Modern History of Islamic Finance and a Strategic Roadmap for Its Development in Turkey

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1 Introduction

Unlike many financial centres that have recently been keen to become hubs of Islamic finance by promoting Islamic financial products and services in the last decade, Turkey has more than a 30 year history in Islamic finance. The government of Turgut Özal in the 1980s introduced a number of initiatives as part of the government strategy for developing the Islamic finance industry. However, Turkey, according to an Islamic Finance Development Index report published by Thomson Reuters in 2016, is not among even the top 20 Islamic financial centres. Poor legal and regulatory frameworks and a lack of supportive government policies,

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in the period after Turgut Özal, have been major reasons for the stagnation of Islamic finance in Turkey. Moreover, increasing political pressure against Special Finance Houses (SFHs) after the so-called post-modern coup in 1997 that ousted the government at the time led to a bill proposal in 1999 regarding the inclusion of SFHs in the Banking Act aimed at obliging it to follow conventional banking principles. This would have signalled the end of Islamic banking in Turkey in legal terms if some prominent members of parliament members and leading businessmen had not objected so strenuously to the bill.

After the election of the AK Party government in 2002, the removal of political pressures on the Islamic finance industry enabled the achievement of double-digit growth over the next decade. Recently, the government has been keener to promote the development of Islamic finance in Turkey through initial steps aimed at improving legal and regulatory frameworks as well as the establishment of state-owned Islamic banks to enable further growth (Aysan et al. 2013). However, those initiatives are still far from achieving Turkey's potential to expand this market as well as to become a regional and, later, a global hub of Islamic finance.

This chapter contributes to filling the gap in the literature by investigating the modern history of Islamic finance in Turkey in detail to understand its challenges and potential and providing a general framework for designing initiatives and strategies for the development of an Islamic financial services industry in Turkey.

2 Modern History of Islamic Finance in Turkey

2.1 Islamic Banking

The enactment of the Special Finance Houses decree in August 1983 enabled the establishment of Islamic banks under the legal title of Special Finance House (SFH) as part of a plan to attract deposits from religious citizens. Bahrain-based Albaraka Türk, the first Islamic bank in Turkey, acquired a license to begin operations in 1984, while a Saudi-owned

Islamic bank, Faisal Finans, followed it in 1985. In 1988, the assets of SFHs reached 1.3 per cent of total financial assets, despite a market survey showing its potential to be around 15 per cent (Pir 1988). In 1989, another Gulf-based Islamic banking group established Kuveyt Türk (KT) in a partnership with the Directorate General of Foundations in Turkey and Islamic Development Bank based in Saudi Arabia. In 1991, the first domestic SFH, Anadolu Finans, was established by a family business group from Kayseri. In 1991, the total assets of Islamic banks in Turkey reached 2.8 per cent of total banking assets (Milliyet 1991).

In the early 1990s, the Turkish economy suffered severe setbacks from large and volatile international capital flows. Firstly, the embargo on Iraq due to the Gulf War in 1991 and Iran's reorientation of its exports to Asia and Europe led to the loss of a huge export market. Secondly and more importantly, huge requirements for public sector borrowing combined with major policy errors to finance the deficit led to the currency crash in 1994. However, Prime Minister Tansu Çiller stated that SFHs had shown better performance than conventional banks during the currency crisis in 1994 (Özgentürk 1994).

In 1995, Ihlas Finans and, 1 year later, Asya Finans became new domestically owned players in the Islamic banking industry. In 1996, a segment of the Islamic banking sector with six actors increased its penetration to 3 per cent of the industry's total. Meanwhile, MUSIAD, a well-known Islamic business association in Turkey, also attempted, yet failed, to acquire a licence for the establishment of two more SFHs, Genç Finans and Gümüş Finans in 1996 (Güngör 1996). The post-modern coup in February 1997 forced the resignation of Islamist Prime Minister Necmettin Erbakan's Welfare Party and dissolved parliament by ending the coalition government. The establishment of the new Mesut Yılmaz-led government in June 1997 was a sign of an impending period of tremendous political pressure on the Islamic banking industry while deposits, namely participation accounts of SFHs, were at their highest market share of 10 per cent of total banking deposits in 1998 (Sabah 1998). Afterward, the Mesut Yılmaz government also announced stricter regulations and supervision of SFHs not only to ensure the stability and soundness of the sector but also to remove some advantages enjoyed exclusively by SFHs, such as lower reserve ratio requirements, as a response to the political discomfort felt due to the high market penetration of SFHs (Sabah 1998). Meanwhile, Prince Muhammed Al-Faysal, as the owner of Faisal Finans, was summoned to court owing to allegations of the involvement of Faisal Finans in a deal involving fake invoices during one of its purchase and sale transactions. Thus, in 1998, Prince Muhammed Al-Faysal sold Faisal Finans to OLFO AG, a Swiss Company owned by Kombassan Holding in Turkey because of a lawsuit against him (Yeni Şafak 2002). Similarly, 75 per cent of Anadolu Finans's shares has been sold to Boydak Holding in June 1999.

