

**THE REGULATORY FRAMEWORK AND STRATEGY
OF PARTICIPATION (ISLAMIC) BANKS IN TURKEY:
ISSUES AND CHALLENGES**

BY

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A thesis submitted in fulfillment of the requirement for the
degree of Doctor of Philosophy in Islamic Banking and
Finance

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ABSTRACT

Despite having a long history of Islam, not much research has examined Participatory (Islamic) banking in Turkey. The legacy of strong Islamic law, the majority Muslim population, and the strategic location of the country have not been able to boost the market share of Participation banks in this country. This research has explored the issues and challenges faced by Participation banks, especially on legal and regulatory framework and propose strategies for developing them. This study is a qualitative study as a main method that takes data from various works of literature, namely books, journals, and other sources. Primary data also been explored by conducting in-depth interview with the experts regarding these issues. The interview is conducted in three big cities in Turkey, namely Istanbul, Konya, and Ankara in December 2019. Basically, they were bankers, Islamic scholars, participation bank officers and academicians. Meanwhile, this research also applied a quantitative approach to answer the fourth (the last) question of the research objective. Analytic Network Process (ANP) was used as the method of analysis. This research found that government support stands as the first priority from opportunity aspect. Islamic bank in Turkey also needs to be aware on the absence of separate law as the main priority of threats aspect. Another finding shows that separate law and regulation is the main strategy to enhance participation banks in Turkey. This study could serve as reference point for the regulator in formulating appropriate policy strategies to increase market share of participatory banks in Turkey. This research is also expected to be able to contribute to enriching scientific studies in an effort to popularize Islamic banking in Turkey.

Keywords: Participation Bank, Turkey, Issues and Challenges, legal and regulatory framework, Strategy.

ملخص البحث

على الرغم من وجود تاريخ إسلامي طويل، لم تفحص العديد من الدراسات المصرفية الإسلامية في تركيا. لم يتمكن الإرث القوي للشريعة الإسلامية، وأغلبية السكان المسلمين، والموقع الاستراتيجي للبلاد من زيادة الحصة السوقية للبنوك الإسلامية في هذا البلد. تستكشف هذه الدراسة المشكلات والتحديات التي تواجه البنوك الإسلامية، لا سيما في الإطار القانوني والتنظيمي وتقتراح استراتيجيات لتطويرها. يعتبر هذا البحث بحثاً نوعياً كأسلوب رئيسي يأخذ البيانات من مختلف الأعمال الأدبية من كتب ومجلات ومصادر أخرى. تم استكشاف البيانات الأولية أيضاً من خلال إجراء مقابلات مباشرة مع خبراء حول هذه القضية، والتي كانت موجودة في ثلاث مدن رئيسية في تركيا في ديسمبر 2019. وهم في الأساس مصرفيون وعلماء ومسؤولون في البنوك الإسلامية وأكاديميون. وفي الوقت نفسه، تطبق هذه الدراسة أيضاً نهجاً كمياً للإجابة على السؤال الرابع (الأخير) من أهداف البحث في هذه الرسالة. تم استخدام عملية الشبكة التحليلية (ANP) كطريقة للتحليل. وجد هذا البحث أن الدعم الحكومي هو الأولوية الأولى من ناحية الفرص. تحتاج البنوك الإسلامية في تركيا أيضاً إلى أن تكون على دراية بغياب قانون منفصل كأحد جوانب التهديد. تشير نتائج أخرى إلى أن التشريع المنفصل هو الاستراتيجية الرئيسية في التعامل مع هذه المشكلة. في الوقت نفسه، يقترح هذا البحث قوانين ولوائح منفصلة كاستراتيجية رئيسية لتحفيز تطوير الخدمات المصرفية الإسلامية في تركيا. يمكن أن تكون هذه الدراسة بمثابة مرجع للمنظمين في صياغة استراتيجيات السياسة المناسبة لزيادة الحصة السوقية للبنوك الإسلامية في تركيا. ومن المتوقع أيضاً أن يكون هذا البحث قادراً على المساهمة في إثراء الدراسات العلمية في محاولة لنشر الخدمات المصرفية الإسلامية في المستقبل في تركيا.

