The History and Growth of Islamic Banking In Turkey; Comparison With The Conventional Banks

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The History and Growth of Islamic Banking In Turkey; Comparison With The Conventional Banks

Türkiye'de İslami Bankacılığın Tarihi ve Gelişmesi; Geleneksel Bankalarla Mukayesesi

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ÖZET

Bu tez Türk bankacılık sisteminde Katılım bankacılığı olarak bilinen niş sektörün daha yakından incelenmesi amacıyla yazılmıştır. İlk bölümde, İslami bankacılığın özet tarihi hakkında bilgiler sunulmuştur, akabinde temel prensipler ve ürünler anlatılmıştır. Devam eden bölümlerde, Türkiye'deki Katılım bankacılığının gelişimi incelenerek, Katılım bankalarının ticari bankalara kıyasla maruz kaldıkları risk ve yönetimi açısından olumlu ve olumsuz yönleri verilmiştir.

ABSTRACT

This dissertation is written in order to examine more closely the niche sector of Turkish Banking System which is known as Participation Banking. In the first stage, the information are provided regarding the brief history of Islamic banking, then the fundamental principles and products are explained. In further sections, this paper explores the evolution of the participation banks in Turkey and the difference in terms of risk exposures and management are given with about positive and negative aspects of the participation banks comparison with the commercial banks.

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1. INTRODUCTION

Islamic banking is subject to the law of beliefs which are written in the Qur'an (Shari'ah) and the Sunnah. Shari'ah is a general expression. Though scholars agree on the basic principles, there are differences in comments between the assorted schools of Islamic religious scholarship and different jurisdictions. That is why, there are of course varios definitions of Islamic bank. General Secretariat of the Organization of The Islamic Conference's definition is, "An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations." Ziauddin Ahmad (1989) describes "Islamic 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".

It is understood from the above definitions that Islamic banking is a system of banking activities that prohibits receipt and payment of interest (Riba) in its transactions and conducts its operations in a way helping an islamic economy in achieving its goals. Alternatively, this is a financial intermediation whose operation is based on Islamic principles of transactions of which profit and loss sharing (PLS) is a major feature, ensuring justice and equity in the economy. Hence, Islamic banks are mostly known as PLS banks. (Nienhaus, 1983)

In Islamic economic countries, of which Islamic finance is an essential part, the economy is commonly based on some prohibitions and encouragements. The prohibition of Riba and permission to trade, as enshrined in verse 2:

275 of the Holy Quran Allah has allowed profit from trade and prohibited Riba, drive the financial activities in an Islamic economy towards asset-backed businesses and transactions. This implies that all financial transactions must be representative of real transactions or the sale of goods, services or benefits. "The sale is very similar to Riba." Their objection was that one can increase the price of a commodity in the original transaction of sale because of its being based on a deferred payment, which is treated as a valid sale. But if they add to the due amount after the maturity date and the debtor is not able to pay, it is termed Riba, while the increase in both cases is similar.

In their Tafsir, 1997, Ibn Abi Hatim provided explanation about the case of Riba in that a person sells any commodity on credit; when the payment is due and the purchaser can not repay that, the price is enhanced and the time for payment extends.

The structure of Islamic finance avoids any return derived on a loan or debt (Riba) and the legality of profit. Riba commonly known as interest is an increase taken as an extra charge from the debtor. It represents the return on transactions involving exchange of money for money, or an addition, on account of delay in payment, to the agreed price on sale debts. The Shari´ah has prohibited it as it generates imbalances in the economy. As all transactions involving interest payments are strictly prohibited, debt contracts cannot be sold at a premium or discount, and exchange transactions of money or goods representing money like gold and silver must be equal for equal.

So, the parties must share the risks and rewards of a business transaction. The transaction should match with a real economic purpose without inappropriate speculation and not involve any exploitation of either party or any activities considered sinful. Pure financial transactions are generally not acceptable under Shari'ah law. In practice, Islamic transactions tend to be asset based, although the underlying assets do not necessarily constitute collateral and the transactions may be effectively unsecured. Even where the assets constitute collateral, the legal environment may well prevent significant and timely recoveries. Unlike conventional banks, Islamic bankers do not expect to advance money and receive a expected profit on a determined date in the future. However, in many countries Islamic and conventional institutions operate side by side.

The Shariah, which designates the activities of the banks as well as forming the basis of the daily lives of all Muslims, requires that reward comes from risk sharing. Profit must be justified through the creation of value that the banker brings to complement the value of the borrower's efforts and skills. Under the Shariah, if the project succeeds the banker shares in the profit. If it fails he suffers the losses as well.

As there is a huge demand and interest on islamic banking activities all over the world, this dissertation aims to provide information about the nature of islamic banking, its history, structures and different kinds of financing tools. Furthermore, it focuses on specifically islamic banks in Turkey so called participation banks. After giving the history of participation banks, this thesis distinguishes participation banks' risk exposures that needs to be

observed differently to the conventional banks. According to the banking act and the principles of central bank, banking regulation and supervision agency and capital market, the legal status of participation banks are told. At the latest, the design of this study results from careful consideration of how to effectively compare the efficiency of participation banks in each other. Finally, the allocation of efficiency is observed for participation banks. In this research study data envelopment analysis method is used for measuring the efficiency. In this analysis applying study realized with 3 inputs (total deposits - funds collected, personel expences, interest expences - profit share expences) and 2 outputs (total credits - funds utilised, interest income - profit share income) used between the years 2001 to 2005.

2. ISLAMIC BANKING IN THE WORLD

2.1 History of Islamic Banking

Philiph Moore (1997) indicates in his publication on Islamic Finance that is not a new phenomenon, having been practised since the Middle Ages, but has risen in prominence over the last 35 years. This is largely due to the acceleration of industrialization and the growing financial resources of oilproducing countries where Islam is the main religion, increasing wealth and financial sophistication and increasing demand for financial services.
"It is not surprising to hear that the first interest-free bank (Agibi Bank) was founded circa 700 BC, in Babylonia, and functioned on an equity basis." (Baron, 1952)
Although it is still uncertain that who was the first financial institution that started to provide interest-free banking activities, according to the some experts in this area the first full-fledged Islamic Bank was established in Egypt in 1963 namely Mit Ghamr Saving Bank. The first modern Islamic bank was established in Egypt in 1970 and called Nasser's Social Bank. Islamic accounting, an essential tool for the success of Islamic banks, is said to have been developed as modern at the University of Cairo. (Craine, 1981)

At the first meeting of Islamic Organization Conference in 1973, one of the major topic was related to doing economic business compliant with the principles of Islamic rules. After that meeting Islamic Development Bank was founded in Jeddah in 1975 under the profit and loss sharing system (PLS), and of a number of commercial banks such as Dubai Islamic Bank /

UAE; Faisal Islamic Bank of Sudan / Egypt; Bahrain Islamic Bank; Malaysia, Philippines, Nigeria, Indonesia; Islamic Finance House, Luxembourg; DMI Geneva; Al Rajhi London, Denmark, Australia, South Africa; HSBC Amanah Fund; ANZ First ANZ International Murabah Ltd., International Banking Unit of United Bank of Kuwait.

According to the research of Institute Islamic Banking and Insurance (Information on the website of IIBI www.islamic-banking.com) as of the ending year 2008 more than 300 Islamic banks operate in almost 75 countries in the Muslim world, most of them in the Middle East and Asia. Recently, Islamic 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 Islamic mode of finance. The most significant and largest number of Islamic banks are based in the GCC (Gulf Commonwealth Countries) and broader Middle East, although other areas have grown in importance such as South-east Asia (Malaysia, Indonesia and Brunei), Pakistan, Bangladesh and Turkey. A number of major international banks have also provided products tailored to Islamic investors for many years. The growing interest from banks in western markets for Islamic finance can be explained by the fact that there are an estimated 11 million Muslims in Europe, around 6 million in the USA and a global Muslim population of over 1 billion.

The growth arises because of the rapid build up of wealth in so many Islamic countries, particularly the oil rich Gulf States, where a large middle income group has emerged. Increasing awareness of, and sensitivity

towards, Islamic issues has also played an important role. However, of the many Islamic banks that exist today, only a few have equity of over USD 100 million. The growth pattern in Islamic banking has been contrary to that seen in western markets over recent years. Whereas for the latter the focus has often been on consolidation, Islamic banks have burgeoned in response to increasing demand. In spite of this growth, many countries have only a single or a small number of Islamic financial institutions. Consequently, the penetration of Islamic assets as a percentage of the system total is often small; in most cases less than 10% and often less than 5%, even in Arab countries normally associated with Islamic finance. The figure is significantly higher, or even 100%, in countries such as Iran and Brunei.
The countries where Islamic financial institutions are functioning as follows; 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, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, The Netherlands, Niger, Nigeria, Oman, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad & Tobago, United Arab Emirates (Abu Dhabi, Dubai, Sharjah), United Kingdom, United States, Yemen.

According to The Participation Banks Association of Turkey, as of 2008 year-ended Islamic financial institutions are estimated to be managing funds to the tune of USD 700 billion. Its clients are not only confined to Muslim

countries but also are spread over Europe, United States of America and the Far East. Islamic banking has substantially growing since its value orientated ethos that enables it to draw finances from both Muslims and non Muslims alike.

Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but also ethically motivated. The Islamic banking market has grown significantly in the last 30 years and is expected to continue to grow strongly. Volumes are difficult to measure because of the growing number of conventional banks that provide Islamic finance/services through an islamic window or branches but which do not report volumes separately in financial statements.

For instance, Citibank has the US origin was the first major conventional bank to establish an Islamic bank in Bahrain, with an operating capital of USD 20 million (The Economist, 1996). It may be a small amount, but, it does suggest to some degree that conventional banks have begun to embrace Islamic banking on a moderate scale. According to the Fitch ratings report (2007), a number of other Western financial banks have followed suit by offering Islamic mutual funds and other investment products in an attempt to attract liquidity from this growing market. Recognising the size of the potential market, a number of Western banks are now active in Islamic banking. These include Citigroup (rated 'AA+'), HSBC ('AA'), Barclays ('AA+'), ANZ ('AA-') and,more recently, BNP Paribas ('AA').

Furthermore, many of the conventional banks offer Islamic products via an Islamic window (separate brand), or through branches/subsidiaries.

The GCC region has emerged as the home of Islamic banking. It is the region where the largest Islamic banks reside and where many international participants have established their in house Islamic banking units. The Bahrain banking regulator has taken a pro-active approach to developing prudential guidelines for Islamic banks, and Bahrain is also the domicile of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the Liquidity Management Centre (LMC) and the International Islamic Financial Market (IIFM). AAOIFI was established in 1990 and has taken the lead in developing accounting, auditing and banking practices appropriate to Islamic financial institutions. The LMC was founded in 2002 and aims to facilitate the investment of surplus funds of Islamic financial institutions into financial instruments structured in accordance with Shari'ah principles. The IIFM was created in 2002 as cooperation between various supervisory authorities of Islamic countries as well as the Islamic Development Bank. The primary purpose of the IIFM is to support the development of an Islamic financial market, based on Shari'ah rules and principles, as a viable alternative to the conventional banking system. One of the aims of the IIFM is to harmonise Shari'ah interpretations of Islamic products and practices. In February 1999, Dow Jones launched the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with the Shariah laws to provide a wide variety benchmarks tracking Shari'ah compliant securities including indexes for specific

countries, regions, industries and market capitalization ranges. (website of dow jones : http://www.djindexes.com/mdsidx/html/pressrelease)

2.2 The Nature of Islamic Banking

2.2.1 Riba

The best known characteristic of Islamic banking is the prohibition on usury (Riba). Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by the Shari'ah since it is unfair for the borrower. However, it also shows that paying interest to a lender in a period of high inflation at a rate less than the inflation rate, which is called negative rate of interest, is also unfair for the lender and, therefore, should be avoided. In other words, the prohibition of riba applies to real interest, not nominal interest, as with inflation a ban on the latter may result in negative real interest (Baldwin, 1990). Moreover, in the case of deflation there is a possibility of positive real interest as well, even in the case a borrower is returning only the principal amount of' the loan. Even though falling prices are practically seldom experienced, their occurrence is not impossible, as was experienced in the great depression of the 1930s.

