



# Participative Banking in Turkey

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## 12.1 INTRODUCTION

*From the Beginning to Nowadays* Modern Islamic finance has been existing for more than 30 years in Turkey. Indeed, Ottoman Empire had imposed that all kinds of financing must be compliant with Islamic Law.<sup>1</sup> But, the secular Republic of Turkey has ended up, since 1923, with the application of Islamic Law (*Shari'ah*) and had forbidden all shapes of religious reference, above all the Islamic reference, a movement that matched during decades with religious freedom restrictions<sup>2</sup> and coup d'état against governments that are potential threats to the secular State.<sup>3</sup>

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<sup>1</sup>H. Tünç, *Katılım Bankacılığı, Felsefesi, Teorisi ve Türkiye uygulaması* (in Turkish, our translation: Participative Banks, Their Philosophy, Their Theory and Their Regulation in Turkey), Nesil, Istanbul, p. 175 et s; H. Döndüren, *Delileriyle Ticaret ve İktisat İhmihali* (in Turkish, our Translation: Encyclopedia of Islamic commercial Law and Islamic Economy with Their Legal Sources), Erkam Yayinlari, Istanbul, 1424/2003, pp. 362–366.

<sup>2</sup>For example, Turkish authority had closed many Mosques, Koranic schools (madrassa), Sufi places (zawiya) and had forbidden the Appeal for Prayer (Athan), holding at home Koran, obligating the former Sultans and Scholars to leave the country.

<sup>3</sup>The last coup d'état dated 28 February 1997 was against the coalition government headed by the Prof. Dr. Necmettin Erbakan. Regarding the figures, the Islamic economic

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However, for several years, the government has allowed Turks to draw in their “glorious” past. This return to the authentic sources has allowed the establishment of an even stronger legal base to Islamic financings. The first Islamic finance activities began in 1985 with the setting of *Albaraka*. After, *Kuveyt Turk* began its activities in 1989. The Islamic banks were created with local capital like *Anadolu Finans* in 1991, *Ihlas Finans* in 1995 and *Bank Asya* in 1996.<sup>4</sup>

For several years, the Turk authorities have sustained the Islamic finance development. The former prime minister had set up in 2015 a coordination committee for interest-free finance that always depends on Public Revenue Office and aims to fulfill the development of Islamic finance in Turkey. He invited all the concerned public authorities to make their contribution to this development.<sup>5</sup>

*Former Legal Environment* Islamic financing found a legal base with the Law of 1983 which named participative banks as “Special Finance Institutions” (*Özel Finans Kurumları*)<sup>6</sup> in line with the Turks’ expectations<sup>7</sup> Thanks to the Law, many banks had got the authorization to become an Islamic bank.

The Banking Law n° 4389 of 1999 set all the banks under control of the same regulator “without any religious distinction”. Then, the Law imposed the setting of the Special Financial Institution Association and a Warranty Fund of Islamic deposits.<sup>8</sup>

*New Legal Environment* However, the publication of a Bank Law<sup>9</sup> on 19 October 2005 (hereinafter the “Bank Law”) marked a new turning point. Indeed, Specialized Financing Institutions are now named as *participative*

activities had registered a loss of around several billions of dollars: see N. Erbakan, *Davam* (in Turkish, our translation: My Involment), Milli Gazete Ankara Kitab Kulübü, 2013.

<sup>4</sup> Undersecretariat of Treasury of Republic of Turkey, Prime Minister, *Turkey Participation (Islamic) Finance Country Report*, November 2016, p. 15.

<sup>5</sup> Circular of Prime Minister Services, n° 2015/17.

<sup>6</sup> Law n° 83/7506 of the 19th December 1983 on Specialized Financial Institutions; completed by two Decrees of the Economy Minister and one circular of the Central Bank of Turkey in 1984. The Government published more than 20 texts between 1984 and 2004.

<sup>7</sup> Undersecretariat of Treasury of Republic of Turkey, Prime Minister, *prec.*, p. 19.

<sup>8</sup> *Idem*.

<sup>9</sup> Law n° 5411 of 19 October 2005, OJ p. 25983.

*banks*, whereas the Law never refers to the Islamic Law or to the forbidden interest. Participative and traditional banks are now considered to be equal. By the way, this Law defines some Islamic credit operations and Participative Investment Account referring to the principle of loss and profit sharing.

*Definition of the Participative Bank* The Banking Law defines participative banks as *fundraising structures using Current Accounts and Participative Investment Accounts and which distributes credit to the clients*. However, this definition does not admit the legal nature of the Islamic bank operations except to the fact it refers to the definition of the participative accounts. It is important to highlight that this activity is also open to foreign banks which have agencies in Turkey.

*Underlying Islamic Contracts* According to the Sub-secretary of the Treasury of the Republic of Turkey, participative banks use under Islamic contracts in order to structure credit operation and deposits whose name and the terms of contracts are indicated in Table 12.1.<sup>10</sup>

It would be judicious to study the figures of the Market of Participative Banking (1) as well as the various factors which could contribute to this development (2) which is largely bound in the conditions of implementation of the participative banks (3) and to the legal framework of its activities (4).

**Table 12.1** Islamic contracts use in Turkey's Islamic Banks

<i>Asset</i>	<i>%</i>	<i>Liability</i>	<i>%</i>
<i>Nature of the underlying Contracts</i>			
<i>Mourabaha</i>	90	Capital	15
<i>Ijāra</i>	5	Participative Investment Account ( <i>moudaraba</i> )	70
Istiṣnā <sup>c</sup>	2	Current Account	15
<i>Salam</i>	1		
<i>Mousharaka</i>	1		
Moudaraba	1		
<b>Total</b>	<b>100</b>	<b>Total</b>	<b>100</b>

<sup>10</sup> Undersecretariat of Treasure of Republic of Turkey, Prime Minister, prec., p. 30.

