The Evolution of Participation Banking in Turkey

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INTRODUCTION

Participation banking, a moniker for financial practices structured in accordance with Islamic law, has not traditionally made up a large segment of Turkey’s finance sector due to the country’s secular tradition since the start of the modern Republic in 1923. However, participation banking has grown in recent years because of more permissible public attitudes, decreased trust in the conventional banking sector after financial crises in 2001 and 2008, and the desire to attract capital from the Gulf region. As a result, the current government, led by the Justice and Development Party (AKP), has sought to shape a regulatory framework for participation banking in line with the country’s changing sensibilities towards the role of religion in public life. This has developed in conjunction with an expansion of Islamic finance in the global economy more generally.

Given its secular identity, Turkey would at first appear incompatible for Islamic finance in its economy. The modern nation-state of Turkey, founded after the breakup of the Ottoman Empire, was deeply influenced by the reforms of its founder and first president, Mustafa Kemal Ataturk. While Ataturk set about implementing the country’s reforms in the 1920s and 1930s, religiously conservative segments of Turkey became marginalized in both policymaking and business, which were highly interconnected. The country’s constitution and government were modeled after France’s “laïcité” system, which mandated a separation of religious and political affairs. The Caliphate and Sultanate were disestablished, the veil was banned from public venues, religious convents and dervish lodges were closed, and the Directorate of Religious Affairs was entrusted with writing the Friday sermons and monitoring religious activity.

The state bureaucracy and military routinely resisted Islamic influence in business and finance throughout the Republican period following these reforms. During much of this time, Turkey had a highly centralized economy and followed a policy of “etatism,” whereby state institutions owned and managed most important industries. The issue of Islamic finance was not a consideration, as conventional financial intermediation was practiced in line with European norms, as it had been since the Ottoman period.

Islamic finance in Turkey is a more recent phenomenon. Changes in government priorities and public sensibilities have allowed participation banking to gradually acquire legitimacy, particularly within the past decade.
and public sensibilities have allowed participation banking to gradually acquire legitimacy, particularly within the past decade. The expanding magnitude of associated clientele and deposits has allowed participation banks to reach over 4.5 percent of market share in total assets, up from nearly 1 percent in 2001. Turkey has gone through a fundamental shift since the rise to power of the AKP, which has sought to promote greater religious influence in the country despite the historically secular identity of its ruling bureaucracy and military. The country recently passed new legislation to encourage Islamic banking in the private sector, and government officials have indicated interest in issuing sovereign sukuk, comparable to bonds, for funding federal budget requirements.

These changes represent a shifting paradigm in the level of acceptance for participation banking in Turkey. They have also unfolded in the context of two periods of economic turmoil: the domestic financial crisis of 2001 and the global financial crisis of 2008. Participation banking emerged stronger after each of these periods of instability. The shift in tolerance fits a trend of moving away from a highly state-controlled economy towards greater economic liberalization. However, participation banking’s role in the economy will likely grow as Turkey considers options for attracting investors from the Arab Gulf region who are currently highly liquid in terms of capital and also religiously conservative.

Despite its growing popularity, Islamic banking remains a small part of the total financial sector and will likely remain so due to lack of penetration in the market and strong competition from the conventional banking system. Turkey also has much deeper conventional capital markets than other Muslim majority countries that did not pursue similar policies of modernization during the last century. Meanwhile, the compatibility between the country’s secular legal identity and state forms of participation finance, such as sovereign sukuk issuances, remains contentious.

**ISLAMIC FINANCE IN THE GLOBAL ECONOMY**

Islamic finance is a source of funding that adheres to Islamic fiqh, or jurisprudence, and its development as part of the global economy has been a relatively recent phenomenon. While the idea of modern Islamic finance has been traced to Indian Muslims in the 1940s, and precursors took place in Egypt in the 1960s, the first Islamic financial institutions took shape during the 1970s. Under the auspices of the Organization of the Islamic Conference (OIC), and with backing from Saudi leaders such as King Faisal, Muslim leaders sought to create an Islamic banking system that could help manage the “political and economic destiny” of the Islamic world. The challenge would be creating a system that would be “consistent with religious precepts” and “viable in the modern global economy” through a process of *ijihad*, loosely defined as the careful reflection and effort used for interpreting Islamic texts. Under these conditions, the Islamic Development Bank was founded in 1974 at an OIC summit in Lahore, and a number of Islamic banks began to operate in the following years.