The definition of riba extends beyond interest and usury, and volumes have been written by scholars to explain the concept. In simple terms, riba can be considered as exploitation of one party who owns goods that includes money and capital and which another party wishes to acquire. Although

interest comes very close to this definition, it is still better to consider riba as “unfair exploitation”. (Wilson, 1999)

Riba is described by Ibn Qayyim and Al-Jawziyya (1996), one of the prominent Islamic scholar, to imply any form of unfair trade, market manipulation or engaging a market participant to trade under risk-free debt contracts. From a financial economist's perspective, riba can be defined as a risk-free return from an investment vehicle or strategy.

The standardization of Shari’ah may become against the fundamental premise of Ijtihad which has existed for centuries. Ijtihad is the process of deducting Shari’ah rules from their authentic sources. It is a continuous process used by the highest authorities in Shari’ah. If rules become standard, and imposed by legal authorities, then Ijtihad cannot be applied anymore. This will eventually damage the very reason that we are able to apply Shari’ah in all times and places, that is, Ijtihad is the main reason why Shari’ah is dynamic and is able to be applied in different circumstances.

There are different schools of thought in Shari’ah and these schools of thought differ in their opinions in many specific rulings although they agree on most important Shari’ah issues. To standardize Shari’ah rulings may mean the precedence of one school of thought over the other, which cannot be universally acceptable.

How to bring together those two views (The need for harmonization and the difficulties arising from existence of different schools of thought and the necessity of Ijtihad).

There is no doubt that the synchronization of these two views has to be done through mutual understanding and collaboration between Shari'ah scholars and market leaders and regulators. To be very clear and accurate, the question of whether Shari'ah standards can be harmonized is a matter to be dealt with by Shari'ah scholars and not market professionals or regulators. The simple reason for this is because Shari'ah scholars are specialized in their field and whether a Fatwa can be standardized or not is a matter of religious reasoning and should be taken from Shari'a's own instructions and judgments.

Islamic Financial institutions and funds typically have a Shari'ah Board that monitors transactions and operations to ensure compliance with Shari'ah. These boards are staffed with Shari'ah scholars who are regarded as expert in Islam, particularly as it relates to finance. Given that Shari'ah is core to the operations of any Islamic financial institution, these boards have significant authority regarding investment decisions and potential financings which must all be Shari'ah compliant.

Qur'an mentioned about the prohibition of Riba in four different verses. The first verse states that interest deprives wealth of God's blessings. The second verse emphasizes it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third verse says Muslims to stay clear of interest for the sake of their own welfare. The fourth verse establishes a clear difference between interest and trade, urging Muslims to take only the principal sum and to give up even this sum if the borrower is unable to repay. It is further declared in the Qur'an that those who disregard

the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith. The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.

Some scholars have explained with providing economic reasons why interest is banned in Islam. It has been argued, for example, that interest, being a pre-determined cost of production, tends to prevent full employment (Khan, l968). Others, anxious to vindicate the Islamic position on interest, have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment (Ariff, l982). A common thread running through all these arguments is the exploitative character of the institution of interest, although some have pointed out that profit can also be exploitative.

Some writings have implied to the unearned income aspect of interest payments as a possible explanation for the Islamic doctrine. The objection that rent on property is considered halal is then answered by rejecting the analogy between rent on property and interest on loans, as the benefit to the tenant is certain, while the productivity of the borrowed capital is uncertain. However, property rented out is subject to physical wear and tear, while money lent out is not. The question of erosion in the value of money and hence the need for indexation is an interesting one. But the Islamic jurists

have ruled out compensation for erosion in the value of money, or, according to Hadith, a fungible good must be returned by its like (mithl): 'gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, and hand to hand '.

The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit-sharing can be a viable alternative (Kahf, l982). In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit sharing ratio, not the rate of return itself that is predetermined.

“It has been argued that profit sharing can help allocate resources efficiently, as the profit sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit sharing ratio to the investor, other things being equal. One dissenting view is that the substitution of profit sharing for interest as a resource allocating mechanism is crude and imperfect and that the institution of interest should therefore be retained as a necessary evil. However, mainstream Islamic thinking on this subject clearly points to the need to replace interest with

something else, although there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest." (Mohammed Arif, 1988)

2.2.2 Gharar (Uncertainty or Speculation)

Another significant principle of Islamic finance is the prohibition of transactions involving gharar, or uncertainty. Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials. 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 a void a loss in the future is condemned. The reason is that speculators generate their private gains at the expense of society at large.

2.2.3 Halal

Investments should only support halal activities. The Shariah does not permit Muslims to invest in any business or activity that involves the production of items or pursuit of activities the shariah considers haram or impermissible.

Scholars have devised a set of rules to govern such investments. Some of them are:

The main business of the company in which the investment is sought to be made is not in violation of Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, such as those manufacturing, selling or serving liquor, pork, haram meat, or involved in gambling, night club activities, pornography etc.

If the main business of the companies is halal, like automobiles, textiles, etc. but they deposit their surplus amounts in a interest-bearing account or borrow money on interest, the shareholder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general body meeting of the company.

If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

2.2.4 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 zakat, 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 Islamic bank has to establish a zakat fund for collecting the tax and distributing it exclusively to the poor directly or through other religious institutions.

2.3 Islamic Finance Products

2.3.1 Murabaha

Murabaha is a non-participatory mode of Islamic financing where the bank sells the asset required by its client to the client on cost-plus basis. Under this financing arrangement, bank purchases an asset on behalf of an entrepreneur and resells the asset to the entrepreneur at a predetermined price that includes the original cost and added, negotiated profit margin. Asset is first purchased by the bank so bank incurs the risk of any loss or damage to the asset as long as asset remains under its ownership. Ownership remains with the bank until all payments are made. Upon sale of the asset, this is an obligation of the Islamic bank to inform the client the original cost

incurred in the purchase of the asset and the profit margin incorporated in the sale price.

Payment is made in the future either in installments or in lump sum. Payment of the sale price by the client may be deferred but in that case it would become muajjal. The selling price once agreed can not be changed even when the client fails to pay on the agreed date.

Murabaha is the classic Islamic financial instrument for trade financing, dating to ninth century Arabia (Aggarwal and Yousef, 2000).

Permission for credit sale has been described thus:

“A sale is valid either for ready money or for a future payment provided the period be fixed, because of the words of the Holy Qur’an ‘Trading is lawful’ and also because there is a tradition of the holy Prophet (peace be upon him) who purchased a garment from a Jew, and promised to pay the price at a fixed future date by pledging his iron breast-coat. It is indispensably a requisite of business but the period of payment should be fixed. Uncertainty in the period of repayment may occasion a dispute and jeopardize the execution of the transaction since the seller would naturally like to demand the payment of the price as soon as possible, and the buyer would desire to defer it.” (Al-Marghinani, 1957)

Murabaha is the most popular and most common mode of Islamic financing. It is also known as Mark up or Cost plus financing. The word Murabaha is derived from the Arabic word Ribh that means profit. Originally, Murabaha was a contract of sale in which a commodity is sold on profit. It has been

estimated that 80 to 90 percent of financial operations of some Islamic banks belong to this category.

2.3.2 Mudaraba

The term refers to a form of business contract in which one party brings capital and the other personal effort. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. The financier is known as 'rabal-maal' and the entrepreneur as 'mudarib'. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of terms of the contract by the 'mudarib' is borne by the Islamic bank. The bank passes on this loss to the depositors.

Mudaraba can also be defined as a contract between at least two parties whereby one party, the financier, entrusts funds to another party, the entrepreneur, to undertake an activity or venture (Suleiman, 2001).

In the theoretical model of Islamic banking Mudaraba has been suggested a technique which shall provide the basis for the Islamic re-organisation of commercial banking sector. In actual practice of Islamic banking, Mudaraba has not made much progress on t he asset side of the balance sheet, although on the liability side the Islamic banks on Mudaraba accept the funds in

investment accounts. Mudaraba is mostly translated in English as profit and loss sharing.

There is no loss sharing in a Mudaraba contract. Profit and loss sharing is more accurate description of the Musharaka contract. The Mudaraba contract may better be represented by the expression profit sharing Mudaraba is an Islamic contract in which one party supplies the money and the other provides management in order to do a specific trade. The party supplying the capital is called owner of the capital. The other party is referred to as worker or agent who actually runs the business. In the Islamic Jurisprudence, different duties and responsibilities have been assigned to each of these two.

Islamic banks practice Mudaraba in its both forms. In case of individual Mudaraba an Islamic bank provides finance to a commercial venture run by a person or a company on the basis of profit sharing. The joint Mudaraba may be between the investors and the bank on a continuing basis. The investors keep their funds in a special fund and share the profits without even the liquidation of those financing operations that have not reached the stage of final settlement.

Mudaraba is akin to western style limited partnership where one or more of the parties contribute capital and the remaining parties bring their efforts/expertise to the business venture (Aggarwal and Yousef, 2000).

2.3.3 Musharaka

The term refers to a financing technique adopted by Islamic banks. It is an agreement under which the Islamic bank provides funds which are mingled with the funds of the business enterprise and others. All providers of capital are entitled to participate in the management but not necessarily required to do so. The profit is distributed among the partners in predetermined ratios, while the loss is borne by each partner in proportion to his contribution.

Musharaka is another popular techniques of financing used by Islamic banks. It could roughly be translated as partnership. In this technique two or more financiers provide finance for a project. All partners are entitled to a share in the profits resulting from the project in a ratio which is mutually agreed upon. However, the losses, if any, are to be shared exactly in the proportion of capital proportion. All partners have a right to participate in the management of the project. However, the partners also have a right to waive the right of participation in favour of any specific partner or person.

2.3.4 Ijarah

Ijarah is simply referred to as "Islamic leasing". A contract in which bank first owns an asset which it leases to its customer. Or the bank gets a tangible asset on lease from a third party and subleases it to the customer (Salman, 2004). Ijarah is a contract of a known and proposed usufruct of particular assets for a specified time period against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, it is the transfer of usufruct for a consideration, which is rent in the case of

hiring assets or things and wages in the case of hiring people. 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 Islamic 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.

2.3.5 Salam

It is 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.

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. The scope of Salam sale is large enough to cover the needs of various people such as farmers, industrialists, contractors or traders. It can cover the finance of operational costs and capital goods.

2.3.6 Istisna

It 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 the price is fixed with the consent of the parties and that necessary specification of the commodity 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.

Istisna contracts open wide fields of application for the Islamic banks to finance the public needs and the vital interests of the society to develop the Islamic economy. Istisna contracts are applied in high technology industries such as the aircraft industry, locomotive and ship building industries, in addition to the different types of machines produced in large factories or workshops. The Istisna contract is also applied in the construction industry for apartment buildings, hospitals, schools, and universities.

2.3.7 Sukuk

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines Sukuk as:

“... certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned,

common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity."

