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Participation Finance Standards

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**NON-COMPLIANT INCOMES WITH
PARTICIPATION FINANCE PRINCIPLES AND
THEIR ELIMINATION STANDARD**

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**NON-COMPLIANT INCOMES WITH
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THEIR ELIMINATION STANDARD**

Content of the Standard

This Standard contains provisions and their rationale for what constitutes income from operations and transactions that do not comply with the principles and standards of participation finance, how such income should be managed and how it should be eliminated by participation banks.

1. Definition of Non-Compliant Income

Non-compliant income refers to revenue that participation banks must avoid because it fundamentally contravenes participation finance principles and standards. However, it may occur as a result of transactions and operations due to regulatory requirements, necessity, error, or negligence, and must be eliminated.

2. Types of Non-Compliant Income

Revenues obtained from the following transactions are considered non-compliant with participation finance principles and standards:

2.1. Incomes from Interest-Based Transactions

Participation banks, by their foundational purposes, cannot engage in any interest-based transactions nor can they facilitate such transactions. However, if they become a party to or intermediary in any interest-based transaction due to regulatory requirements, error, negligence, or similar reasons, the revenue obtained from such a transaction is considered non-compliant revenue. The main types of revenues from interest-based transactions include:

- a. Revenues obtained from the deferred exchange of money or assets considered equivalent to money in Islamic jurisprudence,
- b. Revenues derived from derivative transactions determined to be non-compliant with participation finance principles and standards,
- c. The portion of returns exceeding the inflation difference paid to participation banks for funds held in accounts opened at central clearing institutions as a necessary consequence of conducting their commercial activities,
- d. The portion of returns exceeding the inflation difference paid to participation banks due to required reserves deposited at the Central Bank,
- e. The portion of returns exceeding the inflation difference paid by domestic and foreign banks under conventional systems, for funds in accounts opened by participation banks, due to their necessary commercial activities,
- f. The portion of interest revenues exceeding the inflation difference obtained from interest-bearing receivables when a conventional bank transitions to a participation bank or is acquired by a participation bank,

- g. Revenues obtained from the trading of interest-bearing securities.

2.2. Incomes Derived from the Financing of Transactions Non-Compliant with Participation Finance Principles and Standards

- 2.2.1.** Financing cannot be provided for goods and services that are non-compliant with participation finance principles and standards. However, if cash or non-cash financing is provided for such goods and services due to error, negligence, or similar reasons, the revenues obtained from this financing are considered non-compliant revenue.
- 2.2.2.** No cash or non-cash financing may be provided to enterprises whose primary activity is not in compliance with the Participation Finance Principles and Standards for transactions and activities directly or indirectly related to that primary activity. Revenues derived from the financing of such activities are considered non-compliant revenues. Conversely, revenues from the financing of transactions and activities of these enterprises which are not directly or indirectly related to their primary activity and which comply with the participation finance principles are not considered problematic.
- 2.2.3.** It is not appropriate to provide cash or non-cash financing for transactions that are not in compliance with the Participation Finance Principles and that are conducted by businesses whose primary activities are in compliance with these Principles but that also engage in impermissible transactions.

2.3. Incomes Obtained from Banking Services Non-Compliant with Participation Finance Principles and Standards

- 2.3.1.** Participation banks cannot provide banking services for transactions that are non-compliant with participation finance principles and standards. Regardless of the manner in which these services are provided, the revenues obtained from them are considered non-compliant revenue. The main types of these revenues include:
 - a. Revenues obtained from transactions where it is determined that the POS services provided to member businesses are used for interest-bearing or fictitious transactions,

- b. Revenues obtained from POS services provided to businesses whose primary activities are determined to be non-compliant with participation finance principles and standards,
 - c. Revenues obtained from POS services provided to businesses whose primary activities are compliant with participation finance principles and standards but also engage in impermissible transactions,
 - d. Revenues obtained from domestic and international money transfers related to transactions that are determined to be non-compliant with participation finance principles and standards based on the transaction descriptions or the primary activities of the sender or receiver,
 - e. Revenues obtained from brokerage activities for the trading of shares of companies found to be non-compliant with participation index principles, as well as revenues from brokerage activities for the sale of shares of companies that were removed from the participation index after losing the required conditions,
 - f. Revenues obtained from brokerage activities for investment funds determined to be non-compliant with participation finance principles and standards.
- 2.3.2.** Banking services cannot be provided to businesses whose primary activities are non-compliant with participation finance principles and standards for the purpose of conducting these primary activities or for transactions related to these primary activities. Otherwise, the revenues obtained from these services are considered non-compliant revenue.
- 2.3.3.** Banking services cannot be provided for transactions that are non-compliant with participation finance principles and standards, or for transactions that cannot be clearly distinguished as compliant or non-compliant, within businesses that engage in both compliant and non-compliant activities. Otherwise, the revenues obtained from these services are considered non-compliant revenue.

