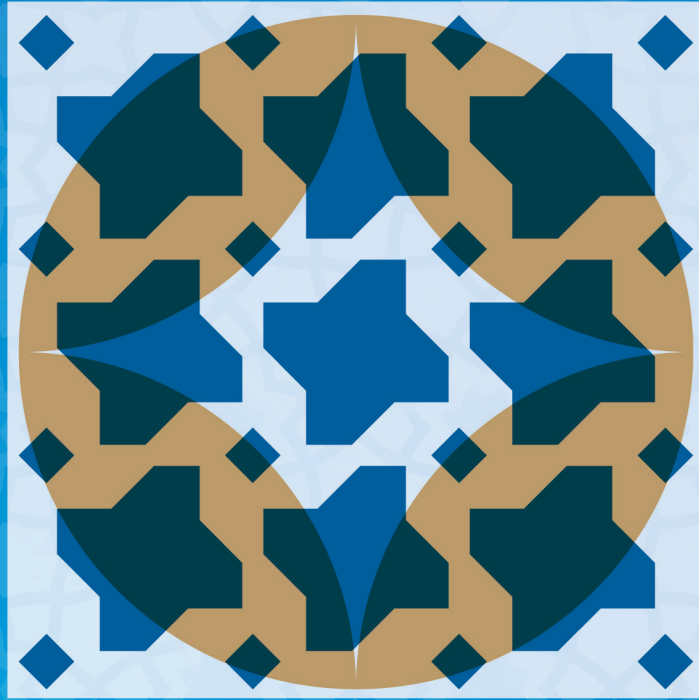




# PARTICIPATION (ISLAMIC) FINANCE COUNTRY REPORT



REPUBLIC OF TURKEY  
PRIME MINISTRY  
Undersecretariat of Treasury





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NOVEMBER 2016



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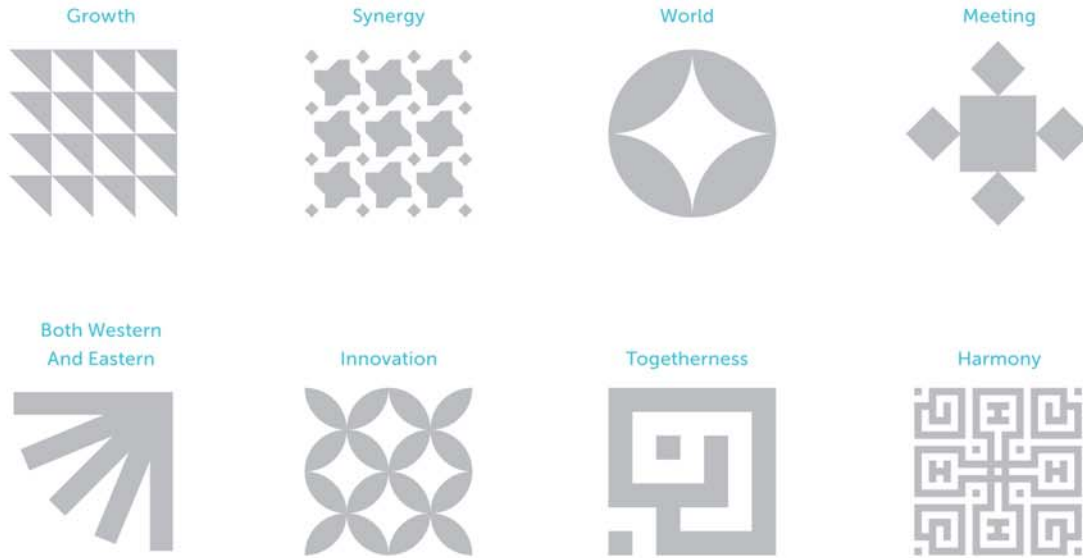




## Discover the potential

Turkey Discover the Potential logo is made up of 8 key traditional motifs. Each motif represents a different value of rising Turkey.

Here are the motifs and their meanings.



Turkey Participation (Islamic) Finance Report is a report prepared for 32nd session of the Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation (COMCEC) under the coordination of the Undersecretariat of Treasury, with the invaluable contributions from Central Bank of the Republic of Turkey, Banking Regulation and Supervision Agency, Capital Markets Board of Turkey, Savings Deposit Insurance Fund and Participation Banks Association of Turkey.

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# FOREWORD BY THE DEPUTY PRIME MINISTER



The global financial crisis has revealed the importance of more resilient and more inclusive financial systems. The policy makers have been trying to reestablish the nexus between financial system and real economy since then.

Assessing vulnerabilities at global financial systems and restructuring the global financial architecture to avoid a similar crisis have been top agenda items of international fora and governments over the last years.

In this conjuncture, Islamic finance has come under the spotlight. The essence of Islamic finance, its equity-based or asset-backed finance principle, was successfully deliberated during Turkey's G20 Presidency in 2015. The world now focuses on strong fundamentals of Islamic finance to be utilized in achieving the UN Sustainable Development Goals. It attracts interest from all over the world with its socially responsible and inclusive growth friendly nature.

We have a great window of opportunity for Islamic finance. The Turkish government is committed to improving the interest-free finance sector ecosystem in Turkey. We have already devised a comprehensive action plan to strengthen Islamic finance as a part of our efforts to turn Istanbul into an international financial center.

To boost the interest-free finance sector in Turkey, we have established Interest-Free Finance Coordination Board. The Board brings together relevant policy makers and institutions responsible for interest-free finance in Turkey. Based on our strong support for the sector, the sector set an ambitious target to triple the share of Islamic finance in ten years. In order to achieve this target, the sector should lead through innovation, leaving behind mimicking conventional financial products.

I hope the report will serve as a valuable source for the readers and policy makers, who seek to have a deeper understanding of Islamic finance sector in Turkey. I would like to thank everyone for their valuable works and significant contributions to this report.

**Mehmet ŞİMŞEK**  
Deputy Prime Minister

# FOREWORD BY THE UNDERSECRETARY



Islamic finance does not allow charging of interest (riba), speculative behaviors and transactions, which include extreme uncertainty (gharar), gambling (maysir) and excessive risk taking as well as short sales and money hoarding.

In this sense, Islamic finance, with its strong principles, promises a new breathe to the world after the severe financial crisis.

The report takes a snapshot of the Islamic finance landscape and exhibits the initiatives and strategies deployed to improve the sector. With more than a thousand branches and around 5 percent share of the overall banking sector, participation banks in Turkey have a highly promising potential for growth. The sector aims to triple the share of the participation banks to 15 percent by 2025.

Turkey issued its first corporate sukuk in 2010 and sovereign sukuk in 2012. We consider and aim that the future of Turkey's sukuk market will be exceptionally favorable and thriving for the following years. Participation insurance (takaful) is a relatively new but highly promising market in Turkey.

As the secretariat of the Interest-Free Finance Coordination Board and the responsible institution to prepare this report, Turkish Treasury has coordinated and successfully finalized this invaluable report with the strong support of the relevant institutions.

It took several months to prepare this report; however, our purpose is to be a catalyzer for the efforts in this area. I am sure that, especially, the sector and academia will take breathtaking initiatives and conduct spectacular studies to lead disruptive changes for a more prosperous future.

I would like to thank all my colleagues and the contributors for their dedicated work to launch this report.

**Osman ÇELİK**  
Undersecretary of Treasury

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# ABBREVIATIONS

ALC	Asset Leasing Company
BRSA	Banking Regulation and Supervision Agency
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CBRT	Central Bank of the Republic of Turkey
CMB	Capital Markets Board of Turkey
EU	European Union
G20	Group of 20
HMVKŞ	Undersecretariat of Treasury Asset Leasing Company (Hazine Müsteşarlığı Varlık Kiralama Şirketi)
IDB	Islamic Development Bank
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
LOLR	Lender of Last Resort
MPC	Monetary Policy Committee
MTP	Medium Term Program
OECD	Organization for Economic Co-operation and Development
OIC	Organization of Islamic Cooperation
OMO	Open Market Operation
PBAT	Participation Banks Association of Turkey
PD	Primary Dealer
REIT	Real Estate Investment Trusts
REMF	Real Estate Mutual Funds
SFH	Special Finance House
SPV	Special Purpose Vehicle
VCPET	Venture Capital and Private Equity Investment Trust

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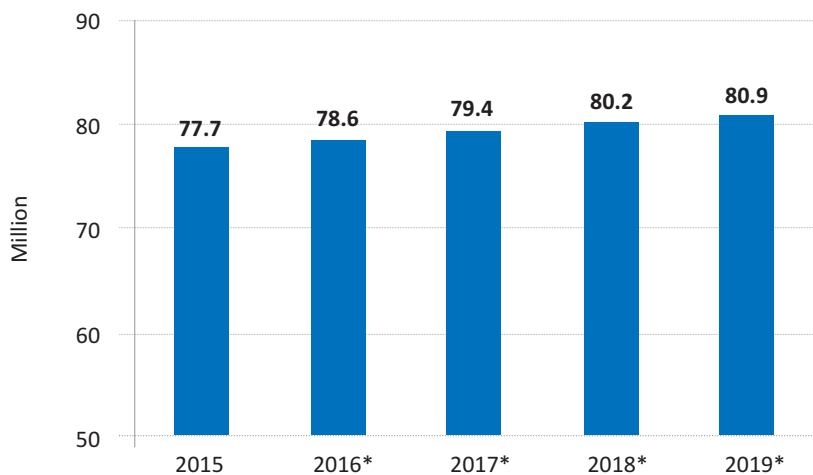
## A

# Country Overview

Turkey, situated at the junction of Europe and Asia in the Anatolian peninsula, is an important crossroads between Western Europe, the Middle East and Asia. Turkey's location has been a central feature of its history, culture and politics. Turkey has an area of approximately 780 thousand square kilometers. While Turkey's sea coastal line is around 8.3 thousand kilometers, its land borders extend for more than 2.6 thousand kilometers and are shared with eight countries: Greece and Bulgaria in the northwest, Iran in the east, Armenia, Georgia and Azerbaijan in the northeast and Iraq and Syria in the south.



**Figure 1 Population Prospects (Mln. People, Mid-Year)**



Source: Ministry of Development

(\* ) 2017-19 Medium Term Economic Program

Turkey has young, dynamic, well-educated and multicultural population and largest youth population among the EU countries. Turkey has more than 78 million population, which is expected to increase as seen in the Figure 1 (Ministry of Development), and half of which is under age 31. Forward looking, as of 2050, Turkey is expected to have more than half of its population between 14 and 60 years old (Turkish Statistical Institute, 2016).

**Table 1 Quick Facts about Turkey (2015)**

<b>Government</b>	Parliamentary Democracy
<b>Population</b>	78.7 million
<b>Labor Force (Population)</b>	29.7 million
<b>Median Age</b>	31
<b>Neighboring Countries</b>	Bulgaria, Greece, Syria, Iraq, Iran, Azerbaijan, Armenia, Georgia
<b>Major Cities (Population)</b>	Istanbul (14.6 million) Ankara 5.2 million Izmir (4.1 million) Bursa (2.8 million)
<b>GDP</b>	720 billion USD (Current Prices)
<b>GDP Per Capita</b>	USD 9,261
<b>Trade Agreements</b>	Customs Union Agreements with the EU Free Trade Agreements with several countries
<b>Diplomacy</b>	Member of G20 EU Candidate Country Member of NATO Member of OIC

Turkish Grand National Assembly exercises legislative power on behalf of the Turkish nation and this power cannot be delegated. Parliamentary elections are held every four years for 550 deputy's seats.

Independent courts and high judicial institutions have judicial power in Turkey; they apply the laws on behalf of the Turkish nation. The judicial section of the Constitution is based on the principle of the rule of law. The judiciary is founded on the principles of the independence of the courts and security of judicial tenure.

Turkey's executive branch structure is composed of the President of the Republic and the Council of Ministers (Cabinet). The President of the Republic is the head of State and represents the Republic of Turkey and the unity of the Turkish nation.

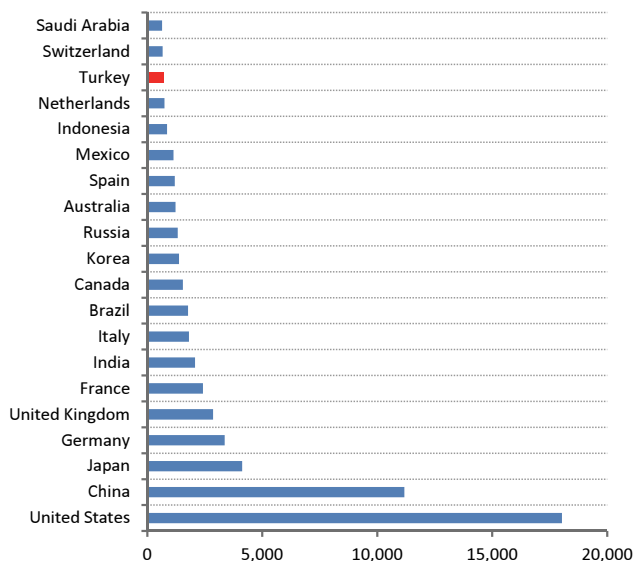
Turkey is highly active in diplomacy and a member of many multilateral organizations such as Group of 20 (G20), Organization for Economic Co-operation and Development (OECD), International Monetary Fund (IMF), and Organization of Islamic Cooperation (OIC). It has also candidacy status for the European Union and the accession negotiation has been progressing.

# 1. Macroeconomic Outlook

Turkey has showed a significant transformation progress and achieved a rapid and fairly stable growth performance over the last decade thanks to prudent macroeconomic policies and the structural reforms implemented. Since 2002 per capita income has almost tripled.

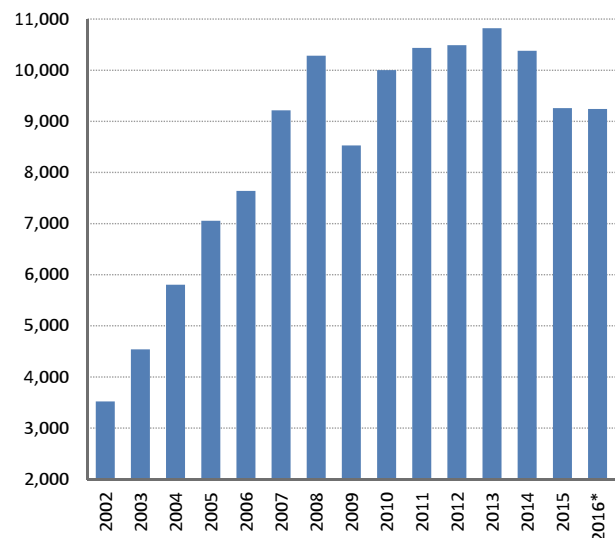
As of 2015, Turkey is the 18th largest economy in the world and 7th largest within the European countries according to the IMF with its USD 720 billion GDP and USD 9,257 GDP per capita (International Monetary Fund, 2016). Real GDP of Turkey has been growing at an annual rate of 5 percent approximately over the past 13 years. With its strong economic fundamentals Turkey was able to overcome the adverse effects of the global financial crisis. So it has performed positive growth rates since the last quarter of 2009. The growth momentum is expected to continue according to Medium Term Program 2016-2018.