In simple terms, Sukuk are tradable Shariah compliant fixed income securities representing ownership of an asset or its usufruct. The primary condition of issuance of Sukuk is the existence of assets on the balance sheet of the government, the monetary authority, the corporate body, the banking and financial institution or any entity which wants to mobilize the financial resources. The identification of suitable assets is the first, and arguably most integral, step in the process of issuing Sukuk certificates. Shari'ah considerations dictate that the pool of assets should not solely be comprised of debts from Islamic financial contracts (e.g. Murabaha, Istisna). Sukuk and conventional bonds are different, whereby Sukuk is not simply a claim to cash flow but an ownership claim while conventional bonds focus on interest-bearing securities. Unlike conventional bonds that represent a pure debt obligation of a lender to a borrower, Sukuk represent an ownership interest in existing, well-defined assets or a pool of assets. It is important to note, however, that Sukuk is not the same thing as an equity stake or share of the company, in as much as a share is an ownership claim on the company itself while Sukuk are a claim on a well-defined, specific asset. Therefore the sale of Sukuk in the secondary market represents the sale of a right of use of an asset, while the sale of a bond in the secondary market represents the sale of a debt obligation. Another difference is the tax treatment, under several tax systems, of the rental payments for Sukuk versus the interest payments for conventional bonds. Sukuk rental payments

are not deductible before tax in the same way as conventional interest payments. This fact negatively impacts a company's reported net income by denying it the use of the tax shield. Of the 14 structures listed by AAOIFI, only two of them are being mostly used as follows;

2.3.7.1 Asset Backed Sukuk

Asset-based Sukuk represent an ownership interest in a specific asset so as to identify the proportional profit generated from that asset. Effectively structured asset-backed securities represent a secured claim on some specific underlying equipment, such as airplanes, that can be seized and liquidated in order to service a debt claim. Sukuk can be credit enhanced and rated just like secured debt if additional asset encumbrance were wrapped into the Sukuk issues. Market participants involved in securitisation will be familiar with the issues that exist in creating non-recourse Sukuk whose credit risk performance is determined solely by the underlying assets. While there are many reasons for borrowers to pursue a strategy of asset backed financing, one key driver is that the rating of such instruments can be significantly higher than the unsecured rating of the borrower, thus allowing them to raise secured financing at a lower cost.

2.3.7.2 Ijarah Sukuk

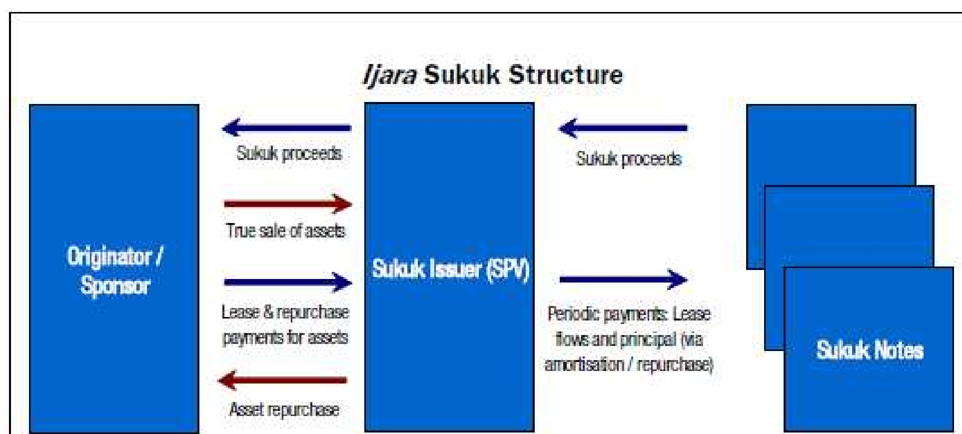
These certificates are issued on immoveable assets determined on the balance sheet. The assets can be parts of real estate to be leased or leased equipment such as aircrafts and ships. The rental rates of returns on these Sukuk can be both fixed and floating depending on the particular originator.

Many of current Sukuk are essentially a simple ‘leasing’ or Ijara nature. In such structures, the originator seeking financing ‘sells’ the asset to the Sukuk SPV for a value equal to the financing provided, and then leases it back. The lease payments provide the fixed income stream which may be benchmarked to an index. For simplicity, we consider a single asset in this example but it could easily be a portfolio of assets which are then leased or a pool of Ijara leases. A mismatch in the term of the lease and Sukuk may expose the investor to the refinancing risk on the underlying asset.

Although ijarah sukuks are the most common form of Islamic securitization, sukuks on other Islamic finance transactions have been structured as well over the recent past.

Ijarah sukuks are financial obligations, issued by a lessor, and backed primarily by cash flows from lease receivables from a credit lessee, such as sovereign governments, regional governments, corporations, and multilateral lending institutions (Richard, 2006). In the popular sale-leaseback ijarah sukuk transaction structure (“sale model”), the SPV holds legal title to the assets, which are leased back to the originator in return for rental payments (and possibly other cash flows from the assets depending on the transaction structure) to service payments on the issued sukuks. The SPV holds a repurchase obligation for a price equal to the amount of outstanding debt in order to insulate the transaction from an adverse performance of the underlying assets (see Figure 1).

Figure 1: Ijara Sukuk Structure



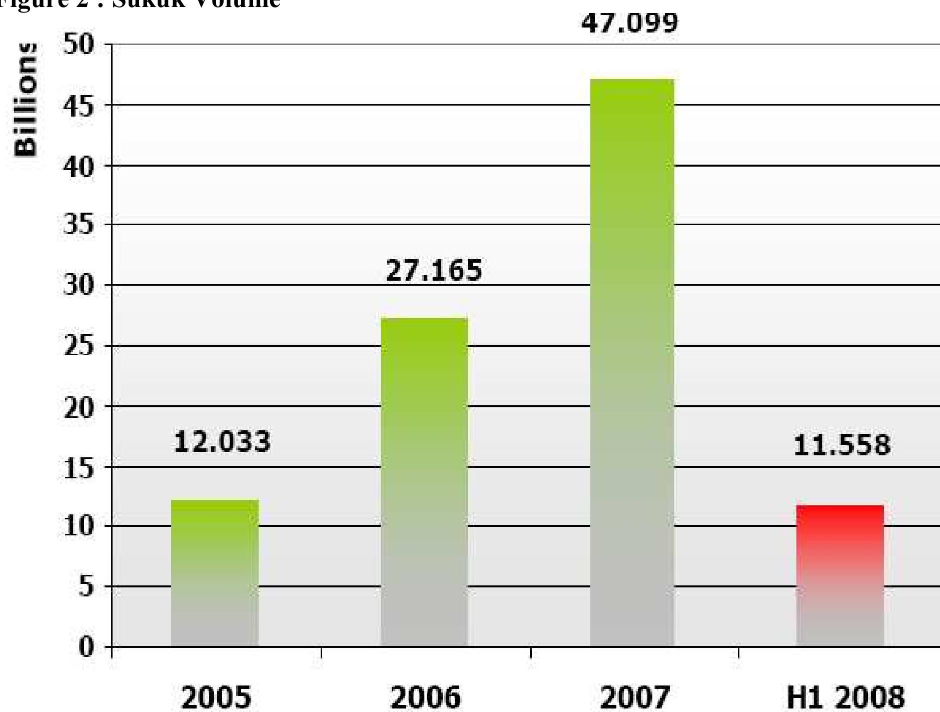
Source: Moodys' Special Report 31 May, 2006, "Shari'ah and Sukuk"

2.3.7.3 Sukuk Market In the World

The Sukuk market has emerged during the previous ten years, first Bahrain issuing domestic sovereign fixed-rate Ijara and Salam Sukuk. It was followed by the issuance of floating rate Ijara Sukuk as well as pooled Sukuk by both corporate bodies and sovereigns in several countries. Islamic bonds or Sukuk are one of the fastest growing segments in the financial markets.

Growth is fuelled in large part by the recycling of petro-dollars from the Gulf region. The Gulf countries are not the only ones issuing Sukuk. But also Malaysia and Indonesia, even non-muslim countries such as Japan and China, as these countries offer products that will be Shari'ah compliant and therefore suitable for Muslim investors. A report from the Islamic Finance Information Service (IFIS) has claimed that the global sukuk market is enjoying a year-on-year increase despite its growth rate slowing. The report shows the global volume of sukuk issued rose by 73 per cent to $47.1 billion. This is a decline from the 2006 growth rate of 125.75 per cent.

Figure 2 : Sukuk Volume



Source: Islamic Finance Information Service, http://www.securities.com/ifis/

2.3.7.4 Sukuk Issues In Turkey

Sukuk and Ijara which are Shariah-compliant financial products to attract capital owners with interest-free banking sensitivities against interest-yielding instruments has been on the present government schedule since 2002. But to avoid fierce rejection by secular powerhouses, it had to shelve its intentions despite the fact that even centers of capitalism like the US and Britain have taken a great interest in interest-free finance. But, global financial turbulence and the concurrent liquidity squeeze made the establishment of these interest-free tools urgently necessary.

The government declared in 2003, they were intending to implement a legal framework for the issuance of Ijara Sukuk that is based on leased assets. The Undersecretariat of Treasury had prepared a draft sukuk law and

presented it to the related prime minister in 2004 and re-presented in 2005. Though the draft has not been announced to the public, speculators state that almost any state owned real estate would be made subject to an Ijara lease.

Then, in November 2008 in Istanbul, Kursat Tuzmen, the Turkish formerly foreign trade minister, confirmed that the Undersecretariat of Treasury had concluded a study and consultation on the possibility of the issuance of a sovereign Sukuk by The Turkish Finance Ministry in the wholesale markets. The study was done jointly by the Privatization Administration and State Planning Office. The projected plan targets to attract Gulf capital to Turkey by creating shari'ah compliant instruments such as rent certificates, real-estate partnership bonds and participation certificates. But, the financial market in Turkey and especially investors in the gulf region still awaiting to finalizing the process of legal infrastructure whereby the debut Sukuk can be issued. The aims of draft act are being presented about the mentioned draft act; (also the translation of subject draft act is attached)

2.3.7.4.1 Notes about The Draft Act

It is mainly aimed to develop a new debt instrument through the use of public properties by that draft act. The aims of the debt instrument to be developed are;

- To diversify public finance instruments,
- To broaden the spectrum of international investors who invest in our country.

Followings are other points which are important in evaluation of that debt instrument:

- The cost of borrowing through that newly developed instrument will be closer to the cost of borrowing through the Eurobond issue.
- It will generally be possible to provide mid term borrowing via that new instrument. (5-7 years)

For that purpose, it is proposed to provide financing from international capital market through the lease of an asset owned by the public. Within this transaction;

- There will be no change in the status of social services concerning to the asset subject to the transaction, or in the status of the actual user of that asset.
- The assets that are planned to be included in the scope of this arrangement are as follows: all kinds of immovable assets belonging public or public entities and concessions and operating rights pertaining to those assets, dams, motorways, health care institutions, ports, social facilities, public service buildings and public apartments.
- Council of Ministers will have the right to exempt any public asset from this transaction on the national security and public interest concerns.

It is aimed to operate the subject borrowing mechanism as follows;

- Council of Ministers will determine the public assets to be used for that purpose. Council of Ministers will have the authorization to set methods and procedures about the application.