Turkey went through a severe financial crisis between 1999 and 2001 owing to a financing budget deficit and a fragile banking system suffering from lack of prudential regulation and supervision, political instability, and over-reliance on foreign investment in high yield bonds. Consequently, five conventional banks filed for bankruptcy in December 1999 after the closure of interbank credit lines to vulnerable banks ended in a liquidity crisis. At the same time, a bill regarding the abolition of the SFH decree by incorporating it into the Banking Act, which disregards SFHs' need to ensure compliance with Islamic financial principles, was considered as marking the end of Islamic banking in Turkey (Milliyet 1999). However, an objection from some prominent parliament members, including Prime Minister Mesut Yılmaz, as well as complaints from well-known intellectuals and CEOs of the biggest conventional banks, enabled adjustments to the draft of the Banking Act to ensure that Islamic banks could maintain compliance with Shariah principles in business activities.

After the establishment of the Banking Regulatory and Supervision Authority (BRSA) in 2000 to regulate and supervise banks more effectively, BRSA registered 12 more banks for bankruptcy by the end of 2001. In the middle of the financial turbulence, where the soundness and the stability of all banks were called into question, insider sales of 3.79 per cent of total shares by Enver Ören, president of İhlas Finans, and news about its poor performance caused a flurry of rumours about the insolvency of İhlas Finans in November 2000 (Milliyet 2000). Moreover, a lack of corporate governance mechanisms and a large asset–liability mismatch also precipitated a bank panic. After İhlas Finans faced a liquidity crisis and could not meet depositors' withdrawal demands, BRSA revoked its banking licence in February 2001. The cancellation of its banking licence, which required the liquidation of its assets and the bankruptcy of İhlas Finans, spread panic and fear to other Islamic banks. Thus, total deposits of SFHs except İhlas Finans fell from USD1.75 billion to USD1.05 billion in just a few weeks. The lack of deposit insurance in SFHs, unlike conventional banks, incited bank runs during the financial panic, and financial assets of SFHs fell to their lowest level, 1.08 per cent of industry totals. Thus, a bill regarding the establishment of deposit insurance by SFHs was passed in the following year (Yeni şafak 2001). In May 2001, Ülker Group acquired Faisal Finans, and the name of the bank was changed to Family Finans House.

Following improvements in macroeconomic stability, decreasing political uncertainties, and the disappearance of political pressure put on the Islamic banking industry with the victory of the AK Party in the general elections, Islamic banks have enjoyed high rates of growth: the share of total Islamic banking assets rose from 1.08 per cent in 2001 to 1.83 per cent in 2002. In 2003, the establishment of state-owned Islamic banks was put on the agenda of the AK Party government through workshops managed by new board members of Ziraat and Halk Banks with Islamic banking experience (Milliyet 2003a).

In 2005, the Banking Law officially replaced the term *special finance house* with *participation banking* to enable SFHs to equip themselves with major financial instruments peculiar to Islamic banks, yet the law does not define in detail many Islamic financial contracts and products, as well as reporting, auditing, and corporate governance from the perspective of Islamic finance. In the same year, the merger of Anadolu Finans with Family Finans gave birth to Türkiye Finans. In 2007, AlBaraka Türk had its initial public offering, floating 25 per cent of its total shares. Islamic financial assets of Islamic banks rose from USD 2.4 billion in 2002 to USD 16.7 billion in 2007, with an average annual growth rate of 47.4 per cent, while its market share increased from 1.8 per cent to 3.4 per cent. As a result of promising growth rates in the Islamic banking industry and political stability under the AK Party government, investors from Gulf countries were keen to invest in Turkey's Islamic banks again. In 2007, National Commerce Bank, based in Saudi Arabia, acquired 60 per cent of Türkiye Finans.

In 2009, Istanbul International Financial Centre put the promotion of Islamic financial products and the development of Islamic financial institutions on its agenda. Islamic financial assets of Islamic banks increased from USD 16.7 billion in 2007 to USD 45 billion in 2013, with an average annual growth rate of 18 per cent, despite the 2008 global financial crisis, while its market share increased from 3.4 to 5.5 per cent. In early 2013, the government announced that two state-owned conventional banks, Ziraat Bank and Halk Bank, were planning to launch Islamic bank subsidiaries (Sabah 2013). The establishment of state-owned Islamic banks signified the AK Party government's determination not only to develop the Islamic banking industry but also to ensure the future of Islamic banks in Turkey against possible political threats by a secular government. However, the Gezi protests in May 2013, which demanded the downfall of the Erdoğan government, and the 17–25 December political crises organized by the Gülen Movement's arm in the judicial system slowed down this process. The latter event involved demands to arrest several family members of cabinet ministers, pro-Erdoğan businessmen, and the CEO of Halk Bank based on corruption charges; this led to political uncertainties and slowed down the launch of state-owned Islamic banks until the AK Party government scored consecutive victories in general and presidential elections the following year.

