2- It is manifest in the states which have authorized the foundation of participatory banks, and issued laws which regulate their operations as separate from conventional banks. They have set limitations and regulations for such banks, and have dedicated specific government structures to supervise their activities, and verify their practices. Such type can be found in Turkey, Malaysia, Jordan, and the United Arab Emirates. Within this type the relationship between central banks and participatory banks is highly regulated. No conflicts or problems arise between both parties .

3- This type can be found in countries which have established participatory banks in accordance with special laws, unlike conventional banks which are established in terms of a contract similar to that of corporations. Within this type participatory banks are not exempt from the laws which regulate the activity of other banks. They operate as small units within a large group of conventional banks which are regulated by the state law, and supervised by the central bank.

Such participatory banks can be found in Egypt, the Sudan, Kuwait, Bahrain, and other countries. participatory banks of this type have specific nature and qualities which make them distinctive from other conventional banks. There is also a specific relation between such banks and those dealing with them, and they have achieved certain success on economic and social levels.

2.7.1. Future Perception of the Relationship between participatory Banks and Central Banks .

It should be recognized that participatory banks do not avoid central bank supervision; rather, they welcome such supervision, and hope it would be processed within a framework which complies with their specific nature, and understands their role. It has become evident that

Participatory banking units, after a long period of participatory banking operations, have managed to produce a distinguished type of banking activities, and have been met with success and appreciation on the part of large numbers of bank clients. The position of such banks necessitates that central banks facilitate the work of such units, and support them in performing their positive role in sustainable development in the countries in which they operate (Crane, 1981).

It is our conviction that in order to develop a positive relationship between monetary authorities (represented by central banks) and participatory banks as well as cause such supervision on participatory banks to be of benefit to the national economy and bank clients, future perception of the relationship between both parties within the current dual system could include two major steps: 1. Central banks should now begin to make some modifications on conventional supervisory methods which are suitable to the position of participatory banks, and based on putting the recommendations of the expert sub-committee of the Islamic Conference Organization into effect. The following points include the most important procedures which could be taken into consideration in that respect:

a) Designing patterns and forms of regular data required from participatory banks to be developed and approved by central bank officials and participatory bank representatives. Such new forms should meet supervision objectives, and comply with the nature of participatory bank operations.

b) Human resources within central bank supervisory systems are usually divided into groups, each of which undertakes supervisory tasks on a specific number of banks.

c) Reconsidering cash reserve policy in so far as investment accounts in participatory banks and credit ceiling policy are concerned, especially that there are current legislations within the dual system which have exempted investment and business banks from these two tools taking into consideration the nature and importance of their work.

d) Conducting research studies on the availability of a method approved by Islamic Sharia which aims at causing participatory banks to benefit from Central banks in their capacity as the last sanctuary of banking units operating under their supervision; or more accurately, it is indeed the optimal lender in cases of liquidity deficit which could pose as a setback in participatory bank operations.

2. Banking regulations, laws and legislation for participatory banks should be developed and enforced.

2.8. Advantages & Disadvantages of participatory banking .

2.8.1. Advantages of participatory Banks:

First of all, Islamic finance forges a closer link between real economic activity that creates value, and financial activity that facilitates it. Islamic finance is global and cosmopolitan. Committing itself to a text accessible to all and prophetic precedence, easily available. Islamic finance is open to any innovations that are in congruence with its fundamentals. Moreover, It is not a closed system as it has no regional, ethnic or class affiliations. Islamic finance will foster greater stability as it synchronizes payment obligations of the entrepreneur with his or her revenues.

Also it is a more efficient as it allocates invest able funds on the basis of expected value productivity of projects rather than on the criterion of creditworthiness of those who own the projects, as is the case in debt-based finance. Finally, Islamic finance will be less prone to inflation and less vulnerable to gambling like speculation, both of these being currently fuelled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money substitutes while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.

As participatory banking has it disadvantages, it also as its advantages. It has been reported by many scholars that the system of participatory Banking has different advantages.

Murabaha is considered to be better than debt financing. We claim that it serves to keep the financial market in sync with the market for real goods and services, therefore making it less capable of betting like speculation.

Representing these and possibly other qualities require Murabaha to be practiced in real earnest. For example as a means of financing the acquisition of production means and needed goods by people who are expected to be able to pay for them, but after sometime. It is only the practitioner who can ensure that Murabaha does not degenerate to that level.

Since financial intermediation does not involve selling goods and services directly, it would be more appropriate to get financial intermediaries involved in Murabaha business indirectly. The same applies to other forms of business like Salam, Istisna. lending. A financial institution is not really qualified to handle these businesses directly. It is often unwilling to expose its capital to the risks involved in direct businesses. As a result it tries to make the transactions as risk free as

Possible. It does not matter if these means, on the average and in the long run, settling down for a lower rate of return.

They would also be able to branch out their activities as a means of decreasing the risk. Perhaps they are already specializing in handling different market segments in terms of the commodities involved. These businesses would need financing. This way there would be a buffer between the changing circumstances of real businesses and those handling only finance. The fact that their stake will be not in individual deals based on one of the contracts mentioned above but in a large basket of deals will make a crucial difference. In its own interest, the business being financed will have reduced the risk of loss by diversification and other methods.

What would be the basis for the Islamic financial institutions' financing of Murabaha companies, in this case of Lending companies? In my opinion, the basis for Islamic financial insinuations will be more appropriate in the form of Mudaraba or profit sharing. This conforms to the earliest form of financial intermediation discussed in Islamic jurisprudence, al Mudarib yudarib.

Whether it is the building and construction area or agriculture, manufacturing industries or the transport and communication sector, foregin trade or domestic commerce or the government's infrastructure building activities, ways can be found to meet their financial needs through these companies, without recourse to interest based lending and borrowing.

However, with this change they could rightfully demonstrate how their activities avoid contributing to the unsteadiness of the system, something we accuse interest based institutions of doing. By doing this the system will enjoy the unique feature of sharing based intermediation: synchronization between revenues and payment obligations, and still keep the flexibility which the presence of very low risk modes of financing impart to a system.

2.8.2. Disadvantages Of participatory Banks:

Everything has its advantages and its disadvantages; so do participatory Banks. The Islamic system is not well known in the world therefore some countries might fight the system itself and some countries fight the interest-free rate system. It has been said that the concept of the Profit Loss Sharing used in participatory Banks a better system than the one used in Conventional banks. But that has been proven wrong, as there are four main problems where participatory Banks found the profit loss sharing a problem while financing.