While conventional finance facilitates the flow of capital to investment opportunities that provide the highest return in the marketplace, Islamic finance governs investments with an underlying altruistic rationale of producing the most optimal socioeconomic outcome in line with Islamic norms. Some notable characteristics include its avoidance of *riba*, interest-based lending or usury, and *gharar*, speculation or uncertainty. It also has a special focus on *halal*, or religiously permissible activity – such as observing dietary restrictions on alcohol, tobacco, and pork – as well as other ethical and religious goals. The reason for these distinctions involves Islam’s preoccupation with creating a “moral economy,” where profits from commerce are generally seen as more favorable in comparison with profits from money-lending or speculation, which are considered sinful or undesirable because of potential negative social consequences.

The underlying contracts of Islamic products differ from their conventional counterparts in structure. For example, *murabaha*, a sale-based instrument similar to a conventional loan, involves the purchase of an asset by a bank and its sale to the client at a cost plus a declared profit. The structuring as a sale has important legal implications according to fiqh, which has an
elaborate set of rules governing sales that dictate the terms of risk and mutual consent. These rules seek to ensure the security of the investment and avoid social conflict among the relevant parties through framing the transaction as a commercial one involving an agreed-upon cost and profit. Other sale-based products can include the financing of commissioned manufacturing or construction, istitna, or a forward sale, salam, which require structures different from their conventional equivalents as well. Lease-based instruments, ijara, are similar to traditional leasing with certain distinctions, and equity-based financial intermediation can take place through profit and loss arrangements known as mudaraba.

These products can be disputed and can differ among geographic regions because local religious scholars often have different interpretations of the Islamic law underlying the financial transactions. The rising use of Islamic finance in the global economy, however, suggests a more standardized future. Governments in many countries are creating regulatory frameworks for Islamic financial products that will contribute to this process. This is particularly true for the recent and somewhat controversial financial innovations, like sukuk, which are certificates representing ownership of an underlying pool of assets that are religiously acceptable, allowing the holder to collect returns from the sale or lease of the assets. These can be traded as fixed income like bonds, and some non-Muslim countries, such as South Africa, have considered issuing sovereign sukuk. As of December, nearly 86 corporate issuances valuing over $23.3 billion had been offered globally in 2011, with 71 occurring in Malaysia, which dominates the market and has been a leader in the innovation and growth of Islamic finance outside of the Gulf region. Central governments issued four tranches valued at nearly $4.7 billion, two of them coming from Malaysia. Islamic finance has grown in Pakistan, Iran, Sudan and the Gulf states of Saudi Arabia, Bahrain, Qatar, United Arab Emirates and Kuwait. Beyond the Islamic world, Singapore, Hong Kong, the United Kingdom and the United States have also developed windows for Islamic banking in their private sectors. To the extent that globalization has affected capital markets in the past several decades, Islamic finance has become transnational in scope and importance.

ORIGINS OF ISLAMIC FINANCE IN TURKEY

Conflict between Islamic banking and Turkey’s secular identity seemed inevitable from the start. Islamic finance faced strong competition from both public and private conventional banks and a skeptical public. Since Ataturk’s reforms, Turkey had a highly centralized economy and followed a policy of “etatism,” whereby state institutions owned and managed most important industries. However, the 1980s saw a period of liberalization of Turkey’s tightly controlled economy under the Prime Ministry of Turgut Özal. This followed the global trend away from centrally-planned economies and also resulted from poor economic performance under the etatist system. As part of a plan to attract more foreign direct investment from the Arab Gulf states, a 1983 federal decree legalized the operation of “special finance houses” to provide interest-free banking without any direct reference to Islam or religion. These institutions were highly regulated by a skeptical bureaucracy, however, and did not have the same status as conventional banks. They were not covered by the Central Bank of Turkey’s insurance program and could not invest in government securities.

The sector experienced further growth, however, when established Islamic finance houses from the Gulf began setting up “special finance houses” in Turkey to provide non-interest finance without any direct reference to Islam, and smaller domestic companies followed in their

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wake. Key players included Bahrain-based Al Baraka Turk and Saudi-based Faisal Finans Kurumu, which each opened subsidiaries in 1985. The Kuwaiti-based Kuveyt Turk Kurumu began operations in 1989. These financiers from the Gulf maintained a small presence and catered to Turkey’s religious clients who needed financing but did not want to turn to the country’s conventional banks. Eventually, special finance houses began lending with mainly domestic capital, including: Anadolu Finans (1991), İhlas Finans (1995) and Asya Finans (1996). Like their Gulf-state predecessors, they maintained a small presence in the market and catered mainly to a specialized and religious clientele while trying carefully not to attract too much attention from the secular establishment.