**Figure 2 World's Largest Economies (Trillion Dollar, 2015)**



Source: IMF, World Economic Outlook, October 2016

**Figure 3 Per Capita GDP (USD)**



Source: TURKSTAT

\*2017-2019 Medium Term Program

The Turkish economy grew by 4.0 percent in 2015, more than twice the growth rate of emerging market economies excluding China and India. This growth was achieved in spite of two general elections, geopolitical tensions in the region, weak performance in Turkey's trade partners and the volatility in global financial markets.

In the first half of 2016, real GDP growth realized at 3.9 percent, due to strong domestic demand mainly driven by private consumption. Domestic demand contributed 5.7 percentage points to growth while contribution of net external demand was negative 1.8 percentage points. Private consumption remained to be the main contributor of domestic demand with 4.1 percentage points to annual growth. Contribution of public sector consumption was 1.5 percentage points.

Within this period, industry and service sectors grew by 4.8 percent and 4.3 percent, respectively. Agriculture sector, however, increased only by 0.3 percent due to momentum loss in production because of unfavorable weather conditions and the high base effect of the previous year.

The weakening in global trade, volatility in global financial markets and ongoing geopolitical tensions in the region limited the economic growth performance in the first half of 2016.

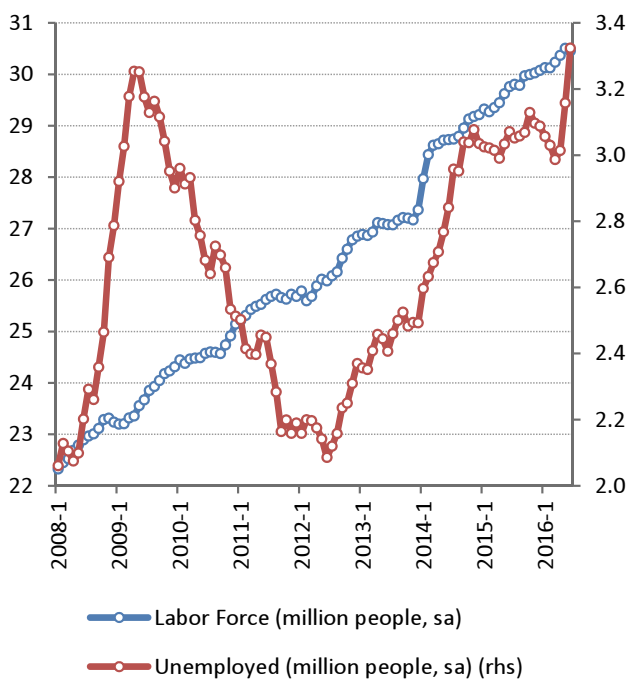
Economic growth is expected to slow down noticeably in the third quarter of 2016 due to the negative impact of the failed coup attempt on 15th of July and further decline in tourism revenues. On the contrary, in the last quarter, the economy is expected to rebound again thanks to the measures taken in the domestic market and normalization process with Russia. As a result, 2016 year-end growth rate is projected as 3.2 percent in the recently announced Medium Term Program (MTP) 2017-19 (Ministry of Development).

Turkey gives utmost importance to inclusive growth and has made important progress in employment generation due to the active labor market policies and strong economic recovery achieved in the post-crisis era. Additional 6.5 million jobs have been created between April 2009 and 2015.

Employment rate has followed an upward trend and realized as 46 percent in 2015. Labor force participation rate has also been on rise since 2009 and reached to 51.3 percent by 2015, mainly due to increase in female labor participation rate. As a result, unemployment rate decreased from 13.1 percent in 2009 to 10.3 percent in 2015. Moreover, there has been also a significant improvement in decreasing informal employment in recent years. It declined by 10.3 percentage points since 2009 and realized as 33.6 percent in 2015.

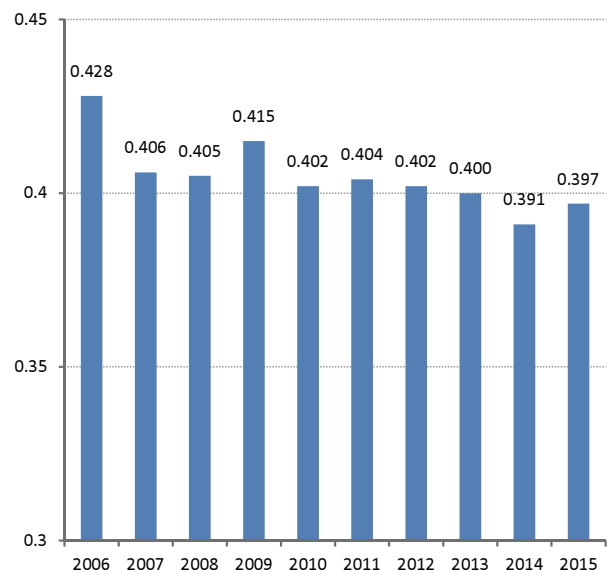
Employment generation remained strong in 2016. As of June 2016, 390 thousand additional jobs were created y-o-y. According to seasonal adjusted figures, unemployment rate and labor force participation rate realized as 10.9 percent and 51.9 percent respectively as of June 2016. According to MTP, employment rate and labor participation rate are 46.3 percent and 51.8 percent, respectively in 2016. Unemployment rate is expected to realize as 10.5 percent as a result of high increase in labor supply.

**Figure 4 Labour Force Indicators (Seas. Adj.)**



Source: TURKSTAT  
As of June 2016

**Figure 5 Gini Coefficient (2006-2015)**



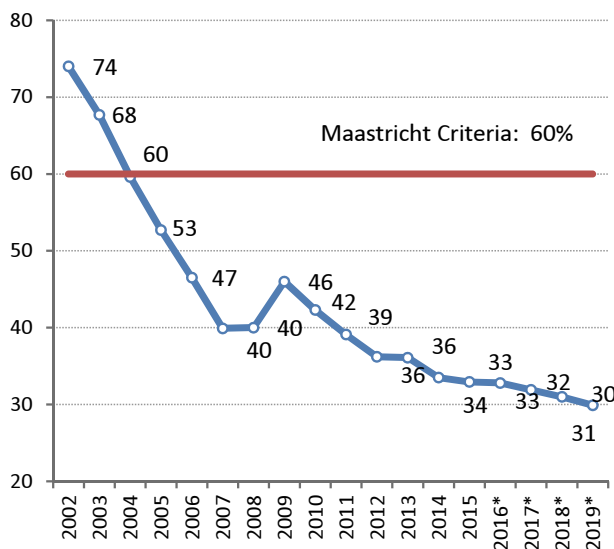
Source: TURKSTAT



Turkey has made a significant progress in terms of reducing poverty, adjusting income equality and sharing prosperity. According to TurkStat Poverty Study 2014 people consuming less than USD 4.3 per day fell to 1.62 percent from 30.3 percent in 2002 (Turkish Statistical Institute, 2015). Improvement in income inequality is reflected by the decrease in Gini coefficient (Turkish Statistical Institute, 2016), which fell to 0.397 in 2015 from its 2006 value of 0.403. Additionally, access to health, education, and municipal services vastly improved for the less well-off.

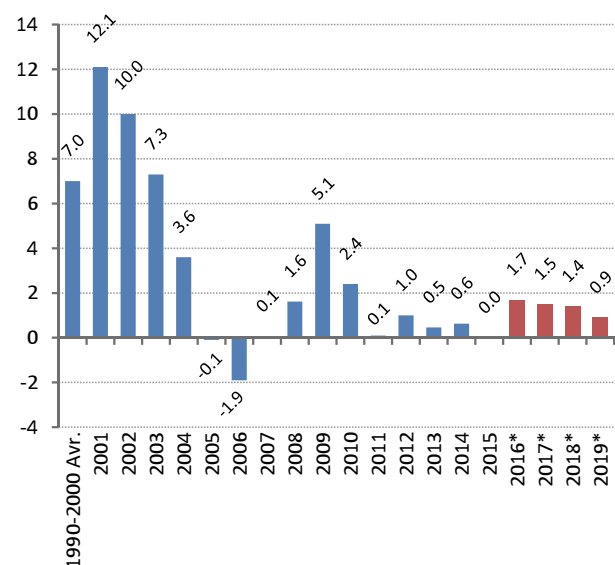
Sound fiscal policy has been one of the main anchors of the country's economic success. In line with stable economic growth, Turkey has made significant progress in public finance with ongoing reforms initiative on public financial management, debt management, taxation and social security system which has led to further improvement of the sound fiscal structure.

**Figure 6 General Government Gross Debt Stock (EU Defined, % of GDP)**



Source: Undersecretariat of Treasury  
\* 2017-2019 MTP

**Figure 7 Public Sector Borrowing Requirement (% of GDP)**



Source: Ministry of Development  
\*2017-2019 MTP

Since 2002, central government budget deficit to GDP ratio has decreased by more than 10 percentage points to 1.2 percent while the primary balance realized as 1.5 percent in 2015. Meanwhile, the interest expenditures to tax income ratio decreased sharply from 85.7 percent in 2002 to around 13 percent in 2015 which also indicates the improved quality of the budget structure. Thanks to on-going fiscal discipline, public sector borrowing requirement to GDP ratio in Turkey declined to 0 percent in 2015 from 10 percent in 2002. This ratio is expected to realize as 1.7 percent by the end of 2016 due to the increase in primary expenditures and moderate growth in tax revenues. The figure is expected to decline gradually to 0.9 percent by 2019 as a result of the revision and rationalization of public expenditures (Ministry of Development).

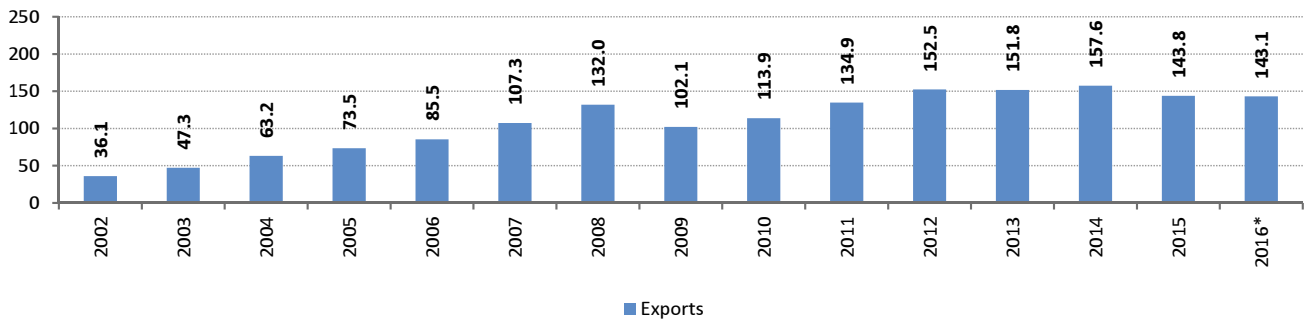
Thanks to a sound fiscal policy, high growth rates and effective public debt management, Turkey's EU-defined general government nominal debt stock fell to 32.9 percent in 2015 from 74 percent in 2002. Turkey has been able to meet the "60 percent EU Maastricht Criteria" for public debt stock since 2004. Moreover, significant progress has been achieved in terms of maturity and foreign exchange composition of debt stock.

In the last 13 years, foreign trade markets have undergone market and product diversification. As a result of these efforts, Turkish economy has successfully improved and diversified its exports not only to the neighboring countries, but also nearly 200 countries all over the world. Foreign trade volume increased to USD 351.1 billion in 2015 from USD 87.6 billion in 2002.

However, due to geopolitical and economic developments in the neighboring countries and the EUR/USD parity fluctuations as well as ongoing global trade deteriorations, exports declined by 8.7 percent y-o-y and realized as USD 143.8 billion in 2015. Turkey’s imports also declined by 14.4 percent and realized as USD 207.2 billion in 2015. The decline in imports was mainly driven by the energy and commodity prices.

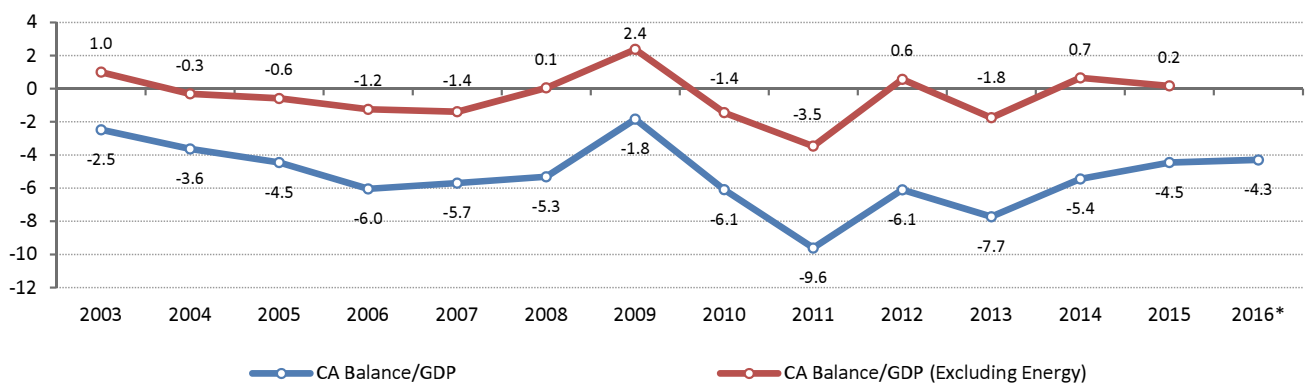
In the January-August period of 2016, exports and imports declined by 2.4 percent and 7.2 percent y-o-y respectively. As a result, the 12-month rolling foreign trade deficit improved by USD 7.8 billion in August compared to 2015. According to the MTP, the foreign trade deficit is expected to realize as USD 54.9 billion in 2016.