APPROVAL PAGE

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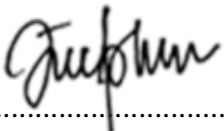
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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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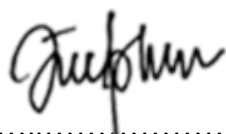
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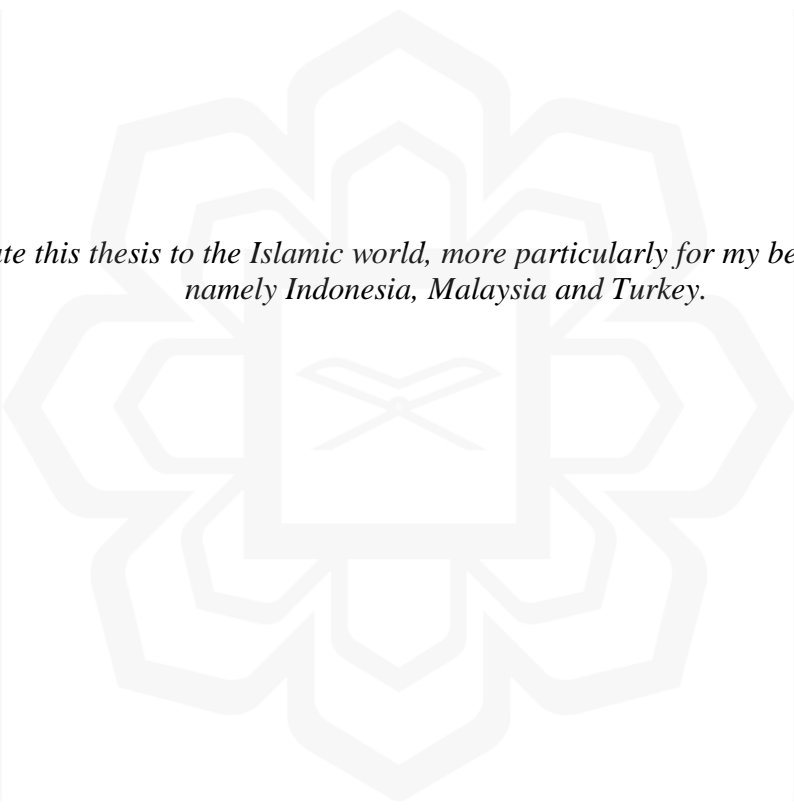


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*I dedicate this thesis to the Islamic world, more particularly for my beloved countries
namely Indonesia, Malaysia and Turkey.*

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Alhamdulillah, in the name of Allah, The Most Compassionate, The Most Merciful. All praise be to Allah. May His peace and blessings be upon our beloved Prophet Muhammad (peace be upon him) and upon his family, his companions and all his sincere followers after them. My utmost gratitude to Allah for His blessings and for granting me the strength, patience and endurance to achieve this dissertation completely.

