

Causes and solutions for the stagnation of Islamic banking in Turkey

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Abstract

Purpose – This paper aims to evaluate the root causes of stagnation of the Islamic banking sector in Turkey in three steps and proposes solutions and policy recommendations.

Design/methodology/approach – First, global Islamic banking practices in terms of governance and instruments are summarised and compared with the Turkish experience. Second, the financial and efficiency ratios of Turkish Islamic banks (IBs) and conventional banks (CBs) are compared and analysed for the period 2005 to 2015. Finally, the long-term growth strategy of Turkish IBs is evaluated.

Findings – This paper asserts that Islamic banking in Turkey diverges from Islamic banking practices of prominent countries by not having a Sharī'ah governance framework at either a national or bank level. Turkey is thus immediately in need of a sound Sharī'ah governance framework. Increasing the variety of instruments and improving the perception of Islamic banking in the society are other critical points. Furthermore, regulatory and research institutions specifically focusing on Islamic banking are insufficient. A large number of financial and efficiency ratios reveal that the efficiency and profitability of IBs fall behind that of CBs. IBs should improve their business models, operational efficiencies and information technology infrastructure as these issues are undervalued in their growth strategy.

Originality/value – This study sheds light on the Turkish Islamic banking sector, which is a rarely studied topic. It is the first study that provides institutional differences of banking practices and evaluates the efficiency status and growth strategy of IBs in Turkey.

Keywords Islamic banking, Profitability, Sharī'ah governance, Turkish participation banking

Paper type Research paper

Introduction

The Ernst & Young World Islamic Banking Competitiveness Report (EY, 2016, p. 10) reveals that international participation banking assets reached US\$882bn and have spread widely from the Gulf to the Far East. There are more than 900 Islamic financial institutions (IFIs) according to Thomson Reuters Islamic Finance Development Report 2014 (ICD Thomson Reuters, 2014, p.34).

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While Islamic banking, which is called “participation banking” in Turkey, started there in 1985, at roughly the same time as other Muslim countries, it has failed to reach the market share levels of other successful countries. Islamic banking in Turkey was initially established under the name “Special Finance Houses” (SFHs) without making any reference to Islamic requirements because of the secular political culture of the country. Islamic banking stayed at a crawling stage for a long time because the secular sensitiveness hampered the improvements required to catch up with the global practices of Islamic banking (Asutay, 2013). In 2002, the Justice and Development Party, which has a strong bond with the Islamic heritage, won the majority in Parliament, whereupon conditions for Islamic banking started to improve. In 2005, a new banking law brought a legal framework which is deemed more sound, entitling the SFHs to be recognised as participation banks (PBs)[1]. Recently, two state banks established Islamic banking subsidiaries with very ambitious targets.

Even though both the political and economic situations have substantially improved[2] over the past 15 years, the market share of Islamic banks (IBs) has stagnated at around 5 per cent, which is quite small compared to countries such as Malaysia (21 per cent), Qatar (26 per cent) and Kuwait (45 per cent). Thus, Islamic banking in Turkey still remains as a “big potential”.

The purpose of this study is to critically review the global Islamic banking practices and identify how Islamic banking in Turkey resembles or differs from Islamic banking in other prominent countries. This study also examines a large number of key ratios reflecting business models and efficiency of conventional banks (CBs) and IBs in Turkey between 2005 and 2015 to provide a more comprehensive picture of the problems and to recommend workable solutions.

The rest of the paper is organised as follows:

- the next section summarises the global practices of Islamic banking;
- this is followed by an explanation of the progress of the Turkish Islamic banking experience along with a comparison of financial and efficiency ratios of PBs; and
- the final section then concludes the paper.

Islamic banking practices

The progress of the Islamic banking industry has followed different paths in different countries/regions, based on their diverse political, cultural, religious environments and financial structures. Full-fledged IBs were first launched in Saudi Arabia (1974), the United Arab Emirates (UAE) (1975), Kuwait (1977), Bahrain (1978) and Malaysia (1983). While Islamic banking has been spreading over the world, Iran (1979), Pakistan (1980) and Sudan (1984) tried to convert their banking systems into Islamic. However, Sudan and Pakistan left off and turned back to a dual banking system later (Imam and Kpodar 2010). Even though Iran banned interest-related transactions, it is said that interest has not been fully removed from the monetary and banking system (Hassani, 2010). The UK’s interaction with Islamic banking started with wholesale banking. UK banks provided deposit accounts with *murābahah* markup to IBs in the Gulf region based on London Metal Exchange rates. Afterwards, the first IB of the UK was established in 1982 (Ainley *et al.*, 2009).

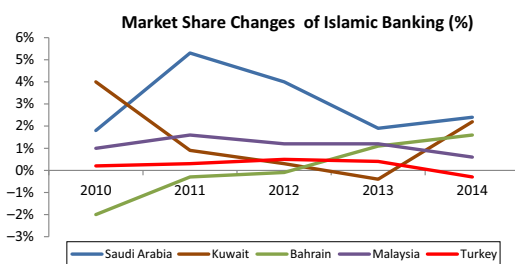
The annual growth of international participation banking assets is 15-20 per cent, and, between 2010 and 2014, assets increased from US\$490 to 882bn (EY, 2016, p. 10). In terms of market share, Figure 1 reports the changes in domestic markets. It is noted that even with a very small base level, changes in market share in Turkey are far from satisfactory compared with other countries.

Governance and regulations

Banking is a highly regulated sector. A sound regulatory framework is the foremost requirement for the success of the industry. Moreover, governments should provide the necessary confidence by protecting banks and depositors against liquidity shortfalls and bankruptcies. Modern Islamic banking is not independent from the aforementioned issues. Malaysia is a very good example of how government support and planning is fruitful. The Malaysian government initially established a council to study how to set up Islamic banking in 1981, and the first Malaysian IB was launched in 1983. Afterwards, the Islamic money market (1983) and the first *takāful* company (1985) were established. In 1990, Malaysia issued its first *ṣukūk* and has presently become one of the leaders in the global *ṣukūk* and Islamic finance markets[3]. The UK failed to support Islamic banking and stumbled at her first attempt because of tax and regulative disadvantages faced by IBs (Wilson, 2010). In 2000, a working group was established by the Bank of England to study how to make Islamic banking sustainable (Hasan, 2009). This resulted in new and efficient regulations, and Islamic banking started to flourish (Khan and Bhatti, 2008).

