

The future of participation banks and new banking licences in Turkey

The market share of participation banks in Turkey has increased since the 2001 crisis. ALI CEYLAN and BURAK GENCOGLU delve into the banking laws in the country and discusses how it may affect the Islamic finance industry.

Islamic finance is a relatively new and developing sector for the Turkish economy. The country got acquainted with the Islamic banking model while it was shifting its closed economy to a liberal and open economy in 1980s. During those years Turkey was trying to enrich its economic system in terms of financial instruments and institutions. Hence participation banks (formerly known as private finance houses) were included into the Turkish financial system as a result of these efforts.

Islamic finance in Turkey was introduced to attract people who are not willing to engage in the conventional banking system due to their religious beliefs. From a broader perspective another purpose was to attract foreign capital particularly from the Gulf by establishing these Shariah compliant financial institutions.

During the first 10 years of the new millennium, although the 2001 crisis in Turkey pointed out some problems concerning participation banks, they have a growing share in the market since then.

The total size of the participating banks was TRY5.51 billion (US\$3 billion) as at the end of 2003 and it has reached to TRY48.28 billion (US\$26.5 billion) in 2011.

The share of participation banks in the banking sector also increased from 2.01% in 2003 to 4.2% in June 2011. There has been a significant growth in terms of branch and personal numbers of these banks.

However, it is not quite possible to define the participation banks in Turkey as pure Islamic banks or as banks engaging in Islamic banking; since these banks are operating in a system which has close links to western economic systems and different from the countries with Islamic financial rules.

Nevertheless, regulations implemented within the last eight years can be defined

as 'Islamic finance friendly' and we do expect more will come from Turkey to promote Islamic banking and finance.

“ Participation accounts do not guarantee a pre-specified return unlike time deposits ”

The new banking law

Unlike the former banking law, the Banking Law No. 5411, dated the 19th October 2005 (the Law) separately describes the funds similar to deposits but pertaining to participation banks by using new terms such as participation funds and participation accounts.

Participation banks can be defined as the banks which are situated in Turkey or the branches of foreign-based banks which collect funds through private current or participation accounts and provide loans.

It should be noted that the term "bank" was not used until the enactment of the Law in 2005 which recognized Islamic banking and converted the 'private finance houses' into the banks. As stated by the Law, participation banks may also 'open private current account' which does not offer any profit or loss.

Article 3 of the Banking Law defines participation accounts as "accounts constituted by funds collected by participation banks that yield the result of participation in the loss or profit to arise from their use by these institutions, that do not require the payment of a pre-determined return to their owners and that do not guarantee the payment of the principal sum".

According to the participation account definition, the aim of this financial

instrument is to put the amounts together which are paid by the account holders and create a fund.

These funds are controlled by the participation banks and account holders share the profit or loss which arises from the management of these funds. The difference between deposit accounts and participation accounts can be described as follows:

- Participation accounts can only be opened at the participation banks while deposit accounts are pertaining to deposit banks.
- Participation accounts do not guarantee a pre-specified return unlike time deposits.
- There is a risk of loss for participation accounts and therefore even the principal sum is not under the guarantee of the bank. The amount in the deposit accounts however should be returned to their owner on a certain date of maturity or whenever it is called.
- Participation accounts constitute an agreement between the account holder and the bank. This agreement specifies the projects to be financed and types of commercial activities to be performed by using the account holder's funds.

As it can be clearly seen from the above explanation, the participation account holder bears a commercial risk. Any failure of the bank in its commercial decisions will result in a loss for the account holder.

Participation accounts can be described as a version of the Islamic finance instrument Mudarabah in many ways.

Bearing of losses is the most significant feature and it distinguishes the participation account from deposit accounts.

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This characteristic of the participation account appears as the reason to be preferred by the people who act with religious concerns in their financial activities.

Turkish banking licenses

Banking Law Article 60 states: "Other than credit institutions and those authorized by special laws, no real or legal person, essentially or secondarily by assuming a profession, shall accept deposits or participation funds. Neither shall they make announcements to the public by notice or advertisement using commercial titles or other expressions nor terms that give similar impressions thereof".

Considering the above Article, it is required for banks to obtain required permission and licenses from the relevant authorities in order to execute banking activities. The law separately regulates the incorporation of the banks and launching their activities in Articles 6 and 10.

As per Article 6 of the Law, the Banking Regulation and Supervision Board (the Board), the Turkish watchdog in banking sector, has the authority to issue permissions for incorporation providing five affirmative votes out of seven board members.

This permission should be obtained both for establishing a new bank in Turkey or opening up the first branch of a bank registered abroad.

Another permission required for the establishment of a bank is the authorization from the ministry of industry and commerce on incorporation of a joint-stock company as it is stipulated in the Turkish Commercial Code.

The Board shall give its decision in three months following the application or the date deficiencies in the application are corrected.

In case there is no decision given within three months, the application should be deemed as rejected. However, as indicated above, the permission for a new establishment or opening a branch in Turkey is not sufficient to accept deposits or participation funds.

Since there is a two stage procedure for banks to execute their activities in Turkey, a bank which obtains an establishment permission should seek for an operating permission as well.

Following the permission for the establishment of a bank, Article 10 stipulates that an application should be made to the Board for obtaining operating permission.

“ The Board investigates the conditions stipulated in Articles 7, 8 and 9 for establishment and operating permissions ”

Article 10

"The banks that are permitted to be established in Turkey or permitted to open up branches in Turkey within the framework of the provisions of Article 6 of this Law shall be obligated to receive permission for operation from the Board".

The decision of the Board shall be given in three months following the application and in case of an affirmative decision; it should be published in the Official Gazette.

The Board investigates the conditions stipulated in Articles 7, 8 and 9 for establishment and operating permissions. These conditions should be met before a bank or an abroad registered bank's branch can operate in Turkey.

A broad discretionary power is given to the Board while giving its decisions on the establishment or the opening of an abroad registered bank's branch in Turkey.

For instance, Article 8 (e) and (f) of the Law states that founder partners of the bank should "have necessary financial strength and respect" and "have the

honesty and competence required for the business". These requirements are open to subjective decisions and applications can easily be rejected based on these paragraphs.

As it is well known that the Board does not issue banking permissions for almost for 10 years; and recently although there were rumors that a new license will be issued for a major Lebanese bank; the Board made a public statement which emphasize that there will not be such an issuance.

The reason for being reluctant to grant permissions to new banks may be the strict financial control over the banking sector after the destructive 2001 crisis.

Article 48/2 of the Turkish Constitution authorizes the state, thus the Board, to regulate the sector by stating that "the state shall take measures to ensure that private enterprises operate in accordance with the national economic requirements and social objectives and in conditions of security and stability".

However, we expect that new banking licences will be issued in upcoming years providing that the Turkish economy maintains its stability and strength against external and internal factors.

Conclusion

It is not difficult to predict the future of Islamic banking in Turkey and even in the Middle East region. Turkish economy has a huge growth rate and while its economy expands its economic and political roots become stronger.

Thus, it is quite possible that Turkey will attract more capital from Middle East countries and this capital is likely to be collected by the participating banks in Turkey due to their 'interest-free' feature. In five years' time, we expect that the steady growth will continue and the market share of Islamic banks will increase.

However, there is a great importance in co-operating with the other Islamic banks in the Middle East region to support this growth.⁽⁵⁾

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