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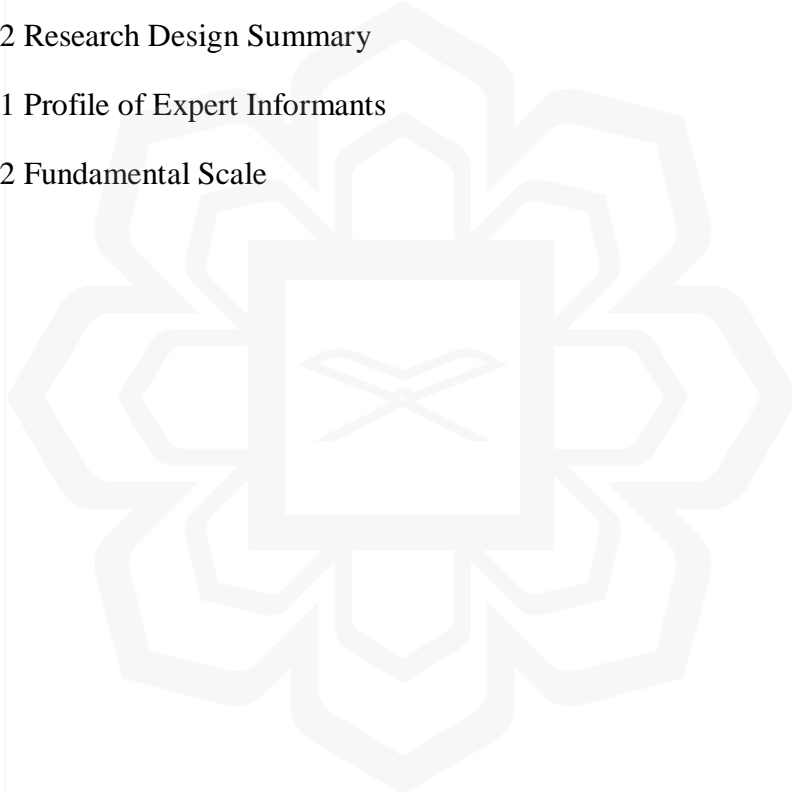
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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
AHP	Analytic Hierarchy Process
ANP	Analytic Network Process
BBA	Bay' Bithaman Ajil
BIMB	Bank Islam Malaysia Berhad
BMIS	Bursa Malaysia Islamic Services
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
PB	Participation Banks
BRSA	Bank Regulation and Supervision Agency
BSAS	Bursa Suq Sila'
CB	Conventional Bank
DIB	Dubai Islamic Bank
DAB	Dallah Al-Barakah
IBs	Islamic Banks
IFN	Islamic Finance News
IFSB	Islamic Financial Services Board
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Services Act
IT	Information Technology
KFH	Kuwait Finance House
LME	London Metal Exchange
MIFC	Malaysia International Islamic Financial Services Centre
SC	Shari'ah Committee
MPO	Murabahah to Purchase Orderer
OIC	Organisation of Islamic Cooperation
PBUH	Peace Be Upon Him
PE	Plastic Resin
RBD	Refined, Bleached & Deodorised
SAC	Shariah Advisory Council
SFH	Special Finance House
SGF	Shariah Governance Framework

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic Banks (hereinafter referred to as IBs) have been undergoing unprecedented growth over the past few decades across the globe. The number of full-fledge IBs coupled with its window has been flourishing not only in Muslim majority countries but also in non-Muslim countries such as the United Kingdom (UK), France, Luxembourg, France, Australia, Singapore, and others. Even so, IBs has started its operations in South America following the successful conversion of a conventional bank in Suriname into a full-fledged IB in early 2018. This has paved the way for the better development of the Islamic banking and finance industry. At the global market, IBs has been growing enormously with the volumes approaching US\$ 1.6 trillion as of the end of 2017, marking a growth rate of 4.3 % annually (IFSB, 2018). The industry is expected to reach US\$ 2.6 trillion by 2020. This statistical figure, therefore, indicates that IBs have performed very well thus far and gaining well acceptance in many countries.

According to the Islamic Financial Services Industry Stability Report 2018 (IFSB, 2018), there is a presence of IB in at least 36 jurisdictions in the world. The share of IB has continued to increase in many countries, and hence deepening its penetration. The increases in IB market share were experienced across 19 countries, including Gulf-Cooperation Countries (GCC), Middle East and North Africa (MENA, exclude GCC), and Asia region. In this regard, the International Monetary Fund (IMF) has highlighted the key success factors of the IB market penetration as follows: (i) the ethical principles and socially responsible business, (ii) the resilience during the global financial meltdown, (iii) the increasing demand for shariah-compliant instruments, (iv) the innovation of shariah-compliant products, and (v) the sound regulatory framework and infrastructure (IMF, 2015).