2.4. Incomes Obtained from Erroneous and Incomplete Transactions

2.4.1. Revenues obtained in violation of participation finance principles and standards due to an erroneous transaction caused by an employee, customer, or the system;

a. Revenues from financial transactions based on contracts containing terms that are not in line with participation finance principles and standards, such as the requirement of capital and/or profit guarantee in investment agencies and partnerships, the requirement for the agent to also act as a guarantor, the condition of a benefit or surplus in favour of the lender in a loan contract, are considered non-compliant revenue.

b. Revenues obtained from a financial transaction conducted without adhering to the terms and processes required by the contracts involved in the transaction are considered non-compliant revenue. The main transactions leading to such revenues include:

- (i) The customer having performed transactions that should have been done by the bank directly or by granting power of attorney to the bank, before applying to the bank,
- (ii) The sale contract between the bank and the customer not being concluded or being concluded after the goods subject to financing are consumed or transferred to a third party after the goods are purchased by the participation bank,
- (iii) Discrepancies between the information in documents such as proforma, order form, and request form regarding the type, nature, primary characteristics, and unit price of the goods purchased directly from the primary seller by the bank or through power of attorney, and the invoice.

2.4.2. Revenues derived from financial transactions that remain incomplete due to the inability to obtain the relevant documents (such as invoices, title deeds, producer receipts, etc.) within the specified period, even though the terms and processes required by the contract were not initially clearly violated, are considered non-compliant revenue. However, situations, where the documents cannot be obtained

due to force majeure, bankruptcy, liquidation, and similar reasons, are not included in this scope.

2.5. Late Payment Penalties

- 2.5.1.** The contract may provide for late payment penalties to be charged to customers who fail to pay their debts on time. The portion of these penalties that the Participation Bank collects from the customer, excluding the inflationary difference due to the delay in payment and the actual costs of collecting the debt, is considered to be non-compliant revenue.
- 2.5.2.** No amount, by whatever name or for whatever purpose, may be charged to the Customer for late payment of its debt, other than the penalty for late payment.
- 2.5.3.** The late payment penalty is applied to customers who have the ability to pay but fail to do so. The customer is presumed to have the ability to pay unless the customer proves otherwise.
- 2.5.4.** The rate of the late payment penalty to be charged to the customer is determined in accordance with the principle of fairness, taking into account the rates set by public institutions and organisations for similar situations and prevailing market practices, provided that these rates are not exceeded.
- 2.5.5.** The late payment penalty is calculated only on the total amount of the Customer's overdue debt. No separate penalty can be applied to the late payment penalty itself.
- 2.5.6.** It makes no difference whether the debt that is subject to the late payment penalty is denominated in Turkish liras or in a foreign currency.
- 2.5.7.** If the Participation Bank collects its receivables by means of legal enforcement, the interest on arrears awarded by the courts and enforcement authorities due to the delay shall also be subject to the provisions of the penalty for late payment. However, receivables awarded in favour of the Participation Bank for the collection of the debt, such as court and enforcement costs and attorneys' fees, are considered compliant income.

- 2.5.8.** The portion of the collected late payment penalty that exceeds the sum of the inflation difference and the actual costs incurred for the collection of the debt shall be considered as non-compliant income. The Participation Bank may either eliminate this excess amount or return it to the customer, together with any profit, within a period it deems appropriate.

2.6. Cash Surplus Amounts

- 2.6.1.** Cash Surplus amounts collected from customers for any reason, which cannot be identified or have been identified but cannot be returned to their rightful owner, are considered non-compliant revenue.
- 2.6.2.** Any surplus cash transferred to the special account for non-compliant revenue will be returned to the rightful owner if they are identified later. If there are no funds in the special account, the bank will cover this amount from its own equity. This returned amount can be offset by the inflation difference from the amounts that will later accumulate in the special account for non-compliant revenue.
- 2.6.3.** Surplus cash cannot be used to cover cash shortages.
- 2.7.** Furthermore, revenues obtained from other transactions deemed non-compliant by the decision of the Advisory Board or the internal advisory committees of the participation banks will not be accepted.

3. Segregation of Non-Compliant Incomes

- 3.1.** Any revenues that do not comply with the participation finance principles and standards are segregated and kept in a trackable account within the bank.
- 3.2.** The bank is responsible for managing the non-compliant revenue account in order to preserve the value of the money and other assets held within it. However, the bank is prohibited from using any income generated from managing this account for its own benefit. Any income generated from the management of the non-compliant revenue account is also considered non-compliant revenue.
- 3.3.** Should it subsequently be established that the revenues transferred to the special account on the grounds of non-compliance are, in fact, compliant, they will be withdrawn from the relevant account along with the income generated.