From a regulatory point of view, almost every country has its own way of governing the Islamic banking sector. Debate is ongoing whether this heterogeneity is the main reason for the lack of standardisation in Islamic finance instruments. For example, Malaysia has a detailed regulatory framework for Islamic banking. The Shariah Advisory Council was set up under the aegis of the central bank in 1997, and it has been the highest authority for Islamic banking matters since 2009 (Hasan, 2009). IBs also must have their own Shari'ah boards. Indonesia has no separate Islamic banking law (Zaher and Hassan 2001). The central bank is responsible for prudential issues related to IBs just as it is for CBs; however, religious issues are handled by the National Shari'ah Board of the Ulama Council of Indonesia (Lindsey, 2012). Legal disputes regarding Islamic banking are handled by the Shari'ah court (Majid and Ghazal, 2012). IBs have separate Shari'ah boards, and CBs are allowed to have Islamic windows.

Although the Gulf Cooperation Council (GCC) countries have very common economic, political and cultural attributes, they have considerably different practices for Islamic banking. Saudi Arabia does not specifically regulate IBs. There is no National Shari'ah Board, and IBs are not obliged to have Shari'ah boards. It does not even mention the term interest and neither regulates nor prohibits it (Hasan, 2009). Even with this peculiar framework, IBs have been able to reach 51 per cent market share, and banks do have Shari'ah boards even though it is not necessary. Table I provides the basic statistics related to Islamic banking for a number of countries.



Source: EY (2016, p. 13)

Figure 1.
Changes in market share of Islamic banking

Table I.
Basic statistics on
Islamic banking

Country	Population (millions)	Muslim population (%)	GNI per capita 2013 (USD)	Islamic banking market share (%) (2014)	Islamic banking global market share (%) (2014)	National Shari'ah Board	Islamic bank level Shari'ah board	AAOIFI accounting standards
Bahrain	1.3	81.20	21,050	29.30	1.60	Exists	Required	Required
Indonesia	257.56	88.1	3,511	3.7	2.5	Exists	Required	Not required
Kuwait	3.89	86.40	52,000	45.20	10.10	None	Required	Not required
Malaysia	30.33	61.4	10,551	21.3	15.5	Exists	Required	Not required
Oman	4.49	87.70	16,870	7.5a	N/A	None	Required	Not required
Qatar	2.23	77.50	89,950	25.80	8.10	None	Required	Required
Saudi Arabia	31.54	97.10	25,140	51.20	33	None	Optional	Not required
Turkey	78.66	98.60	10,260	5.50	5.10	None	Optional	Not required
United Arab Emirates (UAE)	9.15	76.00	43,860	21.60	15.40	Exists	Required	Required
United Kingdom (UK)	65.10	4.6	42,350	<1	<1	None	Optional	Not required

Notes: ^aOman Islamic Bank market share is 2015 data; ^bFatwa Board in the Ministry of Awqaf handles Shari'ah-related disputes

Source: Data derived from EY Islamic Bank Competitiveness Report 2016, World Bank and Sescric databases

Bahrain is distinctive with its regulation-oriented approach and hosts crucial Islamic finance institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency and the Liquidity Management Center. Bahrain has a National Sharī'ah Board which is at the advisory level (Shanmugam and Zahari, 2009). The UAE, a federal union of seven emirates, has two different Sharī'ah governance frameworks as IBs in Dubai have to comply with the Dubai Financial Services Authority (FSA) (Hasan, 2009). The Sharī'ah governance in the UAE can be considered as more restrictive. The National Sharī'ah Board decisions are binding. Further, IBs have to get approval from the National Sharī'ah Board before assigning scholars to bank-level Sharī'ah boards. IBs in both Bahrain and the UAE have to comply with the AAOIFI accounting standards. Kuwait can be considered as less restrictive as the AAOIFI framework is not a must and Sharī'ah boards of banks are appointed by the bank management. Bahrain, the UAE, Kuwait and Qatar all consider Islamic law as the main legislative source but make exceptions for commercial transactions and allow interest-based transactions.

Oman resisted implementing Islamic banking for political reasons (Hasan, 2009). In May 2011, Islamic banking products were allowed along with conventional ones (Magd and McCoy, 2014) to attract capital from other GCC countries. Its market share reached 7 per cent in three years.

As a non-Muslim country, the UK does not have a national Sharī'ah board. There is also no requirement for IBs to set up their own Sharī'ah boards, and Islamic windows are allowed. The FSA allows banks to have Sharī'ah boards as long as their role is not executive. The FSA also expects IBs not to adopt a Sharī'ah governance framework tied to a jurisdiction outside of the UK (Hasan, 2009).

The overall picture of Islamic banking practices indicates a strong relationship between the development of Islamic banking and government support as well as regulations related to Islamic banking. Almost all prominent countries have the necessary regulatory frameworks and the solid intention to enlarge their Islamic banking sectors. The only exception seems to be Saudi Arabia, which is silent on the term "interest" and on Islamic banking. However, this negligence is not meant to discourage Islamic banking; instead, its implicit purpose is to allow the existence of conventional banking. Meanwhile, there are very different practices regarding Sharī'ah governance. National Sharī'ah boards, if they exist, mostly perform in an advisory capacity as their decisions are not binding for the IFIs, and the overall banking systems work with conventional banking principles.