A similar development is currently ongoing in Turkey. According to the report of the Participation Banks Association of Turkey (TKBB, 2014), IBs in Turkey reached total assets approaching more than TL 100 billion in 2014. The number of IBs and its

branches) in Turkey have been proliferated and emerged as important players in the Turkish economy with more than 900 IBs being operated in this country. Turkey is also registered as the top 10 jurisdictions for its assets in the world (IFSB, 2018). Currently, there are five IB exist in Turkey such as Albaraka Turk Participation Bank, Kuveyt Turk Participation Bank, Asya Participation bank, Turkiye Finans Participation Bank, and Ziraat Katilim Participation Bank (Orbis Bank Focus, 2018).

Although its rapid penetration, the IBs industry is still at the infancy stage of its development. As highlighted by Saat, Ramli, and Aminuddin (2011), the modern IB has just started in the early 1970s, while the conventional banking system has been firmly established for more than 400 years. At this level, IB faces various challenges from the regulatory and market perspective. Among the challenges faced by IB such as (i) the difficulty of regulatory harmonization of IB across jurisdictions, (ii) the poor shariah governance framework in some countries, (iii) implementing the Basel III¹ particularly in the inclusion of Tier-1 and Tier-2 capital and that regulatory capital should comply with Islamic principles (ISRA and Thomson Reuters, 2016).

Moreover, it is worth noting that the IB industry is highly concentrated in a few countries. As of December 2016, it has been observed that Iran, Saudi Arabia, Malaysia, UAE, and Kuwait appear as the top five largest IB markets with the total assets of 28.6%, 24.9%, 11.1%, 8.7%, and 6.3%, respectively (see Table 1.1 for the details). In comparison with conventional banks, however, it remains to be seen that the market share for the IB industry is far below the conventional banking industry. For example, IB only reach 1.6% share of the total banking size of the top 50 largest Conventional Banks worldwide in 2011 (GIFF, 2012). Another report released by SESRIC (2012) shows that emerging economies like Indonesia, Egypt, and Turkey have only a 4% to 6% share of their total domestic banking assets. The table below shows the share of the current global Islamic Banking assets across several jurisdictions in 2020.

¹ The Basel III regulatory capital has been issued to strengthen banking sector ability against the shocks arising from economic difficulties. Basel III has increased the minimum capital levels to 10.5% by 2019 compared to the current 8% of risk-weighted assets (RWA).

Table 0.1 Share of Global Islamic Banking Assets (%) (3Q19)

Source: (IFSB Report, 2020)

Country	Total Assets (in million US\$)	Percentage (%)
Bahrain	31,860	1.8%
Bangladesh	37,170	2.1%
Brunei	7,080	0.4%
Egypt	14,160	0.8%
Indonesia	35,400	2.0%
Iran	506,220	28.6%
Jordan	12,390	0.7%
Kuwait	111,510	6.3%
Malaysia	196,470	11.1%
Oman	12,390	0.7%
Pakistan	19,470	1.1%
Qatar	107,970	6.1%
Saudi Arabia	440,730	24.9%
Sudan	10,620	0.6%
Turkey	46,020	2.6%
UAE	153,990	8.7%
Others	27,435	1.6%
TOTAL	1,770,885	100%

Notably, unlike other countries, IB in Turkey is called ‘Participation Banks’. The IB in Turkey has experienced a dramatic development since its establishment in 1985 (Yanikkaya and Pabuccu, 2017). In the beginning, IB in Turkey was established under the name ‘Special Finance Houses’ (SFH) without making any reference to the shariah tenets due to the secular political system of the country. As the name implies, they were not considered banks. The secular sensitiveness of public policies is no less significant precluded the development of IB in Turkey and making them at the crawling stage for a long time. This has caused Turkey to catch up with the global development and innovations of IB (Asutay, 2013). The IB conditions were started to improve

following the triumph of the Justice and Development Party (*Adalet ve Kalkınma Partisi*, AKP) as the majority in the Turkish Parliament in 2002. Since then, IB in Turkey had begun the new development and significantly improved.