- 3.4. Any tax deductions or exemptions that result in an advantage for participation banks due to expenditures from the non-compliant revenues account will also be transferred to this account.
- 3.5. All expenses related to taxes and similar charges for the non-compliant revenues accounts are covered from this account.
- 3.6. Any commissions, fees or similar revenues determined to have been taken from customers in violation of participation finance principles and standards are withdrawn from the non-compliant revenues account and returned to the customer, along with any profits generated from managing these amounts.

4. Elimination of Non-Compliant Incomes

- 4.1. It is imperative that revenues accumulated in the account be eliminated as soon as possible, and no later than the end of the following calendar year.
- 4.2. Non-compliant revenues must be spent on one of the following areas: However, the participation bank is not permitted to use its own name in the execution of these expenditures and activities.
 - a. Assisting individuals affected by natural disasters, pandemics, or economic crises.
 - b. Providing social assistance to the poor and needy.
 - c. Funding projects in the public interest, such as schools, hospitals, soup kitchens, nursing homes, fountains, bridges, roads, and their maintenance and equipment.
 - d. Providing unconditional funds to institutions providing microfinance in accordance with participation finance principles to those in need.
 - e. Supporting education and research activities, such as seminars, conferences, scholarships, research projects, and publications, as long as they do not contradict Islamic and humanitarian values.
 - f. Other areas approved by the advisory committees of participation banks.
- 4.3. It is not permitted for participation banks to benefit from non-compliant revenues in order to reduce expenses or generate income. Consequently, the funds and other assets accumulated in this account cannot be used in the following areas:
 - a. Payment of premiums to the Savings Deposit Insurance Fund,

- b. Covering the deficit arising from the payment of insurance premiums on behalf of the customer but not collected from the customer later,
 - c. Covering advertising expenses,
 - d. Payment of bonuses or promotions to employees,
 - e. Employees' vocational training,
 - f. Offering promotions to customers,
 - g. Payment of taxes, fines, and compensation,
 - h. Fulfilling obligations for debts that must be paid even though they are not in compliance with participation finance principles,
 - i. Lending (qard) transactions,
 - j. Other areas not approved by the advisory committees of participation banks.
- 4.4.** Non-compliant revenues can be allocated to relevant areas or distributed through charitable organisations.
- 4.5.** It is contrary to the principles and standards of participation finance to expend non-compliant revenues on advertising and promotion.

Justification of the Non-Compliant Incomes with Participation Finance Principles and their Elimination Standard

1. Justification for the Definition of Non-Compliant Income

Participation banks are characterised by the fact that their activities in raising funds, providing financing and offering other banking services are carried out in accordance with the principles and standards of participation finance. This fundamental characteristic distinguishes these institutions from conventional banks, both in terms of methods and jurisprudence. Notwithstanding this general rule, however, participation banks may occasionally engage in certain transactions which they generally avoid for regulatory reasons, necessity or error. In the event that such transactions generate income, Islamic jurisprudence does not consider it permissible for the Participation Bank or its depositors to benefit from such income. Therefore, such income is considered to be non-compliant.

2. Justifications for Regulations on Types of Non-Compliant Income

2.1. Justifications for Regulations on Incomes from Interest-based Transactions

Participation banks are prohibited from engaging in interest-bearing transactions. If these institutions receive income from an interest-bearing transaction as a result of regulatory obligations, error, negligence or similar circumstances, such income is considered non-compliant. An interest-bearing transaction is the deferred exchange of money or assets that are legally considered to be money. In such transactions, the actual or constructive receipt of payments at the time of the contract is essential, and the deferment of delivery results in the accrual of deferred interest (*riba al nasiah*) (Merghīnānī, *al-Hidāya*, Beirut, n.d. III, 81). Therefore, income from derivative transactions such as futures, forwards, swaps and options, where conditions similar to deferred interest exist, are considered non-compliant.

Where participation banks trade in *sukuk*, equities, foreign exchange and similar instruments, they open accounts with central clearing institutions for the purpose of settlement. These central clearing institutions may pay returns on the balances held in such accounts. Any returns paid in excess of the inflation differential on the principal amount are considered to be non-compliant income.

Since the amounts held in these accounts with the central clearing institution are considered to be loans (*qard*) granted by the participation bank, any returns (*namā*) paid by the borrower to the lender in addition to the principal in excess of the rate of inflation are considered to be interest (*ribā*). The same legal basis applies to the amounts paid by the Central Bank of the Republic of Turkey (TCMB) on the mandatory reserves that the participation banks hold with the TCMB against their financial liabilities. In these cases, the consideration of the inflation differential on the capital and the treatment of any excess amount as non-compliant income is based on the principle of fairness and sensitivity to ensure that no party suffers a loss in the debt relationship.

