REPORT

THE POLITICAL ECONOMY OF THE TRANSFORMATION OF ISLAMIC FINANCE IN TURKEY

MÜCAHİT ÖZDEMİR, HAKAN ASLAN

SETA

THE POLITICAL ECONOMY OF THE TRANSFORMATION OF ISLAMIC FINANCE IN TURKEY

SETA

SETA Yayınları 115
I. Baskı: 2018
ISBN:

Uygulama: Hasan Suat Olgun
Baskı: Turkuvaz Haberleşme ve Yayıncılık A.Ş., İstanbul

SETA | SİYASET, EKONOMİ VE TOPLUM ARAŞTIRMALARI VAKFI
Nenehatun Cd. No: 66 GOP Çankaya 06700 Ankara TÜRKİYE
Tel: +90 312 551 21 00 | Faks: +90 312 551 21 90
www.setav.org | info@setav.org | @setavakfi

SETA | İstanbul
Defterdar Mh. Savaklar Cd. Ayvansaray Kavşağı No: 41-43
Eyüpsultan İstanbul TÜRKİYE
Tel: +90 212 395 11 00 | Faks: +90 212 395 11 11

SETA | Washington D.C.
1025 Connecticut Avenue, N.W., Suite 1106
Washington D.C., 20036 USA
Tel: 202-223-9885 | Faks: 202-223-6099
www.setadc.org | info@setadc.org | @setadc

SETA | Kahire
21 Fahmi Street Bab al Luq Abdeen Flat No: 19 Cairo EGYPT
Tel: 00202 279 56866 | 00202 279 56985 | @setakahire

THE POLITICAL ECONOMY OF THE TRANSFORMATION OF ISLAMIC FINANCE IN TURKEY

Mücahit Özdemir, Hakan Aslan

SETA
SİYASET, EKONOMİ VE TOPLUM ARAŞTIRMALARI VAKFI
FOUNDATION FOR POLITICAL, ECONOMIC AND SOCIAL RESEARCH
مركز الدراسات السياسية والاقتصادية والاجتماعية

CONTENTS

ABSTRACT

When Islamic finance is mentioned around the world, the first thing that comes to mind is Islamic banks. The sphere of Islamic finance has expanded in the last decade with developments particularly in capital markets and the insurance sector. Nonetheless, the market share of Islamic finance in the world's financial market merely accounts for approximately 1 percent. Still, many segments are interested in Islamic finance because of its high growth figures, resilience against crises, and the fact that it offers a system that prioritizes ethical values in contrast to conventional finance. Islamic banks in Turkey date back to the establishment of the Adapazarı Islamic Trade Bank (Adapazarı İslam Ticaret Bankası) in Sakarya (Adapazarı) in 1913. However, examples of globally accepted Islamic banking models in Turkey appeared with the emergence of Special Finance Houses (SFHs) following the passage of relevant legal regulations in 1984.

Although SFHs had significant demand potential, their share in the banking sector in the early 2000s was barely 1 percent. One of the most important reasons for this is the negative approach of politicians and bureaucratic cadres towards SFHs. The banking sector in Turkey was restructured after the 2001 economic crisis. Negative attitudes towards the Islamic financial sector permanently changed when the Justice and Development Party (AK Party) came to power, and especially in recent years, it is considered a strategic area. In this study, the history of Islamic finance in Turkey is scrutinized by considering its development in the world through the present and future projections. At the end of the report, policy recommendations regarding steps that should be taken for the development of the Islamic financial sector in Turkey are offered.

INTRODUCTION

At the heart of the global financial crisis in 2008, was the finance sector's craving for making more profit by taking excessive risks. The sector tried to achieve high profit through complex and abstruse finance products that were generated by dint of weak regulations. The price of the trillion dollars' worth of toxic derivative products were unrealistic, and after a point the financial crisis was inevitable.[1] One of the main characteristics of Islamic finance is its asset-based nature. Financial products with excessive uncertainty (*gharar*) are not allowed. Financing the real economy based on interest-free methods and profit/loss sharing are Islamic finance's main principles. Islamic Financial Institutions (IFIs) showed successful performance during the global crisis and captured the international community's attention.[2] Moreover, the high growth performance of Islamic finance has increased this attention.

Islamic banking in Turkey started a decade after the establishment of the Islamic Development Bank (IDB) in 1975, which is considered as a turning point for Islamic finance. Although it seems a long time, it is fair to say that a decade later was not late to launch the Islamic financial sector when Turkey's political and economic circumstances at that time are considered. However, SFHs were ignored by both governments and bureaucracy, and were treated unfairly within the financial system.

1. James Crotty, "Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'", *Cambridge Journal of Economics*, Vol.: 33, Issue: 4, (July 2009), pp. 563-580.

2. For the news published in a Vatican newspaper, see "Vatican Paper Supports Islamic Finance. France Wants Its Share of Sharia Banking", *The Brussels Journal*, March 12, 2009.

Thus, their share in the sector remained around 1 percent for a long time. Similar to Turkey, Malaysia established its first Islamic bank in 1983. Although just a bit more than half of its population is Muslim, Malaysia has the largest share in the Islamic finance market in the world.[3] The country owes this success to the fact that governments and the public view Islamic finance as a strategic area and provide support. In contrast, Turkey has turned a blind eye to Islamic finance for a long time.

Turkey restructured the banking system after the 2000-2001 crises. In 2002, the periods of the AK Party governments began. Although not immediately, the state's perspective notably changed towards Islamic finance in the following years. The change of attitude on the state's part was a critical turning point for Islamic finance in Turkey. Hence, this study first discusses the development of Islamic finance in the world and then examines the Islamic finance under two separate headings: before and after 2002. Finally, policy recommendations for further development of Islamic finance in Turkey are provided.

3. Munawwar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking*, (New York: Palgrave Macmillan, 2004), p. 45.

DEVELOPMENT OF ISLAMIC FINANCE IN THE WORLD

Intellectual efforts on Islamic economics in the modern era date back to the 1950s. In particular, postcolonial Muslim countries partook in the first struggle to figure out how to build an economic system that would comply with the Quran and Sunnah, the ontological sources of Islam. In this approach, there is an understanding of an alternative system which addresses not only the aspects overtly mandated or prohibited by Islam – e.g. *zakah* and *riba* – but also the basic principles and values that embrace society at large.

Mehmet Asutay states that the aim of the presumed founding fathers of Islamic economics is to set up an economic system using an approach that cares about human and ethical values versus the failure of the capitalist economic development strategy.[4] During this period, discussions intensified over what the main values and axioms of the Islamic economics ought to be, its aspects that would be different from those of the current economic systems, and its main institutions. Islamic banking was considered as a functional unit of the Islamic economics model.

Theory was somewhat put into practice with the establishment of the first Islamic bank. The first modern experiment with Islamic banking was the Mit Ghamr Savings Bank established by Ahmad Al Naggar in 1963 in the town of Mit Ghamr, Egypt. The goal of this bank was to collect the savings of low-income groups and generate returns for them on the basis of profit-loss; it was inspired by German

4. Mehmet Asutay, "A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System", *Kyoto Bulletin of Islamic Area Studies*, Vol.: 1, Issue: 2, (2007), pp. 3-18.

saving banks known as *Sparkasse.*[5] However, such an important initiative lasted only three years and Mit Ghamr, including its nine branches in Egypt, closed down in 1967.[6] The founder of the bank and one of the founding fathers of Islamic banking Ahmad Al Naggar stated upon the closure of Mit Ghamr that "those who are blindfolded by fanaticism, who are caught by the storm of their emotions and who do not want the good of the people" were responsible for the bank's closure.[7] Despite the difficulties, Mit Ghamr's successful operation drew the attention of many. Mit Ghamr was a remarkable experience as it showed that an interest-free institution in the areas of savings and investment could be formed and operate profitably; it also expedited the establishment of other interest-free banks.[8]

After Al Naggar's bank was closed down in 1967, other Muslim countries made some attempts to set up interest-free banks. The most critical turning point in Islamic banking, however, occurred when the IDB was founded in the city of Jeddah, Saudi Arabia, in 1975.[9] After the establishment of this institution, interest-free banks became more visible.[10] The IDB made tremendous contributions of capital and ideas to the formation of interest-free banks in other Islamic countries. The IDB usually supports interest-free banks founded in member states by making capital contributions as a shareholder. The IDB is also a shareholder of two participation banks in Turkey.[11]

Dubai Islamic Bank, founded in 1975, is also the first Islamic commercial bank and the oldest bank to date following the IDB. Many Islamic banks were founded mostly in the Middle East in the following years such as Faisal Islamic Bank of Egypt (1977); Faisal Islamic Bank of Sudan (1977); Faisal Islamic Bank of Jordan (1978); Jordan Islamic Bank (1978); Bahrain Islamic Bank (1979); and the United Arab

5. Hussein E. Kotby, *Financial Engineering for Islamic Banks*, (Japan: Institute for Middle Eastern Studies, 1990), p. 16.

6. Ahmed Akgündüz, "The History of Islamic Banking and Finance", *Studies in Islamic Economics (Islamic Banking and Development),* ed. Ahmed Akgündüz, (Rotterdam: IUR Press, 2009), p. 40.

7. M. A. Zerka and A. M. Neccar, *İslam Ülkelerinde İktisadi ve* İç*timai Kalkınma Stratejisi Olarak Faizsiz Bankalar,* İslam *Düşüncesinde Ekonomi, Banka ve Sigorta*, (Interest-Free Banks as Economic and Social Development Strategy in Muslim Countries in *Economics, Banking and Insurance in Islamic Thought*) translated by Hayrettin Karaman, (Istanbul: İz Yayıncılık, 2011), p. 73.

8. Cihangir Akın, *Faizsiz Bankacılık ve Kalkınma* (Interest-Free Banking and Development), (Istanbul: Kayıhan Yayınları, 1986), p. 113.

9. Salahuddin Ahmed, *Islamic Banking Finance and Insurance: A Global Overview*, (Kuala Lumpur: A. S. Nordeen, 2006), p. 44.

10. Akgündüz, "The History of Islamic Banking and Finance", p. 41.

11. IDB has a 7.84 percent partnership share in *Albaraka Türk* and 9 percent in *Kuveyt Türk*.

Emirates Islamic Investment Co. (1979).[12] The first interest-free bank in a non-Muslim country was established in Luxembourg in 1978. This bank operated with two objectives: the first was to function as an agency for Islamic banks and the second was to provide services to Muslims living in the West. It was authorized in 1983.[13] Some international commercial banks also began to operate through Islamic Windows[14] between 1980 and 1999. Citigroup, HSBC, Deutsche Bank, UBS, and Standard Chartered Bank were the leading ones among them. It is worth noting that the Dow Jones and Financial Times Islamic Indexes were created for Muslim investors.[15]

In the 2000s, substantial developments took place in interest-free banking. Increasing product variety and capital accumulation in Muslim countries helped interest-free banking to gain more shares in the global financial system. Furthermore, due to the hostile attitude of the Western world - especially the United States - in the aftermath of the September 11, 2001 terrorist attacks, Muslims, starting with the Arab investors, living in these countries transferred their money to both IFIs and conventional commercial banks.[16]

Modern Islamic finance, kicking off with Islamic banking operations, continues to develop with non-bank financial institutions (NBFIs) such as *sukuk*[17] and Islamic indexes in capital markets; the *takaful* (Islamic insurance) model in insurance; Islamic microfinance products that aim to fight poverty; and financial inclusion. According to the Global Islamic Finance Report 2017, the annual growth of the global Islamic financial sector increased by 7 percent amounting to USD 2.3 trillion.[18] Compound annual growth rate (CAGR) was 15 percent in 2007-2016, and if the sector maintains the same growth rate, it is expected to amount to a total of USD 4.3 trillion in 2020. (Figure 1) The distribution of assets by sectors reflects that Islamic banking has 75 percent of the share, *sukuk* has 15 percent, Islamic investment funds have 4 percent, and *takaful* and Islamic microfinance each have 1 percent.

12. Ahmed, *Islamic Banking Finance and Insurance: A Global Overview*, p. 45.

13. M. A. Zerka and A. M. Neccar, “Dördüncü Baskıya Önsöz”, *İslam Düşüncesinde Ekonomi, Banka ve Sigorta* (Economics, Banking and Insurance in Islamic Thought), translated by Hayrettin Karaman (Istanbul: İz Yayıncılık, 2011), p. 55.

14. Islamic Window refers to services provided by conventional banks but based on Islamic principles.

15. Akgündüz, “The History of Islamic Banking and Finance”, pp. 42-43.

16. Akgündüz, “The History of Islamic Banking and Finance”, p. 42.

17. Generally known as an Islamic bond it provides fixed return but is interest free. For details see Abdulkader, Thomas and Adam Nathif, 2004, “Islamic Bonds: Your Guide to Structuring, Issuing and Investing in Sukuk.”, *Economy Institutional Investor*.

