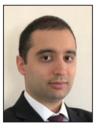
Islamic finance challenges in Turkey

Having almost 40 years of history, the Islamic banking sector in Turkey currently only has a 5–6% share of the finance market in the country. Out of 40 active banks, six are operating (excluding investment and development banks) under the Participation Banks Association of Turkey (TKBB) as Islamic banks and they have not yet reached the average level of their conventional competitors in terms of profits, total assets, deposits and loans. Despite the undeniable progress made, contemporary problems slow down economic expansion of the sector. ALI CEYLAN and MEHMET EMIN KARADENIZ explore.

__Ali Ceylan__ is a partner and __Mehmet Emin Karadeniz__ is the associate at Başpınar & Partners Law Firm. They can be contacted at ali.ceylan@baspinar.av.tr and mehmetemin.karadeniz@baspinar.av.tr respectively.

Islamic banking is trying to prevail as an alternative to the conventional banking (interest-based) system, which is dominant in almost the entire finance market in Turkey. To achieve this however, it must remain true to Islamic principles while adapting itself to the ever-changing needs of modern and complex economic relations. As a result, Islamic banks do not have a broad product scope like their conventional counterparts, which in return causes the lack of an ability to satisfy the aforementioned needs. The fact that Islamic banks in Turkey were not even able to issue letters of credit until the early 2000s due to religious concerns is an example of this internal brake mechanism.

Whether Islamic banks can provide a specific service is not only a matter of conformity to banking legislation but also to the religious rules. However, there was no central authority to officially declare a banking transaction "permissible" and each bank used to have its own counsel for religious matters. This situation created divergence among banking practices and lasted until the forming of the advisory council, the equivalent of Shariah boards in Islamic countries, in 2018 under the TKBB.

Another important factor related to the development of the sector is individuals' perception of these institutions. In Turkey, it is often possible to witness people saying that these banks are not any different from other banks. The essence of Islamic finance is based on the idea that no wealth should be gained without consideration. The concept of profit-sharing distribution, according to some people, is just another name for interest payments, especially when they see interest and profit-sharing rates float around the same levels and show similar reaction to changes in the market.

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Bank choices may depend on varying conditions and preferences. Islamic banks in Turkey do not have the same resources that conventional banks possess, lacking the required capital such as funds or trained manpower in Islamic banking even for opening a new branch. This might seem less important at first glance, but people tend to prefer banks with a branch or at least with an ATM near their neighborhood. The inability to expand prevents these banks from reaching new people, while at the same time the inability to reach people hampers further expansion.

Apart from the fact that intensifying competition forces all banks to adjust their rates in favor of their customers more and more, Islamic banks in Turkey are believed to be less profitable than other banks. While this is true for some time periods, this generalization seems to be wrong. Due to the different nature of Islamic banking, these banks respond to market fluctuations with delay and when interest rates increase, their profit share distribution rates may remain lower. However, when interest rates are decreasing, the delay occurs again and Islamic banks may become more profitable this time.

There are also problems with the application of Islamic investment instruments. Sukuk certificates are major instrument in the sector, getting more popular worldwide as well as in Turkey. Previous problems with taxation of Sukuk have been resolved but some of the issues remain. The pricing of Sukuk and other Islamic investment instruments is made like conventional instruments which contradicts their nature. Also, there is no secondary market for Sukuk which reduces the overall demand for these instruments. These are some of the reasons why private companies do not prefer to issue Sukuk over bonds generally.

Islamic banking had a difficult start in Turkey, coping with ideological prejudice and disadvantages of restrictive legislation. Although most of the obstacles were tackled one by one, there are still improvements waiting to be made.

Islamic finance education is currently at a minimal stage, and not sufficient to effectively support the sector. Advancements in academic education to train the necessary staff should be a priority. Alongside bank employees, the public needs to learn about Islamic finance as well. Considering that the community in Turkey know very little about Islamic banking, it is no surprise they avoid it. How these banks advertise themselves has a big role in drawing attention and they need to do better no doubt. The participation banks have the resources to be more aggressive and extend their reach of coverage to people, yet whether they wish to do so is another matter. Are the banks fine with their existing profits and not willing to take risks to expand?