For the same reason, the amounts held in *nostro/vostro* accounts with domestic and foreign correspondent banks operating under the conventional system, as a requirement for conducting commercial activities, and the returns (*namā*) paid by these institutions to the participation banks that exceed the inflation differential, are also considered as non-compliant income.

When an institution with interest-bearing claims converts into a participation bank or is acquired by a participation bank, any interest income earned on these claims in excess of the inflation differential is considered non-compliant income. While the transformation of the institution into a non-interest-bearing structure is a positive step, it does not change the fact that the existing contracts underlying these claims contain interest. Therefore, as stated in the Advisory Board's Decision No. 4 of 15.11.2018, if the institution transforms into or joins a participation bank and has interest-bearing receivables and rights, efforts should be made to recover them by foregoing the interest income, using methods such as the "discounted early payment" (da' wa ta'ajjal) known in the literature. If this is not possible for regulatory or operational reasons, the new management should undertake the liquidation of this income, which has become part of the participation bank's assets.

Participation banks cannot, in principle, be involved in transactions related to interest-bearing securities such as bonds or notes, nor can they hold such securities. The illegality of the income from these types of securities stems from their interest-bearing nature. If an institution holding such securities transforms itself into or joins a participation bank, and if interest-bearing securities are included in the bank's assets, any income from these assets in excess of the inflation differential will be considered illegal income.

The matters mentioned in this article are not exhaustive but are provided as examples. The nature, cause, and scope of interest have been extensively examined in fiqh literature. Income derived from contemporary financial transactions that the advisory committee of the relevant financial institution determines to contain interest, within the framework of these views, is also considered non-compliant income.

2.2. Justifications for Regulations on Incomes Derived from the Financing of Transactions Non-Compliant with Participation Finance Principles and Standards

While Islam considers things to be permissible in principle, it keeps the halal circle quite wide, but prohibits the consumption, use and legal transactions of certain things because of their material and moral harm to individuals and society. This principle, expressed in fiqh as *ibaha-i asliyye*, is also considered applicable to legal transactions. The prohibitions established by the two fundamental sources of fiqh, the Qur'an and the Sunnah of the Prophet Muhammad (peace be upon him), have influenced its contract theory; for a contract to be valid (legitimate), among other conditions, the subject of the contract must be a

property or service that is permissible in religious terms. Therefore, since it is not permissible to include impermissible or illegitimate goods or services in legal transactions, it is not appropriate for Participation Banks to mediate in the trade of such goods and services and to earn income from transactions involving them. However, due to error, negligence or similar reasons, such transactions may have been financed and income may have been generated. In this case, the income received must be segregated and purified from other income.

It is not permitted to engage in legal transactions, in particular buying and selling, involving prohibited goods or providing prohibited services. Nor is it permissible to finance commercial activities directly or indirectly related to the main activities of companies whose main activities involve such illicit goods and services. The wisdom and utility behind prohibiting something also requires prohibiting the means and ways of achieving it. In fact, the Qur'an explicitly prohibits cooperation in sinful matters (Ma'idah 5:2). Islamic jurists have developed various principles based on the relevant texts: that which leads to haram is haram, actions that lead to religiously objectionable results should be prohibited (sadd al-dhara'i), and if a permissible contract leads to something haram, it becomes impermissible to carry it out despite its original permissibility. Although jurists have expressed different opinions on specific issues of what constitutes aiding and abetting haram, they agree that it is not permissible to assist in something that is religiously illegitimate (Juwayni, *Nihayat al-Matlab*, Damascus, 1428/2007, V, 280; Kasani, *Bada'i al-Sana'i*, Egypt, 1328/1910, V, 233). However, there is no such objection to transactions that are in line with the principles of participation finance and do not directly support the primary activities of such enterprises. Therefore, it is permissible to respond to requests for financing of legitimate goods and services that are not related to or supportive of the impermissible main activities of such companies.

For businesses whose primary operations are compliant with participation finance principles and standards, but which also engage in some impermissible activities, financing transactions that are not in line with participation finance principles are not permitted. Income derived from such transactions is considered improper income because these transactions are not in accordance with the religious principles of the institution. However, it is permissible to finance their transactions that comply with participation finance principles and to provide them with other banking services, provided that their

impermissible activities are not directly supported. This is because their primary activities are legitimate. It is acceptable to provide financing for legitimate commercial activities.