18. Global Islamic Finance Report, (EDBIZ: 2017), p. 36.

FIGURE 1. ASSET SIZE OF THE GLOBAL ISLAMIC FINANCIAL SECTOR (BILLION USD)

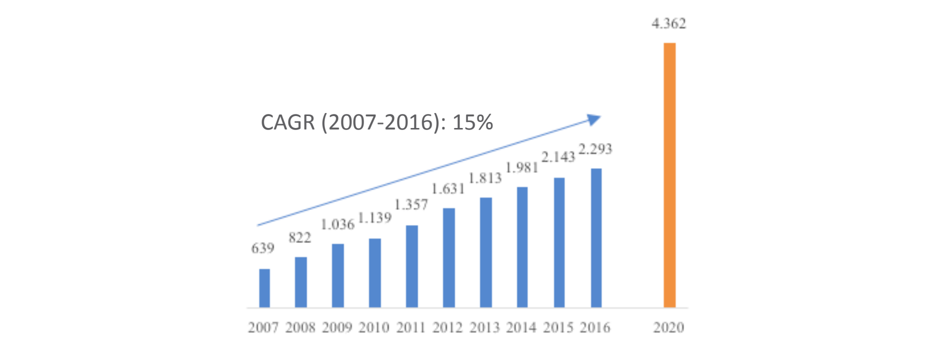
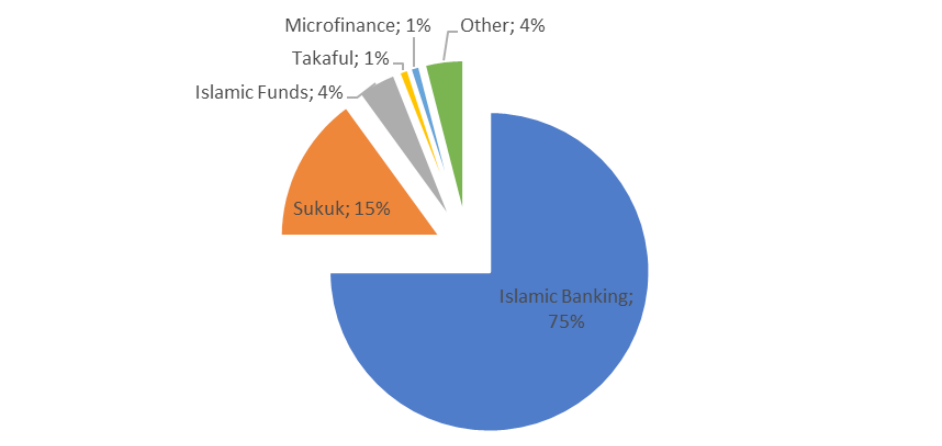


FIGURE 2. DISTRIBUTION OF ISLAMIC FINANCIAL ASSETS



Source: EDBIZ, GIFR 2017

Table 1 below depicts the sizes of the Islamic finance assets and an average CAGR of countries in the period 2007-2016 according to the Global Islamic Finance Report data. Iran tops the list with USD 560 billion, Saudi Arabia follows with USD 401 billion, and Malaysia with USD 335 billion, according to the year-end data of 2016. The last three countries are the Gulf countries: the United Arab Emirates (UAE), Qatar, and Kuwait with USD 197 billion, USD 130 billion and USD 121 billion respectively. Turkey is ranked seventh with USD 81 billion, and is followed by Indonesia, Bahrain, and the United Kingdom. The eye-catcher here is that the United Kingdom, as a Western country having a relatively small Muslim population, appears among the top 10 countries in Islamic finance. The U.K. views the Islamic financial sector as a strategic area. Global Islamic financial assets amounted to approximately USD 2.3 trillion with a 15.3 percent CAGR between the years of 2007 and 2016. In the same period, Turkey grew above the world average by nearly 20 percent.

TABLE 1. GROWTH OF ISLAMIC FINANCE ASSESTS IN GIVEN COUNTRIES (BILLION USD)

COUNTRIES	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	CAGR (2007-2016, %)
IRAN	235	293	369	406	413	416	480	530	544	560	10,1
SAUDI ARABIA	92	128	161	177	205	215	270	339	371	401	17,8
MALAYSIA	67	87	109	120	131	155	200	249	254	335	19,6
UAE	49	84	106	116	118	120	123	144	157	197	16,7
KUWAIT	63	68	85	94	95	103	105	107	115	121	7,5
BAHRAIN	17	21	18	18	20	21	25	27	32	43	10,9
QATAR	21	28	35	38	47	68	70	111	122	130	22,5
TURKEY	**16**	**18**	**22**	**25**	**35**	**41**	**43**	**69**	**80**	**81**	**19,7**
U.K.	18	19	24	27	33	37	40	43	55	61	14,5
INDONESIA	3	3	4	5	9	22	25	49	51	66	41,0
BANGLADESH	6	8	9	10	13	17	19	21	26	31	20,0
EGYPT	6	6	8	9	12	19	19	20	25	31	20,0
SUDAN	5	7	9	10	11	14	15	16	21	24	19,0
PAKISTAN	6	5	6	7	12	13	13	16	18	23	16,1
JORDAN	3	5	6	6	11	13	13	14	17	19	22,8
IRAQ	-	4	5	5	9	12	12	13	23	25	25,7
BRUNEI DARUSSALAM	3	3	4	4	8	10	10	12	18	21	24,1
SYRIA	2	3	5	5	5	4	4	4	4	4	8,0
OTHER	**27**	**32**	**51**	**57**	**170**	**331**	**327**	**200**	**210**	**120**	**18,0**
TOTAL	**639**	**822**	**1.036**	**1.139**	**1.357**	**1.631**	**1.813**	**1.984**	**2.143**	**2.293**	**15,3**

Source: EDBIZ, GIFR 2017, p 46

ISLAMIC FINANCE IN TURKEY PRIOR TO 2002 (1913-2002)

Discussing the history of Islamic finance in Turkey involves examining three institutions: the Adapazarı Islamic Trade Bank (1913), the State Industrial and Labor Investment Bank (DESIYAB) (1975), and the Special Finance Houses (SFHs) (1984). Although SFHs, as the first ring of today's participation banks, are generally presumed to have been the first Islamic financial institutions in Turkey, the other two banks should be considered in this assessment due to their characteristics. These institutions are worth examining since they represent the beginning of Islamic finance in Turkey despite the fact that they did not last long.

ADAPAZARI ISLAMIC TRADE BANK

The Adapazarı Islamic Trade Bank is one of the institutions that warrants discussion when examining the history of Islamic banking in Turkey. However, more comprehensive studies are required in order to consider it as the beginning of Islamic finance in Turkey - even though its title includes "Islamic Bank." The reason is that the existing academic literature does not examine whether this bank practiced Islamic banking in the real sense and does not include any in-depth analyses on the subject matter. In this section, Adapazarı Islamic Trade Bank will be briefly discussed, and a short assessment will be made on whether this institution can be considered as the first Islamic bank in Turkey. It has not been completely accredited as an Islamic bank in literature to date, but future academic research will enable a more explicit determination in this direction.

The need for financing has been met through different methods and institutions in every period. In the Ottoman Empire as well, cash *waqfs* were leading institutions that fulfilled this need. With the decline of the Ottoman Empire, the state lost control of the financial system to foreigners as a result of the concessions that were granted to them. Efforts were made for "national banking" under such circumstances. The first examples of such efforts, *Memleket Sandığı* (Homeland Fund) and *Emanet Sandığı* (Deposit Box), were founded in 1864 and 1866, respectively, on Mithat Pasha's initiative, who was the governor of Nis in former Yugoslavia, then under the ruling of the Ottoman Empire. *Memleket Sandığı* later on, in 1880, was converted to *Menafi Sandığı* (funds for public works, Public Fund).[19] The state tried to meet people's financing needs through "national" institutions.

In 1913, a group of entrepreneurs established the Adapazarı Islamic Trade Bank as an alternative to existing foreign banks. Ziyaeddin Fahri Fındıkoğlu states that the bank was not founded only for economic reasons, but was also the manifestation of a social reaction.[20] The method of operation was stated in the bank's corporate charter as follows: "… On the other hand, to have shareholders through limited partnership; and to deal with all procedures for lending and borrowing in the frame of Shariah Law; and, if required, (all procedures) for Financial, Commercial, Civil Industrial, movable and immovable properties …"[21] Here, it is overtly stated that the bank will comply with Islamic methods (Shariah Law) in business activities. However, the goal of the foundation is stated in the Administrative Board Report, in 1922, as follows: "… Our company is founded to save tradesmen, artisans and our previous market from the control and occupation of foreign capital and from practicing usury and touting by stateless profiteers; to provide loans to Muslims with low interest, and to contribute to the development of national trade." The bank aimed to prevent exploitation by foreign investors, yet its intention to give loans with low interest poses a question whether it was in compliance with Islamic Law.

The clarification of several points in the above statement is of critical importance in relation to the latter question: whether the word "interest" refers to an excess rather than *riba* (usury), whether it suggests that lending was proportional to the inflation rate, and whether giving credit to Muslims at a lower interest rate in the face

19. Münir Kutluata, "Sakarya'da Bankacılık ve Türk Ticaret Bankası" (Banking in Sakarya and Turkish Bank of Commerce), *Sosyoloji Konferansları Dergisi*, Issue: 11, (1970), pp. 55-106.

20. Ziyaeddin Fahri Fındıkoğlu, "Adapazarı'nın Şehirleşmesi Problemleri Başlıca Sosyolojik Problemleri", *Sosyoloji Konferansları Dergisi*, Issue: 7, (1966), p. 36.

21. Kutluata, "Sakarya'da Bankacılık ve Türk Ticaret Bankası" [Banking in Sakarya and Turkish Commerce Bank], p. 79

of excessive pricing was seen as the lesser of two evils. These points could be better clarified in the future through in-depth studies on its banking transactions such as lending methods, account holders, collaterals taken, and agreed deposits.

On the other hand, the presence of "Islamic" in the name of this institution is explained in the Administrative Board Report as follows: "…In order to distinguish it from the Bank of Adapazarı established by Christians, our bank title includes ISLAM…"[22] In other words, "Islamic" was used to differentiate the bank from existing banks owned by non-Muslims. Quite interestingly, the transformation of the bank's name reflects the conditions of that particular period of time. The partnership structure of the Islamic bank was converted from limited partnership to corporation in 1919 and its name was changed to Adapazarı Islamic Trade Bank Ottoman Co. upon the Sultan's approval.[23] After the declaration of the Republic, the word "Ottoman" was replaced with the word "Turkish" in 1924. Lastly, the Administrative Board Report, dated 1926, stated that the word "Islamic" was also removed from the title because it had been added to the title for the sole purpose of distinguishing the bank from a Christian bank and since no such competitor existed anymore, the word "Islamic" was no longer necessary. Thus, "Islamic" was officially discarded from the title on March 29, 1928.[24] In consequence, the bank's new name was announced as "Adapazarı Turkish Trade Bank." Fındıkoğlu claimed that the aforementioned changes in the title did not simply mean the assignment of a new name but had further meanings .[25] He interpreted the changes as follows:

> The location of the establishment in 1913 necessitated the inclusion of "Islamic" in the name due to the ethnic and religious state of affairs. Later on, the secular mindset settled in around 1930-1932. Also, a change of the center, a shift from local to national might have also played a role in this conversion.

The bank's headquarters were moved from Adapazarı to Ankara on October 25, 1934. Its name was renewed as *Türk Ticaret Bankası* (Turkish Bank of Commerce) or *Türk Bank*, in short.[26] The Savings Deposit Insurance Fund (TMSF) confiscated *Türk Bank* in 1997 due to financial problems and terminated its activities.

22. Kutluata, "Sakarya'da Bankacılık ve Türk Ticaret Bankası" [Banking in Sakarya and Turkish Bank of Commerce], p. 78.

23. For an article on the sultan's approval of this change, see Nurullah Nehir, "Osmanlı'da Sosyoekonomik Hayatta Sakarya Belgeleri", (2015), p. 36.

24. Kutluata, "Sakarya'da Bankacılık ve Türk Ticaret Bankası", p. 83.

25. Fındıkoğlu, "Adapazarı'nın Şehirleşme Problemleri Başlıca Sosyolojik Problemleri", p. 37.

26. Mustafa Sarı and Resul Narin, "Osmanlıdan Cumhuriyete Adapazarı İslam Bankası", *I. Uluslararası Kocaeli ve Çevresi Kültür Sempozyumu Bildirileri,* ed. Işıl Altun, (Kocaeli: Kocaeli Büyükşehir Belediyesi Kültür Yayınları, 2006), pp. 938-962.