- Within the framework of methods and procedures set by Council of ministers, all operational transactions will be executed by the Minister of State to whom Under Secretariat of Treasury is reporting to and the user or owner of the subject assets.
- The owner (public entity) of the asset to be subject to the transaction will sign a sale agreement with a financial institution such as a company, real estate investment trust or in mutual fund incorporated in Turkey or abroad with an undertaking to purchase back at maturity.
- The asset purchased by the financial institution, will be used to issue promissory notes, certificates and/or similar debt instruments for international investors. The public institution's sale revenue from this selling will be credited as revenue in State Treasury.
- A lease agreement will be signed between authorized financial institution and Under Secretariat of Treasury
- Under secretariat will sub lease the subject asset to the public entity that is the last beneficial of the asset taking into consideration the terms and conditions of issued promissory notes, certificates and similar debt instruments.
- The lease payments will be paid by relevant entity's appropriation in fiscal budget. Financial institution will periodically pay the lease payments to investors.
- The lessee entity and financial institution which issues debt instruments will sign a purchase back agreement within the framework of the same conditions of the sale agreement concluded.

At the same time, debt instruments will be redeemed and the principal will be paid to investors.

The Capital Markets Board introduced regulations to allow the use of interest-free financial instruments in private pension funds. The Banking Regulation and Supervision Agency and the Turkish Central Bank have expressed support for the new CMB regulations. The Participation Banks Association of Turkey secretary general Osman Akyüz said however that the Turkish Treasury still needs to create the interest-free instruments that are to be used to that end.

In July 2008, some complaints were occured as it became clear that the accounts at Central Bank of The Republic of Turkey (CBRT) where Turkish banks were obliged to deposit 11% of their foreign currency deposits and 6% of their domestic currency deposits, only accrue interest revenues on those deposits, which the CBRT gains from lending the banks' money back to the banks. It is obvious that the participation banks strongly oppose receiving the interest revenue. The participation banks suggested that instead of receiving the interest, their fixed deposit rate should be cut from 11% to 5.5% or 6% in foreign currency and from 6% to 3% in domestic currency. The suggestion was rejected by the Central Bank, since the deposit is an instrument of monetary policy. The participation banks have decided to receive interest revenues, according to the Participation Banks Association of Turkey (PBAT). Al Baraka Türk is reported to spend the interest income on corporate social responsibility projects, sponsorship deals and advertisement expenditure. Türkiye Finans would transfer the money to

the Savings Deposit Insurance Fund TMSF. It is clear that the present vacuum weighs unnecessarily on the participation banks' profitability and should be addressed as soon as possible.

On the other hand, Turkish Treasury issued on January 28, 2009 USD 310 million worth of revenue indexed bonds (rib), with the target of diversifying borrowing instruments and increasing domestic savings, of which coupon payments are indexed to the transfers of State Owned Enterprises, Turkish Petroleum Corporation (TPAO), State Supply Office (DMO), State Airport Authority (DHMİ) and Coastal Safety (KIYEM) to Budget as "Revenue Shares". It was the only a quarter of an expected 1.89 billion Lira issue. In its second sale of revenue indexed bonds in April 2009 the worth of issued bonds were 737.8 million Lira. The bond, which has a redemption date of May 4, 2010, will have two coupon payments (Reuters). These Islamic bonds will also help money in the coffers of participation banks remain within the Turkish financial system. These banks usually invest their excess capital in Shariah-compliant fund management instruments abroad since there have until now been no such instruments in Turkey. Therefore, the Treasury's ability to garner wealth from the domestic market will also increase. The new instruments will be based on the revenue of wealth-generating assets such as highways, bridges and dams. Since these notes do not promise a set profit unlike interest-yielding Treasury bills the government hopes Gulf capital will flow into Turkey to purchase them.

3. HISTORY OF ISLAMIC BANKING IN TURKEY

There are three types of banks in Turkish Banking System namely, the commercial banks, the investment & development banks and the participation banks (Islamic banks). All of them operate under the same banking act which came into force in 2006. Since 2006, they have been regulated and supervised by BRSA and also they are subject to Central Bank regulations. A previous banking law, the Banking Act no. 4491 effective from May, 2001 however provided the Islamic banks more secure positions and the legal arrangements they demanded. This law was implemented commonly by the suggestion of the IMF and World Bank in the process of financial sector reform that the Islamic banks should be transformed into the current banking system and be guaranteed by necessary legal arrangements in order to avoid unfair competition, which overlapped with the demands of the Islamic banks. As a result, the Islamic banks could be guaranteed by the deposit insurance fund of the government, and liquidation would be more difficult than earlier. Also, they established their own public and legal association “the Special Finance Institutions' Union (OFKbir)” as a banks’ union. After the names of special finance houses were changed, this union has been called The Participation Banks Association of Turkey. After the publication of the new Banking Act in the Official Gazette on November 1, 2006 the title of Special Finance Houses were changed into Participation Banks.

Islamic banking was first introduced to Turkey in 1985 after the government of Prime Minister Turgut Ozal passed a special legislation on interest-free banking, the Decree no. 83/ 7506 issued on December 1983. (Annual report of Kuveyt Turk, 2008) The goals were two folds: first, it is to bring into the economy all funds that oppose to interest and thus do not go into the conventional banking system, including foreign exchange kept under pillows and jewelries of wives and daughters. Second, it is to develop economic linkages to the oil-producing Arab states and to attract a fair amount of the Gulf capital, which also avoids interest-paying financial institutions. By encouraging the Islamic banks or "the Participation Banks", (before called Special Finance Houses) Ozal cemented his ruling coalition of the center-right by developing domestic political counterbalance to the secular left, which he was seeking to destroy to help paving the way for structural adjustment.

Similar to other Islamic banks, the Turkish Islamic banks also offer their customers profit-sharing proceeds instead of interest and charge borrowers participation-sharing instead of loan interest. Thus, the banks operate two types of accounts to collect funds from their depositors. One is "current accounts" that do not entail any return in any form and receive conventional services such as check book, money transfer, and documentary collection. The second and most popular one is "profit-loss sharing participation accounts" that can be opened in US dollars, Euro, and Turkish lira for a minimum of thirty days. The accounts can be opened by signing a "contract for participation in profits and losses" and in the name of depositor or

anonymously. The holders of accounts share both the profits and losses as a result of investment of these funds. At the end of the investment activity, profits are shared between the banks and account holders, and the banks could get a maximum of 20% of the profits. After the deduction for the banks' share from the accruing profits, the balance is paid to the holders prior to maturity provided. Not surprisingly, the profit-loss sharing participation accounts are the major earning assets of the banks constituting around 85-90% of the total funds collected by the Islamic banks than the current accounts.

The first Islamic bank was the Al Baraka Katılım Bankası A.Ş. established in February 1985 followed by the Faisal Finance House two months later. These two Saudi-Turkish joint ventures represent Islamic banking's two principal transnational networks, Sheikh Saleh Kamel's Al Baraka group and Prince Mohammed al Faisal's Dar al Mal al Islam. Korkut Ozal, Prime Minister Turgut Ozal's younger brother has a close business relationship with Sheikh Saleh Kamel, the main shareholder of the Al Baraka Group and introduced him to Turgut Ozal.

Meanwhile, Prince Mohammed Al-Faisal, the main shareholder of the Faisal Finance House sold the bank to the Kombassan Holding in 1998, which resold it to the Ulker Group, a leading food, biscuit, beveraging and packaging producer with 22 companies in 2002. Sabri Ulker, the owner of the Ulker Group was one of the founding shareholders of the Faisal Finance House and the name of finance house was changed into the Family Finance House. As for locally-financed Islamic banks, Turkish private investors

established three banks: the Anadolu Finance House in 1991, the Ihlas Finance House in 1995, and the Asya Katılım Bankası A.Ş. in 1996. The Asya Katılım Bankası is owned by more than 200 partners from different industries. The Anadolu Finance House was owned by Boydak Group, the leading furniture, textile and cable manufacturer in Turkey. In the ending of 2005, Anadolu Finance and Family Finance merged and the name of the bank changed its name into Turkiye Finans Katilim Bankasi A.S and each group had 50% stake in the bank. In 2007 Ulker and Boydak groups had signed a protocol with the National Commercial Bank of Saudi Arabia to sale of their 60% of their shares to them. Subsequent to the approval of Banking Regulation and Supervision Agency the National Commercial Bank of Saudi Arabia has became the major shareholder of the bank and now they are holding almost 65% of the total shares and with 4 members out of 7 in the board level NCB group are being represented.

The owner of the Ihlas Finance House was Enver Oren, the owner of the Ihlas Holding was covering divergent sectors of industry and focusing on a media sector with ownership of daily newspaper Turkiye and television channel TGRT TV. The Ihlas Finance House however, went bankrupt in February, 2001. The Banking Regulation and Supervision Agency (BRSA) revoked the license of the Ihlas Finance House, a subsidiary of media and industry group Ihlas Holding because the finance house faced acute liquidity problems. According to the BRSA, the funds were transferred to the companies of the affiliated group who used them to their own advantage,

impeded it from working in a reliable manner, and had difficulties paying back to the Ihlas Finance House.

Another Arab capital-financed bank is the Kuveyt Turk Katılım Bankası founded in 1989, a joint venture between the Kuwait Finance House, Islamic Development Bank and Turkiye Vakiflar General Directorate. Owing to its shareholders structure, the bank has been supported by 3 governments.

During the late 1980s, the decree that allowed the establishments of the Islamic banks had given them a competitive advantage compared to other conventional banks. The decree reserved to the Prime Ministry the right to supervise them, and especially exempted the Al Baraka and Faisal Finance House from the provisions of the banking law. For instance, the Islamic banks were required to keep only 10% of their current accounts and 1% of their much larger profit and loss sharing participation accounts as required reserves with the Central Bank, whereas other banks lost the use of 10 to 15% of their deposits. Nevertheless, their market share in the total banking system's total assets was less than 1% before 1990 and could not exceed 2% until 1994. Their market share of the total banking deposits also started to exceed 1% in 1990 and 2% in 1992.

3.1 During the economic crisis in 2001

As in many emerging market banking crises, the runs on the participation banks occurred during in a period of macroeconomic and financial crisis. In 1999, Turkey had embarked on an IMF supported stabilization program that

was aimed to decrease the inflation rate using a crawling exchange-rate program, while reducing fiscal imbalances through privatization. But by late 2000, continued heavy government borrowing created doubts about whether the peg could be sustained. In a first wave of pressure on the peg in November 2000, the central bank ran down $7 billion of its reserves to support the Lira, and the crisis abated only when a $10 billion loan was arranged with the IMF. Yet financial markets continued to expect a departure from the peg, and by February 22 the pressure on it became so severe that government had to let the lira float. It immediately depreciated by 30%.

Since 2000 when Turkey began to experience a major banking crisis followed by a severe foreign exchange crisis in 2001 that adversely affected the financial performance of virtually every commercial bank in the country, the Islam banks' total assets also decreased. The assets declined from TL 164.06 trillion in 1999 to TL 143.47 trillion in 2000 and TL 96.98 trillion in 2001 in real terms. In addition to the general economic crisis, the severe decline of 2001 was mainly ascribed to the collapse of the Ihlas Finance House in February, 2001. Just after the collapse, the state stopped the activities of other Islamic banks in a short period, which resulted in US 300 - 400 million dollars loss from the savings of other Islamic banks within three months (Turkish Daily News, May 22, 2001). With regard to the loans or the sum of funds used through profit-loss sharing (musharaka and mudaraba), production support (murabaha), and leasing (ijara), they show a quite similar growth trend to that of the total assets.

Meanwhile, in order to examine their growth in comparative perspective, it needs to observe the changes of their market share in the total banking system. Concerning their market share of the deposits, the Islamic banks were steadily expanding their share since 1990 even though it was minor portion. Yet the market share dramatically diminished as 1.63% in 2001 due to the collapse of the Ihlas Finance House which possessed about 40% of the Islamic banks' total assets in 2000 as table 3 shows. As for the changes of Islamic banks' market share in the loans, the share tends to be higher than that of the deposits. In figure 3, it started as 1.92% in 1991 and exceeded 3% in 1993. The share in the total banking loans has steadily grown during the mid of 1990s and exceeded 5% in the end of 1990s, but dropped off as 2.61% in 2001. In fact, the Islamic banks tend to carry more loans or investments on their balance sheets than deposits.