Following the AK Party's victory in the presidential election in 2014, state-owned companies and pro-AK Party businessmen also withdrew many deposits from Bank Asya, an Islamic bank associated with the Gülen Movement, and so Bank Asya faced a huge risk of bankruptcy, although it was the largest Islamic bank in Turkey. Consequently, between 2013 and 2015 the Islamic banking industry recorded very low growth in financial assets, at 11.8 per cent annually, and experienced a loss in market share, falling to 5.1 per cent following large-scale deposit withdrawals and political pressure that forced Bank Asya to downsize. Eventually, the banking licence of Bank Asya was revoked by BRSA on 22 July 2016 because of the significant deterioration in its financial figures (Banking Regulation and Supervision Agency 2016).

Recently, the government has become keen to introduce initiatives and launch governmental Islamic financial institutions to spur growth in the Islamic finance industry. Thus, Ziraat Participation was established in

May 2015 as the first state-owned participation bank (PB), followed by the launch of Vakıf Participation in February 2016. In 2017, the total assets of Ziraat and Vakif reached USD 4.28 billion, which represents 11 per cent of total assets of Islamic banks. However, the total share of PBs in the banking sector was still around 5 per cent at the end of 2016.

2.2 Islamic Capital Markets

Capital markets play a crucial role in the economy by channeling savings and investment from those with excess funds (such as retail and institutional investors) to those in need of such funds (such as individuals, companies, and government). This applies especially to developing countries, including Turkey, which are intensively dependent on savings and investments to maintain economic growth. However, domestic savings levels in those countries generally do not furnish the required capital. Therefore, they must develop and differentiate capital market products to attract not only domestic funds but also international savings and investments. On this point, Islamic capital markets in which activities are compliant with Islamic principles, such as the prohibition of *riba* (interest), *maisir* (gambling), and *gharar* (excessive uncertainty), provides the best opportunity to attract foreign investment to not only Muslim-majority countries but also to other non-Muslim-majority countries. In this section, the progress of Islamic capital markets in Turkey will be investigated from a historical perspective, especially focusing on recent developments, dividing the discussion into two categories: *sukuk* and Islamic indices and funds.

Sukuk

The Islamic capital market is the fastest growing constituent of the overall Islamic finance system, although it has been a late entrant into the industry, starting only in the mid-1990s. Islamic capital market instruments consist of three main sectors: Shariah-compatible indices (equities), sukuk (Islamic bond market), and Islamic funds market (e.g. mutual, pension funds) (IFSB 2015). The sukuk market comprises 15 per cent of the Islamic financial services industry and is the most widespread and known Islamic capital market instrument (IFSB 2016). Global sukuk issuances in 2012 (USD 138 billion) and in 2013 (USD 136 billion) reached peak levels; however, the market witnessed sharp decrease (43 per cent fall compared to 2014) in 2015, with only USD 61 billion sukuk being issued. The reason behind this major decline is the strategic decision of Bank Negara Malaysia to discontinue issuance of short-term investment sukuk (International Islamic Financial Market 2016). Apart from sukuk, other Islamic capital markets, such as Islamic indices and funds, have been showing significant development in recent years.

Although Turkey has recently embraced Islamic capital markets by issuing its first sovereign dollar currency sukuk in 2012, major attempts to introduce Islamic capital market products began in the 1980s. In particular, the Legislation to Promote Savings and Acceleration of Public Investment was issued in 1984 so that state institutions and organizations could issue revenue sharing certificates (RSCs), which entitle certificate holders to the revenues of publicly held infrastructure facilities such as those related to transportation and communication. The Turgut Özal government issued the first RSCs supported by revenues of Bosporus Bridge tolls in 1984 (Milliyet 1984) and later Keban and Oymapinar barrage RSCs in 1985 (Milliyet 1985).

In 2003, the AK Party government also attempted to issue new RSCs supported by the revenues from several barrages (Radikal 2003a), bridges, and highways (Radikal 2003b), but the draft legislation was merely issued in 2005 as a result of asset extensions with hydroelectric plans (Hürriyet 2005). Although there has been significant progress with new RSC issuances, the size of the RSC market continues to fall short of its potential. Another kind of interest-free certificate that is issuable by joint stock companies is the profit and loss sharing certificate (PLSC). Unfortunately, PLSCs and RSCs have not been issued since 1995 and 1996 (Capital Market Board of Turkey 2017) respectively, and these products have not been used effectively by the government or companies.

The most significant and controversial interest-free certificate is the revenue indexed bond (RIB), which was first issued by the Turkish treasury on 28 January 2009, with the aim of encouraging domestic savings, broadening the investor base, and diversifying borrowing instruments. The coupon payments on these instruments are indexed to the revenues of some state-owned enterprises including Turkish Petroleum Corporation, State Procurement Office, General Directorate of State Airports Authority, and General Directorate of Coast Safety, which is transferred to the state's budget as "Treasury Levy Payments" (REVENUE INDEXED BONDS 2017). Moreover, the yields of these securities are guaranteed within a certain range for eliminating uncertainty over fluctuations of revenues during the lifetime of the bond.