The first problem is that long-term projects have been proven to be a problem using the profit loss-sharing concept. Twenty participatory Banks have figured out in the year 1998, that less than only about ten percent of the capital is used in long term projects. That's because long term projects take a long time and so the bank cannot give the customer back his money except after a period of time, while on the other hand conventional banks pay the customer back his money right from the beginning. Also participatory Banks have to wait until the end of the project to give the customer his profit, unlike conventional banks pay the profit quicker. Second, another reason is that a project with the basis of the profit loss sharing concept would take a long time because it needs expertise and experience.

Third, most of the banks customer work with the bank in small business, but it is difficult to give these investors money even if there is a lot of money in the bank because it is difficult to finance small business under the Profit Loss concept Forth, as participatory Banks operate differently than conventional banks, the new staff have to learn many new skills that they will need to work with which takes time. Also new principles have to be taught, which would also be time consuming.

CHAPTER THREE

3. DEVELOPMENT OF PARTICIPATORY BANKS IN TURKEY OVER 1985-2010

3.1. Participatory Banks in Turkey .

Following liberalization in Turkish economy in the early 1980s, the financial sector was restructured through deregulations that also directed innovations to those markets. In this context, IFBs or special finance houses (SFHs), providing financial products and services based

on Islamic principles, were introduced to the Turkish financial market, Following Ozal's special legislation on interest-free banking, (Decree no.83/7506 issued on December, 1983) IFBs have started their operations in Turkey in 1985. The reason behind the introduction of interest-free banking was two folds: first, it was to bring into the economy all funds that oppose to interest and thus do not go into interest based banking system. Second, it was to develop economic linkages to the oil-producing Arab states and to attract Gulf capital (Jang, 2003). It was suggested that at the time introduction of interest-free financial products and services to Turkish financial markets was more of a political strategy rather than an economic or religious move (Special Finance House, 2003)

During the early-1980s, the then-Turkish government also invested particular efforts to encourage capital from Middle East Countries into the Turkish Financial markets. Simultaneously, Turkey was already a member of the Islamic Development Bank that became operational in 1975 (Saduman, 2005). In line with these developments, the government approved the introduction of interest-free financial products and services in 1983. The Council of Minesters' Decree dated December16, 1983 exempts SFHs from the provisions of the banking law that regulates the conventional banks operating in Turkey. Consequently, the SFHs had competitive advantages over the conventional banks (Al Baraka, 1987). Until interest-free banks became subject to the Banking Law in 1999, the activities of the SFHs were accomplished by the decrees of the Council of Ministers on the one hand, and by the directives of the Central Bank (March 21, 1984) and Under secretariat of Treasury (February 25, 1984) on the other hand. By this move, SFHs became subject to the Banking Law No.4389. In other words, they came under the same body of legislation as the conventional banks. According to new requirements, the SFHs are required to 6% and 11 % of reserve ratio for deposits in Turkish Lira (TL) and foreign currency, respectively (Saduman, 2005). Until the legislation in 1999 there was an ongoing argument on whether to consider SFHs as banks or not. After this legislation they are considered as banks. In December 19, 1999, Special Financial Institutions were put under the coverage of Turkish Banking Law, provided that they operate in an interest free window. According to Decree of May 2001 "Assurance Fund", current accounts and profit/loss participation accounts of natural persons are defined as deposits to be insured. 2005, the name of Special Finance Houses changed to Participatory Bank (Doğan, 2008).

The first participatory banks and the concept of ‘participatory banking’ were introduced to Turkey by Middle Eastern capital groups with the joint ventures of Özal’s family members, the-then prime minister. The prime minister’s brother and some other politicians were among the founding members of first participatory Banks, Faisal Finance House and Albaraka Türk, while Kuwait Finance House was established a few years later. Turkish participatory Banks such as Anadolu Finance House, Ihlas Finance and Asya Finance followed these examples.

While the majority of shares in the first three participatory banks belong to foreign nationals, from gulf countries Turkish nationals own the last three. The Hess Kablo Group, a corporation based in a provincial city (Kayseri), had the majority of shares in Anadolu Finance (established in1991). Ihlas Finance (1995) was part of a large Islamic company, Ihlas Holding Corporation, which came out in the 1980s. Asya Finance (1996) is known as related Fettullah Gülen Community (Bulut 1997; Baldwin 1990; Moore 1990). Financial crisis in 2000 and 2001 affected interest-free banks deeply, and Ihlas Finance was not able to carry on its operations anymore, In 2002 the name of Faisal Finans changed to Family Finans, and Family Finans merged with Anadolu finance, as a result their name became Turkiye Finans (Adas, 2003). After the approval of interest free banking system, in 1983, six IFBs were founded. Today, four IFBs are operating in Turkey and financing real economic investments under interest free banking principles.

When the history of interest free banks in Turkey has been examined, it can be divided into three phases of development:

- 1983-1999 period includes the beginning of interest free banking experience of financial sector in turkey and the legislation that IFBs were put under the coverage of Turkish

Banking Law. Although it has been believed that Turkey has a huge potential in participatory banking, the performance and market share of IFBs in that period indicated that they did not reach the expected success. There may be some reasons that explain why they could not reach their expected potential. It can be said that the main problem is their legal situation. Since they were not regarded as banks and the deposits in those institutions were not under the state guarantee, they were not particularly preferred by customers. Another reason may be lack of experience and qualified staff of those institutions. It is also worth to mention that they had some political difficulties too. In the period of "28 February" period, they were taken under the tight control of government since they were regarded as a part of green capital in Turkey. Therefore, they were not able to open new branches and their relations with bureaucratic mechanisms were going very slowly. As a result their operations' qualities were not satisfactory to attract new customers.

- 2000-2005 period starts from the twin crises in 2000/1 and goes to the legislation that may be regarded as corner stone for IFBs because their name became Participation Bank, and they were called as bank. According to some manager in those PBs this is a very important phenomenon for consumer perception and will lead PBs to attract customers. In the beginning of this period the financial crisis severely affected the IFBs in Turkey, since there was no state guarantee for deposit in these banks, most of their customer withdrew their money, and they have lost nearly 50 % of their deposits. However after the crisis, with the new legislation, the IFBs recovered their lost rapidly, and started to grow fast and performed better than conventional banks.

