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ECONOMICS DEPARTMENT

# THE ROLE OF ISLAMIC BANKS WITHIN THE TURKISH FINANCIAL SYSTEM

by

**David T. Baldwin**

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September 1988

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*To my parents*

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## ABSTRACT

Since the establishment of the first Islamic bank twenty-five years ago, the concept of Islamic banking has gained world-wide acceptance. The main feature that distinguishes Islamic banking from conventional banking is the prohibition of interest, or "riba".

The choice of Turkey was made for several reasons. Firstly, although Turkey has a large and overwhelmingly Muslim population, it is also a secular state. In many ways the problems experienced by the Islamic banks in Turkey are similar to those faced by Islamic banks in non-Islamic countries. Secondly, since 1980, the Turkish economic and financial sector has undergone rapid change, with the entry of many conventional banks. Turkey therefore offers an example of how Islamic banks can survive and prosper in a very competitive financial environment. Thirdly, due to Turkey's strategically important position between the Middle East and Europe and increasing trade and political ties with both areas, the potential for further expansion in the field of Islamic banking in Turkey is enormous.

In the introductory chapter, the economy of Turkey from the founding of the Republic to the present day was examined. Chapter 2 dealt with the activities and functions of the Central Bank. The conventional banks and other financial institutions were discussed in Chapter 3. Reasons for the prohibition of interest in Islam, together with a short account of the origins of banking in the Islamic world and the emergence of Islamic banking were covered in Chapter 4. In Chapter 5, the position of Islam and the establishment of Islamic banks in Turkey were discussed, followed by details of the types of Islamic investment, accounts and services available to the committed Muslim. Finally, the concluding chapter examined the performance of the Islamic banks and assessed their role within the Turkish financial system.

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## INTRODUCTION

Turkey, with its vast and strategically placed land mass acts as a bridge between Europe and the Middle East. Its geographical position, between communist Soviet Union, "fundamentalist" Iran, war-torn Iraq and Syria to the East and the economically and technically advanced capitalist countries to the West appears to ensure that Turkey suffers from a permanent crisis of identity. Its geopolitical importance continues to be a mixed blessing. In economic matters, Turkey benefits far more from trade and tourism with countries in the West, but in social, cultural and religious terms Turkey probably has more in common with its Muslim neighbours in the East. Turkey endeavours to strike a balance in its dealings with both blocs.

Since the founding of the Republic in Turkey in 1923, Turkey's economic, social and political life has undergone vast change. The main aim of Mustafa Kemal, better known both in Turkey and abroad as Kemal Atatürk, was to create, from the disintegration of the Ottoman Empire, a new country and society patterned directly on the countries and societies of Western Europe.

There is general agreement that secularism was, and still is, the most significant and also the most controversial aspect of the doctrine of Atatürk. The Turks had converted to Islam by the time they began establishing their political sovereignty in parts of Anatolia during the tenth century. Throughout the next nine centuries, Islam was the primary guiding force in social development and all aspects of life were influenced and regulated by Islamic tenets, precepts and law.

From 1925 to the mid-1940s, the government attempted to suppress all public manifestations and observances of religion that the secularist minority believed hindered the development of a modern state. Since the late 1940s, successive governments have made concessions to popular demand. However, even in 1988, the position of religion in society is no less problematic than at the beginning of the reforms.

Despite attempts to suppress religion, Islam has continued at the very root of life and culture but secularism has remained Turkey's official ideology, as it has for sixty-five years. The present government has encouraged an "Islamic revival" but it appears that religious sentiment among the masses had never weakened but rather that public religious practices had declined.

Turkey now takes an active part in Islamic organisations such as the Islamic Development Bank and the Organisation of Islamic Countries. In recent years it has strengthened political ties with most Middle Eastern countries. The revival of Islam alarms western-oriented Turks, as well as the armed forces, who see themselves as the guardians of Kemalist reforms. Although the secularists fear the creeping influence of religion, their worries seem somewhat exaggerated given that the religious vote in the 1987 general election accounted for less than 10 per cent of the total vote. However, a

serious divide on the question of secularism versus religion at the national level continues to exist and it will remain central to Turkish life for some time.

Although the present government contains a notable proportion of people with strongly Islamic backgrounds , the country continues to pursue a very pro-Western policy orientation. Turkey's long history of involvement in the politics of Europe, and thereby the West, has often been stormy, characterised by confrontation, antagonism and mutual mistrust, primarily because of the religious divide between Christianity and Islam. In spite of these past historical differences, Turkey today plays an important role in Western institutions such as NATO, OECD, the International Monetary Fund and the World Bank. It is also a member of the Council of Europe and has applied for full membership of the EEC. This contact with Western industrial societies has helped Turkey's industrialisation process and has been the main source for the improvement in its human rights record and for its adoption of increasingly liberal values.

Following several decades of basically inward orientation of policies, in early 1980 Turkey adopted a development strategy that has entailed moving towards an outward orientation and giving an increased role to market forces. The immediate task of the government is to turn Turkey, by the 1990s, into an important trading nation with a modern infrastructure and an efficient bureaucracy. Despite the great economic progress that has been achieved since 1980, Turkey still faces the problems of most developing countries such as rapid population growth, urbanisation and socio-cultural transformation. Inevitably, attempts at social, cultural and economic modernisation have often collided with conservative forces and attitudes, and in some ways Turkey is now experiencing the problems of clashes between old and new, tradition and change, reaction and progress, resembling those of the early years of the Republic.

Despite its secular constitution, in 1983 the Turkish authorities passed legislation to permit the establishment of financial institutions which operate in conformity with the principles and doctrines of Islam and which are commonly known as Islamic banks. Until the arrival of Islamic banking, the entire banking system in Turkey, and in all other Muslim countries, was based on the Western banking system which was inconsistent with Islamic law due mainly to the the disapproval of interest, or "riba", in Islam.

The main aims of the Islamic banks, the first of which was set-up twenty-five years ago, are to provide a fair return to investors and to offer social services to the Muslim community, or "umma". In an Islamic system of finance, risks are borne by both the investor and the financier, on a profit-sharing system which replaces the need for interest.

This thesis focuses on the establishment of Islamic banks in Turkey which is dealt with in the context of the Turkish financial and economic system as a whole. It is necessary to include the non-Islamic institutions because in Turkey a dual financial

system operates, and the riba based banks occupy by far the dominant position.

Since 1980, the financial sector has been opened up to both private Turkish and foreign banks and free market policies have generally been pursued. It is against this increasingly liberal political and economic background that the performance of the Islamic banks is evaluated.

The thesis will show that Islamic banking has succeeded in Turkey in spite of opposition from both secularists and conventional banking and financial institutions. Indeed, not only has it survived, but it is also gaining further strength and momentum.

# CHAPTER 1

## ECONOMIC DEVELOPMENT IN TURKEY

### Introduction

This chapter is concerned with the economic development of Turkey from the early 1930s to the present time. It aims to show how the various regimes, whether authoritarian, liberal, right or left, have tackled economic and industrial development throughout the period. The chapter is, therefore, divided into clearly defined sections, each one covering one or two decades.

The early regime believed that the promotion of state and heavy industry would lead to rapid industrialisation. Later regimes considered import substitution policies and rigorous planning to be the answer, while the present government believes that economic and industrial development lies in free-market policies and the private sector. Certainly, the policies of state intervention which neglected small business, were never too successful.

The structural reforms begun in 1980 have had a major impact on the economy. This section is more detailed than others and is supported by tables. As the Islamic banks were only established recently in Turkey, it is in the context of the current economic scene that their activities, detailed in subsequent chapters, must be evaluated.

### 1930-1950 : State industrial development

Turkey achieved independence in the 1920s without possessing a strong native class of entrepreneurs and industrial producers. Trade, commerce, and manufacturing had been carried out by the minorities in the Ottoman Empire, and many of the more active elements left Turkey in the 1920s. As the prestige of industrial and commercial occupations was low, the most able elements of the Turkish population chose governmental or professional careers.[1]

During the first decade of the Republic, Atatürk concentrated on consolidating political control and enacting reforms. He held no strong doctrinaire positions on the way the economy should develop, and was thus restrained in his economic initiatives.

It was the lack of private capital, compounded by international economic factors arising from the world economic depression, that led to the abandonment of a liberal economic strategy in favour of "etatism" in the 1930s. The Turkish term for etatism is "devletçilik", which means "statehood", or in a derived sense a policy of state control. Atatürk and his aides rejected any attempt to identify etatism with socialism, and

stressed the special nature of Turkish etatism.[2] There was a feeling that political independence had to be complemented by economic protectionism and self-sufficiency. It was a form of state capitalism centred on the creation of government-run manufacturing enterprises. By adopting a policy of etatism, the government had assumed the task of financing development, of creating a basic financial structure and of establishing and operating industrial enterprises.

In the government's economic programme, industry was accorded the main role. By means of industrialisation, the government hoped to achieve economic independence and approximate the level of economic and industrial development of Western Europe.

It was under the policy of etatism that Turkey's first five-year industrialisation plan was initiated (1934-1938). The main aim of the plan was to establish a number of industrial plants in an effort to reduce Turkey's need for imported goods using domestic raw materials. The finance, construction and management of these plants was the responsibility of state agencies. The main industries affected were those manufacturing textiles, paper, glass, cement and sugar. The majority of the new plants were established in the backward regions of central and eastern Anatolia and, with the exception of an iron and steel mill, most of the development was realised within the plan. The Soviet Union, which had helped to draft the plan, provided a loan of $ 8 million gold towards the cost of its implementation.[3]

The government established two new development banks in the 1930s to control the expanding state sector. The first of these was Sümerbank which was set up in 1933 to supervise the operation of the factories formerly run by the Bank for Industry and Mining, and which included most of the new plants established under the five-year plan. The second state agency, Etibank, was established in 1935, and had responsibility for the mining industry. Together with the Ziraat Bankasi (Agricultural Bank), founded in 1888, these two banks were collectively known as State Economic Enterprises (SEEs).[4] Although in theory the SEEs were supposed to operate with a high degree of autonomy and to strive for profits, in practice they were inefficient and bureaucratic and subject to the demands of political patronage. The state revenue and items such as deposits, savings and loans, raised by the state and private banks, served as the main sources of capital.

Throughout the 1930s and 1940s, it was emphasised by the government that there was no bias against private enterprises, and that etatism encouraged private initiative. However, the very nature of etatism meant that the state had an increased role in industrial development. The state also had easier access to capital and tended to own the largest and most modern plants. In 1936 and 1937 special laws were passed to ensure increased government control over private enterprises and to regulate the prices of their products. This control was mainly to prevent private firms from competing with

government undertakings. This policy of government discrimination against private enterprise could certainly not have been expected to lead to greater efficiency. It is important to note, however, that with the exception of foreign-owned railways and coal-mines, there was no important nationalisation of private industries.

During the Second World War, the government took greater control of the private as well as the state sector of the economy with the result that the state sector increased its share of industrial output at the expense of that of the private industrialists. The war severely curtailed the development plans of the second five-year plan and the only important new plant established under this plan was the iron and steel mill at Karabük, which had actually been provided for in the first plan.[5] The construction of the steel mill at Karabük was criticised by opponents of etatism who believed that the decision to establish it had been taken for political rather than commercial reasons and they even argued as to whether Turkey should have established a steel industry at all at that stage of its development.

The war caused high inflation and a shortage of those goods which would normally have been imported and a flourishing black market developed. As a result of wartime profiteering the merchant class was able to expand its capital accumulation. In effect, the private capital which was lacking in the 1920s and 1930s was now available, and with this came a new class of entrepreneurs and technocrats. This social change was perhaps etatism's greatest gain.

The policy of etatism has been criticised by both Turkish and foreign observers for its concentration on industrial development at the expense of agriculture. But, by its very nature, etatism meant a veering towards industrialisation, the purpose of which was to increase industrial production and reduce the dependence on imports, as well as to increase the proportion of industrial workers in the labour force and industry's share in the national product. In the period up to the end of the war, little aid had been given to the farmer, and it was only in the post-war years, when the leaders needed political support, that they began to take agricultural development seriously.

The etatist policy had helped to equip Turkey with basic industries in the 1930s, but the development was uneven and incomplete, and the Turks were unable to break their dependence on imports to operate their newly established industries.

Although some may claim that etatism failed because it ignored free-market principles, others claim it failed because the policy was too capitalist. It would appear, however, that at the time the policy of etatism was necessary in order to remedy the industrial and economic backwardness of Turkey in the early 1930s. The eventual demise of etatism came at the end of the war with the availability of private capital and the influx of foreign aid. Following the war, the United States became Turkey's biggest source of aid and this assistance acted as a significant boost to the Turkish economy. It helped to influence the evolution of economic policy away from etatism towards the

adoption in the 1950s of more liberal and capitalist economic policies.

## 1950-1960:Agricultural development and emergence of private enterprise

The Democrat Party came to power in 1950 following the election victory which saw Turkey move from a single-party to a multi-party democratic regime. In economic matters the new regime believed that private enterprise was the key to economic growth. However, the relative importance of the value of the state and private sectors in industrial development continued to remain a major area of policy.

After 1950 there were proposals for the denationalisation of some SEEs but in fact few industrial concerns were privatised. The unwillingness of private industry to take over the operations of the SEEs stemmed from the fact that most of private industry was dominated by individual entrepreneurs or partnerships and these people were unaccustomed to managing the relatively large state sector plants, and preferred to invest their capital in something they could personally control rather than have to cooperate with the bureaucrats of the state holding companies. With the exception of the SEEs in the textile industry, which were generally profitable, most other state owned companies were making losses and as such there was no incentive for any private sector entrepreneur to take over the operations of these enterprises. One important denationalisation scheme concerned the oil industry.[6] Legislation was passed in 1954 to permit private firms, both Turkish and foreign, to compete in production and distribution.

The transport sector also benefited from Democrat policies. Previous administrations had concentrated on expanding the railway network at the expense of road construction. The 1950s witnessed a reversal of this trend and during the decade a large road construction programme was initiated. As most road transport was privately operated, this signified an important shift in favour of private enterprise.

There was a rapid expansion of the number of private and state firms in the 1950s. By 1952, private investment in the manufacturing industry was greater than that of the state sector and by the second half of the decade, when the new plants had become fully operational, the value added in manufacturing industry by private firms exceeded that of the state sector. However, contrary to the original objectives of the Democrats, after 1954 the state had once again become the dominant investor.

The first four years of the decade saw an increase in both agricultural production and economic activity which, coupled with the free availability of foreign exchange for imports, relatively low inflation and government encouragement, led to a rise in investment by private businessmen and helped to generate a sharp increase in industrial output. However, after 1954 this picture altered radically. There was a

decrease in agricultural production, high inflation and a shortage of foreign exchange for the import of raw materials and new equipment on which industry depended. As the government did not want to see a slowdown in economic growth, it used the state sector to make up the shortfall in private investment. The government thus abandoned its commitment in favour of private enterprise in an attempt to maintain the appearance of increasing prosperity and in doing so the state found itself investing an increasing share of national income for a lower return.

Most of the defects of the planning and management of the SEEs during the etatism period continued into the 1950s. There were three main defects. The first was a system of pricing unrelated to costs, and as a consequence this led to inflationary deficit financing. The prices of most SEE products were fixed at a low level so as to reduce costs for the consumers. The second defect was to set up new industries for purely political reasons without consideration of any locational advantages or needs of the market. The main aim of the Democrats was to win votes and factories were often built in politically sensitive areas irrespective of production costs or level of demand for the products. The third defect was continued government interference and bureaucracy in the day-to-day operations of the plants. These defects, together with the fact that the state accounted for a greater part of new investment in the latter part of the decade, meant that the Turkish industry became less efficient as the 1950s progressed.[7]

Private firms also suffered. They were often too small for maximum efficiency and faced problems of under-capitalisation and unplanned expansion. The private entrepreneurs over-expanded with no regard to the absorptive capacity of the market or the availability of imported raw materials and by the late 1950s the textile industry, in which the private sector had invested heavily, was experiencing over capacity. An overvalued lira prevented the profitable export of commodities.

Towards the mid-1950s, shortages of petroleum and other imported goods required for the operation of the economy led to a slowdown in industrial development. By the end of 1957 Turkey's foreign debt had reached more than one billion dollars, or about three times the 1957 export earnings, and both the International Monetary Fund (IMF) and Western creditor nations were no longer willing to offer aid without economic reforms.[8] In fact it had mainly been the availability of foreign aid which had allowed the government to run a persistent deficit in its visible trade balance throughout the 1950s. Finally, in 1958, the government was forced to accept a deep devaluation, tax reforms, a decrease in spending and an increase in the prices of the SEE products. Following these measures Turkey was able to reschedule its debts and obtain fresh credits. Although imports resumed, they were insufficient to meet the demands of industry and so industrial production fell. This fall was accompanied by rampant speculation, corruption and black marketeering.These economic conditions caused discontent in the army and among the urban population and eventually led to a military

coup in May 1960.

In conclusion, it can be said that at the end of the decade Turkish industry had a bigger physical base than it had at the start of the decade. Agriculture, in particular, had greatly benefited from an increase in resources and from the construction of roads which led to easier communications. The rural population which had gained little in the pre-war years witnessed a vast improvement in their lives. The Democrats were also able to utilise the idle capital and initiative of the private entrepreneurs as demonstrated by the rise in value added in manufacturing industry in the early 1950s.

There were also negative aspects of the Democrats' rule. The regime had failed to bring about any improvement in the structure and efficiency of industry. Although the private and state sectors had expanded, growth was erratic and uncoordinated, without regard to long-range planning. The visible defects of the state sector at the beginning of the decade were still evident at the end. The artificially high level of the Turkish lira and heavy import duties helped to foster the growth of a protectionist import substitution regime based mainly on quasi-governmental enterprise.

## 1960-1980 : Import substitution era

During the 1950s the Democratic Party governments were heavily criticised for their opposition to any sort of economic planning and it was not until 1960 that this approach was reversed and a coherent industrialisation programme was undertaken which sought to establish the heavy industrial base needed.[9] Accordingly, the principle of planning was written into the Constitution and a State Planning Organisation was established, the main function of which was to draw up five-year economic plans.[10]

The framework of the five-year plans was based on import substitution policies although some export incentives were introduced in the early 1960s. There were several objectives of the five-year plans. The first aim was to achieve a high and sustained growth of national income, and the target of the first and second plans was a GNP growth rate of 7 per cent a year. The second objective was the elimination of the severe balance of payments difficulties which Turkey had experienced during the late 1950s. The creation of additional employment has been the third objective of the five-year plans. Finally, all plans had the achievement of greater social justice as one of their aims. A main area of dispute between the politicians and planners was the extent to which the plans should direct the investments of the private sector, and the relative roles of public and private enterprise in the development process.

The politicians saw the creation of an integrated industrial base as essential to economic independence and as such the industrial sector expanded rapidly. The government believed that self-sufficiency in the production of iron and steel was

necessary for economic independence and accordingly two iron and steel complexes were constructed between 1960-1980 despite there being insufficient demand to warrant their construction.

By the 1960s Turkey was benefiting from the infrastructure investments which had been funded by foreign assistance in the 1950s.

Although the development plans stressed the state role in heavy industry, private industry played an important part in the production of textiles, non-metallic minerals and machinery. The increase in the output of private industry since the mid-1960s was accompanied by changes in its structure, as employment and output have become concentrated in larger and more capital-intensive firms. The government encouraged private industrial development by offering tax rebates and whole or partial exemption of customs duties for imported equipment.[11]

In the 1960s a number of efforts were made to reform the SEEs, but new legislation failed to bring about any significant changes in their efficiency, and most of the defects of the SEEs in the 1950s, such as unrealistic pricing and planning, deficit financing, political interference and bureaucracy, continued into the 1970s.The SEEs recorded an annual net profit in most of the years between 1960 and 1974 but in 1975 the state sector finances worsened due to oil price increases and rising wage demands.The result was that the formerly profitable enterprises began to show losses and thus became a serious drain on public funds. The resort to deficit financing was a major source of inflationary pressure.

In the 1970s the rate of investment in Turkish industry rose sharply but the production costs of products was such that exports grew only slowly in this period. The protection and favourable conditions in the domestic market discouraged efficiency and economies of scale that would have helped exports. The Turks were encouraged to develop their internal market independent of the world economy by the belief that international assistance would close the growing gap between imports and exports.[12]

Although the government passed laws to encourage foreign investment from the private sector, there was only a relatively small capital inflow. Foreign investors were generally unwilling to invest due to bureaucracy and inertia, fears about the repatriation of capital and profits and a rigidly controlled currency which did not reflect the high inflation rates.

The quadrupling of world oil prices in 1973 adversely affected economic growth and left Turkey facing mounting deficits in its balance of payments, simply in its attempt to meet the foreign exchange needs for essential energy imports. The remittances from Turkish workers abroad, which form a crucial part of the current account balance, also peaked in 1974 as the demand for surplus labour in Europe was reversed. The world recession caused a decline in Turkey's exports, while unrealistic exchange rates for Turkish currency encouraged imports, thus worsening the balance of

payments deficits. The policy of continued government subsidies, financed through Central Bank borrowing, cushioned domestic consumers from many of the price rises in the world market, and led to hyperinflation. The control of inflation was perhaps the major challenge which faced the economy in the 1970s. Inflation was caused mainly by excessive public sector spending and money creation by the Central Bank and by heavy military expenditure.

The deficit in the balance of payments was initially met by the drawing down of official reserves and short term borrowing from international private lenders, but as the domestic economic situation worsened the source of such funds dried up. These developments led to a steep decline in imports in 1978 which led to shortages in basic commodities and a decrease in the use of industrial capital. The government secured IMF stabilisation loans in 1978 and 1979 and in return agreed to devalue the currency, reduce the budget deficit, restrain Central Bank lending and even increase the prices of public sector products. The government also agreed to implement tax reforms and subsidy reductions but it failed to carry out the more difficult aspects of the commitment.

Although GNP growth declined, the economic situation stabilised. However, the current account deficit worsened in 1979 after more oil price rises and there was a rise in both the import bill and in the average rate of inflation, which had risen from 16 per cent in 1976 to 107 per cent by the end of 1979.

The austerity policies hit investment and private consumption very hard, and this, together with increased political instability, led ultimately to the military coup in September 1980.

During the period 1960-1980 the Turkish economy underwent major structural changes. Agriculture fell as a percentage of GDP from 42 per cent in 1960 to 23 per cent in 1980, while that of industry rose from 16 per cent to 25 per cent in the same period. Turkey's trading relations also changed. In 1965 agricultural products made up 76 per cent of total exports, but by 1980 this share had fallen to 60 per cent. In the same period the exports share of manufactures rose from 20 per cent to 35 per cent.[13]

### The 1980s : Economic liberalisation

In early 1980, the head of the State Planning Organisation, Turgut Özal, was made responsible for designing a programme to liberalise the structure of the Turkish economy, dismantle the system of subsidies, maintain a realistic exchange rate, reduce budget deficits and stimulate exports through streamlining administrative procedures and providing wide-ranging incentives.[14] The economic strategy was aimed at reducing the influence of the State on the economy and gradually moving towards a

market-determined regime of resource allocation. Even after the military coup in September 1980, the generals kept Özal in charge of economic policy.

There were several features of the stabilisation programme. Perhaps the main feature of the package was the introduction of realistic interest-rate and exchange-rate policies. There was also to be tighter control over the money supply and credit and most state sector price subsidies and price control boards were to be abolished. Legislation was passed to reform the tax system and measures were introduced to encourage foreign investment, which up to 1980 had been negligible.

The results of the stabilisation effort were rapid. By the end of 1980, the inflation rate had fallen, exports and remittances had increased and the current account deficit had declined. However, the stabilisation measures mainly benefited the larger concerns and many smaller firms still had idle or under-utilised capacity.

The stabilisation programme was given fresh impetus in November 1983 when elections returned to power a government with a strong market-oriented liberal platform. This government, known as the Anavatan Partisi (Motherland Party), is led by Turgut Özal and supports free enterprise, modern Islamic traditionalism and economic liberalisation.[15]

This government introduced further economic reforms at the end of 1983. It attempted to tackle the low productivity and inefficiency of the state sector industries by administrative reform of the SEEs. State subsidies, price controls and protective tariff barriers were reduced. The government made export incentives more selective and partly liberalised the import both of raw materials and of some consumer goods. The import of luxury goods was allowed, although they were subject to heavy surcharges. The revenue earned from this source was allocated to low-cost housing.[16] Public spending programmes were reviewed in order to reduce the budget deficit and keep monetary growth under greater control. Most foreign currency controls were removed and restrictions on capital transactions were eased. These measures were viewed as important steps towards the convertibility of the lira. Özal believed that by opening Turkey up to world market forces the resulting foreign competition would lead to the production of higher quality goods and lower prices. It was also hoped that the rise of exports would sharply reduce the balance of payments deficit.

The Fifth Five Year Plan (1985-89) was developed in 1984 and reiterates the guiding principles of the economic programme developed in January 1980. It states that economic activity will take place in a competitive environment with encouragement being given to private sector development. The plan also stresses the importance of policies designed to increase exports, reduce the current account deficit and improve international creditworthiness. The Fifth Plan envisages a fall in unemployment and an average real rate of GNP growth of 6.3 per cent over the five year period.[17]

In early 1986, most of the remaining quantitative controls on imports were

removed, but protection is still provided through customs duties and surcharges. Further measures to increase foreign direct investment have been introduced and four customs-free industrial zones have been established on the Mediterranean at Mersin, Antalya, Nemrut (İzmir) and Yumurtalik (Adana).

## Public and private sector industry

Turkey's industrial profile has been influenced by the etatist policies followed from the 1930s and industrialisation has followed an explicit governmental decision. The SEEs still play a considerable role in the economy and a high proportion of manufacturing industry remains under state control. The SEEs were partly reorganised in May 1983. Those that provided essential public services became known as Public Economic Corporations and were allowed to fix their own prices under government control. Other institutions, which were operated in competition with the private sector, were allowed greater freedom in pricing and production decisions. This reorganisation was an attempt to make the state organisations more efficient and to reduce the drain on the national treasury.

Since 1980, the government has followed a policy of cutting subsidies and reducing overmanning in the SEEs, and in recent years the SEEs have made operating profits largely due to the freedom to fix their own prices. The improved financial position of the SEEs means that the government can begin implementation of its privatisation programme. Besides generating revenue for the economy, the government believes that privatisation will also make the economy more responsive to market forces, increase industrial efficiency and promote real growth. The public will obviously only purchase shares in the better managed and profitable concerns. However, the sale of bonds in the Bosphorus bridge in 1984 was heavily oversubscribed, as was the government's sale of 22 per cent of its 40 per cent share in the telecommunications equipment company, Teletaş, in March 1988. This would appear to indicate that a privatisation policy would be both popular and successful. Preparations are now being made to privatise other SEEs, but the authorities admit that many of the SEEs will need to be financially restructured as a prerequisite to successful privatisation.

In the private sector, most businesses are concentrated around İstanbul. Holding companies, often controlled by families, dominate big business. Many concerns have begun to export only since 1980, preferring instead to concentrate on the domestic market.[18] Private sector manufacturing has continued to grow steadily since the 1980s and seems set to continue to do so. The private sector is becoming much more diversified with the food-processing and textile industry now less important than

in the 1970s. Although foreign private investment in Turkey in the early 1980s was not great, it seems possible that following Özal's re-election in 1987 the flow of capital into the country may increase considerably. To date, most of the foreign investment has been in the profitable banking and tourism sectors.

The import substitution policies between 1964 and 1980 left Turkey with overcapacity in many sectors, with most firms concentrating solely on the home market. However, in recent years, Turkey's manufacturing base has expanded and diversified. In 1987 it grew at 10.1 per cent and was the fastest growing sector of the economy. This growth reflected the high rates of growth in the rest of the economy.

The government is now actively engaged in promoting economic development in the less developed areas of central and eastern Anatolia. To emphasise its commitment to the east, the government is involved in the ambitious south-east Anatolia Project (GAP - Güneydoğu Anadolu Projesi). The GAP consists of 13 projects, seven on the Euphrates and six on the Tigris rivers. The project covers 42.6 per cent of the country's area and 25 per cent of its population and includes the construction of 22 dams, 19 hydroelectric power-plants and 26 irrigation units. Once completed, it seems that the project will have a far-reaching beneficial impact on Turkey's irrigation facilities, agriculture and energy supply.

On the whole, economic reform measures introduced so far have led to greater private initiative and better functioning markets and an improving balance of payments, and have made economic policy implementation more effective. However, problems still remain and economic debate now concentrates on the persistence of high inflation, unemployment and the increasing disparity between the incomes and living standards of the owners and managers of private industry on the one hand and the majority of workers in the public and private sectors on the other.

## The twin problems of unemployment and inflation

The high rate of unemployment in Turkey seems set to continue and remain a problem for the foreseeable future. There are now few opportunities to export labour and indeed there are pressures to send overseas workers home from Europe and the Middle East. The reduction in unemployment is a hard task due to high population growth and a large increase in the active population.Although the government estimated that the rate of unemployment fell from 16.7 per cent of the civilian labour force in 1985 to 15.6 per cent in 1986, the first decline in a decade, it appears from preliminary statistics that unemployment rose slightly in 1987. Employment in the services sector, industry and construction benefited most from the strength in economic activity and it was only in the agricultural sector, which still employs the largest number of workers,

that employment decreased slightly, continuing a long established trend.[19]

Inflation has probably been the most serious problem the Turkish economy has had to deal with since 1980. The sources of Turkish inflation seem to be a high budget deficit to finance repayment of foreign debts and public sector investment, and the increased cost of imports due to the depreciation of the lira. Inflation has also been fuelled by price rises by state enterprises which the Treasury no longer subsidises, as well as by inefficient private producers attempting to maintain profit margins. The rate of inflation rose in 1987 due mainly to increases in wages, food prices and the continued depreciation of the lira in foreign exchange markets. The policy of managed floating of the currency to maintain export competitiveness limits the effect of stabilising influences on domestic prices through the exchange rate mechanism. Table 1.1 indicates that, according to the wholesale price index of the State Institute of Statistics (SIS), the inflation rate rose to 32.0 per cent in 1987 compared to 29.6 per cent in 1986. In the same period the SIS consumer price index rose to 38.9 per cent from 34.6 per cent . Other indices published by the Treasury and the İstanbul Chamber of Commerce showed even faster wholesale and consumer price rises. Towards the end of 1987, there was a dramatic escalation in inflation, which has had an impact on 1988. Most economists believe that the annual rate of inflation will be around 65 per cent in 1988. It would appear that only a marked tightening in fiscal and monetary policy could lead to a substantial decrease in the rate of inflation.

