

Islamic finance: interest free banking in Turkey

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In the last decade, importance of Islamic banking institutions has increased not only in the Islamic countries but also throughout the world. The term 'Islamic finance' refers to a system of financing or financial activity that is consistent with Islamic rules and principles. The model outlined under Islamic finance is based on two main understandings: sharing profit and loss and prohibition of charging interest. Islamic finance does not accept lending of money against a pre-determined risk free/guaranteed growth, in other words interest. To avoid lending of money against interests, Islamic finance is structured on asset-based finance, partnership, and shared risk and reward principles.

In order to adapt to the secular system in Turkey, Islamic finance appears as 'interest free banking' in Turkey. Turkey has been using Islamic finance techniques since late 1980s however; interest free banking system in Turkey is not fully compatible with specifications of Islamic finance. Financial institutions whose services and products are in such a manner compliant with Islamic law are called "participation banks" in Turkey. Formerly, these institutions carried out their activities as "special finance houses"; upon enactment of the Banking Act No. 5411 on November 2005, special finance houses became participation banks. As being part of banking system in Turkey, participation banks have to operate in line with the Banking Act.

Participation banks are supervised by the Banking Regulatory and Supervision Agency. They are also subject to control of the Savings Deposits and Insurance Fund. The '*Shariah* board', which plays an important role and supervises Islamic transactions as to compliance with Islamic rules, does not legally exist in Turkey. Instead, participation banks maintain an independent advisory board to ensure that all their products and services are compliant with *Shariah* principles. This advisory board approves services and products before it is made available to customers. However, advisory boards do not participate in corporate governance or credit decisions of participation banks and Islamic compliance is not *per se* considered as a requirement under the Banking Act.

Participation banks are authorised to perform all banking activities in traditional sense except collecting deposits. Instead of deposits, participation banks are authorised to collect funds under

"special current accounts" and "participation accounts". Special current accounts consist of funds that can be partially or fully withdrawn upon request at any time and for which no charge is paid to the owner of the account in return. Participation accounts are constituted by funds collected by participation banks that yield the result of participation in the loss or profit to arise from their use by these institutions, that do not require the payment of a pre-determined return to their owners and that do not guarantee the payment of the principal sum. Therefore, no pre-determined return can be paid to account owner nor can a guarantee regarding payment of the principal sum be given in return for participation.

Participation banks are involved in commercial and retail banking. They issue letter of guarantee, documentary letter of credits, conduct exchange transactions and money transfers. As a comparative advantage to conventional banking, participation banks are allowed to carry out financial leasing activities without having a separate licensed company for this purpose. In addition, limitations which apply to conventional banks regarding owning or trading immovable property do not apply to participation banks in case such transactions are conducted in the course of providing finance through financial leasing, profit and loss sharing partnership or joint investment operations. Due to the principal feature distinguishing participation banks from conventional banks, which is not paying or receiving interest in their activities, they do not maintain government securities portfolios. Loans from participation banks are also structured as interest-free products. Instead of paying interest on principal, borrowers repay principal plus a set premium/profit.

Addressing the difference between interest in conventional banking and premium/profit in Islamic finance is complicated. Indeed, differences in nature of underlying transactions have to be examined. Basically, the nature of funds used is different; in Islamic finance there is profit-sharing accounts rather than deposit accounts that promise an interest rate of return. In addition, in Islamic finance when premium/profit is set generally it does not float during the term of a loan or it does not even change in case of late or non-payment. Furthermore, in Islamic finance the principles underlying Islamic finance products also largely dictate the purposes for which loans can

be given and procedure by which loan proceeds are extended. For instance, loan proceeds may not be used for purposes or products deemed to be unethical, including, expenditures for or related to alcohol, tobacco and gambling; loan proceeds may only be used for purposes of production support and for paying certain service providers, so long as such services were rendered in connection with the acquisition of permitted tangible products. So as to ensure compliance with these principles funds are essentially disbursed directly to provider of products and services or transferred to the borrower's account but then automatically debited and transferred to vendors. Generally, participation banks try to abide by these principles which are not *per se* required by the Banking Act.

The Banking Act sets forth rules on, including but not limited to, incorporation of banks, collection of funds and financing activities, acquisition and transfer of shares in banking sector, lending limits, loan loss reserves, capital adequacy reserves, auditing and cancellation of banking license which do also apply for participation banks. Specific rules and regulations related to participation banks are quite limited under Turkish banking legislation, since structuring, marketing and

supervising of Islamic products are not regulated. Participation banks may use Islamic finance instruments to the extent such instruments are consistent with the Turkish legislation. Accordingly, usage of Islamic finance instruments in Turkey is relatively inadequate.

Commodity *murabaha* is the most common transaction used by participation banks. It provides finance to purchase tangible assets whereby product is purchased by participation bank and sold to customers with deferred payment with a premium reflecting bank's profit. Although this financing offers enough flexibility to be used in real estate and project financing, historically it has been used primarily for trade finance. While using *murabaha*, participation banks observe compliance with *Shariah* rules. Accordingly, the purchase price is directly paid to seller, cash may not be disbursed to customer of the bank; there should be a genuine purchase and sale of a tangible product which may freely be traded under Islamic rules; even an indirect relationship between purchaser and seller is not permitted, products or services may only be purchased from a third party; and purchase price may not be increased in case of late payment or reduced in case of prepayment. Furthermore, participation accounts

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have to be used to fund such purchases. Although the Banking Act differentiates participation banks from conventional banks in terms of sources of funds, it does not stipulate any distinction in the usage of such funds. Therefore, there is no restriction to conduct *murabaha* transactions for conventional banks under Turkish legislation.

As participation banks are permitted to engage in profit and loss sharing partnership or joint investment operations under the Banking Act, they may also conduct *mudaraba* and *musharaka* transactions in line with the said act. In *mudaraba* transactions, participation banks provide the entire capital to finance an investment and customer manages the agreed trade activity. The profit distribution ratio for customer and participation bank is clearly pre-defined yet the actual amount of profit remains uncertain. *Musharaka* transaction is similar to *mudaraba* in terms of investment financing. However, in *musharaka* both parties, participation bank and customer contribute to required capital amount for proposed investment and jointly manage the investment. The profit ratio is determined according to the amount of contributed share capital. Participation banks may also use *ijara* (lease-to-own) as an Islamic finance instrument as they are authorised to do financial leasing. However, such transactions have to be primarily in line with the Turkish Financial Leasing Act.

An important Islamic finance instrument, *sukuk*, has not yet entered into reach of participation banks in Turkey. *Sukuk* is the equivalent of bond in conventional banking with differences arising from Islamic finance rules; mainly it is a bond without a pre-set

interest. Technically, under Islamic law it may be called as securitised assets and it operates similar to asset backed securities. The Banking Act does not prohibit issuance of securities, moreover asset backed securities were introduced in 1992 in Turkey with Capital Markets Board legislation; the Capital Markets Board legislation permits asset backed securities for consumer credits, real estate credits, receivables from financial leasing contracts and receivables arising from export transactions. Therefore, with minor changes in Capital Markets Board legislation and thus allowing securitising receivables from genuine commercial transactions and with approval of *sukuk* products by advisory boards of participation banks, financing through *sukuk* may be achieved in Turkey.

With the recent merger in the sector, there are currently four participation banks in Turkey. The share of participation banks in Turkey is 5.7% and it is expected that this share would increase up to 10% within the next couple of years. The expected growth may be supported and accelerated by open minded approaches of advisory boards and by introducing secondary implementing legislation related to participation banks and their products.

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