- The period after 2006 indicates a new phase for IFBs. With the new legislation in 2001 they are regarded as banks, and the better conditions in Turkey and global economy

exposed them to sustain their growth. However the global mortgage crisis also affected them, but they did not affected seriously from this crisis as conventional banks.

In Turkey, the participation banks were first introduced under the name of *Special Finance Houses* in 1985 following completion of the legal arrangements between 1983 and 1985. Under new regulations promulgated in 2005, the names of these institutions were converted to participation bank and they were subjected to the same regulations as conventional banks in 2006. Although the number of these interest-free banking institutions was 7 at the beginning, this figure is now 4. The activities of Ihlas Finans were terminated in 2005 by Banking Regulation and Supervision Agency and in the end of 2005 Anadolu Finans and Family Finans merged into the name of Turkiye Finans. The four active participation banks are Albaraka Turk, Bank Asya, Kuveyt Turk and Turkiye Finans.

Table 4: Selected Banking Indicators of Participation and Conventional Banks in Turkey

(%)	**Participation Banks**					**Conventional Banks**				
	2005	**2006**	**2007**	**2008**	**2009**	**2005**	**2006**	**2007**	**2008**	**2009**
Share in Total Assets	2.69	3.04	3.67	3.90	4.50	97.31	94.96	96.33	96.10	95.50
Share in Total Loans	5.05	5.11	5.59	5.72	6.82	94.95	94.89	94.41	94.28	93.18
Share in Total Private Loans	5.14	5.20	5.68	5.86	7.04	94.86	94.80	94.32	94.14	92.96
Share in Total Deposits	3.52	3.83	4.34	4.41	5.46	96.48	96.17	95.66	95.59	94.54

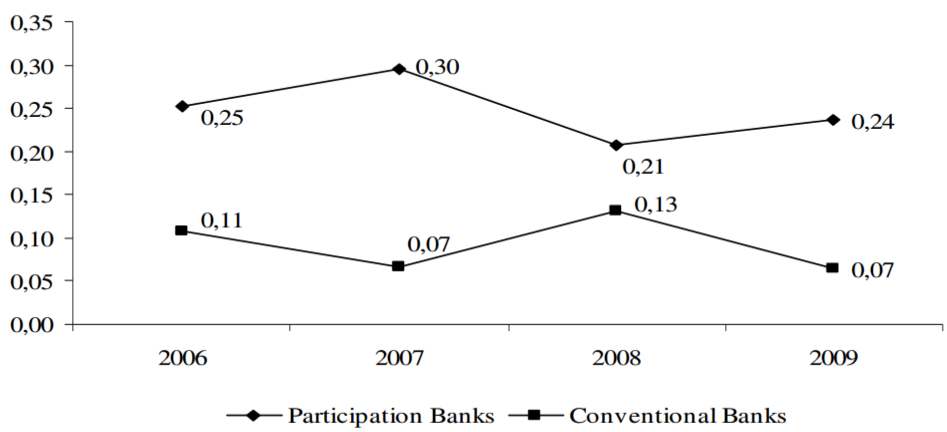
Share in Total FX Deposits	4.70	5.19	5.39	5.39	6.05	95.30	94.80	94.03	94.61	93.95

Source: Calculated from Central Bank of the Republic of Turkey Electronic Data Delivery System

Table 4 provides some ratios on participation banks and conventional banks for the purpose of seeing the development of participation banks after 2005. In this 5-year period, it can be seen that the in-system weight of the participation banks operating in Turkey has visibly increased. These banks target to increase their in-system total stakes up to 10% in the near future (Participation Banks 2009, p.5).

Graph 1 provides the annual rate of change in total real size of assets of participation banks and conventional banks doing business in Turkey between 2006 and 2009. The size of assets of participation banks refers to a greater development than that of conventional banks in the given period. Considering the higher rate of development displayed by the interest-free finance markets in international markets, it is necessary to expect the participation banks in Turkey will continue to increase their in-system weight.

Graph 1: **Annual Growth Rate of Total Assets**



return rate of PBs in comparison with conventional banks interest rates

Rate of interest has always been featured as one of the important considerations in explaining the saving behaviour of individual. Saving, according to Classical economists, is a function of the rate of interest. The higher the rate of interest, the more money will be saved, since at higher interest rates people will be more willing to forgo present consumption. Based on utility maximization, the rate of interest is also at the center of modern theories of consumer behaviour, given the present value of lifetime resources. For a net saver an increase in the rate of interest will have an overall effect composed of two partial effects: an income effect leading to an increase in current consumption and a substitution effect leading to a reduction in current consumption (Hadjimatheou, 1987).

Keynes (1936) despite arguing the quantitative importance of the interest rate effect believes that in the long run substantial changes in the rate of interest could modify social habits considerably, including the subjective propensity to save. Friedman (1957) in his neoclassical analysis of the consumption function suggested that the main variables determining the average propensity to consume are 'the rate of interest, the relative dispersion of transitory components of income and of consumption, the ratio of wealth to income, and the age and composition of consumer units'. In view of the importance of the rate of interest on consumption, many researchers using various methodologies try to establish the strength of relationship between these two elements. Wright (1967), Taylor (1971), Darby (1972), Heien (1972), Juster and Watchel (1972), Blinder (1975), and Juster and Taylor (1975) in their studies found an inverse relationship between interest rate and consumption. Modigliani (1977) based on his works and after seeing evidence on the effect of interest rate on consumption concludes that the rate of interest effects on demand, including the consumption component, are pervasive and substantial.

Each of the different types of deposits available at the conventional banks carries a different rate of interest or yield to the depositor. In general, the longer the maturity of a deposit, the greater the yield that must be offered to depositors, in part because of time value of money and the frequent upward slope of the yield curve. For example, notice of withdrawal (NOW) deposits and money market deposits (MMDAs) are subject to immediate withdrawal by the customer and, accordingly, interest rate offered to depositors is among the lowest of all deposits. In contrast, negotiable CDs and time deposits of a year or longer to maturity often carry higher rates.

Similarly, savings or thrift deposits are designed to attract funds from customers who wish to set aside monies in anticipation of future expenditures or financial emergencies. These deposits generally pay significantly higher interest rates to customers than transaction deposits do, particularly for those deposits the customer agrees to hold with the bank for several months or years.