## Exports and imports

The promotion of exports and the liberalisation of imports and capital flows are the key elements of the structural adjustment programme adopted in 1980.[20] The Turkish lira was devalued and regularly adjusted to ensure sustained external competitiveness. The switch from domestic to external markets entailed extra costs for entrepreneurs and certain tax rebates and subsidies were introduced to assist exporters. However, in February 1985, Turkey signed the GATT convention on export subsidies and agreed to phase out all export subsidies by the end of 1989. Exports are now promoted through more market-oriented mechanisms, such as a competitive exchange rate and investment incentives.

It was, therefore, only after 1980 that foreign trade began to play a greater role in the economy, but even today foreign trade accounts for a smaller proportion of GNP than for most countries in a similar stage of economic development. Since 1980, there has been a change towards predominantly industrial exports, in contrast with the situation prior to 1980 when the majority of exports were agricultural. In 1987 the agricultural export share was 18.2 per cent, down from a figure of 57.5 per cent in

Table 1.1

## Prices

Percentage change over previous year

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Wholesale price indices (1963 = 100) | | | | | | | | |
| General index[1] | 107.2 | 36.8 | 25.2 | 30.6 | 52.0 | 40.0 | 26.7 | 39.0 |
| General index[2] (1981 = 100) | - | - | 27.0 | 30.5 | 50.3 | 43.2 | 29.6 | 32.0 |
| Agriculture | - | - | 24.5 | 31.2 | 57.5 | 37.4 | 25.3 | 29.7 |
| Mining | - | - | 49.3 | 20.5 | 41.2 | 63.9 | 6.0 | 35.7 |
| Manufacturing | - | - | 26.5 | 31.2 | 46.6 | 41.9 | 32.6 | 33.6 |
| Energy | - | - | 45.7 | 25.7 | 75.3 | 97.6 | 35.6 | 23.4 |
| Consumer price indicates[2] (1978-79 = 100) | | | | | | | | |
| National index | - | - | 34.1 | 31.4 | 48.4 | 45.0 | 34.6 | 38.9 |

Source: [1] The Evaluation Department of the Undersecretariant of Treasury and Foreign Trade

[2] State Institute of Statistics

1980. By contrast, the export share of manufactured goods was 79.1 per cent in 1987, compared with a figure of 36.0 per cent in 1980. Although the external competitiveness of Turkish goods has greatly improved in recent years due to a gradual depreciation of the exchange rate, there is still a need to improve the quality and range of merchandise exports.

The growth in exports has been primarily in textiles, steel, leather goods, chemicals and petrochemicals. Although Turkey now has a highly diversified industrial base, textiles still account for 26.6 per cent of total exports.

The structural reform programme has shown significant results in stimulating exports. Table 1.2 shows that, in 1987, exports totalled $ 10,190 million, some 36.7 per cent higher than in the previous year. Despite the rise in imports of $ 3,058 million to $ 14,163 million, export earnings covered 71.9 per cent of import expenses as against 67.1 per cent in 1986. The OECD countries accounted for 63.2 per cent of Turkey's exports in 1987, a proportion which has risen steadily since 1982. By contrast, the Islamic countries accounted for only 30.3 per cent of exports, a figure which has declined in recent years due primarily to the fall in the oil revenues of the OPEC countries and the dwindling foreign exchange reserves of Iran and Iraq, the two most important trading partners of Turkey in the Middle East.

Some Turkish exports are subject to trade restrictions. The Multifibre Arrangement places restrictions on Turkish textile exports to the European Economic Community (EEC) and the United States and there are also quantitative restrictions on certain agriculural exports to the EEC.

The import structure has also changed since 1980 and although most goods may now be imported freely and are subject to only tariffs, around 100 items still require an import licence. Table 1.3 indicates that, in 1987, a total of 63.8 per cent of Turkey's imports were from OECD countries and 22.2 per cent from the Islamic countries, mainly petroleum products .

The foreign trade deficit in 1987 rose from $ 3,648 million in 1986 to $ 3,973 million. However, the increase was offset by increased tourist receipts and remittances, and the current account deficit declined from $ 1,518 million in 1986 to $ 987 million in 1987. As a percentage of GNP the current account deficit fell from 2.6 per cent in 1986 to 1.5 per cent in 1987.

A continued good export performance is necessary for Turkey to be able to service its foreign debts. Despite the fall in oil prices, it appears that the current account and trade balance will continue to remain in deficit for the immediate future. Turkey cannot now escape the impact of world trade and the shift towards export orientation is likely to be permanent. Turkey is now closely linked to the global economic structure and the expected entry of Turkey into the EEC in the 1990s can only lead to an increase in the volume of trade.

Table 1.2

## Geographic Distribution of Exports[a]

| | $ million | % of total | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1987 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
| OECD countries | 6444 | 57.7 | 48.1 | 44.5 | 48.2 | 52.4 | 51.6 | 57.6 | 63.2 |
| EEC countries | 4868 | 42.7 | 31.9 | 30.5 | 35.1 | 38.3 | 39.4 | 43.8 | 47.8 |
| of which: | | | | | | | | | |
| France | 500 | 5.6 | 4.6 | 3.4 | 3.2 | 2.8 | 2.7 | 4.0 | 4.9 |
| Italy | 851 | 7.5 | 5.2 | 5.7 | 7.4 | 7.0 | 6.3 | 7.8 | 8.4 |
| United Kingdom | 541 | 3.6 | 3.1 | 3.3 | 4.3 | 3.7 | 6.8 | 4.5 | 5.3 |
| West Germany | 2184 | 20.7 | 13.7 | 12.3 | 14.6 | 17.9 | 17.5 | 19.4 | 21.4 |
| Other OECD countries | 1576 | 15.0 | 16.2 | 13.9 | 13.1 | 14.1 | 12.2 | 13.8 | 15.5 |
| of which: | | | | | | | | | |
| Japan | 156 | 1.3 | 0.7 | 0.7 | 0.6 | 0.5 | 0.5 | 1.3 | 1.5 |
| Switzerland | 356 | 4.3 | 5.6 | 5.6 | 5.0 | 5.0 | 1.6 | 2.2 | 3.5 |
| United States | 713 | 4.3 | 5.7 | 4.4 | 4.1 | 5.2 | 6.4 | 7.4 | 7.0 |
| CMEA (Comecom) | 334 | 16.9 | 7.0 | 5.6 | 4.3 | 4.0 | 4.2 | 4.2 | 3.3 |
| of which: | | | | | | | | | |
| Soviet Union | 169 | 5.8 | 4.1 | 2.2 | 1.1 | 2.0 | 2.4 | 1.9 | 1.7 |
| Islamic countries | 3088 | 22.3 | 41.1 | 45.0 | 41.1 | 42.0 | 42.8 | 34.9 | 30.3 |
| of which: | | | | | | | | | |
| Iran | 440 | 2.9 | 5.0 | 13.8 | 19.0 | 10.5 | 13.6 | 7.6 | 4.3 |
| Iraq | 945 | 4.6 | 11.9 | 10.6 | 5.6 | 13.1 | 12.1 | 7.4 | 9.3 |
| Libya | 141 | 2.1 | 9.4 | 4.1 | 3.2 | 2.0 | 0.7 | 1.8 | 1.4 |
| Saudi Arabia | 408 | 1.5 | 4.0 | 6.2 | 6.3 | 5.3 | 5.4 | 4.8 | 4.0 |
| Other Countries | 324 | 3.1 | 3.8 | 4.9 | 6.4 | 1.6 | 1.4 | 3.3 | 3.2 |
| TOTAL | 10190 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

[a] Excluding transit trade

Source: State Institute of Statistics

Table 1.3

Geographic Distribution of Imports[a]

| | $ million | % of total | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1987 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
| OECD countries | 9032 | 45.3 | 47.9 | 50.1 | 48.5 | 51.7 | 56.1 | 65.9 | 63.8 |
| EEC countries | 5666 | 28.7 | 28.2 | 25.6 | 28.1 | 27.6 | 31.3 | 41.2 | 40.0 |
| of which: | | | | | | | | | |
| France | 608 | 4.8 | 4.5 | 3.0 | 2.4 | 2.3 | 4.5 | 4.9 | 4.3 |
| Italy | 1076 | 3.8 | 4.2 | 4.7 | 5.5 | 5.8 | 5.8 | 7.8 | 7.6 |
| United Kingdom | 697 | 4.0 | 4.9 | 4.9 | 4.8 | 4.1 | 4.1 | 4.7 | 4.9 |
| West Germany | 2109 | 10.6 | 10.5 | 11.4 | 11.4 | 10.9 | 12.1 | 16.0 | 14.9 |
| Other OECD countries | 3366 | 16.6 | 19.7 | 19.2 | 20.4 | 24.0 | 24.8 | 24.7 | 23.8 |
| of which: | | | | | | | | | |
| Japan | 860 | 1.4 | 2.3 | 4.0 | 3.8 | 3.8 | 4.5 | 6.2 | 6.1 |
| Switzerland | 365 | 4.4 | 6.0 | 3.5 | 2.9 | 2.2 | 1.6 | 2.6 | 2.6 |
| United States | 1366 | 5.6 | 6.6 | 9.2 | 7.5 | 10.0 | 10.1 | 10.6 | 9.6 |
| CMEA (Comecon) | 968 | 10.5 | 9.4 | 4.8 | 8.7 | 8.8 | 5.7 | 7.8 | 6.8 |
| of which: | | | | | | | | | |
| Soviet Union | 307 | 2.3 | 1.8 | 1.2 | 2.6 | 2.9 | 1.9 | 3.2 | 2.2 |
| Islamic countries | 3143 | 40.7 | 39.2 | 41.9 | 36.7 | 36.2 | 33.0 | 19.2 | 22.2 |
| of which: | | | | | | | | | |
| Iran | 948 | 10.1 | 5.8 | 8.5 | 13.2 | 14.4 | 11.2 | 2.0 | 6.7 |
| Iraq | 1154 | 15.6 | 17.5 | 16.0 | 10.3 | 8.8 | 10.0 | 6.9 | 8.1 |
| Libya | 305 | 9.8 | 8.8 | 10.4 | 8.6 | 6.1 | 5.5 | 2.6 | 2.2 |
| Saudi Arabia | 168 | 1.3 | 4.6 | 5.4 | 2.9 | 2.0 | 2.0 | 1.6 | 1.2 |
| Other countries | 1020 | 3.5 | 3.5 | 3.2 | 6.1 | 3.3 | 5.2 | 7.1 | 7.2 |
| TOTAL | 14163 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

[a] Excluding transit trade

Source: State Institute of Statistics

## The twin benefits of remittances and tourism

In contrast to the foreign trade deficit, Turkey earned a surplus on the services and transfer account, mainly due to remittances by Turkish workers abroad and tourism.

In the past, tourism has not been a great money earner for Turkey due to limited facilities and an unfavourable political climate.This is now changing and tourism is expected to be a major growth area for the economy over the next few years. Many new investments are planned and a large number of hotels are under construction along the Aegean and Mediterranean coasts. The government is also undertaking basic infrastructural developments in the coastal region and since 1982 has provided major incentives for the tourism industry, such as the right to cheaper utilities. Most tourists come from European countries, but the government also wishes to encourage Middle Eastern visitors. Receipts from tourism in 1987 were $ 1,476 million, a rise of 55 per cent over the 1986 figure, and 1988 figures are expected to be substantially higher.

Net earnings from tourism by Turkey are much less than those of most other countries in the Mediterranean and, barring any unforeseen political crisis, it seems certain that the number of tourists will increase in the coming years, and that tourism will become a valuable source of foreign exchange and employment.

Workers' remittances have been another major source of foreign exchange since the 1960s. In 1987, workers' remittances increased by 24 per cent to $ 2,102 million, compared to a 4.5 per cent decrease in 1986. The increase can be attributed partly to the depreciation of the dollar in international markets which has exaggerated the remittances recorded in dollars. The figures may, however, be misleading because many Turkish workers living abroad are now opening foreign exchange accounts in Turkish banks which is recorded in the short term capital account of the balance of payments rather than in the transfers account.[21] Some funds are also deposited in special accounts with the Dresdner Bank, to which the Turkish Central Bank has access. The export of labour to both Europe and the Middle East has played an important part in the economic development of Turkey. The remittances have helped reduce the visible trade deficit and have boosted national income. Emigration has also helped to reduce domestic unemployment. However, contrary to early expectations, most returning migrants did not invest their savings to set up a business or purchase agricultural machinery, which would have benefited the economy, and instead invested in housing and land.[22]

## Debt, aid and GNP

The major burden on the current account arises from interest payments on

external debt which amounted to $ 2,507 million in 1987, an increase of $ 374 million over the 1986 figure. Debt has been rising steadily for many years and at the end of 1987 stood at $ 38,304 million,[23] which represented 57 per cent of GDP, well up from the 29 per cent equivalence in 1980. Meanwhile, the debt service ratio rose from 21 per cent in 1981 to 31 per cent in 1987. The ending of debt relief in 1985 and large rises in both interest and principal due since 1985 account for this leap. The largest category of debt is that of medium and long term government to government debt incurred during the 1960s and 1970s to finance public sector investments. The government is trying to lessen its dependence on external borrowing and is endeavouring to increase direct foreign investment by liberalising and simplifying controls and legislation and by concentrating authority for foreign investment decisions in the Foreign Investment Department of the State Planning Office.

The budget deficit rose in 1987 to TL 2,460 billion from TL 1,406 billion in 1986, and the budget deficit to GDP ratio rose to 4.3 per cent in 1987 from 3.6 per cent in 1986. This reflected overspending during the election year, the heavy burden of debt servicing and continued high levels of state infrastructural investment.[24] The bulk of the deficit was covered by domestic borrowing. The budget deficit to GDP ratio is expected to decline to 2.8 per cent in 1988.

Turkey still relies on project credits, foreign aid and direct foreign investment for its economic development. The United States is the largest donor country and for the year 1987-88 it pledged $ 525 million, most of it for military purposes.[25]

In 1987, real GNP growth was 7.4 per cent, compared to GNP growth of 8.0 per cent in 1986, as shown in Table 1.4. The industrial and services sectors, which grew at 9.7 per cent and 8.2 per cent respectively, recorded the highest growth rates, and the agricultural sector, which grew at 1.8 per cent, the lowest. In 1988, GNP is expected to slow down further to around 6 per cent, due mainly to a tightening of fiscal and monetary policy. Since the introduction of an economic stabilisation programme in 1980, GNP growth has averaged 4.6 per cent a year, but despite this relatively buoyant economic growth, GNP per head at $ 1,279 in 1987 is the lowest in the OECD area.

Following the balance of payments crisis at the end of the 1970s and near collapse of the economy, the Turkish authorities made a radical departure from the past and turned to market forces to influence resource allocation. Positive real interest rates were introduced, subsidies to the SEEs were drastically cut and the lira was devalued and floated to improve international competitiveness. The authorities were successful in stimulating the exports of goods and services and, recently, in attracting foreign investors and in developing a tourism industry. The structural policy changes which freed the economy from excessive controls and allowed private initiative have had beneficial effects on the economy and GNP growth has been relatively high. However, a particular problem for the policy-makers is the persistance of inflation which although

Table 1.4

Gross National Product (GNP) and Gross Domestic Product (GDP) 1987

| Sector | GNP at Current Prices TL billion | Percentage volume change over previous year | As percentage of GDP |
|---|---|---|---|
| Agriculture, forestry and fishing | 9310 | 1.8 | 16.1 |
| Industry | 18754 | 9.7 | 32.5 |
| Construction | 2374 | 6.7 | 4.1 |
| Services | 27328 | 8.2 | 47.3 |
| GDP | 57766 | 7.3 | 100.0 |
| Net income from abroad | 91 | | |
| GNP | 57857 | 7.4 | |

Source: Akbank "Turkish Economy" Monthly Economic Indicators

State Institute of Statistics

less than the triple digit figures of 1980 remains at a high level.

Overall, it would appear that the stabilisation and adjustment policies have been successful in modernising and developing the economy and in raising living standards, and, with the recent re-election of the government, it seems certain that the free-market policies will continue well into the next decade.

## Conclusion

Since the foundation of the Republic in 1923, Turkey's economic life has been vastly transformed. At the beginning of the 1920s, Turkey had little mechanised industry and agricultural activities accounted for almost half of national income and employed over three-quarters of the working population. Today, non-agricultural activities account for more than 80 per cent of national income and employ about 45 per cent of the working population.

The etatist policies developed in the 1930s assumed that economic development depended on industrialisation, and that industrialisation required extensive state holdings. These state interventionist policies continued until 1980, despite changes in internal and external conditions.

In the 1950s, the Democrat Party placed greater emphasis on agriculture, which had been neglected by the previous regime. The Democrats had originally intended to sell off the SEEs, but instead they used the public sector industries for political purposes and to maintain the appearance of economic growth once the economic downturn began in the mid 1950s. Indeed, the SEEs were prone to political interference throughout the 1950s and 1960s.

Since the Second World War, the Turkish economy has suffered from periodic but damaging foreign trade deficits. This is in marked contrast to the period 1930-1947 when visible trade was in surplus for every year except 1938, achieved mainly by the conserving of foreign exchange for the import of industrial inputs, at the expense of agricultural development. Following the war, imports began to outpace exports and this finally culminated in a severe balance of payments crisis in 1958. This cycle of expansion and crisis was repeated again in the 1970s, and on both occasions the IMF and Western creditor nations forced Turkey to agree to economic reforms in return for further financial assistance.

From the early 1960s, national economic and social development planning has been a feature of the Turkish economy. The constitution requires the submission of Five Year Plans and Annual Programmes to Parliament. The proposals contained in the plans have often been too ambitious and it has been the desire to fulfil the targets of the Plans that has led to periodic economic crises.

It has been only in the 1980s that the government has abandoned the import substitution policies and has proposed turning over the SEEs to the private sector. Most import controls have been withdrawn and Turkish industry is now relatively unprotected against international competition. The long term development prospects for Turkey appear favourable. The country has important minerals, and a large agricultural potential and, since 1930, has acquired a modern and diversified industrial base. Given reasonably favourable external conditions, there seems no reason why its national income should not continue to grow at around 6 per cent a year, its long term historical growth rate since the 1930s.

Footnotes

1. G.S. Harris, Turkey: Coping with Crisis (1985), p. 74.
2. Z.Y. Hershlag, Introduction to the Modern Economic History of the Middle East (1980), p. 191.
3. W.M. Hale, The Political and Economic Development of Modern Turkey (1981), p. 56.
4. Ibid., p. 58.
5. Ibid., p. 59.
6. Ibid., p. 89.
7. Ibid., p. 93.
8. Ibid., p. 106.
9. EIU (Economist Intelligence Unit), Country Report on Turkey 1987-88, p. 17.
10. Four plans were drawn up in the period 1960-80 covering the years 1962-67, 1967-72,1972-77 and 1979-83.
11. W.M. Hale, op. cit., p. 201.
12. G.S. Harris, op. cit., p. 82.
13. EIU, op. cit., p. 17.
14. G.S. Harris, op. cit., p. 85.
15. The government consolidated its victory in the more open elections held on 29 November 1987 when it took 36.3 per cent of the votes and gained 292 of the 450 parliamentary seats.
16. G.S. Harris, op. cit., p. 89.
17. OECD (Organisation for Economic Co-operation and Development), Economic Survey of Turkey 1984-85, p. 37.
18. D. Barchard, Turkey and the West (1985), p. 33.
19. OECD, Economic Survey of Turkey 1986-87, p. 11.
20. Ibid., p. 17.
21. Ibid., p. 21.
22. W.M. Hale, op. cit., p. 249.
23. Excludes military debt of $ 2,591 million.
24. EIU, Country Report on Turkey 1988-89, p. 40.
25. Ibid., p. 11.

## CHAPTER 2

# THE CENTRAL BANK OF TURKEY

### Introduction

In Turkey, the banking system dominates the entire financial sector. The total consolidated assets of all the banks, which includes the Central Bank, the deposit money banks and investment and development banks, at the end of 1987 amounted to TL 43,000 billion, or almost 75 per cent of GNP of that year.

This chapter deals with the role of the Central Bank in regulating and monitoring the financial sector, and focuses on the changes introduced by the Central Bank in the fields of interest rates, reserves, foreign exchange and monetary aggregates since 1980, the year the Turkish authorities designed a structural reform programme.

Since 1980, the Turkish banking system has been going through a period of major change and the Central Bank now plays a greater and more important role in the design and implementation of Turkish monetary policy. Most of its efforts are concentrated on removing or simplifying the vast array of rules and regulations in force prior to 1980 in order to create a more efficient and modern financial sector.

### Foundations and functions of the Central Bank

Türkiye Cumhüriyet Merkez Bankasi, or the Central Bank of Turkey, was established under Law number 1715 of 11 June 1930, and began operations on 3 October 1931.[1] The issue of Turkish currency, which had previously been divided between the State Treasury and the Ottoman Bank, became the sole privilege of the Central Bank. The bank's nominal capital was fixed at TL 15 billion and its head office was established at Ankara. Four branches of the bank were opened in the main cities of the country: İstanbul, İzmir, Mersin, and Samsun. Its manager[2] was appointed by the government, and the board of directors was elected by the shareholders.

The functions and operations of the Central Bank are governed by a series of laws and regulations, with Law number 1211 giving the Bank authority to "regulate monetary and credit policy according to the government's development plans, stabilise the value of the lira, regulate the volume of currency, and lend money to the government, commercial banks and cooperatives." The bank also issues currency, sets reserve requirements for conventional and Islamic banks, specifies liquidity ratios, and fixes a daily rate of exchange for most major foreign currencies. The Central Bank engages in rediscount lending and since 1986 has organised an interbank money market

and introduced the sale of treasury bills. The interbank market is now the major vehicle through which the Central Bank adjusts bank reserves.[3] It acts as the lender of last resort and in February 1987 began conducting open-market operations in order to influence the short term supply of liquidity to the economy. Open-market operations will also encourage the development of the capital market. It is envisaged that the Central Bank will eventually set up a foreign exchange interbank market which could then lead to full convertibility of the currency. The bank is also obliged to fund selective credit programmes and to finance the budget deficits of the public administration and of some State Economic Enterprises.

Besides acting as banker to the government, the Central Bank provides a full range of banking services to the public, similar to those offered by other commercial banks. It now has 24 branches in Turkey and overseas representative offices in Frankfurt, London, New York, Rotterdam and Zurich.

The size of the Central Bank within the financial sector is comparatively large and it continues to grow at a fairly rapid pace, mainly due to the high level of reserves which deposit money banks are required to maintain with the Bank. The Central Bank's deposits rose by 74 per cent to TL 2,371 billion in 1987, up from TL 1,1760 billion at the end of 1986. Credits extended by the Bank in 1987 totalled TL 3,438 billion, compared with TL 1,828 billion in 1986. It reported a profit of TL 22.7 billion in 1987, up by 109 per cent over the 1986 level. At the end of 1987, foreign currency reserves and gold holdings at the Central Bank amounted to $ 3,254 million, compared to $ 2,605 million in 1986.

Traditionally, the Bank shares responsibility for monetary and credit policy with other government institutions. In order to co-ordinate economic and financial policy a Money and Credit Committee was established in January 1980. It was abolished in 1982, but formed again in December 1983. The Deputy Prime Minister chairs the committee, which is made up of senior officials at the Ministries of Trade and Industry, Agriculture, Finance and Customs, the State Planning Organisation and the Office of the Undersecretary for the Treasury and Foreign Trade.[4] The Central Bank is represented on the committee by its governor.

In May 1986, the Central Bank Act was amended to define the responsibilities of the Bank more closely in the monetary and credit fields and the Bank has been given greater powers to move from its traditional role of engaging in lending to one of supervision and regulation.[5]

Since 1986, the Bank has required all commercial banks to adopt unified accounting and financial reporting methods, and to submit regular financial statements to enable the Bank to monitor such things as capital, assets and liquidity of the individual banks. The Central Bank, together with the Undersecretariat of the Treasury and Foreign Trade, supervises the operations of the Islamic banks, or finance houses,

and these establishments are subject to different regulations and reporting methods.

All banks are now required to submit annually to the Central Bank independently audited balance sheets which now makes it more difficult for the banks to conceal the true volume of their "non-performing loans" and bad debts.

The aim of the measures and reforms introduced since 1980 has been to strengthen the role of the Central Bank as the guardian of monetary stability and help make monetary policies more effective.

## Liquidity and reserve requirements

The control of the banking system's total reserves allows the Central Bank to regulate the money supply in accordance with the established monetary policy and to provide funds to the government sector.

Both the commercial banks and the finance houses are required to hold a fixed percentage of their deposits in the form of legal reserves, which the Bank regularly adjusts.

Liquidity reserves are held in the form of cash and interest-earning government bonds. The latest Central Bank adjustment occurred in September 1988 when the ratio of liquidity reserves to total deposits held in commercial banks was raised from 27 per cent to 30 per cent. Of this amount, only 5 per cent needs to be kept as cash. Prior to 1983, the ratio had depended on the size of the bank. The liquidity ratio is a convenient device to create a captive demand for government securities by deposit money banks. At the end of August 1988, the yield on treasury bills and government bonds was around 65 per cent and represented an attractive and safe return for the banks. The liquidity reserves for the finance houses differ from those of the commercial banks. The finance houses are required to keep 10 per cent of the value of their current accounts in cash.

Required reserves consist of deposits which banks have to maintain in the Central Bank. Traditionally, these had been calculated on the basis of monthly average levels of deposits, adjusted for special exemptions in order to encourage bank lending to priority sectors. The different required reserve ratios were unified at 25 per cent in 1983 and are regularly adjusted. At present, the ratio stands at 14 per cent. Since 1980, the rate of interest paid by the Central Bank on these reserves was steadily decreased and all interest payments were abolished in December 1985. For the finance houses, a total of 10 per cent of all funds collected in current accounts and 1 per cent of funds accumulated in profit and loss sharing (deposit) accounts must be deposited with the Central Bank.

Although no interest is paid by the Central Bank on lira reserves, the

conventional banks, but not the finance houses, do receive interest on their foreign currency reserves. These interest rates closely reflect those prevailing in the Euromarket.

There are perhaps a number of reasons for the different reserve requirements of the conventional banks and the finance houses. Firstly, the Central Bank appears to take the view that the way the finance houses are structured and operate makes them far less likely to go bankrupt than the conventional deposit taking banks. Secondly, if the Central Bank were to impose the reserve requirements of the conventional banks on the finance houses, it would be seen as unjust by these establishments because for religious reasons they cannot hold, or deal in, interest-bearing instruments, and thus their reserves would lie idle and earn no return. Thirdly, the finance houses have only recently been set up in Turkey and control only a small percentage of the banking sector. The imposition of high reserve ratios could therefore adversely affect their growth and development at a time when the Central Bank is keen to encourage competition and diversification within the banking sector.

In the past, banks have been able to abstain from meeting their obligations concerning reserve requirements and detection of non-observance could be delayed through late reporting. Although the Central Bank has strengthened its supervision, it is still concerned about the banks that delay their reserve deposits or whose required reserve deposits are incomplete. In March 1988, the Central Bank issued a decree stating that banks will be subject to a penalty rate equal to twice the short term discount rate of Central Bank credits. The penalty rate is therefore 108 per cent and is levied on the deficiency.

The system of required reserves has made it possible to mobilise, at a comparatively low cost for the Central Bank, a substantial proportion of the financial resources collected by deposit money banks, and to a far lesser extent those of the finance houses, for the financing of budgetary deficits, public enterprises, and selective credits.

The Central Bank clearly believes that the high liquidity and reserve requirements are necessary for the control of inflation, but for the conventional banks the decrease in liquidity has led to a sharp decline in the availability of funds for lending, and certain banks have been forced to restrict credit to their customers which could lead to an economic slowdown. However, with inflation at very high levels the Central Bank will not, it appears, lower liquidity and reserve ratios in the near future.

## Interest rates and foreign exchange policies

Since 1980, major changes have occurred in the areas of foreign exchange and

interest rates. The monetary authorities have removed many of the foreign exchange restrictions and interest rate differentials and given an increased role to market forces.

Throughout the 1970s, nominal interest rates were fixed by the authorities at low levels in order to stimulate investment as well as minimise the cost of servicing the domestic public debt.[6] Towards the end of the decade, inflation increased rapidly and interest rates became negative in real terms. This led to a sharp decline in the volume of bank deposits as funds were withdrawn from the banking system and channelled into real assets, foreign exchange and unregulated financial markets which caused serious distortions in resource allocation and had adverse effects on economic growth.

The setting free of the interest rates in July 1980 was a decisive step in Turkey's policy to allow market forces to play a greater role in resource allocation.[7] However, following deregulation, the banks avoided a sharp rise in nominal rates by a "gentlemen's agreement" which fixed rates at a uniform level with the effect that real interest rates remained negative. As a result of competitive pressures from private banks and moneylenders and the scarcity of funds owing to a tight monetary policy, the larger banks were obliged to increase their deposit rates and with decelerating inflation, real interest rates became positive in 1981. This helped to reduce the importance of the unofficial money market into which funds had poured in search of interest rates which were well in excess of 100 per cent.

In early 1983, fixed interest rates were reintroduced, with the nine major banks fixing rates. The banks lowered time deposit rates, and as inflation rose real interest rates became negative once again and the volume of deposits declined in real terms.

The reluctance of the large banks to raise interest rates to positive real levels led the government, in December 1983, to authorise the Central Bank to fix (maximum) deposit rates and to review rates regularly. The Bank did, however, permit an initial degree of freedom when it decreed that rates to borrowers should be competitive. Official policy was aimed at maintaining positive real interest rates to promote savings and to discourage excessive consumer spending.

The Central Bank continued to fix deposit rates until July 1987 when it freed one year deposit rates. The setting free of this rate led to the outbreak of competition for such deposits among the conventional banks and as a result the rate rose rapidly. It was in an effort to halt this increase that the Central Bank imposed a ceiling of 65 per cent on one year deposits in February 1988. At the same time it raised rates on demand and other time deposits as well as its own rediscount rates. Although these measures were taken in an attempt to decrease the volume of currency in circulation and hence reduce spiralling inflation they also marked a retreat from the partial liberalisation of deposit rates taken in July 1987. The Central Bank, by raising deposit rates, wished to maintain higher real returns on assets in lira with respect to the real rates in the international

money markets to prevent excessive depreciation of the currency and currency substitution for the lira. However, with the August 1988 consumer price index of the State Institute of Statistics indicating annual inflation of 78.4 per cent, real interest rates are once again showing negative returns. The continued existence of interest rates below the inflation rate will hinder the growth of domestic savings and have adverse effects on resource allocation.

All interest rates on lira deposits are subject to taxes. The depositor has to pay a 10 per cent withholding tax and an extra 4 per cent of this tax has to be paid to the Defence Industry Support Fund. These taxes influence effective interest rates and distort the interest rates' function as indicators of the scarcity of capital.The returns of the profit and loss sharing lira accounts of the finance houses are also subject to the same withholding tax and Defence Industry Support Fund levy.