In conclusion, Adapazarı Islamic Trade Bank, as a bank founded on an initiative of the private sector, in its corporate charter affirmed its purpose to choose its activities according to Shariah principles with the aim of supporting Muslim artisans against foreign bankers/investors, i.e. supporting the real economy, and distinguished itself from existing similar but non-Muslim institutions by inserting the word "Islamic" into its title. As the bank remained active, critical radical changes not only manifested in the title, but inevitably affected its banking activities, as well. Considering the political and social repercussions in terms of the secular nation-state after the Declaration of Republic, it is fair to say that dropping the word "Islamic" from the bank's title practically meant that Shariah principles would no longer be implemented. For all these reasons, this institution was most likely an Islamic bank from the year of the establishment of the Republic of Turkey (1923) to the year in which the word "Islamic" was removed from the name (1928), and, therefore, may be considered the first Islamic bank established in Turkey. In no uncertain terms, however, all types of transactions - during the formation period and afterwards - should be scrutinized in order to prove this. Today, the resumption of *Türk Bank* as a participation bank has become a current issue.[27] Such a step will be quite important for the bank's return to its original founding principles and for the continuity of its banking operations. Keeping in mind that the oldest Islamic banking implementations in the world began in the 1950s according to literature, it may be a significant promotion of Turkey in the international arena if Adapazarı Islamic Trade Bank, with a history dating back to 1913, is introduced to academic literature, publicized, and revived as a participation bank.

STATE INDUSTRIAL AND LABOR INVESTMENT BANK (DESIYAB)

The State Industrial and Labor Investment Bank (DESIYAB) may be designated as the first public institutional step taken in interest-free financing in Turkey. DESIYAB was founded through the "Statutory Decree No. 13 on State Industrial and Labor Investment Bank," pursuant to the authority granted by Law No. 1877 and dated April 17, 1975. Article 3 of the decree states the goal of the bank as follows:

> Rapid and countrywide industrialization of Turkey: For this reason, a) to put the savings of those who worked/work domestically and abroad in particular into good use and combine the savings into an economic power with the understanding of

27. "Türkbank ve Adabank Katılım Bankası Oluyor" (Türkbank and Adabank Becoming Participation Banks), *Sabah*, October 29, 2014.

> profitability and productivity, b) to approach nationwide enterprises, industrial investments in particular, that are in accordance with fundamental principles of development plans.

DESIYAB's structure, based on "profit sharing," was often emphasized in the decree. At this point, the following remarks by Mehmet Zeki Sayın, one of the founders and the second general manager of DESIYAB, are important to understand the state of affairs in which this law was passed, and learn why "profit sharing" was used rather than profit and loss sharing, which underlies Islamic finance:

> The Council of Ministers did not release DESIYAB's founding charter for months as there was a sentence that included the expression of "profit and loss sharing." When I asked Mr. Yahya (then undersecretary of the Ministry of Industry) why the blueprint has not been released, he said, 'It is at the Council of Ministers, they insist on stating that you will bring back Shariah. The Justice Party (Adalet Partisi, or AP in short) does not accept this.' Eventually, the word 'loss' was crossed out and then the blueprint was approved by the Cabinet.[28]

DESIYAB was founded by the efforts of the government coalition partner, the National Salvation Party (*Milli Selamet Partisi* or MSP in short), and by taking into account the "sensitivities" of the secular ideological structure dominating Turkey.

In order to support the industry in an interest-free method, this bank aimed to use people's savings, starting with workers abroad. Even if it was not an independent Islamic bank, because profit sharing and financing the real economy were among its basic activities, DESIYAB may be described as the most important institutional step taken in Islamic finance considering the period. After the 39th government of Turkey was overturned in 1977, DESIYAB continued activities institutionally, but diverged from its interest-free banking ideals during the subsequent government periods as it had a weak legal foundation in terms of Islamic finance.[29] Still, DESIYAB was quite an important experience and led the establishment of interest-free banking in Turkey.[30]

28. For the remarks of Mehmet Zeki Sayın, see "23.02.2013/ Part-2/ Prof. Dr. Necmettin Erbakan'ı Anma Programı-Server Vakfı", YouTube, September 29, 2014, https://www.youtube.com/watch?v=NuguUHdAp8g, (Access date May 29, 2017). Sayın continued to say that when he was the general manager, he allowed a signboard to be hung outside the building where it was written "First interest-free bank of Turkey."

29. The name was changed to "Development Bank of Turkey" in accordance with Law No. 4456, dated October 14, 1999.

30. Halil İbrahim Bulut and Bünyamin Er, *Katılım Finansmanı Katılım Bankacılığı ve Girişim Sermayesi* (Participation Finance, Participation Banking and Venture Capital), (Istanbul: Participation Banks Association of Turkey, 2012), pp. 24-25.

SPECIAL FINANCE HOUSES (SFHS)

Special Finance Houses (SFHs), as the first interest-free banks in Turkey, were established upon the approval of Cabinet Decree No. 83/7506 dated December 16, 1983. Procedures and principles regarding the activities of SFHs were published in the *Official Gazette* on February 25, 1984, and put into effect afterwards. Arrangements for the establishment of SFHs were made during [the then Prime Minister (later President)] Turgut Özal's term in the wake of the military coup in 1980. Similar to the DESIYAB case, tough negotiations were held while the establishment of SFHs were being debated. The following incident quoted by the former President of the Central Bank Osman Şıklar is important as it reflects the conditions under which SFHs were founded in Turkey:

> This time (late President Kenan) Evren said to Özal: "We will say yes to this, but I would like to especially express our concern whether we might face a situation like the bankers' incident. I am talking by emphasizing this: We say yes to Special Finance Houses, but don't forget that if anything goes wrong, you and the Central Bank will be totally responsible." … After the voting by the President and the approval of the legislation was prepared, Özal told me, "Please, let's implement this sensitive issue very carefully and let's tread lightly. Because everybody will keep an eye on this matter and will wait for us to fail.[31]

After the decree on the establishment of SFHs was published, the legal infrastructure was created through communiques and regulations that were issued by the Central Bank, the Undersecretariat of Treasury and Foreign Trade, and various institutions. Although SFH-like institutions are regulated by a single law or laws, regulating SFHs by decrees and communiques rather than by legislation seems problematic in terms of legal technicalities and implementation.[32] Problems caused by a multi-headed authority occurred in practice as well. Under the influence of the dominating secular understanding, strict arrangements were made in many aspects.[33] For instance, advertisements of SFHs were closely followed by the Undersecretariat of Treasury and Foreign Trade. The announcement and advertisement rules and principles that SFHs were required to comply with were published on April 22, 1986. Accordingly, the use of some words that appear in international literature on

31. Osman Şıklar, *Bir Ara Rejim Bürokratının Anıları*, (Ankara: İmge Kitabevi Yayınları, 2010), pp. 212-213.

32. Zühtü Aytaç, "Özel Finans Kurumlarının Hukuki Yapısı" (Legal Structure of Special Finance Houses), *Ankara Üniversitesi SBF Dergisi*, Vol.: 41, Issue: 1, (1986), pp. 221-246.

33. Although SFHs faced some difficulties during the set-up period, they also benefited from positive discrimination compared to other banks. For instance, while normal banks have 20 percent of savings blocked in the required reserve in the Central Bank, this ratio was set at 10 percent for current accounts and 1 percent for participation accounts for SFHs. Following the publication of "The Communique on Required Reserves" in the *Official Gazette* No. 24710 on March 29, 2002, the situation changed and SFHs were scaled up to equal status with other banks.

similar interest-free institutions, such as "Islam" and "Shariah" were categorically not allowed in SFH advertisements in the media. Hence, SFHs used expressions, such as "interest-free returns" and "your door to *barakah* (plenitude)" in order to draw devout people's attention and show their difference from other banks.[34] Nonetheless, both conventional bankers and secular groups criticized the formation of SFHs although they did not really view them as rivals.[35]

After the legal arrangements about SFHs were clarified, first, *Albaraka Türk* and *Faysal Finans*[36] were founded in 1985. Later on, *Kuveyt Türk* (1989), *Anadolu Finans* (1991), *İhlas Finans* (1995) and *Asya Finans* (1996) were established.[37] The names of these institutions reflect the names of their investors. As *Albaraka Türk, Faysal Finans* and *Kuveyt Türk* were dominated by foreign partners, *Anadolu Finans, İhlas Finans,* and *Asya Finans* were founded with national capital.

The weak legal ground of SFHs and the ever-changing political atmosphere caused a serious problem for such institutions in the late 1990s. In the aftermath of the February 28 post-modern coup in 1997, devout people and related institutions were targeted.[38] SFHs faced potential closures with an amendment planned in the Banking Law in 1999. Following the criticisms of the ruling power and the opposition wing, such a mistake was not made.[39] SFHs became the subject to Banking Law No. 4491, associated with the Law on the Amendment of Banking Law, published in the *Official Gazette* No. 23911 of December 19, 1999. During this period, SFHs held many meetings, and made TV appearances to inform the public, and, thus, increased public awareness about Islamic banking.[40]

34. David Baldwin, "Turkey: Islamic Banking in a Secularist Context", *Islamic Financial Markets*, ed. Rodney Wilson, (New York: Routledge, 1990), p. 41.

35. Baldwin, "Turkey: Islamic Banking in a Secularist Context", p. 38. Although conventional banks did not see SFHs as rivals at the beginning, as these institutions began to grow, bankers expressed discontent towards them. For an example see "Kâr Payı, Faiz Kapışması", *Milliyet*, January 2, 1998.

36. Later on, it was named Family Finans and following a merger with *Anadolu Finans* in 2005, it was named *Türkiye Finans*.

37. Hüseyin Tunç, *Katılım Bankacılığı Felsefesi, Teorisi ve Türkiye Uygulaması*, (Philosophy, Theory and Turkish Practice of the Participation Banking), 8th edition, (Istanbul: Nesil Yayınları, 2010), p. 177.

38. "Faizsiz Bankacılığa Sıkıyönetim Geliyor" , *Sabah*, March 25, 1998. The first sentence of the article is as follows, "İrtica ile mücadeleyi hızlandıran Yılmaz hükümeti, faizsiz bankacılık sektörüne de el attı." (The Yılmaz government speeding up the fight against religious reactionarism, made a dent in interest-free banking sector as well.); Enis Berberoğlu, "28 Şubat Finans Muhtırası", *Hürriyet*, December 6, 1999. The last paragraph of the article states, "If you ask my personal opinion… Neither the interest tax nor the ban on interest-free banking are anything to be ashamed of, but rather to be applauded. This is why we find it odd that they were made surreptitiously." ("Kişisel kanımızı sorarsanız... Gerek faiz vergisi gerekse faizsiz banka yasağı utanıp saklanacak değil alkış tutulacak kararlardır. Gizli-saklı yapılmalarını yadırgamamız bu yüzden.")

39. "Recep Bey'e Göre İslami Bankacılık Gözden Kaçmış", *Hürriyet,* December 9, 1999.

40. Tunç, *Katılım Bankacılığı Felsefesi, Teorisi ve Türkiye Uygulaması,* p. 181.

Before the AK Party, SFHs faced another risk, this time from the "inside." The 1994 economic crisis did not significantly influence SFHs – although they were subject to unfair competition due to a change in the withholding rate in favor of banks.[41] The 2001 economic crisis, however, became a severe test for SFHs. *İhlas Finans*, founded in 1995, was badly affected by the crisis. Due to failure to fulfill its financial obligations, *İhlas Finans* terminated activities pursuant to the Banking Regulation and Supervision Agency (BRSA, or BDDK in Turkish) Decision No. 171 of February 10, 2001. The reasons behind the bankruptcy of *İhlas Finans* were pronounced as liquidity crunch and mismanagement.[42] Asutay attributes this situation to the weak corporate governance structure.[43]

Canceling *İhlas Finans's* official authorization, as the biggest player in the sector caused distrust towards the entire SFH sector and account holders rushed to withdraw their money. Withdrawals continued for five months and about 50 percent of the funds collected in SFHs were withdrawn.[44] Following the approval of Law No. 4672 on May 12, 2001, Article 20/6 of the Banking Law was amended and as a result, two critical developments involving SFHs took place. Pursuant to the amendment made in the law, the Special Finance Houses Association was founded and SFHs were granted the authority "to create a 'Guarantee Fund'"[45] in order to guarantee the savings of real individuals who own private current accounts and participation (profit/loss sharing) accounts. With this legal change, a guarantee fund[46] on behalf of these institutions was created within one month. Demands for withdrawal by account holders ceased following the formation of the guarantee fund.