The first issuance of RIBs was followed by new issuances on 29 April 2009, 24 February 2010, 11 August 2010, 23 February 2011, and 24 August 2011. PBs were the main investors behind the RIBs, and the total amount of RIBs in their portfolios reached USD 1 billion by the end of 2011. This new instrument allowed PBs to diversify their asset structure and was used as collateral to obtain funds from the Central Bank of the Republic of Turkey (CBRT) through weekly repo transactions starting in the third quarter of 2011. However, Hayrettin Karaman, who is one of the most prominent Shariah scholars in Turkey and a member of some Shariah boards of Islamic banks, declared in his article (Karaman 2012) on 19 February 2012 that RIBs do not comply with Shariah since they are not backed by assets that create a cash flow but by coupon payments linked to an index, and therefore their return is treated as interest until they are converted into RSCs. PBs did not participate in the RIB issuance by the Treasury on 17 February 2012 because they had been informed before the article became publicly available. After this article, PBs were seen as investing in interest-based securities with ongoing 1 billion RIB portfolios and facing a Shariah risk. The uncertainty regarding Shariah compliance of RIBs continued for several months, and the Participation Banks Association of Turkey has made some announcements in order to mitigate Shariah risk ("Karaman: GES´ler devlet tahvilinden farksız" [Karaman: RIB'S are no different from government bonds.] 2018). Although this undesirable development has negatively affected PBs' credibility in the eyes of customers, it has accelerated the long-awaited sovereign sukuk issuance. The AK Party government (Hürriyet 2003) and KT (Milliyet 2003b) made some attempts to issue the first sovereign and corporate sukuks in Turkey in 2003 to attract funds from Gulf countries.

However, corporate and sovereign sukuks were not realized until 2010 and 2012 respectively by Islamic banks and the government.

Turkey was very late in entering the global sukuk market – so much so that the first sukuk issuance was done by the KT participation bank only in 2010 with USD 100 million. KT used KT Turkey Sukuk Limited as an special purpose vehicle (SPV) that was registered not in Turkey but in the Cayman Islands because of a lack of legislative infrastructure for sukuk issuance in Turkey. The Turkish government introduced legislation regarding sukuk just in 2010 and called it a 'lease certificate' since it only has to do with Ijarah Sukuk (Official Gazette of the Republic of Turkey 2010). Some amendments were made in the income tax law, corporate tax law, VAT law, stamp duty law, and charges law to eliminate tax obstacles for the issuance of sukuk in Turkey through the Finance Bill legislation for sukuks in 2011 (Official Gazette of the Republic of Turkey 2011).

A high-performing economy and close relationship, especially with Gulf countries, enabled Turkey to issue its first sovereign sukuk of USD 1.5 billion with 5.5-year maturity on 18 September 2012. The demand for the issuance was almost five times more than the actual amount. Two hundred fifty international investors (58 per cent from the Middle East, 13 per cent from Europe, and 12 per cent from Asia) invested in the sukuk. This successful issuance and strong demand directed the government to issue sukuks in USD and TRY currency regularly. The Turkish Treasury has issued 10 sukuks (three of them in USD) between 2012 and 2015. The size of the sukuk market in Turkey has reached USD 11.5 billion and TRY 3.8 billion at the end of 2015. The type of all issued sukuks is Ijara sukuk since an abundance of tangible assets of the Treasury such as public buildings enabled them the Treasury to securitize them. The issuance of sovereign sukuk had a very positive effect on the issuance of corporate sukuk and thus directed the attention of international investors to Turkey.

The Turkish government also introduced legislation to support sovereign and corporate sukuk issuances. On 7 June 2013, a communiqué ("Sukuk communiqué") prepared by Capital Markets Board (CMB) was published in Official Gazette and went into effect (Official Gazette of the Republic of Turkey 2013). The new legislation defined and enabled corporations to make use of different sukuk structures such as *mudaraba*, *musharaka*, *murabaha*, *salam*, and *istithna*. Thanks to these regulations and issuances by the Turkish Treasury, PBs have accelerated sukuk issuance in different types such as *Ijarah*, *Wakalah*, and Tier 2 and in currencies such as TRY, USD, and the Malaysian Ringgit (MYR). The total issuance of sukuk by the private sector registered with the Capital Market Board of Turkey (CMBT) between the first quarter of 2011 and second quarter of 2016 reached USD 8 billion. The positive trend in the growth of the Turkish sukuk market is expected to continue, and new actors in the market such as state-owned PBs will contribute to the growth of the market (Aysan Dolgun and Turhan 2013).

Islamic Indices and Funds

Islamic indices are a subset of global stock market securities and include securities that are free from prohibited activities and elements such as riba, maisir, and gharar, *haram* (or forbidden) business activities. The Shariah screening attempts to exclude those securities that contravene these Shariah principles. The first Islamic index was established in 1998 in collaboration with Kuwait and FTSE Group and was followed by the Dow Jones Islamic Market Index the following year. Today, there are more than a hundred Islamic indices all over the world. The volume of these indices is very low compared with conventional securities; however, they have been outperforming conventional ones in recent years.

The Dow Jones Islamic Market Turkey Index was first calculated on 30 September 2004, with companies trading on the Istanbul Stock Exchange (Borsa Istanbul-BIST) and compatible with Shariah investment guidelines. However, this index was not registered with BIST. Some attempts were made to establish an Islamic index in Turkey by BIST, but they did not work out and were postponed because of the global financial crises. The first Islamic index that was created domestically and registered with Borsa Istanbul, namely Participation Index 30 (PI30), was established in 2007. It is composed of 30 companies traded on the Borsa Istanbul and complies with Islamic banking principles. This PI30 was followed by the PI50, introduced in 2014. PI30 has outperformed the BIST 100 index in the period 2011–2015, and the compound annual growth rate (CAGR) was 10.6 per cent (CAGR of BIST 100 was 8.8 per cent during the same period).