The deposit taking banks are free to set their own rates for foreign currency deposits and considerable competition has resulted here. Interest rates in the interbank market and in the secondary market for government securities are also freely determined.

Until July 1984, when Decree 30 was introduced by the Özal government, there was an extremely tight foreign exchange regime in Turkey dating back to the 1930s. This was linked to a restrictive and protectionist foreign trade. This decree, which largely replaces the law of 1930 on the Protection of the Value of Turkish Currency, integrates all regulations relating to foreign exchange transactions ,including those dealing with exports and foreign investment.

The first major change in the foreign exchange policy occurred in January 1980 when the Turkish lira was devalued by 33 per cent against the dollar to stand at TL 70 per dollar and this was followed by periodic small exchange adjustments until May 1981, when the adjustments became daily. This policy marked a change from that pursued in the 1970s when adjustments were made at irregular intervals and in large steps. A complex system of multiple rates, which had encouraged the growth of a currency black market, was also gradually phased out by mid-1981. The Turkish authorities thus succeeded in demystifying the exchange rate which has been one of the major political taboos of the past.[8]

As Tables 2.1 and 2.1.1 indicate, the lira has been devalued by about a third against the US dollar every year since 1980. The regular revision of exchange rates has resulted in stabilising the real effective exchange rate and has thus removed a major uncertainty for Turkish exporters.Over recent years, the real exchange rate, against which competitiveness can be more easily measured, has shown an average annual depreciation of 10 per cent. As long as inflation is more rapid in Turkey than in its major trading partners, it will be necessary to continue with the policy of making

Table 2.1

## Exchange rates

Annual Average Turkish Lira Exchange Rates

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|---|
| Dollar | 31.08 | 76.04 | 111.22 | 162.55 | 225.46 | 366.68 | 521.98 | 674.51 | 857.17 |
| Deutsche Mark | 16.96 | 41.83 | 49.21 | 66.99 | 88.30 | 128.85 | 177.30 | 310.62 | 476.89 |
| Sterling | 65.94 | 176.88 | 225.54 | 284.54 | 342.02 | 489.99 | 676.64 | 989.51 | 1404.82 |
| Yen (100) | 14.18 | 33.54 | 50.43 | 65.26 | 94.93 | 154.38 | 218.82 | 400.26 | 592.62 |

Source: Derived from IMF International Financial Statistics



Table 2.1.1

End of Year Turkish Lira Exchange Rates

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|---|
| Dollar | 35.35 | 90.15 | 133.62 | 186.75 | 282.80 | 444.74 | 567.86 | 757.79 | 1020.90 |
| Deutsche Mark | 20.42 | 46.02 | 59.26 | 78.58 | 103.83 | 141.28 | 234.37 | 390.45 | 645.53 |
| Sterling | 78.62 | 215.00 | 254.95 | 301.51 | 410.23 | 514.34 | 833.27 | 1117.36 | 1910.61 |
| Yen (100) | 14.75 | 44.41 | 60.76 | 79.47 | 82.11 | 177.12 | 287.71 | 476.30 | 826.64 |

Source: Derived from IMF International Financial Statistics

adjustments in exchange rates in line with the inflation differential. There is now increased reliance on the exchange rate as against export subsidies and import protection.[9]

In January 1984, the exchange and payments system was liberalised in several important respects: domestic commercial banks were allowed to engage in foreign exchange operations with certain limits in proportion to their foreign exchange liabilities; the surrender requirement was reduced on export earnings and eliminated on invisibles; foreign exchange deposits, yielding market interest rates, could be opened and used without limits; and restrictions on foreign travel and investment from abroad were eased and simplified.[10]

The Central Bank abolished the freedom of commercial banks to fix their own buying and selling rates for foreign currency and devalued the currency by 5 per cent against the US dollar in March 1986. The Bank did this to try to prevent speculation against the Turkish lira which had occurred after some banks had offered very high premiums over the Central Bank rates in order to attract funds. The margin of commercial banks for buying and selling foreign currency was fixed at 1 per cent either side of the Central Bank rate but later that year the Central Bank announced that the selling rates of commercial banks should not exceed the selling rates determined and announced daily by the Bank. The banks were free to fix their own buying rates , provided that they did not exceed the Central Bank selling rates.

In August 1988, the Central Bank sent directives to banks and other financial establishments detailing the new exchange rate system by which official rates will be determined. The directives state that banks and private financial institutions will be free to fix rates independent of the Central Bank for transactions of more than $ 50,000. For smaller sums, the financial establishments will be free to buy and sell within 0.5 per cent of the official daily rate. This new procedure is seen by many as a significant step towards convertibility of the lira.

Despite the imposition in 1984 of a 3 per cent surcharge on bank borrowing in foreign currency, foreign exchange transactions are still subject to lower levies and commission rates than lira transactions. This has led to the substitution of the lira by foreign currency, even for domestic financing. Foreign currency deposits earn attractive interest rates but since February 1988 have been subject to a 5 per cent withholding tax and this is expected to make these deposits less attractive in 1988. The easing of most foreign currency regulations has resulted in a huge inflow of foreign currency into Turkey and, particularly, into the banks. At the end of 1987, the lira value of all foreign currency deposits at the Central Bank and at deposit taking banks stood at TL 6,268.5 billion, an increase of 136.5 per cent over the 1986 figure.

The conventional banks and finance houses are mandated to sell a proportion of their foreign exchange reserves to the Central Bank. The ratio was increased from 15

per cent to 25 per cent in early 1988. The foreign exchange is required by the Central Bank for foreign debt interest payments.

At the beginning of 1988, Turkey experienced a foreign exchange shortage which was caused mainly by the high levels of foreign debt servicing at the end of 1987. As a result the unofficial foreign exchange market, known as "tahtakale", developed again and rates were 15 to 20 per cent higher than the official exchange rates. The Central Bank was able to increase the supply of foreign exchange for debt servicing by reducing importers' access to foreign exchange and stipulating that exporters should repatriate their export earnings more quickly.

In an effort to shore up the lira's rate against foreign currencies, the Central Bank also began buying lira from the markets which had the effect of reducing domestic credit and raising interbank interest rates. The increase on lira deposit rates was aimed at stopping the run on the lira. These measures have succeeded in reducing the differential between the black market and official rates to around 2 per cent at the end of August.

The Central Bank will continue to implement a flexible exchange rate policy in 1988 in accordance with the government's policy of encouraging exports and increasing foreign exchange receipts. The government has indicated that it would eventually like to see the establishment of a foreign money market, freely determined exchange rates and full convertibility for the lira, but such things are unlikely while the lira continues to depreciate against the major currencies.

The reimposition of maximum time deposit rates by the Central Bank is seen as a temporary measure and the hope is that interest rate ceilings can be lifted once a degree of stability returns to the financial markets. The monetary authorities are now implementing tighter monetary policies to control domestic demand and to reduce inflation and it is therefore likely that real interest rates will shortly become positive again.

### Rediscounts and advances

The widespread use of selective credit policies is one of the most important features of the Turkish financial system. Selective credits are provided to agriculture, artisans and tradesmen, exports, housing, tourism, and certain types of investment and regional development.

The bulk of the credits are provided by the Central Bank through the provision of low interest rates on credits and rediscounts, often channelled through specialised institutions like Ziraat Bankası, Eximbank[11], Halk Bankası (Peoples Bank), Turizm

Bankası and others. Table 2.2 shows that in 1987 the total value of Central Bank's rediscounts and advances amounted to TL 3,438.7 billion, an increase of 88.1 per cent over the 1986 figure.

The process of rediscounting allows the Central Bank to influence monetary policy. The Central Bank determines the rediscount interest rates and the type of acceptable collateral. The latest Central Bank rediscount rates are shown in Table 2.3.

Although the Central Bank still remains the principal source of short term finance for the Treasury, some State enterprises and the large agricultural sector, in recent years various policy changes have been implemented to reduce the reliance of deposit taking banks on Central Bank refinancing. The availability of preferential credits as well as the degree of subsidisation of their interest rates has been lowered, which is revealed by the share of bank credit refinanced at the Central Bank which has fallen from nearly 28 per cent at the end of 1980 to around 11 per cent at the end of 1987.

The Central Bank advances funds on behalf of the State to Ziraat Bankasi to finance agricultural support purchases. These debts should be self-liquidating, but it does sometimes happen that the ultimate borrowers, such as the agricultural sales co-operatives, have been unable to repay their debts, mainly due to mismanagement. Over the years, fairly large sums of such claims have accumulated which were periodically consolidated to the state at a nominal interest charge and over very long periods. In effect, such a procedure can be likened to deficit financing of a government subsidy through monetary expansion, because Ziraat Bankası usually refinances such operations at the Central Bank.[12] Since 1986, the Central Bank has accepted the agricultural rediscount credit demands of other banks besides Ziraat Bankası. At the end of 1987, agricultural credits represented about 13 per cent of all Central Bank credits.

Some exports are eligible for preferential credits. Exporters can obtain export credits from the banks to finance the production, purchase, storage, packaging and transportation of goods for exports. The borrowers who receive short term export credits benefit from lower interest rates as against non-preferential credits and exemption from certain financial transaction taxes. The Central Bank rediscount rate for export credits is set at 35 per cent. The Bank believes it is necessary to offer preferential credits to encourage new exports of industrial goods and to offset the bias against exports resulting from the protection of industries which rely mainly or exclusively on the domestic market. However, in recent years the volume of export credits has decreased and in 1985 Turkey signed the GATT subsidy code and agreed to phase out all subsidies on exports by the end of 1989.[13]

The bulk of Central Bank credits are for the Treasury and the public enterprises and account for 65.5 per cent of all credits. Besides direct credits, the State Economic Enterprises have benefited from budgetary transfers based on funds provided by the Central Bank to the Treasury. In Turkey, the financing of budget deficits through

Table 2.2

Central Bank Credits
(TL billion)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Public Sector | 412.8 | 540.5 | 566.7 | 631.1 | 565.3 | 916.7 | 1,303.0 | 2,270.4 |
| Treasury | 188.7 | 261.9 | 266.2 | 338.6 | 528.3 | 794.5 | 1,051.5 | 1406.6 |
| Public enterprises | 224.1 | 278.6 | 300.5 | 292.5 | 37.0 | 122.2 | 251.5 | 863.8 |
| Private Sector | 242.4 | 385.0 | 343.8 | 603.0 | 314.6 | 382.9 | 525.0 | 1,168.3 |
| TOTAL | 655.2 | 925.5 | 910.5 | 1,234.1 | 879.9 | 1,299.6 | 1,828.0 | 3,438.7 |

Source: Akbank "Turkish Economy" Statistics, July 1988
Central Bank of Turkey Annual Reports

Table 2.3

Central Bank Rediscount Rates
Effective from 24 June, 1988

| Item | Rate |
| --- | --- |
| **Short - term loans** | |
| General | 54 |
| Special (Agricultural loans extended by Ziraat Bankasi and loans extended by Halk Bankası to small industrialists, artisans, tradesmen and tradesmen associations) | 40 |
| Export credits | 35 |
| **Medium - term loans (with Incentive Certificates)** | |
| General | 60 |
| Investment loans: | |
| with Export Guaranty | 40 |
| without Export Guaranty | 45 |
| Loans extended to manufacterers - suppliers of investment goods | 50 |
| **Advances against bonds** | 75 |

Source: Türkiye İş Bankası "Economic letter" July 1988

monetary expansion is partly legalised through the provision that 15 per cent of budget appreciations can be met by short term (but, in fact permanent) advances from the Central Bank.[14] The share of credits to public enterprises in the total credits of the Central Bank was 23.4 per cent in 1987 which was less than the figure of 34.2 per cent in 1980, but still represented an important factor in the expansion of the money supply.

The loans of the Central Bank to the banking system, which in 1987 represented 34.5 per cent of all Central Bank credits, reflect mainly the operation of selective credit policies. These loans are used for the financing of agriculture, medium term credits and export credits.

The system of cheap Central Bank selective credits creates conflict with the objectives of monetary policy and reduces competition among financial institutions and efforts have been made since 1980 to lessen the reliance on this method of inflationary financing. Although reforms have been made to the system of selective credits and allocation of financial resources has been improved, further reforms are still necessary, and in particular the Central Bank needs to reduce the dependence of the system of selective credits on its own rediscounts.

## Monetary policy

Following the introduction of the economic restructuring programme of 1980, monetary policy began to play an important role in the fight against inflation, which in Turkey continues to be a major problem and an obstacle to balanced growth. The two principal operational instruments were quantitative limits on Central Bank credit and interest rates on bank deposits.

High real interest rates were fixed to encourage deposits and to discourage excessive credit demand. The monetary authorities have, in recent years, set targets for the expansion of money supply and Central Bank credit, although monetary limits have not always been adhered to for a variety of reasons such as variations in foreign exchange inflows, larger than planned budget deficits and, in the early part of the decade, lender of last resort support to commercial banks in difficulties. Political considerations also continue to play an important part.

The volume of financial resources of the banking system is determined by the stock of money and by other net domestic and foreign liabilities of the system.[15] Among these influences, the money supply has been the most important.

Table 2.4 indicates that during the period 1980 to 1987 the money supply figure M1, which consists of currency in circulation, demand savings and demand commercial deposits, and deposits with the Central Bank, increased at an annual rate of 44.8 per cent. The figure M2, which is a broader definition of the money supply and includes

Table 2.4

Money Supply
(TL billion)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| M1 | 704.0 | 972.0 | 1,341.9 | 1,941.0 | 2,252.7 | 3,208.7 | 5,016.6 | 8,237.5 |
| % change | 58.4 | 38.1 | 38.1 | 44.6 | 16.1 | 42.4 | 56.3 | 64.2 |
| M2 | 881.9 | 1,637.2 | 2,554.1 | 3,288.4 | 5,179.0 | 8,145.5 | 11,644.0 | 18,437.8 |
| % change | 67.1 | 85.6 | 56.0 | 28.7 | 57.5 | 57.3 | 42.9 | 58.3 |
| M2X | | | | | 5,696.6 | 9,299.3 | 14,236.5 | 24,035.9 |
| % change | | | | | | 63.2 | 53.1 | 68.8 |

Source: IMF, International Financial Statistics
Central Bank of Turkey

time deposits and certificates of deposits, rose at 56.7 per cent over the same period.

In 1986, the Central Bank introduced the policy approach of targeting a monetary aggregate. M2 was selected to be kept on a growth path during the year with the growth being derived from projections for real income growth, inflation and interest rates. As a result of the considerable expansion in the foreign exchange operations of the conventional banks in recent years the authorities have introduced the monetary aggregate M2X (M2 plus foreign exchange deposits) and this may be a better aggregate for monetary targeting purposes than M2.

In April 1986, the Central Bank set up an interbank market where commercial banks can invest excess reserves for short periods. Overnight transactions as well as transactions maturing at seven days, two, three and four weeks are made in the interbank market. However, most transactions are for overnight and seven day trading of funds. Interest rates, which are freely determined, vary considerably and offer the Central Bank an indication about the tightness of bank liquidity. At the end of August 1988, the interbank interest rates were around 63 per cent, compared to average rates of between 40 to 45 per cent in January. The average daily volume of trading in the interbank market in August was around TL 380 billion.

The establishment of an interbank market was a necessary preliminary step in the implementation of open-market operations which began in February 1987 and which will eventually become the instrument to control reserves.

During 1987, monetary targets were greatly exceeded as the government permitted increases in demand and credit for electioneering purposes. The aggregate M1 increased by 64.2 per cent over the 1986 figure, and M2 rose at a slightly lower rate of 58.3 per cent over the same period. These figures also represented higher private sector savings deposits after the partial liberalisation of deposit rates in July 1987. The authorities are endeavouring to curb the high growth rates in money supply by the abolition of certain rediscounts and by increases in the reserve and liquidity requirement ratios.

Overall, the monetary authorities have generally succeeded in improving monetary and economic targeting, although there are still periodic liquidity shortages and difficulties in adhering to specific targets. The introduction of an interbank market and open-market operations should, however, contribute to a more efficient use of financial resources in the banking system.

## Conclusion

Prior to 1980, money management had been based on a rigid and complex

system of administratively set interest rates and quantitative controls on Central Bank rediscounts and multiple reserve requirements. In recent years, the adoption of a realistic exchange-rate policy and a reduction in the huge subsidies to State industries are indications that greater emphasis is now placed on market forces in the allocation of reserves.

Substantial progress has been made in respect of making monetary instruments more effective. The Central Bank has strengthened supervision of the conventional banks, introduced a unified required reserve ratio, opened an interbank market and established a secondary market for government securities through which it can conduct open-market operations to regulate bank liquidity.

The Central Bank now plays a greater role in the determination and implementation of monetary policy, and it is likely that further reforms will be introduced in an effort to achieve greater liberalisation within the financial sector.

Footnotes

1. Z.Y. Hershlag, Turkey: The Challenge of Growth (1968), p. 86.
2. The Central Bank governor, since October 1986, is Dr. Rüşdü Saraçoglu.
3. P. Murphy, " The good, the bad and the ugly", The Banker, March 1988, p. 77.
4. OECD, Economic Survey of Turkey 1983-84, p. 53.
5. EIU, Country Report on Turkey 1987-88, p. 43.
6. Central Bank, Annual Report 1985, p. 23.
7. OECD, Economic Survey of Turkey 1980-81, p. 26.
8. OECD, Economic Survey of Turkey 1981-82, p. 16.
9. World Bank, Turkey - Industrialization and Trade Strategy (1982), p. 56.
10. G. Kopits, Structural Reform, Stabilization and Growth in Turkey (1987), p. 12.
11. Formerly called Devlet Yatirım Bankası (State Investment Bank).
12. OECD, Economic Survey of Turkey 1984-85, p. 35.
13. Some large exporters will continue to receive credits at subsidised rates from Eximbank.
14. Loc. cit.
15. World Bank, op. cit., p. 122.

# CHAPTER 3

## THE TURKISH FINANCIAL SECTOR

### Introduction

The major domestic money market in Turkey is the commercial banking system. Since 1980, this sector has undergone a rapid transformation as a result of changes introduced by the government which have generally led to greater liberalisation, an increase in the number of banks and diversification of the market. The banks are now much more geared-up for the needs of an export-orientated economy. The opening up of the economy and the banking sector has also encouraged the flow of foreign capital into the country which has helped to promote economic growth in Turkey, and aided development.

This chapter provides a brief survey of the establishment of banking in Turkey and discusses developments since 1980 in the banking sector and in the recently opened capital markets. It considers the changing status, growth and profitability of the commercial banks, and assesses how the commercial banking system is responding to the problems of increasing bad debts, shortages of funds and growing competition. The final sector of the chapter focuses on the capital markets with particular emphasis on the Capital Market Board and the İstanbul Stock Exchange.

The text is supported by tables, and in an effort to make this information easier to read, comparisons have often been made between only three years - 1980, the start of the Ozal reforms, and 1986 and 1987. The intervening years have only been included when it was felt that such information and statistics were helpful in understanding the actions or measures of the Government, Treasury and Central Bank.

The developments that have occurred in the Turkish financial sector since 1980 have important implications for the Islamic banks which are required to operate side by side with the conventional riba based banks. Therefore, the information contained in this chapter is necessary in order to understand the position and role of the Islamic banks within the Turkish financial sector.

### Establishment and classification of banks in Turkey

Banking in Turkey began in the nineteenth century with the establishment of Bank-ı Osmani Şahane ( Imperial Ottoman Bank) in 1856. It was founded by the British with a capital of $ 500,000. However, the British soon became dissatisfied at the restrictions placed on the bank by the Ottomans and most of its shares were sold to

the French. The Ottoman Bank, as it is known today, came into being in 1863. This bank, together with the State Treasury, was responsible for the issue of Turkish currency until the founding of the Central Bank of Turkey in 1930.

Other smaller banks were set up during the Ottoman period, the most notable of which was Ziraat Bankası, founded in 1888 and today Turkey's largest bank. This bank was established to assist agriculture and continues to be the major supplier of funds to the agricultural sector.

In 1924, Turkey's first important private and domestically owned bank, Türkiye İş Bankası (the Business Bank) was set up with an initial paid-up capital of TL 250,000.[1] Another bank, Türkiye Sanayi ve Maadin Bankasi (Bank for Industry and Mining) was established in 1925. Both banks provided capital for long term industrial development.

During the 1930s, two new development banks were set up to finance and control the expanding state industrial sector.[2] The first of these, Sümerbank, was set up in 1933 and took over the textile factories formerly run by the Bank for Industry and Mining. A second development bank, Etibank, was established in 1935 and had primary responsibility for the mining industry. Today, Sümerbank has 44 bank branches and continues to provide loans for the textile sector. It also operates textile factories and ready-to-wear clothing stores. Etibank, with 128 bank branches, continues to provide loans for the mining sector and for its own affiliates.

Following the proclamation of the Turkish Republic, the number of state owned banks increased and the banking sector further expanded with the establishment of private banks, both domestic and foreign. At the end of 1987, there were 56 banks operating in Turkey, compared to only 40 at the end of 1980. These banks can be categorised as follows:

| | | |
|---|---|---|
| National Commercial Banks | | 33 |
| State owned | 9 | |
| Private (including joint ventures) | 24 | |
| Foreign Banks | | 17 |
| Development and Investment Banks | | 6 |
| Public | 4 | |
| Private | 2 | |
| | | 56 |

Source:"Banks in Turkey, 1987"
Banks Association of Turkey, Ankara

Banks in Turkey are subject to the Banks Act which was contained in Decree number 28 dated 31 August 1979, Decree number 70 dated 22 July 1983 and Law number 3182 of 27 April 1985. This Act, which is regularly amended, contains 100 articles detailing all aspects concerning the formation and operations of the commercial, development and investment banks.

To form a bank in Turkey, permission from the Council of Ministers is required. Each bank must have a paid-up capital of at least TL 5 billion, which for the foreign banks must be paid in foreign currency. Further branches require additional capital increases, but the foreign banks, with the exception of the Ottoman Bank, are restricted to a maximum of six branches.

Of the 33 commercial banks, 9 are state owned and 24 are in private hands. Most of the state owned banks are based in the capital, Ankara, while the majority of the Turkish private banks (and all of the foreign banks) have their headquarters in İstanbul.

The state banks were established to provide credits to certain sectors of the economy, for example, Ziraat Bankasi assists in agricultural development and Halk Bankası specialises in credits to small industrialists, artisans and tradesmen.

The four largest banks in Turkey, in terms of equity and liabilities, are the state owned Ziraat Bankasi, Türkiye İş Bankası which is twenty-five per cent state owned but considers itself to be a private bank, and the private banks, Yapı ve Kredi Bankası and Akbank. Together they control about 60 per cent of all banking transactions.

Most of the large private banks are linked to industrial groups although the banking law of 1933 aimed to discourage this.[3] The Çukurova group has the largest stake in the banking sector, owning Yapı ve Kredi Bankası, Pamukbank and Uluslararası Endüstri ve Ticaret Bankasi. The most profitable bank in Turkey, Akbank, is owned by the Sabanci group. Another large industrial group, Koç, established a joint venture with American Express in 1986.

There are a number of private banks, such as İktisat Bankası, Türk Ekonomi Bankasi and Finansbank, that act like Western merchant banks and which concentrate on trade financing and loans to concepts new in Turkey like mergers and acquisitions, equity and capital market activities, government bond trading and corporate syndications.

The state owned banks and some of the private banks have equity stakes in major Turkish corporations and companies. At the end of 1987, Türkiye İş Bankası, for example, had equity participations in around 60 companies valued at more than TL 200 billion.

All the state banks and the larger private banks have branches throughout Turkey and some have opened branches overseas and have established international reputations. The total number of branches in Turkey of the national, foreign and

development and investment banks at the end of 1987 was 6,427, compared to a figure of only 5,966 at the end of 1980.[4]

The majority of the foreign banks arrived in Turkey after 1980. The government gave the banks incentives to open branches in Turkey, believing that an outward-oriented strategy would not be successful unless the financial sector was opened up to foreign competition. In 1980, there were only 4 foreign banks operating in the country, but that figure has increased substantially in recent years. At the end of 1987, 17 foreign banks had branches in Turkey, and a further 11 had representative offices. The foreign banks can be divided into three main groups: Western commercial banks, Middle Eastern banks and joint ventures.[5]

The Council of Ministers has recently approved the applications of six more foreign banks wishing to open branches in Turkey and more applications are pending. This would appear to indicate that Turkey is seen as an increasingly profitable, stable and liberal economic environment in which to conduct international banking operations.

In addition to the commercial banks, there are six investment and development banks in Turkey. Of these, four are state owned and two are private. The largest and most important is Eximbank, which was established in 1964. Its main function is to allocate Treasury funds to finance investments in the public sector. It also provides exporters with short and medium term, pre and post shipment credits. Türkiye Kalkınma Bankası[6] (Development Bank) was founded in 1976 to handle loans to workers' companies set up by returning workers from abroad.[7] The oldest of the investment and development banks is İller Bankası which provides loans for investment in the lesser developed provinces of Turkey. For the tourism sector, Turizm Bankası provides loans at reasonable rates of interest but, so far, its funds have been too limited to enable it to carry out a major role in this sector.

The private development banks receive most of their resources from foreign loans provided by such bodies as the World Bank, the European Investment Bank and other official financial institutions, and use these funds essentially to provide medium and long term loans to private enterprise.

## Deposits and credits

Table 3.1 shows that the deposits of the commercial, development and investment banks[8] rose by 58.8 per cent in 1986 and 52.7 per cent in 1987 and reached a level of TL 24,163.2 billion at the end of 1987.

The market share of deposits held at the Turkish commercial banks and the foreign banks has not changed significantly since 1980, and the Turkish banks still account for over 96 per cent of all deposits, as indicated in Table 3.2. There has,

Table 3.1

Total Deposits (by type) at the Commercial, Development and Investment Banks (TL billion)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Savings deposits | 383.1 | 901.1 | 1508.6 | 1932.4 | 3255.8 | 5212.9 | 6540.2 | 8321.3 |
| Time (including Certificates of Deposit) | 186.6 | 677.6 | 1234.4 | 1333.6 | 2819.2 | 4608.0 | 5650.7 | 6809.2 |
| Demand | 196.5 | 223.5 | 274.2 | 598.8 | 436.6 | 604.9 | 889.5 | 1512.1 |
| Government deposits | 287.0 | 469.8 | 660.1 | 819.7 | 571.0 | 886.4 | 1325.3 | 2237.3 |
| Commercial deposits | 84.1 | 157.4 | 220.3 | 365.3 | 1169.3 | 1911.7 | 3192.3 | 5179.0 |
| Interbank deposits | 56.9 | 111.8 | 220.5 | 257.9 | 363.3 | 780.2 | 1654.3 | 2035.9 |
| Other deposits | 2.7 | 8.0 | 5.3 | 11.5 | 15.0 | 22.6 | 523.2 | 791.6 |
| | 813.8 | 1648.1 | 2614.8 | 3386.8 | 5374.4 | 8813.8 | 13235.3 | 18565.1 |
| Foreign exchange deposits | | | | | 517.6 | 1153.8 | 2592.5 | 5598.1 |
| TOTAL DEPOSITS | | | | | 5892,0 | 9967.6 | 15827.8 | 24163.2 |

Source: Banks Association of Turkey Annual Reports

Table 3.2

Distribution of Deposits and Credits at the Commercial, Development and Investment Banks (TL billion)

| | Deposits | | | | | | Credits | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1980 | | 1986 | | 1987 | | 1980 | | 1986 | | 1987 | |
| National Commercial Banks | | 792.4 | | 15262.2 | | 23276.2 | | 781.3 | | 9725.6 | | 15924.7 |
| Banks with public capital | 274.5 | | 6510.9 | | 10007.0 | | 426.7 | | 4960.2 | | 9006.9 | |
| Banks with private capital | 517.9 | | 8751.3 | | 13269.2 | | 354.6 | | 4765.4 | | 6917.8 | |
| Foreign Commercial Banks | | 19.0 | | 564.0 | | 885.5 | | 17.4 | | 300.0 | | 472.2 |
| Development and Investment Banks | | 2.4 | | 1.6 | | 1.5 | | 144.5 | | 1491.6 | | 2312.7 |
| Banks with public capital | 2.4 | | 1.6 | | 1.5 | | 101.9 | | 1093.4 | | 1768.2 | |
| Banks with private capital | - | | - | | - | | 42.6 | | 398.2 | | 544.5 | |
| | | 813.8 | | 15827.8 | | 24163.2 | | 943.2 | | 11517.2 | | 18709.6 |

Source: Banks Association of Turkey Annual Reports

however, been a considerable increase, mainly at the expense of the private sector banks, in the volume of deposits held at the public sector banks. The share of deposits held in these banks has risen from 33.7 per cent in 1980 to 41.4 per cent in 1987, against a decrease for the private banks from 63.6 per cent to 54.9 per cent over the same period. This increase appears mainly as the result of the concentration of public sector funds in public sector banks. The government continues to conduct most of its financial transactions through these banks on which it has traditionally relied, but this preference now seems somewhat paradoxical given the supposed bias of the government in favour of private enterprise. The foreign banks increased their share of deposits from 2.3 per cent in 1980 to 3.6 per cent in 1987. All deposit money banks are obliged to buy insurance coverage for savings deposits from the Savings Deposits Insurance Fund, established under Central Bank supervision. The details of this fund are contained in Articles 65-69 of the Banks Act.

The increased attraction of short and medium term treasury bills for banks as revenue earning assets is reflected in the growth of their share in bank deposits from 8.6 per cent in 1980 to 49.7 per cent in 1987, as shown in Table 3.8.

In Table 3.1, it can be seen that the total credits of the commercial banking sector expanded by 77 per cent in 1986 and 62.5 per cent in 1987, and at the end of the year stood at TL 18,709.6 billion. Article 38 of the Banking Law stipulates that the total value of credits extended by the commercial banks must not exceed twenty times the bank's capital and reserves, and that a bank must not lend more than 10 per cent of its own resources to any one client unless the credits are to be used in financing investments in sectors and regions indicated in the Annual Programmes of the Development Plan.

The incentives to the banks for granting medium and long term credits have included preferential rediscount rates and interest rate subsidies paid by the "Resource Utilisation and Support Fund", established by the Central Bank in 1984 to replace the "Differential Interest Rate Rebate Fund". Its resources are a surcharge on bank lending, interest charged by the Central Bank on credits to State Economic Enterprises and interest penalties paid by banks to the Central Bank.

The share of bank credit refinanced by discounting bills at the Central Bank has fallen substantially since 1980 and now stands at only a few percentage points. This reflects the more restricted access to the discount window as well as the consolidation of non-performing loans by the Central Bank to the agricultural sector and to state enterprises.