Instruments

Instruments have a crucial role in Islamic banking as its *raison d'être* comes from the prohibition of interest in Islamic law. IBs are obliged to use Sharī'ah-compliant instruments for both the asset and liability sides, as well as for liquidity and risk management. Put simply, a commercial activity can be financed in two ways, via borrowing or establishing a partnership. Establishing a profit-and-loss sharing (PLS) contract is the ideal case for Islamic banking (Khan, 2010). *Muqārabah* and *mushārah* are PLS-based contracts in which IBs set up a partnership with an entrepreneur. However, in practice, trade-based or debt-based instruments heavily dominate the PLS instruments, which often leads to the criticism that IBs actually resemble CBs (Khan, 2010; Azmat *et al.*, 2015; El-Hawary *et al.*, 2007). Widely used trade-based instruments are *murābahah* (cost plus sales), *salām* (forward sales), *ijārah* (leasing) and *istiṣnā'* (project financing).

Figure 2 reports the instrument breakdown of some of the prominent countries. *Murābahah* is the most widely used instrument worldwide. Saudi Arabia and Iran are distinct with more than 90 per cent utilisation of *murābahah*.

Other than available banking instruments, new products have been developed with the help of financial engineering to support liquidity and risk management in Islamic finance. This process gave birth to *ṣukūk* and Islamic equity funds (Mannan, 2008). According to the Islamic Financial Services Industry Stability Report (IFSB, 2015, p. 17), *ṣukūk* represent the fastest growing market in the Islamic banking and finance industry. Practically, *ṣukūk* are referred to as Islamic bonds or Islamic investment certificates. The key distinction is that *ṣukūk* must be asset-based and should represent a cash stream tied to the underlying asset instead of a debt.

Islamic indices and Islamic funds are also available in Islamic capital markets. Malaysia was the first country that published a list of Sharī'ah-compliant equities in 1983. The first Islamic equity index was also introduced in Malaysia in 1996. Afterwards, in 1999 the Dow Jones Islamic Market, the Kuala Lumpur Sharī'ah Index and the FTSE Global Islamic Index Series were launched (Mannan, 2008). The first Islamic fund was established in the USA in 1986. Saudi Arabia is the leader of the fund market; however, Malaysia is growing fast with related tax incentives (Shanmugam and Zahari, 2009). According to IFSB (2015 p. 22), the annual growth of Islamic funds was 6.6 per cent between 2009 and 2013. As of the third quarter of 2014, the Islamic funds sector reached US\$75.8bn. Table II provides a breakdown of the key components of the Islamic finance industry by region.

Takāful is the Sharī'ah-compliant substitute for insurance. The major distinction of *takāful* models is that customers are considered as partners, and they receive a share of the profit at the end (Billah, 2007). *Takāful* is important for Islamic banking for risk management purposes. Malaysia and Saudi Arabia are the leaders of the *takāful* market.

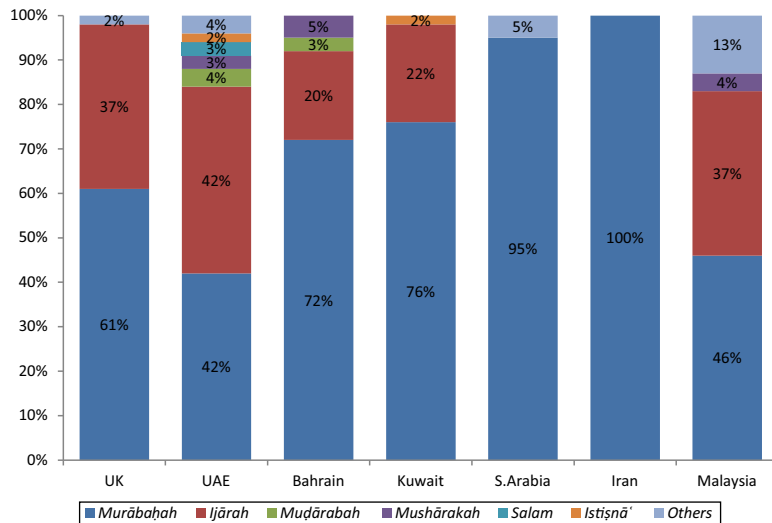


Figure 2.
Use of Islamic
banking instruments
in 2013

Source: Islamic Development Bank Data Center cited in PBAT Strategy Document 2015-2025 (2015, p. 15)

The annual growth in the *takāful* market was 17 per cent between 2005 and 2008 (Ernst and Young, 2010, p. 31) and 16 per cent between 2008 and 2013 (IFSB, 2015, p. 44).

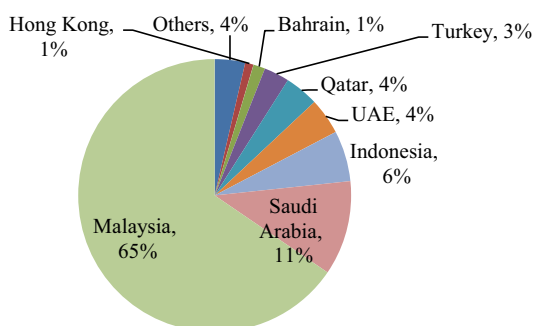
Turkey heavily relies on *murābahah* on the Islamic banking side. For capital markets, Turkey entered the *ṣukūk* market quite late. The first regulation titled “rent certificates” was released in 2010 and Kuveyt Türk PB then issued the first *ṣukūk* in Turkey. In 2011, some tax exemptions (stamp tax, notary duties and others) were introduced, and income tax was reduced to 10 per cent. In 2012, the Turkish Treasury entered the *ṣukūk* market and the Lease Certificate Market was opened at Borsa Istanbul to stimulate the market. The Turkish central bank also started to accept *ṣukūk* as collateral. In 2013, more comprehensive regulations were issued allowing five schemes (*murābahah*; *ijārah*; *ijārah and wakālah*; *muḍārabah* and *mushārakah*; and *istiṣnā*) corresponding to most of the schemes in the world (Deloitte, 2016, p. 18). Alternative schemes are also allowed to be proposed to the Capital Markets Board of Turkey. According to the Deloitte Islamic Finance Insights Series Report (Deloitte, 2016, p. 18), between 2013 and 2015, *ṣukūk* worth US\$10bn and TRY 10bn (roughly US\$4.43bn) were issued in Turkey. Currently, *ṣukūk* issuances in Turkey reached 3 per cent of the global market and seem to be competing well with most of the GCC countries even though the Turkish *ṣukūk* market is not as mature as the GCC *ṣukūk* markets. Figure 3 depicts the percentage of *ṣukūk* issuances in key jurisdictions.