41. "Kriz İslami Bankacılığı da Vurdu" (Financial Crisis Hit Also Islamic Banking), *Milliyet*, February 18, 1994.

42. "İhlas Finans'a Kilit Vuruldu" (İhlas Finans Locked Up), *Milliyet*, February 11, 2001; Syed Ali, "Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans in Turkey", *Islamic Economic Studies*, Vol.: 14, Issue: 1-2, pp. 1-52.

43. Mehmet Asutay, "The Development of Islamic Banking in Turkey: Regulation, Performance and Political Economy", *Islamic Finance in Europe: Towards a Plural Financial System*, ed. V. Cattelan (Cheltenham: Edward Elgar Pub., 2013), pp. 213-227.

44. Tunç, *Katılım Bankacılığı Felsefesi, Teorisi ve Türkiye Uygulaması* (Philosophy, Theory and Turkish Practice of the Participation Banking), pp. 182-183.

45. Article 11, 6/b.

46. The system was based on the fact that individuals who bring in their money to SFHs will share all profits and losses. Account holders were informed of the possibility that, theoretically, all the money they deposited could not be paid back in case of loss. This was a complete implementation of profit/loss sharing. Hence, setting up this guarantee fund caused discussions about the principles of interest-free banking activities. With this fund, if some amount of money deposited by account holders was to be lost, it was to be paid back partially to the holders even if the bank went bankrupt, which was against the principle of the system that "all the money could be lost." Question marks in people's minds were removed by Hayrettin Karaman, one of the leading scholars of Islamic Law, who is trusted by the interest-free banking sector. According to Karaman, since the guarantee fund's resource comprised of deductions made upon mutual consent, procedure and agreement, the fund was covered in the frame of solidarity through "mutual donation," and was not objectionable according to Shariah.

After SFHs were included in the Banking Law in 1999, other legal arrangements were also made through communiques issued by the BRSA in the following years.[47] Disposition of funds by SFHs were reregulated pursuant to the by-laws published in the *Official Gazette* No. 24529 of September 20, 2001. Prior to the by-laws, SFHs could buy goods from a seller upon the request of a customer, and add their profit to the price of the good and sell it for the settlement. With this regulation, SFHs were not allowed to purchase goods, but instead they were granted the right to pay cash price to the seller on behalf of the customer, and the enterprise was allowed to get a time loan. SFHs no longer were subject to double taxation and joint liability - this arrangement in technicality created a problem in terms of conformity with Islamic jurisprudence, which provides legitimacy to SFHs activities. Under these circumstances, Hayrettin Karaman, who is one of the leading scholars specialized in Islamic jurisprudence and a member on SFHs' boards, found a "temporary" solution in order for SFHs to continue operations. Thus, he suggested to purchase and sell goods based on a verbal agreement and according to the old procedure, but to keep records as prescribed by the new by-laws. This is an example indicating that regulations of Islamic finance should be made not only through assessing the technical aspects but also the Islamic law.

In conclusion, in about two decades - from the issuance date of the first government decree (1983) until the AK Party's rise to government (2002) - SFHs faced many legal uncertainties. They were regulated by communiques until 1999, not by laws. After the February 28 post-modern coup, SFHs even faced closure. Considering all the above, it is fair to say that SFHs were unfairly treated for political reasons.[48]

47. Amendments were made and published in the *Official Gazette* No: 24529 of September 20, 2001; No: 24688 of March 7, 2002, and No:24980 of December 31, 2002.

48. In her article dated December 24, 2000 and titled "Özel Finans Kurumları" (Special Finance Houses), Meliha Okur expressed her opinion on the issue as follows: "However, it is clear that bureaucrats, in particular, did not lean towards these institutions ten years ago. Because special finance houses were 'unfairly treated' both by political and banking systems at that time." Ali Babacan also talked in the same manner (according to the daily *Sabah*): "He said that there were four participation banks in Turkey, that they were unfairly treated in certain periods and that these banks were granted equal terms of competition and leveled with commercial banks through legal regulations made in 2005 and 2006." "Ziraat ve Halk'a Katılım Talimatı", *Sabah*, March 29, 2013.

ISLAMIC FINANCE IN TURKEY AFTER 2002

The AK Party's formation of a single-party government in 2002 became a critical turning point for the Islamic financial sector in Turkey. In order to look into the developments of Islamic finance in this period, first of all, the objectives set in government programs regarding Islamic finance, participation banking or interest-free finance were noted. In terms of the steps taken in Islamic finance during the AK Party governments, it will be beneficial to examine them in three separate periods: The first includes the 58th and 59th government terms in which no noteworthy steps were/could be taken in Islamic finance as the AK Party was trying to familiarize itself with the bureaucracy and the state. The second is the 60th and 61st government terms in which the government played a role in paving the way for Islamic finance. The third is the time span from the 62nd government to the present in which Islamic finance has been regarded as a strategic sector. Approaches, policies and gains involving Islamic finance are considered in this categorization.

Table 2 below depicts the objectives set for Islamic finance in the AK Party government programs and important developments that took place in these periods. As is seen in the table, there were different priorities in the first period, targets for Islamic finance were not clearly stated, and improvement was very limited. The second period appears to be a time span in which Islamic finance not only was involved in banking, but also explored different institutional structures and products, while the government paved the way with regulations for the sector. The third period appears to be a period in which Islamic finance is included in government programs and has gained strategic importance.

TABLE 2. PLACE OF ISLAMIC FINANCE IN THE AK PARTY GOVERNMENT PROGRAMS

GOVERNMENTS	TERM OF OFFICE	ISLAMIC FINANCE IN GOVERNMENT PROGRAM	IMPORTANT DEVELOPMENTS
THE 58TH GOVERNMENT	Nov. 18, 2002-March 14, 2003 /4 months	No objective set	
THE 59TH GOVERNMENT	March 14, 2003-Aug. 29, 2007 / 3.5 Yrs	No objective set	Banking Law No. 5411 passed and SFHs are renamed "participation banks" (2005)
THE 60TH GOVERNMENT	Aug. 29, 2007-July 6, 2011 / 4 Yrs	No objective set	The establishment of the first takaful company (2009); the first sukuk issuance by Kuveyt Turk (2010); the communique of lease certificates (sukuk) issued by CMB (2010); tax regulation for lease certificates (2011)
THE 61ST GOVERNMENT	July 6, 2011-Aug. 29, 2014 / 3 Yrs.	No objective set	Participation Index formed (2011); the establishment of the first interest-free private pension company (2011); the issuance of the first sovereign USD- and TL-denominated lease certificates (2012); the World Bank Global Islamic Finance Development Center established in Istanbul (October 2013); the Participation Banking and Interest-Free Finance Workshop was jointly organized by the BRSA and the PBAT (December 2013)

THE 62ND GOVERNMENT	Aug.29, 2014-Aug.28, 2015 / 1 Yr.	"We will continue our works on the establishment of state-owned participation banks for the development of interest-free banking." (*Government Program*, p. 119)	First state-owned participation bank (Ziraat Participation Bank) founded (2015)
THE 64TH GOVERNMENT	Nov. 24, 2015-May 24, 2016 /6 months	"We will establish a mechanism for the coordination in the field of interest-free finance and will determine ethical principles and corporate governance principles for this area. We will increase the product diversity." (*Government Program*, p. 77). "We will issue new legislations, which will open the way for new financing methods such as sukuk, for the urban transformation projects." (*Government Program*, p. 125)	Establishment of Vakıf Participation Bank (2016), Formation of Interest-free Finance Coordination Board (2015), Establishment of Implementation Department in BRSA for interest-free finance (2015)
THE 65TH GOVERNMENT	May 24, 2016 - Present	"We will establish a mechanism for the coordination in the field of interest-free finance and will determine ethical principles and corporate governance principles for this area. We will increase the product diversity. We will make arrangements for tax incentives to increase the market share of interest-free financing methods and to ensure more inclusion for these financial instruments." (*Government Program*, p. 66). "We will issue new legislations, which will open the way for new financing methods such as sukuk, for the urban transformation projects." (*Government Program*, p. 107)	Establishment of Turkiye Wealth Fund Management Co. (2016)

Source: Government Programs

Note: The 63rd Government was interim election government was a temporary government for elections, therefore it was not included in the table.

FIRST PERIOD (2002-2007): DIFFERENT PRIORITIES AND FAMILIARIZATION WITH THE STATE

Founded in 2001, the AK Party acceded to power after its first general election. The 58th AK Party government, under Abdullah Gül, was a four-month transition period. Long-running AK Party rulings began with the 59th government, under Recep Tayyip Erdoğan. The AK Party came to power at a time when the effects of the 2000-2001 economic crises were still being seen. The governing AK Party prioritized putting the economy in order and making the necessary reforms. The 58th and 59th government programs did not exhibit any objectives set for or in reference to Islamic finance for two reasons. Firstly, the AK Party governments inherited many problems of the past governments and people expected solutions to these problems - in particular, economics. Therefore, no objectives were specified, and no priority was set in this particular area. The second reason is the historical secular dynamics of the country, and the institutional identity that the AK Party chose to adopt.

The AK Party identifies itself as a conservative democratic mass party.[49] That is, the AK Party should not overlook the demands of its conservative constituents. To the contrary of the method followed by different parties in the past, the AK party aimed to gradually fulfill expectations by creating a social consensus. The AK Party came to power but needed time in order to become more capable; thus, it tried to familiarize itself with the bureaucracy and the state during the 58th and 59th government periods.

Although the Islamic financial sector in Turkey does not use the word "Islamic" in the titles, it actually represents an Islamic identity. Therefore, in order not to cause a stir among secular dynamics, government programs did not include any specific objectives for Islamic finance and remained harmonious with the conjuncture. Instead, the AK Party governments attempted to take society's pulse. For instance, the AK Party vice chairman of the period, Nazım Ekren, in 2003, stated that public banks should also get involved in Islamic banking activities.

49. Yalçın Akdoğan, *AK Parti ve Muhafazakar Demokrasi* (AK Party and Conservative Democracy), (Istanbul: Alfa, 2004), p. 8. In founding the AK Party no association with a conservative democratic identity was made. However, after Akdoğan's book was published, such an identity for the AK Party was invoked. The AK Party was described as a conservative democratic party in the party program entitled "2023 Political Vision: Politics, Society, World (2014)". "Adalet ve Kalkınma Partisi kendisini siyasetin merkezinde konumlandıran muhafazakâr demokrat bir kitle partisidir" (AK Party located itself at the center of politics as a conservative democratic mass party), p. 4. See "Tayyip Erdoğan Partisinin Politikasına İsim Koydu" (Tayyip Erdoğan Named His Party Policy), Haber Vitrini, http://www.habervitrini.com/gundem/tayyip-erdogan-partisinin-politikasina-isim-koydu-muhafazakar-demokrat-42277, (Access date May 29, 2017).

Accordingly, opening a kind of Islamic window by public participation banks was considered; hence, such banks were to form a separate pool where they could also engage in activities based on profit/loss sharing.[50] In the same year (2003), the Undersecretariat of Treasury carried out studies for *sukuk* issuance by the public sector.[51] At that time, even *Kuveyt Türk* conducted studies to meet SFHs' liquidity needs and bring foreign funds into the country. However, efforts made in 2003 and 2004 to create a legal ground for the expected issuance could not be concluded.[52] State-owned participation banks were founded in 2014 and treasury *sukuk* issuance began in 2012.

During the terms of the 58th and 59th AK Party governments, the most critical step in favor of Islamic finance was to create a sound legal ground for SFHs consistent with the Banking Law No. 5411 in 2005 and acknowledge their contribution to the economy.[53] With this law, the name "Special Finance House" was changed to "Participation Bank." The term "participation banking" was first used by Hazıroğlu and Özcan.[54] The word "participation" implies that operations of such institutions are based on the principle of "profit/loss sharing."[55] The name "SFH" was used from the very first establishment of these institutions until 2005. These institutions carried out many transactions also performed by other banks, but only in compliance with the principle of interest-free. SFHs were also involved in international banking and foreign exchange transactions. However, they were treated in the category of non-bank financial institutions by some foreign correspondent banks because the word "bank" was not in their titles. The concept, however, created misunderstandings both inside the country and abroad, and different treatment of these institutions under different procedures ensued. This resulted in a business loss for customers who were doing export/import through SFHs with such countries.[56]

50. "Kamu Bankaları da İslami Bankacılık Yapacak" (State-Owned Banks Will Also Do Islamic Banking), *Milliyet*, March 31, 2003.