**Figure 8 Annual Exports (Billion USD)**



Source: TURKSTAT  
 (\*) 2017-2019: Medium Term Program

**Figure 9 Current Account Balance / GDP (%)**

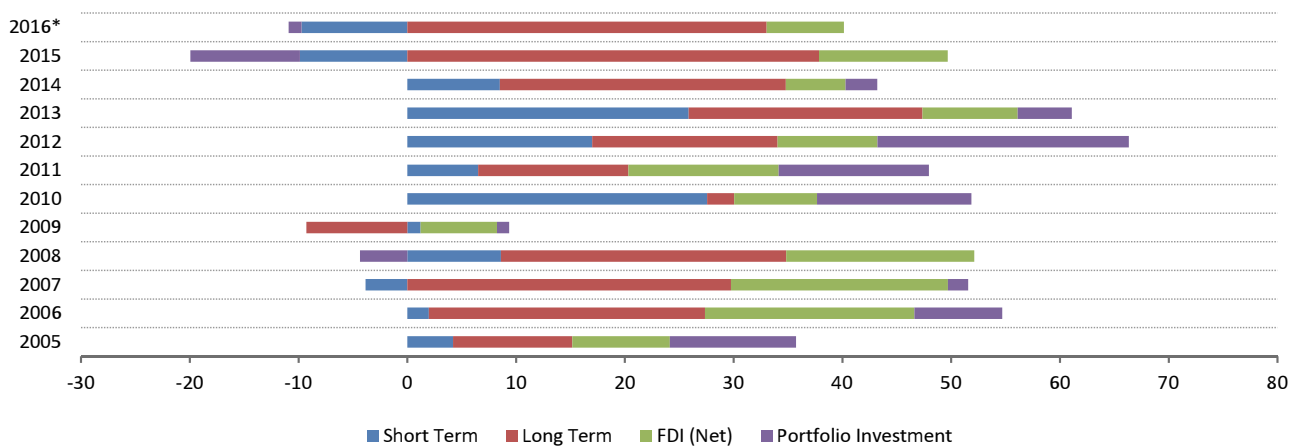


Source: CBRT, TURKSTAT  
 (\*) 2017-2019: Medium Term Program

As an energy importer, Turkey has benefited from lower oil prices, which has significantly reduced Turkey’s current account deficit in recent years. Thanks to low oil prices and rebalancing in gold trade, current account deficit narrowed by USD 11.3 billion to USD 32.2 billion and 4.5 percent of GDP posted a non-energy current account surplus in 2015. Macro-prudential measures have also contributed to the improvement of current account deficit.

There has been an improvement in the financing of the country's current account deficit has become healthier in recent years and the country continued to post current account deficit in the first seven months of 2016. Thus, 12-month rolling deficit declined to USD 28.9 billion as of July 2016. However, deterioration in tourism revenues is likely to limit the further improvement and the current account deficit is projected to realize as USD 31.3 billion at the end of 2016 according to the MTP.

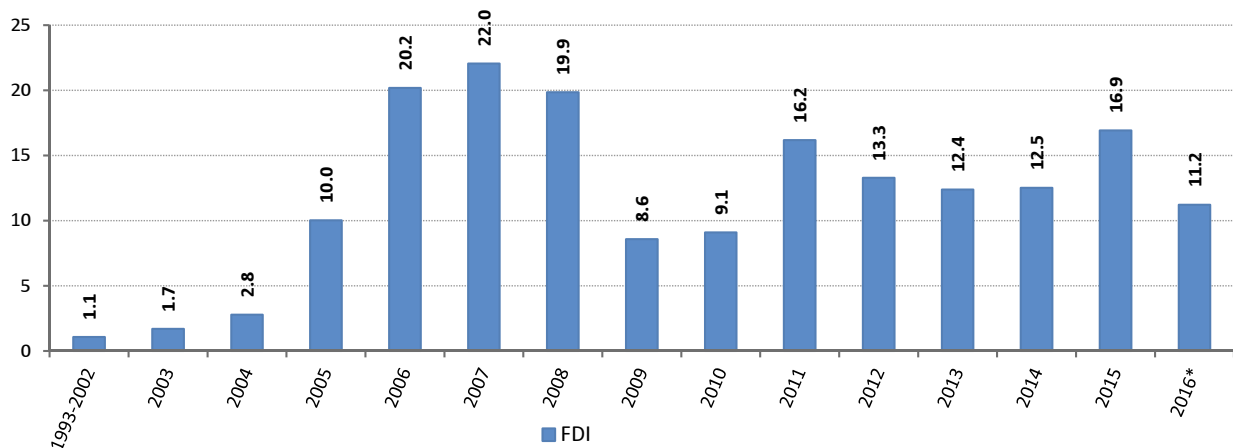
Figure 10 Capital Inflows (Billion USD)



Source: CBRT

(\*) 12 month rolling as of July 2016

Figure 11 FDI Inflows (Billion USD)



Source: CBRT

(\*) 12 month rolling as of July 2016

Thanks to comprehensive structural reforms and prudent macroeconomic policies, Turkish economy integrated into globalized world and the country transformed into one of the major recipients of FDI in its region. FDI inflows alone financed the half of the current account deficit in 2015. However, financial volatility caused by uncertainties in the monetary policies of advanced economies as well as the persistence of the weak global economic activity led to a negative trend in the global risk appetite. Therefore portfolio outflows have been experienced in Turkey as in other emerging markets.



**Box 1 Recent Reforms to Improve Investment Climate and Boost Investment**

Although it has been seven years since the global crisis, global economic growth still remains low, fragile and uneven. Global economy can now be characterized by weak demand, low inflation and interest rates, struggling investment and weak productivity growth. Turkish economy has been adversely affected by this situation, especially through investment channel. After the global crisis, Turkish economy has grown 5.2 percent y-o-y on average; however, the investment levels are still below the target levels.

In this context, some decisive steps are taken to support investments and investment climate. Most recently, Turkey has put into force two major laws in order to improve investment climate and boost investment as part of its comprehensive reform agenda.

As of August 9, 2016, a new law on “improving investment climate in Turkey” entered into force. With this law, legislations have been renewed with reducing tax burden on investments, improving investment climate, deepening capital markets and strengthening registered economy.

According to the new law, the establishment and liquidation processes of companies will be simplified and shortened while costs will be minimized. Moreover, with the new law, expenses for thermal insulation and energy saving for buildings, including commercial enterprises can be written as direct expenses. Turkish Commercial Code with check law were renewed to increase reliability of checks and to prevent dishonored check. Punitive fine for the situation dishonored checks was imposed.

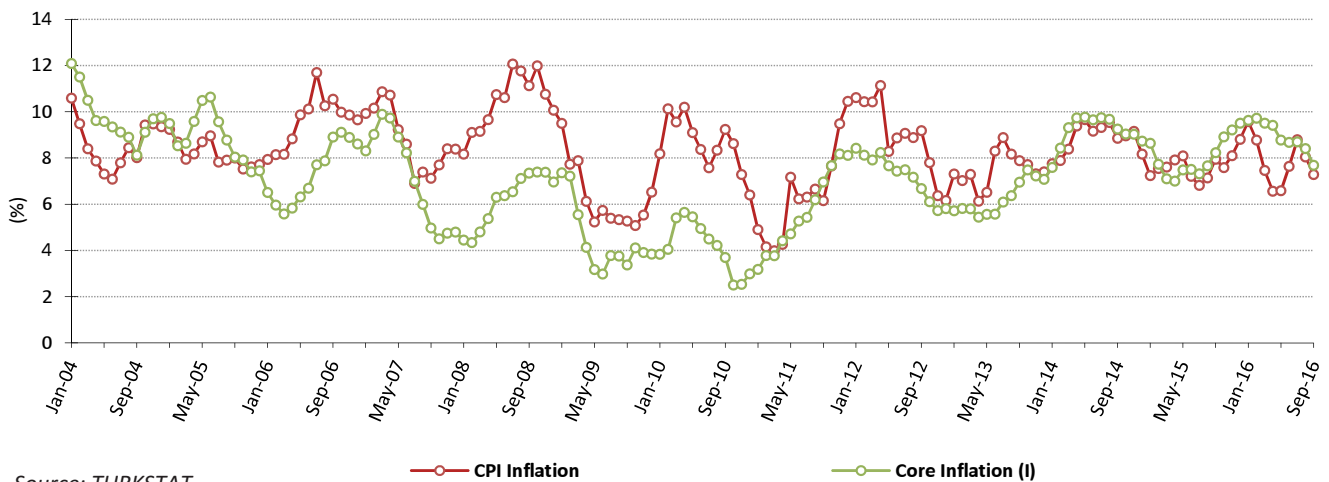
Another law supporting project-based investments has become effective on September 7th, 2016. Purposes of this law are to reduce red tapes for the investors, reducing state insurance premium share of the investor, decreasing part of the energy cost of investor companies and introduce project-specific tax incentives including corporate tax reduction and exemptions.

With this law, corporation tax discount up to 100 percent and customs tariff exemption for the qualified projects will be provided. The state can co-invest in these projects on condition that state contribution does not exceed 49 percent of the total amount. The use of state land will be facilitated for these projects if desired and give the property free of charge on condition that the project succeeds to ensure pledged job creation for 5 years. Moreover, energy costs of the projects will be covered up to 50 percent. Finally, financial support will be offered up to 20 times the gross minimum wage, regarding wage payments for strategic, qualified employees.



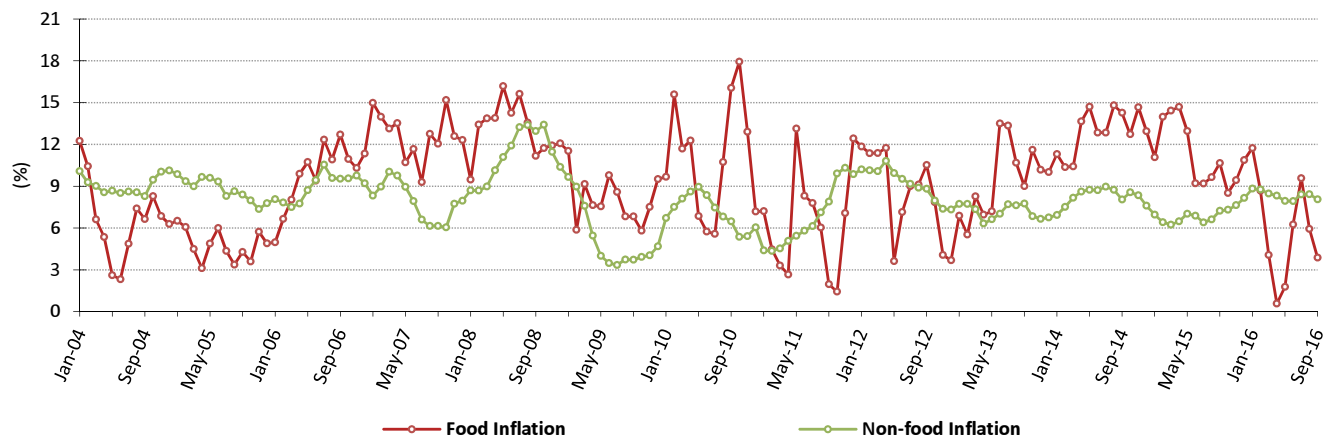
The independence of the CBRT was enhanced by the Central Bank Law enacted in 2001, and the primary objective of the central bank was clearly defined as maintaining price stability. The CBRT introduced a free-floating exchange rate regime and switched to inflation-targeting scheme. In this regard, one of the most prominent achievements in the recent past of the Turkish economy has been reducing inflation from persistent high levels to single digits thanks to prudent macroeconomic policies and structural reforms.

**Figure 12 Annual Inflation Rates**



Source: TURKSTAT

**Figure 13 Food and Non-Food Inflation Rates**



Source: TURKSTAT

Consumer prices experienced inflationary pressure in the near past, and annual inflation realized at 8.8 percent at the end of 2015, mostly because of exchange rate developments and unfavorable food prices. However, inflation has undergone a downward trend since early 2016, and headline figure declined to 7.3 percent as of September thanks to the moderate course of food inflation and alleviation of exchange rate pass-through effects. The inflation rate is expected to realize as 7.5 percent at the end of 2016 and to stabilize at 5 percent in the medium term (Central Bank of Republic of Turkey, 2016).

## 2. Financial Outlook

Turkey has implemented a set of comprehensive structural reforms over the last decade to design an efficient, resilient and deeper financial system, since it is one of the key elements of a sustainable economic growth.

The reform started with elimination of ailing banks from the system in 2001. The private banks were recapitalized while the government revised financial and operational structures of the state banks and privatized some of them. A new Banking Law was introduced in 2005 in order to enhance legal infrastructure and new regulatory and supervisory framework was established in accordance with the law.

Macroprudential policy framework has also been strengthened and actively used over the last decade. Thanks to these efforts, the Turkish economy outperformed in the last fourteen years and the financial sector also recorded significant growth, accordingly.

### a. Banking Sector

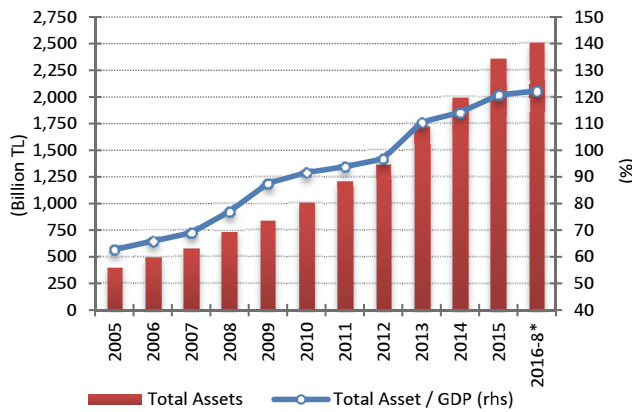
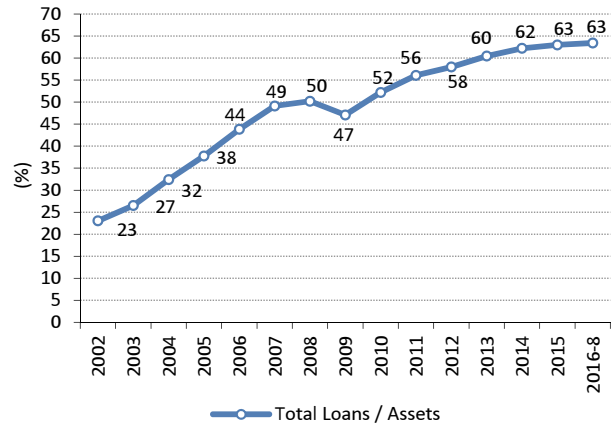
Banks dominate the financial services sector in Turkey with a share of over 80 percent as of 2015. Out of 51 banks currently operating in the sector, five of are participation banks (Banking Regulation and Supervision Agency, 2016). Thanks to its strong capital structure and effective risk management applications, the sector has been functioning well. Intermediation function has been performed much more efficiently and loan to deposit ratio reached 124.6 percent as of August 2016. Thus, together with strong public finance, the banking sector has become one of the sources of strength in Turkish economy and made a significant contribution to sustainable growth by ensuring financial stability.

