Participation Banking in Turkey and Its Effects on the Turkish Financial System

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Abstract: The share of participation banking in the banking system keeps increasing both in Turkey and the world. Participation banking is not a rival to the conventional banking system but it is an integral part of the system. Participation banking and its tools contribute to the increase in the financial depth in Turkey. The share of participation banking in total banking system in Turkey is about 5 percent which is lower than expectations. In this study, operations of participation banking in Turkey and its complementary effects on the financial system have been analyzed.

Keywords: Participation Banks, Turkish Financial System, Participation Banking

Introduction

Interest-free financial instruments and participation banks offer banking services for the procurement of machinery, equipment and real estate needed by the trade and industry. The basic dynamic in this system is to share both profit and loss with the depositors without giving a fixed income guarantee. Participation banks provide customers with credit which is not in the form of cash funds. As such, participation banks purchase the goods in accordance with the needs of customers and sell the same to the customers with a profit. Participation banks invest the funds which they collect on a profit-loss partnership and contribute to real economic financing (Varsak, 2017: 33).

Social reasons are one of the fundamental reasons which lead to the emergence of participation banks in both Turkey and the world. Islamic thought gives very importance to the production. Production relations are more important than consumption and debt relations in Islamic economic thought. The basic philosophy of Islamic societies is the establishment of a system for ensuring social equality. In this context, applications such as alms, charity and foundations are introduced to meet the basic needs of human being in Islamic societies (Varsak, 2017: 34).

Another reason for the need for a participatory banking system is religious judgments. As a matter of fact, all religions are sensitive to interest, and in Islamic sources interest is forbidden and prohibited. In this context, there are investors who want to assess their savings in interest-free banking system in Turkey as a part of the Muslim world (Varsak, 2017: 34).

The main function of participation banking is the contribution it makes to the real economy. Depositors who wish to engage in economic activities such as production, service, investment, etc. may be included in the participation banking system in an attempt to transform their savings into a production input. Ultimately, people tend to route their saving into the participation banking system in Turkey and the Islamic banking system in the word with social, religious and economic reasons (Şen, 2011: 48).

1. Interest Free Funds Collection Methods of Participation Banks

1.1. Collecting Funds through Current Accounts

Interest Free Current Accounts is the type of account that can be opened in Turkish Liras (TL) or foreign currency (FX) without maturity and income return. The interest free current account is the same as the current account in conventional banking. Deposits deposited in these accounts are considered "debt" to the participation bank. Interest free current account performs all banking transactions such as deposit, withdrawal, money order, EFT, invoice payments, etc. (Yıldırım, 2015).

It is analogous to a escrow account in traditional banking practice. However, there is no interest payment or dividends to the account holder (Atlaş, 2008: 19-23). In the current accounts, various payment transactions such as automatic payment order, credit card payment, check bond payment, credit card payment, invoice, dues, tax, fee, EFT and money transfer transactions can be carried out (Dağ, 2011: 22).

1.2. Collecting Funds through Participation Accounts

The Participation Account is a type of account that is opened with a maturity of at least 1 month as such the return is calculated at the end of the maturity based on the profit / loss partnership. The return of the participation account is based on profit or loss of the projects financed by the bank. There is no predefined and committed return for these accounts (Yıldırım, 2015).

The Participation Account enables depositors to obtain a return in accordance with interest-free banking principles with a profit-loss partnership. The maturity of the participation accounts can be one, three, six and twelve months. The participation accounts can be opened in TL, Euro, USD, Gold or Silver. The relationship between the bank and the depositor who opens the participation account is the labor-capital partnership (mudârebe). The return on the participation accounts is not determined and the bank can't promise any pre-determined amount at the beginning of the deposit time. Up to TL 100 thousand at the participation accounts and interest-free current accounts are covered by the state insurance fund in Turkey (Yıldırım, 2015).

1.3. Special Fund Pools

Participation Banks may create a separate financial fund account provided that they are allocated to a specific project and their maturities are not shorter than three months. Funds to be utilized in this group can't be transferred to other accounts and therefore they are operated separately from funds collected in other accounts. These pools can't be allocated to the specific sector. For these fund pools, the project to be financed is clearly defined and this procedure is actualized before the collection of financing (Özgür, 2007: 73-73).

2. Interest-Free Funding Methods of Participation Banks

Participation banks provide customers with credit but not in cash. They purchase the goods in accordance with the needs of customers and sell the same to the customers with a profit. However, they don't finance buying and selling of pig, alcohol, tobacco, guns and obscene publications. Participation banks accept foreign exchange and gold in payments but don't buy and re-sell them (Yıldırım, 2015).

2.1. Mudaraba Financing (A Trust Financing Contract)

The modern mudaraba application used in the Participation Banking system is different from the classical mudaraba process defined in Islamic jurisprudence. In the case of mudaba application in the Participation Banking system, there are two mudaraba agreements. The first one is between the bank and depositor whereby the bank provides its labor and depositor provides capital. The second one is between the bank and credit customer whereby the bank provides capital and credit customer provides his/her labor. The bank provides financial funds in the pool with companies provided that profit rate is pre-determined and the risk is shared. The realized profit and loss return to the pool and distributed to the depositors based on the pre-determined profit rates (Döndüren, 2008: 132).