The first participation index in Turkey was initiated in 2008 and has been calculated and disseminated by Borsa Istanbul since 2011. The index consists of 30 companies that are in line with Islamic banking principles. The Participation 50 index was established in 2015.

Region	Banking assets	<i>Ṣukūk</i> outstanding	Islamic funds assets	<i>Takāful</i> contributions
Asia	203.8	188.4	23.2	3.9
GCC	564.2	95.5	33.5	9.0
MENA (exc. GCC)	633.7	0.1	0.3	7.7
Sub-Saharan Africa	20.1	1.3	1.8	0.6
Others	54.4	9.4	17	0.3
Total	1,476.2	294.7	75.8	21.5

Table II.
Breakdown of Islamic finance segments by region (USD billion, 3Q 2014)

Source: IFSB (2015, p. 7)



Source: Islamic Financial Services Industry Stability Report (2015, p. 19)

Figure 3.
Ṣukūk issuances by domicile and share (October 2014)

Turkey has lagged behind in Islamic equities and funds. Even though Turkey has reached a significant share in the global *şukuk* market, its share in Islamic funds is still negligible. The *takāful* market is also at its infancy stage and is thus not satisfactory either. Nonetheless, IBs recently started to establish *takāful* subsidiaries. The first *takāful* company – Neova Sigorta – was established in 2009, and, in 2014, its market share reached 1.67 per cent (Aslan, 2015). However, *takāful* is not well known in Turkey and customer awareness is extremely low.

Islamic banking in Turkey

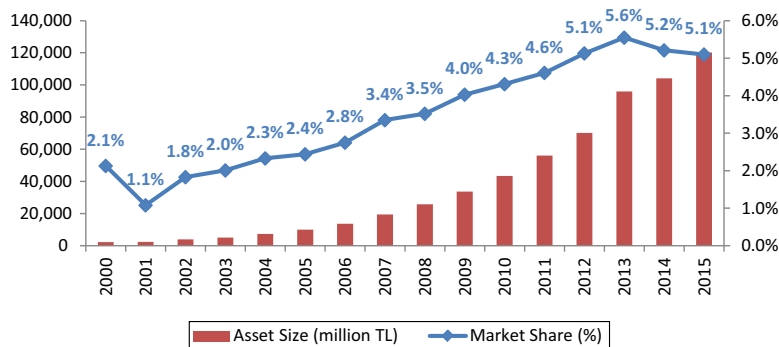
Islamic banking began under the name of SFHs in 1985. However, for a long time, IBs had to operate within a minimal legal and regulatory framework and even without mentioning interest-free banking principles. The lack of necessary framework was mainly because of the dominant secular sentiments that prevailed within the state, businesses and media. Any sign of religious symbols could easily ignite irritation and anger at the Islamic banking system. Between 1985 and 1991, six interest-free finance companies, namely, Al Baraka, Kuveyt Türk, Faisal Finans, Anadolu Finans, İhlas Finans and Asya Finans, were established. In 2001, Turkey experienced a devastating economic crisis, during which İhlas Finans – the key player – went into bankruptcy because of a liquidity problem. On the conventional banking side, over 20 banks also failed during the crisis (Hardy, 2012). Because deposits of IBs were not covered by a deposit insurance scheme, the bankruptcy of İhlas Finans caused a chain reaction such that many customers of the remaining IBs rushed to withdraw their monies (Tunç, 2010). The market share of Islamic banking was thus reduced by 50 per cent, and the necessity of the deposit insurance scheme became undeniable. Thus, in 2001 the Union of SFHs was established and at the same time a deposit insurance scheme was launched among IBs.

In 2002, the Justice and Development Party gained a majority in the November election, which eased pressures on Islamic institutions. At the same time, the economic situation as well as Islamic banking started to normalize and then to improve. A new banking law issued in 2005 altered the name of SFHs to “Participation Banks” and finally provided an acceptable legal framework for Islamic banking. Further, the Union of SFHs changed its name to Participation Banks Association of Turkey (PBAT, 2016).

Between 2014 and 2015, the Islamic banking sector faced another internal hardship. It was no secret that Bank Asya, the leader of the market, had a direct relation with the Gulenist movement[4], and a significant amount of deposits was withdrawn by the public because of hostile actions of Gulenists against the Turkish government in late 2013. Afterwards, Bank Asya rejected to share information about its privileged shareholders and its control was transferred to the Saving Deposit Insurance Fund in 2015. This issue significantly disturbed the Islamic banking sector and considerably reduced its total market share.

One significant development in Turkey was the recent entry of two state banks to the Islamic banking sector. Two state banks – Ziraat Bankası and Vakıflar Bankası – established Islamic banking subsidiaries in 2015 and 2016, respectively.

Figure 4 shows the market share of Islamic banking assets as a percentage of the total banking sector in Turkey. For the first 15 years (1985 to 2000), the share of Islamic banking rose to around 2 per cent. During the 2001 economic crisis, in which İhlas Finans went bankrupt, Islamic banking lost almost half of its market share. Since then, the share of Islamic banking has been steadily but slowly increasing to 5.5 per cent until 2013. While the disenchantment of Bank Asya caused a negative effect on the increasing trend, the entrance of two large state banks into the sector is expected to put the trend on the right track. It is



Source: PBAT Participation Banks 2015 (PBAT, 2015, p. 44); PBAT General Board Presentation (PBAT, 2010, p. 5)

Figure 4.
Islamic banking
assets and market
share in Turkey

noted that in 2015 PBAT issued a strategy document that covers 2015-2025 to achieve 15 per cent domestic market share until 2025.