Turkey enacted its Banking Act No. 5411 in 2005, which promulgated the transformation of the status of ‘Special Finance Houses’ (SPH) into Participation Banks (hereinafter referred to as PB). The former was regarded as non-bank financial institutions and were not governed by the regulator. Because of this reason, they were covered by deposit insurance. Meanwhile, the latter has the status of banks and therefore has the same regulatory treatment as conventional banks. PB, in this regard, is also covered by the Saving Deposit Insurance Fund (Ayse et al., 2012).

Nevertheless, although the political and economic conditions have impressively developed over the past decades, the market share of Turkish PB is quite small at around 5.2% compared to other countries, such as Kuwait (46%), Malaysia (21%), and Qatar (26%). PB in Turkey is untapped and remains as a ‘big potential’. Moreover, the decline in the value of the Turkish Lira against the US Dollar has important ramifications to the decline in PB asset growth rate at around -6.8% between the years 2016 and 2017 (IFSB, 2018). It is worth noting that the drop in overall PB assets in this country has gained serious attention from the regulators and policymakers in Turkey.

Therefore, given the peculiarities and the recent state of Turkish PB, this study examines the state of the legal and regulatory framework of IB in Turkey. This study also investigates the issues and challenges in legal and regulatory aspects of IB in Turkey. This study also recommends several policy measures in enhancing the development of IB in Turkey.

1.2 PROBLEM STATEMENT

Turkey has been striving to encourage the development of Islamic banking (participation banking) for the past decades. Way back in 1983, it has been practicing Islamic banking up until now. Al-Baraka Turk was the first Islamic banking institution to be established as “Special Finance House” (SFH) and followed by Faisal Finans immediately after. Nevertheless, it is worth noting that the legislation for participation banks was drafted firstly in 2005.

When Turkey started Islamic banking, the banking legislation available in the country was one that merely supported conventional banks. The SFH, as an interest-free banking institution, was merely promulgated with the Council Minister Decree in 1983 as their legal standing. During that period, there was no specific banking legislation that govern SFH operations in Turkey. Thus, it had to pave away the unique legislations to the country that supported the development of Islamic banking.

Until 1999, the establishment and functioning of SFH were governed by this Minister Decree 1983. It is worth noting that the Turkish government had taken a significant effort by placing SFH under the jurisdiction of Banking Law in December 1999. Since then, SFH were subject to the Banking Act No.4389 of 1999 and were brought under the same regulations of conventional banks.

Like other countries, Turkey needs to introduce unique legislation to surface the way to develop and flourish the Islamic banking industry. It needs to innovate the products and services following the appetite of its society. Besides, it necessitates finding ways in which it can offer Islamic banking products and services competitively. In doing so, the Islamic banking industry in the country can gradually develop in a competitive ambiance and the industry started to flourish. In December 2005, the Turkish government promulgated the new Banking Act No. 5411 of 2005, and the SFH were renamed as “Participation Banks”. This new legislation had allowed participation banking to integrate fully into the financial system. The new law guarantee participation banks to be treated similarly to those of conventional banks. The point to be noted here is that although the country is encouraging with the new legislation and it’s coming into force, the country is far beyond maturity in terms of legal backbone.

Turkey is an Islamic country that embraces secularism. The triumph of the Justice and Development Party (AKP) had altered the traditional socio-economic balance, with the government removing some restrictions on religious practices. In the financial sector, the government allowed participation banking more fully into the regulatory landscape. The participation banking industry can expand its branch offices and raise funds through the issuance of Islamic bonds (Sukuk). In a nutshell, the current political environment is more favorable to the development of participation banking in the country, hence, they obtained greater freedom to compete with commercial banks in the financial markets. However, as this study argued earlier, the participation banking

remained a modest component with the share at around 5 percent of the overall financial system. To some extent, it is indicating limits on the popularity of participation banking than those of traditional commercial banking.