**Table 2 Financial Summary of Participation Banks, Deposit Banks, and Development and Investment Banks**

Banks	Number of Institutions	Assets			Deposits			Loans		
		2015 (USD Mln)	2015 Share (%)	2014 Share (%)	2015 (USD Mln)	2015 Share (%)	2014 Share (%)	2015 (USD Mln)	2015 Share (%)	2014 Share (%)
<b>Participation Banks</b>	5	41,417	5.1	5.2	25,567	5.9	6.2	24,824	4.8	5.4
<b>Deposit Banks</b>	34	735,307	90.4	90.5	404,209	94.1	93.8	462,139	90.2	90
<b>Development and Investment Banks</b>	13	36,688	4.5	4.3				25,371	5.0	4.6
<b>Total</b>	52	813,412	100	100	429,776	100	100	512,334	100	100

Source: BRSA

In 2015, banking sector's total assets reached USD 813 billion, which was about 120 percent of the GDP. Sector's loan-to-asset ratio reached 63.4 percent in August 2016 from 23 percent in 2002 (Banking Regulation and Supervision Agency, 2016).

**Figure 14 Banking Sector Total Assets**

**Figure 15 Banking Sector Loans to Assets**


Source: BRSA, TURKSTAT

(\*) GDP is 12 month rolling as of 2016Q2

Source: BRSA

**Table 3 Participation Banks and Banking Sector: Key Financial Indicators (TL million) (December 2015)**

Financial Highlights		Participation Banks			Banking Sector		
		2015	2014	Change (%)	2015	2014	Change (%)
Deposit*	TL	40,740	38,979	4.5	719,120	664,528	8.2
	FC	31,406	23,004	36.5	519,845	375,790	38.3
	FC- Metal	2,216	3,422	-35.2	11,051	16,311	-32.2
	Total	74,362	65,405	13.7	1,250,016	1,056,629	18.3
Loans**		79,191	69,622	14.1	1,513,969	1,262,621	19.9
Non-Performing Loans (Net)		1,775	1,203	47.5	12,082	9,516	27.0
Total Assets		120,252	104,319	15.3	2,357,522	1,994,329	18.2
Shareholders' Equity		10,462	9,673	10.0	262,271	232,007	13.0
Net Profit		405	144	181.3	26,062	24,610	5.9
Number of Employees		16,554	16,280	1.7	217,504	216,912	0.3
Number of Branch	Domestic Branches	1,076	986	9.1	12,185	12,125	0.5
	Branches Abroad	4	4	0	84	85	-1.2
	Total	1,080	990	9.1	12,269	12,210	0.5

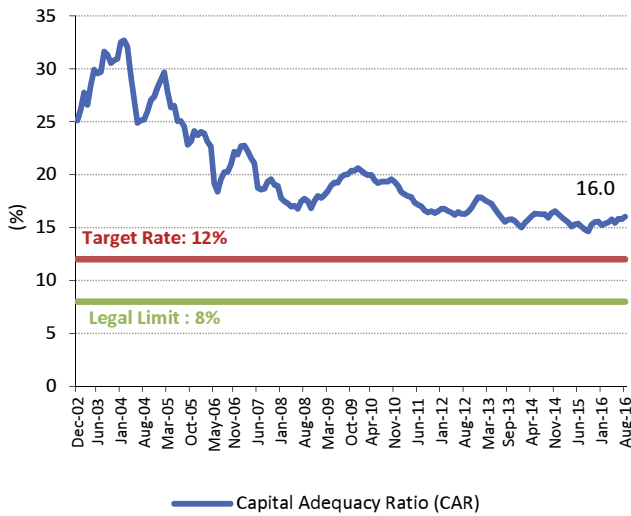
\*Bank deposits are excluded. Rediscounts are included.

\*\* Loans under follow-up are excluded. Rediscounts are included.

Source: BRSA

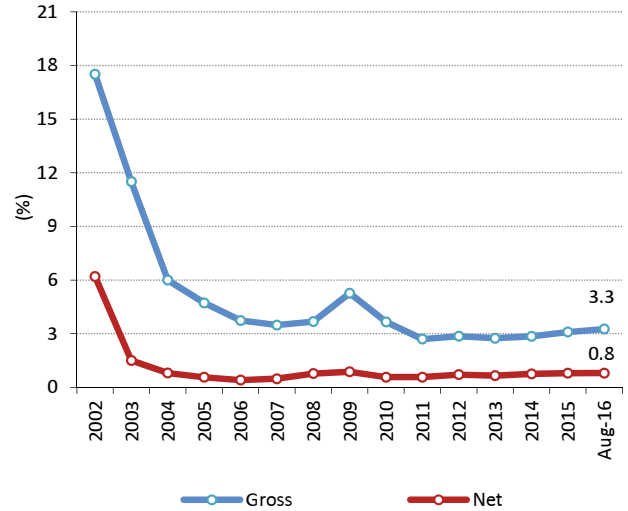
In comparison with the peer countries, capital adequacy ratio (CAR) of the Turkish banking sector remained high as 16 percent, which was above the legal ratio (8 percent) and the target ratio (12 percent) of the BRSA as of August 2016.

**Figure 16 Banking Sector: Capital Adequacy Ratio**



Source: BRSA

**Figure 17 Banking Sector: Asset Quality (NPL)**

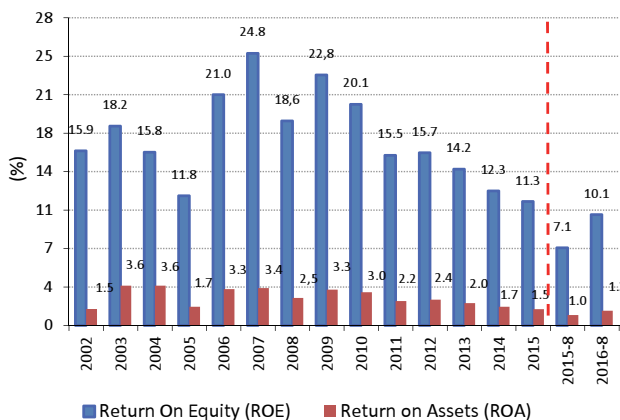


Source: BRSA

The sector kept enjoying high asset quality while non-performing loan ratio was standing at low levels. As of August 2016, the non-performing loan ratio realized at 3.3 percent (Banking Regulation and Supervision Agency, 2016).

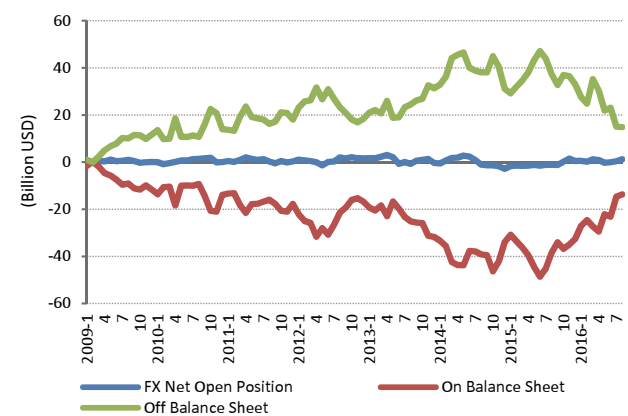
Turkish banking sector maintained its robust position during the recent financial turmoil as the profitability of the banking sector continued to be sufficiently high and return on equity of the sector realized as 11.3 percent in 2015. In addition, Turkey improved the regulatory and supervisory framework, and harmonized its banking sector with international best standards. In this regard, Turkey’s banking sector fully complies with the Basel II and Basel III standards as of 2016.

**Figure 18 Banking Sector: Return on Equity (%)**



Source: BRSA

**Figure 19 Banking Sector: FX Net General Position**

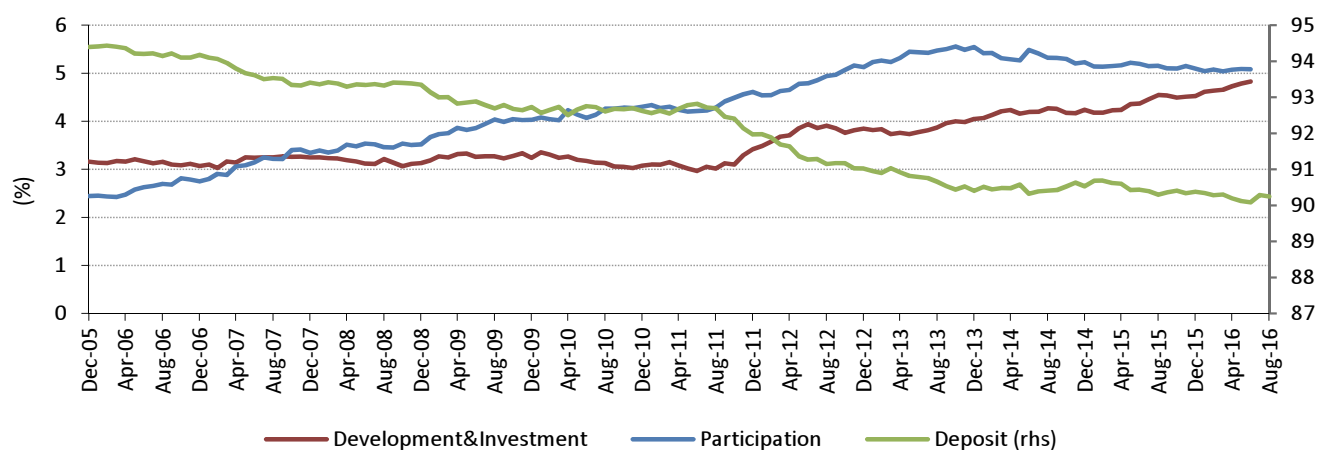


Source: BRSA



Although the banking sector carries the exchange rate risk on balance sheet, banks are able to mitigate the risk via off balance sheet operations. Therefore, banking sector indicates a neutral net general FX position.

**Figure 20 Share of Banks' Assets in Banking Sector**



Source: BRSA

In order to strengthen interest-free finance and participation banking, Turkey has implemented a comprehensive strategy to ensure a more favorable environment for participation banks to grow in a healthier and efficient way. In this regard, two state-owned participation banks were established and started operating. Together with the government's efforts to pave the way for the development of interest-free finance, the share of participation banks more than doubled in the last decade, and it is expected to reach 15 percent by 2025 (Participation Banks Association of Turkey, 2015). In December 2015, the Interest-Free Finance Coordination Board has been established.

## b. Capital Markets

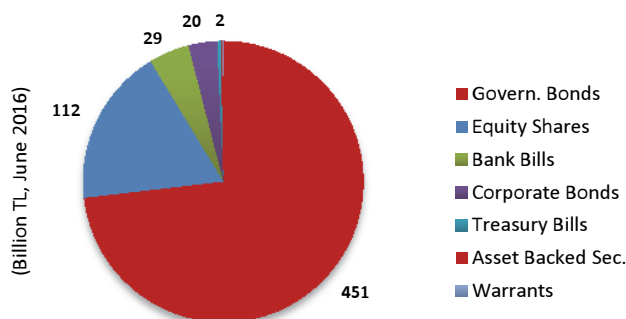
Turkey has carried out key reforms in capital markets in order to enhance legal infrastructure, improve institutional capacity and increase the diversity of financial products and services.

The new Capital Markets Law which is aligned with the EU standards was introduced in late 2012. In line with the new law, Turkey established Borsa Istanbul gathering Istanbul Stock Exchange, Istanbul Gold Exchange and Turkish Derivatives Exchange under a single entity. As of June 2016, there are 413 firms listed in Borsa Istanbul with USD 205 billion capitalization of the listed companies currently. Traditionally, foreign investors hold a large market share in the stock market, which increased from 43 percent to around 63 percent between 2002 and 2016. In the first half of 2016, daily average trading volume in Borsa Istanbul equity market realized around USD 1.5 billion.

Considering the figures of capital markets, the share of private sector securities in total outstanding securities has increased substantially in Turkey. In the past, private debt instruments were crowded-out by government bonds. However, a substantial growth has been achieved in the private debt market since the year of 2005.

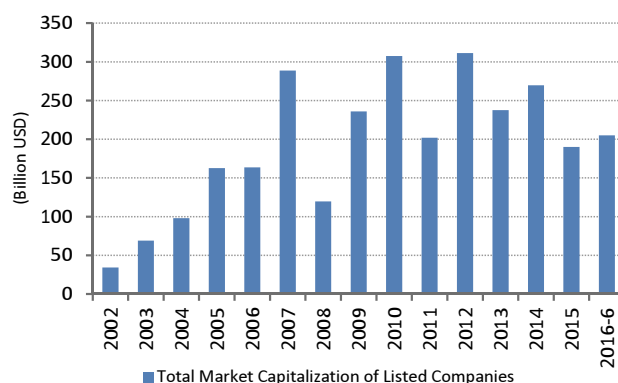
In addition, improved economic conditions, facilitated offering processes, and the introduction of new instruments have contributed to this trend. Accordingly, the share of private sector securities in total outstanding securities increased to 26.4 percent in June 2016 from 11.5 percent in 2005.

**Figure 21 Outstanding Securities in Capital Markets**



Source: Capital Markets Board

**Figure 22 Total Market Capitalization of Listed Companies**



Source: Capital Markets Board

There has also been considerable growth in investment funds in terms of portfolio size, from USD 5.7 billion in 2002 to USD 14 billion in June 2016. The latest figure for the net asset value of a total of 417 investment funds is TRY 40 billion.

As for the interest-free finance, Turkey has taken a number of steps in order to meet the demands of investors with usury-intolerance and to increase diversity of financial instruments. Necessary legal arrangement enabling the Turkish Treasury to issue sukuk (lease certificates) was finalized in 2012, and the Treasury has conducted regular sukuk issuances in both domestic and international markets since 2012. Further, the private sector sukuk issuance in domestic markets was commenced in 2011.

### c. Insurance Sector

Compared to developed countries, Turkish insurance market is still underpenetrated with 1.55 percent of GDP as of 2015. This implies significant potential for new investment in relatively untapped Turkish insurance market.