## 12.2 THE FIGURES OF THE PARTICIPATIVE BANKS SECTOR

*Size in the Global Market* According to the Islamic Financial Services Board, the part of Turkish Participative Banks in the global Islamic bank market represents 2.9% in 2016. It increased to 9% in 2007.<sup>11</sup> However, other structures estimate that Participative Banking industry represents at least between 4.5% and 5% of the global market.<sup>12</sup>

*Nationwide Figures* In August 2017, there were five participative banks in Turkey, with two of them being public banks called *Ziraat Katilim Bankasi* and *Vakif Katilim Bankasi*. The three other banks are private banks: *Türkiye Finans*, *Albaraka* and *Kuveyt Turk*.<sup>13</sup>

They represented only 4.71% in April 2017 compared to the Turkish banking sector, whereas this rate was 5.32%<sup>14</sup> in 2016 and 6% in 2014, respectively.<sup>15</sup> The decrease can be explained by the liquidation of two participative banks (*Ihlas Finans* and *Bank Asya*): contrary to this, the rate could have reached 10%.<sup>16</sup> Nevertheless, the creation of two new participative banks is expected: the first will be a public bank named *Halk Katilim Bankasi* and the second will be a private sector bank.

*Dynamic Growth* In 2016, the asset of participative banks was around US\$41.417 million compared to the US\$813.412 million representing the total amount of the assets of all banks in Turkey. Those assets represented 5.1% of the total bank assets. During the same period, they raised a fund of US\$25.567 million (for a total of US\$427.778 million), and they provide US\$24.576 in the form of Islamic loan<sup>17</sup> (for a total of US\$512.333).

<sup>11</sup> Islamic Financial Services Board, *Islamic Financial Services Industry, Stability Report*, 2017, pp. 7–10.

<sup>12</sup> Turkey Participative Banks Association, *Katilim Finans*, Revue, June–July 2017, p. 3 and Ernst & Young, *World Islamic Banking Competitiveness Report 2016*, p. 12.

<sup>13</sup> [www.tkbb.com.tr](http://www.tkbb.com.tr)

<sup>14</sup> Katilim Dünyası, *Katilim bankalarının bankacılık sisteminde payı yüzde 4.71'e geriledi*, Journal of 31 May 2017, <https://katilimdunyasi.com/2017/05/31/katilim-bankalarinin-bankacilik-sistemindeki-payi-yuzde-4-71e-geriledi/>

<sup>15</sup> Ernst & Young, *World Islamic Banking Competitiveness Report 2016*, p. 12.

<sup>16</sup> Idem.

<sup>17</sup> Undersecretariat of Treasure of Republic of Turkey, Prime Minister, op. cit., p. 10.

In fact, participative banks succeeded less than traditional banks because they first have displayed a growth rate of 4.5% of the funds raised and, second, they practically doubled this rate reaching 8.2%. This lag is also present in the repartition of the credits where participative banks increased the allocated funds to 14.1%, whereas traditional banks realized a growth of 19.9%.<sup>18</sup>

*Growth of Assets, Profits and Agencies* The financial assets of participative banks grew up to 21% between 2011 and 2015, with 2.5% in four months, passing from 132,874 million of Turk lira, hereafter “TL” (in December 2016) to 136.210 million TL (in April 2017), whereas their own funds also topped up from 11,494 million TL to 11.986 million TL, which means an increase of 4.3% (for the same period).

It is surprising that for the same period, the profits significantly increased with a growth rate of 254% starting from 130 million TL to 461 million TL. In the same period, the staff employed in the banks expanded from 14,465 to 14,594 employees which means an increase of 0.9%.<sup>19</sup>

Otherwise, the number of agencies topped up from 959 to 978 with a growth rate of 2%.<sup>20</sup> Yet, in 2015, 1080 participative bank agencies were mapped—990 agencies in 2014, while the total number of bank agencies in Turkey was 12,269 in 2015 and 12,210 in 2014.<sup>21</sup>

*Raised Funds* Concerning the funds raised by the participative banks, they also augmented from 85,283 million to 92.502 million TL in five months, which is an 8% increase. However, these banks have injected 86.705 million TL in December 2016 and 91,148 million TL in May 2017. It is important to highlight that the fundraising is made with both local and national currencies (the last representing about 10% of the total of the funds raised).<sup>22</sup>

<sup>18</sup> Ibidem, p. 11.

<sup>19</sup> For example, the number of employees of Albaraka was 400 in 2001 and 3800 in 2017 (Turkey Participative Banks Association, *Katılım Finans*, préc., p. 32).

<sup>20</sup> Ibidem, p. 12.

<sup>21</sup> Undersecretariat of Treasury of Republic of Turkey, Prime Minister, préc., 11.

<sup>22</sup> Ibidem, p. 12.

*Growth Rate Expected* The Secretary of the Turkey Participative Banks Association (*Türkiye Katılım Bankaları Birliği*) has declared that the growth rate expected for the 2017 exercise is about 20%.<sup>23</sup> The rate is due by a state credit support policy: participative banks should have increased the amount of the credits from 20 billion TL to 160 billion TL this year.

*Individualized Growth Rate* Among the public participative banks, *Vakif Katılım* began its activities in February 2016. In just a year, this bank achieved a growth rate of 27% allocating loans which the total amount matches with 5.92 billion TL, with 25 million TL of profits, and raised 4.43 million TL of funds for the first quarter of 2017.

For the following year, *Vakif Katılım* will open agencies in all the 81 cities of Turkey. For the moment, the bank has 46 agencies based in 26 cities of Turkey. Its CEO explained that if participative banks represent 5% of the market, it will be a serious challenge to reach 15% by 2025, and he will be delighted to contribute to it.<sup>24</sup>

The first public participative bank of Turkey, *Ziraat Katılım*, has just celebrated its two-year anniversary. The bank has relocated 11 billion TL of funds and collected 8 billion TL, dealing at the same time several syndicated loans backed by the *Murābaḥa contract* for a total of US\$500 million and a *ṣukūk* issuance of US\$500 million. This bank has only 7% of the parts of the participative banks sector.

*Kuveyt Turk* increased its profits to 21.3% with 152 million TL during the first quarter of 2017. The total of the assets cumulated is now equal to 49 billion TL. The bank frequently issued *ṣukūk*.