The institution/education side of Islamic banking is quite underdeveloped in Turkey. Graduate/undergraduate programmes targeting participation banking or Islamic economics are at the initiation level. Currently, there are three graduate (master) level programmes offered by Sakarya University, Istanbul Sabahattin Zaim University and Istanbul University. Istanbul University (PhD level) and Karatay University (undergraduate level) each have a department of Islamic economics and finance. The International Islamic Economics and Finance Research Centre was established under Istanbul Sabahattin Zaim University in 2012, and the World Bank Global Islamic Finance Development Centre has been operating at Borsa Istanbul. The current academic performance of Turkish scholars on Islamic economics is quite poor. According to Thomson Reuters Islamic Finance Development Indicator (IFDI), Turkish scholars published only 10 research papers between 2011 and 2013 and 33 papers between 2013 and 2015. The numbers for Malaysia are 421 and 833 respectively (ICD Thomson Reuters, 2014, p. 21; 2016, p. 31).

Studies regarding Turkish Islamic banking are very rare. Savaşan *et al.* (2013) investigate the demand side of Islamic banking by surveying a large sample of conservative businessmen. The results are very interesting and have significant repercussions. They report that 54 per cent of businessmen choose banks to work with based on the cost of financing regardless of the bank type. Only one-third of the businessmen consider IBs to be Sharī'ah-compliant, which is another sign of the poor perceptions of Islamic banking. Another 34 per cent of them declare that they have no idea whether IBs are Sharī'ah-compliant or not.

Ongena and Şendeniz-Yüncü (2011) show that IBs mainly deal with young, multiple-bank, industry-focused and transparent firms. Aysan *et al.* (2016) demonstrate that IBs are relatively more involved in SME financing. Hassan *et al.* (2016) utilise stress tests to determine how capital adequacy ratios of IBs and CBs react to credit, market and operation risks and find that IBs in Turkey are more sensitive to stress compared to CBs.

Governance and regulations

Between 1985 and 1999, IBs – called SFHs at that time – were excluded from the banking law and were governed based on cabinet notices without any solid legal

background. IBs were included within the scope of banking law only in 1999. This change brought a more acceptable legal framework (Battal, 2000). In 2001, as mentioned previously, the union of IBs was established to start deposit insurance. Additionally, invoicing obligations during deferred sales were abolished[5], and further adjustments were carried out to make guarantee letters of IBs acceptable by state institutions (Halaçoğlu, 2014).

2005 represented a key milestone for the Islamic banking industry in Turkey. The regulation introduced in 2005 further strengthened the legal framework for IBs. The area of activities of IBs was defined as being wider than that of CBs. IBs were allowed to do leasing and PLS investments over and above banking activities. IBs were permitted to do some real estate and commodity-related transactions that CBs could not carry out (Halaçoğlu, 2014). Deposit assurance funds of IBs were merged with the funds of CBs under the name of savings deposits insurance fund. It is noted that two decades after the establishment of Islamic banking, the sector has finally attained a sound legal framework that enables it to compete with the conventional banking system.

However, Shari'ah governance issues and sustaining the compliance of banking instruments to Islamic principles are still grey areas. There is no nationwide Shari'ah board in Turkey. IBs have their own internal "advisory boards", and there is no standard procedure on how to set up a board, what are its responsibilities or how it is expected to function.

Islamic banks in numbers

IBs have been operating under an improved legal framework since 2005. Therefore, this paper evaluates the Islamic banking industry vis-à-vis the conventional banking sector between 2005 and 2015[6] by using some key performance indicators (KPIs). The related data were derived from the Banking Regulation and Supervision Agency (BRSA, 2016) database.

The study considers the market share of IBs in terms of financial values (total banking assets, total financing/credit allocation, total deposits/all deposits, current accounts, PLS/ interest bearing accounts and off-balance sheet items) and in terms of number of branches/ personnel/ATMs in Figures 5 and 6, respectively. Figure 5 shows that there are no considerable improvements in any of the KPIs of IBs in terms of their market shares. For example, the market share of off-balance sheet items reached 16 per cent in 2008 but then returned to its 2005 level in 2015.

Figure 6 indicates that the stable growth of the number of branches, ATMs and personnel clearly imply their intentions to expand more. Although the exit of Bank Asya

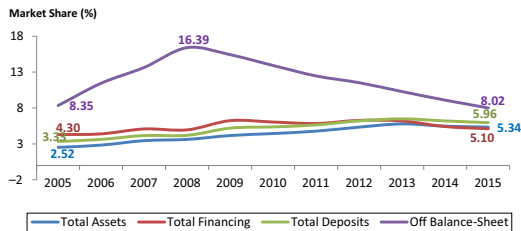


Figure 5.
IBs Market shares in assets, financing and deposits

Source: Banking Regulation and Supervision Agency Database

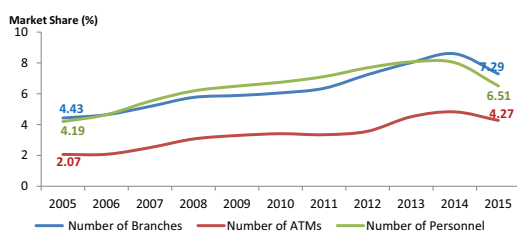
reduced IBs' market share in 2015, it seems that expansion of current IBs and entry of newcomers can make up this loss quickly.

Figure 7 reports several critical financial ratios for IBs and CBs such as return on asset, return on equity, net interest/profit margin and non-performing loans. The first salient point is the substantial decrease in the profitability of IBs. Although CBs' profitability significantly fluctuates over the period, their average level in 2015 is similar with the 2005 average with a decreasing trend since 2010. It seems that IBs were more profitable than CBs until 2009. It is noted that NPL of IBs has an increasing trend since 2012, which further raises concerns over IBs' profitability.

Figure 8 shows a comparison of IBs with CBs in terms of a number of efficiency ratios. The asset and deposit per personnel/branch figures indicate the improvements in efficiencies of both IBs and CBs. However, CBs have usually been more efficient, and the gap continues to increase. Personnel per branch figures are pretty close to each other. Thus, the efficiency gap should not be a result of excess employment. Overhead costs per asset have been decreasing for both bank types. Considering commission and banking service income ratio, IBs have a decreasing trend, which may explain the decrease in the profitability of IBs. While IBs may have to charge less in commissions to compete with CBs, it seems that they cannot increase their deposits and financing amount in parallel. In short, IBs collect fewer deposits, do less fund utilisation and gain less commission income per personnel and per branch.