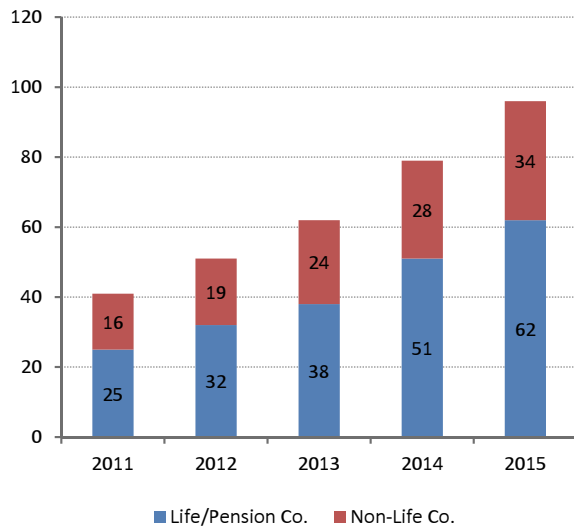
The insurance sector gradually increases its share in the Turkish financial system. The sector has reached a sound legislative infrastructure which is broadly aligned with EU norms with the new Insurance Law.

The law brought new standards to the sector in order to strengthen the capital structure, technical reserves and asset allocation of insurance companies and reinforced the supervisory framework.

There are 60 insurance and retirement pension companies in Turkey, of which 36 are non-life insurance, 4 life insurance, 19 pension, and 1 reinsurance companies as of 2015. Total asset size of the sector increased by 21.5 percent and reached TL 98.4 billion in 2015.

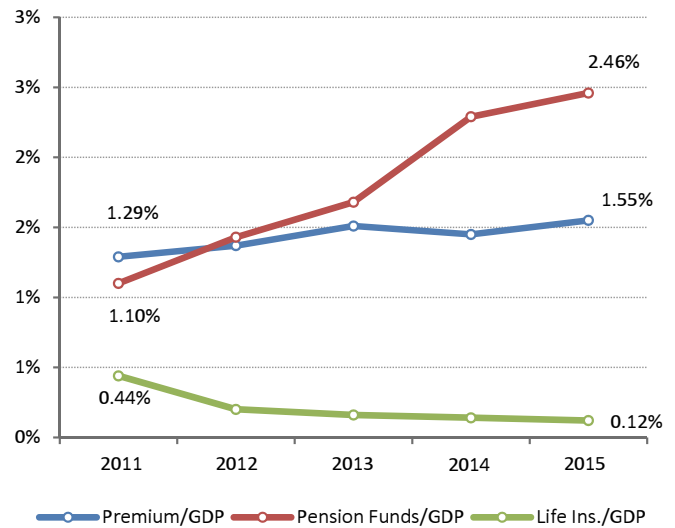
In order to boost domestic savings and enable healthier financing with long-term resources to capital markets, Turkey has launched a new Private Pension System in 2013 based on 25 percent state contribution. The net asset value of pension funds almost tripled between 2012 and September 2016 in TL terms and the number of participants have increased by 3.4 million in the same period. As a result, the pension fund system currently has 6.5 million investors and a USD 20 billion portfolio size.

**Figure 23 Total Asset of Turkey's Insurance Sector (Billion TL)**



Source: Undersecretariat of Treasury

**Figure 24 Insurance Sector Premium Generation**



Source: Undersecretariat of Treasury

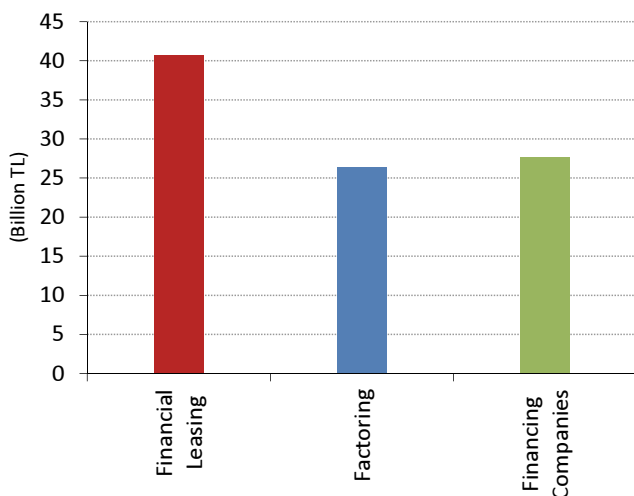
In addition to boosting enrollment in the private pension system and increasing its effectiveness, the works to introduce auto-enrollment in private pension system have recently been finalized, and the necessary legislation was enacted in August 2016. The auto-enrollment system will start in January 2017.

#### d. Non-Banking Financial Sector

Financial Leasing, Factoring and Consumer Financing Companies Law came into effect in December 2012 to strengthen the regulatory landscape of non-bank financial sector. The new law unified and simplified regulations of non-bank financial sector and brought regulatory provisions in order to ensure level playing field for the sector.

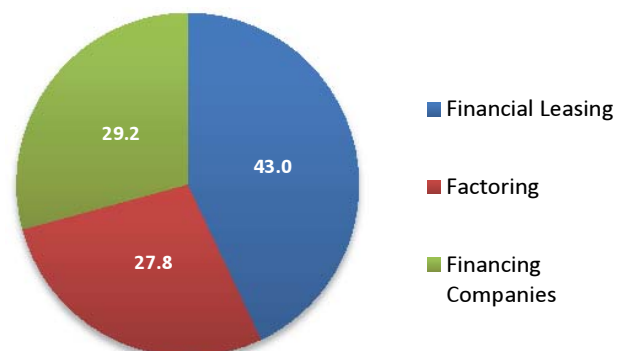
There are 27 financial leasing companies, 63 factoring companies and 13 consumer financing companies in the sector. Total asset size of the sector increased to 4.8 percent of GDP in 2015 from 1.8 percent in 2002. In this regard, total asset size of the sector increased at a CAGR of 20 percent between 2007 and 2015 (The Association of Financial Institutions , 2016).

**Figure 25 Non-bank financial institutions: Total Assets**



Source: BRSA

**Figure 26 Non-bank financial institutions: Share of Total Assets (%)**



Source: BRSA



**Box 2 Auto-Enrollment in the Private Pension System and Sovereign Wealth Fund**

Turkey has recently developed two coherent economic policies to stimulate economic growth. These two policies aim to stimulate growth via promoting domestic savings. First, the legal framework for auto-enrollment in the private pension system, which aims to create an additional asset size of TRY 100 billion in the next decade, has been completed. Second, sovereign wealth fund has been established.

In order to boost domestic saving rates, deepen capital markets, and to increase employee welfare, the Private Pension Law was amended to include the automatic enrollment of employees in the private pension system. The changes will be effective as of January 1st, 2017. According to this amendment, employees under 45 years old, regardless of working in the private or public sector, will automatically be enrolled by their employers in private pension plans. Employees will have the right to opt-out within the two months of their auto-enrollment in the private pension system. In case of an opt-out, the contributions paid to the private pension company and any returns on savings must be repaid to the employee within ten business days.

The rate of contribution is 3 percent of their gross income, which can later be amended by the Council of Ministers up to 6 percent or down to 1 percent. The employee has the right to contribute more than the percentage determined by the legislation. Similar to the current system, the government will make a state matching contribution of 25 percent of the member contribution into the private pension account of the member, subject to the current vesting rules. Furthermore, the government will make a one-time TRY 1,000 welcome bonus contribution per employee for the ones who do not choose to opt-out. This additional contribution is also subject to vesting rules applicable to the 25 percent state match to increase long term savings in the country.

Sovereign wealth fund management was established under the title of “Turkey Wealth Fund Management Company” with initial paid-in capital of 50 million Turkish Liras (~USD 16 million). The aim of Turkey’s sovereign wealth fund is to contribute to the deepening of the capital markets and diversification of products and services; to utilize national assets, obtain external funding to the Turkish economy; and to contribute to financing strategic, large-scale investments.



## B

## Participation (Islamic) Finance Landscape in Turkey

Islamic finance in Turkey represents a relatively small share in the entire financial system but is projected to be a systemically important market in the medium term.

Taking into account that the value of global Islamic financial assets is around USD 1.88 trillion by 2015 and that Turkey's share is around 3 percent, Turkey has a considerable potential to discover (IFSB, 2016). Thomson Reuters projected that the global Islamic financial services assets to grow annually at an average of 10 percent and reach USD 3.2 trillion by the end of 2020. The composition of Islamic Finance is concentrated primarily in banking assets followed by capital market (Sukuk, Islamic funds), and takaful contributions.

Islamic banks emerged as the first modern Islamic financial institutions. The Islamic banking sector had an impressive growth thanks to increasing oil prices and excessive amount of funds from Arab world in 1970s. These funds and wealth in the region provided a source of substantial liquidity for the Islamic banks. As a result of its early head-start, Islamic banking is today the most developed component in the Islamic financial system.

The IFSB's Islamic Financial Services Industry Stability Report 2016 indicates that the Islamic banking sector has the largest share of the total Islamic financial assets with 80 percent. The Islamic Banking sector had 16 percent CAGR between 2010 and 2014. On the other hand, the average industry growth in US dollar terms in 2015 was at 1.4 percent y-o-y, due to the exchange rate depreciation. Assets in the Islamic Banking industry are heavily concentrated in the Middle East and Asia. The ten largest Islamic Banks comprise approximately 94 percent of global Islamic banking assets and Islamic banking sector is systemically important in 11 jurisdictions. The Islamic Banking industry has the potential to contribute to the growth in global Islamic banking assets. It is also expanding into new countries in Africa and Europe (IFSB, 2016).

The Islamic capital market offers valuable services to Islamic banks, individual investors, and Islamic fund managers for both investment and risk management. In this context, the Sukuk market segment has grown faster than any other segment in the Islamic Financial Services Industry in between 2009-2014. The amount of sukuk outstanding globally reached over USD 300 billion in 2014. On the other hand, the outstanding sukuk amount decreased by 3.4 percent and realized as USD 290 billion in 2015 as result of considerable downsizing in primary market issuances especially in Malaysia and decreasing investments in the overall Islamic capital markets due to decreasing oil prices as well as increasing uncertainties in the global financial system. In 2015, sukuk comprised 15 percent of Islamic finance assets. There has been an increase in demand for sukuk to use it for the purpose of liquidity management. This market has potential to expand further from new issuances throughout Europe, Asia, and Africa (IFSB, 2016).

Takaful sector, in early 1980s, was the second significant development in Islamic finance industry after the establishment of Islamic Banks. Takaful plays an important role in mobilizing long-term funds, providing risk protection as well as supporting overall economic growth and development.

Takaful sector has been growing consistently over the last decade. The IFSB Report estimates that the global takaful industry grew at 8.4 percent and reached USD 23.2 billion in 2015 from USD 21.4 billion in 2014. Takaful has the potential for growth in existing new markets. Takaful operators are heavily concentrated in GCC countries as well as Southeast Asia, with growth potential in the Middle East, Africa, and Southeast Asia. According to IFSB, Turkey's share in the global Islamic banking sector was around 3 percent, Turkey also took over 3 percent of global sovereign sukuk market in 2015. Turkey's Islamic finance sector is relatively in the improving phase as per assets share in the whole Turkish finance sector compared to countries such as Bahrain, Malaysia, Saudi Arabia, and United Arab Emirates. On the other hand, Turkey has great potential with well-developed financial system, strong human capital and strategic location. In this respect, the potential asset size of Turkey was almost twenty times of the actual Islamic finance assets in 2012 (Thomson Reuters; Dinar Standard; Dubai Islamic Economy Development Centre, 2014).

As for the regulatory framework in Turkey, there are several institutions related to Islamic finance. Banking Regulation and Supervision Agency (BRSA) regulates and supervises all aspects of banking including the participation banks. The Central Bank of the Republic of Turkey (CBRT) is also involved with regards to foreign currency operations, reserve requirements, and liquidity regulations. The Capital Markets Board of Turkey (CMB) has authority for developing the regulatory framework for corporate lease certificates and to take all the necessary measures to protect the rights of investors. Treasury is responsible for issuing and managing Turkey's sovereign lease certificates. Savings Deposit Insurance Fund is responsible for deposit insurance, bank resolution and recovery processes for banks including participation banks. In addition to this, Turkish Treasury is responsible for regulating and supervising the insurance and private pension sectors covering takaful operators and participation pension funds.

# 1. Historical Background

Islamic finance has a long history and some of the concepts and instruments such as *mudarabah* and *musharakah* dated back to pre-Islamic days. While the Islamic banking has conceptually existed during of human history, official records mentioning this system goes back to Hammurabi who reigned in Babylon between 2123-2081 BC. The chapters 100-107 of the famous Code of Hammurabi explaining how to grant loans particularly appears to be the first example of an interest-free investment in history. Along with the emergence and spread of Islam, main concepts of modern Islamic finance such as interest-free borrowing, partnerships and leasing have been developed and applied in a wider geographical area (Vakıf Katılım, 2016).

However, the requirement of interest-free banking in a modern sense emerged in the 20th century in conjunction with industrialization observed in Muslim countries and oil spike in 1970s (Vakıf Katılım, 2016). Since its modern inception, Islamic finance has been steadily growing in the Muslim world and has now been expanding into western countries, as well. With over 40 years' experience, Islamic finance gains attraction from both Muslim and western countries all over the world with its infrastructure, international organizations and academic programs.

The history of Islamic banking in Turkey is considered to have started with Special Finance Houses (SFH) after an increasing demand from the Turkish society for interest free banking, investment, and lending requirements in 1984. The decree regarding the foundation of SFHs was signed by the Council of Ministers and published in the Official Gazette on December 16, 1983, which came into force on February 19, 1984. Until 1999, the establishment and functioning of the SFHs were regulated by this decree. On December 19, 1999, with a significant amendment to the decree, these houses were covered in the scope of the Banking Law.

The Islamic finance in Turkey has first been operational in 1985 with the launch of Bahrain based Al Baraka Turk and Saudi based Faisal Finans. The Kuwaiti-based Kuveyt Turk was opened in 1989. Afterwards, new SFHs were opened with domestic capital. These institutions included Anadolu Finans in 1991, Ihlas Finans in 1995 and Asya Finans in 1996. The main objective of the SFHs practice was to promote private savings hovering at low levels in Turkey, and thus to channel these savings into the real economy. Traditionally interest-averse money either stays idle or tends to be invested in real estate, foreign currency, and precious metals.