*Türkiye Finans* achieved a profit of 91.4 million TL which means its profits increased to 9% at the first quarter of 2017 and have disclosed that 695.5 million TL will be relocated under the principle of profit and loss sharing.<sup>25</sup>

*Albaraka* has set up a network of 132 agencies in the country, whereas *Kuveyt Turk* has got 338. The first bank has participated to syndicated financing based on the *Murābaḥa* (the last of these unions is dated on this current year for an amount of 213 million TL) and frequently issued *ṣukūk*.

<sup>23</sup> Ibidem, p. 13.

<sup>24</sup> *Katılım Bankaları Dergisi* (Revue of Participative Banks), n° 2, avril 2017.

<sup>25</sup> Turkey Participative Banks Association, *Katılım Finans*, prec., p. 17.

*Profit Rate* Participative banks propose for their clients Participative Investment Accounts. The beneficiaries fulfilled a very good deal for their savings because the profit rate of their accounts averaged 8.18% in 2017, whereas this rate was around 7.59% last year.<sup>26</sup>

*Growth of the Chief Executives' Wage* Logically, participative banks which have realized profits consequently have well-paid their chief executives which is reflected by an increase of 32% of their wages representing an additional amount of 20 million TL. This figure shows the good health of this field, in the same time pulling critics up vis-à-vis the figures of the profit rate really relocated.

*Bank Innovations* Several bank innovations can be highlighted. These banks offer accounts based on gold starting from 50 g of gold. For example, *Albaraka* distributed 2.34 g of gold of profits on the first quarter for 100 g deposited, *Türkiye Finans* 1.96 g, *Kuveyt Turk* 1.92 g and *Ziraat Katılım* has distributed 0.6 g of gold.<sup>27</sup>

The *Kuveyt Turk* bank offers credit cards cumulating points which will be transformed into gold after purchasing with the card.

Also, in order to support the Turk economy, *Ziraat Katılım* issues securities (*sukūks*) when clients deposit gold in the bank. It should be better to enlighten that *Vakif Katılım* and the Turk Post Mail office signed an agreement for facilitating the fund transfer.

FinTech (which means a designed technology to serve finance) is expected to contribute to the development of the Islamic finance in Turkey. It uses robotics, *Blockchain* mechanisms and also the *Bitcoin*. For example, *Kuveyt Turk* set up an R&D committee in FinTech. The committee keeps an eye on the finance innovations on the markets and the start-ups alleged to add a plus-value in the bank field as the “Open Bank”. In fact, all the participative banks watch over the news about the evolutions of the sector.<sup>28</sup>

<sup>26</sup> *Katılım Dünyası*, Journal of the 1st August 2017: <https://katilimdunyasi.com/2017/08/01/katilim-bankalarinin-ortalama-kar-payi-orani-yuzde-8-18-oldu/>

<sup>27</sup> *Katılım Dünyası*, Journal of 12 may 2017: <https://katilimdunyasi.com/2017/05/12/altin-hesaplara-en-cok-kar-payi-veren-albaraka-en-az-vereni-ziraat/>

<sup>28</sup> Turkey Participative Banks Association, *Katılım Finans*, p. 59.

*The Contributions of the Participative Banks in the Economy* According to the figures displayed above, the contribution of the participative banks to the economy of Turkey should be admitted. These banks have not only supported the small and medium firms but also, according to the former Prime Minister's words, Mr Nurettin Canikli, prevented these firms from going into bankruptcy.

So, the amount of the allocated credits to the firms, supported by public authorities, reached 140 billion TL in just a year, particularly by financing companies evolving in the real economy sector.<sup>29</sup> For example, the first industrial group specialized in robotics has benefited from the principle of profit and loss sharing.<sup>30</sup> The same example is applicable for the Ertemeller group specialized in the real estate and tourism sectors.

Moreover, traditional banks have contributed to the development of the Islamic finance sector. Indeed, the CEO of HSBC, Turkey, has declared that his bank played an important role in the syndicated financing and the issuance of *şukūk*.<sup>31</sup>

*Takāful* Except the participative banks, other structures are taking part in the development of the Islamic finance in Turkey. For example, the Islamic insurance is gaining momentum in Turkey. According to the former Vice-Prime Minister Mehmet Simsek, the sector is expected to collect 180 billion TL by 2023 to reach 10% of the market share.<sup>32</sup>

*Istanbul Stock Exchange and IsDB* The Islamic Development Bank (IsDB), localized in Saudi Arabia, wants to buy equities of Istanbul Stock Exchange. The exchanges between the two actors have already begun and reportedly passed through public offer of securities of which a part should be reserved to the IsDB.<sup>33</sup>

*Stock Exchange of Real Estate Securities* During the meeting of the Member-States of the Islamic Organization, the former Vice-Prime Minister, Mr. Canikli, announced that Turkey will set up an Islamic Stock Exchange for real estate securities, when the technical works are completed.<sup>34</sup>

<sup>29</sup> Ibidem, p. 25.

<sup>30</sup> Ibidem, p. 38.

<sup>31</sup> Ibidem, p. 22.

<sup>32</sup> Ibidem, p. 20.

<sup>33</sup> Ibidem, p. 21.

<sup>34</sup> Ibidem, p. 25.



*Application in the Implantation of the “Islamic Mega-bank”* For several years now, Turkey and Indonesia have been racing for hosting the “Islamic Mega-bank” headquarters in their respective country. However, the two states show a concerted action because the IsDB has decided that the two countries should collaborate to find a solution soon.<sup>35</sup>

*Academic Works* For a harmonious development, the help of university lecturers is obvious. In Turkey, the multiplication of academic works is important. For example, the “Islamic economy workgroups” conducted at Sakarya University has hosted a great number of speakers from different countries.<sup>36</sup>

In addition, the Turkey Participative Banks Association decided to publish a book titled “The Development of Participative Banks”. This book has 12 chapters lightening its report on juridical matters and regulatory issues.<sup>37</sup> After obtaining the authorization of the Organization of Higher Education, the Social Sciences Institute of the Technical University of the Black Sea allocated a grant for a PhD student of up to 1,80,000 TL a month for a duration of four years.<sup>38</sup>

*A Cross-Border Standardization* The university lecturers will bring in their experience for translating Islamic rules published by the *Auditing and Accounting Organization for Islamic Financial Institutions* (AAOIFI). Both the last and the Turkey Participative Bank Association have signed a memorandum of understanding on 26 April 2017 aimed to translate the 58 *Shari‘a* standards. This work is supported by the Bank Control Authority of Turkey and managed by the University of Sabahatin Zaim.<sup>39</sup> The group will be composed of 17 experts and translators.