Table III presents several KPIs for the business patterns of both IBs and CBs. As expected, IBs at least initially have higher overall financing ratios. However, CBs have raised their funding ratio from 37 to 62 per cent during the period considered and lately outperformed IBs. Regarding funding specifically to SMEs[7], IBs utilise almost 40-45 per cent of their funding activity on SMEs, whereas the number is around 25 per cent for CBs. This is a very critical distinction and an indication of IBs' contribution to the real economy through supplying loans to small-scale businesses that are supposed to be riskier. However, it is noted that NPL resulting from SME funding activities is on the rise.

An interesting finding from Table III is the higher ratio of current accounts to total deposits for IBs. Given that current accounts are deposits for which customers receive no profit or interest, it is important to understand why customers of IBs tend to keep their monies in current accounts and give up profits. There are at least two possible explanations. Either customers do not prefer PLS accounts because of the risk of losses or they hesitate to obtain a surplus from a PLS account and consider the gains as quasi-interest or within the "grey area". Anyhow, in both cases, although IBs may take advantage of these higher ratios, it is crucial to understand the underlying problem causing the higher ratios. This ratio may



Source: Data derived from Banking Regulation and Supervision Agency Database. Bank Asya branches and personnel deducted from 2015 values

Figure 6. IBs Market shares in terms of number of branches, ATMs and personnel

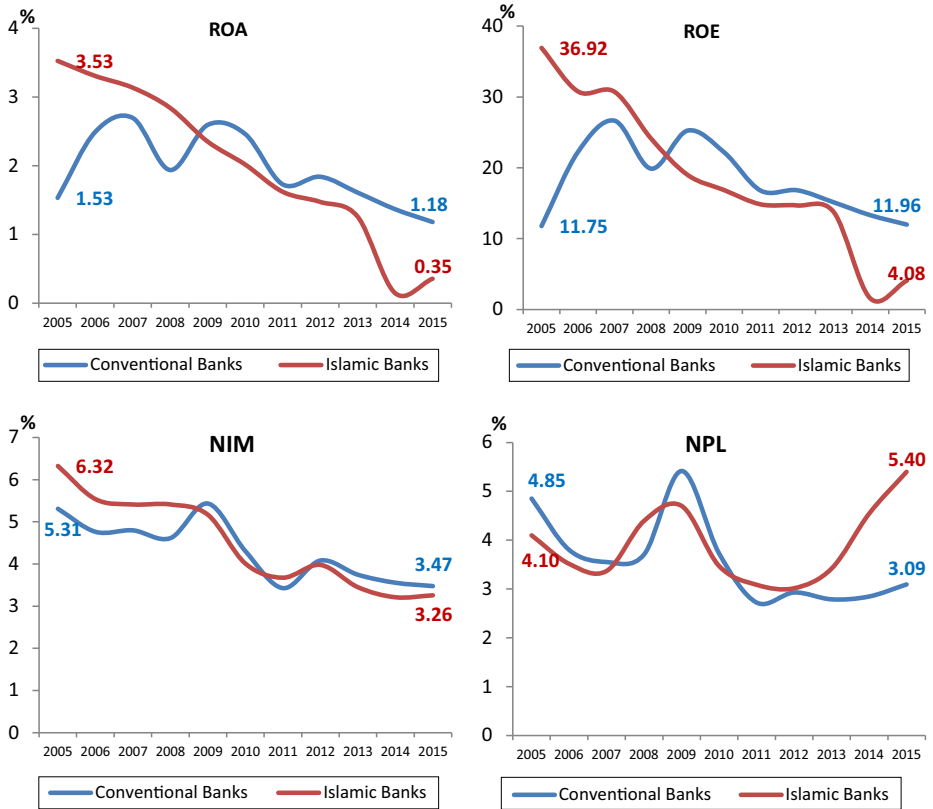


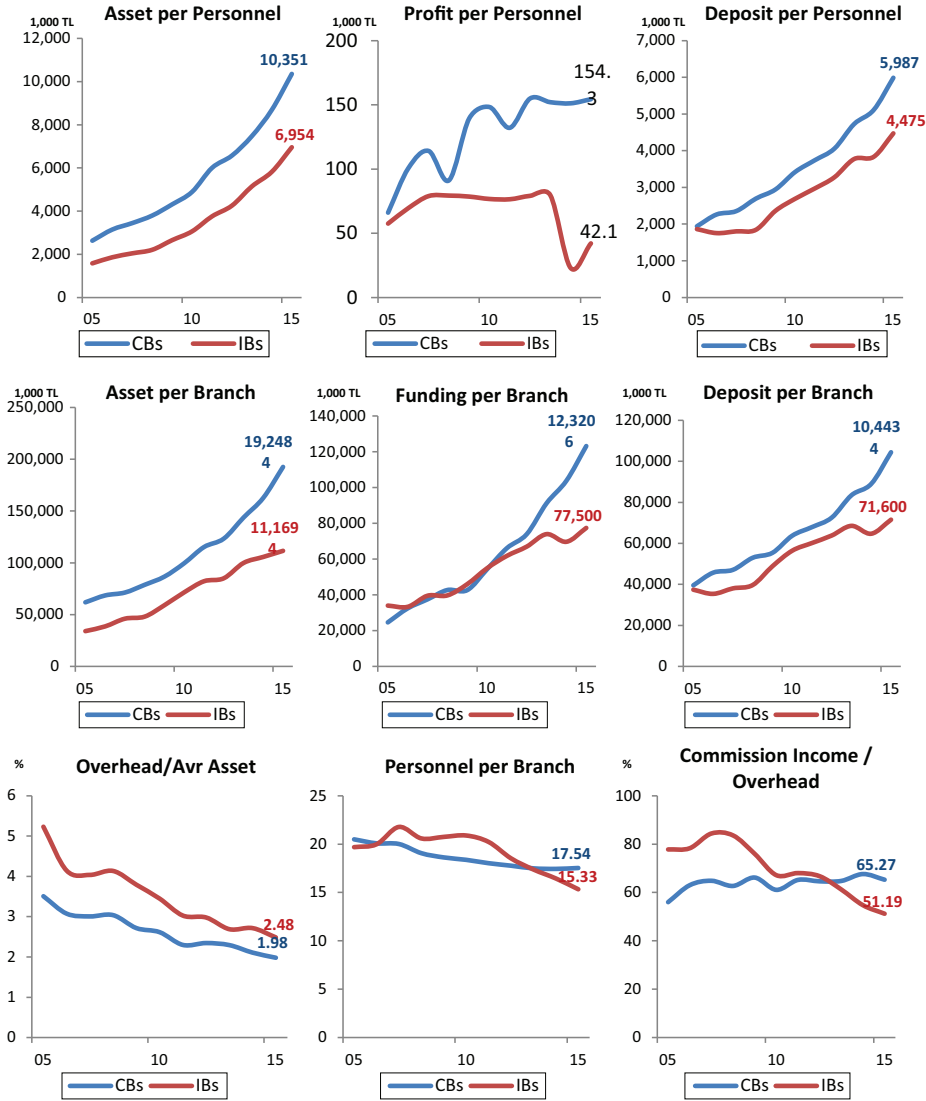
Figure 7.
Key financial ratios

Source: Data derived from Banking Regulation and Supervision Agency Database

implicitly indicate serious doubts about Islamic banking in general, given that IBs always distribute comparable profits with CBs.

Overall, these numbers imply that because Islamic banking was not able to reach a certain size to take advantage of economies of scale, IBs try to grow further by opening new branches. IBs generate less profit and operate with higher NPL. However, ignoring the situation that IBs cannot utilise their resources as efficiently as CBs might prevent IBs from finding the real problems and their solutions. Identifying the reasons behind these problems is crucial. These issues may not be directly related to the absence of nationwide Shari'ah governance or regulatory constraints. A decade after the major legal provisions in 2005, Islamic banking has a very small market share considering Turkey's potential. It is noted that utilisation of information technology (IT) is especially crucial to raise the efficiency of IBs, considering that banking is increasingly being shifted to the online system.

The lack of instrument variety could be another explanation for the very small market share and lower efficiencies. As discussed above, IBs heavily rely on *murābahah* instruments (more than 90 per cent), and the current business model for IBs may have reached its limits. Given that there exist serious concerns on the legitimacy of Islamic banking, it is clear that the *murābahah* scheme is not well understood and