In 1999, the parliament enacted a new law in order to discipline and rehabilitate the overall banking system (Banking Act Nr. 4389). Under this new law, SFHs became subject to the same umbrella of regulations with conventional banks. This law introduced wide-ranging adjustments for the Turkish banking sector that encompassed two major regulatory developments for the Islamic banks. These were the establishment of Special Finance Houses Association and the implementation of Islamic deposit insurance scheme administered by this association. In 2001, the parliament enacted a new law (Law Nr. 4672) amending the Banking Act No. 4389

In November 2005, upon enactment of the new Banking Law (Banking Act Nr. 5411), the "dual" deposit insurance system was revised and the management of the Islamic deposit insurance fund (safety fund) was transferred to the Savings Deposit Insurance Fund. The SFHs were renamed as "Participation Banks", which allowed them to integrate fully into the financial system with the bank statue. This law is applied for all the three types of Turkish banks (deposit banks, development and investment banks, and participation banks). The adoption of the new law has opened a new era for the participation banks as they are treated similar to the conventional banks in the sector.

The interest-free finance sector intends to support development and stability of Turkey's overall financial sector more via contributing to the country's bid to be an international financial center. Over the years, the interest-free finance has flourished on the capital markets side and gradually represented by other financial instruments, such as lease certificates (*Ijarah Sukuk*), which was introduced by the Capital Markets Board of Turkey (CMB) in 2010.

**Figure 27 Historical Background of Interest-Free Finance in Turkey**

1983	<ul style="list-style-type: none"> <li>•Government Decree for SFH</li> </ul>
1985	<ul style="list-style-type: none"> <li>•Albaraka Turk and Faisal Finans established</li> </ul>
1989	<ul style="list-style-type: none"> <li>•Kuveyt Turk established</li> </ul>
1991	<ul style="list-style-type: none"> <li>•Anadolu Finans established</li> </ul>
1995	<ul style="list-style-type: none"> <li>•Ihlas Finans established</li> </ul>
1996	<ul style="list-style-type: none"> <li>•Asya Finans established</li> </ul>
1999	<ul style="list-style-type: none"> <li>•SFH under Banking Law</li> <li>•BRSA established</li> </ul>
2001	<ul style="list-style-type: none"> <li>•Faisal Finans became Family Finans</li> <li>•Ihlas Finans left the market</li> <li>•Association of Special Finance Houses established</li> <li>•SDIF established</li> </ul>
2005	<ul style="list-style-type: none"> <li>•5411 Nr. Banking Act passed</li> <li>•SFHs renamed Participation Banks</li> <li>•Security Funds transferred to SDIF</li> <li>•Anadolu Finans and Family Finans merged as Türkiye Finans</li> </ul>
2008	<ul style="list-style-type: none"> <li>•Türkiye Finans acquired by National Commerce Bank</li> </ul>
2010	<ul style="list-style-type: none"> <li>•First Corporate Sukuk issued by Kuveyt Turk*</li> </ul>
2012	<ul style="list-style-type: none"> <li>•First Sovereign Sukuk issued by Turkish Treasury</li> </ul>
2013	<ul style="list-style-type: none"> <li>•World Bank Global Islamic Finance Development Center established</li> </ul>
2015	<ul style="list-style-type: none"> <li>•Istanbul International Financial Center Program Aciton Plan approved</li> <li>•Ziraat Katılım established</li> <li>•Interest-Free Finance Coordination Board established</li> </ul>
2016	<ul style="list-style-type: none"> <li>•Vakıf Katılım established</li> </ul>

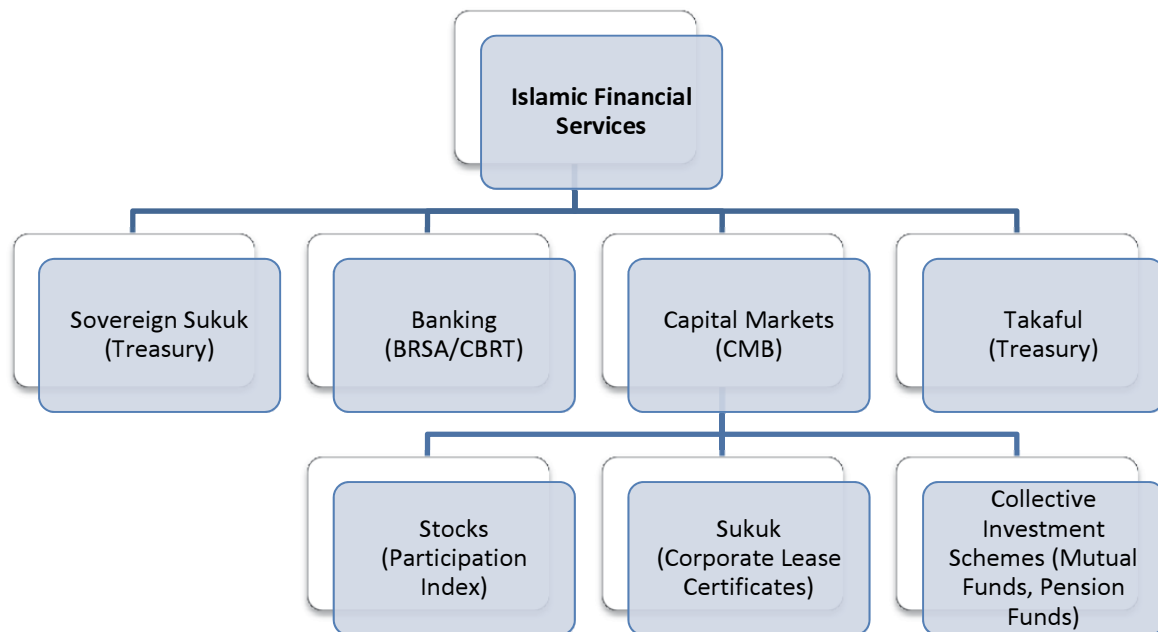
Source: BRSA, PBAT, Undersecretariat of Treasury

\* It should be noted that the first corporate Sukuk issue made in 2010 by Kuveyt Turk as shown in the table was an issue made abroad, this issue was not made under the Sukuk Communiqué published by the CMB. The first corporate Sukuk issue under the Communiqué was made in 2011 as presented in Table 14.



Lease certificate has been improved since 2010 by market share and regulatory setting. Moreover, on the collective investment schemes side, the legal framework for participation funds has been established. Thanks to this regulation, the Islamic collective investment schemes have been established in Turkey as in the form of participation funds.

**Figure 28 Institutional Setting for Interest-Free Finance**

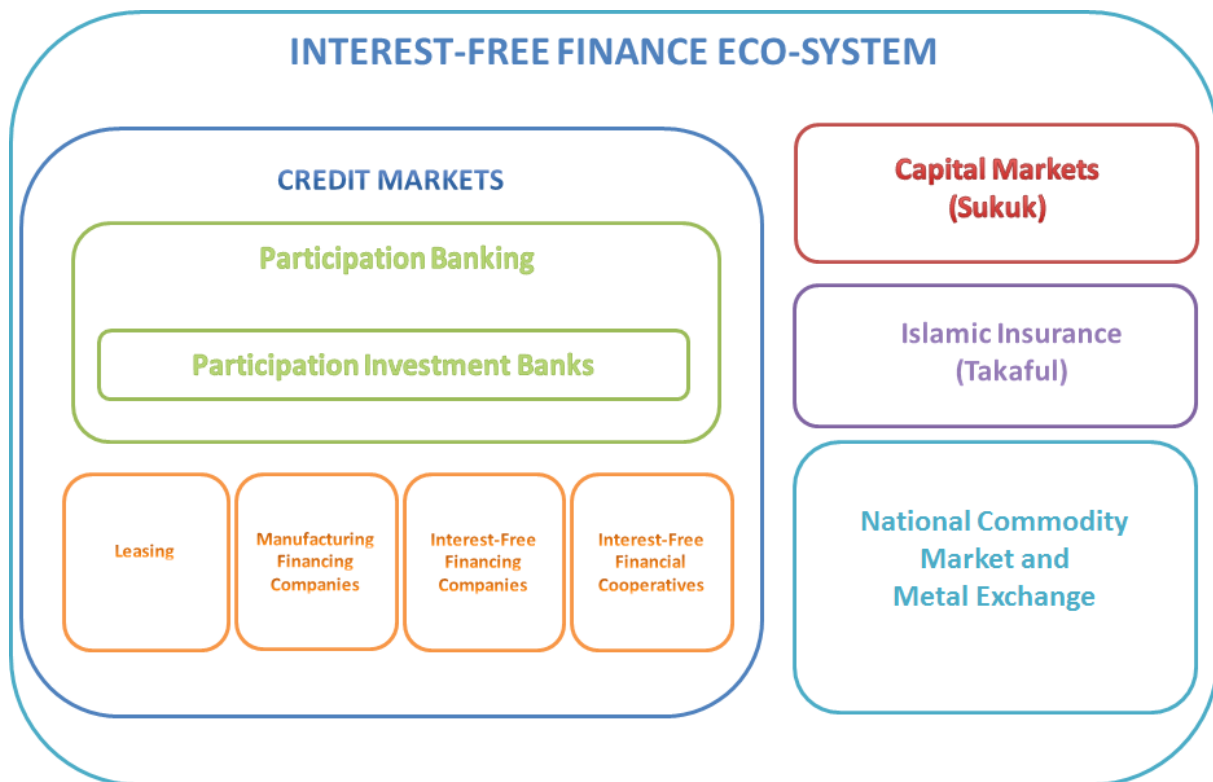


## 2. Interest-Free Finance Ecosystem

An inclusive finance system integrates interest-free financial system to better serve the needs of the economy and to promote inclusive growth. To this end, Turkey plans to build a full-fledged interest-free financial ecosystem.

This structure intends to resolve all financial needs of natural and legal entities that have interest sensitivity and represents Turkish “Interest-Free Finance Ecosystem”. This structure includes not only credit products but also capital market instruments.

Figure 29 Interest-Free Finance Eco-System



In Turkey, non-banking financial institutions operate within the scope of Financial Leasing, Factoring and Financing Companies Law (Nr. 6361).

Financial leasing, which is generally used for financing for middle-term investments, provides an advantage towards funding needs for capitalization of institutions. Currently, participation banks can also operate financial leasing according to Banking Law (Nr. 5411).

Customer financing companies provide funding to individual customers and firms in the process of buying goods and services. Contract between customer and the company can be compliant with interest-free finance principles. Currently, participation banks serve financing companies with murabaha contract, which is fit and proper to interest-free finance principles.

Due to the nature of factoring, it cannot be compliant with interest-free finance principles under the current conditions.

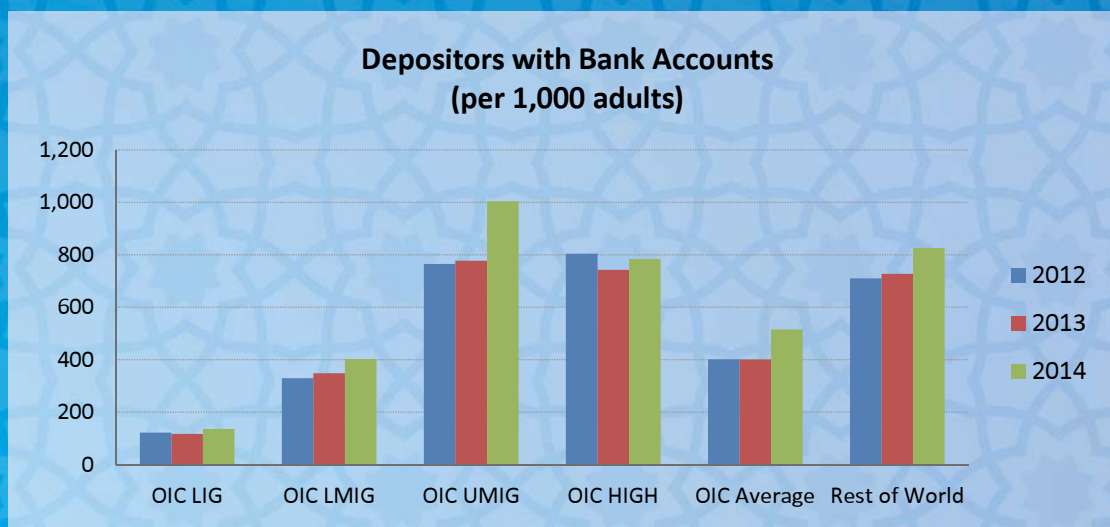
To build an inclusive interest-free finance ecosystem in Turkey, the BRSA initiated a legislation process after examining all the relevant financial structures and organizing a workshop with the collaboration of Sakarya University on saving based interest-free finance products.

### Box 3 Financial Inclusion and Islamic Finance

More than 50 countries have set formal targets and goals and regulatory and supervisory agencies of these countries have been tasked to improve financial inclusion all over the world (International Finance Corporation; Multilateral Investment Guarantee Agency; The World Bank, 2015). Greater financial inclusion can help to mitigate extreme poverty, support sustainable and inclusive economic development (International Finance Corporation; Multilateral Investment Guarantee Agency; The World Bank, 2015). In 2014, World Bank President announced a global target of universal financial access by 2020.

Financial inclusion has improved across the world at a considerable level since 2011. Global Financial Inclusion Database (Global Findex) of 2014 indicates that the number of unbanked adults reduced by 20 percent to 2 billion between 2011 and 2014 while 62 percent of adults have accounts in a financial institution or mobile money providers as of 2014.

However, some key OIC countries have not been keeping up with the global trend in regard to financial inclusion. According to the Global Findex Report, the percentage of adults citing religious reasons for not having an account is noticeably higher in OIC countries, the worldwide average of the religious self-exclusion was 5 percent whereas in some Muslim countries, including Niger, Turkey, Turkmenistan, and Uzbekistan, this ratio is between 20 and 25 percent in 2014 (Findex). Additionally, While the world's average depositors with bank accounts per 1,000 adults was just less than 826, OIC member countries average was about 516 in 2014. Moreover, lack of access to finance, especially for firms and entrepreneurs, was one of the key constraints on growth in MENA countries (Bhattacharya & Wolde, 2010).







Islamic finance has favorable facilities such as zakat, sadaqah, qard al-hassan and waqf to increase financial inclusion and eliminate poverty which is still a pervasive problem among many Muslim-majority nations through wealth redistributive effect of these facilities. In this regard, the World Bank estimated that 20 out of 39 OIC countries have zakat collection large enough to alleviate poverty for those living on income below USD1.25 per day (Mohieldin, Iqbal, Rostom, & Fu, 2012).