*Weakness of Participative Bank System* Nevertheless, all the political actors, economic sector and scholars have highlighted the weakness of this activity which matches with ignorance, and furthermore suspicion from the

<sup>35</sup> Ibidem, p. 22.

<sup>36</sup> Ibidem, p. 21.

<sup>37</sup> Ibidem, p. 29.

<sup>38</sup> [www.ktu.edu.tr/sbc](http://www.ktu.edu.tr/sbc)

<sup>39</sup> Turkey Participatives Bank Association, *Katılım Finans*, Revue, préc., p. 28.

population.<sup>40</sup> They want the communication about it to be simplified and better-axed forward to all the sections of the population because Turkey is a country with a very high rate of banking system usage and the needs of financing are becoming more and more significant.

### 12.3 PARTICIPATIVE BANKS SETTING CONDITIONS

*Supervisory of Participative Banks* Traditional and participative bank activities are watched over by the same independent authority (*Bankalar Düzenleme ve Denetleme Kurulu*) which is called “Bank Control Authority” or “BCA”.

This BCA has the power to control and regulate. This institution can define the significance of the legal rules.<sup>41</sup> Except all the traditional aspects linked to power,<sup>42</sup> participative banks are watched over in order to make enough profits for meeting their commitments about their clients’ return on investment, in particular, to remunerate Investment Participative Account beneficiaries.

Moreover, participative banks are subjects of a specific supervisory consisting of the quality of the assets in the achievement of a credit operation. For example, if participative bank meets financial difficulties, the BCA is empowered to increase the capital, to suspend profit distribution, to reduce credit loan or to suspend long-term investments.<sup>43</sup> To solve the deficit position of a bank, the BCA is able to set one or several preventive measures such as the liquidation of their positions on raw material market, the liquidation of fixed assets, the suspension of payments and/or the replacements of managers.

Turkey Participative Bank Association has published a recommendation with principles governing the fees of the Islamic banks. This text completes<sup>44</sup> the previous texts defending clients who can be considered as consumers for the following operations: Investment Participative Accounts, payment and credit cards, fund withdrawals, funds transfer and so on.

<sup>40</sup> Ibidem, p. 25.

<sup>41</sup> Ibidem, p. 25.

<sup>42</sup> Classically, the supervisory of banks consists of accountability and financial reports in order to reduce the market risk, credit risk, liquidity risk and rate risk.

<sup>43</sup> Article 68 of Banking Law.

<sup>44</sup> Law n° 6502 of 7 July 2013 on the protection of consumers.

Among these rules, the bank must reimburse the funds when the client requests after a conviction by a court.<sup>45</sup>

*Authorization* Obviously, a bank either traditional or participative needs an authorization from the BCA to provide its services (Articles 6–14 of Bank Law). As a result, the bank must have a public limited company with a capital of up to 30 million TL and owning shareholders under thorough transparency obligation. Indeed, Article 8 of the Bank Law defines the conditions shareholders of a bank have to fulfill: to not have been the subject of a bankruptcy or of criminal condemnation, to have a sound finance background, to have sufficient reference and competent staff. They must be upright and skillful in carrying out banking operations.

*Establishment Bank by Foreign Shareholders* Article 9 of the last Bank Law does not limit in any shape the opening of a participative bank to nationwide shareholders. On the contrary, it allows banks and foreign shareholders to enter into the domestic bank market. This means that every foreign Islamic bank willing to be established in Turkey requires an authorization that follows a specific procedure (Articles. 16–21 from the Bank Law).

*Threshold Crossing* Regarding Article 18 of the Bank Law, if the shareholder crosses over 10%, 20%, 30% or 50% of the capital of a bank, he must ask the BCA for authorization. In the same way, a shareholder must ask for authorization when he wants to decrease the rates presented above.

Indeed, both the BCA and the bank customers and partners will be notified about capitalistic operations on a participative bank notably for reasons linked to financing terrorism, money laundering or corruption. This obligation of transparency should ensure the markets or “stress” them moreover. We can take the example of the judicial liquidation of a participative bank whose shareholders owned privileged shares representing more than half of the capital, whereas their identity and their actual rights on the capital securities was not comprehensive.

<sup>45</sup> The Law n° 6361 du 13 décembre 2012 on the financial leasing, the factoring and others financing companies is applicable to participative banks. For example, the client who has the quality of a lessee has the same right imposed by Islamic Law.

*Board of Directors* A participative bank must have a board of directors composed of a CEO and four other members. This means that the board of directors cannot be composed of less than five members.<sup>46</sup> Nevertheless, a foreign bank willing to implant in Turkey requires to set an ad hoc board composed of at least three members aimed to implement all the proceeds to assure the domestic control, risk management and the compliance of the operations with the laws and regulation of the country.

*Skills of Directors* The CEO must be a graduate with at least an MBA degree in Law, in Administration or in Management. Also, he/she must have an experience of ten years in the banking sector. The other members of the Executive Board must have a graduate diploma and at least seven years of experience. Before embodying their functions, they have to declare their identity, diplomas and CV to the BCA. All the directors must be free from any court penalty and not be a subject of any personal bankruptcy.<sup>47</sup>

*Audit Committee* The participative bank must set up a three-member audit committee who are not part of the managing team of the bank. The committee has the responsibility to establish an activity report linked to internal control, to risk management and the compliance of the operations with laws and regulation.<sup>48</sup> Nevertheless, it is regrettable that the bank law does not respond to the expectation of the setting up of a *Shari'ah* audit committee.

The same remarks must apply to the designation of a *Shari'ah* audit board. Indeed, none of the participative banks have implemented this type of Committee, which will lead to, thereafter, shape critics about the Islamic validity of different operations.