Although Islamic finance grew steadily during the 1980s and 1990s, it still constituted a small portion of the banking sector, offering mainly retail banking and deposit accounts as basic services. The state bureaucracy, military and leading business figures in Istanbul and Ankara viewed Islamic finance suspiciously due to their strong commitment to Kemalist and secular values. However, a growing class of more conservative and religiously-observant businessmen eventually began to challenge this norm.

THE 2001 ECONOMIC CRISIS AND COLLAPSE OF İHLAS FINANS

Following the Asian financial crises in the late 1990s, Turkey’s economy experienced tremendous volatility, which caused some consolidation of the participation banking sector. Poor regulation, the accumulation of bad debt, and politically motivated lending contributed to a severe financial crisis in Turkey in 2001. This affected all aspects of the banking sector, although state and conventional banks suffered more than the special finance houses since they had a much larger role in the overall economy. In the 1990s, the banking sector had channeled too much financing to the public sector and not enough to private enterprises, leading to large interest rate and foreign exchange risks. On February 22, 2001, the Turkish lira moved from a crawling peg to a free floating regime and depreciated by 40 percent in three days, negatively affecting the values of assets on the balance sheets of banks and the companies they financed. As Turkey began suffering from rapidly increasing inflation, the International Monetary Fund (IMF) was consulted to mitigate instability with a disinflationary program.

The crisis had a major negative effect on the entire banking sector, and the participation banks also suffered. Turkish holding company Ülker purchased Faisal Finans in 2000, changing its name to Family Finance House. Then, İhlas Finans filed for bankruptcy in 2001 as the liquidity crisis in Turkey reached its peak. Of the six participation banks in Turkey, only the largest and most exposed, İhlas, went into bankruptcy. In comparison, over twenty conventional banks failed. Because the deposits of İhlas Finans were not protected by the Central Bank’s insurance system, and İhlas could not invest in government securities, a major proportion of the investments were in illiquid assets and projects. In the initial stages of the financial crisis, İhlas and other participation banks were thus not as greatly affected as state and conventional banks, which could hold liquid government securities. However, when the liquidity crisis hit, İhlas’ exposure led to its collapse. It experienced a traditional bank run on its deposits and could not find the cash needed to cover outstanding liabilities. The remaining participation banks survived the crisis intact, and the country’s state and conventional banks suffered most, as the special finance houses still only represented less than three percent of the total financial sector.

The 2001 crisis led to an overhaul of Turkey’s financial system, and the parliament passed a new banking law in response (No. 4389). In addition to strengthening banking regulations and creating new oversight bodies for conventional banks, law No. 4389 founded the “Union of Private Finance Houses” in order to address common issues among participants and provide a level of state control for the sector. All special finance institutions were required to become members of this association, but they still lacked many of the privileges of state and conventional banks, such as the provision of deposit insurance. In 2006, banking law No. 5411 officially replaced the term
“special finance” institutions with the moniker “participation banking,” which was considered more appealing, and the Union of Private Finance Houses became the “Participation Banks Association of Turkey” (TKBB). The new law created a Savings Deposit Insurance Fund for participation banks, which granted much needed security for depositors. Accounts of up to 50 thousand Turkish liras became insured and additional uninsured deposits became eligible for protection under Turkey’s bankruptcy laws.20 These changes were instrumental in creating a more favorable regulatory framework for participation banking in Turkey.

The TKBB currently consists of the four practicing institutions in Turkey - Kuveyt Turk, Al Baraka Turk, Turkiye Finans and Bank Asya and represents their interests. According to its website, the TKBB’s objective is to defend the “rights and interest of participation banks within the frame[work] of the free market economy and full competition principles in direction of the banking system regulations.”21 It also carries out studies and advocates for the practice of participation banking in line with Turkish banking laws.22 The TKBB provides statistics, reports, training and conferences about interest-free banking. It operates with a committee structure that includes working groups on legislation and ethics, law, arbitration, financial affairs, financial advice, risk management, training, banking services, techniques, prevention of money laundering and administrative works.23