2.3. Justifications for Regulations on Incomes Obtained from Banking Services Non-Compliant with Participation Finance Principles and Standards

Any bank that wishes to be classified as a "participation" or "interest-free" bank must adhere to the principles and standards set out by participation finance. This includes all aspects of the bank's operations, including its methods of gathering and utilising funds, as well as its banking services and other commercial, financial, and economic activities. Therefore, any activities or transactions deemed inappropriate from a religious perspective are prohibited within the participation sector. Consequently, it is not appropriate for any participation bank to provide guarantees, POS services, or money transfer services, to engage in the buying and selling of shares that are not compliant with participation finance principles, or to facilitate investment fund activities involving such shares. However, if a non-compliant service has been provided, the income generated from such services is considered improper income. Therefore, it is essential to thoroughly investigate businesses requesting services before providing them. If, following a thorough investigation, it is not possible to clearly distinguish between compliant and non-compliant activities of the business, banking services should not be provided to such businesses for transactions that cannot be verified as compliant with participation finance principles. In the event that this rule is violated and a banking service is provided, the resulting income is considered improper income.

2.4. Justifications for Regulations on Incomes Obtained from Erroneous and Incomplete Transactions

In accordance with standard practice, participation banks are prohibited from engaging in transactions that contravene the principles and standards of participation finance. Participation banks adhere to their principles by conducting fund collection, fund utilisation and banking services based on commercial contracts. There are specific obligations that personnel and customers must fulfil within the system overseen by participation banks. However, in some cases, due to errors by the personnel conducting the transaction, the customer receiving the service, or systemic issues, income that is not compliant with participation finance principles may be generated. If one of the parties fails

to fulfil their obligation properly, even if by mistake, the compliance of the transaction with participation finance principles may be compromised, and the resulting income is considered improper.

In accordance with the principle of contractual freedom espoused by the fiqh doctrine, parties may stipulate certain conditions on one another during the contract. However, the imposed condition should not alter the fundamental structure of the contract and should not result in an adverse outcome. As narrated in a hadith by the Prophet Muhammad (peace be upon him), "Muslims are bound by their conditions, except those that make lawful what is unlawful or make unlawful what is lawful" (Tirmidhi, "Ahkam," 17). In this context, stipulating that an agent will guarantee commercial risks for the principal and provide capital or profit guarantees in agency contracts involving participation banks would contravene the fundamental rules of agency contracts and result in the same outcomes as an interest-bearing loan (Decision of the Advisory Board of the Ministry of Investment dated 30.06.2018 and No. 2; Talal Suleymān, *Aqd al-waqāla bi al-istismār*, Riyadh, 1437/2016, p. 339). Similarly, stipulating capital or profit guarantees in contracts based on agency, such as capital partnerships and labour-capital partnerships, would result in the same problematic situation (Ibn al-Munzir, "al-Ijma," Riyadh, 1425/2004, p. 102). When establishing a loan contract, stipulating an additional amount on the principal or imposing conditions that indirectly benefit the lender falls under the same scope (Burhanuddin al-Bukhari, "al-Muhit al-Burhani," Beirut, Please refer to 1424/2004, VII, 126; Ibn Hajar al-Haytami, "Tuhfat al-Muhtaj," Egypt, 1357/1983, V, 46.)

The participation finance transaction process comprises a number of stages that must be completed by both the participation bank and the customer utilising the financing. Should the bank or customer fail to fulfil their obligations at any stage of the transaction process, this could result in non-compliance with Shariah principles. Consequently, the income generated from such a transaction is considered to be improper. In this context, it is important to note that:

In Murabaha financing, where the participation bank purchases a good either directly or through an agent and then transfers it to the customer, if it is discovered that the customer had already entered into a sales contract with the original seller before the participation bank's involvement, the income from this financing is considered improper. This is because if the customer had previously purchased the financing-related good from the original

seller, even verbally, it would not be appropriate to acquire the same good through Murabaha unless the initial sale is nullified through a mutual rescission (ikala) (Murabaha Standard, Article 2.2.2).

In instances where the participation bank or its agent purchases a good and transfers it to the customer, and due to error or negligence, the sale from the bank to the customer does not occur at all or occurs after the good has already been consumed, the income from this financing is considered improper. This is because the process outlined in Article 1 of the Murabaha Standard was not adhered to.

In financings where a participation bank purchases a good from the original seller and transfers it to the customer through either itself or its agent, if the information provided by the customer in the proforma or similar documents submitted to the bank when requesting financing does not match the information on the invoice, it indicates that the Murabaha process was not conducted properly. In such instances, the income derived from the transaction is considered improper, as it becomes evident that the transaction was merely a superficial one conducted solely to obtain financing.

In the financing transactions and banking services carried out by participation banks, customers are required to provide documents such as invoices, title deeds, producer receipts, etc., to determine that the transaction/service is not a direct cash loan or fictitious. If the customer fails to submit these documents within the period specified in the legislation or relevant rules after the financing, there is a possibility that the transaction does not comply with the principles of Islamic law or involves collusion. Consequently, the income generated by participation banks from such transactions is deemed to be improper. However, income derived from transactions where documents cannot be obtained due to force majeure events such as natural disasters or reasons such as bankruptcy or liquidation of the business involved in the transaction is considered legitimate. Regulations made by regulatory and supervisory authorities are also taken into account in this process.