Being a Muslim country, drafting laws by Islamic commercial transactions was a challenge since the country embraces secularism values for several decades. Next, as Turkey had opened its door for the practices of Islamic banking and finance to the rest of the world, Turkey had to understand how to keep abreast with the legal requirements imposed by other countries. As more investors, either local or foreign, started coming into the Turkish Islamic financial market, the need for banking and financial legislation increased. However, as reported by Halit Yanikkaya (2017), the regulatory framework of Islamic Banking in Turkey is still not proper while in building a strong Islamic banking system, a clear legal and regulatory framework is required. One of the main problems inhibiting an expansion of the Turkish Islamic banking sector is the lack of regulatory institutions that focus on Islamic banking constraints and legal improvements.

This condition has written by Halit Yanikkaya in his journal with the title “Causes and solutions for the stagnation of Islamic banking in Turkey”, Yenikkaya explained that even though in turkey both the political and economic situations have substantially improved over the past 15 years, the market share of Islamic banks (IBs) has stagnated at around 5 percent, which is quite small compared to countries such as Malaysia (21 percent), Qatar (26 percent) and Kuwait (45 percent). Thus, Islamic banking in Turkey remains as a “big potential”. According to these evidences, this study will design the appropriate method to discover these issues and try to find the significant problems that have related to the legal framework of Islamic banking in this country.

Discussion about the current progress of Islamic Banking in Turkey, the journal is written by Halit Yanikkaya (2017) about the current issues of Participation Bank in Turkey could be the important source to see the condition of Islamic Banking progress in this country nowadays. This article explained that the problems or concerns inhibiting an expansion of the Turkish Islamic banking sector have summarised as follows:

- 1- Lack of Sharī'ah governance causes misperceptions. Except for Saudi Arabia, all Muslim countries have Sharī'ah governance frameworks at the bank level and some even have nationwide boards. It is hard to standardize practices among IBs without the jurisdiction of a higher board.
- 2- There is a lack of regulatory institutions focusing specifically on Islamic banking constraints and legal improvements.
- 3- Lack of instrument variety pushes IBs to operate almost solely on murābahah transactions. Only Saudi Arabia has achieved high Islamic banking penetration by using murābahah schemes dominantly. All other prominent countries have introduced various instrument schemes.
- 4- The perception of Islamic banking is very weak within society. A significant portion of the society thinks that IBs are not necessarily interest-free and makes choices based on cost-benefit considerations. IBS have to express their moral merits more and be cost-efficient at the same time.
- 5- The operational efficiency of IBs is lower compared with CBS. Worse, the gap is not closing.
- 6- The lack of academic research and educational institutions to study the aforementioned problems further aggravates them.

According to these problems, this study intends to fill the gap by critically examining the issues and challenges faced by participatory banking, especially in the legal and regulatory framework that supports the development of Islamic finance in the country. In doing so, this study will design the appropriate methods to discover these issues and try to find the significant problems related to the legal framework of participatory banking in Turkey.

1.3 OBJECTIVES OF THE STUDY

Having said the aforementioned above, the objectives of this study are as follows:

- 1- To examine the Turkish PB practices and their distinguishing feature with Islamic banking in other countries.
- 2- To comprehensively examine the issues and challenges faced by PB in Turkey.

- 3- To explore the issues and challenges of the legal and regulatory framework of Turkish PB.
- 4- To recommend appropriate strategies based on PB SWOT to increase the development of Participation (Islamic) banking in Turkey.

1.4 RESEARCH QUESTIONS

Based on the above research objectives, this study aims to answer the following research questions.