**TRENDS AFTER THE 2008 GLOBAL FINANCIAL CRISIS**

Participation banks have experienced steady growth as a result of more conducive regulatory and legislative measures instituted by the ruling Justice & Development Party, or AKP. After a series of coalition governments in Turkey, the AKP was voted into power in 2002 largely because of the previous year’s economic crisis. The dual emphasis on “justice” and “development” embodied by the party’s name has made the AKP popular among not only its more conservative and religious base but also a large number of centrist voters who became discouraged by the alleged corruption and lack of progress made by the secularist coalition governments during the 1990s. The AKP has its roots in the Islamist-oriented Welfare Party, which had been elected to parliament in 1996 but was disbanded after the Turkish military threatened to stage a coup the following year. The party has a strong constituency of conservative businessmen in central Anatolia, sometimes referred to as the “Anatolian Tigers,” and migrants to major cities.24

This change in political leadership has ushered in a wider level of acceptance for participation banking in Turkey. The sector has grown annually since 2001 in terms of deposits. Exhibit 1 shows the levels of growth of participation banking in terms of total assets and as a percentage of the entire financial sector in Turkey and displays a steadily rising trend. The sector increased from 2.4 million to 33.6 million Turkish liras in deposits and from a 1.08% to 4.03% growth rate from 2001 to 2009. This occurred despite a 4.8% contraction of GDP growth rate in 2009 due to the global recession.25

While the country responded quickly to the downturn and has maintained high GDP growth rates in 2010 and 2011, the participation banks are clearly gaining market share. Exhibit 2 compares the share of participation banks and conventional banks according to five metrics. It shows a steady increase for participation banks and decrease for conventional banks from 2005 to 2009. Significantly, while percentages of assets and deposits have grown to 4.5% and 6.05% respectively, they still remain minor as a share of the total banking sector in Turkey. Though the use of participation banking has increased dramatically, it has a long way to go before it competes with conventional banking as the dominant form of financial intermediation.
The global financial crisis has allowed proponents of Islamic finance to market interest-free banking as a more secure alternative to conventional banking, and this may account for the increases in deposits seen in Turkey during the past few years. Scholars Ismail Özsoy and Aydın Yabanlı said the 2008 crisis “drew focus to Islamic banking” because it “does not allow foreign exchange speculation, hedge funds and transfer of debts as is the case with the mortgage crisis in the U.S.”26 They also argued that participation banks in Turkey are stronger now that they are subject to added regulations and take part in a Savings Deposits Insurance Fund in case of liquidation.27 While Turkey made progress in developing its capital markets since the 2001 crisis, the 2008 crash may have signified the pitfalls of conventional finance and the potential for exploitation to many religiously observant Turks who may have turned to participation banking believing that Islamic finance represents a safer or more ethical financial system.

Despite the global financial crisis, participation banks have benefited from the rise of the AKP and the regulatory changes. Bank Asya, founded in Turkey largely with Turkish capital, has become a popular retail bank for religious clients, and its recent success signifies the sector’s legitimization in recent years. The origin of the bank lies with a religious tarikat, or movement, called the Gulen movement. In 2006, the bank floated 23 percent of its shares on the Istanbul Stock Exchange in the first initial public offering for a participation bank in the country since İhlas Finans collapsed.28 By 2010 it floated 52.5% of its shares.29 In 2007, the Bank also established a Level 1 American Depository Receipt program with Bank of New York Mellon, which is traded on the over-the-counter market under the ticker symbol ASYKY.30 Bank Asya has been the fastest growing participation bank in Turkey over the past several years, experiencing a 56 percent rise in deposits to 9.1 billion liras in 2009 alone.31 While financial institutions in the United States and Europe were contracting and laying off employees, Bank Asya increased its number of branches and employees in 2009 and 2010.32 In 2009 it took a 40 percent stake in Tamweel Africa Holding SA, an Islamic bank in Dakar, Senegal, hoping to spread its activity in Africa. Furthermore, the bank has marketed aggressively in the past several years, recently sponsoring the First League of Turkish Professional Soccer in 2008.33