The poor performances of the conventional banks in late 1990s reflected the banking crisis starting in 1999. In fact, the conventional banks operated at a loss in 1999 and 2000 under the burden of bank failures. Among them, 11 banks with 12.9% of the total bank deposits were managed by December 31, 2000 under the deposit insurance fund. It implies that the financial crisis have more serious effects on the conventional banks than the Islamic banks resulting in poorer performances of the former compared to the latter.

Table 1: Comparison of balance sheets of conventional banks and participation banks

	Conventional Banks			Participation Banks		
	1998	1999	2000	1998	1999	2000
Composition of assets (percent):						
Liquid (ex. govt.)	18.5	18.9	20.9	12.7	15.9	18.2
Govt. securities	14.6	17.9	11.9	-	-	-
Loans	36.7	28.3	31.2	75.6	76	71.4
Permanent assets	8.0	9.3	15.0	8.5	7.0	7.3
Other	22.1	25.6	21.0	2.2	1.1	3.1
Total	100	100	100	100	100	100
As % of total loans:						
FX-denominated	48.6	49.1	41.5	82.7	86.4	80.9
Non-performing loans	7.7	11.7	12.5	1.3	1.6	3.2
Maturity < 3 months.	Na	Na	Na	17.1	16.6	15.2
Composition of liabilities (percent):						
Deposits	64.5	62.7	60.3	86.1	88.0	85.8
Non-deposit funds	13.1	11.0	9.3	-	-	-
Shareholders equity	8.5	8.6	10.9	5.9	5.3	5.9
Net income	4.3	4.4	3.0	1.1	0.9	0.7
Other	8.1	7.3	6.3	6.9	5.8	7.6
Total	100	100	100	100	100	100
As % of total deposit and non-deposit funds:						
FX-denominated	57.0	53.1	51.9	91.5	93.3	91.9
Maturity < 3 months	78.0	71.0	84.0	85.8	86.5	86.3

Source: Banks Association of Turkey, 1998-2000
(http://www.tbb.org.tr/tr/Banka_ve_Sektor_Bilgileri/Istatistiki_Raporlar_Yillar.aspx)

It is shown in the above table, the balance sheets of the participation banks were considerably stronger than those of the conventional banks in the period before the crisis of 2001, reflecting their conservative, interest-averse strategies. The participation banks tend to be squarely focused on traditional banking activities of deposittaking and making loans in 1999 deposits constituted 88% of their liabilities and loans were 76% of their assets, compared to figures of 62.7% and 28.3% respectively at conventional banks. In place of traditional lending to large businesses (some part of which had shifted to Turkey's emerging capital markets), the conventional banks were increasingly involved in raising shortterm non-deposit funds

abroad and investing them domestically in government securities paying high interest rates. This practice built a fair amount of risk into banks' balance sheets since investors would want to liquidate their holdings if devaluation risks rose, at the same time as lira-denominated securities became difficult to sell. The participation banks were also much dollarized than conventional banks in 1999, 93% of their deposits and 86% of their loans were denominated in a foreign currency, compared to shares at conventional banks of 53% and 49% respectively. Finally, although non-performing loans were on the rise at both participation and banks towards the end of the 1990s, at conventional banks non-performing loans had risen to 11.7% of total loans, versus 1.6% at the participation banks.

Table 2 : Percent decline in deposits at the Participation Banks

Name of the banks	Percent decline
Al Baraka Turk	42.1
Family Finance	29.4
Kuwait Turkish	22.3
Anadolu Finance	55.0
Ihlas Finance	100.0
Asya Finance	34.2
Total Participation Banks	63.0
Total excluding Ihlas	36.4

Source: Bankers' Almanac, between the period of December 31, 2000 and June 30, 2001

Table 3: Main Indicators of the Participation Banks Balance Sheets and Income Statements in Nominal Terms (Million TL)

Years	Total Assets	Loans	Deposits	Equities	Profits
1991	3.65	2.48	2.63	0.23	0.05
1992	7.94	5.89	6.14	0.40	0.10
1993	17.73	13.81	13.89	0.75	0.15
1994	41.61	29.11	33.92	1.39	0.21
1995	84.84	60.34	66.81	4.24	0.79
1996	198.69	144.63	157.12	10.20	2.54
1997	462.11	332.11	361.46	24.09	6.81
1998	853.19	622.18	686.17	56.91	12.45
1999	1,672.92	1,260.40	1,420.56	101.85	14.66
2000	2,266.40	1,726.29	1,863.46	161.02	11.90
2001	2,365.53	1,071.92	1,917.50	203.53	-24.81

Source: The Central Bank of the Republic of Turkey 1991-2001
(http://evds.tcmb.gov.tr/cbt.html)

Table 4: Asset Growth of Participation Banks in comparison with the Conventional banks in Turkey, Asset Size (1,000 TL)

Years	Participation Banks	Change (%)	Conventional Banks	Total	Share of P. Banks (%)
2000	2,266,000		104,283,106	106,549,106	% 2.13
2001	2,365,000	% 4.37	216,507,617	218,872,617	% 1.08
2002	3,962,000	% 67.53	212,675,488	216,637,488	% 1.83
2003	5,112,934	% 29.05	249,692,000	254,804,934	% 2.01
2004	7,298,601	% 42.75	304,524,090	311,822,691	% 2.34
2005	9,945,431	% 36.26	382,241,594	392,187,025	% 2.54
2006	13,729,720	% 38.05	469,418,839	483,148,559	% 2.84
2007	19,435,082	% 41.55	542,293,125	561,728,207	% 3.46
2008	25,769,427	% 32.60	673,444,000	699,213,427	% 3.69

Source: The Presentation about Participation Banks In the Financial System of Turkey, prepared by The Partici̇pation Banks Association Of Turkey (http://www.tkbb.org.tr/en/index.php?option=com_doqment&cid=4&Itemid=105)

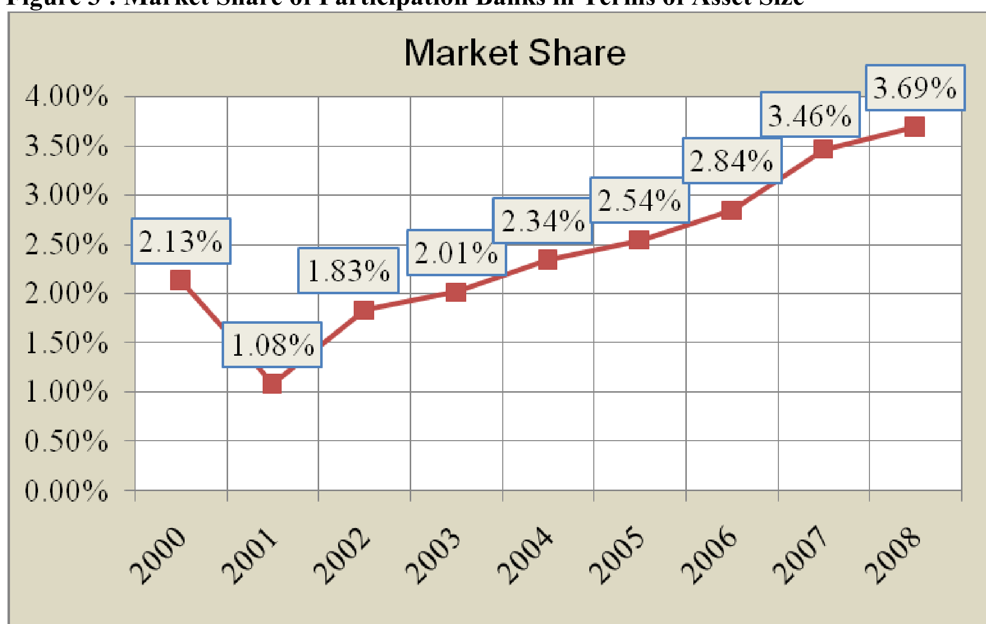
According to table 4, the total asset size of 4 participation banks has grown 33% per annum in 2008 and reached YTL 26 billion in total. They are holding the 3.69% of the total market share. Also, we can easily figure out there is a substantial and stable growth since 2001. Total asset size has been increased by 11 times over the 7 years which is making Participation banking one of the fastest growing sectors in the financial services industry.

Table 5: Growth of Participation Banks in comparison with the Conventional banks in Turkey in terms of equity, (1,000 TL)

Years	Participation Banks	Change (%)	Conventional Banks	Total	Share of P. Banks (%)
2000	161,000		8,133,517	8,294,517	1.94%
2001	203,000	26.09%	18,800,473	19,003,473	1.07%
2002	400,000	97.04%	22,703,101	23,103,101	1.73%
2003	670,000	67.50%	31,349,780	32,019,780	2.09%
2004	891,851	33.11%	40,822,704	41,714,555	2.14%
2005	951,089	6.64%	44,613,138	45,564,227	2.09%
2006	1,559,717	63.99%	50,409,209	51,968,926	3.00%
2007	2,363,811	51.55%	64,528,000	66,891,811	3.53%
2008	3,728,929	57,75%	73,450,000	77,178,929	4.84%

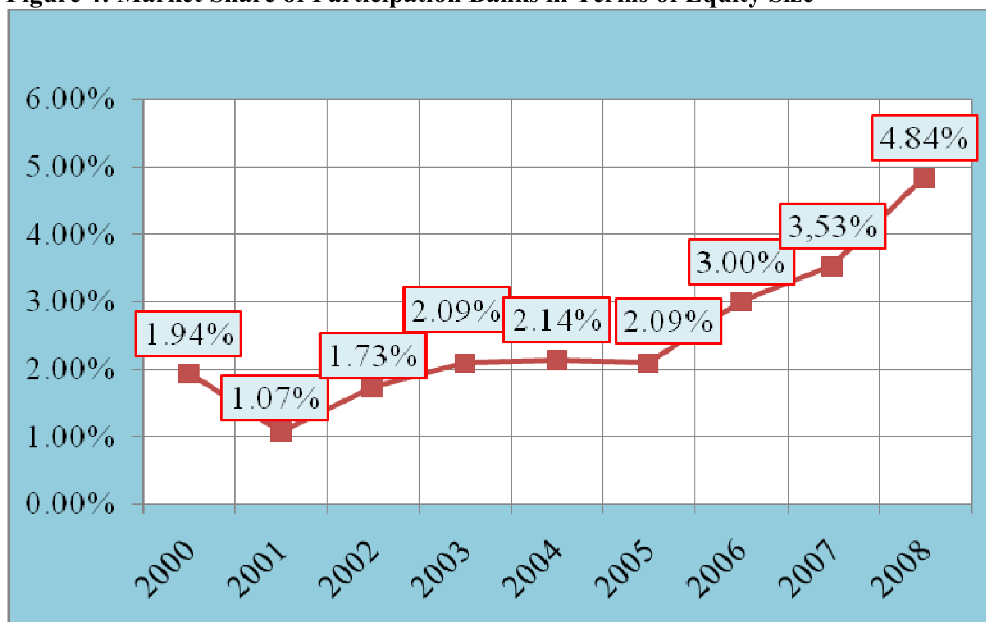
Source: The Presentation about Participation Banks In the Financial System of Turkey, prepared by The Partici̇pation Banks Association Of Turkey (http://www.tkbb.org.tr/en/index.php?option=com_doqment&cid=4&Itemid=105)

Figure 3 : Market Share of Participation Banks in Terms of Asset Size



Source: The Presentation about Participation Banks In the Financial System of Turkey, prepared by The Particıpation Banks Association Of Turkey (http://www.tkbb.org.tr/en/index.php?option=com_doqment&cid=4&Itemid=105)

Figure 4: Market Share of Participation Banks in Terms of Equity Size



Source: The Presentation about Participation Banks In the Financial System of Turkey, prepared by The Particıpation Banks Association Of Turkey (http://www.tkbb.org.tr/en/index.php?option=com_doqment&cid=4&Itemid=105)

Figure 3 and Figure 4 illustrate increasing the market share of the participation banks in terms of both equity and asset size. The equity size of participation banks are considerably higher than the market average. As

Table 5 shows, they have controlling 4.84% of total market share after Al-Baraka Bank has been listed in the Istanbul Stock Exchange and Turkiye Finans has been acquired by The National Commercial Bank, Saudi Arabia. Asya Participation Bank is also listed and it has more than 200 shareholders apart from its investors in ISE. Al-Baraka is the member bank of Al-Dallah group. Moreover, the branch networks and the personnel numbers of participation banks are increasing day by day, as it is shown on Table 6 in 2008 the participation banks have expanded their branch network up to 536 and also there are more than 11,000 employees.