Conventional bankers have learned that deposit pricing can be used to shape the kind of customer base each bank can best serve. Changing deposit prices affect not only spread between bank loan rates and deposit interest rates but also customer balances and deposit mix decisions, which in turn, influence both bank growth and profit margins (Edmister, 1982). As Rose (1991) points out, deposit pricing is best used to protect and increase bank profitability, rather than to simply add more customers and to take market share away from competitors. Indeed, when new deposit plans are introduced, its biggest appeal and greatest chance for success lies with those customers who already hold deposits with the bank. And even those customers the bank already has will not automatically pay higher prices for deposit services. They will pay no more for a deposit than the sum total of its benefits to them and will go elsewhere when the value of those benefits falls below the deposit's price or if a competitor offers a significantly better package of services.

In summary, two important elements emerge from this overview. First, the acknowledgement by conventional banks that those who are willing to part with their monies must be rewarded. Second the recognition that different types of deposits carry different amount of returns or rewards. Therefore, if the management of participatory banks believe that the attitude of depositors of participatory banks are indifferent to those of conventional banks, the same rates of return will be rewarded with rates of conventional banks. There are several serious repercussions if the management of participatory banks believe that depositors at participatory banks possess similar attitudes to those at the conventional banks. The interest rate will continue to have an influence on the operations of participatory banks as long as this thought remains in the mind of their management. Findings of Metwally (1997), for example, confirmed that conventional and participatory banks offer their depositors similar returns.

Although some empirical research have found that people who patronise participatory banks look for monetary rewards, this is not necessarily true for all cases. In 1984, Kuwait Finance House did not distribute any profit to their depositors, but there was no evidence of massive withdrawal of deposits. Similarly, participatory banks in Sudan never reward their current account holders, but a bulk of their funds is supplied through these facilities. As institutions whose foundations are based on religious doctrines, it is paramount for participatory banks management to believe there are other factors that dominate the economic behaviour of Muslims. These principles comprise the belief in the day of Judgement and the life in the hereafter, the Islamic concept of riches, and the Islamic concept of success. All of these principles are expected not only to have a significant impact on the decision-making process of Muslims, but also to have an influence on their perceptions of participatory banks.

The first principle has an effect on the depositors' behaviour and their decision-making process. The choice of action is based not only on the immediate financial returns but also on those returns in the hereafter. Therefore, the decision to place deposits with participatory banks is not because of a profit motive but rather to gain the blessing of Allah. One of the ways to gain this blessing is to support any program that will improve Muslim communities. Since participatory banks operate on an interest-free basis and their establishment is designed to improve Muslim communities, Muslims who support these banks are therefore considered people who achieve salvation as indicated by Verse 20 of *Al Tawbah*.

In the case of the second principle that involves wealth, Islam has given a clear guideline to be followed by Muslims. In Islam, wealth is a bounty from Allah and is a tool that may be used for good and evil. Poverty is, in some instances, associated with disbelief and riches are considered a gift from Allah. Wealth itself is considered as an important means by which man can pave the way for the attainment of his ultimate objective. All persons are exhorted to work to earn a living and to accumulate wealth. Accumulating wealth is considered among the highest blessings bestowed on man and everyone is encourage to strive for wealth (Verse 10 of *Al Jumu'ah*).

The methods of earning, possessing, and disposing of wealth, however, must be in line with the *Shariah*. The best method of accumulating wealth as defined by *Shariah* is by striving to succeed on one's own and not from the income generated from other peoples' efforts. This is in line with many *hadiths* in which the Prophet (pbuh) had given his advice to Muslims to work for their own food. Therefore, in line with these *hadiths* Muslims should not regard rewards from participatory banks as a source of income.

The Islamic concept of riches also serves as an important factor that influences Muslim attitudes towards the existence of participatory banks. Islam defines success as the level of obedience to Allah and not the accumulation of wealth. Service and obedience may be rendered by the positive use of capabilities and resources given by Allah. According to Islamic teachings, if a man really wants to serve Allah, the utilisation of the natural and human resources made available to him is not only a privilege but also a duty and obligation prescribed by Allah. This is in line with Verse 27 of *Al Anfal* which commands Muslims not to betray the trust given by Allah and His Apostle. Applying this principle to the banker-customer relationship would mean that the customer should not be discouraged by the low profits or limited success of participatory banks.

In light of these three principles, participatory bank customers are expected not to be guided by the profit motive. Instead, the reason for placing their monies with the participatory banks is directed towards receiving a blessing from Allah and this action is considered the best way of managing the resources given by Allah. Since it is a belief of every Muslim that all properties belong to Allah, returns on their deposits are also considered a gift from Allah irrespective of amount. Similarly, in the case of loss, it is all from Allah.

3.2. Financial Development and Market Shares of Participation Banks .

The place of Participation Banks in Turkish financial system and their development can be examined under many main titles. These can be listed as deposit, credit, size of assets, personnel branch number, and other quantities.

Table.5: The Share of PBs in the Funds collected in Turkish Banking Sector (%)

Period	Banks (TL)	Participatory Bank. (TL)	PB/Total	PB Share Growth Rate %
1985	7.970.010	28.893	0,36	**-**
1986	13.404.447	75.823	0.56	55,56

1987	20.647.512	158.688	0,76	35,71
1988	32.903.667	325.033	0,97	27,63
1989	54.674.035	689.065	1,24	27,84
1990	82.313.007	1.197.993	1,43	15,32
1991	153.048.251	2.827.549	1,81	26,57
1992	269.202.642	6.141.858	2,23	23,2
1993	433.083.902	14.081.498	3,15	41,26
1994	1.013.157.250	33.917.400	3,24	2,86
1995	2.367.547.175	68.452.825	2,81	-13,27
1996	5.509.031.000	157.618.000	2,78	-1,07
1997	11.415.893.000	363.657.000	3,09	11,15
1998	23.439.028.000	746.263.000	3,09	0
1999	46.781.434.000	1.482.335.000	3,07	-0,65
2000	57.039.757.000	1.860.304.000	3,15	2,61
2001	108.352.470.000	1.945.530.000	1,76	-44,13
2002	134.735.128.000	3.237.872.000	2,34	32,95
2003	147.350.714.000	4.004.306.000	2,65	13,25
2004	190.996.041.000	5.992.159.000	3,04	14,72
2005	243.066.274.000	8.369.155.000	3,33	9,54
2006	296.495.000.000	11.237.284.000	3,65	9,61

Source: www.tkbb.org.tr and the archives of Turkey Finance Participation Bank Inc.