During 1987, the market share of credits offered by the Turkish commercial banks rose slightly over the 1986 figure and stood at 85.1 per cent. However, this increase was accounted for by greatly increased state sector bank lending, and lending by the private and foreign banks actually fell. This decrease appears to have been the

result of both a shortage of funds and a desire on behalf of the non-state banks to control and reduce credit risk.

Besides the local currency deposits and credits, the banks in Turkey have recently expanded their foreign currency denominated assets and liabilities significantly following increased liberalisation of international capital transactions and the easing of most foreign exchange restrictions which has led to a substantial inflow of funds from Turkish workers abroad. Foreign exchange deposits outside the Central Bank rose from TL 2,592.5 billion in 1986 to TL 5,598.1 billion in 1987 and represented 23.2 per cent of local currency deposits. The foreign exchange credits of the banks accounted for about 18 per cent of total credits at the end of 1987, compared to only 1 per cent at the end of 1983. This figure has risen sharply due to Turkey's increased volume of international trade which has led the commercial banks to place greater emphasis on credits for trade finance and less emphasis on loans for investment.

As mentioned in the previous chapter, the Central Bank fixes, and regularly adjusts, the (maximum) interest rates to depositors. Table 3.3 shows that, since early September 1988, the interest rates for demand, one month, three months, six months and one year deposits have been 10, 35, 42, 51 and 64 per cent respectively. In a further effort to attract funds, Turkish workers abroad are offered an extra four percentage points on Turkish lira deposits. However, it appears that most workers prefer to keep their earnings and savings in more stable foreign currency denominated accounts which maintain their value.

The commercial banks are allowed to set their own rates for borrowers and a certain amount of competition has broken out. As Table 3.4 shows, interest rates for credits are presently at around 75 per cent but the true figures are closer to 120 per cent when taxes and surcharges are included. However, most reputable concerns can obtain lower rates and there are still various incentive rates, which can be as low as 35 per cent, such a those given by the Eximbank to exporters. Nevertheless, the private industrial sector has been particularly hard hit by these rates and the high cost of funds is a major brake on investment. Despite this, interest rates are likely to remain high in Turkey for the foreseeable future.

Interest rates on government securities are higher than on bank deposits and in recent months an increasing volume of savings have been directed into these holdings and away from the commercial banks, which consequently now find themselves with reduced deposits to lend. This problem has been highlighted by increased turnover and higher rates in the interbank money markets.

In an attempt to remedy this situation, the government has proposed a forced savings scheme to raise the savings rate of wage earners.[9] Once this scheme is fully implemented, it is expected to raise TL 350 billion annually. According to the proposals, the wages and salaries of most workers will be subject to 2 per cent savings

Table 3.3

## Gross Interest Rates for Time Deposits[a]

| Validity date | Demand | One month | Three months | Six months | One year |
|---|---|---|---|---|---|
| 1. 3.80. | 3.0 | | 8.0 | 12.0 | 20.0-24.0 |
| 1. 7.80. | 5.0 | | | 15.0 | 33.0-36.0 |
| 1. 1.81. | 5.0 | | | 32.0 | 40.0 |
| 1. 2.81. | 5.0 | | | 42.0 | 50.0 |
| 1. 7.81. | 5.0 | | 45.0 | 50.0 | 50.0 |
| 1. 1.83. | 20.0 | | | 40.0 | 45.0 |
| 1. 7.83. | 20.0 | | | 35.0 | 40.0 |
| 19.12.83. | 5.0 | | 49.0 | 47.0 | 45.0 |
| 1. 3.84. | 5.0 | 43.0 | 49.0 | 47.0 | 45.0 |
| 14. 5.84. | 5.0 | 35.0 | 52.0 | 48.0 | 45.0 |
| 11. 8.84. | 5.0 | 35.0 | 53.0 | 52.0 | 45.0 |
| 1. 7.85. | 5.0 | 35.0 | 48.0 | 52.0 | 56.0 |
| 1. 8.85. | 5.0 | 35.0 | 45.0 | 50.0 | 55.0 |
| 1. 3.86. | 5.0 | 35.0 | 44.0 | 48.0 | 55.0 |
| 1. 5.86. | 11.6 | 35.0 | 42.0 | 45.0 | 52.0 |
| 7. 6.86. | 10.0 | 30.0 | 40.0 | 45.0 | 52.0 |
| 30.10.86. | 10.0 | 29.0 | 36.0 | 41.0 | 48.0 |
| 31.12.86. | 10.0 | 28.0 | 35.0 | 39.0 | 45.0 |
| 9. 2.87. | 10.0 | 28.0 | 35.0 | 38.0 | 43.0 |
| 3. 7.87. | 10.0 | 28.0 | 35.0 | 38.0 | Free |
| 4. 2.88. | 36.0 | 40.0 | 45.0 | 52.0 | 65.0 |
| 1. 7.88. | 30.0 | 40.0 | 45.0 | 52.0 | 65.0 |
| 6. 8.88. | 25.0 | 35.0 | 42.0 | 51.0 | 64.0 |
| 12. 9.88. | 10.0 | 35.0 | 42.0 | 51.0 | 64.0 |

[a] Ceiling rates determined by the Central Bank

Source: Akbank "Turkish Economy" Monthly Economic Indicators
Central Bank of Turkey Annual Reports
Türkiye İş Bankası Monthly Economic letters

Table 3.4

Deposit Bank Rates for Credits

| Validity Date | Short term | Medium term | Long term |
|---|---|---|---|
| 1. 5.79. | 19.0 | 20.0 | 20.0 |
| 1. 3.80. | 21.0 | 22.0 | 22.0 |
| 1. 7.80. | 31.0 | 33.0 | 36.0 |
| 1.10.80. | 31.0 | 33.0 | 36.0 |
| 1. 2.81. | 36.0 | 38.0 | 41.0 |
| 1. 7.83. | 32.0 | 34.0 | 34.0 |
| 19.12.83. | 50.0 | 52.0 | 52.0 |
| 14. 5.84. | 53.5 | 52.0 | 52.0 |
| 1.10.86. | 50.0 | 52.0 | 52.0 |
| 9. 2.88. | 77.0 | 79.0 | 79.0 |
| 12. 9.88. | 72.0 | 74.0 | 74.0 |

Source: Akbank "Turkish Economy" Monthly Economic Indicators
Central Bank of Turkey Annual Reports

which will be matched by a 3 per cent contribution from the government and employers.

## Banking sector performances and prospects

Table 3.5 indicates that in 1987 the combined net profits of the commercial, development and investment banks amounted to TL 899.4 billion, an increase of 96.2 per cent over the 1986 figure. The percentage growth was most marked in the case of the Turkish commercial banks who together accounted for over 86 per cent of all banks' profits.

The foreign commercial banks, which control only around 3 per cent of the banking market made a profit of TL 51.7 billion in 1987, or 5.7 per cent of the total banks' profits. This market share figure was slightly down on that of 1986 and reflected the higher cost of funds and greater interbank competition.

Akbank, a Turkish private bank, recorded a profit of TL 167.9 billion and was the most profitable of all banks operating in Turkey. The most profitable state bank was Vakıflar Bankası and the most profitable "foreign" bank was Osmanlı Bankası. They reported profits of TL 81.3 billion and TL 17.8 billion respectively. Citibank, which made a profit of TL 5.6 billion in 1987 was the most profitable of the foreign banks with a limited number of branches.

The low cost of funds in the 1970s led to a rapid expansion of the branch network and by 1980 most banks were under-capitalised and inward looking. In recent years, the Central Bank has forced the commercial banks to increase their capital in line with the volume of their transactions and their size.The combined equity of all the banks increased by 81.4 per cent in 1987 and at the end of the year stood at TL 4,151.8 billion, as shown in Table 3.6. The largest percentage increases were recorded by the private banking sector. Table 3.6.1 indicates that the capital to assets ratio, which provides a measure of the bank's ability to generate additional capital funds stood at 9.6 per cent in 1987, up from 8.8 per cent in 1986. By international standards, this figure was relatively high. Indeed, the average ratio of capital to assets of the world's "Top 500" banks was only 3.85 per cent in 1987.[10] Two Turkish banks, Ziraat Bankası and Türkiye İş Bankasi also appeared in the "Top 500" table according to assets size. The former was ranked at 348 and the latter at 443.

In Table 3.7 it can be seen that in 1987 the assets of the banks grew by 65.1 per cent over the 1986 figure and at the end of the year stood at TL 43,033.6 billion. The older local commercial banks, state or private, are still less efficient than their foreign competitors, as indicated in Table 3.7.1. In 1987, the Turkish state and private banks had returns on their assets of 1.6 per cent and 2.5 per cent respectively, compared to a

Table 3.5

Net Profits at the
Commercial, Development and Investment Banks
(TL billion)

| | 1980 | | 1986 | | 1987 | |
|---|---|---|---|---|---|---|
| National Commercial Banks | | 16.5 | | 386.2 | | 781.1 |
| Banks with public capital | 9.0 | | 142.0 | | 309.4 | |
| Banks with private capital | 7.5 | | 244.2 | | 471.7 | |
| Foreign Commercial Banks | | 1.2 | | 29.9 | | 51.7 |
| Development and Investment Banks | | 0.5 | | 42.4 | | 66.6 |
| Banks with public capital | 0.5 | | 39.5 | | 57.7 | |
| Banks with private capital | - | | 2.9 | | 8.9 | |
| | | 18.2 | | 458.5 | | 899.4 |

Source: Banks Association of Turkey Annual Reports

Commercial, Development and Investment Banks

Table 3.6

Capital (TL billion)

| | 1980 | | 1986 | | 1987 | |
|---|---|---|---|---|---|---|
| National Commercial Banks | | 128.1 | | 1733.3 | | 3286.0 |
| Banks with public capital | 108.3 | | 1109.8 | | 1913.2 | |
| Banks with private capital | 19.8 | | 623.5 | | 1372.8 | |
| Foreign Commercial Banks | | 1.2 | | 75.1 | | 98.0 |
| Development and Investment Banks | | 5.8 | | 480.2 | | 767.8 |
| Banks with public capital | 5.8 | | 446.9 | | 717.7 | |
| Banks with private capital | - | | 33.3 | | 50.1 | |
| | | 135.1 | | 2288.6 | | 4151.8 |

Table 3.6.1

Capital Ratio

| | 1980 | | 1986 | | 1987 | |
|---|---|---|---|---|---|---|
| National Commercial Banks | | 8.6 | | 7.6 | | 8.6 |
| Banks with public capital | 14.3 | | 9.7 | | 9.9 | |
| Banks with private capital | 2.7 | | 5.4 | | 7.3 | |
| Foreign Commercial Banks | | 2.6 | | 7.8 | | 7.6 |
| Development and Investment Banks | | 15.1 | | 22.3 | | 21.1 |
| Banks with public capital | 15.1 | | 27.7 | | 25.4 | |
| Banks with private capital | - | | 6.2 | | 6.2 | |
| | | 8.5 | | 8.8 | | 9.6 |

Source: Banks Association of Turkey Annual Reports

Commercial, Development and Investment Banks

Table 3.7

Assets (TL billion)

| | 1980 | | 1986 | | 1987 | |
|---|---|---|---|---|---|---|
| National Commercial Banks | | 1493.9 | | 22942.2 | | 38101.4 |
| Banks with public capital | 758.2 | | 11440.5 | | 19235.8 | |
| Banks with private capital | 735.7 | | 11501.7 | | 18865.6 | |
| Foreign Commercial Banks | | 47.8 | | 967.2 | | 1295.9 |
| Development and Investment Banks | | 38.7 | | 2150.7 | | 3636.3 |
| Banks with public capital | 38.7 | | 1615.9 | | 2830.0 | |
| Banks with private capital | - | | 534.8 | | 806.3 | |
| | | 1580.4 | | 26060.1 | | 43033.6 |

Table 3.7.1

Return on Assets

| | 1980 | | 1986 | | 1987 | |
|---|---|---|---|---|---|---|
| National Commercial Banks | | 1.1 | | 1.7 | | 2.0 |
| Banks with public capital | 1.2 | | 1.2 | | 1.6 | |
| Banks with private capital | 1.0 | | 2.1 | | 2.5 | |
| Foreign Commercial Banks | | 2.5 | | 3.1 | | 4.0 |
| Development and Investment Banks | | 1.3 | | 2.0 | | 1.8 |
| Banks with public capital | 1.3 | | 2.4 | | 2.0 | |
| Banks with private capital | - | | 0.5 | | 1.1 | |
| | | 1.2 | | 1.8 | | 2.1 |

Source: Banks Association of Turkey Annual Reports

4.0 per cent return by the foreign banks. There are several reasons for these disparities. The foreign banks have generally provided efficient services to customers using the latest technology and have been able to choose to do business with only the most successful or export-oriented firms. In comparison, most of the Turkish banks have been obliged to work mainly with local companies trying to adapt themselves to the new economic policies. They have suffered from a lack of modern technology, over-manning and a bureaucratic and conservative management.

Until 1980, the legal regulations on interest rates that were in force gave the banks the possibility of maintaining high costs of operation. The absence of any interest rate competition and the substantial margin between deposit and lending interest rates made the business of attracting deposits very profitable. The banks resorted to non-price competition, in the form of heavy advertising, luxury office building, the opening of many branches and overstaffing. The expansion of the bank network led initially to increases in deposits but this later led to diminishing marginal productivity, and returns which were below the costs of overbranching.

All this, of course, resulted in very high operating costs. It has only been in recent years, with the arrival of foreign banks that competition between the financial institutions has broken out which has led to the state and private sector banks reducing costs and increasing efficiency. As a result, the return on assets has increased for the private banks, but for the state sector banks the return on assets has remained virtually unchanged since 1980. Although competition often reduces margins, in the case of the private sector banks in Turkey it appears that the rise in the return on assets has been due mainly to a reduction in staffing costs and increased efficiency as a result of modern technology. This is borne out by a look at the net profits per employee figures: in 1986, this stood at TL 398,945 at the state owned Ziraat Bankası and at TL 1,610,273 at the private sector Türkiye İş Bankası, figures which had risen to TL 620,616 and TL 2,912,502 respectively in 1987. The former bank increased the number of its employees by 2,337 in 1987, the latter reduced its number by 492. Excluding Finansbank, which opened in 1987, the overall number of staff at the private sector Turkish banks increased by 1,151, or 1.8 per cent, to 65,991, but at the state owned banks the figure increased by 4,423, or 6.0 per cent, to 78,390 during 1987. It would appear, therefore, that the state sector banks are relying on higher staff numbers to conduct their increased business, while the private sector banks are making greater use of computers and data-processing facilities. The government would obviously like the state sector banks to increase their profitability and efficiency and to match the returns of the private sector banks. It believes that this can only be achieved through privatisation and, accordingly, it has recently announced that Sümerbank will be the first state bank to be sold off and hopes that the sale will take place in 1989.

In the early 1980s, the Turkish commercial banks had tended to focus their

activities on the needs of the domestic market while the foreign banks concentrated on providing trade finance. However, as funds have now become more expensive, the Turkish banks have started to move away from their traditional areas of activity and towards trade finance and government bond sales to make money. The foreign banks are also moving away from a heavy reliance on trade finance towards investment banking. The government has, however, indicated that it would like to see the foreign banks channel their operations to serve domestic sectors like housing, industry and commerce. Although the foreign banks have no natural base to work from, they do seem to have been successful in finding niche opportunities to which they can apply their expertise.

Despite the fact that Turkish commercial banks have become more efficient since 1980, old-fashioned attitudes and operating methods still remain. For example, in retail banking personal loans are seldom given, cheque cards rarely issued or used and automatic teller machines hardly in evidence. In short, the large Turkish banks still have a long way to go before they can match European operating costs and standards. The smaller or more specialised banks can compete on almost equal terms with the foreign banks, and as such their market share is increasing.

## The problem of non-performing loans and bad debts

Up to 1980, the main problems of the Turkish banking system had been insufficiency of competition, narrow specialisation of some of the most important state sector banks and the high costs of intermediation of the banks. [11] Although these problems have now largely disappeared other problems remain, such as those of bank reporting and bad debts.

The accounts of many state banks still do not reveal the true picture of their activities. In an attempt to improve bank reporting, the Central Bank has, since 1987, required banks to adopt a unified reporting and disclosure format and has issued a clear definition of bad loans to prevent banks from concealing their figures for bad debts and non-performing loans.

The current most pressing problem is that of bad debts. In the past few years, several Turkish banks have been taken over by the Treasury after becoming insolvent and their assets disposed of through state banks. It seems that these banks had such large amounts of bad debts in their portfolios that the government had no real option other than to rescue these institutions.

Until recently, many Turkish banks had low capitalisation and were thus vulnerable in a crisis, and had traditional links with either the State or large private

business interests which strongly influenced the composition of their loan portfolios. Estimates of the level of bad debts prevalent in the Turkish banking sector vary widely, but it is estimated that 20 to 30 per cent of total bank lending is non-performing. High and rising interest rates, which reflect inflation, have exacerbated the bad debt problem and caused uncertainty for the borrowers. Interest rates will only fall once inflation is brought under control and is fixed on a downward trend. Most banks made provision for bad and doubtful debts in 1987. The amount set aside for provisions increased substantially from TL 125.3 billion in 1986 to TL 427.0 billion in 1987. The rise was most marked in the case of the Turkish state owned banks which increased their 1987 provisions more than five-fold over those of 1986, to TL 317.1 billion. The provisions made by foreign banks decreased in 1987 and accounted for less than 1 per cent of the total banking provisions. In 1987, the total provisions for bad and doubtful debts amounted to 2.28 per cent of total loans, up from 1.09 per cent in 1986.

The Banking Law also deals with bad debts and non-performing loans. Article 32 requires the commercial banks to set aside 5 per cent of their annual net profits as "contingency reserves" until its total equals the amount of paid-up capital which can only be used to offset the bank's losses.

The bad debt problem forced a number of rationalisations among the Turkish banks in 1987. The large proportion of non-performing loans in the books of the state banks, Anadolu Bankası and Denizcilik Bankası, and the private banks, İmar Bankası and Türkiye Öğretmenler Bankası (Töbank), were brought under government supervision according to Article 64 of the Banking Law. This article deals with the measures for the rehabilitation of banks in financial trouble. Denizcilik Bankası, which is the smallest state bank in terms of assets, also had the unenviable distinction of being the only state bank to have recorded a loss in 1987.

The banks have themselves criticised the government for their high level of bad debts which they believe results from the many insolvencies in industry and the lack of an efficient bankruptcy process which has allowed companies to continue trading whilst technically insolvent. However, the banks themselves must take some of the blame. In the past, they have been willing to lend money freely, and without sufficient enquiries being made into a borrower's status and business activities.

The government introduced new measures to tackle the massive problem of non-performing loans in June 1988. The Central Bank will implement the provisions which will shorten mandatory recovery periods from 27 months to 24 months and require banks to make provisions of 15 per cent of the loan, a figure which rises to 50 per cent after one year and to 100 per cent after two years.

The banks will now have to make more provisions for bad debts and non-performing loans and it therefore seems likely that further rationalisation will occur within the banking sector in the next few years.

### Other Turkish financial institutions

Although more than 80 per cent of all financial transactions carried out in Turkey occur within the banking system, there are other recently established financial institutions whose activities complement those of the banks.

In the early 1980s, one major shortcoming in mobilising domestic savings in Turkey was the fact that the capital market was not well developed. Traditionally, the State Economic Enterprises looked to the government for their financial resources, while the private sector relied mainly on self-financing or on its special links with private banks.

The lack of a functioning capital market and a modern banking sector had limited the effectiveness of Central Bank monetary policy and its use of interest rate and reserve ratio requirement instruments. No capital market can exist without a freely functioning money market which allows supply and demand to set interest rates.[12]

In 1981, a capital market law was adopted which led to the establishment of the Capital Market Board in early 1982. The main objective of the law is to provide greater security to savers who buy shares and bonds and to encourage them to participate in the equity of companies or to contribute to their long term financing by subscribing bonds.[13] The board issues regulations for institutions marketing bonds and other financial instruments. The bond market is now closely supervised in order to avoid a repeat of the financial crisis of 1982 when several bond dealers in the unorganised market went bankrupt. This market, in which interest rates of more than 100 per cent were paid to savers, had sprung up following the economic liberalisation measures of 1980.

Until 1983, government bond issues had tended to be limited and the absence of attractive interest rates led to little demand. Most of the government bonds were bought by the commercial banks as they could be counted as part of their reserves. Table 3.8 indicates that in recent years the amount of government bonds and treasury bills issued has greatly increased. In 1987, the volume amounted to TL 6,330 billion, compared to a figure of only TL 60 billion in 1980. The share of treasury bills, which have maturities of under one year, was larger than that of government bonds, which are longer term investments. There are several reasons for this large increase in the demand by both individual and institutional investors for government securities. These securities are free of default risk and are tax exempt and can be held against liquidity requirements of commercial banks and as collateral at the Central Bank for interbank operations.[14] The yields on government securities are also higher than those on time deposits and are thus seen as a profitable alternative investment by savers. Interest rates

Table 3.8

Capital Market - Securities Issued
(TL million)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|---|
| Public Sector | 75,800 | 135,000 | 74,730 | 200,343 | 558,638 | 1,990,086 | 3,250,947 | 6,989,633 |
| Government bonds | 50,000 | 70,000 | 69,730[a] | 190,343 | 195,484 | 656,757 | 1,242,861 | 2,518,026 |
| Treasury bills | 10,000 | 65,000 | - | - | 353,154 | 1,193,329 | 1,788,806 | 3,811,607 |
| State Investment Bank bonds | 15,000 | - | - | - | - | - | - | - |
| Real Estate Bank bonds | 800 | - | 5,000 | 10,000 | - | - | - | - |
| Certificates of revenue partnership | - | - | - | - | 10,000 | 140,000 | 220,000 | 660,000 |
| Private Sector | 39,926 | 41,288 | 122,768 | 52,400 | 75,600 | 133,100 | 274,000 | 682,500 |
| Bonds | 18,011 | 15,981 | 13,245 | 17,500 | 11,800 | 36,200 | 110,900 | 317,500 |
| Equities[b] | 21,915 | 25,307 | 109,523 | 34,900 | 63,800 | 96,400 | 101,900 | 187,200 |
| Others | - | - | - | - | - | 500 | 61,200 | 177,800 |
| | 115,726 | 176,288 | 197,498 | 252,743 | 634,238 | 2,123,186 | 3,524,947 | 7,672,133 |

a TL 9730m bonds issued for special purposes
b Quoted on the Stock Exchange

Source: Central Bank of Turkey Annual Reports

are determined through weekly auctions of these securities.

In 1986, new short term money market instruments were introduced by the Capital Market Board. Development and investment banks were given permission to raise short term funds by selling bank bills and bank guaranteed bills. Joint stock companies, excluding deposit money banks, were also allowed to issue commercial papers with maturities ranging from three months to one year, subject to permission of the Capital Market Board.[15]

Private sector companies have begun to show an increasing interest in capital market instruments and in 1986 both the number of companies issuing bonds and the volume of bonds has increased significantly. As the interest rate (including taxes) on bank loans is in excess of 100 per cent, privately owned companies in need of money can increase their capital and sell part of their newly issued shares or bonds to the public and obtain loans directly, at a rate much lower than that offered by the banks. However, only the more efficient and well-managed companies are in a position to fulfil the stringent requirements set by the Capital Market Board to be able to issue such securities. During 1987, the Capital Market Board authorised 303 companies to issue securities worth TL 682.5 billion compared to TL 274.0 billion by 240 companies in 1986, as shown in Table 3.8.

Maximum interest rates on private sector bonds are fixed by the Central Bank, and the interest rates' ceiling is determined by the one year savings time deposits rate multiplied by a coefficient not exceeding 1.3,[16] which, since August 1988, has been 83.2 per cent. Bonds can be sold below face value and the Central Bank permits daily adjustments in bond prices. This has led to the establishment of a secondary market, but trading in this market remains limited. The amount of bonds issued by private sector companies in 1987 reached TL 318 billion, a significant increase from TL 111 billion in 1986. The main motivation for this was the high level of interest rates on bank loans. In order to enable small savers to buy private bonds, the Capital Market Board stipulated, in January 1987, that 20 per cent of bonds issued by companies should be in denominations of TL 500,000 or less. Most bond issues took place during the first half of 1987 when private sector bonds were more attractive instruments for investment than bank deposits.

Despite the increase in the number of securities issued by the private sector in recent years, the public sector remains the major fund raiser in the capital markets. Its share of the capital market in 1987 was 91.1 per cent.

Perhaps the most disappointing aspect of the capital markets is the slow development of the equity market. In Turkey, where experience of the financial markets is limited, it appears that for the typical investor the yield of an investment is more appealing than capital appreciation. With high interest rates bonds are more preferred instruments than equities.

The İstanbul Stock Exchange opened at the beginning of 1986 after the rules governing its establishment and operations had been published in the Official Gazette on 18 December 1985. The Stock Exchange consists of four separate markets. Trading of the most actively traded stocks takes place in the Senior Market while other listed stocks are traded in the Second Market. In 1986, the stocks of forty companies were traded in the Senior Market. The list of equities traded in this market is reviewed periodically and amended when necessary. Bonds which are listed with the exchange are traded in the official market and public sector securities are traded in the unlisted market. At the end of 1986, the stock market had forty-seven members who were authorised to trade.

The fact that established family held companies are reluctant to go public has hampered the development of the equity market. Most of the larger companies quoted on the Stock Exchange are closely held by family groups and the supply of shares which can be traded on the Stock Exchange is very limited. However, in 1987, there was a significant increase in the volume of new equity issues which rose to TL 187 billion from TL 102 billion in 1986. The total market value of the companies quoted on the Stock Exchange at the end of 1987 was recorded at TL 3 trillion 181 billion. To date, turnover on the exchange has been slow, averaging around 3 per cent of the market's capitalisation.[17] In December 1987, the volume of equities traded in the market was TL 943 billion.[18]

The government would like to see the stock market grow, realising that a healthy stock market is essential if its privatisation plans are to be successful. In early 1987, it introduced a measure to allow for the proportional reduction of corporation and dividend tax paid by private firms which float shares to the public.

In recent years, the authorities have introduced "revenue sharing certificates" on earnings from the Bosphorus bridge and Keban dam at rates more attractive than those offered on bank deposits. The proceeds of these sales were channelled to the Public Participation Fund, an off-budget fund to speed up the construction of development projects, particularly in the energy field.[19] These revenue sharing certificates have proved popular with savers who, for religious reasons, wish to avoid fixed interest payments. The certificates have the added advantage, from the investor's point of view, of not identifying the holder.[20] Such savers may also now purchase Profit and Loss Sharing Certificates from companies and the special finance houses.

The government is also planning to encourage individuals to sell gold in exchange for certificates, as it is generally agreed that this capital is needed in the economy. However, as many people hold gold as a hedge against inflation and economic instability, they may be reluctant to participate in such a scheme. It has also been suggested that inflation linked instruments should be introduced in a country still experiencing inflation rates in excess of 70 per cent.

Although the paper market accounts for less than 5 per cent of total bank lending, its importance is growing. The sale of treasury bills in 1984 has been an important factor in the growth of the capital market and has also helped to reduce the heavy reliance of the Treasury on the Central Bank for funds.

It appears that most Turkish firms whose financial structure has been adversely affected by high inflation, wish to see a better functioning capital market in order to reduce their dependence on bank borrowing with high interest costs. In most cases, their equity base has been eroded by high inflation and needs to be rebuilt through new share issues.

A small number of brokerage firms dominate the money markets and some bodies such as foreign banks, which are eager to market bonds, are at present restrained from doing so.[21] The government, through the Capital Market Board, is expected to introduce greater competition within the capital markets and hopes that, as accounts of companies and banks are brought up to international standards and new financial instruments are introduced, more use will be made of the capital markets which will then begin to play a greater role in the financial sector.

## Conclusion

The last few years have seen the transformation of the Turkish banking scene. Prior to 1980, the Turkish banks were insular, inefficient and uncompetitive, but the opening up of the economy has changed this. The foreign banks have brought competition and innovation and have played an important role in familiarising the outside world about Turkey and its economic conditions. Turkish banks have expanded abroad and the Government, the Central Bank and the Treasury appear determined to bring the Turkish banking sector up to European standards ready for a possible entry into the EEC in the next decade.

Greater competition in the banking sector has led to sizeable increases in Turkish banks' capital, an accelerated trend to reduce costs and investment in modern infrastructure to provide a similar range and quality of service as that of the foreign banks. However, the problem of bad debts still remains and greater provisions and better bank disclosure will have to be made.

Although money and capital markets have been established, they still play a relatively minor role within the financial sector, and further developments and incentives are required to ensure their success. The introduction of new saving and investment tools and the emergence of new financial sub-sectors like leasing, are seen as important developments in the banking sector. The lack of significant stock market activity and the emphasis on fixed return securities has implications for the Islamic

banks, as will be shown in later chapters.

Overall, the increased liberalisation of the sector and simplification of the maze of regulations surrounding banking operations should lead to the development of more sophisticated public and private financial institutions and help to ensure the long term success of Turkey's economic reforms.

Footnotes

1. W.M. Hale, The Political and Economic Development of Modern Turkey (1981), p. 42.
2. Ibid., p. 57.
3. EIU, Country Report on Turkey 1987-88, p. 44.
4. Banks Association of Turkey, Banks in Turkey 1980 and 1987, Ankara.
5. As Turkish banks and companies own the majority shareholding in joint venture banks, for statistical purposes the Treasury and Central Bank classify such banks as private (Turkish) commercial banks.
6. Until July 1988 this development bank was known as Devlet Sanayi ve İşçi Yatırım Bankasi (DESİYAB).
7. EIU, op. cit., p. 40.
8. The development and investment banks are not allowed to accept deposits from the public. According to Article 95/2 of the Banks Act all funds obtained by these banks, from other banks and their own debtors are not considered deposits.
9. EIU, Country Report on Turkey, Quarterly Survey No. 2, 1988, p. 9.
10. M. Blanden and C. Jones, " Down, but by no means out", The Banker, July 1988, p. 57.
11. World Bank, Turkey - Industrialization and Trade Strategy (1982), p. 135.
12. G. Rischer, " Building Turkey's capital market is no mean task", The Banker, November 1985, p. 47.
13. World Bank, op. cit., p. 142.
14. Central Bank, Annual Report 1986, p. 60.
15. Ibid., p. 60.
16. Ibid., p. 61.
17. P. Murphy, " The good, the bad and the ugly", The Banker, March 1988, p. 67.
18. Akbank, Turkish Economy No. 1, January 1988.
19. OECD, Economic Survey of Turkey 1985-86, p. 37.
20. G. Kopits, Structural Reform, Stabilization and Growth in Turkey (1987), p. 14.
21. EIU, Country Report on Turkey 1988-89, p. 45.