Table 6: Branch Networks and Staff Growth of Participation Banks

Years	Branches	Variance (%)	Staff	Variance (%)
2000	110		2,182	
2003	188	71%	3,520	61%
2004	255	36%	4,789	36%
2005	290	14%	5,740	20%
2006	355	22%	7,114	24%
2007	422	19%	9,215	30%
2008	536	27%	11,022	20%

Source: The Presentation about Participation Banks In the Financial System of Turkey, prepared by The Particıpation Banks Association Of Turkey (http://www.tkbb.org.tr/en/index.php?option=com_doqment&cid=4&Itemid=105)

Although almost 40% of funds were drawn by depositors after the economic crises in 2001, the participation banks were not hit by the big financial crisis that hit Turkey in 2001 and they recovered fast. Their deposits now have

been taken into the guarantee fund of the banks and the sector has acquired bank status. So, it may helps to avoid other shock withdrawals in the future. Moreover, the sub-prime mortgage crise in 2007 did not hit directly any Islamic bank unlikely its impact on investment and commercial banks all over the world. As the Islamic banks do not touch toxic derivative instruments, they do not suffer any losses for that.

Because, the Participation banks have survived from the crises during 2001 with the help of their own internal features. The main difference between the participation banks and commercial banks in Turkey is existing in the liability side of their balance sheets. Thanks to their PLS account style, the participation banks do not carry any interest risks and foreign exchange risk either as they do not make foreign exchange position deficits. The conventional banks pay fixed rates on its deposits, regardless of whether it makes profits or losses. The participation banks however, do 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.

3.2 The Differences in terms of Risk Management

According to figure 3 and figure 4, Participation banks are holding about 5 percent of the assets with the banking systems that they co-exist with conventional banks, they have to adapt to the same banking regulations. In some cases, participation banks have to alter their procedures and structures. In terms of financial stability and international acceptance, participation banks had to comply with the regulations set forth by BRSA and also Basel.

Although major risk differences are existing between the participation and the conventional banks, it is required for participation banks to deal with international banking standards and provide viable and safe banking grounds. Basel II emphasizes capital adequacy, risk management techniques, internal controls, and external audits. New approaches are described for weighting assets. Participation banks will be required to comply with the standardized approach and measure risk exposure for capital adequacy. As the participation banks are working with mostly SMEs in Turkey, they need to alter the risk weight formula for SME borrowers. This will be useful for participation banks considering their relatively larger risk exposure of SMEs. Sinkey and Bessiz (1998) categorizes the risks exposures as credit, liquidity, interest, market, foreign exchange, solvency, operational and management which are the western standards and are also applicable to the islamic banks.

3.2.1 Market Risk

The assets and liabilities of banks are part of the overall financial system. Market risks are the risks originating from the market itself. Market risk (or Value at Risk) is the uncertainty of a financial institution's earnings resulting from changes in market conditions, e.g. interest rate, market volatility, etc.) It can be measured over periods as short as one day namely DEAR (daily earnings at risk). Usually it can be measured in terms of dollar exposure amount or as a relative amount against some benchmark. (Saunders, 1997)

Market risk can be divided into two sub categories; systematic and unsystematic. Overall changes in market conditions will expose banks to systematic market risk. (Saunders, 2004)

Movement in specific asset will generate unsystematic risk for banks holding those assets. For instance, any change in the price of domestic currency will expose banks to systematic risk whereas changes in the price of cotton will only affect banks that hold positions in cotton.

There are many market conditions that affect the banks and expose them to market risk. Changes in price of equity, interest rate, foreign exchange rates and prices of commodities are the main conditions. The balance sheets of the banks contain assets, liabilities and equities that are financed. Any price change in any one of the items will affect the banks' financial standing. A bank with unmatched currency of assets and liabilities will be exposed to foreign exchange risk. A variable interest rate on assets and fixed interest rate on liabilities will expose banks to interest rate risk.

Through utilization of murabaha or ijarah, participation banks are exposed to market risks of specific commodities. Since participation banks purchase commodities and take them into their possession, any change in price will affect their ability to sell them to third parties. Also, same risk applies to the value of the collateral. Although, participation banks collateralize murabaha and ijarah transactions, the commodity is also considered part of the collateral. Any change in price would not affect the amount of debt owed to the participation bank but would change the value of the collateral.

Through mudaraba and musharakah partnerships, participation banks expose themselves to risks that are specific to line of businesses. For instance, if mudaraba partnership is established for a company that deals in textiles and if the prices of textiles decrease drastically, participation banks' investment would be affected negatively. Such risk is unique to participation banks and should be evaluated thoroughly. participation banks prefer trade related instruments over equity related instruments due to the business risk involves. (Obaidullah, 2003)

Participation banks also face unsystematic risk with istisna and salam contracts. Any single and independent event may affect the production/harvest of the subject goods. Therefore participation bank would receive the promised goods late or may not receive at all. Product specific risk is also vital for participation banks to evaluate.

Investment account deposit holders are not promised a fixed return. Thus, participation banks are not exposed to any interest rate risk directly. However, participation banks face interest rate risk in two indirect ways.

First, any profit margin (mark-up) added to the murabaha transactions would use a benchmark rate. This rate should be high enough to meet the expectations of PLS account holders for their investments and should be low enough to be acceptable for the credit customer. Therefore the benchmark rate will be a rate close to market interest rate. Any increase in benchmark rate will expose participation bank to risk of withdrawals due to the fact that murabaha deals have fixed payment schedule and the profit amounts cannot be changed.

Second, some of the credit customers of participation banks also work with conventional banks. In case of interest rate jumps, such companies would prefer to make payments to conventional banks due to high cost of increased interest. They may even choose to divert the funds that they plan to pay towards their murabaha payments, to their debt with conventional banks. The fact that participation banks cannot impose penalty on late murabaha payments exposes participation banks to late payment risk and such risk increases with increased market rates.

Participation banks may have different currency denominations for assets and liabilities and any changes in currency prices exposes participation banks to foreign exchange rate risk. While conventional banks may employ derivative products to hedge such risk, no financial product exists for participation banks. Therefore participation banks are exposed to foreign exchange rate risk more than conventional banks.

Credit instruments of participation banks require involvement into real business sectors. Conventional banks on the other hand, may choose to keep more government bonds than commercial credit. Therefore participation banks would be exposed to macroeconomic changes more than conventional banks. For instance, any change in corporate taxes would affect the income of commercial customers and therefore participation banks.

3.2.2 Credit Risk

Banks are exposed to credit risk through default. Any counterparty of a credit transaction will expose the bank to credit risk. A customer at a loan agreement will expose the bank with credit risk due to the chance that s/he

will not meet his/her obligation on time or at all. On such a circumstance the principal and the earnings are at risk. Banks are exposed to credit risk on treasury operations as well. Bonds carry the default risk of the issuer for the coupon payments and for the principal.

Even a simple foreign exchange deal exposes banks to credit risk. As long as the currencies are not exchanged simultaneously and at the same physical place, the credit risk of the trading partner will stand. Credit risk limits the amount of transaction that will be conducted with a specified counterparty.

Even governments can expose banks to credit risks. Eurobonds issued by different countries carry different interest rates. The differences in interest rates reflect the terms of the bonds and the amount of credit risk each country exposes to bond holders.

Stiglitz (1988) argues that interest rate is not like a conventional price (price of credit) which adjusts to clear the market. It is a promise to pay a sum in the future. However, promises are often broken. If they were not, the issue of creditworthiness would certainly not arise. Conventional banks' lending, which is influenced by interest rates, is carried out on the basis of the creditworthiness of the borrowers. Banks may credit rationing its borrowers if, firstly, the banks cannot differentiate between borrowers with different credit risks before providing loans, and secondly, the loan contracts were subject to limited liability (if project returns were less than the debt obligation, the borrowers bear no responsibility for making the payments) (Gavin and Hausmann, 1998). Computed as the difference between the interbank market three months rate and the interest rate for customer

deposits. Interest rate risk is expected to increase bank interest margins. (Saunders and Schumacher, 2000) Also, raising the interest rate may cause adverse selection which would leave a more risky pool of borrowers in the market for funds. With higher debt obligations due to higher interest rate only the risky borrowers with higher returns would be ready to take up the banks contract, thereby causing moral hazard (Stiglitz and Weiss, 1981). Hence, banks are then more likely to be lending to high-risk borrowers, because those who are willing to pay high interest rates will, on average, be worse risks.

The nature of murabaha and ijarah transactions of participation banks exposes them to similar credit risk with commercial credits of conventional banks. However, mudaraba and musharakah partnerships have unique credit risks. In mudarabah partnership, the operations depend on the managing partner. Therefore the creditability of the managing partner becomes a major issue. participation banks are exposed to credit risk in mudaraba via managing partner's fraud, misconduct, negligence and incompetence. The credit risk of the resulting business also exists. (Al-Ghari, 2001)

Table 7: Deposit Classification in Turkey as of June 2007

	Participation Banks	Commercial Banks
Insured Deposit / Total Deposit	41%	31%
Time Deposit / Total Deposit	81%	84%
Up To 1 Month Deposit / Total Deposit	62%	28%
Between 1-3 Months Deposit / Total Deposit	12%	46%
Between 3+ Months Deposit / Total Deposit	7%	10%

Source: TMSF Presentation (http://www.tmsf.org.tr/index.cfm?fuseaction=public.dsp_menu_content&menu_id=65)

According to the table 7, 62% of funds in participation banks have less than one month maturity, whereas maturity of deposits in conventional bank is longer. Since their funding is from mostly short term deposits, participation banks are exposed to much higher credit risk relative to commercial banks.

3.2.3 Liquidity Risk

Banks have daily liquidity requirements arising from activities including withdrawals, paying Cheques, regulatory payments and credit payments. It is the responsibility of banks to undertake these payment obligations on a timely manner. Risk of failure to do so is the liquidity risk. Banks have the option of borrowing in the money market for short term liquidity needs but such borrowing will be costly. (Bessis, 1998)

Almost all of the central banks as the regulatory agencies over banks require some percentage of assets to be kept in liquid assets. Central Bank of Turkey declared the cash portion of reserve, liquidity requirement and reserve requirement for both commercial and participation banks, which is 5 percent for TL liabilities and 9% for FX liabilities. (Central Bank of Turkey, www.tcmb.gov.tr/yeni/bgm/dim/disponibilite.html) While some of these liquid assets are kept at the bank, some are kept as liquidity reserves at the central banks.