51. "İslam Bonosu" (Islamic Bond), *Milliyet*, April 25, 2003. It is important to note that first sentence of the article starts with "[C]arrying out with quiet and retiring efforts" ("sessiz sedasız yürütülen çabalarda.")

52. "Sukuk-u İcara Ne Demek?" (What Does Sukuk-u Ijarah Mean?), *Hürriyet*, January 8, 2004.

53. Asutay, "The Development of Islamic Banking in Turkey: Regulation, Performance and Political Economy", pp. 213-227.

54. "Albaraka Türk", *Bereket Dergisi*, Issue: 9.

55. Tunç, *Katılım Bankacılığı Felsefesi, Teorisi ve Türkiye Uygulaması* (Philosophy, Theory and Turkish Practice of the Participation Banking), p. 184.

56. . Mehmet Emin Özcan and Temel Hazıroğlu, "Bankacılıkta Yeni Bir Boyut: Katılım Bankacılığı" (New Dimension in Banking: Participation Banking), *Türkiye'de Özel Finans Kurumları Teori ve Uygulama*, (Istanbul: Albaraka Türk Yayınları, 2000), p. 194.

Another critical step taken for participation banks by the first two AK Party governments was that Adnan Büyükdeniz, then *Albaraka Türk* general manager, was recommended for the position of chairman of the Central Bank to the Presidential Palace. However, the president of the period did not find this appropriate. Discussions reflected concerns of secularism regarding the candidate's religious life, whether his wife wore a headscarf, or the kind of institution he worked for, but not about his competence.[57] In the following terms, however, managers in bureaucracy with experience in participation banking were appointed to the Central Bank.

As a result, during the AK Party governments in 2002-2007, government programs did not overtly include any objectives set for Islamic finance, yet still limited steps were taken in this direction. The forethoughtful attitude was not only towards Islamic finance but also towards conservative segments of the society who were subject to various bans, such as the headscarf ban, and the reduced weightings for university entry test scores for Religious High School graduates in the aftermath of the February 28 post-modern coup. In fact, the AK Party faced a closure case filed by the Office of Chief Prosecutor a year later, in 2008. The statement of "[a]nti-secular model is not in the party program, it is in the discourse and actions,"[58] as part of the case is critical to point out why the aforementioned AK Party governments did not explicitly set an objective for Islamic finance. An examination of the remarks made to justify the allegation that the AK Party was at the center of anti-secular actions reveals that if the government program had included an objective about Islamic banking, it would have been a reason for the AK Party's immediate closure. In this period, there were two very critical steps taken despite the problems involving the political structure: changing the phrase "Special Finance Houses" to "participation banking" and subjecting these institutions to similar regulations with other banking operations according to the Banking Law.

SECOND PERIOD (2007-2014): GOVERNMENTS' LEADING ROLE DESPITE POLITICAL AND ECONOMIC CRISES

The 60th and 61st AK Party governments, which served between 2007 and 2014, faced stern political and economic hardship. In 2008, a closure case was filed against the AK Party and the global economic crisis broke out, the effects of which were deepened in 2009. Turkey was distressed both politically and economically

57. "Merkez Bankasına Faizsiz Bankacı Sürprizi", *Hürriyet*, March 22, 2006; Çiğdem Toker, "'Faiz Haram'cıya Veto Çıktı, Merkez'e Yeni Aday Geliyor", *Hürriyet*, March 26, 2006; "Merkez'de Hesaplaşma", *Evrensel*, March 25, 2006.

58. "İşte AKP İddianamesi Tam Metin", *Hürriyet*, March 18, 2008.

due to negative developments both inside and abroad, namely the violent Gezi Park protests, the December 17-25 judicial coup attempt by the FETÖ terrorist organization, and the Syrian civil war and its repercussions on Turkey. At such arduous times, neither government programs included any objective for Islamic finance. However, regulations were made to clear the way for the private sector, and Turkey, for the first time, joined Islamic capital markets via issuing sovereign lease certificates (*sukuk*).

Albeit the Islamic Financial Institutions (IFI) were affected by the global financial crisis, these institutions recovered more wholesomely than conventional financial institutions because IFIs did not have overly venturesome instruments in their activities and had smaller shares in the global banking sector. In the post-crisis period, low interest rates and expansionary monetary policies implemented by leading central banks of the world to consolidate their economies formed a basis for the flourishing of Islamic capital markets. Thus, the global finance crisis turned into an opportunity for IFIs. After 2009, the Islamic financial sector in Turkey benefitted from the liquidity surplus abroad.

The Treasury Undersecretariat made a first ever export of Revenue Indexed Securities (RIS) on January 28, 2009. In an attempt to "expand investor-base and diversify government debt securities," RIS were issued to gain returns indexed to four state-owned economic enterprises' revenue shares transferred to the budget.[59] Participation banks purchased RIS through direct sale. Later on, new RIS were issued on April 29, 2009; February 24, 2010; August 11, 2010; February 23, 2011; and on August 24, 2011. Therefore, participation banks managed to diversify their assets. Private Pension Funds investing in interest-free instruments have also used RIS.

Fatawa are rulings on a point of Islamic law given by a recognized authority who is specialized in Islamic jurisprudence and are bounding for participation.[60] The reason is that all operations and activities should be based on Islamic principles, and these banks cannot operate on products and transactions if they are not Sharia-compliant. Whether a product is attractive or not is decided by advisory boards consisting of Islamic law scholars. Participation banks in Turkey have structures similar to "Sharia Boards" abroad, and these structures are called "advisory boards." By

59. "Gelire Endeksli Senetler Tanıtım Kılavuzu" (Revenue Indexed Securities Introductory Guide), T.C. Prime Ministry Undersecretariat of Treasury, (2009), p. 1, https://www.hazine.gov.tr/File/?path=ROOT%2F1%2FDocuments%2FYat%C4%B1r%C4%B1mc%C4%B1lar+%C4%B0%C3%A7in+Bilgiler%2FGes_brosur.pdf, (Access date May 29, 2017).

60. *Fatawa* is the plural form of *fatwa*.

analyzing the information given in the *Introductory Guide* published by the Treasury Undersecretariat, Hayrettin Karaman stated in an article in 2009 that investment in RIS is compliant with Sharia law. [61] Yet, in another article on February 19, 2012, Karaman said that RIS should be transformed into revenue sharing certificates, because the existing RIS bear interest.[62] Upon Karaman's evaluation, participation banks announced that they will not participate in new RIS issues from that time onwards, and, thus, the Treasury ended RIS issuances.[63]

Even though no plan relevant to Islamic finances appeared in the 60th and 61st government programs, arrangements were made that enabled IFIs to diversify their activities. In this respect, many "firsts" - particularly by the private sector – occurred in the area of Islamic finance. First, *takaful* and interest-free private pension companies were founded in this period. The first ever Turkish private corporate *sukuk*, worth USD 100 million with a three-year maturity, was issued by Kuveyt Türk Participation Bank (*Kuveyt Türk Katılım Bankası* or *Kuveyt Türk,* in short*)* on August 23, 2010. Prior to this issuance, the infrastructure of *sukuk* was constituted under the name of "lease certificates" after the release of a communique[64] by the Capital Markets Board of Turkey (CMB) in April 2010. Since *Kuveyt Türk* had launched lease certificate activities before this communique, the issuance was realized through a Special Purpose Vehicle (SPV) founded abroad without complying with the CMB communique. Tax uncertainty involving lease certificates was clarified by Law No. 6111 on January 25, 2011.[65] With an amendment in the Income Tax Law, revenues from lease certificates were deemed as returns on stocks and bonds and subject to 10 percent withholding tax. Moreover, SPVs were fully exempted from corporate tax. SPVs were to be exempted of any added-value tax, tax on relevant title deeds, and revenue stamps arising from movables or immovables that they took over or were to transfer, and from all transfer transactions therein. As a consequence of ameliorating tax arrangements, *Kuveyt Türk* issued the first lease certificate on October 30, 2011, this time in accordance with the CMB communique on lease certificates.

61. Hayrettin Karaman, "Gelire Endeksli Senetler" (Revenue Indexed Securities), Hayrettin Karaman's personal website, February 15, 2009, http:// www.hayrettinkaraman.net/makale/0389.htm, (Access date May 29, 2017).

62. Hayrettin Karaman, "Devletin Borç Senetleri" (Government Debt Securities), Hayrettin Karaman's personal website, February 19, 2012, http:// www.hayrettinkaraman.net/makale/0850.htm (Access date May 29, 2017).

63. "Faiz Fetvası Bankaları Harekete Geçirdi", NTV, March 29, 2012.

64. Kira Sertifikaları Tebliği" (Communiqué on Lease Certificates), *Resmi Gazete*, June 7, 2013, Issue: 28670.

65. The Law for Amendments in the Law regarding the Restructuring of Certain Receivables and Amendments in Certain Laws on Social Security and Public Health Insurance and in Some Other Laws and Statutory Decrees, Date of approval: February 13, 2011.

Along with the Undersecretariat of Treasury, the CMB and the BRSA making arrangements in favor of Islamic financial sector, the Central Bank of Turkey, too, plays an active role in Islamic finance by taking part in the International Islamic Liquidity Management (IILM). The IILM, as an important actor in the international arena, aims to facilitate liquidity management, which is one of the most important problems among IFIs. To this end, the organization facilitates effective liquidity management instruments for IFIs by issuing short-term *sukuk* that IFIs issue with minimum cost and consistent with interest-free banking principles. The Central Bank of Turkey is a member of the IILM and the IILM Governing Board.[66]

Lease certificates allow participation banks to procure funds both from domestic and international investors. Thus, the arrangements involving lease certificates were the most critical steps taken for the Islamic financial sector. Owing to these arrangements, participation banks founded SPVs and issued *sukuk* multiple times. With the issuance of the CMB communique on lease certificates and with the issuance of the first lease certificate by the Undersecretariat of Treasury, the government's role in paving the way for participation banks reached a new level. The Treasury issued 5.5-year maturity lease certificates worth USD 1.5 billion on September 8, 2012. This issuance immediately brought in about five times more demands both from within the country and abroad: 58 percent was sold to the Middle East, 13 percent to Europe, 12 percent to Asia, 9 percent to the Turkish domestic market, and 8 percent to a total of 250 investors in the U.S.[67] Such high demand beyond expectations proved that the decision was right, but late. On October 2, 2012, the Undersecretariat of Treasury issued the first Turkish Lira-denominated lease certificate worth 1.6 billion Turkish Liras. With the effect of high demands following the issuance mentioned above, the Undersecretariat of Treasury included issuance of lease certificates both in Turkish Liras and American Dollars in regular issuance programs, and has launched annual and regular imports in various amounts. Lease certificates issued by the state have become an investment instrument for participation banks to diversify their active assets. They also have provided a tremendous opportunity for IFIs such as *takaful* and private pension companies, that need fixed income interest-free products.

Another example from the same period showing the state's attention to Islamic finance, was the "Participation Banking and Interest-Free Finance Workshop" co-organized by the BRSA and the Participation Banks Association of Turkey (PBAT, or

66. "About Us", IILM, http://www.iilm.com/about-us, (Access date May 29, 2017).

67. Republic of Turkey Prime Ministry Undersecretariat of Treasury Press Release, Issue: 2012/ 143, September 18, 2012.

TKBB in Turkish) on December 21-23, 2013. The Islamic financial sector in Turkey was reviewed by academics, practitioners, and regulatory institutions. Different work tables were created for different areas and the findings were collected in a report[68] released after the workshop. However, the report remained on the agenda momentarily due to the December 17-25 judicial coup attempt.

In that period, another development regarding Islamic capital markets was the Participation Index created in 2011. Participation indexes have similar features with Islamic indexes which have been around for long (Dow Jones Islamic Market Index, FTSE Shariah Global Equity Index, etc.). Companies having shares traded in Borsa Istanbul and complying with the principles of participation banking, in other words Islamic finance, are identified by these indexes.[69] The aim here is to offer investors an alternative. Thus, in the second period of the AK Party governments, diversification of Islamic finance activities followed various legal regulations for the development of the sector in Turkey.