3.2.1. Developments in the Weld Structures of Participation Banks .

When the direction of Participation Banks' share in the banking sector is observed in terms of the funds collected over years, it can be seen that it has increased continuously, and this fact has emerged a balanced view. Despite this entire stable rise trend, all figures reveal the fact that Participation Banks in Turkey have not been able to show an adequate performance compared to the other countries where participatory Banking has been applied broadly. Generally analysed the development of Participation Banks in Turkish financial system and banking sector with regard to collected funds; it can be seen that while consolidated bank deposits in 1985 were 7.998.903 TL, the collected funds of Participation Banks happened as 28.893 TL. In that sense, Participation Banks (named as Private Financial Institutions at that period) accounted for %0.36 of banking sector in terms of collected funds in their early years of establishment. Starting from their early years, Participation Banks have shown a steady increase in the collected funds. Fund increase took place %55, 56 in 1986, and %35,71 in 1987. This upward trend continued through having increase rates ranging from %25 to %50 each year in 1994-1995. Participation Banks experienced their first fund loss in their history as -13,27 in the period passing through 1995 from 1994. Main reason of the recession taking place in 1994 can be thought as April 5 Measures and crisis sphere. Then, the most significant and largest decline happened as a ratio of -%44,13 in 2001 because of the transfer of Ihlas Finance Corporation to SDIF, the liquidity crisis of banking sector, and February 2001 crisis.

Except these mentioned crisis periods, Participation Banks have a fund structure which has perpetually increased. Even it increased by the ratio of %32,95 in 2002 after the distress experienced in 2001, but it could not prevent its collected fund share in banking sector to decrease to %3.

As can be understood from Table-1, the increase of funds that have been collected since 2003 continues to show an increase with an average ratio of %10-15.

This increase is expected to continue in following periods. Because after the formation of assurance fund under the roof of PFIA through considering the fact that it cannot provide assurance to funds like SDIF according to the present legislation and laws in 2002, a balanced and crucial increase has been witnessed in the collected funds. With the subjection of Participation Banks to the Banking Law No. 5411, these funds are expected to be put under guarantee within the scope of SDIF, and to increase parallel to such developments.

Table.6: The Share of PBs in the Disbursed Funds within Banking Sector (%)

Period	Banks (TL)	Participatory Banks (TL)	PB/Total	PB Share Growth Rate %
1985	5.577.514	27.086	0,48	-
1986	10.147.446	71.854	0,7	45,83
1987	16.314.746	123.754	0,75	7,14
1988	23.594.931	275.669	1,15	53,33
1989	38.677.700	682.000	1,73	50,43
1990	68.074.108	1.212.592	1,75	1,15

1991	104.098.174	2.392.526	2,25	28,57
1992	188.678.800	6.503.300	3,33	48
1993	348.901.200	14.125.000	3,89	16,82
1994	711.953.237	29.105.763	3,93	1,03
1995	1.580.422.000	61.560.000	3,75	**-** 4,58
1996	3.490.751.000	146.129.000	4,02	7,2
1997	7.924.097.000	329.185.000	3,99	-0,75
1998	13.291.914.000	644.303.000	4,62	15,79
1999	20.466.011.000	1.248.963.000	5,75	24,46
2000	30.118.652.000	1.726.000.000	5,42	-5,76
2001	39.909.000.000	1.073.000.000	2,62	-51,69
2002	41.092.000.000	2.101.000.000	4,27	63,12
2003	48.018.584.000	3.001.313.000	5,88	37,77
2004	89.900.000.000	4.894.665.000	5,16	-12,25
2005	143.969.486.000	7.407.508.000	4,89	-5,23
2006	202.469.000.000	10.492.453.000.000	4,93	0,083

Source: www.tkbb.org.tr and the archives of Turkey Finance Participation Bank Inc.

It is observed that the share of Participation Banks in banking sector has had a more stable and observable increase in terms of disbursed funds according to the funds collected over years. When the share of the funds collected by Participation Banks in the whole banking sector and the share of their disbursed funds in the whole banking sector are compared, disbursed funds from higher percentages than collected funds as can be seen from the chart. The share of Participation Banks in Turkish Banking Sector ‘s collected funds has achieved %3,65 via having a dramatic increase in recent years. Compared to this, its share in disbursed funds realized around %5, but the eras when it reached %5,88 also happened. In the periods when the ratio of disbursed funds surpassed the ratio of collected funds, the difference was provided as a result of the fund disburse made by Participation Banks from their capital stocks.

In general, when the increase and share of disbursed funds in the sector are evaluated, it can be seen that disbursed credits reveal a tendency of continuous increase. In the first 5 years starting from 1985, when they started to work actively, to 1989; Participation Banks just constituted %1,15 of sector’s total credit volume with their credit volume of 682.000 TL in the entire banking sector. Participation Banks, which reached %2s regarding the credit disburse volume in sector within first 5-year-period, achieved the share of % 4,02 in 1996 as a result of their 10-year-performance via maintaining this increase steadily. While this increase lost blood 2 times under the effect of two crises occurring in our country in 1994 and 2001, it managed to get recovered fast. While the fund disburse of 61.560.000 TL took place via the contraction of % 4,58 in 1995 after 1994 Crisis, a significant recovery happened both in the whole banking sector and among Participation Banks numerically in 1996. Through increasing their credit shares to % 4,02 in the entire banking sector, Participation Banks provided a fund disburse of 146.129.000 TL in 1996. In 2001, the contract of -%51,69 causing a harder impact took place, so the fund disburse realizing as 1.726.000 TL in 2000 decreased to 1.073.000 TL and this caused the reduction of Participation Banks’ credit share in Turkish Banking sector from %5,42 to %2,62.

Yet, since Participation Banks kept the amount of payments constant through continuing to implement the principles of interest-free banking without making any alterations contrary to many interest-bearing (classical) banks that caused the credit users to experience harsh times through making drastic changes in the interest ratios of previously disbursed credits over a night in the crisis period, especially the credit usage from Participation Banks had a significant increase following the crisis.