- 1- How are the Turkish PB practices and distinguish features with Islamic banking in other countries?
- 2- What are the significant issues and challenges faced by PB in Turkey?
- 3- What are the issues and challenges in realizing a strong system regarding the regulatory and legal framework of Turkish PB?
- 4- What are the priority strategies for improving the development of Turkish PB based on its current SWOT?

Table 0.2 Summary of Research Objectives and Research Questions

Research Objectives	Research Questions
To examine the Turkish PB practices and their distinguished features with Islamic banking in other countries.	How are the Turkish PB practices and distinguish features with Islamic banking in other countries?
To comprehensively examine the issues and challenges faced by of Turkish PB	What are the significant issues and challenges faced by Turkish PB?
To explore the issues and challenges of the legal and regulatory framework of Turkish PB.	What are the issues and challenges in realizing a strong system regarding the regulatory and legal framework of Turkish PB?

To recommend appropriate strategies based on PB SWOT to increase the development of Participation (Islamic) banking	What are the priority strategies for improving the development of Turkish PB based on the current SWOT?
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1.5 SIGNIFICANCE OF THE STUDY

This study is significant in identifying those issues and trying to find out the alternative solution for the problems above. This study will concern to examine that problem especially for the second issue which is the lack of regulatory institutions focusing especially on Islamic banking constraints and legal improvement.

The result of this research will be capable of providing valuable input to the parties who are directly involved in legal administration in Turkey. Moreover, it will contribute significant feedback to the Islamic finance authorities and in particularly TCMB (Türkiye Cumhuriyet Merkez Bankası), the Central bank of Turkey, to strengthen the legal aspect of Islamic banking based on the focus research and analysis about how to solve the problems that faced by this country relating to legal framework issues and challenges of Islamic Banking.

Finally, the result of this research will contribute to enriching the literature of the Islamic finance sector in general and the legal framework aspect of Islamic banking in particular. This Study also will contribute as the answer to the problems about the lack of academic research and educational institutions to study the aforementioned problems of Islamic Banking in Turkey.

1.6 METHODOLOGY

This research will apply both qualitative and quantitative approaches, for the qualitative approach, as the main method, this research will interview experts in these issues in Turkey. They are Bankers, Islamic Scholars, Participation bank officers, and academicians. In addition, for the quantitative approach, this research will survey PB's officers to gauge their perception towards the issues and challenges of those banks, regarding the legal and regulatory of Islamic banks in Turkey.

Accordingly, a series of attempts will be made in one semester that covers six months of observation and fieldwork. The fieldwork will be taken place in Turkey. The Issues and Challenges of Islamic Banks in this country can be measured both by using qualitative and quantitative methods and techniques. Different variables and statistical techniques will be also used to analyze the legal and regulatory of Islamic bank Turkey.

This research will try to come out with a recommendation in the aspect of regulation which is extracted through the legal practices of Islamic banking in Turkey. The research will examine the legal and regulatory framework of Islamic banks in Turkey from their beginning in 1984 to the present with a focus on the issues and challenges in legal and regulatory aspects.

Besides that, this research will also examine which of the banking practice is performing better than the other. Overall, the Researcher will interview key persons who have experience and understand this aspect, they are academicians, bankers, and regulators. A series of interviews will be conducted to get deeper information to support the library research data.

Moreover, based on the aforementioned theories especially in the legal and regulatory framework of Islamic banking, this research also emphasizes analysis of how government and Islamic scholars (Ulama) in this country regulate the Islamic banking system and supervise legal practices. Last but not least, The Analytical Network Process (ANP) will be adopted to prioritize the legal framework recommendations that are explored from the results of the interview.

1.7 SCOPE AND LIMITATION OF STUDY

Islamic Banking in Turkey has started to be seen toward the 1980s. This institution was named a “Participation Bank” and awarded the authority to provide all kinds of banking services in compliance with Islam principles. Although its popularity was already increasing before the recent global financial crisis, Islamic finance has drawn greater attention due to its consistent and durable performance during the crises, including in Turkey.