Turkey's Financial Inclusion Strategy was prepared by the Financial Stability Committee (FSC) and published in the Official Gazette Nr. 29021 dated 5 June 2014 as the Prime Ministry Circular Nr. 2014/10 on Financial Access, Financial Education and Financial Consumer Protection Strategy and Action Plans, covering 2014-2017.

The Undersecretariat of Treasury, secretariat for Financial Stability Committee, is the main coordinator institution and responsible to monitor the overall implementation of the strategy and respective action plans.

Interest-free finance could help increasing financial inclusion for certain parts of society, who voluntarily excludes themselves from financial activities due to non-compliance with their religious beliefs, accessing to finance.

According to the Global Financial Inclusion (Global FINDEX) database, the ratio of of adults indicated that main reason for their exclusion from financial market was non-availability of services compatible with their religion has increased from 6.9 percent in 2011 to 21.6 in 2014 in Turkey.

Turkey's Financial Inclusion Strategy also aims to enhance inclusion by reaching out to adults excluded from financial sector because of the religious reasons.



### 3. Participation Banking

In Turkey, participation banks are functionally similar to deposit banks. But collecting and lending methods of funds are different than those of deposit banks. There is no stand-alone regulation regarding participation banking. However, the law nr.5411 states the conditions of participation banks' minor differences between conventional and participation banking such as deposit collection, fund utilization, accounting methods, and calculation method for Capital Adequacy Ratio.

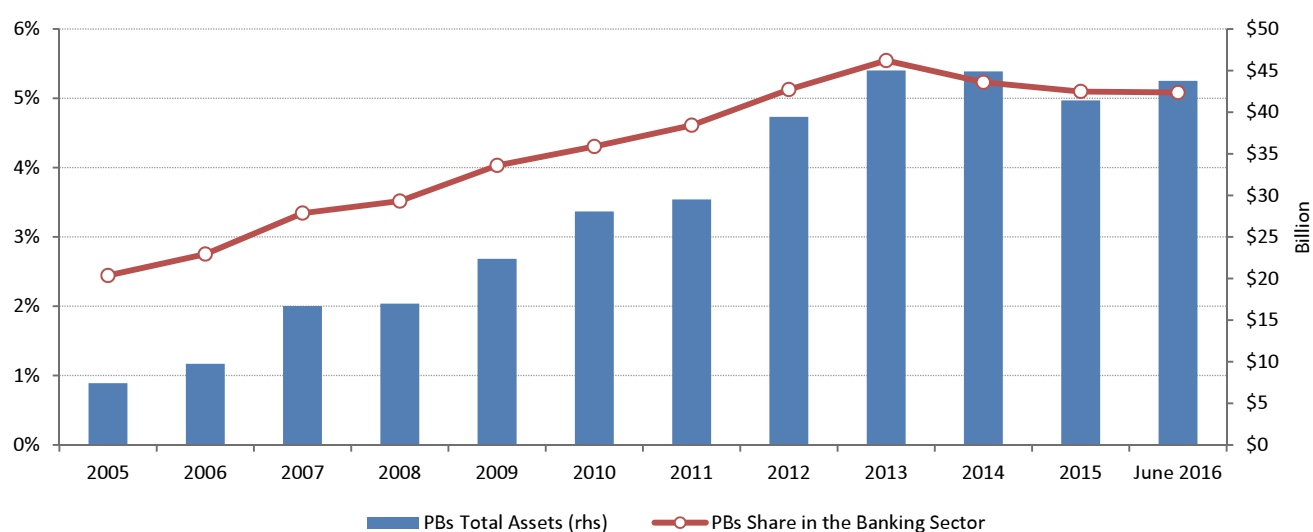
As of end 2015, the size of the financial sector in Turkey reached approximately USD 1.2 trillion. Turkish Financial Sector consists substantially of banking assets (84 percent in 2015).

**Table 4 Market Share of Different Types of Banks in Turkey (as of end 2015)**

	Credits (%)	Total Assets (%)	Deposit (%)	Equity (%)
<b>Commercial Banks</b>	90.19	90.37	94.04	86.99
<b>Participation Banks</b>	4.85	5.10	5.96	4.06
<b>Investment Banks</b>	4.97	4.52	0	8.96
<b>Banking Sector</b>	100	100	100	100

Source: BRSA

**Figure 30 Participation Banks' Total Assets**



Source: BRSA

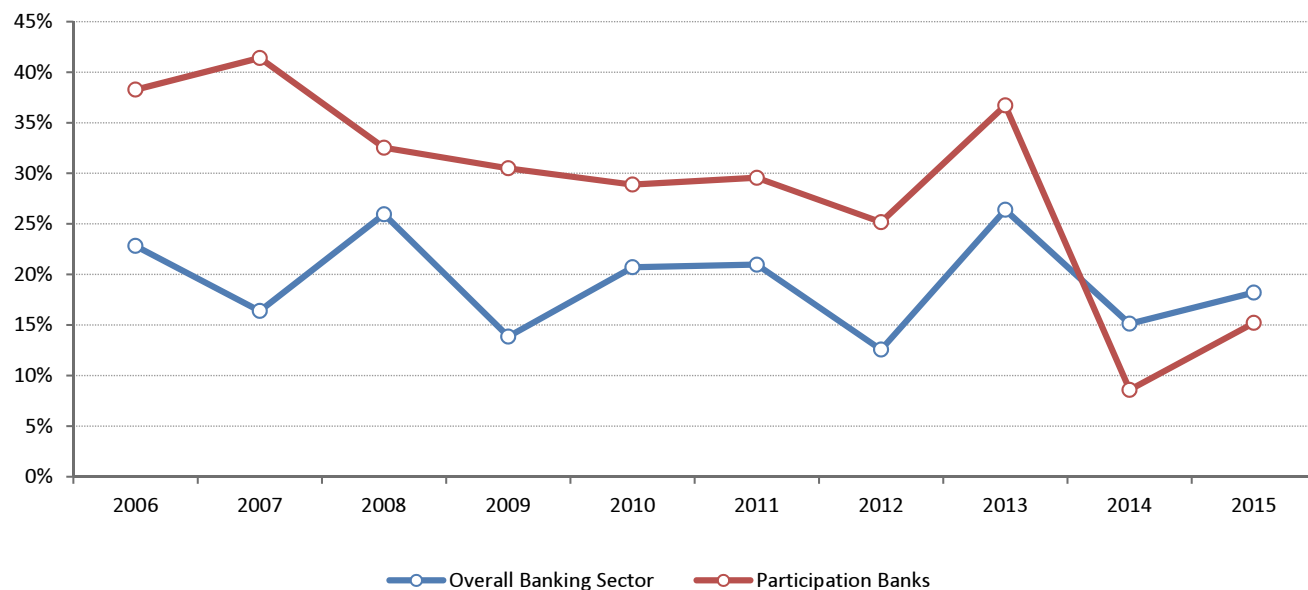
As seen in Table 4, the market share of participation banks, which was 4 percent of banking sector assets in 2009 increased to 5.1 percent by the end of 2015. The total asset size of Turkey’s participation banking sector, consisting of Albaraka Türk, Bank Asya, Kuveyt Türk, Türkiye Finans and Ziraat Katılım, grew by 15.3 percent in 2015 to reach TL 120.3 billion. As in credit; deposit (participation funds) and equity terms are also deemed to have a share of around 5 percent in the Turkish banking sector. While overall banking sector achieved high growth with 18.8 percent annual average growth rate in the last decade, participation banks showed a remarkably better performance than the banking sector with 28.7 percent annual average growth rate at the same period.

Table 5 Key Indicators

Participation Banks of Turkey – Key Indicators (2015)		
Funds Collected TL 74.4 billion	Funds Allocated TL 79.2 billion	Total Assets TL 120.3 billion
Shareholders’ Equity TL 10.6 billion	Number of personnel 16,554	Number of branches 1,080

Source: BRSA

Figure 31 Annual Banking Assets Growth Rate



Source: BRSA

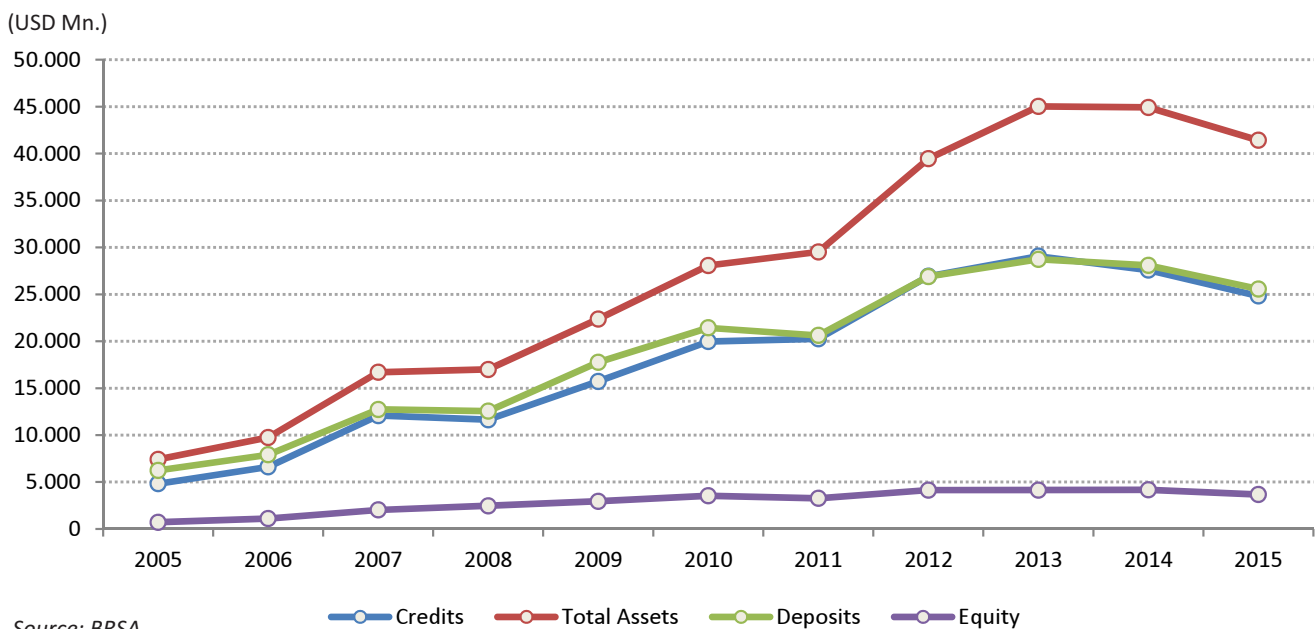
Table 6 Participation Banks Balance Sheet Items

Million USD	2010	2014	2015	Change 2010-2015	
				Amount	%
<b>Loans</b>	19,966.76	27,579.67	24,824.46	4,858	24.3
<b>Total Assets</b>	28,073.42	44,910.95	41,416.85	13,343	47.5
<b>Deposits</b>	21,435.96	28,077.63	25,566.98	4,131	19.3
<b>Equity</b>	3,533.47	4,165.45	3,666.18	133	3.8

Source: BRSA

After SFHs were identified as banks in the new Banking Law in 2005, their financial figures began to grow rapidly (annual average 28.7 percent) and the growth rate did not slow between 2010 and 2015. As can be seen on the Table 6, their total assets increased by USD 13 billion (47.5 percent) in the last five years.

Figure 32 Balance Sheet Items (2005-2015)



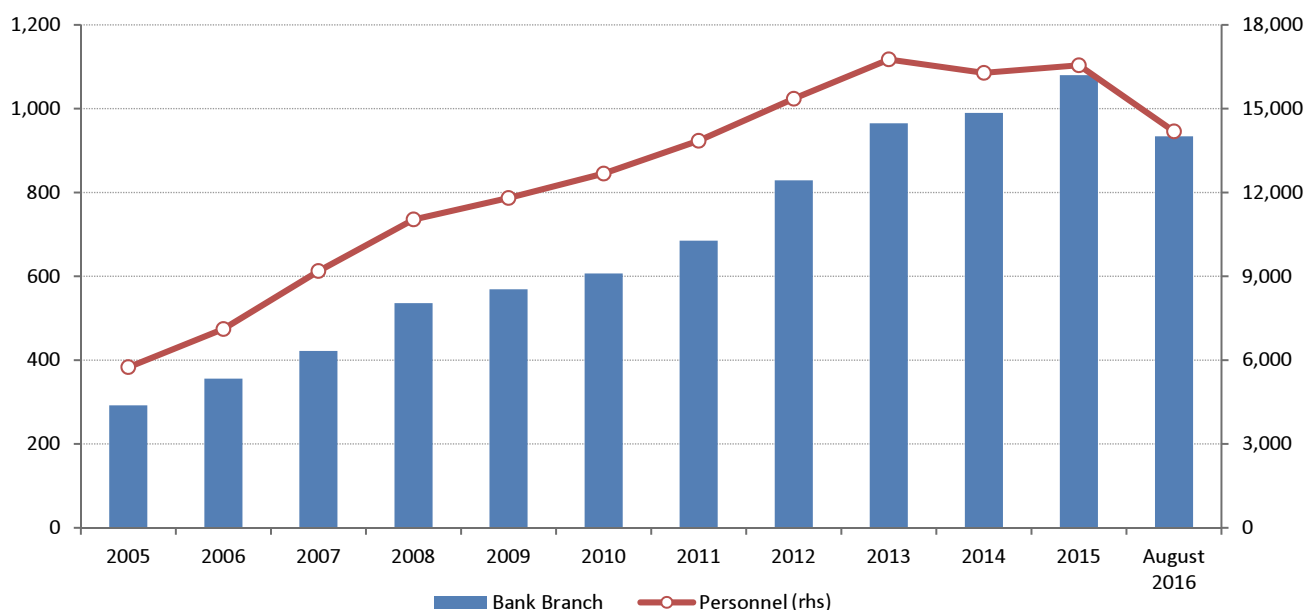
Six participation banks were operating in Turkey, as of June 2016. Ziraat Katılım and Vakıf Katılım have been operational since May 2015 and February 2016, respectively. As seen in Table 8 Kuveyt Türk and Türkiye Finans are the largest participation banks in Turkey. Participation banks succeeded not only in financial figures but also in organic growth in recent years.

**Table 7 Participation Banks Branch**

	2010	2014	2015	2010-2015	2014-2015
<b>Branch</b>	607	990	1,080	473	90
<b>Domestic</b>	605	986	1,076	471	90
<b>Abroad</b>	2	4	4	2	0
<b>Off-shore</b>	1	1	2	1	1
<b>Personnel</b>	12,677	16,280	16,554	3,877	274

Source: BRSA

There were five participation banks operating in Turkey at the end of 2015 with a total of 1,080 branches and they hired 3,877 new staff in the last five years. The data on branches and staff in 2010, 2014 and 2015 of participation banks in total are demonstrated in Figure 33.