CHAPTER 4

# EVOLUTION OF ISLAMIC BANKING

## Introduction

In this chapter, the most distinguishing aspect of Islamic banking, the prohibition on receiving or paying interest, is presented first, followed by sections on trade and the development of conventional banking techniques in the Islamic world. The final section gives a brief history of the evolution and growth of Islamic banking.

There are two main aims of this chapter. The first aim is to explain the meaning of the word "riba" and to give reasons for its prohibition in Islam. This section is supported by references from the Quran. The second aim is to show, by looking at (some) references to trade and commerce in the Quran and, briefly, the Traditions, that commercial activity, whether local or international, has always been important in the lives of the Muslims.

This chapter will show that banking activities in the Islamic world have always been closely linked to matters of trade and that this relationship remains in evidence today, in the activities of the recently established Islamic banks and financial institutions.

## Islamic views on interest

Throughout recorded history, the institution of interest has been a potent source of dissension everywhere. Until very recently, for instance, the Western world was sharply divided over the moral and economic merits of interest.[1] The prohibition of usury has a parallel in almost every religious ethic in the world.

It is necessary to make a distinction between interest and usury. The fourth edition of the Oxford English Dictionary defines interest as " money paid for the use of money lent, or the forbearance of a debt, according to a fixed ratio", and usury as " the fact or practice of lending money at interest; the practice of charging excessive or illegal rates of interest for money on loan". In modern day usage, the word "usury" has come to mean an exorbitant or illegal rate of interest.

The Islamic term "riba" is usually translated into English as "usury" or "interest". The word "riba" literally means "increase", "addition" or "gain", but in general it refers to any unjustified increase in capital for which no compensation is given.

For many, riba refers only to the prohibited payment or receipt of interest on loan of money. But riba has a greater scope than this, and may invalidate any transaction

which involves the exchange of two or more countervalues provided certain conditions are met. These conditions vary among the law schools and change according to whether the exchange is to take place immediately or at a later date.

The prohibition of usury has aroused controversy in Islamic literature among both Muslims and non-Muslims. The first area of controversy is whether the "riba" abolished in Islamic teachings is equivalent to the "interest" as known in non-Islamic economies. Other areas of controversy are connected with the types of "riba" not stipulated in the Quran and only mentioned in the Traditions.[2]

The Quran defines clearly the meaning of riba. It says that a lender only has the right to the return of the principal sum, and therefore usury is the difference between the amount borrowed and the amount returned:

> You may return your principal, suffering no loss and causing loss to none.[3]

Some believe that all forms of usury are forbidden, while others distinguish between usurious interest, which is to be condemned, and participation in the profits of the business, which is permitted.

In recent years, there has been an attempt by a small majority of writers to justify the charging of interest. This group holds the view that the Quranic prohibition of riba was intended to refer only to the taking of exorbitant interest, and believes that modest interest charges are allowed in areas such as the finance of trade, government inducement to encourage savings and for loans made to finance productive investments.

In early Islam, barter, money exchange and certain kinds of sale were all subject to riba and many jurists were concerned with how to prevent economic and commercial exchange being invalidated by the element of usury. To the jurists, the prohibition of riba was linked with the specific Quranic prohibition of gambling and with other illegal practices such as bribery, corruption and the misappropriation of the property of orphans. Riba therefore came to mean the illegality of all forms of gain or profit which were unearned as well as trading practices which were inequitable.

The wide-ranging interpretation of the Quranic prohibition of riba has been followed for centuries by the consensus of Muslims and has therefore become a binding rule of law. Although the consensus is over the broad interpretation of the prohibition, within each school of law, and among scholars, there are divergent views on riba, and this has made the riba issue one of the most debated in Islamic law.

In a prosperous commercial city like Mecca in the Prophet's day, the taking of interest appears to have been commonplace. The Meccans were involved in the import, export and transit of goods, and it appears that the merchants and traders were unwilling to leave their capital unproductive while awaiting the departure or arrival of

caravans. Therefore they involved themselves in loans for interest and speculative transactions. It was against this background that the Quran proscribed the charging of interest for the loan of money.

The prohibition of usury in the Quran refers to only loan agreements, but this was later extended by several Prophetic Traditions to the exchange of currencies and certain commodities. The Quran denounces the practice of riba on four occasions, and distinguishes it from gains on trade. The most explicit and emphatic denunciation of riba occurs in the following verse:

> Those that live on usury shall rise up before Allah like men whom Satan has demented by his touch; for they claim that usury is like trading.[4] But Allah has permitted trading and forbidden usury.[5]

In this verse, although both usury and trade generate an "increase" in capital, the increase generated by trading is permissible, while that generated by usury is not.[6] The main difference between the two transactions is in the risk factor, and in the deemed balance between risk and gains in the allocation of both to the parties concerned. In trading, both parties share risks and gains, while in riba transactions, it is only one party, the borrower, who takes any risk. In addition, the seller recognises a one-time gain from the transaction, because once the exchange has taken place the transaction is over, whereas, in the case of a money loan, the creditor does not cease to demand interest as long as the principal is not returned. Furthermore, the amount of interest owed keeps on climbing with the passage of time, and if interest is compounded it will be the source of gain to the lender on top of his basic gain from the loan.[7]

There are several economic and moral reasons for the prohibition of riba in Islam. One economic reason arises from the principle of justice, which in business deals means the fairness of dividing both gains and losses among the parties. Islam wishes to establish justice between the financier and the entrepreneur. The taking of riba corrupts the recipient because it is a reward without any productive effort. The accumulation of wealth through hard work and personal activity is encouraged whereas the accumulation of wealth arising from riba is regarded as selfish. Another economic reason why riba is prohibited in Islam relates to the practice of treating "time " as having a price which is thus seen as a reward for deferring consumption or waiting, but time is neither a commodity of exchange nor exchangeable wealth. Riba, if offered as an incentive to saving, may result in under-consumption and could adversely affect economic development, and this is a further reason for its prohibition.

The moral motive for the prohibition of riba revolves on the principle of not exploiting the poor through charging them interest on borrowed money. In Islam, where all believers are brothers and therefore ought to help one another financially as

well as in other ways, riba is viewed as regressive because it penalises those in need.

The impact of interest on those who are in need of funds for urgent personal and social purposes is no doubt serious, and the satisfaction of this need requires sacrifice and integrity on the part of the lender.[8] Indeed, closely related to the concept of interest is the transfer of wealth through the institutions of Zakat and Sadakat. The institution of Zakat is a compulsory religious tax which is levied annually at the rate of 2.5 per cent of the total value of a person's wealth, but on certain items, such as income derived from agricultural production and mining activities, a higher rate is payable.Sadakat is a voluntary charitable contribution. Both Zakat and Sadakat are used to transfer wealth from the rich to the poor to fulfil one of the basic principles of Islam, the mutual sharing of wealth between people. Those people who have incurred debt out of need and are unable to repay can be assisted by the Zakat fund.

In the following verse from the Quran, the taking of usury is contrasted with the obligation to pay Zakat, the latter being seen as a much more preferable thing to do:

> That which you seek to increase by usury will not be blessed by Allah; but the alms which you give for His sake shall be repaid to you many times over.[9]

Despite the differing views about what constitutes riba, there seems to be general agreement that receipt or payment of interest is forbidden by the Quran and the Islamic teachings. This prohibition places heavy social and economic responsibility on the Islamic state or financial institution which must endeavour to ensure that all transactions, whether in the Islamic world or with the non-Islamic countries, comply with this ban.

## Quranic references to trade and commerce

The Quran itself deals with both commercial and financial matters, and provides an important source of information on commercial law and practice in Mecca. It contains general injunctions to honour agreements and to deal fairly in all areas of trade and commerce.

In one of the earliest suras, there is a call for the Quraysh tribe, to which Muhammed belonged, to recognise the goodness of God for the prosperity of their caravans:

> For the protection of Quraysh: their protection in their summer and

winter journeyings. Therefore let them worship the Lord of this House who fed them in the days of famine and shielded them from all perils.[10]

But even in this early period, the Prophet warned against the evils which were beginning to be associated with trade. No form of sin is more fiercely attacked than that of unfair dealing:

> Woe to the unjust who, when others measure for them , exact in full, but when they measure or weigh for others, defraud them![11]

Although it is more than once mentioned in the Quran that trade is the most interesting of all pursuits, it warns against the temptation to neglect religion in favour of trade:

> His praise is sung by men whom neither trade nor profit can divert from remembering Him.[12]

> When you are summoned to Friday prayers hasten to the remembrance of Allah and cease your trading...when the prayers are ended, disperse and go in quest of Allah's bounty... Yet no sooner do they see some merchandise or merriment than they flock to it eagerly...Say: "That which Allah has in store is far better than any merchandise or merriment."[13]

The trade routes are referred to in the Quran:

> Between them (the gardens) and the cities that We have blessed, We placed roadside hamlets so that they could journey to and fro in measured stages.[14]

There are also references to the animals, the ships and the aspects of nature which all assist the trader with his commercial activities:

> He created the beasts...which carry your burdens to far-off lands.[15]

> He has subjected you to the ocean...behold the ships ploughing their course through it.[16]

> He set... upon the earth...rivers, roads and landmarks, so that you may be rightly guided. By the stars, too, are men directed.[17]

The Prophet expressly permitted trading during the pilgrimage but emphasised that the family and goods are not to be preferred to God and His Prophet:

> Say: "If your fathers, your sons, your brothers, your wives, your tribes, the property you have acquired, the merchandise you fear may not be sold, and the house you love, are dearer to you than Allah, His apostle and His cause, then wait until Allah shall fulfil His decree. Allah does not guide the evil-doers.[18]

There is nothing in the Quran about the accumulation of private property or about inequality in terms of wealth and possessions but the practice of hoarding, which could harm economic development, is condemned:

> Proclaim a woeful punishment to those that hoard up gold and silver and do not spend it in Allah's cause. The day shall surely come when their treasures shall be heated in the fire of Hell, and their foreheads, sides, and backs branded with them. Their tormentors will say to them: "These are the riches which you hoarded. Taste then the punishment which is your due."[19]

The subject of debts is also covered in the Quran. Both creditors and debtors are given direct advice by the Prophet. Those advancing credit are advised to be understanding to debtors who get into difficulty with repayments, and to be at least lenient with rescheduling:[20]

> If your debtor be in straits, grant him a delay until he can discharge his debt; but if you waive the sum as alms it will be better for you, if you but knew it.[21]

To protect their own interests, both parties are advised to record the transaction in writing before two witnesses:

> Believers, when you contract a debt for a fixed period, put it in writing. Let a scribe write it down for you in fairness...and let the debtor dictate, and not diminishing the sum he owes. If the debtor be a feeble-minded or ignorant person, or one who cannot dictate,

> let his guardian dictate for him in fairness. Call in two male witnesses from among you...so that if either of them commit an error, the other will remember. Witnesses must not refuse to give evidence if called upon to do so.[22]

Trade and commerce are also covered in the Traditions.[23] Fraudulent practices and trade in goods regarded by religion as unclean are forbidden. Trading is not allowed in such things as wine, pigs, animals that have died by means other than ritual slaughter or in goods that are common to everyone such as grass, water and fire. Speculation in food, especially with a view to cornering the market, is prohibited. Above all, it is forbidden to sell any commodity where there is an element of uncertainty (gharar). For instance, sale by auction, since the seller does not know what price he will get for the object being sold, or any sale in which the merchandise is not precisely, numerically defined although the price is expressed in definite terms.[24]

From the presence of such a large number of trade terms and references in the Quran and in other religious and legal texts it is obvious that Islam has never been hostile to fair commercial practices and to economic development. Social justice in all aspects of life is fundamental to Islam and it appears that the prevailing principle in trade and commerce is not competition but cooperation. The basic tenet of Muslim commercial ethics is that the merchant must treat his customer like his brother. Religion, which for every Muslim is the main guiding force in all his dealings, adds to the feeling of being a member of a community and business must therefore submit to its control and cannot adopt an independent position with a morality of its own.

## Development of trade and banking in the Islamic world

In most Islamic countries there has always been a close relationship between the merchant and the ruler which can be traced back to the beginning of Islam and to the establishment of the Islamic community.

Pre-Islamic sources speak of Mecca as a commercial town where both trade and banking activities were undertaken. It appears that an extensive trade was carried out between the merchants in Mecca and those in the Byzantine, Abyssinian and Persian Empires. From early times, Arabia has been a transit area between the Mediterranean countries and the countries in the East. The Meccans were able to increase their capital, which took the form of money, through the buying and selling of commodities and through the granting of loans at interest. The spice trade which was carried out across Arabia brought income to the Meccans and to the nomadic tribes capable of protecting

the caravans along the various sections of the trade-routes. The Arabs of the Hijaz derived their economic strength from the skillful management of these land caravans and from trade with pilgrims.

Following the Prophet's death, Islam rapidly spread, and the Arab conquests created a very powerful zone of economic consumption. The growth of great urban centres throughout the area of Islam led to an increased demand for commodities of all kinds and this in turn quickened the pace of long-distance trade.

By the tenth century, it appears that many areas of the world of Islam were totally integrated into a structure of distant economic exchange, both as producers and as consumers, and that Egypt, the Yemen, Iraq, Oman and parts of Iran possessed local economies dependent on the market mechanism.

Two types of finance developed in Arabia. One type of finance was based on a profit- sharing partnership and the other related to lending at a fixed interest. Partnership refers to a contractual business relationship between two or more parties. One party, the entrepreneur, offers labour and skills, and another party, the investor, provides capital. The profit is divided according to a predetermined ratio while any losses are borne exclusively by the investor. This kind of arrangement was known as "the commenda" or "mudaraba" in Arabic. Although the commenda originated in Arabia before Islam, it was later approved by the Prophet and became an acceptable form of Islamic business practice. The legitimacy of profit in trade was never seriously questioned, so long as certain prohibitions were respected, by the founders of Islam, several of whom, starting with the Prophet himself, had been merchants.[25]

Whenever a barter system is replaced by a monetary economy, a need for financial institutions arises. In pre-Islamic Arabia, trade, which was a prosperous economic activity in the Hijaz, gave rise to the need for financial institutions and led to the development of institutions known as "moneylenders" and "moneychangers".

In early Islam, the pilgrimage created a need for a type of brokerage whereby pilgrims' monetary instruments could be changed for local monetary means. Such a process would require expertise and knowledge of these monetary instruments and it was often the richer merchants who had made trade journeys who provided these moneychanging services.

Lending was carried out by the moneylenders. The moneylenders were often landlords who had enough surplus cash, precious metal, or whatever the monetary instruments might be, to carry out moneylending activities. The practice of the moneylenders was to lend a sum of money at an increase to be paid with the original loan at the maturity date. If the loan was not paid in time, the lender often requested additional increases. It was this increase, or riba, that was later forbidden by Islam. Often the activities of moneychanging and moneylending were carried out by the same people.

In Islamic societies, Islamic laws against the practice of riba or usury in moneylending created a social barrier against the profession of bankers; but the Muslim encouragement of merchants and trade derived its authority from the Prophet Himself and created a paradox.[26] There was a question of how merchants could trade without capital, and what was to regulate the supply of capital without interest payments. The question of interest charges was settled by Islamic merchants indirectly, either by dealings through bankers of another faith or through disguised payments of premiums.

Although the role of the Muslim moneylender declined, the moneychanger, or "sarraf", continued to play an important part in the money market. The market was neither highly structured nor subject to any consistent and effective governmental or administrative controls or regulations, with all transactions being carried out on a very informal basis. One of the most important tasks of the moneychanger was to assess the exchange rate between the two main coins in circulation in the Islamic empire, the silver dirham and the gold dinar, whose relative values fluctuated with the prices of the metals of which they were made and with the demand at any given moment for a particular type of coin.

As trading and commerce expanded in the Islamic world, the demand for a reliable and acceptable means of exchange led to the development of a more formal way of financing trade and to the emergence of credit and banking techniques. There was no specialisation and banking activities were closely related to commercial operations and were usually subsidiary to the merchant's endeavours in the more traditional aspects of trade such as buying, selling, importing and exporting, with the merchants often serving as their own bankers.

In medieval Islam, major trading centres developed and in all the ports and cities of the Islamic world there were established conventions in commercial contracts. The caravan trade became highly organised and each port or caravan town was able to supply various commercial services such as brokers who were able to enter into contracts guaranteeing deliveries of trade goods at a future date, markets supplying them on the spot, and bankers who smoothed out payments through the mechanism of credit and bills of exchange.[27]

When a merchant did not go beyond the limits of the Muslim world or the known and established merchant colonies, measures were taken to restrict the carrying of money by making arrangements with known correspondents. The letter of credit arrangement was used to allow someone to have the necessary sum of money advanced to an associate or partner by a third party at some distant place, on a reciprocal basis, a procedure which implied the maintenance of regular accounts and correspondence.[28] It was also possible to contract ordinary loans and make deposits, and private individuals and governments alike made wide use of promissory notes to be used for payments.

Despite this use of banking techniques in financing trade there was still a heavy

reliance on the moneychangers who continued to provide exchange services on an informal basis which appealed to many merchants.

The institution of the moneychanger remains in evidence today in many Middle Eastern countries and he continues to provide services to complement those of the commercial banks. The commenda, developed in pre-Islamic times and subsequently sanctioned by the Prophet, is now an important element of Islamic business practice.

## Emergence of Islamic banking

Although there is no precedent in traditional Islamic society for modern banking institutions, there are rules of classical Islamic law which regulate financial transactions. But these rules, which were designed with a view to guiding the individual believer in carrying out his personal financial affairs in accordance with Islamic law and morality, do not constitute a banking law. However, certain principles, such as the prohibition of interest charges and the adoption of a profit-sharing model for lending operations, have been borrowed from the Islamic law and applied by the Islamic banks.[29]

The history of modern Islamic banks originated in 1963 when the Mit Ghamr Savings Bank was established in Egypt. The main purpose of this Islamic bank was to attract the untapped savings of low-income peasants and labourers and to mobilise them for developmental investment. The bank quickly grew and within three years the 1000 founding depositors had been joined by 59000 more. Loans, which were generally of a short term duration, were used for a variety of purposes such as home improvements, basic machinery for the textile and handicraft industries and the purchase of farm animals. The loans generated welcome income for these borrowers and there is little doubt that the bank made a useful contribution to development.[30] In 1968, the government closed down the Mit Ghamr Savings Bank for political reasons.

The experience of Islamic banking in Egypt was revived in 1972 when the Nasser Social Bank was established. This bank is authorised to operate only under strict Islamic principles. It is a social welfare organisation rather than a commercial venture, for its basic objective is "qard hasan", an interest-free loan granted to the poor when faced with exceptional expenses arising from illness,weddings or funerals.[31]

Later, in 1975, the Islamic Development Bank was set up which has as its main aims the economic development and the promotion of trade between the Islamic countries. Also in this year the first Islamic bank, Dubai Islamic Bank, was established as a public shareholding company offering traditional banking services in accordance with Islamic laws. It was followed within a short time by many other Islamic banks and investment companies operating in both the East and the West (Table 4.1). Most

Table 4.1

Islamic Financial Institutions*

| Institution | Country | Date of Foundation |
|---|---|---|
| AL Baraka Bank | Bangladesh | |
| AL Baraka Bank | Sudan | 1982 |
| AL Baraka International | UK | 1983 |
| AL Baraka Investment and Development Co. | S.Arabia | 1982 |
| AL Baraka Islamic Bank | Mauritania | 1985 |
| AL Baraka Islamic Investment Bank | Bahrain | 1984 |
| AL Baraka Turk Ozel Finans Kurumu | Turkey | 1984 |
| AL Rajhi Co. for Currency Exchange and Commerce | S.Arabia | 1965 |
| AL Rajhi Co. for Islamic Investments | UK | 1980 |
| Amanah Bank | Philippines | 1982 |
| Bahrain Islamic Bank | Bahrain | 1979 |
| Bahrain Islamic Investment Company | Bahrain | 1981 |
| Bank Islam Malaysia | Malaysia | 1983 |
| Beit Ettamouil Saudi Tunisi | Tunisia | 1984 |
| Dar al-Maal al-Islami | Bahamas | 1980 |
| Dar al-Maal al-Islami | Switzerland | 1980 |
| Dubai Islamic Bank | UAE | 1975 |
| Faisal Finans Kurumu | Turkey | 1984 |
| Faisal Islamic Bank | Bahrain | |
| Faisal Islamic Bank | Egypt | 1977 |
| Faisal Islamic Bank | Guinea | 1984 |
| Faisal Islamic Bank | Niger | 1984 |
| Faisal Islamic Bank | Senegal | 1984 |
| Faisal Islamic Bank | Sudan | 1977 |
| International Islamic Bank | Bangladesh | 1983 |
| Islamic Bank | Bangladesh | 1983 |
| Islamic Bank International | Denmark | 1983 |
| Islamic Bank for Western Sudan | Sudan | 1983 |
| Islamic Banking System International Holding | Luxembourg | 1978 |
| Islamic Development Bank | S.Arabia | 1975 |
| Islamic Exchange and Investment Company | Qatar | 1980 |
| Islamic Finance House | UK | 1982 |
| Islamic International Bank for Investment and Development | Egypt | 1981 |
| Islamic International Company for Real Estate Development | Egypt | 1981 |
| Islamic Investment Company of the Gulf | Egypt | 1982 |
| Islamic Investment Company of the Gulf | Qatar | |
| Islamic Investment Company of the Gulf | UAE | |
| Islamic Investment Company | Bahamas | 1979 |
| Islamic Investment Company | Switzerland | 1979 |
| Islamic Investment Company | UAE | 1977 |
| Islamic Investment House | Jordan | 1981 |
| Jordan Islamic Bank for Finance and Investment | Jordan | 1978 |
| Kıbrıs Islamic Bank | N.Cyprus | 1982 |
| Kuwait Finance House | Kuwait | 1977 |
| Nasser Social Bank | Egypt | 1972 |
| Qatar Islamic Bank | Qatar | 1983 |
| Saudi - Philippine Islamic Development Bank | S.Arabia | 1982 |
| Shariah Investment Services | Switzerland | 1980 |
| Tadamon Islamic Bank | Sudan | 1983 |
| Umma Finance Group | Bahamas | 1987 |

* Excludes Iran and Pakistan

Source: International Association of Islamic Banks

Islamic banks operate in a dual economic system and have to compete with "riba" banks. Only two states, Iran and Pakistan, have carried out a total Islamisation of their economic and banking systems.

The two largest and more internationally active banks are Dar al-Maal al-Islami, established in 1981, and Al Baraka Development and Investment Company, formed in 1982. Both are largely Saudi-inspired institutions and offer a wide range of banking services with emphasis on investment.

Some Islamic banks are owned solely by one government, such as the Nasser Social Bank, or by many governments, such as the Islamic Development Bank. Others are owned by private individuals or other Islamic banks. However, whatever their ownership structure all Islamic banks share an acceptance of the Islamic law on the prohibition on receiving or paying a fixed rate of interest.

Although there is no single, clear-cut definition of what constitutes an Islamic bank, it may be inferred from the aims and objectives of Islamic banks that an Islamic bank is a financial, investment, development and social institution that follows Islamic principles in all its operations.[32] Instead of assuming the bank's traditional role of simple intermediary between savers and investors, the Islamic banks share with the depositors the risk of their common investment and share in the profits and losses. The Islamic banks guarantee to return the initial value of current and savings accounts, but on investment deposits the banks are not liable to the account holders for the principal of such accounts, except in cases of negligence, conscious wrongdoing or breaches of the agreed account conditions. Most Islamic banks have Sharia supervisory boards or Sharia consultants who approve their methods of operation to ensure that all financial transactions comply with the Sharia.

## Conclusion

Since its introduction 25 years ago, the concept of Islamic banking has been viewed with a certain amount of suspicion and scepticism in conventional banking circles. However, the development of Islamic banking has reflected the desire of Muslims to deal with financial institutions whose operating methods conform to their basic religious belief, which prohibits interest and other business practices which are in conflict with the Sharia. Muslim savers and investors throughout the world have been attracted to these institutions. The acceptance of Islamic banks as conduits for savings, investment and banking services has led, in recent years, to their increased capitalisation and number, and this growth and diversification of services seems set to continue.

Of course, the prohibition on interest payments presents considerable problems

for the Islamic financial institutions. But this prohibition has led these institutions to play a more creative and constructive role in economic development by sharing in the success or failure of private and public enterprise.

The references to trade and commerce in the Quran and other religious texts indicates the importance of commercial life for the Muslim. The spread of Islam led to a vast increase in trade between nations, and the moneychanger, who helped facilitate this trade, still remains an important institution in some Islamic countries. Today, the Islamic banks and financial institutions play a vital role in the finance and development of trade.

The rapid expansion of Islamic banks would appear to indicate that Islamic banking is now a permanent feature of the world financial scene.

Footnotes

1. T. Kuran, " The economic system in contemporary Islamic thought: Interpretation and assessment", International Journal of Middle East Studies, Vol. 18 (1986), p.149.
2. A.A.F. El-Ashker, The Islamic Business Enterprise (1987), p. 37.
3. The Koran, translation by N.J. Dawood (1956), The Cow, 2:279.
4. The Arabic word "bai" literally means " sale" but is often translated as "trade" or "trading". In fact, a sale contract has always been considered the typical contract in Islamic law, and the one on which nearly all other contracts are modelled. See N.A. Saleh, Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking (1986), p. 34.
5. The Koran, op. cit., The Cow, 2:275.
6. A.A.F. El-Ashker, op. cit., p. 38.
7. A.M. Abdeen and D.N. Shook, The Saudi Financial System in the Context of Western and Islamic Finance (1984), p. 161.
8. Ibid., p. 164.
9. The Koran, op. cit., The Greeks, 30:39.
10. Ibid., Quraysh, 106.
11. Ibid., The Unjust, 83:1.
12. Ibid., Light, 24:37.
13. Ibid., Friday, 62:9-11.
14. Ibid., Sheba, 34:18.
15. Ibid., The Bee, 16:7.
16. Ibid., The Bee, 16:14.
17. Ibid., The Bee, 16:17.
18. Ibid., Repentence, 9:24.
19. Ibid., Repentence, 9:34-35.
20. R.J.A. Wilson, Banking and Finance in the Arab Middle East (1983), p. 71.
21. The Koran, op. cit., The Cow, 2:280.
22. Ibid., The Cow, 2:282.
23. The records of the actions and sayings of the Prophet.
24. M. Rodinson, Islam and Capitalism (1974), p. 17.
25. P.M. Holt *et al* (eds.), The Cambridge History of Islam: Islamic Society and Civilization (1970), p. 522.
26. K.N. Chaudhuri, Trade and Civilisation in the Indian Ocean: An Economic History from the Rise of Islam to 1750 (1985), p. 210.
27. Ibid., p. 181.
28. P.M. Holt *et al* (eds.), op. cit., p. 525.

29. A.E. Mayer, " Islamic banking and credit policies in the Sadat era: The social origins of Islamic banking in Egypt", Arab Law Quarterly, Vol. 1, No. 1 (1985), p. 35.
30. R.J.A. Wilson, Banking and Finance in the Arab Middle East (1983), p77.
31. N.A. Saleh, Unlawful Gain and Legitimate Profit in Islamic Law:Riba,Gharar and Islamic Banking (1986), p. 87.
32. A.M. Abdeen and D.N. Shook, The Saudi Financial System in the Context of Western and Islamic Finance (1984), p. 171.

# CHAPTER 5

## THE ORIGINS AND OPERATING METHODS OF ISLAMIC BANKS IN TURKEY

### Introduction

The previous chapters have attempted to explain the major aspects of economic and monetary policy as well as the development, trends and problems of the Turkish financial system. The banking scene has been radically transformed since 1980 by the arrival of many foreign conventional banks and, in 1985, by the establishment of two Islamic banks or "Special Finance Houses" as they are called in Turkey.

Since paying or receiving interest is prohibited in Islam, these finance houses are obliged to generate their income from fees for services, profit sharing from equity participation, trading in commodities and foreign exchange, the building and management of industrial and agricultural businesses, leasing operations and other transactions that involve risk and do not violate Islamic principles. Besides having to conduct business in an increasingly competitive market and in accordance with Islamic business practices, the finance houses face an additional obstacle of how to operate in a secular state.

Therefore, in order to understand the position of these finance houses, the first section of the chapter briefly details the changes introduced in Turkey in the 1920s which led to the creation of a secular state, and then deals with the role Islam plays in society today. These reforms had far-reaching consequences, changing the course of Turkish history and influencing the economic orientation of the country for the next half century.

The second section of the chapter begins with an outline of Turkey's role in the Islamic Development Bank and then discusses the origins of Islamic banking in Turkey and details some of the rules and regulations governing the establishment and operations of the finance houses.

The third section deals with the investment of funds using the Islamic financial instruments of Murabaha, Musharaka, Mudaraba and Ijara.

The final section covers the types of account and the range of services offered to the client.

### Islam and secularism

The term "secularist" applies to any view that would openly follow an ideology

other than Islam in most areas of public life. It is perhaps somewhat misleading to speak of secularism as "separation" of religion from public life since secularist governments both support and control religious teaching and institutions to a considerable extent.[1] Essentially, secularism has meant state control of religion and state effort to use religion in the service of its nationalist and developmental goals.

The basic conflict in secularism is often between the forces of tradition, which tend to promote the domination of religion and sacred law, and the forces of change.[2] In a society governed by a tradition which carries the sanction of the dominant religion, as in the case of Turkey, secularisation inevitably involved a major upheaval. In Turkey during the 1920s, the tradition which was challenged by the forces of Western civilisation and development was Islam. In Islam, there are no concepts of "mosque" and "state" as specifically religious and political institutions. Religion and state are believed to be fused together; the state is conceived as the embodiment of religion, and religion as the essence of the state.[3]

For over a millennium, the Turkish speaking peoples and Turks of Anatolia have had distinguished and important roles in Islamic history, but in the twentieth century the position of Turkey within the Islamic world has undergone fundamental changes, caused mainly by the break up of the Ottoman Empire and defeat in the First World War.

Perhaps the greatest change occurred in 1928 when Turkey decided to follow a path of complete secularisation, a move almost unique in the Islamic world.[4] Even today, the government seeks to "separate" religion from politics and other areas of public life despite the fact that 99 per cent of Turkey's population is Muslim. Indeed, the Constitution of 1982 makes no mention of Islam. Under the heading "Characteristics of the Republic", Article 2 states,

> "The Republic of Turkey is a democratic, secular and social State governed by the rule of law; bearing in mind the concepts of public peace, national solidarity and justice; respecting human rights; loyal to the nationalism of Atatürk, and based on the fundamental tenets set forth in the Preamble."

A part of this preamble states,

> "...there shall be no interference whatsoever of sacred religious feelings in state affairs and politics."