2.5. Justifications for Regulations on Late Payment Penalties

The rationale behind charging late fees is to act as a deterrent against customers delaying payment of their debts. If customers do not pay their debts on time, they may incur late fees, which serve as a deterrent to prevent them from delaying payment. Banks using the income from late fees directly or indirectly for their benefit, such as using them in social

responsibility projects or refunding them to the customer after a certain period, also support the idea that this practice serves this purpose.

The customer's failure to pay their debt on time has negative consequences for the Islamic bank, including the need to allocate increasing amounts of reserves due to a decrease in their profits. This, in turn, has negative consequences for depositors in participation accounts. Taking measures to prevent these negative consequences is in line with the principles of Islamic law aimed at preventing harm (see Mecelle, articles 7, 19, 20, 25, 26, 27, 31), as well as the statements of the Prophet Muhammad (peace be upon him). The Prophet Muhammad (peace be upon him) is quoted as saying, "One who delays payment of a debt, although he is capable of paying, deserves blame and punishment" (Bukhari, "Loans", 13; Abu Dawood, "Adiyat", 29).

The late payment penalty, which takes the form of increasing the debt due to delay, is not considered interest. This is because it is not aimed at increasing the bank's receivables. In contrast, interest involves adding an excess amount to the original debt for one of the parties. In this case, however, there is no excess amount required for the benefit of the bank. Instead, the amount obtained to maintain the value of the money is transferred to the account of inappropriate income, exceeding the inflation difference and the actual expenses incurred for the collection of the receivable.

Actual expenses refer to the actual expenses incurred, including public obligations, communication, travel, notary fees, litigation costs, etc., arising from the procedures for the collection of receivables.

The participation bank is entitled to recover the damages it incurs due to the late collection of both the principal amount it is owed and the inflation difference resulting from this delay, as well as other actual expenses, from the late payment penalties it receives. Consequently, to offset the loss of profit and other actual expenses resulting from the delay in payment, imposing an additional fee on customers who fail to settle their debts on time would exceed the scope of compensating for a loss. This would contravene the prohibition set out in the Hadith. In the words of the Prophet Muhammad (peace be upon him), "There should be neither harming nor reciprocating harm" (Muvatta, "Akdiye", 31; Ibn Majah, "Ahkam", 17).

The verse "And if someone is in hardship, then [let there be] postponement until [a time of] ease." "But if you give [from your right as] charity, then it is better for you, if you only

knew" (Quran, 2:280) commands extending a helping hand to the debtor experiencing financial difficulties and granting them time until they are in a better financial situation. However, the creditor is entitled to demand repayment of the debt and pursue the debtor in accordance with the relevant regulations (Serahsi, al-Mebsut, Beirut, 1431/2010, XXIV, 164; Mawsili, al-Ihtiyar, Cairo, 1356/1937, II, 90). Consequently, this verse requires the participation bank to grant the debtor, who can demonstrate that they are unable to pay their debt, an extension without charging them for the delay. If, during the approval stage of the financing by the bank, the necessary investigations are conducted and it is determined that the customer has the financial capability to pay off their debt, it is assumed that this ability to pay will continue. Furthermore, unless proven otherwise, a customer who fails to pay their debt on time is considered to have the ability to pay in accordance with the principle of *istishab*, which states that things remain as they are until proven otherwise (Mecelle, Article 5). Consequently, until proven otherwise, the customer is assumed to have the ability to pay. In the event of a default, they are deemed to have delayed their payment despite having the ability to pay, and late payment penalties are applied.

The objective of imposing late payment penalties in the event of default is not to generate profit but to ensure that the customer pays their debt on time and to compensate the bank for the damages incurred due to this default. If the penalty is set too low, it will be ineffective as a deterrent and will not produce the expected result. Conversely, if it is set too high, it may impose a sanction on the customer that is disproportionate to the harm they have caused, resulting in unfairness. To avoid both negative outcomes, it is recommended that participation banks determine their late payment penalty rates in accordance with the principle of equity, based on market practices and the rates set by public institutions.

The late payment penalty is applied to ensure that customers pay their debts on time. This rule is based on the principles of avoiding harm and, if harm has been caused, remedying it, as well as meeting the needs arising from multi-dimensional financial transactions. Since existing harm cannot be remedied by causing harm to the other party, late payment penalties cannot be applied to receivables that are not yet due. As the late payment penalty is a consequential claim, it is not appropriate to treat it as a principal claim and apply a late payment penalty separately.