Success has also followed participation banks started with Gulf capital. Al Baraka Turk, with roots in Bahraini Dallah al Baraka, has done well in the Turkish market and increased its foreign direct investment. Like Bank Asya, Al Baraka Turk has expanded rapidly in the past decade, increasing its branches from 24 in 2002 to 109 in 2010.34 It held an initial public offering in 2007 and spearheaded some of the advances in the sector in past years, such as the creation of the Savings Deposit Insurance Fund and advocating for the name change to participation banking.35 Sixty two percent of its shareholder structure stems from foreign capital, including 54% from the Al Baraka Group, nearly 8% from the Islamic Development Bank and nearly 3.5% from the Alharthy Group. While 11.4% comes from local Turkish investors, nearly 22.5% is publicly traded on the Istanbul Stock Exchange.36 Kuveyt Turk represents an Islamic bank from the Gulf that is not publicly traded. It is 62% owned by Kuwait Finance House and has minority stakes of nearly 19% from the Directorate General of Foundations of Turkey, 9% from the Kuwait Social Security Institution, 9% from the Islamic Development Bank.37 Lastly, the participation bank Turkiye Finans grew out of the consolidation of several Turkish banks. The National Commercial Bank (NCB) of Saudi Arabia acquired 60 percent of Turkiye Finans’ shares in 2008 in an agreement arranged by HSBC, an acquisition resulting from the global financial crisis.38 These developments reflect a trend of increased foreign direct investment by Islamic banks from Gulf countries into Turkey and
suggest the sector will likely continue to grow as a means of financial intermediation.

**SUKUK FINANCING AND GOVERNMENT INVOLVEMENT**

The creation of the regulatory framework for corporate sukuk demonstrates the Turkish government’s proactive interest in enabling the means for more Islamic finance. First issued in 2002 in Malaysia, sukuk has become a popular form of Islamic financing, and banks in Turkey have experimented with issuances. Sukuk resemble conventional bonds but differ fundamentally in their structure. Whereas bonds are contractual debt obligations, the holders of sukuk own a specific asset backed by other Islamic financial instruments and are entitled to receive the profit generated from that asset as well as the proceeds from its sale. They are tradable, provide periodic returns and may appreciate.39

A framework for selling corporate sukuk in Turkey was set up in April 2010, and Kuveyt Turk issued the country’s first sukuk offering under an arrangement by Citigroup in September of the same year with a $100 million issuance.40 Hulusi Horozoglu, director of global Islamic banking at Citigroup, said at the time: “We believe there is significant appetite for sukuk issuances, both on the issuer and investor sides, and we would expect to see greater volumes going forward,” adding that a “key driver for this market will be the growth in Islamic banking at the retail level, which has shown tremendous growth over the preceding few years.”41

While corporate sukuk has not posed a problem and appears set to expand, the possibility of sovereign sukuk issuance remains controversial. In an August 2010 interview, Finance Minister Mehmet Simsek revealed that the government is considering selling sovereign sukuk in the future. However, such a scenario would have to overcome legal hurdles.42 The country’s Constitutional Court could potentially challenge the issuance of sovereign sukuk on the grounds of violating the policy of state secularism expressed in Article 2 of the constitution.43

There was speculation as to whether Turkey would issue sovereign sukuk as far back as January 2009. As one writer described: “Perhaps not surprisingly, the debate on Turkey’s proposed debut sovereign sukuk is bordering on the farcical, with pundit after pundit either espousing its virtue as a liquidity raising off balance sheet financial tool, or warning of the doom and gloom of creeping Islamism and the erosion of the Kemalist constitution.”44 The article alleged that Finance Minister Simsek confirmed the government was “looking at alternative sources of financing” and was “in the process of drafting enabling legislation to facilitate” instruments that would “meet the demands of investors in parts of the world where liquidity is high” – likely referring to the Islamic Middle East.45 Furthermore, Selim Yesilbas, the head of the International Finance Markets at the Turkish Undersecretariat of the Treasury, allegedly told a local newspaper the government was exploring the possibility of issuing a sovereign leasing sukuk, or sukuk al-ijara, on a “sale-and-lease back structure.”46

The debate over sovereign sukuk issuance in Turkey remains a contentious issue as a means of public financing. As the country needs to finance its current account and the European debt crisis has decreased European portfolio investments to Turkey, it seems logical that sovereign sukuk might be issued to attract Gulf investors if a regulatory framework permits. Turkey’s state banks have allegedly issued non-interest loans successfully in the past, and the Treasury might issue sukuk despite the ambiguity of its legality.47 According to lawyer and Islamic finance expert Jamie Durham, international sukuk ultimately represents “a series of contractual obligations enforceable in accordance with their terms just like any other contractual obligation.”48 Thus, the relevant obligations’ being “part of a sharia compliant structure should not make any difference to their enforceability.”49 The issue
remains opaque as a matter of public policy and hinges on interpretation of the country’s constitution, which defines state secularism. If Islamic financial products are structured in a way that provides interest-free tranches without direct reference to religion, there appears to be no conflict – although the line between interpretations of state law and religious law becomes less clear.