The Constitution contains other references to religion. Article 24, which deals

with religious freedom, makes clear that religion must be kept separate from other matters,

> "No-one shall be allowed to exploit or abuse religion or religious feelings, or things held sacred by religion, for the purpose of personal or political influence, or even for partially basing the fundamental social, economic, political and legal order of the State on religious tenets."

Propaganda against the principles of secularism was prohibited by Article 163 of the Penal Code adopted in 1926.

The main reason for the secularisation of Turkey arose from the concern for "progress" and national strength. Mustafa Kemal Atatürk, the founder of the Turkish Republic, believed that this could only be achieved by following an essentially Western model. He officially opted for Europe, or as he preferred to call it, "civilisation", and any suggestion that Turkey was not part of Europe was thereafter resented.[5]

In an effort to achieve this aim Islam was disestablished, European laws and customs were introduced and the Arabic script was replaced by the Latin alphabet. Religious institutions such as the Sultanate and the Caliphate which had been an integral part of the Ottoman Empire, together with the religious orders, religious schools and the religious legal system were all abolished.

The main consequences for religion in Turkey of the reforms were to break the power of institutional Islam completely, and make it directly subject to the secular authorities.

Atatürk and his followers emphasised the technology, science and humanism of the West, not its Christianity, and ceased to think of a world divided into Muslim and infidel.[6] These reformers took nationalism as a substitute for Islam and attempted to adopt territorial and linguistic rather than religious nationalism. They thus transformed the message of Atatürk into an official ideology.

However, for the Muslim, in theory, the political loyalty is to the religious community of the faithful, the "umma", within which all men are brothers, regardless of language, customs, loyalty, ethnic origin or political affiliation.[7] Nationalism, therefore, would appear to involve a theoretical conflict with Islam and for many the official ideology of Kemalism which comprised such principles as republicanism, nationalism, popularism, secularism, etatism and reformism could not be a substitute.[8]

Since Atatürk, various governments have made concessions to Islam and in recent years the visibility of Islam among the educated appears to have intensified. Several factors lie behind these changes. The first is that since 1960 the Westernised elite of Turkish society has felt able to co-exist with Islam, and a religious political party,[9]

which has called for a more Islamic way of life, has been allowed to operate. The second element which has enabled greater openness in Islam was the re-introduction of vocational education of the clergy after 1965, which was later followed by an expansion of school religious education. About ten per cent of all secondary education and over forty per cent of the highest grade secondary education is conducted in Islamic religious schools. The third factor which lies behind the increasing visibility of Islam has been the developments in the Middle East. This was not confined solely to the developments in Iran, but extended to the Arab oil exporting countries which have been financing religious activity within Turkey.

Although the influence of Islam remains especially strong in the rural areas which were less affected by the secular reforms there is now increasingly visible evidence of Islam in Turkish urban life, among all classes of society. The vast rise in the number of European tourists visiting Turkey can only accelerate the spread of Western life-styles and habits. As a result of this tourist influx modern Western values are competing with Islamic mores.

Recently, the army has expressed concern at the influence of the "radical" Turkish outlook, or "irtica", and the president has even equated the dangers represented by Marxism and Islam to the secular traditions of Turkey.[10] The president's views seem to contradict those held by the prime minister and many of his associates who support moderate Islamic traditionalism and thus the re-emergence of Islam in Turkey.

Turkey does play an active role in both Western and Islamic organisations. It is a member of such institutions as NATO, the OECD and the Council of Europe and has recently applied for full membership of the EEC . However, to many in Europe, Turkey's "European" credentials remain open to question. They cite such features of Turkish life such as Islamic dress, the public role of the army, the cult of the founder of the Republic and the deep hold of religion on rural society which they believe would make economic and political integration extremely difficult, if not impossible, to achieve.[11]

The prime minister himself certainly appears to hold a somewhat ambivalent attitude towards Europe and one faction within the ruling party has been openly critical of Turkey's application to join the EEC. This faction would prefer to see Turkey playing a greater role in the economic and political organisations of the Islamic world. Some have even criticised the monetary authorities for what they perceive as their pro-Western attitude in their dealings with the country's creditors.

Turkey has good relations with most Middle Eastern countries and is a member of the Organisation of Islamic Countries and the Islamic Development Bank, despite its secular status. Turkey is under some pressure from Islamic states of the region to relax further its secular traditions. To emphasise his attachment to Islam, and, some would say, to gain the votes of millions of devout Muslims at the coming local elections and to

pre-empt the growing challenge to his leadership from the Islamic faction of the party, the prime minister made the annual pilgrimage to Mecca in July 1988. He was the first prime minister in modern times to do so while in office.

The transformation of Turkey from a traditional to a secular state has involved great religious, political, economic and social changes. Some believe that Turkey has only managed to develop a modern economy because it has followed the path of secularism. However, others would argue that the social and cultural upheavals which resulted from the secularist policies have been too high a price to pay and believe that a similar stage of development would have been achieved by an open adherence to Islamic ideas and principles. The appearance of Islamic dress in the cities would appear to challenge the widely held assumption that as Turkey became more industrial, urban and modern, it would also be more secular and Western in its cultural attitudes.

The question of the role of Islam in Turkey arouses intense political debate and is potentially a very divisive issue, and a real divide persists between Westernised Turks who have chosen Europe and traditional Turks who still consider themselves as part of the Islamic world.

## Origins of Islamic banking in Turkey

Despite being a predominantly Muslim country, the concept of Islamic banking is a relatively recent phenomenon in Turkey. While not wishing to see Islamisation of the banking system, the authorities recognised that many believers were unhappy with the kind of banking facilities offered by the riba commercial banks. There also seems to have been external influences and pressures exerted on the authorities to permit the establishment of Islamic banks. Following his election in 1983, the prime minister pledged specific legislation to allow the entry of Islamic banks into Turkey's financial system in an effort to expand and improve economic relations between Turkey and the Islamic countries, particularly those in the Middle East. It appears that certain member states within the Organisation of Islamic Countries and the Islamic Development Bank (IDB) had been pressing Turkey to allow Islamic banks to operate alongside the riba banks. Özal clearly believed that the individual should have a choice of where to bank and to his supporters, many of whom are religious, the setting up of Islamic banks seemed to be a way of acknowledging their electoral support. However, the establishment of the Islamic banks in Turkey was not without controversy and the decision to allow their opening was criticised by both the conventional bankers and the secularists.

As mentioned earlier, Turkey already had financial and economic ties with the

Islamic world through its membership of the IDB which it joined in 1974. One of the main aims of the IDB, stated in its foundation agreement, is that "the bank, based on a philosophy of Sharia, aims to strengthen economic development and social improvement among Islamic countries."

Since 1980, Turkey's ties with this bank have been strengthened and Turkey is now the fifth largest shareholder,[12] and the largest beneficiary of credit. The Özal family are heavily involved with this bank. The prime minister's brother, Korkut, who was previously a director of the Islamic Research and Training Institute, one of the main subdivisions of the IDB, is now one of eleven executive directors of the bank. This board position was vacated by the prime minister's other brother, Yusuf Bozkurt, who is now Minister of State for Economic Affairs.

Within Turkey, the IDB has an exalted status. Law number 3259 of 11 December 1986 exempts the IDB from all taxes, duties and fees arising from its assets, incomes, profits and share dividends on business transacted in Turkey. It is worth mentioning that the IDB holds a 13 per cent stake in one of the two Islamic banks operating in Turkey, namely Al Baraka Türk Özel Finans Kurumu. This is the only Islamic bank in which the IDB has a shareholding.

There are strict and detailed rules governing the operations of Islamic banks, or "Special Finance Houses" in Turkey, issued by the Council of Ministers, the Undersecretariat of the Treasury and Foreign Trade and the Central Bank. Nowhere are the words "Islam" or "Sharia" mentioned and this would appear to indicate an attempt by the authorities to avoid an open conflict with the aims and principles contained in the secular constitution. These rules detail the functions, objectives, management structures and capital provisions of the finance houses.

In the Banks Act, which governs the activities and operations of the conventional banks, Article 96 states that the finance houses are not subject to the banking laws contained in this Act. It states that the finance houses are regulated by the Council of Ministers.

The decision to allow Islamic banks to operate in Turkey was contained in Decree number 83/7506 of 16 December 1983 and published in the Official Gazette number 18256 dated 19 December 1983. This decree was issued by the Council of Ministers shortly after the Özal administration had taken office. It contains 17 articles and deals with "the methods and procedures of the founding of the Special Finance Houses, their activities and liquidation, under the Protection of the Exchange Value of the Turkish Currency Law number 1567 and Decree number 70 regarding banks."

More comprehensive rules and regulations were formulated by the Undersecretariat of the Treasury and Foreign Trade and published in the Official Gazette number 18323 of 25 February 1984. There are 35 articles covering "the

founding structure, operation and liquidation of the Special Finance Houses". Article 3 states that the minimum amount of capital needed to set up a finance house is TL 5 billion and that there must be at least a hundred shareholders. Foreign shareholders are required to bring in their capital in foreign exchange. Other regulations stipulate that each share certificate shall have a nominal value of TL 100,000 and that the board of directors shall consist of seven members. Articles 15 to 24 deal with the two types of account that the finance houses may offer to the public: "Current Accounts" and "Participation Accounts" (deposit accounts). These articles describe the operating methods which the finance houses should follow in administering these accounts and give examples of how the profits and losses should be calculated.

The Central Bank of Turkey has also issued rules governing the finance houses. These appear in the Official Gazette number 18348 dated 21 March 1984. In all there are 18 articles which stipulate "the requirements for the application and issue of licences to establish and commence business by the Special Finance Houses", and they give a general outline of some of their activities.

Permission to set up a finance house needs to be obtained from both the Central Bank and the Council of Ministers. It appears that the Central Bank firstly scrutinises the application and then recommends approval or rejection to the Council of Ministers which ultimately issues the operating licence.

The Central Bank fixes the reserve and liquidity ratios which, as mentioned in Chapter 2, differ from those of the riba commercial banks. At the present time, a total of 10 per cent of all funds collected in current accounts and 1 per cent of funds accumulated in profit and loss sharing accounts must be deposited with the Central Bank, on which no interest is paid.The finance houses themselves must keep an additional 10 per cent of the value of their current accounts in cash. The Central Bank is also responsible for the audit of all the accounts and operations of the finance houses.

So far two Islamic banks have been established in Turkey. One is called Al Baraka Türk Özel Finans Kurumu (Turkish Special Finance House or Institution) with the majority shareholder being Al Baraka Investment and Development Corporation, Jeddah whose chairman is Sheikh Saleh Kamel. The other is Faisal Finans Kurumu whose main shareholder is Prince Muhammed Faisal al-Saud's Dar al-Maal al-Islami group. Although largely set up with foreign capital, these finance houses consider themselves to be Turkish banks. However, it appears that like the foreign conventional banks they will be limited to only six branches. Each new branch requires permission from the authorities and an increase in capital. The extra capital requirements are not detailed in the decree or in the other articles but it is known that there is a capital requirement of TL 2.5 billion for each full service branch and TL 1 billion for each limited service branch.

The finance houses began with a capital of TL 5 billion but this figure has steadily been increased to allow the opening of branches. The names of the founding shareholders and their contribution to capital are shown in Table 5.1. Both now have an authorised capital of TL 10 billion. Al Baraka Türk's paid-up capital at the end of June 1988 was TL 8.75 billion and that of Faisal Finans TL 9.88 billion, and both finance houses expect their capital to be fully subscribed by the end of 1988.

Although it is not possible to give the names of the Turkish shareholders, it is known that several former politicians own shares in both finance houses. Yusuf Bozkurt Özal, for example, is a founding member of Al Baraka Türk. Two members of the now dissolved Milli Selamet Partisi (National Salvation Party), Salih Özcan and Ahmet Tevfik Paksu, are founding members of Faisal Finans and both are on the board of directors of this finance house.

Initially, the two finance houses had only the minimum 100 shareholders, as any number in excess of this would have led to the affairs of the houses coming under the scrutiny of the Capital Market Board, and full disclosure of the shareholders was something that both finance houses seemed keen to avoid. However, in 1988, Al Baraka Türk decided to permit an increase in its number of shareholders and to become a public company, subject to the rules and regulations of the Capital Market Board. One of the main benefits of becoming a publicly quoted company will be a sharp reduction in capital gains and profits tax from around 46 per cent to 30 per cent. As no shares have yet been traded in the İstanbul Stock Exchange, it is not possible to give a current share price value.

Al Baraka Türk received its official permit to operate on 21 January 1985 and opened to the public on 18 February 1985. Faisal Finans was given a licence on 23 January 1985 and opened its office on 2 April 1985. Both finance houses have their headquarters in İstanbul.

Al Baraka Türk opened limited service branches in Ankara on 10 September 1987, in İzmir on 6 June 1988 and in Bursa on 15 June 1988. It plans to open another branch in the central banking district of İstanbul before the end of 1988 and to move its head office from its present leasehold premises to a freehold building a short distance away.

Faisal Finans opened a limited service branch in Ankara on 15 December 1987, in İzmir on 17 December 1987, in Konya on 18 April 1988 and in Bursa on 30 May 1988.

These limited service branches are only authorised to collect funds and to conduct a very restricted service, with all investment decisions being made in İstanbul. Both finance houses expect to open their sixth and final branch during 1989.

In order to compensate for their lack of branches, the finance houses have deposit collecting agreements with conventional banks, enabling them to attract funds from

Table 5.1

Shareholders and Percentage Distribution of Capital in AL Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu

| | Founding Shareholders | |
|---|---|---|
| | TL million | Percentage |
| **AL Baraka Turk** | | |
| 1. AL Baraka Investment and Development Corporation, Jeddah | 2,500 | 50 |
| 2. Islamic Development Bank | 650 | 13 |
| 3. Dubai Islamic Bank | 100 | 2 |
| 4. Qatar Islamic Bank | 50 | 1 |
| 5. Bahrain Islamic Bank | 50 | 1 |
| 6. Bahrain Islamic Investment Company | 25 | 0.5 |
| 7. Jordan Islamic Bank | 25 | 0.5 |
| 8. Others | 1,600 | 32 |
| | 5,000 | 100 |
| **Faisal Finans** | | |
| 1. Muhammad Faisal al-Saud | 50 | 1 |
| 2. Dar al-Maal al-Islami Trust | 2,550 | 51 |
| 3. Faisal Islamic Bank, Egypt | 1,250 | 25 |
| 4. Faisal Islamic Bank, Sudan | 400 | 8 |
| 5. Masraf Faisal al-Islami, Bahrain | 250 | 5 |
| 6. Others | 500 | 10 |
| | 5,000 | 100 |

Source: AL Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu Annual Reports

throughout Turkey. Faisal Finans uses Vakıflar Bankası,[13] a state bank with 278 branches, and Al Baraka Türk uses Vakıflar Bankası, Türk Ticaret Bankası, a private bank with 407 branches, and the PTT's[14] postal cheque service. Both finance houses have extensive networks of correspondent banks in most parts of the world, and whenever possible they prefer to use the services of other Islamic banks to those of conventional banks.

The establishment of the finance houses brought considerable media coverage, not all of it positive. It appears that some newspaper articles were more interested in discussing the political, religious and financial affairs of some of the leading Turkish shareholders than in explaining to the public the aims and operating methods of Islamic banking. These articles also stressed the "Saudi connection" which gave some of the initial depositors the confidence to invest their funds. Some apparently believed that the backing of the finance houses by two leading Saudi businessmen would lead to high and guaranteed returns.

In view of the constraints imposed by the constitution, the finance houses found it difficult to publicise their activities. The content of all advertisements is strictly regulated and monitored by the Undersecretariat of the Treasury and Foreign Trade which issued detailed guidelines on 22 April 1986 covering "the principles, terms and conditions to be adhered to by the special finance houses in their publicity and advertisements." All media advertisements must avoid the use of the words "Islam" or "Sharia", and, in an attempt to get their message across the finance houses use the phrase "interest-free" and hope that the public will associate this with Islamic banking. Most advertisements appear in right-of-centre newspapers and magazines and during Muslim religious feasts such as Eid al-Fitr and Eid al-Haj there are brief television commercials. In the cities where the finance houses operate, there also advertising signs along certain main routes.

## Types of Islamic investment

The finance houses in Turkey have the right to conduct a complete range of conventional banking services, as well as being allowed to provide specifically Islamic transactions such as Murabaha, Musharaka, Mudarada and Ijara. These four types of Islamic investment are described below.

Murabaha, or bai maujjal, is a short term method of finance whose method of operation is directly related to the documentary letter of credit. It refers to a sale under which the price of the item involved is payable on a deferred basis either in a lump sum

or in instalments. Under this method of financing, the bank purchases the assets on behalf of the client, adds a mark-up to the purchase price and sells it to the client.

Although this method of finance is in conformity with the Sharia because it involves a sale contract and avoids any dealing with interest, it has been criticised by some Islamic lawyers and economists who believe that the mark-up determined by the bank is simply a replacement for interest. However, the banks themselves believe that the risks involved in these transactions justify the profit. There is a risk during the purchase transaction which could involve such things as physical losses,unacceptable quality or late delivery which lies entirely with the bank, and there is also a risk during the collection of the debt from the client, for according to the Sharia, the bank's agreement to buy and the execution of the purchase do not impose a legal obligation on the customer to buy.[15]

The banks undertake all proceedings prior to the purchase to try to ensure the best purchase offer. This benefits the client who is freed from a great deal of paperwork which he would have to have carried out himself if he had relied on fixed-interest finance.

The mark-up by the banks is variable and depends on such factors as the profitability of the commodity and the amount of work involved in the processing of the transaction. Generally speaking, imported goods have higher mark-ups than locally purchased goods and the higher the profitability of a commodity the higher the mark-up.

The banks do not accept an advance on the purchase but for most clients they do require collateral or some other form of guarantee, such as promissory notes. In murabaha the bank has title to the goods but seldom handles them physically. The title remains with the bank until the client has paid off the debt. Unless the goods are not at the required specifications or if there is a significant delay in delivery the client is responsible for the acquisition and payment of the goods. In case the client refuses to accept the goods without sufficient good reason then the bank has the right to sell them in the open market, deduct its dues from the proceeds and refer to the client with the difference.

In Turkey, there is a considerable demand for murabaha finance and to date the bulk of all business carried out by the finance houses has been in this field. This would seem to indicate that this method of finance is cheaper than trade finance offered by the riba banks.

Musharaka means a profit-sharing joint venture between the bank and the client, a "partner", where both contribute capital assets as well as technical and managerial expertise in varying proportions, and the client manages the business. It is generally used to finance medium and long term projects, though it could also be used in short

term operations. The bank does not interfere in the arrangement, but retains the right to inspect business operations and to audit the accounts. In effect, the role of the bank is that of sleeping partner.

The realised profit is shared in a ratio agreed upon in advance. The client is entitled to a proportion of the actual realised profit for expenses, labour and effort and the remaining profit is divided between the bank and the client according to the capital contribution ratio. In case of a loss, the Sharia dictates that the loss distribution is identical to the capital distribution ratio without any modification.

The portion of profit that is given to the client for management is not a fixed percentage and varies from one musharaka to another and depends upon the amount of work involved and the skills required of the client. In most cases, the greater the amount of work and the higher the level of expertise, the higher the percentage.

The proportion of capital supplied by the bank in relation to that supplied by the partner varies and depends upon the business history and competence of the client. The client with a long and successful business record is expected to contribute less capital than that of a client with a short business history.

The Sharia allows the bank to ask for guarantees and collateral from the client, not in the capacity of the client as a participating partner but as a manager of the project, in order to assure the bank of honest and efficient management.[16] The success of the musharaka, therefore, depends on the ability of the bank to choose appropriate clients, make a realistic feasibility study of the project and to follow up the progress of the project by periodic audit.

One of the main advantages of musharaka is that the bank participates in the success or failure of a business and if expectations of the sale of the commodities or the manufactured goods are not fulfilled and more time is needed the bank does not pressurise the client on account of added costs. Under conventional riba financing methods, the client would probably be required to refinance the operations and to pay back all bank loans. In musharaka transactions, the Islamic bank helps in the success of the project by exchanging advice with the client about such matters as current market prices of the goods and about the timing of a sale of the products.

In 1987, musharaka projects accounted for only about 5 per cent of total placements by the Turkish finance houses but this percentage is increasing steadily.

Mudaraba, which suits medium and long term operations, is very similar to musharaka except that here the client, or partner, does not participate with capital in the joint venture. The practice of mudaraba existed in pre-Islamic times and was later approved by the Prophet. In mudaraba, the bank provides all the capital and the entrepreneurial client provides his work and expertise.

The profit from mudaraba is divided according to pre-determined proportions,

and once again the client's share of the profit depends upon the amount of work involved and the level of expertise. Accumulated profits may be distributed during the mudaraba or at the end of the contract. Any loss is borne entirely by the bank, but if the entrepreneur is negligent, the original sum would have to be repaid to the bank.

No fixed rate of profit can be guaranteed or specified in advance. Furthermore, the customer cannot guarantee the return of the original sum to the bank because the financial transaction would then be classified as a loan from the bank to the client.

Mudaraba is an important instrument in Islamic banking because it is a mechanism for economic development in which monetary assets are introduced into the production process in order to transform them into real factors of production. As a result, both the owner of the assets and the entrepreneur who contributes his labour and managerial effort share the outcome of the process. Obviously, the bank will only participate in a mudaraba contract if it is satisfied about the client's business history, conduct and expertise which are essential requisites for undertaking these operations. However, the mudaraba contract does offer an opportunity for collective investment to those who lack managerial and technical skills, or the ability to take risks due to the small size of their savings.

Although neither finance house in Turkey has yet arranged any mudaraba contracts, it is the hope of both finance houses that such contracts will be set up in the near future once suitable clients and projects have been identified.

Unlike the conventional banks operating in Turkey which cannot offer leasing facilities, the finance houses are permitted to engage in leasing transactions. The rules and regulations concerning leasing are contained in Law number 3226 dated 10 June 1985 which was published in the Official Gazette number 18795 of 28 June 1985 and number 18882 of 28 September 1985. In all there are 64 articles which deal with the financial, legal and administrative matters of leasing. The operations of the leasing companies are under the control of the Undersecretariat of Treasury and Foreign Trade. Article 3 of the law requires a financial leasing company to have a paid-up capital of at least TL 1 billion, a capital sum which must also be met by the finance houses.

Leasing, or Ijara, is accepted by the Sharia and may take the form of finance leasing or operating leasing. It is a medium or long term source of finance available to the entrepreneur. In finance leasing the bank (lessor) purchases a capital asset and leases it to the beneficiary (lessee) in return for the payment of specified rentals over a certain period. The payments are expected to help the lessor recover the cost of the asset plus a reasonable return.[17] The operating lease is based on profit-sharing in which the bank buys the capital asset and leases it to the client for a limited period of time, at the end of which the client will make a final repayment and obtain ownership of the goods in question.

For the bank, leasing has the advantage of being less risky than other types of finance in that it offers a reasonable profit without having to follow the financial records of the entrepreneur. In Turkey, the lessor is obliged to insure the goods for the duration of the leasing period.

Although leasing has been criticised as not conforming to the Sharia since rentals are determined in advance and there is no concept of profit and loss sharing, most Islamic banks find this method an acceptable form of business transaction. The Islamic banks point out that since leasing does not involve interest because its outcome is either a sale-purchase type of transaction or a rent transaction it conforms to Islamic principles. Of the two finance houses, only Al Baraka Türk has so far arranged any leasing transactions.

## Types of accounts and other customer services

The banking services offered by the Islamic banks, including those operating in Turkey, are generally similar to those of the conventional banks except for the granting of loans or the acceptance of deposits at fixed or varying rates of interest. Unlike the riba banks in Turkey, the finance houses may, as already stated, offer leasing facilities, and may also carry out commodity trading.

The finance houses offer three types of account: Current, Participation and Special Investment. The characteristics and operation of these accounts are described below.

Current accounts are payable on demand. They are accepted in Turkish lira or in foreign currency, either US dollars or Deutsch Marks. These accounts are operated and recorded separately from all other accounts and the finance houses are also required to keep funds in local and foreign currency separate. The regulations governing the operation of the finance houses stipulate that the finance house must keep 10 per cent of funds accumulated in these accounts in cash and deposit a further 10 per cent with the Central Bank. Of the remaining 80 per cent, the regulations state that 40 per cent can be placed for a maximum term of one year and the other 40 per cent for a minimum of one year. Eighty per cent of these placed funds must consist of fixed obligations to be repaid on maturity. The other 20 per cent may be used for profit and loss participation investments.

The finance houses have fixed a minimum opening balance of TL 50,000, or foreign currency equivalent, and subject to satisfactory operation of the account in the first few months, the client receives a cheque-book. Current account services are offered to the client free of charge and no interest or profit is paid to the depositors on

these accounts.

The finance houses also accept deposits in the form of Participation, or Profit and Loss Sharing accounts, and invest the deposited funds on behalf of the depositors in economic sectors or projects whose operations conform to Islamic principles. These accounts can be opened by individuals or businesses who wish to share in the finance houses' profits (or losses) for periods of 90 days, 180 days, 360 days or longer. The accounts may be held in lira or foreign currency and there is a minimum opening balance of TL 100,000 or equivalent in foreign currency. By far the most popular term is 90 days. The finance houses must deposit 1 per cent of all funds collected in these accounts with the Central Bank. The Bank pays no interest on either local currency or foreign currency funds.

Although the regulations state that the funds in each group should be administered separately, in practice this is not done. The finance houses claim that such a separation would make the operations of the fund less economic and more complicated to administer. Some Islamic banks, however, do maintain separate pools and usually allocate a higher percentage of profit to the investment account if the deposit period is longer.

In Turkey, the funds deposited in lira are placed in one pool, and those in foreign currency into another pool. According to the regulations, the finance houses should calculate a "unit value" for each pool. This "unit value", which was set at 100 on the day the finance houses began to collect funds, is a weighted figure and should be announced weekly. It is determined by dividing the total value of assets in each pool of profit and loss sharing accounts by the total "account value" of the preceding day, if any profit and loss has been recorded. The "account value" is calculated by dividing the amount deposited by the investor by the "unit value" prevailing on the day the account is opened, and when multiplied together these two figures give the lira or foreign currency value of the investment. Examples of the operating procedures are given in Table 5.2.

Al Baraka Türk publishes the "unit value" of its lira and foreign currency accounts every Tuesday in the right-of-centre newspapers Tercüman and Türkiye. Faisal Finans does not regularly publish its figures in the media, but they are available, on demand, from any of its branches.

At the present time each finance house takes 20 per cent of all profit received on all profit and loss investment placements as expenses and the remaining 80 per cent is credited to the accounts of the investors. As in the case of the interest rates paid to depositors by the riba banks, the profits paid to the investors by the finance houses are subject to a 10.4 per cent withholding and defence tax. The tax authorities make no distinction between deposit interest and participation account profits. All accounts not closed within five working days of maturity are automatically renewed for a similar

Table 5.2

An example showing the operations of Profit and Loss Participation Accounts

| ay | Procedures | Total Assets (000 TL) | Deposits (+) or Withdrawals(-) (000 TL) | Position of Individual Accounts (000TL) | Account Value (ratio) | Unit Value (weight) | Unit Account Value (000 TL) |
|---|---|---|---|---|---|---|---|
| ne | A,B,and C deposit a total of TL10.0 million. | | A. 1,000(+) | A. 1,000 | 10.0 | 100 | 1,000 |
| | | | B. 4,950(+) | B. 4,950 | 49.5 | 100 | 4,950 |
| | | | C. 4,050(+) | C. 4,050 | 40.5 | 100 | 4,050 |
| | | 10,000 | 10,000(+) | 10,000 | 100.0 | 100 | 10,000 |
| wo | The fund profits TL 6.25 million. 20% is credited to the House (TL1.25m) 80% is credited to the accounts of the account holders(TL5.0m) | | - | A. 1,000 | 10.0 | 150 | 1,500 |
| | | | - | B. 4,950 | 49.5 | 150 | 7,425 |
| | | | - | C. 4,050 | 40.5 | 150 | 6,075 |
| | | 15,000 | - | 10,000 | 100.0 | 150 | 15,000 |
| hree | D deposits TL 3.0 million. | | - | A. 1,000 | 10.0 | 150 | 1,500 |
| | | | - | B. 4,950 | 49.5 | 150 | 7,425 |
| | | | - | C. 4.050 | 40.5 | 150 | 6,075 |
| | | | D.3,000(+) | D. 3,000 | 20.0 | 150 | 3,000 |
| | | 18,000 | 3,000(+) | 13,000 | 120.0 | 150 | 18,000 |
| our | The fund profits TL3.0 million. 20% is credited to the House (TL600,000) 80% is credited to the accounts of the account holders (TL2.4m) | | - | A. 1,000 | 10.0 | 170 | 1,700 |
| | | | - | B. 4,950 | 49.5 | 170 | 8,415 |
| | | | - | C. 4,050 | 40.5 | 170 | 6,885 |
| | | | - | D. 3,000 | 20.0 | 170 | 3,400 |
| | | 20,400 | - | 13,000 | 120.0 | 170 | 20,400 |
| ive | C withdraws TL2.04 million. | | A. - | A. 1,000 | 10.0 | 170 | 1,700 |
| | | | B. - | B. 4,950 | 49.5 | 170 | 8,415 |
| | | | C. 2,040(-) | C. 2,010 | 28.5 | 170 | 4,845 |
| | | | D. - | D. 3,000 | 20.0 | 170 | 3,400 |
| | | 18,360 | 2,040(-) | 10,960 | 108.0 | 170 | 18,360 |
| ix | House loses TL675,000. 20% is met by the House (TL135,000) 80% is debited to the accounts of the account holders (TL540,000) | | - | A. 1,000 | 10.0 | 165 | 1,650 |
| | | | - | B. 4,950 | 49.5 | 165 | 8,167-50 |
| | | | - | C. 2,010 | 28.5 | 165 | 4,702-50 |
| | | | - | D. 3,000 | 20.0 | 165 | 3,300 |
| | TOTAL | 17,820 | - | 10,960 | 108.0 | 165 | 17,820 |

urce: Undersecretariat of the Treasury and Foreign Trade published in the Official Gazette number 18323 of 25 February 1984

term. Money may be withdrawn from these accounts prior to the due date by giving 30 days notice. If the fund is in profit the account holder is entitled to receive the principal only, in cases where the fund shows a loss the depositor is obliged to share in the losses, which are deducted from the original investment.

In the rules covering the operations of the finance houses the maximum profit (or loss) share for the houses is fixed at 20 per cent and both are seeking Central Bank approval to lower this figure to 15 per cent. Such a move would enable the finance houses to offer a greater return to the investor and allow the finance houses to compete more effectively with the riba banks whose deposit rates were raised by the Central Bank in February 1988.