The availability of sukuk and Islamic equity indices has accelerated the formation and development of Islamic funds. More than a thousand Islamic funds operate in the world with assets under management valued at over USD 70 billion (IFSB 2016). In Turkey, the Islamic funds market has gained momentum thanks to the development of Islamic capital market instruments such as lease certificates and a participation index (PI).

Kuveyt Türk is very active in gold banking and has channelized this experience to the Islamic funds market. It has established two exchange-traded funds (ETFs), a type B gold ETF and type B silver ETF. In 2015, KT also established KT Portfoy as a fully owned subsidiary, which has become the first portfolio management firm ever to be established by an Islamic bank in Turkey. Apart from providing private portfolio management and investment consultancy services to its clients, KT Portfoy also deals in collective investment products. KT has been forming various types of mutual funds such as global (foreign currency) and local (TRL) lease certificate funds, participation funds, and others. Another important market player in Islamic capital markets is Bizim Securities Inc. This company also manages a wide range of mutual funds such as a participation fund, lease certificate fund, participation stock fund, PI30 fund, and gold ETFs. Apart from these two companies, leading conventional asset management companies have also formed interest-free mutual funds ranging from lease certificate to participation stock funds.

2.3 Takaful (Islamic Insurance)

While the first implementation of *takaful* started in Sudan in 1979, Malaysia, Saudi Arabia, and other Gulf countries also launched takaful businesses in subsequent years. Global takaful assets reached USD 38 billion in 2015 and were mainly driven by the top three countries, Saudi Arabia, Iran, and Malaysia, which together hold 85 per cent of total global assets. Saudi Arabia is the largest takaful market, and its insurance market is based fully on a cooperative insurance model, after the conversion of its insurance sector and the introduction of the law on the Supervision of Cooperative Insurance Companies in 2002 (World Takaful Report 2016). Considering that total Islamic financial assets reached USD 2 trillion, the takaful market has only around a 1.5 per cent share of the total market, yet it has enjoyed double-digit growth in the insurance and takaful markets, especially in Malaysia and Gulf countries.

In Turkey, the takaful concept was initially discussed by the Congress of International Islamic Commercial Law in 1996 (Yusuf 1996). In 1995, Işık Insurance was the first company to apply takaful in its business. However, it was only able to invest in interest-free financial instruments for the collected funds, yet there has been no official announcement regarding whether the company applies the takaful concept in its business model or not. The first takaful company in Turkey was Neova, a subsidiary of KT, established in late 2009. The takaful assets of Neova reached almost 2 per cent of the Turkish insurance market within 7 years. What is more, the higher-than-average growth rate of takaful premium payments as a share of Neova's business in the insurance industry holds great potential for the takaful market in Turkey. Doğa Insurance, a cooperative insurance company, began to offer takaful products through its takaful window in 2015 (Milliyet 2015). Shortly after its establishment, Ziraat Participation also started to offer takaful products by acting as an agent of Ziraat Insurance's takaful window (Katılım Sigortacılığı [Participation Insurance] – Ziraat Sigorta A.Ş. 2016).

Even though potential is assumed to exist for the Turkish takaful market (EY Takaful Insight 2014), there is as of yet no law or regulation governing takaful companies. Thus, no company is defined as takaful under Turkey's insurance law. However, the lack of a legal infrastructure poses no legal obstacles for the operation of takaful companies and takaful windows in Turkey. However, the reputation and public image of current takaful companies and windows can be damaged unless government immediately issues comprehensive legislation and regulations to define business model and activities regarding takaful companies. Takaful companies were defined as 'participation insurance companies' in the proposed omnibus bill in 2014. However, Article 29, which covers this definition, was removed before passage of the omnibus bill.

2.4 Islamic Pension Funds

A private pension system (PPS) was introduced in Turkey as an alternative to the governmental social security system in 2003. A total of 3.1 million individuals subscribed to the PPS between 2003 and 2013, in addition to the 2 million people who enrolled after major amendments were made to the system in 2013. The government has considered the PPS one of the best instruments contributing to Turkey's economic growth using savings in pension funds. Therefore, the PPS is a win-win system that will benefit both the country and retirees. Thus, the government has also provided an incentive to PPS participants with a 25 per cent contribution. Recently, the government established a new system called 'automatic participation', which obliges companies with more than 250 employees to participate in the PPS. Enforcement of the mandatory PPS commenced in early 2017 (Milliyet 2016).