Banks also manage liquidity risk through cash flow management. It is also reasonable differences between the duration of assets and duration of liabilities. For a bank with all time deposits with a maturity of 30 days and credit deals with maturity of 180 days will face liquidity risk in case time deposits decide to withdraw.

Participation banks cannot borrow from money markets that operate with interest. Central banks also lend money with interest. The fact that there is no lender of last resort exposes participation banks to liquidity risk in a vital way. In fact, illiquidity is the most important risk that an participation bank faces. Also, since 62% of participation funds have less than one month maturity, liquidity risk is higher. To give enough confidence to customers, sound supervision and strong deposit insurance systems are required.

Murabaha and ijarah transactions have fixed scheduled payments. They cannot be called like credits of conventional banks. Mudaraba and musharaka transactions are only make payments in case of profits and principal amount are collected in case of liquidation. Istisna and salam transactions have very long maturity structures and any collection of principal is not possible before the completion/harvest of the goods.

Conventional banks keep fixed income securities within liquid assets. Therefore liquidity of conventional banks is usually higher than participation banks. Since participation banks cannot get any return on liquid assets, the trade-off between safety and profitability is considerably higher for participation banks.

The cost of liquidity is directly reflected upon the profitability of participation banks and their preference is to have lower liquidity levels. The fact that banks keep short term securities as liquidity and earn interest on them provides a safety cushion that is not available for participation banks.

3.2.4 Operational Risk

Operational risk is associated with banking systems and employees. Procedures of banks are handled with integrated technological products. Any failure of these systems exposes banks to operational risks. With the advanced technology, banks can operate more effectively and efficiently. Decision making process, customer database including deposits and credit deals are all processed through computers.

The security of systems are very important as well as the system designs. Any flaw in any of the process will expose banks to risks to a great extend.

Employees also expose banks to operational risks. A foreign exchange transaction conducted by a dealer is vulnerable to risk of human error. A credit proceeding paid without collecting the collateral also exposes banks to operational risk. An unlocked branch of a bank at night also exposes banks to operational risk.

The operations of participation banks are not standardized as well. Even the application of any Islamic banking products may differ from one bank to another. Many products of Islamic banks require adaptation to regulations that are designed for conventional interest bearing systems. These adaptations may bring complications with them and therefore expose Islamic banks to operational risk.

3.2.5 Legal Risk

Risks arising from laws and regulations are legal risks. Many countries have restrictions to kinds of businesses that banks are allowed to conduct. For instance; leasing, insurance or brokerage house activities may be restricted areas of operation for banks. Any trading book activity may become

jurisdiction of capital markets board and may require disclosure of information accordingly.

International business activities may also expose banks to legal risks. A bank that involves marine business may require extensive knowledge about marine laws. Any assumption based activity may become very costly for banks.

In Turkey participation banks, commercial banks and even investment banks are under the same umbrella with the help of regulations. They are all subject to the same supervision and regulations. They are monitored and regulated by BRSA and reporting to Central Bank of Turkey.

3.2.6 Risk Management System

The risks faced by participation banks include the same risks faced by commercial banks and risks associated with facilitating Islamic financial instruments. It is therefore very important for Islamic banks to establish an effective risk management system. In order to operate profitably, it is necessary for the risk management system to be operation oriented.

Establishing risk management systems in Islamic banks involves several stages that need to be custom made. Involvement and dedication of all levels of staff, management and board of directors is necessary. Standardized procedures should be established for each and every operation as well as every financial instrument.

Standards of International Standards Organization (ISO) should provide necessary guidelines for such standardization process. ISO also requires

active participation of staff, management and board of directors. Policies and operational guidelines should be defined and employed.

Compliance with such guidelines within the framework of standardized operations should minimize related risks. However, internal control systems are necessary to Cheque such compliance and to report flaws. Cooperation of staff if very important to locate each flaw within the system and provide solutions. Internal auditing should be alert for controlling systems flaws and to provide solutions for them.

Definition of risks should be made and risk measures should be defined.

Procedural system should include risk measurement procedures and standard internal audit should conduct periodic system wide Cheque-ups. As long as Islamic banks can measure the type and extend of risk exposed to them, they will be able to work for risk mitigation techniques to eliminate risk. However, derivative products available for Islamic banks to mitigate risks are limited compared to conventional banks (Zaher and Hassan, 2001). The procedure for risk management should include definition, measurement, control, mitigation. External audit would bring unbiased opinion but it is more effective to employ such services with expertise in Islamic banking.

Internal audit systems should be adequate to control and correct the bank's overall system. Auditors should be experienced in Islamic banking and all related operations. The authority and responsibility of auditors should be defined by considering many aspects. Auditors should represent all stakeholders. Internal audit should be responsible for, "ensuring that policies and procedures are complied with and review whether the existing policies,

Practises and controls remain sufficient and appropriate for the bank's business" Ahmed J. (2003).

3.3 The Legal Situation Of Participation Banks

Turkey has been utilizing Islamic finance techniques since the late 1980s through financial institutions known as "Special Finance Houses". The decision regarding establishment of special finance houses was taken by ministers of council in 1983 with act number 83/7506. (Yahşi, 2001) In truth, the concept special finance house did not perfectly define them in the actual sense. Particularly, serious problems occurred in that these institutions were perceived as banks in their international relations, in which respect a solution was to be produced and thereby they suggested the title participation bank in place of special finance house. On 1 November 2005 the name of special finance house has became the "Participation Banks" with the enactment of the Banking Act No. 5411 (Banking Act).

The banking based upon profit and loss sharing was mentioned as special finance houses in regulations in Turkey. This concept not only was far from expressing the banking it implied but also associates wrong concepts. One of these miscomprehensions was that these institutions were confused with those companies dealing with leasing, factoring, etc., and it was not perceived as a bank. Still, another misperception was that because of the word special in their name, it could be taken as that as if they were such special institutions as are privileged over the other finance institutions, that they were protected and that they therefore were in an unjust competition. In fact, the special finance houses face at times with unjustified and baseless

accusations both in the press and in the public as result of this sort of deficient and wrong evaluations. On the other hand, since this term does not take place in the literature, the special finance houses' experience quite serious hardships in expressing themselves particularly in the international markets.

Although the participation banks were regulated separately from commercial banks in Turkey at the beginning, afterthat the bank law of 1999 have brought them under the same regulatory requirements and apparatus. In the meantime, certain amendments were being wrought in the Banks' Law in 1999. They were required to meet the same minimum capitalization as banks, the same required reserve ratios, and the same liquidity ratios.

According to the regulation of Central Bank with law number 4651 which was issued on 10th of May 2002, the reserve requirements for participation banks and reserve requirement for commercial banks are unified in order to bring uniformity in practices and to apply similar and identical requirements for the same liabilities. Thus, the current and share accounts of participation banks as well as their other liabilities are subject to reserve requirements. The cash portion of reserve requirement, liquidity requirement and reserve requirement for participation banks, which is 5 % for TL liabilities and 9% for FX liabilities, shall be same as commercial banks'.

Like commercial banks, the participation banks must report weekly to the central bank on their foreign-currency position. However, the participation banks were not covered by deposit insurance, with the rationale that profit-and-loss accounts involved no guarantee of return of principal.

As for Banking Law 5411, the principal plus profit of saving deposits amounting to 50,000 TL belonging to real persons in participation banks are secured under the guarantee of Saving Deposits Insurance Fund. The said insurance is taken into consideration on a separate basis for each participation bank. A participation bank quarterly deposits into that fund a premium at a certain proportion to the portions of those accounts subject to the insurance in order to have them insured, and such premiums are reflected on the account holders in proportion to their contribution to the profit.

As it was explained in the section of Sukuk issues in Turkey, the sovereign sukuk law has not been effected yet. Despite the strong potential for the sukuk market, as is the case with any evolving securitization market, a number of economic, legal, and regulatory challenges remain, irrespective of Shariah compliance. These include the substitution of standard structural features in conventional securities, such as credit enhancements, which are not normally contractually permissible in the Islamic context; legal uncertainty arising from the fact that the transaction structure needs to satisfy commercial as well as Islamic law, in particular in non-Islamic countries; and, regulatory differences between national regulators. On the other hand, with regard to the Capital Market Law dated 27/7/1991 and the lates communiqué in 2002 on principles regarding asset finance funds and asset backed securities (serial III, No:35) there is no objection to issue, sell and trade any corporate sukuk (asset backed securities) in favour of themselves. Furthermore, Bank Asya and Al-Baraka are two listed

participation banks in Istanbul Stock Exchange and they have to comply with the regulations of CMB.

On the other hand, Participation banks can do leasing activities in-house whereas the Commercial banks in Turkey need to establish a subsidiary or affliated company to execute these transactions. Also, with the help of a kind of crediting method in participation banks texture called leasing provides enterprises credited compatible with their cash flow and financing made compatible with crediting technique. In another words, this method provides investments financed by long-term financing. These methods improve the asset quality by means of increasing the security of the credits used.

3.4 Capital Allocation Efficiency Of Participation Banks

The phrase capital allocation has come to encompass activities ranging from measuring the capital used by transactions to calculating performance measures to determining the optimal division of the bank's capital among competing transactions. It is helpful to make a distinction between the attribution of capital to transactions and the process of optimizing the capital allocations to those transactions. Since capital markets are competitive, financial institutions must offer equity investors a return sufficient to justify their investment. (Banerjee and Munshi, 2002)

The optimal capital allocation is one that deploys capital to maximize shareholder value. In an optimal portfolio, marginal return per unit of risk will be equal across business units. Taking a unit of capital from one business and giving it to another will not add additional value to

shareholders, because the return gained equals the return lost. Within the optimization process, an often-voiced question is how to treat regulatory capital. If economic capital exceeded regulatory capital for all transactions, regulatory capital could be ignored i.e., the regulatory capital constraint would be non-binding. (Wurgler, 2000)

The study of banking efficiency is quite important for the following reasons: First, the financial sector is a major player in modern economies, as a producer of financial services and as an employer. The value-added of the financial sector as a share of GDP has grown considerably over the last three decades. Banking system fulfil essential functions in intermediating between savers and investors, financing private sector trade and investment, and helping to ensure that the economy's financial resources are allocated effectively. The banking system must be sound and efficient in order to effectively play its role. Furthermore, well-functioning banking system increases the effectiveness of macroeconomic policy by providing a channel for monetary policy signals.

Second, financial markets have become increasingly globalised. The growth of international financial activities has been more rapid than the growth of domestic markets and access to international capital markets for developing and transition countries has grown rapidly. Technological progress, the development of new financial instruments and liberalization have increased the potential for further growth of the financial sector both domestically and internationally. A key challenge facing the financial sector especially in developing countries is to respond to the recent wave of globalisation and

the move towards global financial markets. Domestic banks have to work side by side with foreign banks. Less efficient banks with high operating costs are likely to suffer from international competition.

Third, the measurement of financial efficiency is also important to all parties that participate in the banking industry. Assessing bank's performance through measuring efficiency helps bank management to improve managerial performance. It assists investor in making investment decisions whether to participate in financial activities. Regulators are also interested in banking efficiency since the performance of the banking sector has significant impact on other parts of the economy. The recent experience of Western Europe shows that achieving a greater efficiency is one motivation for the recent rapid changes in the structure of the banking industry (Molyneux, 1996).