Al Baraka Türk also operates a Special Investment account. This facility was set up in May 1987 and offers investors with a minimum of TL 60 million a higher return. The investor receives 90 per cent of all profit and Al Baraka Türk takes 10 per cent as management expenses. Funds may be placed for 180 days, 360 days or longer.

Unlike funds placed at the conventional banks which are insured, the funds held in Current Accounts, Participation Accounts and Special Investment Accounts at the finance houses are not covered by the Savings Deposit Insurance Fund.

In common with most Islamic banks, the finance houses offer services such as domestic and international transfers, the collection of bills of exchange, letters of credit, travellers' cheques, the purchase and sale of foreign currency in the spot market and trustee services. These services are essential for the bank's clients and as they are offered for a fee they help to reduce the bank's overhead expenses, and thus increase its profits.

Islamic banks may also offer funds to charities and maintain a "qard hasan" or social purpose fund to help the needy. They may also provide facilities for the acceptance of Zakat from individuals or organisations and arrange the distribution of such funds on their behalf in accordance with the Sharia. However, the finance houses in Turkey have so far not provided any individual with a "qard hasan" and neither has a Zakat collection and distribution facility. Both have, however, made charitable donations and Faisal Finans assists with the payment of certain higher education fees for several hundred students.

Although Islamic banking methods of operating are not uniform, all Islamic banks adhere to Islamic principles and seek approval from their own religious supervisory boards or advisers attesting that their banking methods and services are in accordance with Islam. Al Baraka Türk retains the services of a Sharia adviser and Faisal Finans has a board of three religious advisers.

## Conclusion

Despite Turkey's secular constitution, the government has supported the movement of Islamic banking and this support is manifested in the fact that a number of founders and members of the boards of directors of the two finance houses have occupied, or still occupy, important political positions.

The introduction of Islamic instruments of finance and the expansion of the branch network and the fund collection services offered by certain non-Islamic banks now gives the committed Muslim a chance to use his savings profitably and in accordance with Islamic business practices.

By offering a high standard of service and by diversifying their range of products currently on offer to the client both finance houses expect to see a substantial increase in business over the next few years.

Footnotes

1. W.E. Shepard, "Islam and ideology: Towards a typology," International Journal of Middle East Studies, Vol. 19 (1987), p. 310.
2. N. Berkes, The Development of Secularism in Turkey (1964), p. 6.
3. Ibid., p. 7.
4. The constitution of Albania, a state once under Ottoman control, makes no mention of religion. All places of worship have been closed by the authorities.
5. A. Mango, Turkey: A Delicately Poised Ally (1975), p. 3.
6. P. Stirling, " Religious change in republican Turkey", Middle East Journal, Vol. 12, No. 4 (1958), p. 398.
7. Ibid., p. 399.
8. M. Heper, " Islam, polity and society in Turkey: A Middle Eastern perspective", Middle East Journal, Vol. 35, No. 3 (1981), p. 360.
9. Known as "Refah Partisi" (Welfare Party). In the 1987 general election it gained 7.14 per cent of the votes but no parliamentary seats.
10. EIU, Country Report on Turkey 1988-89, p. 10.
11. D. Barchard, Turkey and the West (1985), p. 7.
12. In 1985 Turkey increased its capital in the IDB from 63 million dinars to 160 million dinars, raising its share to 8.2 per cent.
13. "Vakıflar" means waqfs, or religious foundations or charities, and many Turks view this bank as "Islamic", although it is not. It was for this reason that the finance houses set up fund collection services with this bank.
14. PTT is the abbreviation of Posta Telegraf Telefon, the Turkish post, telegraph and telephone service.
15. A.M. Abdeen and D.N. Shook, The Saudi Financial System in the Context of Western and Islamic Finance (1984), p. 189.
16. Ibid., p. 158.
17. A.A.F. El-Ashker, The Islamic Business Enterprise (1987), p. 94.

# CHAPTER 6

## THE PERFORMANCE OF THE SPECIAL FINANCE HOUSES

### Introduction

An assessment of the performance of the two finance houses offers an indication of their potential in the future. An analysis of the financial statements is made for the purpose of assessing and comparing the financial positions and results of operations of the finance houses. However, this task is complicated by the fact that uniformity of accounting policies is necessary for meaningful assessment and comparison of the financial data. Although both finance houses comply with the reporting regulations set by the Central Bank their annual reports do not always appear to give a true and full picture of their activities in Turkey, and direct comparisons between the two institutions are not always easy to make.

The first main section of the chapter covers the growth of the special finance houses. It begins with an examination of the growth and composition of deposits and then goes on to discuss equity and assets growth.

In the second main section the deployment of funds is analysed, and this is followed by smaller sections on the profitability of the finance houses.

The final section discusses the extent of competition between the special finance houses and the riba based conventional banks.

The major topics are dealt with on the basis of findings in the annual reports, articles of association, literature and from other information obtained by the author from employees at the two institutions during trips to Turkey in March and August 1988.

### Growth of the special finance houses

The growth and financial strength of the finance houses are measured in terms of the increase in assets financed by funds available from current and profit and loss sharing depositors and from shareholders as well as from funds generated from operations and retained by the finance houses.

#### Deposit growth

The two finance houses started from modest deposit bases, as would be expected for new, and novel kinds of financial institution. The initial publicity that surrounded

the opening of the finance houses brought a considerable response. The deposits of the two financial houses include current accounts, profit and loss sharing (PLS) accounts and special investment accounts. The funds generated from participation and special investment accounts, and up to 20 per cent of funds generated from current accounts, are used to finance various profit-earning investment projects.

As shown in Table 6.1, during 1985 Al Baraka Türk Özel Finans Kurumu (ABT) and Faisal Finans Kurumu (FFK) attracted combined deposits of TL 28.9 billion despite having been in operation for only 10 months and 9 months respectively. FFK had collected around 30.0 per cent more funds than ABT, and its foreign currency PLS accounts were almost three times the value of those of ABT.

During 1986, there was substantial deposit growth at both houses. The deposits at FFK increased at a rate of 180.2 per cent while those at ABT grew at a rate of 140.5 per cent. Both houses recorded a decrease in the value of their local currency current accounts as investors switched their funds into relatively high yielding PLS accounts. Once again, FFK had far greater foreign currency deposits than ABT and these made up 69.7 per cent of its total deposits. ABT's foreign deposits accounted for only 35.4 per cent of total deposits.

In 1987, the overall increase in total deposits continued at a slightly lesser rate for ABT whose deposits increased by 131.7 per cent, and at a substantially reduced rate for FFK whose deposits only increased by 99.1 per cent. The growth rate of the foreign currency deposits is once again interesting. The value of ABT's foreign current accounts actually decreased by 26.1 per cent over the 1986 figure but its foreign currency PLS accounts increased by a staggering 202.5 per cent. At FFK, there was a huge increase of 245.6 per cent in foreign currency current accounts but a much lesser increase of 86.5 per cent in its foreign currency PLS accounts. Despite the overall increases at ABT, FFK still had more than twice the value of its deposits in foreign currency at the end of 1987. ABT has, however, managed to attract more lira deposits than FFK in each year of its operations.

Perhaps the reason for the greater foreign currency accounts at FFK results from the activities of its representative office in Frankfurt and its public relations office in Jeddah. Both were set up to publicise the services and activities of the finance house among the Turkish workers living in those countries and to suggest to them that they transfer their foreign currency savings to FFK's branches in Turkey.

At the end of 1987, the combined total of the finance houses' deposits stood at around TL 161.1 billion and represented 1.16 per cent of the total current and savings deposits held by the riba commercial banks in Turkey, compared to only 0.83 per cent in 1986.

In the period January to June 1988, the deposit growth at both finance houses has

Table 6.1

## Deposit Growth at AL Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu 1985-1987 (TL 000 and percentage growth)

| Type of account | ABT 1985 | ABT 1986 | ABT 1987 | ABT 1988[a] | FFK 1985 | FFK 1986 | FFK 1987 | FFK 1988[a] | ABT and FFK Combined total 1985 | ABT and FFK Combined total 1986 | ABT and FFK Combined total 1987 | ABT and FFK Combined total 1988[a] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Current Accounts** | | | | | | | | | | | | |
| Turkish lira | 989,955 | 813,069 | 1,332,167 | 5,206,746[b] | 1,952,205 | 1,631,284 | 3,462,614 | 2,321,691 | 2,942,160 | 2,444,353 | 4,794,781 | 7,528,437 |
| % growth | | -17.87 | 63.84 | | | -16.44 | 112.26 | -32.95 | | -16.92 | 96.16 | 57.01 |
| Foreign currency | 1,011,754 | 1,189,629 | 878,524 | 1,687,774 | 461,781 | 855,808 | 2,958,143 | 1,189,350 | 1,473,535 | 2,045,437 | 3,836,667 | 2,877,124 |
| % growth | | 17.58 | -26.15 | 92.11 | | 85.33 | 245.65 | -59.79 | | 38.81 | 87.57 | -25.01 |
| Total | 2,001,709 | 2,002,698 | 2,210,691 | 6,894,520 | 2,413,986 | 2,487,092 | 6,420,757 | 3,511,041 | 4,415,695 | 4,489,790 | 8,631,448 | 10,405,561 |
| % growth | | 0.05 | 10.39 | 211.87 | | 3.03 | 158.16 | -45.32 | | 1.68 | 92.25 | 20.55 |
| **Profit and loss sharing accounts** | | | | | | | | | | | | |
| Turkish lira | 6,828,796 | 18,724,644 | 34,850,131 | 40,309,008 | 2,972,540 | 12,232,724 | 26,794,210 | 39,901,790 | 9,801,336 | 30,957,368 | 61,592,341 | 80,210,798 |
| % growth | | 174.20 | 86.12 | 15.66 | | 311.52 | 119.04 | 48.92 | | 215.85 | 98.96 | 30.23 |
| Foreign currency | 3,741,297 | 9,510,462 | 28,769,618 | 39,722,683 | 10,933,741 | 31,051,234 | 57,848,630 | 69,149,486 | 14,675,038 | 40,525,696 | 86,618,248 | 108,872,169 |
| % growth | | 154.20 | 202.50 | 38.07 | | 183.66 | 86.52 | 19.54 | | 176.15 | 113.54 | 25.69 |
| Total | 10,570,093 | 28,235,106 | 63,619,749 | 80,031,691 | 13,906,281 | 43,247,958 | 84,642,840 | 109,051,276 | 24,476,374 | 71,483,064 | 148,210,589 | 189,082,967 |
| % growth | | 167.12 | 125.32 | 25.80 | | 211.00 | 95.72 | 28.84 | | 192.05 | 107.34 | 27.58 |
| **Special investment accounts** | | | | | | | | | | | | |
| Turkish lira | | | 4,231,350 | | | | | | | | 4,231,350 | |
| Grand total | 12,571,802 | 30,237,804 | 70,061,790 | 86,926,211 | 16,320,267 | 45,730,050 | 91,063,597 | 112,562,317 | 28,892,069 | 75,972,854 | 161,073,387 | 199,488,528 |
| % growth | | 140.52 | 131.70 | 24.07 | | 180.23 | 99.11 | 23.61 | | 162.95 | 112.01 | 23.85 |

[a] Data as at 30 June
[b] Includes Special Investment Accounts

Source: Compiled from Finance House Reports

been rather modest. Although there was an absolute increase in the amount of deposits, there was a sharply declining percentage increase. This was mainly due to very high inflation, estimated at around 70 per cent in September 1988, which has resulted in negative returns and has caused some depositors to switch to other forms of investment. The value of accounts at ABT increased by 24.1 per cent and those of FFK by 23.6 per cent. At Al Baraka Türk the value of its foreign currency deposits increased at a faster rate than those denominated in lira but despite this, ABT's foreign currency deposits at the end of June were still less than those of FFK which, over the same period, recorded greater gains in its lira deposits.

Table 6.2 shows the number and average balance of the deposit accounts for ABT and FFK. It shows that at the end of 1987, FFK had attracted a larger number of depositors in all categories of account, except local currency PLS accounts, than ABT. Over the three year period, participation accounts have shown the largest numerical and percentage increases. At the end of 1985, 1986 and 1987 the total number of participation accounts stood at 7400, 24476, and 38351 respectively. Over the same period the number of current accounts was 1102, 2333 and 3740 respectively.

Both finance houses seem keen to attract a wide deposit base. In 1987, the average balance of current accounts at FFK was around TL 2.9 million, almost double the average balance at ABT, but both finance houses had roughly similar average balances in their PLS accounts. However, the figures for ABT are distorted somewhat by the exclusion from the PLS accounts of its special investment accounts. At the end of 1987 it had 34 such accounts with an average balance of TL 124.5 million for each account. Taking all accounts into consideration, the average balance of each account at ABT and FFK was around TL 3.8 million, an increase of TL 1.0 million over the 1986 figure. This increase in the average balance may have occurred as a result of the confidence and acceptance granted by the deposit customers who feel comfortable in dealing with the finance houses because they can relate to them in spiritual, social and religious terms.

The annual percentage rate of growth in the number of accounts at the finance houses was less in 1987 than in 1986 which is only to be expected given the very large increases in the early months of their operation.

The composition of the current, participation and special investment accounts of both finance houses, as shown in Table 6.3, indicates that there has been a considerable shift away from current accounts towards profit sharing accounts. It is reasonable to assume that the greater the ratio of participation accounts to current accounts, the greater the confidence of the depositors in the ability of the finance houses to generate profits on the investment of deposited funds. Conversely, the greater the ratio of current accounts to participation accounts, the greater the need of the investors for ready and available cash for their personal, business and social transactions. It could also imply

Table 6.2

**Number and Average Balance (in TL 000) of Deposit Accounts for Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu 1985 - 1987**

| | ABT | | | FFK | | | ABT and FFK Combined total | | |
|---|---|---|---|---|---|---|---|---|---|
| Type of account | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 |
| **Current accounts** | | | | | | | | | |
| Turkish lira | | | | | | | | | |
| Number | 299 | 625 | 1,010 | 508 | 1,054 | 1,413 | 807 | 1,679 | 2,423 |
| Average balance | 3,311 | 1,301 | 1,319 | 3,843 | 1,548 | 2,451 | 3,646 | 1,456 | 1,979 |
| Foreign currency | | | | | | | | | |
| Number | 113 | 275 | 487 | 182 | 379 | 830 | 295 | 654 | 1,317 |
| Average balance | 8,954 | 4,326 | 1,804 | 2,538 | 2,258 | 3,564 | 4,995 | 3,128 | 2,913 |
| Total Number | 412 | 900 | 1,497 | 690 | 1,433 | 2,243 | 1,102 | 2,333 | 3,740 |
| Average balance | 4,859 | 2,225 | 1,477 | 3,499 | 1,736 | 2,863 | 4,007 | 1,924 | 2,308 |
| **Profit and loss sharing accounts** | | | | | | | | | |
| Turkish lira | | | | | | | | | |
| Number | 2,014 | 7,616 | 12,274 | 3,110 | 8,783 | 11,648 | 5,124 | 16,399 | 23,922 |
| Average balance | 3,391 | 2,459 | 2,839 | 956 | 1,393 | 2,300 | 1,913 | 1,888 | 2,575 |
| Foreign currency | | | | | | | | | |
| Number | 866 | 2,541 | 4,477 | 1,410 | 5,536 | 9,952 | 2,276 | 8,077 | 14,429 |
| Average balance | 4,320 | 3,743 | 6,426 | 7,754 | 5,603 | 5,813 | 6,448 | 5,017 | 6,003 |
| Total Number | 2,880 | 10,157 | 16,751 | 4,520 | 14,319 | 21,600 | 7,400 | 24,476 | 38,351 |
| | 3,670 | 2,780 | 3,798 | 3,077 | 3,020 | 3,919 | 3,308 | 2,921 | 3,865 |
| **Special investment accounts** | | | | | | | | | |
| Turkish lira | | | | | | | | | |
| Number | | | 34 | | | | | | 34 |
| Average balance | | | 124,451 | | | | | | 124,451 |
| Combined Total | 3,292 | 11,057 | 18,282 | 5,210 | 15,752 | 23,843 | 8,502 | 26,809 | 42,125 |
| Average balance | 3,819 | 2,735 | 3,833 | 3,132 | 2,903 | 3,819 | 3,398 | 2,834 | 3,824 |

Source: Compiled from Finance House Reports

Table 6.3

## Composition of Deposit Accounts at Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu (percentage)

| Type of account | ABT 1985 | ABT 1986 | ABT 1987 | ABT 1988[a] | FFK 1985 | FFK 1986 | FFK 1987 | FFK 1988[a] | ABT and FFK Combined Total 1985 | ABT and FFK Combined Total 1986 | ABT and FFK Combined Total 1987 | ABT and FFK Combined Total 1988[a] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Current accounts** | | | | | | | | | | | | |
| Turkish lira | 7.87 | 2.69 | 1.90 | 5.99 | 11.96 | 3.57 | 3.80 | 2.06 | 10.18 | 3.22 | 2.98 | 3.78 |
| Foreign currency | 8.05 | 3.93 | 1.25 | 1.94 | 2.83 | 1.87 | 3.25 | 1.06 | 5.10 | 2.69 | 2.38 | 1.44 |
| | 15.92 | 6.62 | 3.15 | 7.93 | 14.79 | 5.44 | 7.05 | 3.12 | 15.28 | 5.91 | 5.36 | 5.22 |
| **Profit and loss sharing accounts** | | | | | | | | | | | | |
| Turkish lira | 54.32 | 61.93 | 49.75 | 46.37[b] | 18.21 | 26.75 | 29.42 | 35.45 | 33.93 | 40.75 | 38.24 | 40.21 |
| Foreign currency | 29.76 | 31.45 | 41.06 | 45.70 | 67.00 | 67.81 | 63.53 | 61.43 | 50.79 | 53.34 | 53.77 | 54.57 |
| | 84.08 | 93.38 | 90.81 | 92.07 | 85.21 | 94.56 | 92.95 | 96.88 | 84.72 | 94.09 | 92.01 | 94.78 |
| **Special investment accounts** | | | | | | | | | | | | |
| Turkish lira | | | 6.04 | | | | | | | | 2.63 | |
| | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

[a] Data as at 30 June
[b] Includes Special Investment Accounts

Source: Compiled from Finance House Reports

that the institution provides better banking and social services.

Table 6.3 shows that in the first year of operation the finance houses had approximately 15 per cent of the value of their deposits in current accounts but by the end of June 1988 this figure had fallen to just over 5 per cent, with the depositors having committed a high percentage of their deposits, almost 95 per cent, to profit and loss sharing and special investment accounts.

In 1985, the annualised gross return on PLS lira accounts at ABT was around 59 per cent, considerably higher than that offered by the conventional banks on term deposits. Although the profit distribution decreased to 57.3 per cent in 1986 it remained higher than the deposit yields at the riba based banks. The gross rate of return in 1987 was 54 per cent and up to July of that year this rate was higher than the deposit rates of the conventional banks. In July 1987, the authorities freed the 1 year deposit rate and the riba banks began offering rates of up to 65 per cent, well above the profit distribution rate of ABT and FFK.

Table 6.4 indicates the gross and net yields of 3 month, 6 month and 1 year profit and loss sharing lira accounts which matured on 14 March 1988, 30 June 1988 and 19 September 1988 at Al Baraka Türk. They are compared with the returns on the deposits at the conventional Turkish banks. They show that, with the exception of 1 year deposits placed at the conventional banks after 3 July 1987, the returns offered to the investors on the profit and loss sharing accounts were greater than those offered by the riba based banks. On a three month deposit which matured on 19 September 1988, for example, the investor received more than 9 percentage points on funds placed at Al Baraka Türk and on a six month deposit due on the same day the difference was around five percentage points. However, on a 1 year deposit the conventional banks paid over 3 percentage points more than the finance house. Both ABT and FFK are keen to increase their profit rates for depositors in order to make their yields more attractive vis-a-vis the 1 year deposit rate of the conventional banks. The profits paid to investors by the finance houses on foreign currency accounts closely reflected the returns paid by the riba based banks.

The "unit value", described in the previous chapter, was fixed by ABT at 100 on 29 March 1985, the day it began to collect PLS funds. This weighted figure had risen to 383.1823 on 14 March 1988 and so, for example, an investment of TL 100,000 made on this day would have "bought" 260.9724 units. The "unit value" had risen to 499.1936 on 19 September and so the investment would then have been worth TL 130,276. The number of units or "account value" is written into the PLS agreement, kept by the client. The finance houses disclose the "unit value" weekly, either in the media or upon demand at any of their branches. In effect, the PLS account acts like a "unit trust". A client may, therefore, follow the progress of the investment but is powerless to do anything should the "unit value" decrease, and must wait until the end

Table 6.4

## A Comparison between the Yields of Profit and Loss Sharing Accounts at AL Baraka Türk Özel Finans Kurumu and Deposit Accounts at the Conventional Riba Banks

| Yield on TL 100,000 maturing: | | 14 March 1988 | | | | 30 June 1988 | | | | 19 September 1988 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | ABT | | Riba Banks | | ABT | | Riba Banks | | ABT | | Riba Banks | |
| Term | | Amount | Annual % age | Amount | Annual % age | Amount | Annual % age | Amount | Annual % age | Amount | Annual % age | Amount | Annual % age |
| 3 months | Gross | 11,760 | 47.04 | 8,750 | 35.00 | 13,434 | 53.74 | 11,250 | 45.00 | 13,826 | 55.30 | 11,250 | 45.00 |
| | Net' | 10,537 | 42.15 | 7,840 | 31.36 | 12,037 | 48.15 | 10,080 | 40.32 | 12,388 | 49.55 | 10,080 | 40.32 |
| 6 months | Gross | 24,933 | 49.87 | 19,000 | 38.00 | 27,061 | 54.12 | 19,000 | 38.00 | 28,988 | 57.98 | 26,000 | 52.00 |
| | Net' | 22,340 | 44.68 | 17,025 | 34.05 | 24,246 | 48.49 | 17,025 | 34.05 | 25,973 | 51.95 | 23,295 | 46.59 |
| 1 Year | Gross | 53,337 | 53.34 | 43,000 | 43.00 | 58,160 | 58.16 | 43,000 | 43.00 | 61,423 | 61.42 | 65,000 | 65.00 |
| | Net' | 47,790 | 47.79 | 38,530 | 38.53 | 52,111 | 52.11 | 38,530 | 38.53 | 55,035 | 55.03 | 58,240 | 58.24 |
| Unit value (100 on 29 March 1985) | | 383.1823 | | | | N/A | | | | 499.1936 | | | |

'Net = Gross less 10.0% withholding tax and 0.4% defence fund tax

Source: Al Baraka Türk Özel Finans Kurumu and Central Bank of Turkey Annual Reports

of the deposit term to collect the funds.

The profit distribution on ABT's special investment accounts, which the finance house only began to offer in May 1987, showed an annualised gross rate of return of around 57.5 per cent in 1987. This return, which is higher than that paid to the PLS account holders, is due to the fact that the finance house distributes 90 per cent of its investment profits to the investors.

Although Faisal Finans did not disclose the profit distribution figures to its investors in its annual reports, it appears that the returns were very similar to those of Al Baraka Türk.

As would be expected in inflationary conditions, most deposits are placed for a period of 90 days. At FFK, for example, 90 day term accounts constituted almost 63 per cent of all PLS accounts and over 71 per cent of all PLS funds at the end of 1987, compared to 59 per cent and 69 per cent respectively at the end of 1986.

Although it is not possible to give any precise figure, the finance houses seem to have attracted several thousand customers who had not previously used the services of banks. There are also, of course, clients who have no great religious sentiments and have simply placed their funds with the finance houses in the expectation of earning higher yields than those offered by the conventional banks or by bonds and government securities.

Overall, it appears that the investors with the two finance houses have fared well and have been rewarded adequately with, until recently, relatively high positive real returns. With the opening of branches and with greater public awareness that a safe alternative to conventional banks exists, it is likely that the number of account holders and volume of deposits will continue to grow.

## Equity and assets growth

The equity of the finance houses consists of paid-up capital, capital reserves, undistributed profits and the surplus arising from the revaluation of fixed assets.

Table 6.5 shows that at the end of June 1988, the paid-up capital of ABT was 87.5 per cent and that of FFK 98.8 per cent. Both finance houses have doubled the amount of their authorised capital since their establishment, mainly to allow for the opening of extra branches and to strengthen their ability to meet their objectives. The authorised capital of each finance house at the end of June 1988 was TL 10.0 billion.

The finance houses appropriate a specific percentage of their profits to capital reserves. This appropriation, which is a source of internal financing, is mandatory by law and is presently set at 5 per cent of annual net profits. Besides this "legal" reserve,

Table 6.5

Capital and Reserves of Al Baraka Türk Özel Finans Kurumu
and Faisal Finans Kurumu (TL 000)

| | Authorised capital | Paid-up capital | % paid-up | Reserves, revaluation funds and undistributed profits | % of reserves, revaluation funds and undistributed profits to paid-up capital |
|---|---|---|---|---|---|
| 31 December 1987 | | | | | |
| ABT | 10,000,000 | 6,250,000 | 62.50 | 885,691 | 14.17 |
| FFK | 10,000,000 | 7,000,000 | 70.00 | 1,618,671 | 23.12 |
| 30 June 1988 | | | | | |
| ABT | 10,000,000 | 8,750,000 | 87.50 | N/A | N/A |
| FFK | 10,000,000 | 9,883,906 | 98.84 | 1,959,836 | 19.82 |

Source: Compiled from Finance House Reports

the finance houses also make voluntary reserves, referred to as "special"reserves. These two reserves amount to a substantial sum of money and are considered an integral part of the finance houses' capital.

The amount of undistributed profits, another category of capital composition, is not a significant source of financing due to the fact that the finance houses distribute most of their profits to shareholders after the payment of dividends to depositors and after the appropriation of the reserves.

Also included in the equity of the finance houses is the surplus arising from the revaluation of fixed assets. The amount in this fund at ABT at the end of 1987 was TL 368.9 million, or 5.2 per cent of total equity. The revaluation fund at FFK was far greater, due mainly to increases in the property value of its freehold branches in İstanbul and Ankara. Its revaluation fund stood at TL 1,303.4 million and represented 15.1 per cent of its capital at the end of 1987.

In summary, the total capital of the finance houses amounted to TL 15.8 billion at the end of 1987, 84 per cent of which was derived from paid-up capital, and 16 per cent from reserves, undistributed profits and the revaluation fund.

Total asset growth, especially investments, is an important indication of growth for the finance houses. Table 6.6 shows the growth in total assets at ABT and FFK for the years 1985-1987. The total assets figure excludes the contra accounts which mainly comprise customer liabilities held against letters of credit, guarantees and acceptances and do not represent funds available for the institution's own use.

The assets of ABT grew at a rate of 109.2 per cent in 1986 and 103.6 per cent in 1987 and reached a total of TL 98.6 billion at the end of 1987. Those of FFK recorded growth rates of 135.5 per cent and 98.7 per cent over the same period and at the end of 1987 stood at TL 120.0 billion. At first glance these increases may appear spectacular but several other well-established private Turkish banks and some foreign banks in Turkey actually recorded higher asset growth over the same period. However, this rate of growth would appear to indicate considerable future potential.

The return on assets ratio[1] provides a broad measure of the ability of management to generate earnings from the bank's activities regardless of the source of the funds that support these activities. Table 6.6.1 indicates that the return on assets of ABT has been consistently higher than that of FFK. In 1987, ABT's return on assets was 5.9 per cent compared with FFK's return on assets of 3.4 per cent. The considerable difference between the two ratios appears to indicate management difficulties at Faisal Finans Kurumu. During the first half of 1988 both the general manager and the assistant general manager resigned and the post of general manager remains unfilled. It appears that there have been policy differences between the board of directors and the general management but there are also suggestions that these two employees left to help found

Table 6.6

Assets of Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu, 1985-1987 (TL 000 and percentage growth)

| Type of asset | ABT 1985 | ABT 1986 | ABT 1987 | FFK 1985 | FFK 1986 | FFK 1987 |
|---|---|---|---|---|---|---|
| Unpaid capital | - | - | 3,750,000 | - | - | 3,000,000 |
| Cash* | 6,022,021 | 4,315,385 | 5,630,646 | 3,445,531 | 6,204,122 | 22,774,893 |
| Investments | 14,567,144 | 40,054,865 | 79,557,688 | 18,670,151 | 49,299,398 | 84,534,086 |
| Fixed assets | 57,310 | 1,208,489 | 2,002,942 | 2,092,090 | 2,978,714 | 6,095,314 |
| Others | 2,504,401 | 2,843,184 | 7,621,661 | 1,432,730 | 1,895,660 | 3,589,939 |
| TOTAL | 23,150,876 | 48,421,923 | 98,562,937 | 25,640,502 | 60,377,894 | 119,994,232 |
| % growth | | 109.16 | 103.56 | | 135.48 | 98.74 |

* Includes deposits with the Central Bank and domestic and foreign commercial banks

Source: Compiled from Finance House Reports

Table 6.6.1

Finance Houses: return on assets, 1986-1987 (TL 000)

| | 1985 | 1986 | 1987 |
|---|---|---|---|
| ABT | | | |
| Gross profits | 1,355,583 | 4,629,549 | 5,847,729 |
| Total assets | 23,150,876 | 48,421,923 | 98,562,937 |
| Return on assets | 5.86 | 9.56 | 5.93 |
| FFK | | | |
| Gross profits | 1,235,616 | 2,638,830 | 4,073,728 |
| Total assets | 25,640,502 | 60,377,894 | 119,994,232 |
| Return on assets | 4.82 | 4.37 | 3.39 |

Source: Compiled from Finance House Reports

another finance house in Turkey. Also, unlike Al Baraka Türk, whose balance sheet shows no bad debts, Faisal Finans made bad debt provisions of TL 180.4 million in 1987 and TL 173.5 million in the first half of 1988. These provisions, therefore, may also have hastened their departure.

The structural analysis of deposits, equity and assets involves the consideration of two main ratios, the debt (deposits) to equity ratio and the equity to assets, or capital, ratio. An analysis of the composition of debt and equity in Islamic banking is important due to the restrictions imposed on the use of certain sources, such as current accounts, for investment or loan purposes.[2] As earlier mentioned, the finance houses, in common with all Islamic banks, are not committed to the payment of a fixed rate of interest on time deposits or PLS accounts. Instead, they invest the PLS deposits on behalf of the depositors and charge what is known as a "management fee",which varies between 10-20 per cent. The remaining profit from investment is distributed among the depositors. For this reason, the principle of trading on the equity, or financial leverage, which involves the use of debt in the capital structure to increase the return on investment to the owners, does not apply in Islamic banking, since time deposits are employed in investment projects that could be as profitable as the investments financed from funds derived from shareholders equity. The increase in PLS accounts adds strength to the finance house and creates a significant advantage for the shareholders because the fee charged by the finance house for its role in developing the investment projects financed by the PLS depositors is added to the profits distributed to shareholders. The deposits and equity may also be combined and invested in large and profitable projects that benefit both depositors and shareholders. In other words, there are favourable economic externalities for both depositors and shareholders when their resources are combined.