Debate over the creation of a new constitution in Turkey has been ongoing since the military-imposed 1980 constitution. The AKP has been outspoken about its desire to renew the constitution in order to incorporate more individual freedoms. It formed a new draft in 2007, but this was rejected in the committee stages due to the sensitivity of its potential impact on the use of female headscarves at the time. In September 2010, the AKP passed a package of amendments to the constitution, but throughout the 2011 parliamentary election campaign it called for an entirely new charter with a presidential system. Now that the AKP has won a third term in power after the June 2011 elections, Prime Minister Erdogan has made constitutional reform a top priority. How and whether reform will overcome the constitution’s secular mandate to affect the Islamic finance sector remains unclear.

Meanwhile, government support for Islamic finance has been demonstrated in other ways. The first “participation index,” launched in January 2011 by the Istanbul Stock Exchange, includes equities in Turkey that adhere to the principles of Islamic lending. Fahrettin Yahşi, chairman of the TKBB and general manager of Albaraka Turk, said the index would “provide standardization in the sector.” In February 2011, the Turkish parliament passed legislation for an international deal to “promote Islamic finance and improve access to funding based on religious rules.” The Islamic Development Bank, or IDB, would provide financing to companies in Turkey operating under procedures of Islamic production, according to a 1999 agreement between the Islamic Corporation for the Development of the Private Sector, or ICD, and IDB member countries. Thus, companies processing pork, tourism facilities that provide service for women and men in mixed company and alcohol companies, for example, would be excluded from financial support. The legislation would also give a board based in Saudi Arabia the authority to inspect whether Turkish companies comply with Islamic principles. The main opposition Republican People’s Party, or CHP, successfully blocked the law in 2004, but it passed with less than a minute of debate in the Ankara assembly in 2011. The legislation provides further evidence of the greater legitimacy of Islamic finance in Turkey and the greater inclusion of religion in public life generally.

Thus far, however, the judiciary has not challenged such legislation for violating Turkey’s state secularism as defined by the constitution. Allegations of the potential sponsorship of military coups in Turkey among the secular judiciary, media and military by means of the Ergenekon and Sledgehammer investigations have perhaps deterred investigators from disputing such legislation for fear of becoming associated with these accusations. Ergenekon is an alleged ultranationalist gang accused of planning to topple the government by staging a coup, initially by spreading chaos and mayhem. It is allegedly an extension of the “deep state,” an unofficial organization that has operated above the elected governments. Meanwhile, according to the allegations in the Sledgehammer case, the military planned drastic measures to foment unrest in Turkey in order to remove the AKP from power in a coup. Supporters of the investigations cite their accuracy while critics say the government has manipulated them to suppress opponents in the secular military, bureaucracy and media.

**FUTURE OUTLOOK AND POLICY IMPLICATIONS**

Islamic finance has undoubtedly become a global phenomenon, and as the sector grows, the policy implications for its use merit attention from international observers. Participation banking has gained legitimacy in Turkey over the last decade, particularly since 2008. This trend will likely continue as long as Islamic investments are deemed as secure alternatives to conventional products and devout Muslims increasingly choose to comply with religious norms. Since the AKP
won the June 2011 parliamentary elections by a popular majority of nearly 50 percent of the votes, government support for participation banking is likely to continue. While corporate issuances have already taken place, the issue over whether a sovereign issuance of Islamic sukuk will occur remains opaque since any attempt to issue a sovereign tranche might be challenged in the country’s judicial system as violating the country’s state secularism clause in the constitution.

Whether this happens will be decided by Turkey’s courts and legal scholars. However, the separation of state and religion experiences a paradox in Turkey since the assets of religious institutions are essentially owned and controlled by the state. The Directorate for Religious Affairs is a publicly funded state institution that “exercises guidance on religious and moral issues and administers all 85,000 mosques in Turkey,” usually taking stances that adhere to the interpretations of the Hanafi school of thought in Sunni Islam. In a comparative context, whereas American secularism evolved so that the constitution restricts the power of the government to create religious institutions - and much of the subsequent debate in future years has hinged on the use of money for religious purposes - Turkish secularism evolved as a way of controlling religion in public life. The constitution affirms the country as a secular state rather than restricts the powers of the legislature. Indeed, the Directorate of Religious Affairs has historically used its power to make sure religion remains subservient to the state. Thus, the use of public funds for religious purposes is considered normal, and the use of Islamic finance as a matter of public policy could conceivably evolve in this context.