In that way, Participation Banks managed to quickly pass over the impact Turkish Banking Sector had in 2001, and they reached the peak point through managing to get a balanced increase trend with a share of % 5,88 in 2003. Most important share of Participation Banks, which have succeeded to maintain the level of %5 regarding the share of fund usage in Turkish Banking sector in last few years, is observed as credits. Lastly, through reaching the fund disburse of 10.492.453.000.000 TL and the share of % 4,93, they showed a performance revealing that this increase trend would continue.

Table.7: The Rate of Disbursed Fund/ Collected Fund in Banking Sector

Period	**Banks (%)**	**Participatory Banks (%)**	**Total (%)**
1985	69,98%	93,75%	70,06%
1986	75,70%	94,76%	75,80%
1987	79,01%	78,00%	79,00%
1988	71,70%	85,00%	71,83%
1989	70,74%	98,97%	71,09%

1990	82,70%	100,00%	82,97%
1991	68,01%	84,62%	68,32%
1992	70,08%	100,00%	70,88%
1993	80,56%	100,00%	81,18%
1994	70,27%	85,81%	70,77%
1995	66,75%	93,93%	67,40%
1996	63,36%	92,71%	64,18%
1997	69,41%	90,52%	70,06%
1998	56,70%	86,33%	57,62%
1999	43,74%	84,25%	45,00%
2000	52,80%	92,78%	54,07%
2001	29,62%	55,15%	37,16%
2002	30,49%	64,88%	35,65%
2003	32,58%	74,95%	33,70%
2004	47,06%	79,55%	48,13%
2005	59,23%	88,50%	60,20%
2006	68,28%	93,37%	69,20%

Source: www.tkbb.org.tr and the archives of Turkey Finance Participation Bank Inc.

In Table 7 above, the ratio of Participation Banks' and interest-bearing banks' disbursed funds to collected funds can be seen. When the issued chart is analysed, the fact that Participation Banks can disburse their collected funds in a higher rate than interest-bearing banks can apparently be recognized. Considering their effects in terms of activating idle funds and directly supporting the real sector, it can be understood that Participation Banks, of which contributions to national economy come into foreground more, have disbursed funds in a higher rate contrary to interest-bearing banks in crisis periods and the aftermath. In 2002, while interest-bearing banks disbursed %30,49 of their collected funds, this rate realized as %64,88 in Participation Banks. Interest-bearing banks have placed the large part of the deposits they held in Government Debt Securities.

3.2.2. Financial Development of Participation Banks Regarding Assets .

When Participation Banks are analysed in terms of their size of assets, it can be seen that Albaraka Turk had the largest share in total assets with %37,23 in 1996. The second came as Ihlas Finance with the share of %23,53, third one was Kuveyt Türk with %17,60, the forth was Family Finance Corporation with %11,60, fifth one was Anadolu Finance with %7,79, and the last one was Asya Finance with the share of %2,25. In terms of the increase in the total assets of Participation Banks, the rise of %127 in 1997 takes the attention. This increase is followed by the increase of %92 in 1998, and of %104 in 1999. Participation Banks have shown a steady increase tendency with regard to their assets structures just like regarding collected and disbursed funds.

In Table 8, the assets size of Participation Banks from 1996, when their number was the highest, to their final situation in 2006.

Table.8: The Size and Development of Assets Held by Participation Banks (Thousand TL) ASSET

Period	ALBARAKA	İHLAS*	KUVEYT	ANADOLU	FAMILY**	ASYA	TOTAL
1996	69.252	43.775	32.740	14.474	21.558	4.186	185.985
1997	119.962	122.853	71.154	40.192	37.993	31.207	423.631
1998	221.884	258.680	129.001	65.057	62.658	72.587	809.867
1999	376.816	642.435	235.633	113.875	130.000	158.307	1.657.066
2000	486.978	836.906	309.590	170.900	128.483	237.314	2.170.171
2001	542.983	-	742.528	237.396	252.320	390.569	2.165.796
2002	986.136	-	1.071.840	472.161	520.568	791.106	3.841.811
2003	1.199.600	-	1.365.401	663.288	857.165	1.166.546	5.252.000
2004	1.460.789	-	1.660.017	1.028.301	1.261.805	1.931.016	7.341.928
2005	1.969.598	-	2.339.928	3.025.181	-	2.611.611	9.946.318
2006	2.491.813	-	2.936.082	4.122.636	-	4.179.189	13.729.720

* Ihlas Finance Corporation Inc. was transferred to the SDIF in 2001.

** Family Finance Corporation Inc. and Anadolu Finance Corporation Inc. were renamed as Turkey Finance Participation Bank in 2005 through taking the decision to merge.

Source: www.tkbb.org.tr and the archives of Turkey Finance Participation Bank Inc.

With regard to their size of assets in last three years, Asya Finance ranked first with the largest share of %26,30, the second was Kuveyt Turk with the share of %22,61, Albaraka Turk became the third one with %19,90, the forth one became Family Finance with %17,19, and Anadolu Finance ranked fifth with the share of %14 in 2004.

When the year of 2005 came, all this appearance changed by the decision taken by Anadolu Finance and Family Finance to merge under the name of Turkey Finance Participation Bank Inc. in this issued year. According to their size of assets in 2005, Turkey Finance held the first rank with the share of %30,41, Asya Finance followed it as the second with %26,26, Kuveyt Türk ranked the third with %23, 53, and Albaraka Türk remained in the fourth rank with the share of %19.80. Through increasing its size of assets by %60 compared to the previous year in 2006, Bank Asya rose to the first rank in sector with the share of %30,44. Turkey Finance came after it with a highly close share of %30,02. Kuveyt Turk ranked the third with %21,38 and Albaraka Turk held the forth rank with the share of %18,15.