THIRD PERIOD (2014-PRESENT): CONSIDERING ISLAMIC FINANCE AS A STRATEGIC SECTOR

It seems that every government program since the 62nd government had plans for Islamic finance. Foregoing governments had paved the way for Islamic finance. This time, the view on Islamic finance began to change to an extent that the sector is perceived as a strategically important area. The goal to establish state owned participation banks was voiced[70] in the first quarter of 2013, and *Ziraat Katılım* was opened in 2015. It is quite striking that the then Deputy Prime Minister Ali Babacan at the opening ceremony stressed that the state's involvement in the Islamic financial sector was important for "permeance" in Turkey:

> There were times that participation banking was a sector that the state did not look positively towards, and even "unfairly-treated" it. But today, is a historic day in that sense. It is turning into a sector that the state gets involved in and embraces. This is a very important message to inside and outside, and for the settlement and strengthening of participation banking as well.[71]

68. Participation Banking and Interest-Free Finance Workshop Report (Ankara: BDDK, 2014).

69. "Katılım Endeksleri Tanıtım Sunumu" (Participation Index Introductory Presentation), Katılım Endeksi (Participation Index), http://www.katilimendeksi.org/content/userfiles/files/ yeni_katilim_endeksleri_sunumu.pdf, (Access date May 30, 2017).

70. "Ziraat ve Halk'a Katılım Talimatı" (Order to Ziraat and Halk to Establish Participation Banks), *Sabah*, March 9, 2013.

71. "Babacan: Katılım Bankacılığını Devlet Sahipleniyor" (Government Embracing with the Participation Banking), *Bloomberg HT*, May 29, 2015.

On the other side, *Vakıf Katılım Bankası* launched operations in 2016. Old foundations (*waqfs*)[72] symbolically joined as founding partners, but they do not have substantial shares. With the announcement of the goal to establish state-owned participation banks, *Halk Bank* launched works to set up *Halk Katılım Bankası*,[73] but postponed it until a further date. It is expected that even if *Halk Katılım* does not start operations, it will have a license for activities.[74] Together with the contributions of public participation banks, the share of participation banks in the banking sector is expected to increase to 15 percent by 2025.[75]

The project for Istanbul International Finance Center (IIFC) has strategic importance for the Turkish economy.[76] Initial efforts for the IIFC were made in 2011 and the Ministry of Development published a relevant Action Plan in December 2014.[77] The plan consists of seven subcomponents in the scope of the 10th Development Plan. One of the plan's essential components is the Islamic Finance Center. Accordingly, the 7th component of the Action Plan is entitled "Participation Banking and Developing an Interest-Free Financial System" and consists of four policies and 31 action stages. Some of the headings in the action plan are: "Improving existing perception towards an interest-free financial system", "Improving human resources and literature in the area of interest-free finance", "Improving the institutional structure and legal substructure of interest-free financial system", and "Increasing interest-free finance products and service diversities."[78] It is critical to expeditiously accomplish the Action Plan with such a comprehensive structure.

The goal of becoming an Islamic finance center is not inherent to Muslim countries (Qatar, Indonesia, Malaysia, etc.). Western countries, such as the U.K. and Luxembourg, have the same goal, too. For instance, in order to improve the Islamic financial sector and determine the obstacles of this sector, the U.K. formed a

72. Bayezid Han-ı Sani (II. Bayezid) Foundation; Mahmut Han-ı Evvel Bin Mustafa Han (I. Mahmut) Foundation; Mahmut Han-ı Sani Bin Abdulhamit Han-Evvel (II. Mahmut) Foundation; and Murat Paşa Bin Abdusselam (Murat Paşa) Foundation. The total share of these foundations in *Vakıf Katılım* stands at 1 percent.

73. "Özel Durum Açıklaması, (Genel)", *KAP*, March 12, 2013, https://www.kap.org.tr/tr/Bildirim/266010, (Access date May 30, 2017).

74. "Yılbaşından Önce Faaliyete Girecek" (Operation Will Start Before New Year), *Yeni Şafak*, November 7, 2016.

75. "TKBB Strateji Belgesi 2015-2025" (PBAT Strategy Document 2015-2015), TKBB, p. 3.

76. For detailed information on Istanbul International Finance Center, see Erdal Tanas Karagöl, Yusuf Emre Koç and Mehmet Kızılkaya, *İstanbul'un Finans Merkezi Olma Arayışı*, (Istanbul: SETA Rapor, 2017).

77. "Onuncu Kalkınma Planı-İstanbul Uluslararası Finans Merkezi Programı Eylem Planı (2014-2018)" (The Tenth Development Plan - Istanbul International Finance Center Program Action Plan), Kalkınma Bakanlığı (Ministry of Development), http://odop.kalkinma.gov.tr/dokumanlar/4Istanbul_Uluslararasi_Finans_Merkezi_Programi.pdf, (Access date May 30, 2017).

78. "TKBB Strateji Belgesi 2015-2025" (PBAT Strategy Document 2015-2015), TKBB, p. 23.

working group within the body of its Central Bank in 2001. The United Kingdom also founded the "Islamic Finance Secretariat" in 2011 to coordinate and promote the development of Islamic finance.[79] The U.K. realized its first *sukuk* issuance, worth £200 million, in 2014. By looking at the long-term steps the U.K. has taken as a Western country with a Muslim minority population, Turkey should more rapidly complete bureaucratic processes. Furthermore, the uncertainty that the U.K. is experiencing after Brexit may create an opportunity for Turkey to become an Islamic finance center.[80]

In recent years, Turkey has engaged in significant organizations and cooperation in the area of Islamic finance: Turkey undertook G-20's term presidency in 2015, made efforts to include Islamic finance in the G20's agenda,[81] and to this end, hosted important international organizations in Istanbul.[82] Similarly, Turkey hosted the 32nd Ministerial Meeting of the Standing Committee for Economic and Commercial Cooperation of the Organization of the Islamic Cooperation (COMCEC), and the BIST signed a strategic cooperation protocol with the IDB afterwards.[83] At the same time, all these programs and cooperation contribute to Turkey's goal to become an Islamic finance center. Having said that, the IDB sped up works to establish the Mega Bank to function as an investment bank with the aim to provide liquidity to IFIs with the partnership of Turkey and several Islamic countries (Indonesia comes to the fore presently). The government places great importance on the Mega Bank project in terms of its contribution to Turkey's goal to become an Islamic finance center.[84]

In this period, new structures have been created to demonstrate that Islamic finance is regarded as a strategic sector. The BRSA formed the "Implementation Department" in 2015 to enhance participation banking and run their operations

79. "UK Excellence in Islamic Finance", UK Department for International Trade, (2014), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367154/UKTI_UK_Excellence_in_Islamic_Finance_Reprint_2014_Spread.pdf, (Access date May 30, 2017).

80. Mücahit Özdemir, "Brexit ve İslami Finans" (Brexit and Islamic Finance), *PESA Analiz*, (June 2016).

81. "Integrating Islamic Finance into Global Finance", Draft Note for the G20, (İslami Finansın Küresel Finansa Entegrasyonu Hakkında IMF/Dünya Bankası Grubu Notu), August 2015.

82. For examples, see "Uluslararası Kobi Şurası 2015", Kobi Şurası, http://kobisurasi.org, (Access date May 30, 2017); "Mobilizing Islamic Finance for Long-Term Investment Financing", World Bank, http://www.worldbank.org/en/events/2015/11/18/mobilizing-islamic-finance-for-long-term-investment-financing, (Access date May 30, 2017).

83. For the news article on the agreement, see "Borsa İstanbul ile İslam Kalkınma Bankası İş Birliğine Gitti", *Borsa İstanbul*, http:// www.borsaistanbul.com/duyurular/2016/11/24/borsa-istanbul-ile-islam-kalkinma-bankasi-is-birligine-gitti, (Access date May 30, 2017).

84. "Mehmet Şimşek: Megabank Bu Sene İçinde Kurulabilir" (Mehmet Şimşek: Megabank May Be Establish in This Year), *Fortune Turkey*, May 11, 2016.

more effectively and rapidly.[85] The establishment of such a unit shows a transition from a public authority that, at one time, did not make necessary arrangements for SFHs to a public authority that establishes a special department for participation banks. Another point that showcases the government's interest in the Islamic financial sector is that top executive officers of the most important institutions in the economy today (Central Bank, the BRSA, and the Treasury) have had experience in participation banking.

Yet another goal included in a government program was realized in late 2015 with the establishment of the Interest-free Finance Coordination Board (IFCB).[86] The board aims towards coordination among Islamic financial institutions and to set out ethical and institutional management principles. The setting of such principles and their implementation are achieved with the assistance of advisory boards from across the world. While some countries have only special advisory boards, Malaysia has a centralized advisory board as well. The transactions of IFIs and general principles on potential products and services are determined by approval of these boards. The IFCB taking a step in this direction carries on work to establish a centralized advisory board.[87] As soon as the centralized advisory board comes into effect, IFIs will expectedly have more prestige in the public eye, and the public will have more confidence in such institutions. Questions raised by the public such as "Why does each Islamic bank have a special advisory board?" and "Why are there different *fatawa* (Islamic jurisdictions) on the same product from different advisory boards?" will be answered by this centralized advisory board.

Obviously, the IFIs need qualified human resources in order to take sound steps. The contribution of individuals who work in the field but do not know Islamic finance principles will certainly be different from that of people who adopt the principles of Islamic finance. Since the Islamic financial sector seems to have a strategic position in this period, there has been development in education as well. Considering higher education institutions, there was no course on the subject of Islamic finance before 2014. As of late 2016, however, selective courses in many universities are offered[88] as some universities opened undergraduate, gradu-

85. "2015 Faaliyet Raporu" (2015 Annual Report), BDDK [BRSA], p. 53.

86. "Faizsiz Finans Koordinasyon Kurulu Oluşturuldu" (Interest-Free Finance Coordination Board Established), *Milliyet*, December 15, 2015.

87. "Faizsiz Finans Koordinasyon Kurulunda Reel Sektörün Kur Riski Değerlendirildi" (Currency Risk Evaluated in Interest-Free Finance Coordination Board Meeting), *Bloomberg HT*, December 29, 2016.

88. Gülseven Özkan, "İktisatçılar İslam Ekonomisi Dersine Ne Diyor?" (What Do Economists Say about Islamic Economics Lecture?), *Hürriyet*, December 19, 2014.

ate and doctoral programs. Turkey carried into effect the Higher Education Board 100/2000 Project in an attempt to increase its qualified human resources, which is one of the country's 2023 targets. In this regard, PhD scholarships will be given to 2,000 individuals in 100 priority fields one of which is Participation Banking.[89] In this scope, three different universities accept doctoral students in a participation banking program. Such moves in education help us see the strategic importance Islamic finance has gained.

DEVELOPMENT OF ISLAMIC FINANCE WITH FIGURES AFTER 2002

In the banking sector, Islamic financial institutions had only 1.2 percent market share, with an asset size of 212.7 billion Turkish Liras. The ratio reached 2.4 percent at the end of 2005. Following the name change to "participation bank," the market share of IFIs in the banking sector increased more rapidly. In three years, the ratio increased to up to 3.5 percent, and to 5.5 percent in 2013 - its highest ever in the banking sector. After the December 17-25 judicial coup attempt in 2013, the participation bank linked to FETÖ, dramatically decreased its asset size.[90] As a result, the share of participation banking in the sector dropped from 5.2 percent in 2014 to 5.1 percent in 2015. The BRSA terminated the operations of the participation bank in 2016, and the number of players in the sector dropped to five. Consequently, the market share of participation banks decreased to 4.9 percent in late 2016. As public participation banks have increased their branch networks, their market share is expected to exceed 5 percent again in 2017.

89. For detailed information on YÖK 100/2000 program, see "100/2000 YÖK Doktora Bursları", YÖK, http://www.yok. gov.tr/web/100-2000/hangi-alanlarda, (Access date May 30, 2017).

90. FETÖ refers to the Fetullah Terrorist Organization. For details see https://aa.com.tr/en/turkey/what-is-feto-an-overview-of-the-terrorist-organization/626375 (Access date February 12, 2018).

TABLE 3. SECTOR SHARES AND MAGNITUDES OF PARTICIPATION BANKS IN THE PERIOD OF 2000-2016				
YEARS	Participation Banks (million liras)	Annual Growth (%)	Banking Sector (million liras)	Participation Banks Sector Share (%)
2000	2.266		106.549	2,1
2001	2.365	4,4	218.873	1,1
2002	3.962	67,5	212.681	1,9
PERFORMANCE OF PARTICIPATION BANKING SECTOR DURING THE AK PARTY GOVERNMENTS				
2003	5.113	29,1	249.688	2,0
2004	7.299	42,8	306.439	2,4
2005	9.945	36,3	406.909	2,4
2006	13.752	38,3	499.731	2,8
2007	19.445	41,4	581.606	3,3
2008	25.770	32,5	732.536	3,5
2009	33.628	30,5	834.014	4,0
2010	43.339	28,9	1.006.667	4,3
2011	56.148	29,6	1.217.695	4,6
2012	70.279	25,2	1.370.690	5,1
2013	96.075	36,7	1.732.401	5,5
2014	104.319	8,6	1.994.329	5,2
2015	120.183	15,2	2.357.432	5,1
2016	132.874	10,6	2.730.943	4,9

Source: PBAT and BRSA December 2016 Interactive Bulletin

CONCLUSION AND POLICY RECOMMENDATIONS

Considering that the IFIs spread globally in the late 1970s, it is fair to say that the first steps taken in Turkey took place accordingly. However, the development of IFIs in Turkey lagged behind many countries due to economic, conjunctural, and especially political reasons. For instance, the size of Islamic financial sector in Malaysia, which founded its first Islamic bank just a few years before Turkey, is eight times larger than the Turkish Islamic financial sector's size. Since the AK Party came to power in 2002, various moves for developing, smoothing the way for, and securing Islamic finance on a firm ground have been taken; however, progress does not meet expectations yet. An indication of this is that the share of participation banks dwells at just 5 percent today. In order to increase the market share of Islamic finance, public authorities have not only provided support from the outside but also engaged in the sector as a player by issuing lease certificates and opening state-owned participation banks in recent years.