At the same time, its use will be constrained by markets. For example, in May 2011 Prime Minister Recep Tayyip Erdogan expressed that interest rates for the Central Bank of the Republic of Turkey should be at zero, effectively at a level equal to inflation, but such a goal is highly unlikely in a highly interconnected global economy. “In effect, we have to zero the real interest rate, this should be our goal, this is what we should achieve,” Erdogan told a meeting of the conservative business group the Confederation of Turkish Industry and Business (TUKSON), adding ”So we have to...not make money from money but, quite the opposite, to gain power from production and investments.” While Turkey’s Central Bank ought to pursue an independent policy in order to achieve its principal mandate of maintaining price stability, political pressures can potentially play a role in decision-making. The bank has recently come under criticism for keeping artificially low interest rates due to political pressure. The bank, meanwhile, has defended its policy by saying the low rates are needed to maintain growth due to the possibility of recession in the European Union, Turkey’s largest export market. Thus, while Islamic finance has been discussed as a matter of public policy at top levels, the shape in which it will potentially manifest itself in the economy is unclear.

Surely, participation banking still only reflects a small portion of the total banking sector in Turkey, and it would have to overcome a much larger and well-established conventional banking system to become a dominant form of financial intermediation. Nevertheless, Turkish investors who want to make sure the religious alignment of their investments are finding alternatives, and the changes are significant for Turkey’s identity and policy beyond the scale of the sector. Turkish foreign and economic policy has customarily remained independent from that of the Arab Gulf states since the formation of the Turkish Republic. However, a new activism and increased soft power has emerged as a result of a more Islamist Turkey seeing greater popularity on the “Arab Street.” A “Turkish model” has been discussed in countries like Tunisia, Libya and Egypt that have overthrown secular dictators since the Arab Spring, where Islamist parties promulgate both economic growth and religiosity within legitimate
legislative governments. Some of these countries have recently held elections, and Islamist parties inspired by Turkey’s AKP are competing for power. These include the Al Nahda Party of Tunisia, which won the most parliamentary seats in the October 2011 election, the Justice and Development Party of Morocco, which won the most seats in the November 2011 election, and the Freedom and Justice Party of Egypt, which represents the political movement of the Muslim Brotherhood. 64 Turkey has sought to influence the changes sweeping over the Arab countries and export its brand of secularism, as demonstrated when Erdoğan advocated its adaptation in Egypt during a visit. 65 Given the direction of these ongoing transitions, it is reasonable to assume that Islamic finance may gain additional footholds throughout the region. For example, five new Islamic banks from the Gulf are reportedly planning to enter the Turkish market in the near future, according to a recent report. 66 While the extent to which Islamic finance will affect policy issues in Turkey is yet to be determined, it clearly will take on a larger significance for economic development in a greatly more interconnected region.

The views and opinions expressed in articles are strictly the author’s own, and do not necessarily represent those of Al Nakhlah, its Advisory and Editorial Boards, or the Program for Southwest Asia and Islamic Civilization (SWAIC) at The Fletcher School.
Appendix

Exhibit 1: Participation Banking Growth. The blue bar represents growth in assets in millions of Turkish lira. The black line represents the percentage of the total financial sector. Source: The Participation Banks Association of Turkey (TKBB) website.67

<table>
<thead>
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<th>(%)</th>
<th>Participation Banks</th>
<th>Conventional Banks</th>
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<tr>
<td>Share in Total Assets</td>
<td>2.69</td>
<td>3.04</td>
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<tr>
<td>Share in Total Loans</td>
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<td>Share in Total Private Loans</td>
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<td>Share in Total Deposits</td>
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<tr>
<td>Share in Total FX Deposits</td>
<td>4.70</td>
<td>5.19</td>
</tr>
</tbody>
</table>

Source: Arslan and Ergeç (2010, p. 159)

Exhibit 2: Source: Arslan and Ergeç, "The Impact of Interest Rates on Conventional and Islamic Banks: The Case of Turkey." (Numbers in millions TRY).68
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