Table.9: The Place of Participation Banks in Turkish Banking System In Terms of Assets Size (Thousand TL)

Period	Banks	Participatory Bank	Total	PB/Total
1995	4.102.384	78.070	4.180.454	% 1,90
2000	104.283.106	2.170.171	106.453.277	% 2,08
2001	216.507.617	2.165.796	218.673.413	% 1,00
2002	212.675.488	3.841.811	216.517.299	% 1,81
2003	249.692.000	5.252.000	254.944.000	% 2,10
2004	304.524.090	7.341.928	311.822.691	% 2,41
2005	382.241.594	9.946.318	392.187.912	% 2,60
2006	470.622.000	13.729.720	484.351.720	% 2,92

Source: www.tkbb.org.tr

When Participation Banks are evaluated with regard to their assets size in accordance with their place in Turkish Banking sector in Table-5, it can be seen that they have a lower share compared to the items of collected and disbursed funds. While the share of Participation Banks in disbursed funds was %4,93 and in collected funds was %3,65, their share regarding assets sizerealized as %2,92. It can be observed that their share in the sector regarding assets size has shown an increase trend especially after 2002 just like in other items.

3.2.3. The Development of Participation Banks Regarding Equities .

When the development of Participation Banks is examined in terms of equities according to Table-6 below, it can be understood that it has a structure having a steady increase.

The equity structure of Participation Banks changed %114 in terms of $ through having a significant increase compared to previous period in 1990. This increase realized as %51 in 1995 and as % 231 in 2000.

Because of the 2001 Crisis, Participation Banks experienced a decline regarding equities. In this decline, the transfer of Ihlas Finance to the SDIF had a huge effect. After 2001, the increase trend continued and realized as %74 in 2002, %95 in 2003, % 39 in 2004, %6 in 2005, and %57 in 2006. In that way, the equities of Participation Banks reached $ 1,104,303,000 totally, which corresponded to 1.559.717.000 TL when it was calculated in terms of American Dollar according to the exchange rate in this issued date, through increasing in terms of dollar.

Table.10: Development of Participation Banks Regarding Equities

Period	Shareholders' Equity (Thousand TL)	Shareholders' Equity (Thousand $)	Dollar Basis Change
1985	13	22.334	
1990	140	47.839	% 114
1995	4.298	72.468	% 51
2000	161.000	240.000	% 231
2001	203.000	141.000	-% 41
2002	400.000	245.000	% 74
2003	670.000	478.000	% 95
2004	904.991	664.222	% 39
2005	951.089	705.398	% 6
2006	1.559.717	1.104.303	% 57

Source: www.tkbb.org.tr

3.3. CONTRIBUTIONS OF PARTICIPATION BANKS TO THE TURKISH ECONOMY .

Participation Banks, which have functioned in Turkish financial sector for more than 20 years since 1985, have both grown in Turkish economy parallel to the development of sector and provided many contributions to Turkish economy with their special aspects. Participation Banks have undertaken crucial roles within the process of transition to the free market economy in which Turkish economy has experienced for last 20 years, in globalization movements and the last 2 big crises via their characteristic methods. Participation Banks make many contributions such as preventing informal economy, gaining idle savings to the system, financing the real sector, decreasing the crowding-out effect, increasing competition, decreasing costs, attracting foreign capital to our country, and increasing employment through their own functioning principles and the responsibilities they undertake. The contributions Participation Banks provide to Turkish economy can be summarized as follows:

3.3.1. The Inclusion of Idle Savings to the System .

Participation Banks directly present a huge saving potential, which remained outside the economy or directed to unproductive areas, to industry, trade, and real economy as the source via their interest-free principles.

Participation Banks mediate for regaining the resources that can be named as idle saving or under-pillow remaining outside the economic system because of many reasons to economy. Firstly and specifically, Participation Banks provided the inclusion of the savings remaining outside the system due to religious beliefs through functioning according to interest-free banking principles. The conversion of savings to investments directly affects the development of national economies. In the developing economies as Turkey, low saving rates constitute a crucial issue. It is estimated that there is a significant potential not investing deposits in conventional banks due to religious beliefs in Turkey. The inclusion of a proportion of these savings to the economy by Participation Banks would be a great accomplishment.

3.3.2. The Prevention of the Informal Economy.

In accordance with their working methods, Participation Banks finance real economic activities while disbursing funds. Since credit is given to the sellers supplying goods instead of the company using credit, the usage of this credit in risky, speculative, unproductive, and informal tasks for unrelated purposes is avoided. One of the most important problems Turkish economy attempts to cope with is informal economy, and the tax loss relying on informal economy. Participation Banks have a significant role in supporting the formal economy. Because all transactions consist of real purchases-sales, they are included in the formal economy. That's why, the activities of Participation Banks contribute to the growth of formal economy in Turkey, and the rise of tax revenue as a natural result of this growth. Through their preventive effects on informal economy causing a lot problems in national economies, Participation Banks bring an important discipline to Turkish economy. First of all, since they do not finance any unreal informal and non-invoiced transactions, Participation Banks prevent tax loss via these functioning principles. For instance, purchase-sale facilities become registered because these banks absolutely demand for the approval of issued transaction by the authority in the purchases of vehicle, and house. Taxes and fees obtained from these transactions are gained to the state treasury without any loss. Because payment is directly made to the seller through precisely providing receipt in the task of satisfying raw material, machinery, and other needs, formal economy is formed. The most natural result of formal economy is the fact that state provides its investments more regularly via increasing its tax revenues.The expansion of Participation Banks and the rise of financing amount they provide will be useful for the contraction of informal economy. As the rate of funds used from Participation Banks increase, the credit demanders will have to comply with the principles of these institutions. That's why, these individuals cannot make receipt less or informal transactions, so state will obtain more tax revenue as a result of these activities of Participation Banks.

3.3.3. The Financing of Real Sector .

The crisis periods in Turkey have shown that economies are not just made up of real sector or financial sector. Under a steady growth, the performance of real sector in production and service field is also important in addition to the stable structure in financial sector. The success of real sector in production and service field plays a leading role in the growth of national economy. The necessities of supporting real sector for the healthy growth of national economies and for the most appropriate and productive use of resources initiate to be emphasized. For a long period, the real sector in Turkey was just composed of public investments. Due to the lack of private savings, state made investments in production and service field. In the post-1980 period, significant investments started to be made in real sector through the formation of private enterprises. The resources providing these investments of real sector were composed of its equities and the resources provided by banking sector. Entrepreneurs attempted to use investment, enterprise, and variable commercial credits from banks for these investments. However, especially starting from pre-1990s, conventional (interest-bearing) banks have become the largest fund resource of the public sector instead of transferring resources to real sector; that is, to production and service fields. Beginning from these periods when high inflation, economic instabilities, and crises took place, banks have started to invest almost all of their resources in Government Debt Securities (GDS).