The AK Party's growing confidence in governing, and the fact that both the presidential post and the executive body are represented by the same party have prevented possible political crises, and helped the AK Party government meet the postponed objectives with respect to Islamic finance more comfortably. That has marked a turning point for the sector. A noteworthy reflection of this is the first ever sovereign *sukuk* issuance in 2012 - an Islamic finance instrument for the first time was preferred by the state. Thereafter, the Islamic financial sector has been viewed as a strategic sector by the government - particularly since 2014. The reason for this is not only that the government and the Islamic finance sector share similar worldviews – there have also been pragmatic motives. The global financial crisis in 2008 increased demands for alternative sources of financing and one such source is Islamic finance.

Asset-backed financing, ethical values, institutional management, and social responsibility make the Islamic financial sector a more appealing alternative in global markets. Also, it was compelling for Turkey to step into this area as Islamic finance gained more supporters in Western countries and due to the need for alternative financing methods in the aftermath of the 2008 crisis. Leading central banks, starting with the U.S. Federal Reserve (FED), halted monetary expansion programs and gradually increased interest rates, which caused liquidity problems especially for developing countries. Meanwhile, Turkey seeks to diversify its economic and commercial relations beyond the European Union. Thus, the AK Party government endeavors to bring in the Gulf capital – especially from Qatar – through Islamic finance products and is trying to speed up the necessary arrangements in this regard.

In recent years, the government, bureaucracy and related Islamic financial institutions (participation banks, *takaful*, private pension companies, etc.) have closely cooperated for the growth of the Islamic financial sector in Turkey. A survey reveals that participation banks' employees see the government's supportive attitude as the biggest positive factor in the development of Islamic finance in Turkey and perceive changing political conditions as the sector's biggest threat.[91] The AK Party's attempts to look out for and support the sector - particularly in the last period - have played a critical role in this approach. However, Islamic finance is regarded as a strategic area not only by Turkey but also by other Muslim and non-Muslim states. These countries establish new institutions, increase cooperation, and invest in human resources. For this reason, there are more steps to be taken in order for the sector to reach its goals inside the country, and for Turkey to increase its share in the global Islamic financial markets. In this spirit, recommendations are made under the following headings.

RECOMMENDATIONS ON REGULATIONS

Legal regulations on Islamic banking in Turkey have reflected the differing worldviews of governments and, as a result, the sector experienced tough times. IFIs were liable under the Banks Law in 1999 and the Banking Law in 2005 as "participation banks." These were critical and firm actions in favor of the Islamic financial sector in Turkey. Nevertheless, the relevant laws do not take into account the idiosyncrasies of

91. Hakan Aslan and Mücahit Özdemir, "Development of the Islamic Finance in Turkey: A Questionnaire Study", *Kuala Lumpur International Business, Economics and Law Conference 7 (KLIBEL7*), (Kuala Lumpur: 2015), pp. 40-41.

participation banks. For instance, the most used method of financing by participation banks is *murabaha* (known in practice as individual/institutional finance support); however, Islamic jurisprudence-related problems in *murabaha* transactions remain unresolved,[92] creating the perception in society that participation banks perform the same transactions as conventional banks. Not only the participation banks, but also all other IFIs need an independent set of regulations. Thus, a comprehensive legislation regarding IFIs (such as *takaful*, etc.) should be prepared to remove all question marks, expressed by both domestic and international investors about whether the activities of IFIs are in harmony with Islamic jurisprudence.[93] The legislation should also be consistent with implementations across the world and be congruent with the type and spirit of operations. In the meantime, opinions of all stakeholders should be taken into account, international implementations should be benefitted from,[94] and the public should be informed that the implementation problems derived from the constraints in existing procedures have been resolved.

Informing the stakeholders (customers, or non-customers, of participation banks in particular) is necessary. The following example demonstrates how crucial it is to inform the stakeholders: participation banks deposit the required reserves for the funds they collect (as other banks do) from account holders to the Central Bank. For these reserves, the Central Bank made interest payments until September 2010, but has stopped paying interest since then. Thus, the cause of the public misperception that "participation banks receive interest from the Central Bank" was removed. However, since members of society were not adequately informed on the issue, the misperception that the Central Bank pays interests to participation banks has persisted. Unfortunately, the moment the issue was about to be clarified, the Central Bank reinitiated interest payments in 2014. For this reason, the points that conflict with the religious premise of Islamic banking should be eliminated through new legislation, and the public should be informed effectively. With the desired new legislation, not only will such institutions have a firm ground and guarantee for sustainability, but their credibility in the public eye will also increase.

92. For Karaman's criticism on the subject, see Hayrettin Karaman, "Katılım Bankaları Mevzuatı Problemli", Hayrettin Karaman's personal webpage, May 30, 2014, http://www.hayrettinkaraman.net/makale/1200. htm, (Access date May 30, 2017).

93. Not only the legislation about the Banking Law, but the calculation of capital adequacy and the issues that are of interest to different institutions, such as double taxation and required reserves, should also be reassessed.

94. For instance, in Malaysia, the state swiftly passes regulations about the Islamic finance sector and promotes the sector. Thus, Malaysia has almost the biggest share in the Islamic finance sector albeit its relatively smaller population and its considerable non-Muslim population. Necessary legal regulations should be made expeditiously, in order for Turkey to have a significant share in the Islamic finance market.

Speaking of IFIs, it is known that one of the most important factors that distinguishes IFIs from similar conventional institutions is their advisory boards. IFIs need *fatawa* from such boards for their activities, and for providing services and products. Each participation bank in Turkey has a consultative board of its own. Products offered by some participation banks may not be deemed proper by others. This creates confusion in society. For this reason, a centralized advisory board is needed and the standardization of the sector by this board is crucial. In addition to Malaysia - pioneering in Islamic finance - the UAE, Bahrain, Indonesia, Bangladesh, and Pakistan have centralized counseling boards other than each bank's consultative board. With a centralized advisory board, possible suspicion about IFIs' transactions may be avoided and these institutions may be supervised for compliance with Islamic principles. The top ten countries in the global Islamic financial sector, such as Saudi Arabia, Iran, Qatar, Kuwait, and Turkey among others, have no centralized advisory boards.[95] The Interest-Free Finance Coordination Board is conducting studies regarding a centralized counseling board. Prompt completion of these efforts will be a critical step and have a positive impact on the course of the sector. It is known that the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is preparing a new standard for this purpose.[96] With the standards to be set by a centralized advisory board, confusion among the people will be cleared away, and public confidence in these institutions will increase.

RECOMMENDATIONS ON HUMAN RESOURCES AND PUBLIC AWARENESS

The sound development of IFIs in Turkey requires an increase in qualified human resources consisting of leading experts who have comprehensive knowledge of the rules and principles of Islamic finance. In their initial phases, Islamic banks – as expected – have built up their human resources by hiring employees with experience in conventional banks. Turkish universities did not offer any courses or education on Islamic finance until 2012; hence, participation banks organized training for their employees. The training was generally about in-company procedures, and did not offer any comprehensive training on the functioning of Islamic finance. Thus, employees, without sufficient information about the system, have failed to inform customers about the differences between conventional and participation banks.

95. ICD-Thomson Reuters Islamic Finance Development Report, (2016), p. 31.

96. "AAOIFI Merkezi Danışma Kurulu Standardı Taslak Metni", AAOIFI, http://aaoifi.com/announcement/aaoifi-publishes-central-shariah-board-standard-exposure-draft-and-invites-opinion-from-islamic-finance-industry/?lang=en, (Access date May 30, 2017).

Recent university courses, undergraduate and postgraduate programs on Islamic economics and finance, as well as national and international conferences on the subject contribute to the efforts to close this gap. However, it is safe to say that Turkey remains quite behind its potential competitors in Islamic finance education, too. For instance, U.K. universities, such as Durham and Oxford, have offered Islamic finance programs for almost two decades. Many international students from Malaysia, Indonesia, and the Gulf countries, in particular, receive state scholarships to receive an education in these universities, while leading countries in Islamic finance, e.g. Malaysia, have state-sponsored Islamic finance programs and research centers.

Some Turkish universities opened research centers on Islamic economics and finance after 2012. However, Turkey needs a special education strategy to close the gap with other countries. To this end, the government should craft scholarship programs for postgraduate students to study abroad. Educational scholarships should be offered in accordance with quotas assigned to the U.K., Malaysia, Indonesia, Bahrain, Qatar, and similar countries. Students who go to these countries to study should be asked not only to complete their education, but also share the successful Islamic finance practices they learn abroad upon their return to Turkey. Since postgraduate theses concentrate on a certain topic only, the experience, the obtained know-how, and observations can open new horizons. Thus, both human resources may increase and the practices in such countries may be adapted to the conditions of Turkey. On the other hand, conferences about Islamic finance education at universities should be targeted and organized more frequently. In this manner, the youth may be introduced in universities to Islamic finance.

On the other hand, civil servants who have the expertise, or are interested, in Islamic finance should be assigned to international Islamic financial institutions for a certain period of time, and cooperation for this purpose with public institutions should be assured. For instance, officials at the BRSA, the Central Bank, and the CMB may be temporarily assigned to/employed by the Islamic Development Bank, the AAOIFI, and the Islamic Financial Services Board (IFSB). Some public institutions have already sent their officials to international institutions that regulate Islamic finance; this, however, should be planned more systematically and in a coordinated manner. Therefore, regulations in target/host countries may be better understood and their adaptation by Turkey may be explored. Similarly, the Council of Higher Education and the Scientific and Technological Research Council of Turkey should offer incentives to research centers at universities to participate in academic exchange programs with the Islamic Research and Training Institute (IRTI) and the ISRA.

Turkey's population is over 90 percent Muslim, but the share of participation banks, in the Turkish banking sector, stands at 5 percent. One of the reasons is that society has not been fully convinced about the merits of participation banks. A segment of society shows no sensitivity towards interest as a yield/cost determines their preferences. On the other hand, another segment seeks interest-free financing or savings and they choose participation banks and switch between participation banks depending on differences in profit rates. Yet another segment seems sensitive about interest, but considers that participation banks are not different from other interest-driven banks even if they can reach a certain level of financial services. The reasons are procedure-related problems, as mentioned above, discrepancies in practice - for instance, problems with revenue index bonds (GES), etc. - and lack of information on the part of personnel regarding participation banks. In order to convince this segment of society, awareness about Islamic finance and financial literacy should be increased, and to this end, public service ads should be organized.[97] Conferences should be held under the leadership of the PBAT, and there should be cooperation between non-governmental organizations.

RECOMMENDATIONS ON ISLAMIC FINANCIAL INSTITUTIONS AND PRODUCTS

In Turkey, as in the rest of the world, the first thing that comes to mind in relation to Islamic finance is participation banks. Different types of IFIs have emerged recently around the globe and their weight in the sector has increased. In Turkey, however, a very limited number of IFIs carry on business. Similarly, it is fair to say that product diversity in Turkey until 2010 was almost next to zero. However, initiatives, such as lease certificates (*sukuk*) communique and lease certificate issuances, and the creation of the Participation Index have varied Islamic financial products, while the establishment of interest-free private pension and insurance companies have increased IFI diversity in the country. The model did not change with the introduction of state-owned participation banks after 2010, but the ownership of these banks varied.