Countries whose banking system are more independent exhibit more efficient capital allocation. Countries that entrust their banking systems to either families or states, exhibit less efficient capital allocation. Regulation serves four purposes in successful financial markets: maintaining safety and soundness, promoting competition, protecting consumers, and ensuring that underserved groups have some access to capital. Policy oriented research can be undertaken to improve informational efficiency in a developing country. (Stiglitz, 1994)

The Turkish banking sector provides a perfect environment for testing relative efficiencies of private vs. state-owned, as well as commercial vs. participation banks. Banks account for 75% of assets of the Turkish

financial sector (BRSA, 2001). Yet, during the 1990s, Turkish commercial banks' loans to assets ratio amounted to only 40%, compared to 60% for US banks. The Turkish banking sector has also fared poorly on the deposits-attraction side of financial intermediation: it is estimated that Turkish households are hoarding roughly US$15 billion in cash and gold, the latter serving as an inflation-hedge in a highly inflationary environment. In part this is due to the fact that real return on bank deposits was negative (equal to 1.8% in 2001, relative to base-year 1994).3 In contrast, the real return on hoarding US$ was 27%, that for hoarding DM was 23.2% and gold offered a 24% real rate of return. Consequently, the Turkish banking sector provides ample opportunities for analysing sources of inefficiency in financial disintermediation.

There are two basic models that are widely used as tools in efficiency studies with all sorts of variants in the field of applied research. There are econometric models. They are parametric and rely on sophisticated regression analyses. Since probability estimation lies at their heart to erect the efficiency frontiers and obtain firms' scores they constitute the stochastic frontier approach or the SFA to efficiency evaluation. The majority of these studies were confined to the US financial sector There the large number of banks has traditionally facilitated econometric modeling. The other method uses the non-parametric linear programming or the data envelopment analysis, in short DEA, for the purpose.

Participation banks which is coming in to Turkish financial system in 1980s,

getting improvement durig years. At the end of year 2008 its share in banking sector is 3.69% and share in total equity is 4.84%. From this evaluation of influence and productivity of interestless banking operaters participation banks and competitive with interest basis operaters deposit banks determination is seen significant.

In this research study “Data Envelopment Analysis” method is applied for measuring the infuence. Data Envelopment Analysis (DEA) is a mathematical programming approach for the construction of production frontiers and the measurement of efficiency relative to the constructed frontiers. DEA is based on a concept of efficiency very similar to the data envelopment analysis is a method applying for measuring the productivity when there are many inputs and outputs to be observed and these inputs and outputs could not transformed in to one input and output. (Ersen, 1999) The costs of production factors and inputs used while the banks produce off-balance and on-balance services, have prior impacts on the production decisons of the banks. (Saunders, 1997)

In this analysis applying study realised with 28 decision makers' with 3 inputs (total deposits - funds collected, personel expenses, profit share expences) and 2 outputs (total credits- funds utilized, interest income - profit share income) used between the years 2001 to 2005. The reason of analysis has been done only in between the participation banks is the outputs and inputs criteria are totally different.

These are the participation bank names and their codes used in the analysis; Anadolu Finans, Family Finans, Kuveyt Türk Katılım Bankası, Asya

Katılım Bankası and Al-Baraka Turk Katılım Bankası. Inputs and outputs are as follows and all data (balance sheets and income statements) taken from the Bankscope.

Input 1: Deposits Collected

Input 2: Personal Expenses

Input 3: Profit Share Expense

Output 1: Loans Utilized

Output 2: Profit Share Income

As per the results of the data envelopment analysis applied between 2001-2005 to measure financial efficiency, the resolution entity having most stable efficiency came aut as Albaraka Türk Katılım Bankası A.Ş. Kuveyt Türk Katılım Bankası A.Ş. being away from the efficiency frontier within the first three years happen to approach gradually to the efficiency and eventually became efficient from 2004 to 2005. Research results can be summarized as follows:

It has been evidenced that banks demonstrade positive developments to become efficient in economically stable periods.

It has been evidenced that total factor productivity is closely related to efficiency. To improve efficiency, participation banks are to keep pace with technology, consider cyclical and sectoral developments in their managarial decision making process, apply convenient marketing technics and advertisement applications in their deposit collecting activities, efficient utilization of deposits to ensure minimum risk and maximum efficiency, increase the inflow of foreign capital and its channeling to investments.

4. CONCLUSION

Since the past few decades ago, the number of Islamic banks have rapidly increased worldwide and now there are more than 300 Islamic banks may have total combined assets in excess of USD 700 billion in roughly 75 countries. According to some estimates, it is expected that Islamic banking will be able to attract 40% to 50% of the total savings of the Muslim population worldwide for the next decade. In many countries, Islamic banking has evolved from being a niche offering to part of the mainstream financial services landscape. At the same time, the competitive landscape is being re-drawn with more Islamic financial services institutions than ever before present in the marketplace. So many global banks are willing to have portion in this sector, for example some giant banks such as Citibank, HSBC, UBS, BNP Paribas, Credit Suisse, Deutsche Bank are doing Islamic banking activities through their subsidiaries or Islamic banking windows in house. They develop new products and sources to this market as well.

Parallel to its growth all over the World, Islamic banks in Turkey have gained considerable attention not only in the domestic market, but also in the international financial market. Levels of Middle East investment in Turkey have been significantly increasing in recent years. The Islamic banking sector in particular has been on the receiving end of large sums but other sectors are starting to attract heavy Middle East interest including insurance, energy and real estate.

Banks operating on Islamic principles are a small but rapidly expanding segment of the Turkish financial sector. The participation banks - Albaraka Türk, Bank Asya, Kuveyt Turk and Turkiye Finans - administer about $21.5 billion in assets, representing 5% of the Turkish banking system and the sector aims to double its share within the next 10 years.

The growth in participation banking has not been limited to retail and commercial banking alone. On the asset management side, there has been exponential growth in compliant funds in recent years. Participation banks have started to borrowing from international markets under sydicated murabaha deals and bilateral basis. The growth opportunity as well as the challenges facing the development of the participation banking market have raised public policy issues in the jurisdictions in which they operate and internationally. It is very important for participation banking sector to initiate "Sukuk" bond issuances, but first it needs to have legal construction and political support. So many banks in the Gulf region especially are keen to deal with this shari'ah compliant product. However, the participation banks can have only revenue index bonds for their excess liqudity and hope to be finalized the implementation process of Sukuk issue by the government very soon.

On the other hand, Ihlas Finans is the first participation bank revoked its license. Concerns on its default became contagious to other participation banks and turned out to be a systemic risk. Establishment of Deposit Insurance Agency gave confidence to the fund owners. Participation banks

are subject to the same supervision and regulations as deposit banks. However, due to significant differences in assets-liabilities structure and risk exposures, supervision and risk based should be differentiated. But, for development of participation banks, innovation for new instruments needed.

In the efficiency study, participation banks are found to be relatively efficient in terms of extension of credit and allocation of efficiency. Moreover, their credit extension operations appear to be identical to those of other domestic banks. Hence, to the extent that those islamic banks may draw customers away from the conventional sector, the current results suggest that their presence does not reduce overall banking efficiency. To the extent that they may also bring into the financial system individuals who had chosen not to deal with conventional banks, they may in fact serve a positive role, by increasing financial intermediation. In conclusion, participation banks and deposit banks are similar as fund transferring establishments, but the difference of their operations could be reflected to their influence.

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Appendix 1:

Draft Act for Public Financing Through The Usage of Public Assets

FIRST SECTION

Purpose, Scope and Definitions

Purpose

Article 1 – The purpose of this act, by considering the developmental targets and macro economic balances of the country, provided that public service will continue to maintain their service, is to utilize publicly owned assets efficiently and diversify the financing instruments of the public sector, by use of all kind of immovable public properties, concession rights upon public assets, operation rights of public assets, is to regulate the principles and procedures of the issuance of any capital markets' financial tools.

Scope

Article 2 – This act includes public institutions with distinct budget, state economic enterprises, social security institutions, companies subject to private law procedures but have more than 50 % state owned share, public banks and funds.

Only;

a) Immovable properties allocated to the President of the Turkish Republic, the Turkish Parliament and the Court of Justices
b) Immovable assets under the Forest Act
c) Immovable assets located in the centre of cultural and touristic regions designated by the act of exhortation tourism
d) Immovable assets allocated for the usage of third parties
e) Coasts exempted from the Coast Act
f) Immovable assets not allowed by the Ministry of Culture and Tourism
g) Immovable assets allocated to Turkish Military
h) Immovable assets allocated to MIT

Are excluding from the scope of this act.

Definitions

Article 3 – Application of this act;

a) Minister: The minister responsible for Undersecretaries of Treasury,
b) Undersecretary: Undersecretaries of Treasury,
c) Public entity and institutions: Subject to private law procedures but have more than 50 % state owned share, public banks and funds.

d) Publicly owned immovable assets: In proprietorship certificate which were registered in favor of Treasury, public entity and institutions
e) The rights of usage, utilization and operation belong to public: Given the all sorts of rights of usage, utilization and operation to the public entity and institutions by the relevant laws.
f) Public assets: Public immovable assets and the rights of usage, utilization and operation.
g) Company: A company or companies is/are to be executed the given missions subject to this act.

SECOND SECTION

Jurisdiction

Article 4 – The Council of Ministers is authorized to determine; all the assets, property enjoyment rights and legal rights that will be subject to this act and to include assets into the scope of the act or exclude assets from the application of the act.

Article 5 – Undersecretary is authorized to execute procedures, stated in the Article 6 of this act by the approval of the Minister, without depending on the relevant law of the establishment and the registration, to establish companies subject to the special law adjucations.

Concerning the assets and rights allocated them by the Fiscal Treasury; they are authorized to apply the procedures stipulated in the first clause of Article

1 by taking the approval of Under Secretariat of Treasury and Ministry of Finance.

The secretarial services of the companies are fulfilled by Under Secretariat of Treasury. Any expenditures for the services of companies are borne by the budget of Under Secretariat.

Article 6 - The Minister, within the scope of the application determined public assets by The Council of Ministers, is authorized to permit all kind of contracts between the company and public entity and institutions including purchase, sell, re-purchase, lease and pledge and to approve these contracts, to determine the amounts and the other conditions of operation with the scope of these contracts. The Minister is also authorized to issue debt instruments, to set the terms and conditions of these instruments and to grant treasury the license to issue pay back guarantee for this kind transactions subject to the Law no:4749 on Public Finance and Debt Management.

Under this article immovable assets decided by the Minister for the purchase of the Company, provided that glozing the re-purchase right of concerned public entity and institutions at the end of determined maturity, are registered in favour of the Company by the directorate of the registrations.

The Minister can have the independent rating companies to purchase, sell, re-purchase and indicate the rental amounts of public assets taken with the application scope.

The Minister can transfer all or any part of these jurisdictions by given this act to the Undersecretariate only stating the boundaries clearly.

THIRD SECTION

Various Adjucations

Article 7 -

The Public Entity and Institutions covered by this Act can not make any changes in the current legal position of the assets, rights without prior approval of Under Secretariat of Treasury and Ministry of Finance.

Article 8 -

The transactions and debt instruments to be issued under the framework of this Act are exempted from all kinds of taxes, duties and funds payable.

Article 9 -

All other matters which are not regulated by this Act are governed by Law no:4749 on Public Finance and Debt Management.

Article 10 -

The c clause of the third article of Law no:4734 on Public Tender, has been changed from "all kinds of consultant and credit rating services regarding borrowing through international capital markets" into "all kinds of consultant and credit rating services regarding borrowing through international capital markets and the issuances of capital financial tools through the usage of public assets "

Validity

Article 11 -

This Act will come into force as of its publication date.

Execution

Article 12 -

The rules of this Act are executed by the Council of Ministers