The total amount of debt and equity for the two finance houses, and its ratio, is given in Table 6.7. It shows, as would be expected, that the finance houses were primarily dependent on capital sources of funds in the early stages of their operations, but once the finance houses had gained the confidence of the community through equity capital, they were able to attract funds from current and profit and loss sharing account holders.

At the end of 1987, the debt to equity ratio of ABT stood at 9.8 per cent, up from 5.9 per cent in 1986, and that of FFK was 10.6 per cent in 1987, compared to 7.5 per cent in 1986. The higher 1987 ratios reveal depositor and community acceptance of the relatively new finance houses and reflect the confidence placed in the ability of the bank management to generate profits on investment.

In Islamic banking, the impact of the capital to assets ratio reflects changes in a bank's capital position. A change in the capital ratio indicates that there is expansion or

Table 6.7

Finance Houses: debt to equity ratio, 1985-1987 (TL 000)

| | 1985 | 1986 | 1987 |
|---|---|---|---|
| ABT | | | |
| Debt | 12,571,802 | 30,237,804 | 70,061,790 |
| Equity | 5,042,675 | 5,166,470 | 7,135,691 |
| Debt-equity ratio | 2.49 | 5.85 | 9.82 |
| FFK | | | |
| Debt | 16,320,267 | 45,735,050 | 91,063,597 |
| Equity | 5,185,840 | 6,064,810 | 8,618,671 |
| Debt-equity ratio | 3.15 | 7.54 | 10.57 |

Source: Compiled from Finance House Reports

contraction in the invested capital or deposit accounts. Since depositors are not guaranteed a fixed rate of return, a higher or lower capital ratio changes the degree of risk assumed by depositors. In the event of temporary losses in the joint investment operations of the bank, or in the case of liquidation, a relatively high capital ratio provides a cushion or safety valve for the depositors.[3]

Table 6.8 shows that each finance house had a very high capital ratio in the first year of operation but that this ratio has declined as the finance houses have gained the confidence of the depositors. At the end of 1987, each finance house had a capital to assets ratio of 7.2 per cent. This figure is slightly less than the capital ratio figures of most riba based banks in Turkey, and indicates a higher degree of reliance on financing the assets through an increase in deposits rather than an increase in equity capital. However, this ratio is still relatively high compared to that of most large conventional banks in Europe and elsewhere.

The high capital ratio is an important feature of Islamic banking because it indicates to equity borrowers, depositors and shareholders a continuity in investments, financing and lending policies.[4]

## Deployment of funds

The deployment of funds available to the finance houses from all sources in financing investment projects is of prime importance, not just for the generation of profits, but for the growth of the finance houses themselves.

Table 6.9 and Chart 6.1 show the total loans and investments outstanding at the end of years 1985-1987 at both finance houses. The table also indicates the cumulative total of loans and investments for each year at ABT. The cumulative figures are not available from FFK. The table indicates that the total loans and investments have increased substantially since the commencement of operations. At the end of 1987, FFK had outstanding loans and investments of TL 84.5 billion, approximately TL 5.0 billion more than those of ABT. The phenomenal growth recorded in 1986, the first full year of operation, slowed considerably in 1987 and looks set to slow further in 1988. Indeed, figures released by FFK at the end of June 1988 revealed that outstanding loans and investments totalled TL 110.8 billion, only 31 per cent greater than at the end of 1987.

The bulk of the funds at ABT and FFK, well over 90 per cent, are used to finance trade, known as murabaha investments. Both finance houses fix a maximum repayment period of 12-18 months but most trade finance deals are, in fact, completed within 6 months. During 1987, ABT provided finance for 1166 trade projects valued at TL

Table 6.8

Finance Houses: capital ratio, 1985-1987 (TL 000)

| | 1985 | 1986 | 1987 |
|---|---|---|---|
| ABT | | | |
| Capital and reserves | 5,042,675 | 5,166,470 | 7,135,691 |
| Total assets | 23,150,876 | 48,421,923 | 98,562,937 |
| Capital ratio | 21.78 | 10.67 | 7.24 |
| FFK | | | |
| Capital and reserves | 5,185,840 | 6,064,810 | 8,618,671 |
| Total assets | 25,640,502 | 60,377,894 | 119,994,232 |
| Capital ratio | 20.23 | 10.04 | 7.18 |

Source: Compiled from Finance House Reports

Chart 6.1

## Investment Growth at the Finance Houses

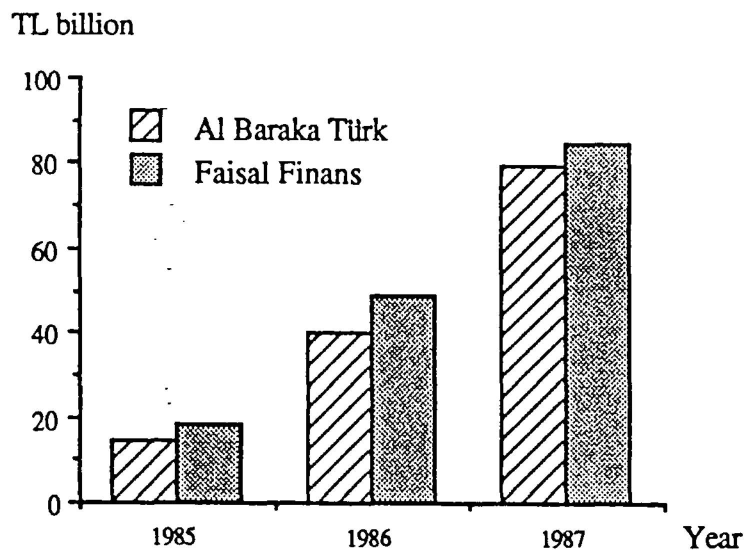


Table 6.9

Loans and Investments of Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu, 1985-1987 (TL 000 and percentage growth)

| | ABT | | | FFK | | |
|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 |
| Loans and investments outstanding at 31 Dec | 14,567,144 | 40,054,865 | 79,557,688 | 18,261,150 | 49,299,398 | 84,534,087 |
| % growth | | 174.97 | 98.62 | | 169.97 | 71.47 |
| Loans and investments made during the year | 24,899,362 | 48,551,614 | 120,978,870 | N/A | N/A | N/A |
| % growth | | 94.99 | 149.18 | | | |

Source: Compiled from Finance House Reports

110.0 billion, as indicated in Table 6.10. This was more than twice the number of projects financed in 1986 and an increase of around 141 per cent in the value of such finance. Although FFK does not disclose the cumulative value or number of its murabaha transactions, its balance sheet does give the value of murabaha projects outstanding at the end of each year. The total at the end of 1987 was TL 82 billion, and this would appear to indicate that for the year as a whole the value of its murabaha projects would have exceeded that of ABT.

Murabaha transactions have covered both national and international trade. In 1987, both finance houses were involved in the syndication of separate murabaha facilities of around $ 50 million each for the importation of crude oil by the state petroleum company Tüpraş. Each finance house had a five per cent stake in the facility which was arranged by their Jeddah and Bahrain offices.

The finance houses are aiming to decrease their involvement in this short term finance and to move towards greater investment in more medium to long term projects. From statements which have appeared in their annual reports, it seems clear that the finance houses believe that there is too much emphasis on easy to arrange and relatively risk-free murabaha projects. ABT's 1985 annual report states "murabaha transactions occupied an overwhelming proportion of Al Baraka Türk's total placements. In the years to come, the finance house plans gradually to increase the share of other types of investment, such as profit and loss sharing." The 1986 annual report of FFK states "profit and loss sharing deals occupied a rather small volume of total financing, due to various market problems encountered during this period. It is hoped that such deficiencies will be overcome in the near future and the priority of FFK operations will shift gradually to PLS projects."

The word "gradually", used by both finance houses, seems significant. In 1986, non-murabaha investments at ABT occupied 6 per cent of total investments and, in 1987, 9 per cent. At the end of 1987 the percentage value of non-murabaha projects outstanding at FFK was 3 per cent, compared to almost 13 per cent in 1986, and figures for the end of June 1988 show a further (slight) decrease.

Non-murabaha projects at Faisal Finans consist entirely of musharaka, or profit and loss sharing, projects. Al Baraka Türk is also involved in ijara finance.

Table 6.10 shows that ABT set up 49 profit and loss sharing projects in 1987, compared to 14 in 1986 and only 3 in 1985. The total value of PLS projects financed in 1987 was TL 9.9 billion, an increase of approximately 234 per cent over the 1986 figure of TL 3.0 billion and representing 8 per cent of total loans and investments. At the end of 1987, FFK had musharaka projects valued at TL 2.5 billion outstanding, or 3 per cent of all loans and investments. In theory, musharaka projects are of a medium to long term nature but in Turkey these profit and loss projects are related only to short term trade finance. This is evident by a look at the end of year figures for Faisal Finans.

Table 6.10

Type and Number of Loans and Investments at Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu, 1985-1987
(TL 000 and percentage growth)

| Type | ABT | | | | | | FFK | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1985 | | 1986 | | 1987 | | 1985 | | 1986 | | 1987 | |
| | Value | Number | Value | Number | Value | Number | Value | Number | Value | Number | Value | Number |
| Murabaha outstanding at 31 Dec | | | | | | | 18,055,161 | - | 43,043,224 | - | 81,987,276 | - |
| % growth | | | | | | | - | - | 138.40 | - | 90.48 | - |
| Musharaka outstanding at 31 Dec | | | | | | | 205,989 | - | 6,256,174 | - | 2,546,811 | - |
| % growth | | | | | | | - | - | 2,937.14 | - | -59.29 | - |
| Mudaraba outstanding at 31 Dec | | | | | | | - | - | - | - | - | - |
| % growth | | | | | | | - | - | - | - | - | - |
| Ijara outstanding at 31 Dec | | | | | | | - | - | - | - | - | - |
| % growth | | | | | | | - | - | - | - | - | - |
| Murabaha 01 Jan-31 Dec | - | 158 | 45,583,167 | 577 | 110,010,819 | 1166 | | | | | | |
| % growth | - | - | - | 265.19 | 141.34 | 102.08 | | | | | | |
| Musharaka 01 Jan-31 Dec | - | 3 | 2,968,447 | 14 | 9,903,490 | 49 | | | | | | |
| % growth | - | - | - | 366.67 | 233.63 | 250.00 | | | | | | |
| Mudaraba 01 Jan-31 Dec | - | - | - | - | - | - | | | | | | |
| % growth | - | - | - | - | - | - | | | | | | |
| Ijara 01 Jan-31 Dec | - | - | - | - | 1,064,561 | 5 | | | | | | |
| % growth | - | - | - | - | - | - | | | | | | |
| TOTAL | 24,899,362 | 161 | 48,551,614 | 591 | 120,978,870 | 1220 | 18,261,150 | - | 49,299,398 | - | 84,534,087 | - |

Source: Compiled from Finance House Reports

In 1986 it had musharaka projects valued at TL 6.3 billion whereas the figure at the end of 1987 was only TL 2.6 billion, a decrease in one year of TL 3.7 billion.

Neither finance house has so far arranged any mudaraba advances.

Although the annual reports of both finance houses do not disclose full details about the types of financing, whether trade or corporate, short or long term, it would appear that most investment is made in the short term financing of working capital or in the short term financing of trade. Medium and longer term financing is provided not on the basis of participation but on the basis of ijara or leasing contracts.

In 1987, Al Baraka Türk started to finance medium term projects by means of leasing. It arranged 5 leasing projects valued at just over TL 1.0 billion. The projects involved the leasing of textile machines, intercity buses, cars and computers. Although repayments will be made over a four year period, which is the legal minimum for such items, the bulk of the repayments will be made in the first two years of the agreement. At the end of the leasing period, the client will make a final repayment and obtain ownership of the goods in question. In Turkey, leasing offers certain tax advantages to the lessee which, the finance house believes, will make leasing an increasingly popular form of finance. Accordingly, ABT expects the total amount of financial leasing to rise considerably in the years ahead.

The sectoral distribution of funds at ABT and FFK, shown as percentages, appears in Table 6.11. The figures reveal a different emphasis on some sectors between the two finance houses. In 1985, for example, ABT invested most funds, 40.7 per cent, in chemical and petrochemical projects, whereas the sector that received most funds from FFK was agriculture. The machinery and equipment sector received most funds from ABT and FFK in 1986, a total of 28.2 per cent and 19.7 per cent respectively. In 1987, the two finance houses invested most heavily in the chemicals and petrochemicals sector, due mainly to murabaha financing of oil imports. The textiles and metals sectors were also important recipients of funds over the period 1985-1987.

The fund utilisation ratio, which gives an indication about the extent of loans and investments made from available funds is derived by dividing the total amount of loans and investments by the total amount of funds available for such purposes. The latter includes all deposits, except current accounts, and total capital and reserves. The current accounts are excluded because they can be withdrawn on demand and are not entitled to any profit distribution. The higher the ratio the greater the employment of funds generated from deposit accounts and capital in investment activities.

As can be seen in Table 6.12, both finance houses had very high utilisation ratios in the period 1985-1987. The two finance houses have generally experienced no

Table 6.11

Sectoral Distribution of Loans and Investments at Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu (percentage) 1985 - 1987

| | ABT | | | FFK | | |
|---|---|---|---|---|---|---|
| Sector | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 |
| Chemicals and petrochemicals | 40.7 | 20.4 | 29.4 | 13.3 | 19.6 | 24.2 |
| Construction | 2.5 | 5.0 | 4.8 | 5.9 | 3.8 | 5.4 |
| Foodstuffs | 10.9 | 5.8 | 1.0 | 11.7 | 9.7 | 8.2 |
| Machinery and equipment | 18.3 | 28.2 | 22.8 | 8.7 | 19.7 | 15.2 |
| Textiles and leather goods | 11.2 | 19.6 | 24.3 | 16.6 | 11.5 | 9.4 |
| Pharmaceuticals | 3.7 | 2.2 | 0.7 | - | - | - |
| Metals | 5.5 | 11.9 | 12.5 | 14.5 | 11.7 | 18.3 |
| Paper and packaging | 7.2 | 6.9 | 4.5 | 8.4 | 9.2 | 6.9 |
| Agricultural produce | - | - | - | 20.9 | 14.8 | 12.4 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Compiled from Finance House Reports

Table 6.12

Finance Houses: funds utilisation ratio, 1985-1987 (TL 000)

| | 1985 | 1986 | 1987 |
|---|---|---|---|
| ABT | | | |
| Deposits plus capital and reserves | 15,612,768 | 33,401,576 | 70,755,440 |
| Loans and investments | 14,567,144 | 40,054,865 | 79,557,688 |
| Utilisation ratio | 93.30 | 119.92 | 112.44 |
| FFK | | | |
| Deposits plus capital and reserves | 19,092,121 | 49,312,768 | 91,778,531 |
| Loans and investments | 18,670,151 | 49,299,398 | 84,534,086 |
| Utilisation ratio | 97.79 | 99.97 | 92.10 |

Source: Compiled from Finance House Reports

problems in utilising their lira or foreign currency funds as there are many opportunities for local trade and import and export finance.The ratio of Al Baraka Türk exceeded 100 per cent in 1986 and 1987, implying that the finance house had employed the amounts received from its current account depositors in its investment activities. However, there is nothing wrong in this, provided that the finance house complies with the requirements of Article 17 contained in the rules and regulations issued by the Undersecretariat of the Treasury and Foreign Trade, governing the "utilisation of funds accumulated in current accounts."

In addition to providing finance to individuals and businesses for investment purposes, Faisal Finans has itself made direct investments. At the end of 1987 it had majority shareholding participations in two companies, Faisal Foreign Trade and Marketing and Faisal Real Estate Construction and Trading, worth almost TL 1.3 billion. It also had 11 per cent stakes in Kıbrıs Faisal İslam Bankası (Faisal Islamic Bank of Cyprus) and Kibris Faisal İslam Yatırım Şirketi (Faisal Islamic Investment Company of Cyprus) valued at TL 120 million. However, during the first half of 1988, it sold these stakes, at a profit, in order to concentrate all activities in Turkey.

To date, the role of the finance houses in Turkey's economic development has been confined mainly to trade financing. It is the hope of many, both within the finance houses themselves, and within the Muslim community at large, that as the technical and managerial skills of the finance houses develop there will be a move away from trade financing activities towards greater investment in more medium and long term projects such as musharaka and mudaraba that will contribute more to Turkey's economic and social development.

### Profits and factors affecting profitability

Of the two finance houses, the operations of Al Baraka Türk are the more profitable, as revealed in Table 6.13 and Chart 6.2. It made a pre-tax profit of TL 5.8 billion in 1987, a rise of 26.3 per cent over the 1986 figure of TL 4.6 billion. Faisal Finans recorded a pre-tax profit of TL 4.1 billion, up by 54.4 per cent over the TL 2.6 billion it made in 1986. After payment of corporation and other taxes ABT's net profit in 1987 was TL 3.3 billion. The annual reports of FFK do not reveal the net profit figures.

Although these nominal increases may, at first glance, appear high it must be remembered that inflation in Turkey in 1987 was around 35 per cent, and so, in effect, ABT actually recorded a negative rate of increase in its profits. Figures released at the

Chart 6.2

Gross Profits at the Finance Houses

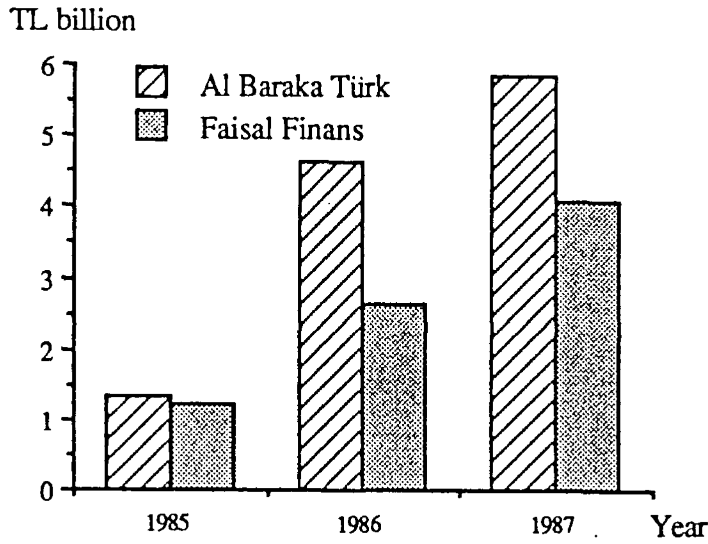


Table 6.13

Gross Annual Profits at Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu, 1985-1987
(TL 000 and percentage growth)

| | ABT | | | FFK | | |
|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1985 | 1986 | 1987 |
| Gross profit | 1,355,583 | 4,629,549 | 5,847,729 | 1,235,616 | 2,638,830 | 4,073,728 |
| % growth | | 241.52 | 26.31 | | 113.56 | 54.38 |

Source: Compiled from Finance House Reports

end of June 1988 show that both finance houses made profits of just under TL 2.0 billion each in the first half of 1988, a rate of growth which, if continued in the second half of 1988, will lead to substantial nominal and real profit decreases over the 1987 figures.

The main reason for ABT's higher gross profit and higher return on assets (Table 6.6.1) is probably due to the composition of its deposits. It has far more lira deposits than FFK and it appears that there are greater profitable opportunities for the deployment of lira funds than for the placement of foreign currency of which FFK has considerably more. The margins earned on lira funds are also generally higher than those on foreign currencies. Other possible reasons for ABT's greater profitability could be its higher utilisation of funds, its sectoral breakdown of investments, the type of business which it finances or simply better management.

The extensive use of modern technology, including on-line computers to all branches, has enabled both finance houses to record substantial gross profits per employee figures. Faisal Finans with 132 employees at the end of 1987, had figures of around TL 31.0 million per employee, while those of Al Baraka Türk, which had just over 100 employees, were in excess of TL 55.0 million per employee.

Once provision for taxation and transfers to reserves have been made the remaining profit is distributed to shareholders as dividends. ABT discloses the amount of its dividend payments, FFK does not. At Al Baraka Türk, dividends as a percentage of paid-up capital increased from 12 per cent in 1985 to 40 per cent in 1986 and 1987. Earnings per share of TL 100,000 in 1985, 1986 and 1987 were TL 14,262, TL 52,227 and TL 53,542 respectively. The dividends paid to shareholders are therefore less than those paid to PLS depositors.

Profits made by the two institutions seem to have suffered as a result of increased competition for funds within the financial sector which has led to a lowering of margins. High inflation has now made the returns on all conventional bank deposits and finance house profit and loss sharing accounts negative which has led the public to invest in higher yielding government securities, gold and real estate. The profits of the finance houses are therefore likely to remain depressed for the foreseeable future.

### Competition within the financial sector

In Turkey, where a duopolistic financial situation exists, competition is the main issue between the two Islamic finance houses and the more than fifty riba based conventional banks. The finance houses compete, in varying degrees, both with each other and with the riba banks and financial institutions.

Legislation sets the finance houses apart from other commercial banks. Their

methods of operation and the financial products they offer are different from those of the riba based banks. Their annual figures are excluded from all Treasury and Central Bank reports and statistics covering the financial sector. The various regulatory bodies deal discreetly with the finance houses and this rather low profile appears to suit the finance houses which do not wish to attract attention or criticism from other financial institutions over what some see as their favoured treatment and status.

Both finance houses offer a similar range of services and it appears that profits paid to their profit and loss sharing depositors are also very similar. Strict rules on advertising preclude the finance houses from making any religious references or direct comparisons with each other or with the conventional riba banks in matters such as returns on deposits, efficiency or profitability. Clients, or prospective clients can, however, work out for themselves, from the unit values that are announced weekly, the rate of return on PLS funds at each finance house but it is unlikely that many do so. A comparison could then be made with the rates offered to depositors by the riba banks which are fixed by the Central Bank and advertised widely.

Although both finance houses are competing for the same funds, there does not appear to be any overt price competition. When deciding such things as murabaha mark-ups, the finance houses take many factors into consideration and so direct comparisons between the two are difficult to make.

The returns on PLS lira deposits of under one year remain higher than the yields of deposits of similar terms at the riba based banks but both finance houses are well aware that their one year participation deposits now offer less returns than such deposits at the conventional banks. The profits distributed on foreign currency participation accounts closely reflect the rates of interest paid by riba banks.

For many Muslims however, the returns offered by the finance houses are of secondary importance. The overriding importance of these institutions is that they provide an opportunity for conducting financial transactions in conformity with Islamic principles by the avoidance of riba. As such, they do not compete directly for existing depositors but represent an alternative to conventional riba banks.

Despite the fact that the market share captured by the finance houses is steadily increasing, it appears that this is a result of these institutions offering financial products which appeal to believers and not as a result of direct competition with riba banks. The finance houses are obliged to act prudently to earn goodwill and customer loyalty and to maintain their good reputation. Profits can only be increased by the development of new products and services and not by trying to increase market share by undercutting riba based banks. This would only lead to a further reduction in their already relatively low margins and possibly liquidation.

Overall, the Islamic finance houses have shown that they can operate successfully in a very competitive financial sector and that they complement, rather than compete

with, the commercial riba banks.

## Conclusion

Although the two finance houses have been in operation only since early 1985 the growth of their deposits, assets, investments and profits has exceeded most expectations. This initial rapid growth has now decreased somewhat and 1988 is likely to see a consolidation of their activities.

Both finance houses have high utilisation of funds ratios but with most of these funds being used to finance short term trade this appears to result in little tangible benefit for the Turkish economy or its people. This emphasis on trade finance conflicts with the ideology and theory of Islamic banking, the main aims of which are to provide a fair return to depositors and shareholders and to offer social services to the Islamic community. It is the neglect of medium and long term profit and loss financing that both special finance houses need to remedy in the near future.

In Turkey, the finance houses can contribute to the country's economic development by attracting the untapped savings of people who at present do not deal with banks and the people who have savings accounts at conventional riba banks, in conflict with their religious convictions. The real contribution of the finance houses will come from their investment activities in development projects on an equity participation basis.

Despite the growing competition in the financial sector, it is likely that the next few years will witness an increase in the number of institutions operating along Islamic lines in Turkey. Indeed, a third finance house, "Türk-Kuveyt Evkaf Finans Kurumu", has recently received permission to operate in Turkey and is expected to open by the end of 1988. This finance house will have an initial capital of TL 15 billion and its major shareholders will be the Islamic Development Bank, the Kuwait Finance House and Vakıflar Bankası.

Islamic banking has thus shown that it can operate side by side with conventional banking and appears to have become a permanent force within the Turkish financial sector.

Footnotes

1. For the finance houses this ratio has been calculated using gross profit figures as net profit figures are unavailable from Faisal Finans Kurumu.
2. A.M. Abdeen and D.N. Shook, The Saudi Financial System in the Context of Western and Islamic Finance (1984), p. 221.
3. Ibid., p. 223.
4. Ibid., p. 225.

## CONCLUSION

The ideology of Islamic banking stems from the principles and beliefs in the basic values of Islam. A great deal has been written about the theory and practice of Islamic banking over recent years. There is no one view about what constitutes Islamic banking nor is there an exact definition of what makes a bank "Islamic". However, there is unanimous agreement about the prohibition of riba, and that the purpose of Islamic banks is not solely economic, but that they exist as instruments for accomplishing the spiritual and religious values of mankind. Much of the literature centres on the methods of financing involved in Islamic banking and documentation on the actual practice is often unpublished. The lack of any concise practical guide to Islamic financial instruments or standard reference manual has led to a considerable divergence in Islamic financial practice between institutions.

Islamic banks differ in form of ownership and in their emphasis on certain goals and operating methods. Other factors such as geographical scope of operations, the size and age of the bank and management structure cause these banks to differ in their form of organisation.

The ban on usury in the operations of the Islamic banks places a heavy burden on the kinds and methods of investment utilised. In theory, the Islamic banks should look for investment opportunities in all sectors of the economy and not just confine themselves to sectors that promise high and quick returns. In practice, however, when management is faced, in some cases, with high cash balances and delays in investing in long term projects, it resorts to other projects and operations that secure adequate return and conform to financially and religiously permitted practice. This often means murabaha finance.

Certainly, in Turkey, there is a heavy concentration on this method of finance and to many the mark-up is seen as unsatisfactory. In Turkey, the emphasis on short term finance has brought little benefit to the economy and has attracted considerable criticism from people who believe that the two finance houses should begin to move away from trade finance to more medium and longer term equity finance. Indeed, Islamic literature stresses the role Islam should play in economic development.

Due to the fact that the Islamic banks' depositors assume a greater degree of risk, the Islamic banks have to provide their investors with a higher rate of return than the rate paid in interest on comparable deposits with conventional riba banks. This is a real challenge in Turkey where high inflation currently makes yields on all finance house participation accounts, and conventional bank deposits, negative in real terms.

With the increase in the number and capital of the Islamic banks due to their acceptance by the people and governments of several Islamic nations, a need for a technical advisory body arose. This led to the establishment, in 1977, of the

International Association of Islamic Banks (IAIB), whose main objective is to strengthen relations and cooperation among Islamic banks. However, not all Islamic banks are members of this association, the most notable non-member being the Al Baraka Group.

Among Islamic bankers, there is a general feeling that the IAIB, or even the Islamic Development Bank, could, and perhaps should, do more to foster relations between Islamic banks and to help unify the banks' diverging practices and operating methods. It could perhaps introduce an international Islamic accounting standard or guidelines although in Turkey the authorities would find this unacceptable, as here the finance houses are required to submit audited accounts in a format decided by the Central Bank. There have also been suggestions that the IAIB could have its own Sharia advisers to audit the member banks but this idea would seem unworkable given the fact that the Islamic banks are operating in countries adhering to different branches or sects of Islam.

Turkey does benefit greatly from its membership of the Islamic Development Bank, and since joining in 1974 it has received credits of around one billion dollars. Turkey's strong links with the IDB are maintained through the Özal family connections.

In countries where Muslims form a minority of the population, some conventional banks are now catering for the demands of their Muslim clients by offering Islamic financial services. In the world's financial centres there are links between Islamic and non-Islamic institutions which mainly revolve around the provision of trade finance facilities. The western money markets also provide Islamic banks with opportunities for diversified portfolio investment which is unavailable in the Islamic world. Several large western banks now offer a range of Islamic products and often act as correspondents for the Islamic banks, ensuring that their services carried out on behalf of the Islamic correspondents avoid riba. Transactions are not undertaken in the forward or futures markets nor are there dealings involving such items as government bills and corporate bonds. There are, however, difficulties involved by wholly Islamic banks operating in a non-Islamic environment. The present banking system and fiscal legislation in practice in Western countries are not compatible with the objectives and characteristics of Islamic banks, and some arrangement with the banking authorities to permit the Islamic banks to function more freely will have to be evolved. Although most non-Islamic banks are concerned mainly with murabaha finance, some also offer Islamic unit trusts. There are also plans by some riba based banks to provide mortgage facilities which avoid the payment of interest and to offer leasing arrangements.

In Turkey, a predominantly Muslim country with around 54 million inhabitants, there are perhaps the best prospects for Islamic banking. Since 1980, Turkey has enjoyed a fast economic rate of growth and prospects for further growth look promising given the fact that there is an established industrial base, agricultural

self-sufficiency, a booming tourist sector and a government committed to private enterprise. In recent years it has become a much more open and liberal society with more toleration being shown towards Islam. The rapid growth at Al Baraka Türk Özel Finans Kurumu and Faisal Finans Kurumu indicates that there is a demand for Islamic banking services. As these two finance houses account for just over one per cent of all Turkish bank deposits, the scope for expansion is clearly enormous. The finance houses have proved that banking growth and profitability do not have to depend on the practice of receiving and paying interest.

The lead taken by the prime minister in enacting legislation to permit the establishment of Islamic banks in Turkey appears to have been justified. Although the finance houses are subject to a heavy degree of close supervision from the various regulatory authorities, the degree of supervision does make investors feel more secure and confident in their dealings with the finance houses. The Islamic banks in Turkey complement the existing conventional banks and other financial institutions and have encouraged banking habits among the Turkish population.

In areas which benefit the economy, the Turkish finance houses still have much to do. They must begin to participate in medium and longer term equity projects. In evaluating the viability of projects, banking skills are important and a fully trained staff, conversant in Islamic ideology, is essential.

The continuing success of Islamic banks in Turkey, and indeed the world, will depend upon cooperation with one another, the conventional banks and the central banking authorities, and on the expansion of Islamic business ventures through the development of existing and innovative financing schemes.

Given support by Muslim governments and Muslims throughout the world, the Islamic banking movement seems set to continue its growth and influence.

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