After establishing a mudaraba partnership between the Participation Bank and credit customer, the bank should deliver the fund to the credit customer as a mudarib (laborer). The Participation Bank does not have the right to interfere with the conditions outside of the signed agreement. However, in the case of risky situations such as irregular operation, non-compliance with the plan, etc., the Participation Bank is entitled to take specific measures. The bank can observe all the work done by the laborer (Akın, 1986: 130).

The profit obtained as a result of the mudaraba is divided between the Participation Bank and depositors at predetermined rates. According to Islamic principles, the basic process is the sharing of profit expressed as a certain percentage, not a certain amount. At the end of the transaction, if a loss occurs, the loss should be undertaken by the capital owner as in the classical mudaraba. In other words, credit customer doesn't undertake any loss and all loss is undertaken by the bank. If there is no profit or loss, the bank will take back its capital as it is. So in this case, neither side receives neither profit nor loss. If the loss is occurred due to the negligence of the credit customer, the whole responsibility belongs to the customer and therefore the damages must be compensated by him/her (Özgür, 2007: 60-61).

2.2. Murabaha Financing (Mark-up Financing)

Murabaha is a cost plus financing. It is the sale of goods as such the profit is added to the cost of goods and the cost and the profit is disclosed to the buyer. In the participation banking, the bank buys the goods on the behalf of credit customers and sells them to credit customers with deferred payment. However, the bank adds a profit amount on the buying price during these purchases and futures sales. This mode of financing accounts for more than 90% of the financial activities of the Participation Banks. Unlike conventional banks, participation banks don't provide consumer credit directly but they directly purchase consumer goods on the behalf of consumers and sell them with deferred payment. Therefore, there is no financial fund available to the credit in the transaction (Terzi, 2013: 64-65).

2.3. Müşareke Financing

In a müşareke partnership, the Participation Bank makes a profit - loss partnership agreement with a person or a company to provide the financial fund they need. The profit is shared according to the prevailing agreement rates; in the case of a possible loss, the loss is compensated by the parties according to their capital ratios (Yeşilyaprak, 2011: 27). There are two different types of interviews. The first one is a labor - capital partnership as described above and operates in the principle of profit - loss partnership. In addition, in this system, the Participation Bank provides some of the financial funding that the customer desires. The other part of the required fund is supplied by the customer. The customer receives a greater share of the profit since the control and supervision of the capital is undertaken by the customer. The second one is named as müşareke-i mütenakısa whereby customer and the bank set up a joint venture. If the customer wants to have all shares of the joint venture company after a while, the customer buys the shares of the bank. The customer can buy the shares of the bank in cash or with installments. If the transaction takes place with installments, then the sale is similar to the sale on installments (Özsoy and İştar, 2010: 478).

2.4. İcare Financing (Leasing)

İcare, finans kuruluşlarının yatırımcıların gereksinim duyduğu bir şeyi satın alarak, onlara kiralamasıdır. Katılım Bankaları tarafından da uygulanan bu sistem, iki farklı şekilde gerçekleştirilmektedir. İlki, kira geliri elde etmek üzere kiraya verilen şeyin, kira sözleşmesi bitiminde geri alınması şeklinde; ikincisi ise, vadeli satışı gerçekleştirilen malın, kira gideri gibi, taksitle Katılım Bankası'na borcunu ödemesini sonunda mülkiyetinin müşteri üzerine geçirilmesi şeklinde gerçekleşmektedir (Gökalp ve Turan, 1993: 98).

İcare is the leasing of something a customer needs. In this mode of financing, first the participation bank buys something a credit customer needs and then lease it to the credit customer. There are two methods. In the case of the first one, the bank takes back the subject of lease at the end of the agreement. In the case of the second one, the ownership right of the subject of lease is transferred to the credit customer (Gökalp and Turan, 1993: 98).

2.5. Karz-ı Hasen Financing

The extension of credit by participation banks for non-profit and social purposes is called "Karz-ı Hasen". The purpose of this kind of financing can be help, lend assistance and upgrading the level of wealth. Thus, it is not possible for the Participation Bank to make any income as a result of this transaction. Karz-ı Hasen involves signing the contract, transferring the necessary financial funds, and the payment of debts at the maturity. The purpose can be the support of entrepreneurs, education and training. For Karz-i Hasen, participation banks can transfer financial funds from current accounts or their own capital. If the individual using the loan is unable to pay the debts, the debts are covered from the social fund of the Participation Bank (Özsoy, 1987: 130).

2.6. Selem Financing

In Islamic law, Selem involves selling a commodity in cash and future delivery of it or swap of a ready commodity with a commodity whose production process is in progress. In the Participation Banking system, for example, a participation bank purchases the goods of a farmer at a pre-harvest time in cash in advance and takes the delivery of goods at harvest time. The aim here is to meet the farmer's financial needs in the pre-harvest period. At the end of the transaction, the participation bank sells the goods at a market price at harvest time and receives the profit from the difference between buying price and selling price (Kaya, 2010: 38).