An Islamic private pension fund was first launched in Turkey by Türkiye Finans under the name Organic PPS. The company cooperated with Garanti Private Pension, a conventional private pension company that offers fund management for Türkiye Finans, in 2010 (Milliyet 2010). Several conventional companies, such as Anadolu Hayat Pension, also started offering Islamic funds in 2010 (Alternative Earning Fund – Anadolu Hayat 2016). The first Islamic private pension company, Asya Pension, was established in 2011. Katılım Pension was established in collaboration with Albaraka Türk and KT in 2013. The Capital Markets Board passed important regulations governing PPS in 2013, one of which is the introduction of non-interest methods as seen in the participation banking system. Although the system is quite new, 370,000 individuals are now increasing the value of their savings with such accounts. There is a fund of around TRY 1 billion in these accounts alone; it was launched in 2015 (Daily Sabah 2015). Two state-owned Islamic banks also started offering Islamic PPS products in collaboration with their conventional counterparts in 2016.

Life insurance and private pension products are generally offered by the same companies in Turkey. The issue of life insurance is more controversial than non-life insurance in terms of Islamic law. Vakıf Pension offers some products for Türkiye Finans called profit sharing participation insurance (Kâr Paylaşımlı Finansman Güvence Sigortası [Profit Sharing Financial Security Insurance] Türkiye Finans 2016). This product targets those who use Islamic financing but may face default risk. Other Islamic private pension companies also offer a similar product that mainly offers protection against default risk. Life takaful products are not well developed in Turkey compared to other Islamic countries. Islamic PPS is more popular for long-term investments and savings. However, the PPS cannot offer insurance in case of death or accident. Thus, family takaful products need further development in Turkey.

Insurance and PP companies are regulated and supervised by the Turkish Treasury. Recently, Osman Çelik (Habertürk 2016), whose background is in Islamic finance, was appointed head of the Turkish Treasury. This new assignment is expected to bring new regulations for takaful and Islamic pension companies.

2.5 Islamic Microfinance

Today eradicating poverty is on the agendas not only of the least developed or developing countries but even of developed countries. Various policies and development strategies of banks have already been implemented by governmental and international institutions and monitored to reduce the poverty level. Microfinance is seen as a significant tool for poverty reduction through the financial empowerment of entrepreneurs and small businesses, which are generally excluded from financial services by conventional financial institutions because of their high-risk profile. Microfinance has proved that the poor can also be financed with a low rate of default, contrary to the general perception, and it can be profitable for financial institutions. Although microfinance started in the 1970s as non-governmental organization (NGOs) with the support of donors but was ignored by formal financial institutions, today even commercial banks are providing small loans especially for the economically active poor through their subsidiaries. It is estimated that more than 10,000 microfinance institutions (responsAbility 2014) ranging from NGOs to microfinance banks are operating and serving millions of people.

While some state-owned banks such as Ziraat and Halk Bank have been providing microcredit to low-income people, especially microenterprises, for a long time, there are two so-called microfinance institutions, MAYA and Turkey Grameen Microfinance Programme, in Turkey. Microfinance institutions in Turkey provide not only financial services such as credit and savings to their clients but also other non-financial services such as education and training. In addition, some public institutions provide loans and charitable donations to low-income people and microenterprises.

One of the main objectives of Islamic finance is to enable distributions of wealth justly by providing financial services not only for wealthy people but also for all segments of society. However, Islamic financial institutions have been diverging from this objective by becoming more like their conventional competitors, although the first modern Islamic bank, Mit Ghamr in Eygpt, was very similar to today's microfinance institutions in terms of providing financial services to low-income people. However, current Islamic banks ignore poor people as conventional counterparts and exclude them from financial services. Therefore, Islamic microfinance institutions have been developed especially in Muslim countries to fill the gap between poor people and Islamic finance.

Although it is asserted by Çizakça (2003) that the first microfinance institutions in the world are cash *waqfs*, an institution what dates back to the fifteenth century under the Ottoman Empire, Islamic microfinance in Turkey is a very new concept and no institution exists for the sole purpose of extending interest-free microfinance to low-income people. Some institutions, such as KOSGEB, extend interest-free credit to microenterprises/small and medium-sized enterprises and insure credit without interest. PBs currently provide financial services to small and medium-sized enterprises; however, there is a need for a more strategic perspective that includes operational adjustments (Aysan et al. 2016). PBs also have small microloan portfolios in their total credit profiles. However, their strategy of targeting the upper segment of poor people, not the poorest of the poor, is one of the most significant criticisms of microfinance institutions globally.

3 Policy Recommendations

Although the Islamic banking industry, with its more than 30-year history, has proved so far that it holds great potential in Turkey, its market share was still less than 6 per cent in 2016. As we have seen, many large-scale failures have led to severe shocks in Turkey's Islamic banking industry and damaged confidence that prevented it from gaining further momentum. Many problems in the Islamic finance industry still need to be addressed by actors in the industry and by government. That is why the market share of Islamic banks is still much lower than past forecasts and polls of market potential had predicted.

In the first decade of Islamic banking, high demand and lax regulations enabled high growth in the industry; at the same time, these very features exposed SFHs to higher risks through the use of a wide range of Islamic financial products whose risks were poorly understood because of poor corporate governance and low capital holdings.