In terms of purpose, there is no distinction between the late payment penalty applied to Turkish lira or foreign currency debts.

In the event that a customer of an Islamic bank fails to meet their financial obligations in a timely manner and becomes in default, the bank may pursue the collection of its receivables through the legal process of execution. During this process, the bank may earn interest income as ordered by courts and execution offices. Receivables such as interest or compensation for delays ordered by the court are subject to late payment penalties. Conversely, costs such as those incurred in the course of litigation and enforcement proceedings, as well as legal fees, are not considered inappropriate income as they are incurred as actual damages.

The actual expenses incurred for the collection of receivables and the resulting inflation difference due to the customer's failure to pay the debt on time are damages suffered by the Islamic bank. Therefore, these damages can be covered from the late payment penalty amounts. However, any amount exceeding this is considered inappropriate income for the Islamic bank. The bank may choose to refund the excess amount to the customer after a period it deems appropriate. If the refund option is chosen, it should be decided from the outset. The entire profit accrued during the period until the refund date should be added to the refund amount.

2.6. Justifications for Regulations on Cash Surplus Amounts

Funds collected in excess from customers, whose ownership cannot be determined, can be considered as found property (*lukata*) by the bank. This is because these funds were provided without the owner's intention to transfer or abandon ownership. The recipient does not know to whom the money belongs. Found property is held in trust by the finder, who must take the necessary care to protect the property and keep it for a reasonable time while searching for the owner, as it belongs to someone else (Ibn Nujaym, *al-Bahr al-Ra'iq*, vol. 5, pp. 161-163). Therefore, the participation bank can hold the excess funds in temporary accounts for a certain period. Islamic jurists have expressed different opinions on the waiting period based on the amount and type of found property. Considering various narrations, interpretations, and opinions on the matter, it is understood that there is no harm in determining the period based on contemporary conditions, provided that the aim is to reach the owner (Zayla'i, *Tabyin al-Haqaiq*, Bulak, 1314, vol. 3, pp. 302-304; 'Ayni, *al-Binaya*, Beirut, 1420/2000, vol. 7, pp. 327-329). If the owner is not found within the specified period, the relevant amount is transferred to the inappropriate income account because it belongs to someone else. This amount can be kept in the said account until the

owner comes forward or can be used for charitable purposes. The responsibility of the finder is to protect the found property. However, this responsibility is not indefinite. The finder can continue to protect the property until the owner is found, or if hope of finding the owner is lost, it can be given as charity on behalf of the owner (Kasani, *Bada'i' al-Sana'i'*, vol. 6, p. 202; *Zayla'i, Tabyin al-Haqaiq*, vol. 3, p. 304).

Once the surplus amount has been transferred to the incorrect income account, the bank will deduct it from the relevant account and return it to the owner if they can be identified. If there is no money in the account, the bank will cover it from its own resources. It is not considered whether the money in the inappropriate income account has been spent for charitable purposes. Although Islamic banks have the authority to spend surplus amounts for charitable purposes, this spending has been done without the owner's permission. It is not permitted to dispose of another person's property or money without their permission. The owner has the right to approve any charitable donations made on their behalf. If they do not approve, the amount spent for charity will be refunded to them (Kasani, *Bedai'u al-Sana'i*, VI, 202; *Ayni, al-Binaya*, VII, 331).

The ownership of lost property is retained by the owner. Personal property is inviolable, unless there are legitimate reasons for disposal. Therefore, no one can dispose of property without the owner's permission. The authority to dispose of lost property after a certain period is one of the exceptions to this general rule (Bukhari, "Lost Property", 1, 3-4, 9-10; Muslim, "Lost Property", 1-3, 5-10). Please also refer to Izzeddin b. Abdusselam, *al-Fevaid fi ihtisari'l-makâsid*, Damascus, 1416/1995, p. 92-93. This authority is mostly limited to actions aimed at protecting the property and giving charity on behalf of the owner. In the absence of poverty, a person cannot benefit from the property for their own benefit (Zeyla'i, *Tebyinu'l-hakâik*, 304, 307). Therefore, it is not appropriate for Islamic banks to cover any of their losses or make any profitable transactions for themselves using surplus amounts from the vault.

3. Justifications for Regulations on Segregation of Non-Compliant Incomes

Income that does not comply with the principles and standards of participation finance should be kept in a separate account to be able to be liquidated and spent in certain areas. This will ensure that the income that is compliant with the religious law and the income that is not compliant will be separated from each other and that the validity of the transactions will not be compromised. Keeping these incomes in a separate account is also

important for auditability and transparency. Furthermore, it would be prudent for the advisory committees of participation banks to assume responsibility for the control and oversight of the management and expenditure of these special accounts.