Source: Data derived from Banking Regulation and Supervision Agency Database

Figure 8. Efficiency KPIs between 2005 and 2015

Table III.
Several ratios
regarding business
patterns

Year	Total financing/ Total assets (%)		Current account/ Total deposits (%)		SME funding ratio (%)		SME NPL (%)	
	CB	IB	CB	IB	CB	IB	CB	IB
2005	37.48	65.09	20.18	23.44				
2006	43.02	67.79	17.59	21.82	27.17	41.79	3.66	2.01
2007	48.33	72.37	15.99	18.80	27.06	31.50	3.75	3.27
2008	49.44	68.46	13.52	17.98	23.09	28.55	4.96	6.11
2009	45.94	70.30	15.40	18.88	21.01	29.64	8.44	6.70
2010	51.38	71.12	15.73	19.31	23.30	37.56	4.70	4.50
2011	55.48	68.64	16.95	25.39	23.29	40.15	3.14	3.30
2012	57.41	68.24	17.65	21.94	24.22	47.21	3.26	3.27
2013	60.00	64.56	18.33	24.54	25.31	46.42	3.17	3.50
2014	61.97	61.41	18.48	24.50	26.66	45.45	3.22	5.15
2015	62.85	59.94	18.64	27.15	26.21	41.92	3.87	6.99

Source: Data derived from Banking Regulation and Supervision Agency Database

accepted in Turkey. Higher ratios of current accounts can also be considered as evidence for this issue.

Way forward

The problems or concerns inhibiting an expansion of the Turkish Islamic banking sector can be summarised as follows:

- Lack of Sharī'ah governance causes misperceptions. Except for Saudi Arabia, all Muslim countries have Sharī'ah governance frameworks at the bank level and some even have nationwide boards. It is hard to standardize practices among IBs without the jurisdiction of a higher board.
- There is a lack of regulatory institutions focusing specifically on Islamic banking constraints and legal improvements.
- Lack of instrument variety pushes IBs to operate almost solely on *murābahah* transactions. Only Saudi Arabia has achieved high Islamic banking penetration by using *murābahah* schemes dominantly. All other prominent countries have introduced various instrument schemes.
- The perception of Islamic banking is very weak within the society. A significant portion of the society thinks that IBs are not necessarily interest-free and makes choices based on cost-benefit considerations. IBs have to express their moral merits more and be cost-efficient at the same time.
- The operational efficiency of IBs is lower compared with CBs. Worse, the gap is not closing.
- The lack of academic research and educational institutions to study the aforementioned problems further aggravates them.

PBAT issued a strategy document in March 2015 regarding how to expand the market. PBAT selected five strategic domains, notably:

- industrial coordination;
- instrument variety;

- Shari'ah advisory boards;
- education/HR/certification; and
- perception and strategic targets.

Actions in the strategy report cover almost all critical fields of Islamic banking. After 30 years of existence, Islamic banking finally has a solid roadmap. There are 84 actions defined in total; 40 per cent of these are PBAT's responsibility, whereas 60 per cent are the government's responsibility. The actions mostly address the problems highlighted in this paper such as establishing a nationwide advisory board, setting up a Shari'ah governance framework for IBs, increasing instrument variety, improving education and perception of Islamic banking. Although PBAT commits to restructure itself to be more proactive and effective, its role will apparently remain advisory and not binding.