*Accountable and Financial Reports* Participative banks are obliged to have a sound accountability. They must publish accountable and financial reports every year.<sup>49</sup> Concerning a banking group, it should be better to do a consolidated report.<sup>50</sup> However, none of these measures

<sup>46</sup> Article 23 de la loi bancaire.

<sup>47</sup> Articles 25 to 27 of the Bank Law.

<sup>48</sup> Articles 29 to 31 of the Bank Law.

<sup>49</sup> Articles 37 to 42 of the Bank Law.

<sup>50</sup> Article 38 of the Bank Law.

specifically administrate the case of the participative banks. This means the participative banks in Turkey are not under any particular accountable or financial constraint although the AAOIFI published standards proper to Islamic banks.

*Own Funds* Following the own funds requirements of the Committee of Basel, Article 45 of the Bank Law has determined the rate of 8%. The method of calculation of this rate is set by the BCA which also has the responsibility to define the liquidity rate.<sup>51</sup>

*Banking Secrecy* It is totally logical for customers to expect their bank to get utmost secrecy on their account. It is interesting to note the fact that the staff of a participative bank is also obliged to keep bank secrecy on bank operations but also on equity participation in another bank or which is aimed to have control of a company.<sup>52</sup> The duty of bank secrecy also spreads to the BCA, particularly in administrative and legal matters, including in the case of judicial investigations, when the collected information is not public.

*Protection of the Reputation* Article 74 of the Bank law forbids all information that affects the reputation of a bank. This is a core point in Turkey because a number of individuals convey a bias that participative banks carry out inconsistent operations with Islamic Law and fraudulent transactions because Turkey has been shaken up with several financial and industrial scandals. This article refers to the Press law which requires the providing of sufficient evidence to accuse a financial structure of unlawful achievements.<sup>53</sup> The journalists have to adopt a specific ethic.

*Ethical Principles* The lawmaker has asked the banks to respect the principles of justice, righteousness, probity and the ones referring to social responsibility. These principles are detailed by the associations and control authorities.

*Dissolution and Liquidation* Participative banks are under general rules of dissolution and liquidation of the companies in Turkey. In this case, management and control of the different steps are devolved to the “Deposit

<sup>51</sup> Article 46 of the Bank Law.

<sup>52</sup> Article 73 of the Bank Law.

<sup>53</sup> Law n° 5187 on the media.

guarantee fund” (*Tassaruf Mevduat Sigorta Fonu*).<sup>54</sup> Several participative banks have been already placed under the authority of this organization.<sup>55</sup> The budget of this institution is raised from all the banks, including participative banks.

*Allowed Transactions* Article 4 of the Bank Law has listed more than 20 transactions that are beyond the simple bank area because all the banks can, for example, achieve financial transactions concerning capital securities, raw material (gold, platinum, etc.) and also derivatives. They have the ability to allocate all types of guarantee, to provide advice to customers on a securities portfolio. This means, by the diversity of the transactions, that Turkey has made the choice of a very liberal legal framework for either traditional or Islamic banks.<sup>56</sup>

## 12.4 LEGAL FRAMEWORK OF PARTICIPATIVE BANK TRANSACTIONS

A participative bank can have numerous banking transactions. Among these transactions, there are the investment participative accounts (1), the credit cards (2) and the credits (3). But, we will finish by an explanation of the different measures for the purification of incomes, taxation and penalties (4).

### 12.4.1 *Investment Participative Accounts*

*Definition of the Investment Participative Accounts* Based on the *Mudāraba* contract, the investment participative accounts are regulated by legal texts. Indeed, the Bank Law defines, in preamble, those accounts as *accounts on which the clients of participative banks deposit funds in order*

<sup>54</sup> Articles 106–110 of the Bank Law and Articles 111–143 which are established through the principle of independence.

<sup>55</sup> The last case is Bank Asya which was accused of financing a terrorist organization led by Fethullah Gülen who has tried to bring down the Turkish government on 15 July 2016. The preparators of putsch have tried to occupy the Istanbul Stock Exchange after bombing the Parliament. The coup d’état did not succeed thanks to the resistance of Turkish People. However, there were about 148 dead and more than thousands injured.

<sup>56</sup> It is forbidden to offer banking and financial services to a person who does not furnish his name, address, tax identity and all information imposed by the regulation (Article 76 of Bank Law).

*to share the profits and losses of those banks so that the profit is not fixed ex-ante and so that the reimbursement of these funds is not guaranteed.* This definition resumes completely the most characteristic condition of the Islamic banks, knowing the fact that customers participate in the losses and profits realized by the bank which has invested their funds. The customers thus take the risk of losing their funds, even if the participative banks limit this risk and distribute profits higher than the interest rates.<sup>57</sup>

*Investment Participative Account Holders* The Bank Law allows the natural person and the legal entity to hold one or several investment participative accounts. This type of account permits to save or to put the cash flow of a company from 1 to 12 months, or from one to several years.

*Nature of the Payments* The funds can be paid in Turkish Lira or in currency (generally in USD or in Euros). The participative account can also be fed with precious metals such as gold or silver. In case of profit distribution, they can take the shape of either paper money or precious metals.

*Nature of the Funds Raised* The funds paid by the clients to the participative bank are not considered as a debt or a claim, but a capital contribution which is structured, thanks to the *Muḍāraba* contract. The rate of profit and loss sharing is fixed in the contract, for example, if the rate is 5%, the client would receive 5% of the profits or would suffer losses with the same rate.

However, the bank never sets in advance a rate or an amount of money to give to the client and does not warrant the initial fund put in the account. But, the risks of loss are lowered thanks to the setting of reserve account or the payment of bonus to the Warranty Deposits Fund.<sup>58</sup>

*Investment of the Raised Funds* Participative banks invest the raised funds according to the Islamic Law. For example, they enter into *Murābaḥa* contracts on raw materials to finance the needs of the firms or lease agreements based on the *Ijāra*. In contrast, they are not allowed to invest these funds in traditional banks or financial institutions. The profits issued by

<sup>57</sup> I. E. Aktepe, *Investment Participative Accounts in Participative Banks*, in Association of Participative Banks of Turkey, *Katılım Finans*, prec., p. 64.