Initially, the Islamic banking industry in Turkey went through a period of high volatility in assets as a result of losses due to poor management of liquidity risk, Shariah non-compliance risk, investment risk, operational risk, and credit risk. Since a lack of familiarity with the inherent risk of Islamic financial products and the absence of tools and control mechanisms to manage those risks decrease the profitability and damage the reputation of the industry, Islamic banks, regulatory bodies, and universities must conduct comprehensive research and policy analysis over the relevant risks of Islamic financial products and improve appropriate risk management mechanisms to ensure the financial stability and sustainable growth of the industry.

Risk sharing is a significant concept in Islamic finance, yet the early development of the Islamic banking industry in Turkey pushed the excessive use of debt-based contracts of *murabahah* and *ijarah*, particularly for more than 90 per cent of funding activities. On a relevant note, fixed-return investment products were almost the only option for investors.

Thus, improvement of higher profit-loss-sharing-oriented products on the liability side and providing more *mudharabah*- and *musharakah*-based financing on the asset side will attract more borrowers and lenders with higher risk appetites.

Since Islamic banking is based on trading such as the purchase, sale, or lease of assets, Islamic banks are exposed to tax disadvantages compared to conventional banks. Tax disadvantages arising from the asset-based structure of Islamic banking should be removed to ensure a competitive environment for Islamic banks in Turkey. Moreover, some Islamic financial products can be promoted by the government by providing special tax benefits as part of relevant tax reforms.

In the Turkish secularist narrative, the word 'Shariah' has always been a buzz-word that has generated fear. That is why, although all activities of Islamic banks must be consistent with Shariah principles, even referring to them as Islamic banks has led to legal concerns in the context of Turkey's brand of secularism. Similarly, such a concern regarding infringements on secularism led PBs to use the term 'advisory committee' rather than 'Shariah Board' and 'Shariah Advisory Council'. Moreover, advisory committees and their fatwas, which plays a key role in ensuring compliance of financial activities with Shariah law, are mostly not publicly available, even though their members are supposed to be well known and fatwas regarding Islamic financial products and activities must have been more transparent and in harmony with the majority rulings of other Islamic banks in the Gulf and South-East Asia regions. However, the presence of contrasting fatwas by different Islamic banks in Turkey and Islamic financial products that are available only in Turkey is also common. That is why Shariah non-compliance risk is one major issue facing Islamic banks and has not only caused financial losses so far but has also severely damaged the reputation of the industry. Therefore, the establishment of a central Shariah authority, implementing external Shariah audits and standardization of Islamic financial products, would facilitate the growth of Islamic banking in Turkey.

Although Islamic and conventional banks seem to have a similar function as financial intermediaries by channeling funds from savers to spenders indirectly, the majority of Islamic financial products and types of contracts are different from their conventional counterparts. However, Islamic banks in Turkey use International Financial Reporting Standards (IFRS) as accounting standards to record Islamic financial transactions, despite the fact that IFRS does not have accounting rules for many types of Islamic financial contracts. What is more, IFRS accounting statements for conventional banks are heavily reliant on the concept of the time value of money, and such a practice is strictly forbidden under Shariah law. For this reason, other countries such as Pakistan and Malaysia use additional Islamic accounting standards alongside IFRS for Islamic banks, while some Gulf countries prefer to apply the guidelines of the Accounting and Auditing Organization for Islamic Financial Institutions as a completely separate set of Islamic accounting standards.

The development of Islamic financial institutions in Turkey is closely related to government support in various aspects. Firstly, the improvement of the legal framework for Islamic financial institutions will make it possible to resolve current legal disputes more effectively. Secondly, more engagement by state-owned companies with Islamic banks in their financial activities will help spur the growth of Islamic finance. The Treasury and central bank should use Islamic financial products more to improve risk management mechanisms and catalyze the growth of the industry. Government should support the establishment of Islamic finance programmes in universities to fill the skills gap in human resources and improve Islamic finance practices through academic researchers. Attracting foreign Islamic banks and increasing the number of state-owned banks will also enable the further penetration of the market since Turkey has the lowest number of Islamic banks compared to its peers in South-East Asia and the Middle East. Finally, the government must ensure that in the context of secularism in Turkey, Islamic financial institutions are never considered a threat to secularism by clarifying the concept of secularism more precisely since Islamic banks suffered severely from political risks in the past.

Compared to Islamic banking, less attention has been paid to Islamic capital markets in promoting Islamic finance in Turkey. However, recent initiatives such as sukuk issuances and incentives for the PPS have shown that developments in capital markets are quite positively affecting Islamic banking and complement each other. Although the Islamic capital market of Turkey has been showing remarkable growth rates in recent years –

which is expected because of a very niche market that values this –much remains to be done to reach the desired level in the development of the Islamic finance industry and particularly in the Islamic capital markets in Turkey.

Private-sector companies such as Islamic banks, asset management companies, and pension funds are making efforts to diversify their products and increase their market penetration. However, new financial service providers, especially in the Islamic fund market, which is relatively niche, offer significant opportunities for attracting foreign investment and catalyzing economic growth. The private sector should also take more responsibility for the development of new products through their relatively greater openness to innovation compared to state-owned financial institutions. South-East Asian countries, especially Indonesia and Malaysia, are very innovative in Islamic capital market products and should be emulated in Turkish regulations and structures. Not only the private sector but also the government has a great responsibility to ensure positive trends in the Islamic capital markets of Turkey. Supporting the role of government is the key determinant in the progress of Islamic capital markets. The Malaysian experience – a pioneer in Islamic finance, especially in capital markets – shows the key role of government in promoting the sector by, for example, introducing needed regulations, providing services as a market player, and issuing capital market instruments with high credit ratings. In recent years, the Turkish government has indeed begun working hard to formulate a strategic role of Islamic finance in its development programme and in supporting the sector.