The income that needs to be liquidated and kept in the inappropriate income account is managed to ensure that it does not lose value against high inflation and that the intended spending purpose is fully realised. However, this management process is not aimed at the participation bank or its shareholders directly or indirectly benefiting from it; it is solely to preserve the value of the money in this account. As the income managed in this way is inappropriate income, the income obtained from it also has the same ruling and is considered inappropriate income. It is then transferred to the relevant account.

Any discounts and rights that will be obtained due to inappropriate income are evaluated in accordance with these incomes. The equivalent is then transferred to this account. Similarly, it is appropriate for any tax or other obligations arising from the opening of this account to be met from this account.

In the event of an error being identified in a ruling on a matter, it is standard practice to revert to the previous ruling. Therefore, if an income is deemed inappropriate from a legal perspective and it is subsequently determined that it is not inappropriate, this income should be considered legitimate and returned to the account from which the inappropriate income was originally taken.

Income that is classified as inappropriate cannot be considered appropriate income. This is because the Mecelle states that "Whatever is subject to a rule is subject to it in every respect" (art. 42) and "No separate ruling is made for what is subject to another ruling" (art. 43). Consequently, any discounts or rights obtained due to inappropriate income are considered inappropriate income and transferred to this account.

In the event that income that is not properly belonging to the recipient is in question, it must be returned to the rightful owner. Similarly, if a property has been taken without a legitimate reason or was taken with the belief that it was legitimate but was later found to have been taken unjustly or by mistake, it must be returned to the owner or their heirs. It is not permissible to take someone's property without a legal reason (Bakara 2/188; Nisa 4/29; Bukhari, "Ilm" 9; Muslim, "Birr" 10; Mecelle, art. 97). The return should be made from the account of inappropriate income.

4. Justifications for Regulations on Elimination of Non-Compliant Incomes

It is imperative that any inappropriate income be kept in a designated account and disposed of without delay. However, operational necessities and the time-consuming nature of the disposal process may require a certain period to elapse. In this context, the following calendar year is considered a sufficient time to complete these transactions. Conversely, the failure of the participation bank to spend the specified amount within the allotted time frame may result in the postponement of meeting the needs outlined in Article 4.2 of this Standard.

It is not appropriate for an individual who has obtained illegitimate income (*milk-i habis*) to retain it as an asset. However, there is no objection to using such assets for those in need and public services. In a related matter, the Prophet Muhammad (peace be upon him) did not consume the meat of a sheep that had become unlawful due to being slaughtered without the owner's knowledge. Instead, he directed that it be distributed to those in need (Ahmed b. Hanbel, *al-Musnad*, Beirut, 1421/2001, XXXVII, 185). The Participation Bank disburses the inappropriate income, which it is obliged to dispose of, in accordance with Article 4.2 of this Standard. These spending areas are aimed at providing social assistance and services. In the disposal of inappropriate income, the Participation Bank may allocate funds to a specific area in consideration of existing needs in special situations or distribute funds to other areas.

With regard to delay penalties, the Participation Bank may either spend the penalty income in the aforementioned areas or refund it to the customer.

A participation bank is prohibited from using inappropriate income for its own benefit. There is no distinction between using these incomes to generate new income and using them to reduce expenses (*Şeyhîzâde Abdurrahman, Mecma'u'l-enhur*, II, 459). In this context, a participation bank is prohibited from spending inappropriate income in areas where it is directly obliged to pay or in areas where it will obtain direct or indirect benefits. Otherwise, it would imply treating inappropriate income as legitimate assets belonging to the bank. Indeed, the Advisory Board's decision No. 62 dated 16 February 2023 stated that the interest from TCMB (The Central Bank of the Republic of Türkiye) Noticeable Foreign Exchange Accounts could not be used for TMSF premium payments. Furthermore, practices such as lending or investing the income in a way that it remains within the special

account to increase the amount should also be avoided as they would delay the outflow of this amount from the bank.

Should a participation bank so desire, it may direct the expenditure of inappropriate income in accordance with Article 4.2 of this Standard. The costs incurred in the course of this activity shall also be met from the special account of the inappropriate income. As the participation bank derives no direct or indirect benefit from these transfers to social areas, and the expenses are related to the disposal, the expenditure from the relevant account does not imply that the participation bank gains a benefit for itself. Furthermore, the participation bank may choose to dispose of the funds through reliable institutions.

It should be noted that expenditures made by the participation bank from inappropriate income are not considered expenditures made directly from its own resources. Expenditures made by the bank from the relevant income are mandatory expenditures to dispose of an illegitimate income, contrary to the charitable activities carried out from its own resources. Using disposal expenses in a way that would enhance the bank's prestige is not considered appropriate, as it implies that the bank indirectly benefits from these inappropriate incomes.