<sup>58</sup> Idem, p. 65.

these transactions will be shared between the bank and its client; the profits paid to the client will be deposited in his/her participative account.

*Separate Accounts, Authorized Accounts* According to Article 60 of the Bank Law, participative banks and the other banks have the obligation to clearly distinguish the accounts. They have to distinguish between the deposit accounts, the short-term deposits and the investment participative accounts.

The conditions of using these accounts are supervised by the Central Bank. In addition, Article 60 of the Bank Law forbids all financial institution to open investment participative accounts for clients without being allowed by the BCA.<sup>59</sup> If the client becomes the holder of this type of account, he/she has to obtain a document or a contract testifying the opening of this account. None of the participative banks have the authorization to raise funds for foreign banks, foreign credit agencies or foreign financial institutions. If participative banks have proceeded to this type of transaction, the Bank Law would consider these raised funds as non-authorized, which can lead to administrative and criminal penalties.

*Obligation to Provide Information* A decree from the Central Bank of the Republic of Turkey outlined the nature of information to communicate to the clients.<sup>60</sup> This information includes the profit and loss rate applicable to participative accounts. The decree refers to the legal-form principle<sup>61</sup> following which the interest rates are freely set by the banks which open short-term accounts. These rates can differ based on classical economic indicators (interest rate performed by the Central Bank, consumption index, Istanbul Stock Exchange, etc.).

This liberty to freely set the interest rate naturally spreads to credit operations (particularly to consumer credit). Article 3 of the decree exposes the same principle of liberty in terms of investment participative

<sup>59</sup>This article excludes from its scope the participation of the moral or physical persons in the share capital of a private or public company, the payment of sum of money in a waqf, the contributions were paid in the bodies of Social Securities. It's the same for funds paid in development or investment banking or for funds paid for the operations in financial markets.

<sup>60</sup>Decree of the Central Bank of Turkey, 9 December 2006, O.J. 26,371.

<sup>61</sup>Article 144 Of Bank Law.



accounts. These rates need to be known by the Central Bank and available to the clients in the bank agencies.

*Permanent Calculation* Participative banks have to set up the amounts of the profits and losses every day because the term of the accounts differs from one client to another and needs a daily update from the bank. If the funds are withdrawn before the term of the account, none of the profits can be paid to the client even though a potential profit could have been generated. That is why it is better to wait for the terms of account to expect to gain profits.<sup>62</sup> If the participative bank had invested its own liquidities, no profit will be shared with its clients who will however not suffer from any loss.<sup>63</sup>

*Unconditional Withdrawal of Funds* Under the provisions of Article 61 of the Bank Law, participative banks do not have the right to impose conditions to their clients that would limit the withdrawal of their funds on their participative accounts. Nevertheless, it is no longer possible to withdraw the funds that are present for ten years in an account that has not registered any transaction during this time (Article 62 of the Law).

*Guarantee Funds* The existence or not of a guarantee fund is a core aspect in the Islamic qualification of a participative account. Generally, the participative account is backed to *Mudārabā* contract where the capital of the partner (*rabb al-māl*)—the client in the case of a participative account—has not been guaranteed. This means that an Islamic bank does not pay bonus to warrant the funds poured in a participative account. Also, the client must neither reclaim nor perceive any amount of money from a guarantee fund in case of bankruptcy of his/her bank according to the rules that manage the *Mudārabā* contract and the principle of the profit and loss sharing. However, the Turkish regulation imposes on the participative banks to subscribe to an insurance by paying bonus to the Guarantee Fund of Deposits. Nevertheless, the Bank Law foresees that the amount of the bonus cannot surpass 20 per 1000 per year.

<sup>62</sup>I. E. Aktepe, *Investment Participative Accounts in Participative Banks*, in Association of Participative Banks of Turkey, *Katılım Finans*, prec., pp. 64–65.

<sup>63</sup>Idem.

### 12.4.2 *The Credit Cards*

*Application of a Profit Rate* All participative banks offer credit cards. Some of them have the originality to apply a profit rate when these credit cards allow their owner the right to pay his purchasing at once or at installments. If the reimbursement of this loan exceeds beyond three months after the purchasing day, a profit rate is applicable because it is the counterpart for the bank to the allocation of credit it made, like, a consumer credit.

It is not about an interest-bearing loan, what the general conditions explicitly indicate, but it is about a loan backed by the *Murābaha mechanism*. This profit rate is generally fixed. For example, *Türkiye Finans* applies a profit rate of 2.02%. However, in its general terms of sale, there is a penalty clause with a rate fixed at 2.52%.<sup>64</sup>

*Fluctuation of Profit Rate* The profit rate is subject to fluctuate from a year to another in function of the indicators communicated by the Central Bank. In this case, the client is made aware of it in earliest convenience (generally 30 days before). In a contract, the terms suggest that if the profit rate has changed and the client has paid his loan by the 60th day of this change, this rate gap is not applicable. If the rate becomes excessive, the client is allowed to cancel the contract, as appropriate, after paying his debt which becomes immediately payable.

*Cash Advance and Withdrawal* Such a credit card can offer to its owner the possibility to demand for a cash advance from his bank adviser. If the cash advance is available, a rate of profit will also apply while knowing that it has the power to modify both the rate as well as the amount of the advance.

*Charging the Participative Account* The credit card allows, throughout the fund withdrawal, the client to use his money from his participative account or from his current account.

*Prohibitive Rates?* There are necessarily several types of credit cards (classic, gold, platinum) offered by the banks, which price is changing in function of the rights they allow and the fees they generate for the user. It is

<sup>64</sup>We refer to the Master Agreement of definitive contract proposed by *Türkiye Finans*.

worrying to note that payments and withdrawals over 1000 TL generally lead the bank to perceive commissions which rate is fixed at 1.5%. This rate is considered as prohibitive for many customers.

### 12.4.3 *Islamic Credit Operation*

A participative bank provides fund to their clients through different means (1). In order to control the participation to the capital of a corporation, there are different kinds of thresholds (2). Finally, we will study the terms of an Islamic mortgage contract (3).