Hence, the real sector that was already attempting to struggle in a harsh economic structure continued its investment and growth race with limited fund opportunities. To sum up, interest-bearing banks used most of their resources in the finance of Public Sector. In such an economic sphere, the applications of Participation Banks entirely focused on meeting the needs of real sector. Participation Banks do not make transactions with interest-bearing placements having fixed return such as Government Debt Securities because of their working principles. All the funds collected by Participation Banks are placed in real sector. Participation Banks have disbursed approximately % 90 of their collected funds for investment and needs of real sector. While this high rate is a natural outcome of the fact that Participation Banks just finance the real sector, it can also be evaluated as filling a market gap neglected by interest-bearing banks because of the reluctant manner of Turkish Banking System in disbursing credit depending upon the real difference in government debiting.

Since interest is prohibited according to the Islamic rules, Participation Banks just deal with commercial purchase and sale facilities in terms of their functioning principles. Therefore, they refer to one of the most important resources financing the real sector. Participation Banks that evaluate their resources on a project basis towards the real sector become effective in the usage of resources in productive areas. Through directly financing the real sector, Participation

Banks provide the usage of resources in the areas such as agriculture, industry, trade, and service. In that way, Participation Banks have a crucial aspect of providing the conversion of collected resources to investment or direct production via directly gaining them to the economy.

3.3.4. The Increase in Employment .

Participation Banks also assume the role of increasing employment through their effects of providing funds to real economy, and contributing to the function and growth of SME-sized enterprises. Through the formation of new employment areas by the investments carried out thanks to the resources they provide to the real sector, Participation Banks also have positive effects on employment. Participation Banks make contributions that increase employment through disbursed funds directly for employment areas to expand and stand in a healthy way, or providing indirect facilities in this direction.

3.3.5. The Development of Competition .

Participation Banks constitute an important competition factor in Turkish Banking system via their different structures, and different financing methods. Since they offer different alternatives both in the collection of funds and in the disburse of collected funds, they revitalise the competitive realm. Participation pools involving profit-loss partnership emerges as an alternative for investors and savers. In last few years, banking service and products served by Participation Banks have been supported by technological means, have been enriched by human resources, and have reached a point increasing the level of competition through the information acquired.

3.3.6. Providence of the Transfer of Foreign Capital .

First interest-free financial institutions functioning in Turkey were established especially by the foreign investors coming from Gulf countries. Majority shareholders and capital resources of Faisal Finance, Kuveyt Türk, and Albaraka Türk were from Gulf and Middle East countries, and these mentioned institutions refer to the banks investing in Turkey regarding interest-free banking for the first time.

Starting from their establishment, Participation Banks have undertaken a bridge mission for foreign capital to come to our country through both new banks established by domestic capital and through the above mentioned banks. With the provided resource, capital movement, and good relations, the foreign trade volume of Turkey grows and economic conditions get better thanks to Participation Banks. The disposition and functioning principles of Participation Banks keeping away from speculative, risky and unrealistic procedures provide global investors to have an interest in our growing economy and capital transfer takes place through Participation Banks.

3.3.7. Their Contributions to Lower Costs .

Since Participation Banks do not collect funds with the promise of fixed retail, they have the opportunity to present their resources to the market as the source in much more flexible ways. They can provide cheaper finance via using this feature in the transition or depressive periods of economies. When it is taken into consideration that entrepreneurs and enterprises make a comparison between expected utility (profit) and investment costs before taking any investment decisions, it can be more understood that the competition-bearing effects rooted from above mentioned advantages of Participation Banks have many contributions of both decreasing costs within the market and resolving the financing shortage.

Especially the cheapness of financing costs in economies provides growth and development to realize faster. Participation Banks' fund-collecting methods carried out without any promise of fixed return and fund disburse facilities providing resources for real commercial transactions give them the opportunity to move independently from current interest rates compared to interest-bearing (classical) banks and have a decreasing effect on these rates.

CHAPTER FOUR

CONCLUSION

The participatory banking and finance system offers more ethical and efficient alternative to the interest-based conventional financial system. participatory banking and finance institutions emerged in the Middle Eastern financial markets in early 1970s, based on models developed by Islamic economists over the past decades. Other Muslim countries also followed the suit and launched their own participatory banking institutions.

Three Muslim countries that include Iran, Pakistan and Sudan embarked upon the project of adopting the participatory banking order at the state level. Some Western banks also launched participatory banking and finance products to serve their Muslim customers. The participatory banking and finance industry made persistent advancements in its early period. Over the recent years, however, it has registered unprecedented growth due to core factors that include consistent high oil prices worldwide, booming economies of the Middle East, increasing diversification of participatory banking products, clients and markets, and other changes in the world of politics. The governments of the Middle East and Asian countries have become very proactive in promoting participatory banking and finance activities that are largely instrumental in further strengthening the regional business and finance links. The success of participatory banking and finance in the Middle East and Asian regions bears profound impacts on global financial markets. The increasing numbers of Western financial institutions are using participatory banking and finance as an opportunity to add innovation and diversity to their operations and attract oil-wealth and local Muslim clientele to their doors. Islamic financial institutions are becoming partners with Western market players to promote participatory banking and finance products and services in European and Western markets. The Western market environments have turned up more conducive for participatory banking and finance practice. These developments are very encouraging and have given the participatory banking and finance industry a window of opportunity to become truly competitive and integrated part of international financial markets.

New formations have been in financial sector and financial instruments in 1980s while trying to create advanced free-market conditions experiencing a serious structural change of the Turkish economy. The fundamental innovation imparted Turkey from this alternation which is Participation Banks. In our study it has been analysed that the participation banks' responses dealing with concept of Participation Banks and reasons for the emergence of historical development in turkey and the crisis processes in Turkey. When in our studies have been seen that playing role in religious, economic, social, political reasons in the emergence of participation banks, all of these reasons peculiar to Turkey, as well as developments in the world, regardless of economic life enrichment and no longer in line with the liberalization efforts, and quickly started to become integrated into the world economy as a requirement in Turkey today called Special Finance Houses' Participation Banks'' s started its activities observed. In this section has been observed taking into account the latest regulations the different definitions of both the world and in Turkey confusion with different designations and definition of the concept of living in the Participation Banks.

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