State-owned participation banks have failed to increase the sector's share according to expectations. A few important reasons may be that they open branches

97. The Economy Bank of Turkey (TEB), in cooperation with the Ministry of National Education, offers free financial literacy courses to parents and students. Participation banks should also make similar efforts. PBAT may take the lead on the subject. For detailed information, see "TEB Finansal Okuryazarlıkta Nüfusun %25'ine Ulaşmayı Hedefliyor", *Bloomberg HT*, February 27, 2017.

in cities where private participation banks already operate, and that they offer the same product varieties and target similar audiences. As a result, the market has divided, not expanded. Thus, in order to branch out, in particular, to products to be offered to target clients, state-owned participation banks should determine a different strategy. In this direction, Ziraat Participation Bank should target rural areas, Vakıf Participation Bank low-income individuals and micro enterprises, and they should develop specific products for each group. The planned Halk Participation Bank can concentrate on providing interest-free services to Small and Medium Size Enterprises (SMEs). By doing so, the segments of society that participation banks has failed to reach, will meet with participation banking, and, therefore, contribute to the increase of the sector's capacity and to financial inclusion. On the other hand, public institutions should direct their funds to public participation banks and prefer participation insurance (*takaful*) companies for their insurance activities. In this manner, they will significantly contribute to the growth of the sector's market share. The transfer of public funds to Islamic finance may increase the market share of the participation sector in Turkey.

Although Islamic banks come to mind when one mentions Islamic finance, non-bank financial institutions (NBFIs) have become more important lately. In many countries, NBFIs offer society financial services. Some of these institutions include Islamic microfinance institutions, Islamic cooperative institutions, pawn-brokering institutions, cash *waqfs*, *zakat* funds, hybrid enterprise models (e.g. a combination of *waqf* and *zakat*), interest free loan (*qard al hasan*) funds, Islamic investment funds, rural and village banks, and micro*takaful* companies. A majority of these institutions – which are unfortunately pushed away by Islamic banks as well – provide financing to low-income groups and aim to reduce poverty. Particularly in Indonesia, Malaysia and Pakistan, different models of institutions other than Islamic banks operate in accordance with relevant legal procedures prepared specifically for them. Thus, such models should be explored and examined, and regulations should be made to apply these models in Turkey.

One of the objectives stated in the foundation charter of Turkiye Wealth Fund Management Co. (TVF) is to "[t]o generalize Islamic financial assets."[98] The fund, established in August 2016, may, thus, contribute to the Islamic financial sector in Turkey and help increase its market share in the world markets. S*ukuks*, issued by wealth funds in the Gulf countries and Malaysia, are preferred

98. For the reason behind the establishment of Turkey Wealth Fund, see "Kanun Tasarısı", The National Grand Assembly of Turkey, August 1, 2016, http://www2.tbmm.gov.tr/d26/1/1-0750.pdf, (Access date May 30, 2017).

for financing many international infrastructure projects.[99] For future infrastructure projects, Turkey may prefer *sukuk* issuance by the Wealth Fund to increase the volume of Islamic finance. In this way, it will create an alternative for private and institutional investors from the Gulf countries who intend to invest in Islamic funds. Furthermore, the method of interest-free borrowing may be opted in; thus, the burden of interest may be reduced. Along with *sukuk* issuance by the TVF, investments in Islamic capital market instruments in other countries may be considered and, thus, the growth of the Islamic fund in Turkey may be achieved through the TVF.

Alternative Islamic financing methods rather than the build-operate-transfer model in infrastructure projects should be used. By doing so, both the diversity and the volume of Islamic financial products may be increased, and private and institutional investors who are willing to invest in an interest-free way may be reached. To this end, as an example, *sukuk* issuances may be structured in a way to accumulate funds from people for public bridges, and then people may be given the right to earn dividends from public (toll) bridges by issuing lease certificates. This way, people can have shares in profit earned from these bridges. When *sukuk* is used for financing infrastructure projects, revenues from public projects, such as bridges and tunnels return either to people or to institutional investors who invest in these projects. Thus, crossing guarantee may not be needed and the burden of additional interest may be avoided. Besides, trading such *sukuks* on secondary markets may create a liquidity management facility for participation banks, private pension, and insurance companies. Since IFIs cannot utilize short-term bonds, repos and stocks, they may be helped by removing disadvantages in this matter.

The growth of the Islamic financial sector in Turkey can be achieved not only by increasing domestic demand but also by accessing foreign investors. Because the growth of the Islamic financial sector, participation banks in particular, is closely related to fund accumulation, and the savings rate in Turkey is very low, some participation banks try to procure funds from foreign markets through *sukuk* issuance, and *murabaha* syndication loans. In order to attract these funds to Turkey at reasonable costs, Turkey should give weight to lobbying activities abroad. Turkey should seriously attach importance to promotion activities by joining international investors' conferences and roadshows.

99. Examples are the Investment Corporation of Dubai in Dubai, Khazanah National in Malaysia, and Mumtalakat Holding Company in Bahrain.

However, foreign investors pay a great deal of attention to credit rating agencies' country credit notes despite the heavy criticism these agencies received after the global financial crisis in 2008. In early 2017, it was a critical step[100] that the BRSA recognized the Islamic International Rating Agency (in the service of Islamic financial institutions), like other leading credit rating agencies, in regards to the calculation of capital adequacy; however, the institution has not yet received consideration in investment decisions. Turkey needs reforms to minimize risks in many areas - currency fluctuations in particular - so as to receive a credit note of "investable." That will enable the Islamic financial sector to reach foreign-based sources and achieve the desired market sector share.

100. "Kurul Kararı", Decision No: 7194, BDDK, January 12, 2017, https://www.bddk.org.tr/WebSitesi/turkce/Duyurular/BDDK_Kurul_Kararlari/157447194.pdf, (Access date May 30, 2017).

APPENDIX: MILESTONES IN THE DEVELOPMENT OF ISLAMIC FINANCE IN TURKEY

DESIYAB - 1975

First banking initiative with profit/loss sharing

Special Finance Houses (SFHs) Issuance of SFH Decree - 1983
Albaraka - 1984
Faisal Finans - 1985
Kuveyt Turk - 1989

Ihlas Holding activities were stopped due to 2001 financial crisis

Establishment of SFHs Association 2001

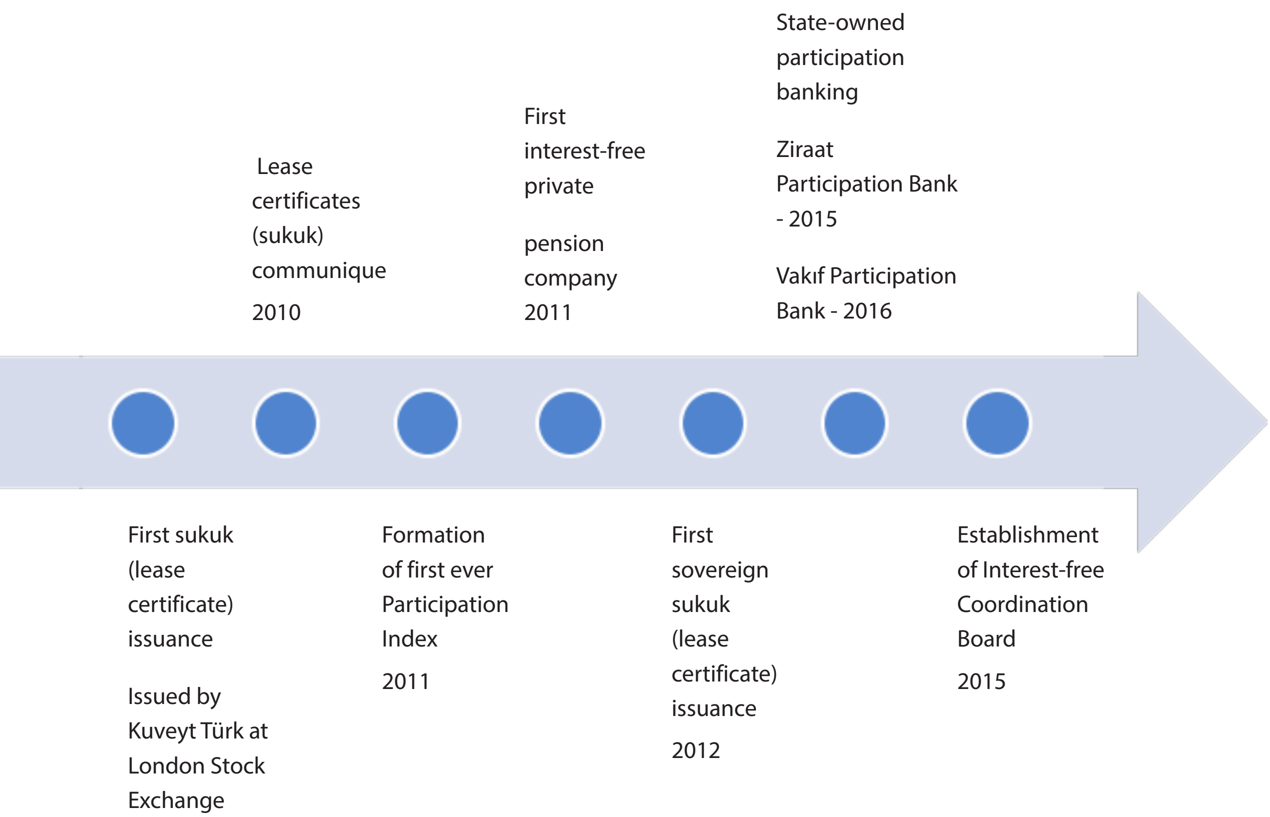
Development of Islamic finance sector accelerated as of 2002

SFHs are described as “Participation Banking” in the law

The Law No. 5411 - 2005

First takaful (Islamic Insurance) company

Neova Sigorta - 2009 December


First sukuk (lease certificate) issuance
Issued by Kuveyt Türk at London Stock Exchange
Lease certificates (sukuk) communique
2010
Formation of first ever Participation Index
2011
First interest-free private
pension company
2011
First sovereign sukuk (lease certificate) issuance
2012
State-owned participation banking
Ziraat Participation Bank - 2015
Vakıf Participation Bank - 2016
Establishment of Interest-free Coordination Board
2015

Mücahit ÖZDEMİR

Özdemir graduated from the Department of Economics at Boğaziçi (Bosphorus) University in 2009 and worked at the Investor Relations Department, *Albaraka Türk* Participation Bank, between 2010 and 2014. He earned his M.A. degree in Banking at Marmara University in 2013. Özdemir pursues his Ph.D. at the Department of Islamic Economics and Finance at Sakarya University, and is currently studying on his dissertation at Durham University, England. The author has worked as an research assistant. at the Islamic Economic and Finance Department at Sakarya University since December 2014.

Hakan ASLAN

Aslan has been awarded his bachelor's degree in Actuarial Sciences at the Marmara University in 2009 and then proceeded to his postgraduate studies in Financial Markets and Investment Management at the same university and awarded his MSc degree in 2012. During his postgraduate studies, he has also served as a Research Assistant at the same department from 2011 to 2015. Currently, he is pursuing his PhD in Accounting and Finance at the Marmara University. He has been to the International Islamic University Malaysia (IIUM) for 1 year as a visiting academic staff to develop his PhD thesis. He is serving as a research assistant in the Research Centre of Islamic Economics and Finance, Sakarya University since 2015.

REPORT

THE POLITICAL ECONOMY OF THE TRANSFORMATION OF ISLAMIC FINANCE IN TURKEY

MÜCAHİT ÖZDEMİR, HAKAN ASLAN

When Islamic finance is mentioned around the world, the first thing that comes to mind is Islamic banks. The sphere of Islamic finance has expanded in the last decade with developments particularly in capital markets and the insurance sector. Nonetheless, the market share of Islamic finance in the world's financial market accounts for merely approximately 1 percent. Still, many segments are interested in Islamic finance because of its high growth figures, resilience against crises, and the fact that it offers a system that prioritizes ethical values in contrast to conventional finance. Islamic banks in Turkey date back to the establishment of the Adapazarı Islamic Trade Bank (Adapazarı İslam Ticaret Bankası) in Sakarya (Adapazarı) in 1913. However, examples of globally accepted Islamic banking models in Turkey appeared with the emergence of Special Finance Houses (SFHs) following the passage of relevant legal regulations in 1984.

Although SFHs had significant demand potential, their share in the banking sector in the early 2000s was barely at 1 percent. One of the most important reasons for this is the negative approach of politicians and bureaucratic cadres towards SFHs. The banking sector in Turkey was restructured after the 2001 economic crisis. Negative attitudes towards the Islamic financial sector permanently changed when the Justice and Development Party (AK Party) came to power, and especially in recent years the sector is considered a strategic area. In this study, the history of Islamic finance in Turkey is scrutinized by considering its development in the world through present and future projections. At the end of the report, policy recommendations regarding steps that should be taken for the development of the Islamic financial sector in Turkey are offered.

SETA

ANKARA • İSTANBUL • WASHINGTON D.C. • KAHİRE