#### 12.4.3.1 *The Different Categories of Islamic Credit*

*No Legal Definition* Article 48 of the Bank Law does not define credit transactions. Nevertheless, it establishes a list of operations from which we understand that credit transactions are direct or indirect provisions of fund to the customers. There are customer credit, credit to professional matter, bills of exchange, endorsements, letter of guarantee, sale of assets on credit, as well as financial instruments opening the right to the bank to demand a claim.

*Participative Credits* The list of credit transactions is stretchable because the legislators added to the list “similar operation”, what opens the way to any shape of banking innovation. However, it looks like Article L. 313–1 of the French Monetary and Financial Code, with the difference that Article 45 of the Turkish Bank Law also includes participative credit. So, are considered as being credits:

- the provisions of fund backed in movables or real property;
- the payments of the financial services related to the credit transaction;
- the investments applying the principle of the profit and loss sharing;
- the operations on the real estate, on the professional equipment and on the raw materials;
- the financial leasing;
- documentary credits backed in a good;
- the participative investments and
- similar operations.

*Variety of Credit Operation* It emerges from this list that the Turkish Law took into account the diversity of the Islamic financing. The characteristic feature of these operations is to back a good which reassures (secures) from an Islamic point of view the financing. To be able to include all transactions of Islamic financing, the Bank Law has taken care of considering as being a credit any similar operations realized by the participative banks.

This flexibility of the Turkish Law will allow to include the Islamic banking innovations, given that the criticisms focus essentially on the credits which are backed by the *mourabaha* which is a sale contract where the bank buys cash for the asset and which resells it to its customer on credit, matched by a profit margin.

*Banking Innovation* To develop credits by applying the principle of the sharing of the profit and the loss, the Association of the Participative Banks of Turkey decided to promote the credit transaction which combines the decreasing *moucharaka* (partnership contract) and the *ijāra* (lease agreement). In reality, the source of this credit is in Article 19 of the Decree applying Bank Law.

This operation aims to finance the real estate projects (residential or professional) by sharing funds bought by the bank and the customer in a participative structure, having the characteristics of a *moucharaka* (company) among which the parts of the bank decrease as the customer pays off funds moved forward by the bank. The customer has the status of a lessee of the company and which pays rents corresponding to the amount of the reimbursement. Finally, the customer stops paying rents because he acquired all the parts of the bank which withdraws by leaving the property title to the customer.

#### 12.4.3.2 *The Rules of Participation of a Bank in the Capital of a Company*

*Thresholds to Be Respected* It is obvious that the participative bank has to determine the financial capacity of its customer to honor its commitments. The scoring became, in reality, by virtue of the Article 52 of the banking law, a legal obligation following the example of the follow-up of a customer. To limit default risks, the bank can require various categories of guarantees (mortgage, personal guaranty, etc.) according to the quality of

the financed assets. The providing of credit is besides limited to ceilings as mentioned in the following:

- The amount of a single credit cannot exceed 25% of the own funds of a participative bank if the borrowers are their managers or their shareholders.
- The amount of the credit cannot exceed 50% of the own funds of a participative bank if the borrowers hold at least 1% of share capital.
- For a “big credit” when the amounts for a single borrower exceed 10% of the own funds of the bank, the total amount of this kind of credit cannot exceed eight times its own funds.

*Limit to the Participation in the Capital of a Project?* Article 56 of the Bank Law limits the participation in the capital of another credit institution. Indeed, a participative bank can hold no more than 15% of the shares of a credit institution or a financial institution, and the total amount of its participation cannot exceed 60% of its own funds.

This provision does not have to be read as a limit in providing funds which are based on the principle of the sharing of the losses and the profit. It limits the exposure to the risk of the bank in the financial sector.

*Not Absolute Limit* Article 57 of the Bank Law gives us more precision on this matter. The principle is that no bank can hold securities valued at amounts exceeding 50% of its own funds. Nevertheless, this article discharges the participative banks of this upper limit when the operations concern securities, equipment, raw materials, including financial rent and all kind of operations applying the principle of the sharing of the losses and the profits.

So, the Turkish Legislation has taken into account specificities of the Islamic bank. But, it is necessary to indicate the risks bound to this exception as far as the banking market and the financial markets seem porous which can lead to unexpected variations on the price of certain products.

#### 12.4.3.3 *The Islamic Mortgage*

*Classical Islamic Operation* Generally, mortgage serving to finance the acquisition of an apartment or a house is subject to the law relative to the protection of the consumers. For the participative banks, this kind of

credit is called “financing of the residential property matched by a fixed profit rate”,<sup>65</sup> which is the mechanism of the *mourabaha* that we kept in order to explain below the specificities of this type of financing.

*Cost of Credit* First, it is important to note that the cost of the credit is going to include not only the profit margin of the banker but also numerous expenses (inspection fees, expertise expenses, all other fees for structuring the mortgage, etc.). So, the credit agreement determines the amount of the funds provided, the rate of profit, the duration and so on.

Then, the bank takes care of including a clause according to which it is not the seller of the asset, but it is an intermediary chosen by the customer to facilitate the financing transaction. However, the bank has the right to inspect the asset, and the customer makes a commitment to pay off expenses engendered by this check. Here, the bank has to make sure that the customer really acquires a real estate which corresponds to the specifications which were communicated to the bank.

*A Doubtful Arrangement?* In the *mourabaha* credit, the bank is going to acquire the asset from the hands of the seller by paying in cash. Then, he is going to resell on credit the aforementioned asset to its customer, by applying a profit margin. The customer will pay it off by installments. However, another point which must support our critic is the fact that the bank considers that the customer got into debt toward it from the signature of the contract of *mourabaha* even though the customer does not have the ownership of the asset.

Indeed, during the first stage of this financing, the signature of the sale contract in cash concluded between the seller and the bank. After the signature of the contract of *murābaha* between the bank and the customer, the latter becomes the owner of the asset. In reality, we observe that these stages and the rules which are governing them were adapted regarding the Islamic Law. It is also necessary to note the practice of the indexation of the funds offered to a currency. It is a very controversial point by the Muslim Scholars because they consider that the indexation is similar to an interest rate.