Several regulatory and advisory entities are suggested to be established under various government institutions such as the Banking Regulation and Supervision Agency and Capital Markets Board. However, an Advisory Board[8] is proposed to be formed under PBAT. It is understandable not to set up this board under a finance-related government institution because of the secular sensitiveness. Yet, letting IBs select board members independently may further damage the perception and trust of Islamic banking within the society. It is noted that involvement of the Presidency of Religious Affairs can certainly be beneficial. Given the fact that there is no formal Shari'ah governance framework in Turkey, the need for a framework is extremely high. However, the strategy document does not mention the IFSB or AAOIFI Shari'ah governance standards. Instead, it claims that different practices are going to be examined and the framework is going to be decided. There is also no clue on the structure of the bank-level framework.

There are 45 actions in the instruments section; 29 of them target raising the efficiency of current instruments. *Şukūk* have the highest number of tasks (17). Actions for *şukūk* are quite specific, and, if implemented, they could reduce the operational effort and time for preparation to issue *şukūk*. There are no strong commitments for PLS instruments. Instead, proposals target improvement of the trade-based instruments. Establishing working groups for regulations and new instruments under PBAT is a right step with potential benefits.

PBAT is the main entity that is responsible for strategic actions regarding human resources and education purposes, and the required actions in the strategy document are reasonable. Regarding the perception side, the report indicates that a survey will be undertaken (actually it should have been implemented already) to gauge the attitude of the society. Currently, there are very few studies on the subject, and they are of narrow scope. Interestingly, the list of actions in the strategy document gives the impression that the main reason for the poor perception of IBs in the public derives from the lack of knowledge within the society. Required actions are listed such as increasing transparency, standardisation and utilisation of campaigns to inform and persuade the public. However, the possibility that people may not be convinced with the current business model is omitted. There should be further actions strengthening perception via improving the business model as well.

The biggest disappointment in the document is that there is almost nothing about improving the efficiency of IBs. It is important to note that IBs can take several actions to raise the efficiency of the sector. While CBs mostly benefit from economies of scale, IBs can also benefit from them in certain areas by acting as partners – that is quite in line with the nature of Islamic banking. For example, IBs can allow customers of other

IBs to use their ATMs free of charge and increase penetration ratios to benefit from economies of scale. A shared credit card and point of sale system can allow IBs to reduce their costs and increase their efficiency and penetration levels in the market. These efforts do not require any new regulations or government support. Indeed, this can improve the overall perception of Islamic banking as well. Considering the efficiency and financial ratios shown above, the performance of IBs is not satisfactory, and solid actions and strategies are required. Moreover, there is no mention of alternative distribution channels and IT. The banking sector in 2025 will be much more in web/mobile applications rather than buildings, and IBs should pay more attention to the related technology to obtain a 15 per cent market share.

Conclusion

This study mainly evaluates the global Islamic banking practices and compares them with those of Turkey. The Turkish Islamic banking sector is also compared with the conventional banking sector by using a large number of efficiency and profitability measures. Successful practices of Islamic banking in the world mostly started with an introduction of the institutional framework. Establishment of IBs was followed by launching *takāful*, *ṣukūk* and Islamic funds. Afterwards, different institutions were set up to study various aspects of Islamic banking and finance. Turkey was not able to follow a similar pattern because of the lack of adequate political support. Turkey was able to set up a reasonable legal framework for IBs comparatively late, in 2005, and introduced *takāful* (2009), *ṣukūk* (2010) and a participation index (2011) quite late as compared to other prominent countries. Problems preventing Turkish IBs from expanding can be summarised in five dimensions:

- (1) *Sharī'ah governance*: No framework exists, and practices of IBs may widely differ.
- (2) *Instrument variety*: IBs rely almost totally on *murābahah*.
- (3) *Perception of Islamic banking*: The public seems to be not convinced of the Sharī'ah compliance of Islamic banking.
- (4) *Inefficiency of IBs*: The figures show that IBs are less efficient and the gap is widening.
- (5) *Lack of academic studies and research institutions*: There are not sufficient intellectual efforts to tackle the aforementioned problems.

PBAT issued a strategy document in 2015 that touches all the dimensions above except for efficiency. There are 84 actions regarding coordination, instrument variety, advisory boards, education/HR/certification. There are a number of proposed tasks meant to improve especially *ṣukūk* and to raise intellectual efforts on Islamic banking. Topics on efficiency improvements, technological developments, and coordination among IBs are largely omitted. It is noted that internal efficiency and utilisation of advanced technology must not be underestimated. Furthermore, the report does not sufficiently focus on the domains of PLS instruments and perception-related issues. It is extremely crucial for IBs in Turkey to understand the sensitivity and the expectations of the public correctly and to take necessary steps. Given the very strong political support from the current top policymakers for interest-free banking, complaining of past attitudes can no longer be used to justify the tiny market share of IBs. A reasonable Sharī'ah governance structure and enhanced instrument variety can indeed boost the growth of the sector.

Notes

1. The term “participation banking” exclusively refers to Islamic banking in Turkey.
2. Turkey is the largest economy in the Organisation of Islamic Cooperation (OIC), ranked tenth in GDP per capita, and ranked seventh in terms of population [Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESERIC) 2015]. Between 2000-2015 inflation was reduced from 55 to 7.7 per cent, and 216 per cent GDP per capita growth was achieved (The World Bank, 2015a, 2015b).
3. As of 2011, Malaysia issued 65 per cent of total global *shukūk* (IFSB, 2015, p. 19). Even presently, Malaysia holds 70 per cent of the Islamic banking assets in Asia. Malaysia also hosts very important institutions for Islamic banking such as the Islamic Financial Services Board (IFSB) and the International Centre for Education in Islamic Finance (INCEIF).
4. The Gulenist movement revolted against the Parliament through its bureaucrats settled in the government in the late 2013. After its failure, the attempt repeated as a bloody military coup on 15 July 2016, which also failed.
5. Similar to the initial experiences in the UK, Turkish SFHs had to buy and sell the assets subject to financing and thus face value-added tax (VAT) and related operations. This obligation was also removed 18 years after the interest-free financing model started.
6. The timing (2005-2015) is also limited by data availability. It is very hard to obtain data for the earlier periods.
7. See, Aysan *et al.* (2016) for the detailed empirical evidence on the subject.
8. The term Sharī‘ah is still a taboo in Turkey so the term “Advisory Board” is in use.

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