Sukuk issuances by the Turkish Treasury have played a significant role in deepening the sukuk market and triggering the formation of a secondary market, which is vital, especially for PBs, for liquidity management. New state-owned PBs will also contribute to the sukuk market by being not only suppliers but also investors. Legislation governing sukuk issuances introduced by the CMBT has paved the way for new issuances and the establishment of SPVs; however, the private sukuk market has still been driven by Islamic banks, which make up the demand and supply sides. Other corporations have not shown the expected interest in sukuk, and corporate sukuk issuances are very low. The main reason behind this is that legislation, especially tax law and procedures, is not easy to understand, and Islamic banks have had difficulties in clarifying the process. This problem has had two negative results for corporate sukuk issuance. Firstly, it has prevented companies from issuing sukuk; secondly, uncertainties increase the cost of issuing because of consultancy fees. Therefore, legislation especially regarding tax issues should be simplified and clarified, on top of incentives such as tax reductions. It should also be noted that companies must make issuance through SPVs, which also increases costs, bureaucracy, and the issuance period. This should also be reviewed by taking into consideration the stability of the market and the health and needs of companies.

The volume of the sukuk market in Turkey is very low. Thus, the secondary market of sukuk has not been developed as expected and remains far from desired levels. New strategies must be developed for domestic and international issuances in order to deepen the market. In recent years, Turkey has carried out high-budget projects such as a third airport, a bridge, and an undersea tunnel. At least some part of these should be financed by issuing Islamic capital market products such as sukuk and RSCs to entice international and domestic investors into contributing to and strengthening the market. Also, issued sukuk for the financing of infrastructure projects should be traded on the Borsa Istanbul. Investing on a secondary sukuk market should be encouraged by introducing tax advantages, especially for individual investors.

Although Islamic equity and fund markets in Turkey are new, market is still in its infancy compared to its potential. A PI provides Shariah-compliant investment opportunities in a stock market, which the majority of Muslims have avoided for many years. Moreover, the fact that Shariah-compliant equities can outperform their conventional competitors will attract more investment into the PI. However, the features and performance of the PI are not well known, and many people are not even aware of its existence. Thus, education and awareness regarding Islamic equity markets are critical for the development and growth of the market.

Capital market investors are quite sensitive to macroeconomic developments. Apart from the evaluation of a company/product, they analyse macro variables such as political stability, legal infrastructure, and credit ratings in detail. All relevant stakeholders ranging from government to

PBs have great responsibilities for the development of the Islamic finance industry in Turkey. In particular, the coordination of related public institutions such as the Treasury, CBRT, BRSA, CMBT, and BIST has a vital role since regulations or incentives may not be effective without price stability or an investable credit rating. Some board members and presidents of three key institutions, CBRT, BRSA, and Treasury, have many years of experience in Islamic banking and they can play a significant role in promoting the development of Islamic finance in Turkey more effectively.

Turkey has significant potential for Islamic microfinance, and 36 per cent of the population is economically vulnerable (Grossman 2006) – the main target of microfinance. Moreover, around 3 million Syrian refugees live in Turkey, and the government is planning to grant citizenship to some of them, which may add to the demand potential of microfinance. PBs can benefit from this potential and develop suitable products for the refugee population. In the short run, it may be expected that there will be limited return, yet in the medium to long run, some of them may turn into profitable customers. Thus, the objective of PBs is to attain a 15 per cent market share in the total banking sector, and this can be achieved by appealing to low-income people. A new state-owned PB, Vakıf Katılım, which was established by charity endowments to have a social impact and earn spiritual rewards for its founders, should serve the poor not only by spending company profits but also by extending them credit as customers.

In Turkey, takaful has a very low market share, around 1 per cent, of the insurance industry. Thus, the development of takaful in Turkey will take longer than other Islamic financial institutions. The situation is similar in the conventional finance sector. Firstly, takaful companies need a legal definition that differentiates them from other insurance companies. Secondly, agency training is very important in takaful, considering that contracts have an important role in the takaful business. Insurance and takaful agents should provide information that clarifies the differences between takaful and conventional insurance. This issue can be resolved easily by adding a module to the agency technical personnel exam, which is obligatory for all insurance agents. Several PBs still work as agents for conventional insurance companies. To develop a better image in society and eliminate misconceptions, PBs should provide takaful products only at their branches. Retakaful, which is a kind of Islamic counterpart to reinsurance, needs to be established in Turkey. The government may lead the establishment of the first retakaful company not only to increase the number of takaful companies for catalysing growth of the takaful market but also to improve the public image of and trust in the takaful market. Deepened Islamic capital markets are a necessity for family takaful and private pension funds. In particular, long-term sukuks can greatly contribute to the development of takaful and a PPS.

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