2.7. Sukuk (Islamic Bond)

Sukuk (Islamic bond) are sources of capital market funds through financial institutions operating in accordance with Islamic rules for entrepreneurs who do not have sufficient liquidity or potential entrepreneurs who do not have financial funds. Types of Sukuk involves labor and capital partnership. One type of Sukuk can provide its owners with predictable and certain income, the other type of Sukuk can provide its owners with profit or loss of investment. Selem and icare represents the first group (entity) and mudaraba and müşareke represents the second group (equity) (Şensoy, 2012: 337).

For the first time, Islamic Bank of Malaysia started to issue interest-free investment instruments in 1983. Later, in the 1990s, countries such as Pakistan and Egypt issued instruments similar to bills and bonds issued by conventional banks. By the year 2000, these Muslim countries have issued bonds and bills in accordance with Islamic principles. However, the modern sense of Sukuk was first issued by Malaysia in 2000. Then Malaysia is followed by Bahrain in 2001 and Indonesia in 2002. Although Sukuk is called as bonds in accordance with Islamic principles, they are different from bonds. While Sukuk refers to ownership over assets; bonds do not grant ownership, they only provide cash flow. In addition, Sukuk is also referred to as securitized assets because it is issued on the basis of a certain asset (Şen, 2011: 63-66).

3. Historical Process of Participation Banks in Turkey

The first participation bank was established in 1985 following the Decree No. 83/7506 of the Council of Ministers in 1983. The name of the first participation banks is Albaraka Türk Special Finance House. In the same year, Faisal Finans Special Finance House, which later served as Family Finance Special Finance House, was set up. Kuwait Turk was established in 1989, Anadolu Finans was founded in 1995, Ihlas Finance House was set up in 1995, and Asya Finance House was established in 1996. Those are pioneer privately-owned Special Finance Houses in Turkey. Ihlas Finance House was liquidated in 2001. Anadolu Finance House and Family Finance House were merged in 2005 and took the name of Türkiye Finance House. The establishment of state-owned participation banks gave momentum to the sector and contributed to increase in the asset size of the participation banks. In this context, Ziraat Participation Bank in 2015 and Vakıf Participation Bank in 2016 have been granted permission to operate. Historical process of participation banking in Turkey is shown in Table 1.

Table 1: Historical Process of Participation Banks in Turkey

Date	Process	Activity Status
1983	Issuance of the Decree No. 83/7506 of the Council of Ministers for the establishment of special finance houses	Status of Special Finance Houses was transferred into status of Participation Banks in 2006.
1985	Establishment of Albaraka Türk Special Finance House	It continues to operate as Albarak Türk Participation Bank.
1985	Establishment of Faisal Finans Special Finance House	The name of the bank was changed as Family Finans Special Finance House in 2001. It merged with Anadolu Finans Special Finance House in 2005 and the name of the bank was changed as Türkiye Finans Participation Bank. It continues to operate under the same name.
1989	Establishment of Kuveyt Türk Special Finance House	It continues to operate as Kuveyt Türk Participation Bank.
1991	Establishment of Anadolu Special Finance House	It merged with Family Finans Special Finance house in 2005.
1995	Establishment of İhlas Special Finance House	It was liquidated in 2001.

1996	Establishment of Asya Finans Participation Bank	It was transferred into Saving Deposits Insurance Fund in 29 May 2005 and liquidated in 22 July 2016.
2005	Establishment of Türkiye Finans Participation Bank	It is established in 2005 with the merger of Family Finans Special Finance House and Anadolu Special Finance House.
2015	Establishment of Ziraat Participation Bank	It continues to operate.
2016	Establishment of Vakıf Participation Bank	It continues to operate.

Source: Buğan (2015) and Varsak (2017).

Currently, there are five participation banks continued their activities in Turkey. These are, Albaraka Türk Participation Bank, Kuveyt Türk Participation Bank, Turkey Finans Participation Bank, Vakıf Participation Bank, and Ziraat Participation Bank.

4. Participation Banks and Their Financial Impacts

Participation banks are not an alternative but as complementary to the conventional banking system in the financial system. Complementary characteristics of participation banks to the financial system can be counted as (Eskici, 2007: 57)

- Prevention of unregistered economic activities

- Incorporating cushioning savings into the system

- Financing of the real sector,

- Increasing employment,

- Development of competition,

- Foreign capital transfer,

- Reducing financing costs,

It can be summarized as. However, the share of participation banks in Turkish banking system is not enough to fulfill its complementary effects in to the financial system.

Conclusion

Despite increasing attention to the participation banking in Turkey in recent years, the share of participation banks in Turkish Banking System is quite low and their structure is not enough to complement conventional banks in Turkey. For the purpose of carrying a complementary role in the financial system, financial instruments of participation banks should increase in order to increase the number of branches, personnel and should increase and technological infrastructure which contribute the financial deepening. Moreover, the differences between the interest-free system and the interest-included should be explained to the financial market actors in detail.

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