<sup>65</sup> In this section, we refer to the mortgage proposed by *Turkiye Finans*.

*A Doubtful Qualification (or Not): Affected Credit (or Not?)* It is interesting to note that the bank specifies in the contract that the credit so granted is not an affected credit but a credit backed on an asset. The bank does not so qualify the contract in order to not support the consequences bound to an affected credit while it exposes, in the contents of the convention, the rules governing this kind of credit.

Thus, it takes care of indicating that the customer has the right to retract, to ask for a discount if the asset presents some defects, to ask for the repair of the asset or to change the asset with an equivalent one. It is rather strange to read that if the customer exercises a right previously expressed, the bank and the seller are jointly responsible. The bank underlines the principle of collective responsibility, that is, responsibility is time-limited and is valid for only one year from the delivery of the good to the customer and for the amount of credit. This obligation seems to be in compliance with the Islamic Law and in compliance with the national law.

But the contract pushes even further by specifying, on the one hand, the address and phone number of the seller and the specifications of the asset under an article entitled *Name and Address of the Seller and the Specifications of the Good, the subject of an affected credit* and, on the other hand, the right of retraction of the customer following the signature of an Agreement entitled “Agreement of cash sale” between the seller and the customer, this agreement producing its effects after the expiration of the deadline of retraction.

Here, we wonder about the reasons which urged the bank not to qualify this financing by affected credit, and the reasons of the signature of an Agreement of cash sale was concluded between the seller and the customer, while this agreement must be concluded between the seller and the bank according to the Islamic Law.

*Private Life?* There is another point in the credit agreement concerning the documents and information that the customer in case of changing the situation has to supply. Among the quoted cases, the bank requires to be informed if its financial situation has changed, if he is pursued or if he is the subject of a foreclosure.

*Reimbursement of Provided Funds and Fees* The participative bank sets up a “reimbursement schedule” and it is indicated that part of capital will be paid off by the customer and a part of the profit awarded to the bank every term.

Yet, it is specified well that the rate of profit cannot be changed. This fixed rate indeed has to remain fixed according to the Islamic rules.

Furthermore, the customer has to pay off solicitor's expenses and all the expenses moved forward by the bank to realize the operation. We wonder if the bank should not take in charge some expenses as far as it acquires the asset to resell to the customer. By the majority of the terms of the contract, the participative bank requires that all the expenses relative to the mortgage are supported by the customer.

*Indexation* It is completely interesting to read in the contracts that the provided funds can be indexed in a foreign currency (generally the USD or the euros). Nevertheless, most of the Muslim Scholars consider that the indexation on a currency is forbidden because it leads to the produced interest. But, in our case, the bank takes care of indicating that funds will be indexed the day when the funds will be reimbursed.

*Anticipated Reimbursement* When the customer decides to pay off in an anticipated way the funds provided to him, the bank makes a commitment to propose him a discount which will be naturally weighted on the profit margin which is due to the bank.

*Restructuring of the Debt* The bank and the customer can make a commitment to restructure the debt by modifying the number of term, the rate of profit and/or the conditions of the Agreement. The parties take care of it indicating that this restructuring is not a new financing and that the banker can demand a fee for restructuring where the fee cannot exceed the amount of the discount which would be granted to the customer.

*Delay Penalty* The contract determines the payment of delay penalty in the case of the customer not honoring one or several terms. The contract fixes the rate of penalty which has not to exceed 30% of the amount of the profits.

In Islamic Law, delay penalties are considered as interests which must be given to charity on behalf of the bank. Unfortunately, this point upsets the specialists of the Islamic finance who judge that this kind of conditions soils the Islamic validity of the contract.



*Failure of the Customer* If the customer is lacking and cannot pay any more, he has to find with the bank the means to pay off his debt. Generally, there is a personal guarantee or a mortgage to limit the risk of the bank.

Naturally, they can also activate the precautionary measures (restructuring of the debt) or the procedure of liquidation of the financed house. Besides, the bank grants itself the right to preempt all the securities, all the funds and all other convertible goods quickly in liquidity to recover its claim.

*Disputes* In order to solve the disputes which can arise from the contract of credit, the customer can request the mediation of a body specially dedicated to this objective or start a particular procedure behind the “Court of the consumers”. The problem is that there is no provision in the Bank Law in case of violation of the Islamic Law. Given that the Turkish Courts do not apply the Islamic Law, the participative banks insist that the customers and their litigation services request the implementation of a court of arbitration.

#### 12.4.4 *Miscellaneous*

*Adapted Tax System* Following the examples of numerous countries which welcome the Islamic finance, Turkey exempted the financing transactions of certain taxes. Such are the cases of double registration fee and fixed taxes which burden the property deals which would come to weigh down the Islamic financing. These exemptions apply in the same way to *sukūk*.

*Criminal Penalties: Prison and Fines* In case of breach of trust imposed by the Bank Law, the authors of these breaches may be condemned to 5 years of prison and a sum equivalent to 5000 “legal days” which have to multiply by 20 or 100 times regarding the nature of breaches. Also, the authors of breach of retention of the funds of the holders of the investment participative accounts can be condemned to 2 years of prison and in a sum of equivalent money in 500 legal days. The penalty is 3 years of prison and a sum of money equivalent to between 1000 and 2000 legal days in case of breach of the bank secrecy.

*Rate of Purification* The Islamic banks have to purify their income when a part of the income is generated by an operation which is not complied with the Islamic Law. So, the impure income has to be given to a charity. Article 59 of the Bank Law fixed the maximum amount to 4 for 1000 of

the own funds of the bank. It means two things: on the one hand, the participative bank has to manage its activities regarding Islamic Law, and, on the other hand, the Bank Law limits the process of purification.

Finally, Turkey, due to its geographical situation, its population and its economy, can become, in the next decades, the center of the Islamic finance on the condition of well applying the requirements of the Islamic Law, whereas the legal framework is clear enough and precise which permits a reasonable growth of the participative banks during the last decade. Supported by the government, they have an objective to reach 15% of the banking market before 2023.

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