**Figure 33 Participation Banks' Branches and Personnel**


Source: BRSA

Loans to SMEs, which form the backbone of the economy along with specific products, services and solutions offered, have improved significantly. Participation banks continued to meet the funding needs of the real sector as well as individuals in 2015. An array of innovations were introduced, from credit cards to electronic banking, further cementing the position of participation banking in the Turkish banking system and they served as significant steps in terms of interest-free financial system, which are to be used by larger masses within the economic life.

Table 8 Participation Banks Selected Indicators

Participation Banks December 2015 (Million USD)	Total Assets	Credits	Deposits	Equity	CAR (%)	ROA (%)	ROE (%)
<b>Albaraka</b>	10,336	6,061	6,908	736	15.27	1.12	17.17
<b>Asya Katılım</b>	2,690	1,507	1,368	391	16.20	-5.60	-34.50
<b>Kuveyt Türk</b>	14,747	8,231	9,663	1,190	14.23	1.13	14.91
<b>Türkiye Finans</b>	13,488	8,926	7,570	1,174	13.51	0.70	8.37
<b>Ziraat Katılım</b>	761	463	427	233	47.41	-1.32	-2.66
<b>Vakıf Katılım (Operational in 2016)</b>	-	-	-	-	-	-	-
<b>Total</b>	42,022	25,188	25,936	3,724	14.91	0.35	4.05

Source: BRSA

In 2015, participation banks sector demonstrated a successful performance in terms of funds collected. The volume of funds collected increased by 13.7 percent y-o-y in TL terms with total funds reaching USD 25.9 billion.

The increase in the volume of funds extended by participation banks to the real sector also continued to grow. "The total funds extended to customers" grew by 12.4 percent in 2015 and reached TL 72 billion. The ratio of "extended funds/collected funds" decreased from its 2014 level to 97.1 percent. On the other hand, there was an increase of almost 10 percent in collected and extended funds per branch.

While the Turkish banking sector as a whole recorded an 18.3 percent rate of growth in deposits and 19.7 percent increase in loan volumes in 2015, the participation banking sector posted lower rates of growth. This situation specifically resulted from a case peculiar to one participation bank. Nevertheless, the sector's share in both collected and extended funds was close to the levels of the previous year. Market shares of participation banks for collected and extended funds in 2015 were 6 percent and 4.9 percent, respectively.

The sector's equity structure remained sound in 2015 and continued to grow. The total equity of participation banks rose by 10 percent, to reach TL 10.6 billion. The sector's capital adequacy ratio recorded as 15 percent during the same period. The share of total equity of participation banks in total sector equities stood at 4.06 percent. This shows the necessity of scaling up equity.

The participation banking sector, which had suffered a sharp decline in profitability in 2014 due to the loss announced by one participation bank transferred to the Savings Deposit Insurance Fund, managed to increase its net profit by 184 percent in 2015 thanks to the low base effect. As such, the sector's return on equity increased from 1.6 percent in 2014 to 4.1 percent in 2015. The sector's capital adequacy ratio sustained its robust level of 14.6 percent in 2014 and recorded an increase in 2015 with 15 percent.



Based on the increase in investment since 2008, Turkey posted the most rapid growth in the participation banking sector between 2009 and 2013, after Indonesia. According to the EY's 2016 World Islamic Banking Competition Report, the participation banking sector's total assets are expected to grow by 78.8 percent over the next 5 years to reach USD 93 billion by 2020.

### a. Legislation Development Process

Within the context of establishing legal infrastructure of interest-free finance in detail, a department has been established within BRSA. The process is carried out under the supervision of two main divisions. One of the divisions follows the IFSB standards and ensures their compliance with internal standards. The BRSA closely follows the international standards related to interest-free finance and ensure the smooth implementation of these standards in Turkey. Additionally, the BRSA is enhancing its capacity and broadening its experience to compose new standards, if necessary.

The other division is responsible for making necessary amendments to the current regulation and new regulations in order to encourage interest-free financial activities including recognition and identifying the philosophy and the principles of interest-free finance system, tax and other financial incentives, enabling easy operational processes.

### b. Mechanism of Participation Banking

Participation banks, a component of the banking system in Turkey, have drawn the idle funds into the system. These banks have provided alternative financial opportunities to manufacturers, businessmen, and individuals having interest sensitivity.

Assets		Liabilities	
Murabaha (Finance Support)	90	Capital	15
Ijarah (Leasing)	5	PLSA	70
Istisna	2	Special Current Accounts	15
Salam	1		
Musharakah (PL Partnership)	1		
Mudarabah (PL Partnership)	1		
<b>Total</b>	<b>100</b>	<b>Total</b>	<b>100</b>

The policy of lending loans in installments and recovering the loans by monthly installments has been generally regulating the cash flow and liquidity needs of participation banks and strengthening the loans security.

Lending method of participation banks (requesting an invoice before lending agreement) curbs irrational behaviors and prevents enterprises from using more credits than their needs. Furthermore, in-kind credit method (leasing) supports enterprises to have more convenient and relatively manageable cash flow. Also, participation banks have helped government in coping with informal economy via asset-based credit methods. So, participation banking is not only an interest-free based banking business, but also a type of banking that can be formulated by "less risk in liabilities, but higher quality in assets, based on high level of credit securities".

To this end, participation banks use two types of deposit collection methods, while they have four types of lending methods.

## ***i. Deposit Collection***

### **Special Current Accounts**

Special current accounts are defined in the Banking Law as:

*“The accounts opened at participation banks consisting of funds that can be partially or fully withdrawn upon request at any time at no charge”.*

There is no return for that type of account, liability of participation banks covers only principal. Special currency accounts represent deposits in Turkish Lira and foreign currencies, mainly the U.S. Dollar and the Euro.

Current accounts present the services of

- Checking,
- Bill payment,
- EFT and invoice services,
- Credit card,
- Automatic payment,
- Financing,
- Physical gold.

Special current accounts within the participation banking is very convenient and easy to access and use via many channels like call centers, online banking, automated teller machines, 24 hours a day, 365 days a year besides the branches all over the country.

### **Participation Accounts (Profit / Loss Participation Accounts)**

Participation accounts are defined in the Banking Law as:

*“Accounts constituted by funds collected by participation banks that yield the result of participation in the form of loss or profit to arise from the use of funds by these institutions, and which do not require the payment of a pre-determined return to their owners and that do not guarantee the payment of the principal sum”.*

Profit/Loss accrued at maturity is shared on a pro-rata basis. In this type of account, participation banks do not offer any pre-determined profit ratio and do not guarantee any revenue or repayment of principal amount after the maturity. Participation accounts are established with maturities of one month, three months, six months and one or more years. Participation accounts can be opened in Turkish Lira, U.S. Dollar, or Euro. Each currency is grouped and accounted separately in a “pool system”. The profit/loss amount of each group is calculated on the maturity date of each deposit, participation banks take 20-25 percent of the profit/loss, while the remaining 75-80 percent belongs to the deposit holders. The percentage share is determined by the maturity period and the size of the deposit before the opening of the account. Profit (return) derived from participation account is subject to tax.

## ***ii. Fund Lending***

### **Corporate Finance Support (Murabaha)**

In this type of financing, participation bank purchases goods and/or services on behalf of corporate customer and makes the payment to the seller. Customer is indebted cost plus profit to the bank and customer pays back to the bank in installments throughout the time. In corporate finance support:

- A tangible asset must be available,
- Asset must be compatible with Islamic rules,
- Customer must know the cost of good,
- During the transaction, bank and customer must agree on the price, on the profit rate and on the term of repayment.
- After the execution of sale, the profit rate cannot be changed.
- Participation bank may grant special authorization to customer (wakalah) for the purchase of goods.

### **Individual Finance Support (Murabaha)**

This type of financing is similar to corporate finance support but the customers are individuals. In this type of financing, participation bank purchases vehicles, houses and consumer goods on behalf of individual customer and makes the payment to the seller. Customer is indebted cost plus profit to the bank and customer pays back to the bank in installments throughout the time. The same rules also apply to this type of murabaha.

### **Leasing (Ijara)**

Financial leasing, according to the Law (nr. 6361), is:

*“A leasing transaction enabling one of the following aspects on condition to be based on a financial leasing contract; transferring the possession of an asset by the lessor authorized pursuant to this Law or related legislation to the lessee at the end of lease giving the lessee the right to purchase the asset at a sum less than its current market value at the end of the lease period, lease period shall cover more than 80 percent of the asset’s economic life, or the sum of current value of lease payments to be made pursuant to the financial leasing contract shall constitute more than 90 percent of the current market value of the asset.”*

Since participation banks (lessor) own the goods until the end of term, investors (lessee) would pledge minimal collateral for this lease contract. Therefore, leasing is more flexible compared to other modes of financing.

Lease payments are determined according to the lessee's request and the project's needs. Also, a payment plan can be made according to the revenue generated by the leased goods; in this way the business may have advantages to control the cash flow.

In this method, participation banks purchase movable or immovable goods. The customer leases the goods within a contract and pays the installments and participation bank transfers the title of the good to the lessee (renter) after all the payments. In leasing,

- An investment good is subject to amortization,
- At the end of the rent period, title of the good is transferred to the customer,
- Tax advantages are available for lessee, for some group of goods,
- Rental period and rent amount can be changed with an emendator contract.

### **Profit and Loss Partnership Investment (Musharaka, Mudarabah)**

In this type of financing, it is the key that there is a partnership between customers and participation bank. Partnership can be organized in two ways:

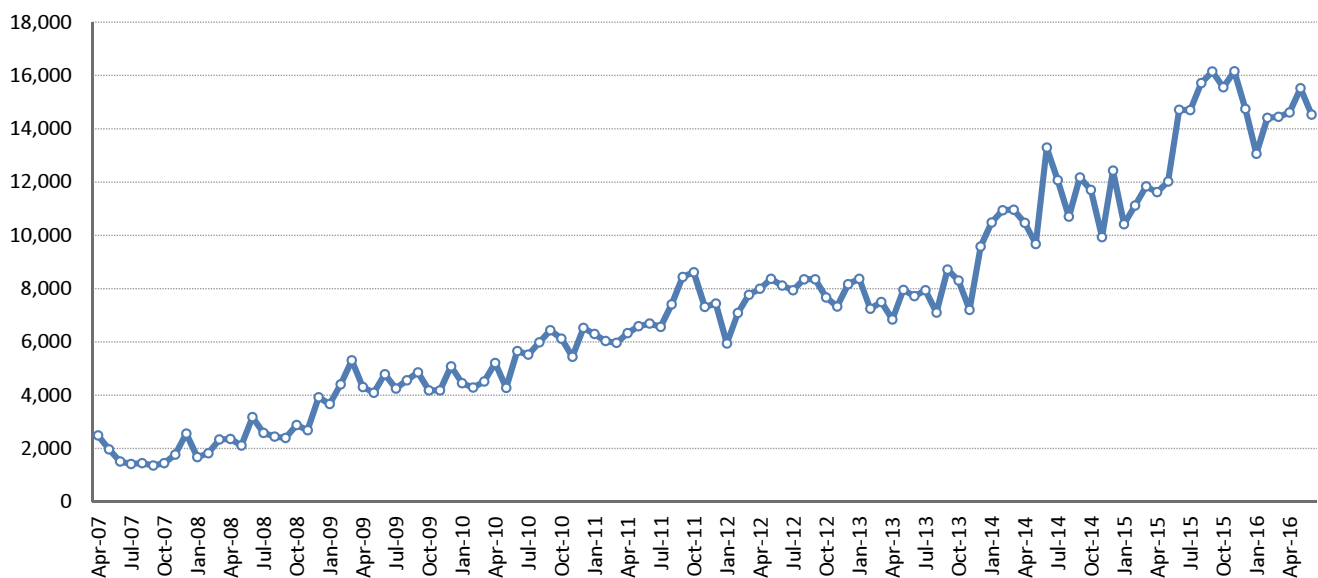
- Parts may contribute both in cash and labor, know-how (Musharaka)
- One part invests cash (investor), the other part labor, know-how (Mudarabah)

Financing amount and profit/loss shares are determined at the beginning. After completion of the investment or projects, the profit or loss incurred is shared by partners.

### c. Liquidity Management of Participation Banks

Participation banks need liquid instruments not only for investment but also for counter-balancing cash outflows. These banks use the profit-and-loss-sharing methodology on the “liability” side of their balance sheets. On the “assets” side, these banks give financing facilities for tangible projects in the real sector (household or companies), which have higher risk weights. For this reason, they need to stay in cash or invest in liquid instruments. Participation banks keep a high proportion of cash in their balance sheets for safeguarding themselves against inherent liquidity mismatches.

**Figure 34 Participation Banks’ Cash and Cash Equivalent Assets (TRY Mln.)**



Source: BRSA, CBRT

Keeping more cash for precautionary purposes may have significant effects on financial development. These banks need to protect themselves against the risk related to market liquidity in times of stress. Liquidity coverage ratio and as well as liquidity requirement ratio of these banks are more than 100 percent threshold.

**Figure 35 Liquidity Requirement Ratio (million TL)-Up to 1 Month**

Source: BRSA, CBRT

### ***i. Liquidity Facilities of the CBRT and Efforts to Facilitate Liquidity Management for Participation Banks***

The CBRT is charged with carrying out the following tasks related to liquidity management and payment systems:

- To have an operational structure with sufficient flexibility against unexpected developments in the markets.
- To maintain the level of short-term interest rates within interest rate corridor and around the level determined by the Monetary Policy Committee.
- To ensure that instruments are in use to support the efficiency of the monetary policy.
- To ensure efficient and stable operation of money markets in accordance with the liquidity management strategy as part of its policy mandate of liquidity management.
- To ensure smooth functioning of payment systems.

As the participation banking industry has grown and obtained a bigger share in banking system in Turkey, the CBRT has made necessary changes in its operational framework, contracts and tools to level playing field for participation banks for their access to liquidity facilities provided by the CBRT.

The CBRT has not only extended the coverage of its liquidity facilities to include participation banks and made necessary changes to its operational framework in that regard, but also taken part in the establishment of the International Islamic Liquidity Management Corporation (IILM).

### ***ii. Overview of the CBRT Liquidity Facilities***

Liquidity facilities of the CBRT can be divided into two main sections based on their roles and functions. Maximum maturity of the CBRT liquidity facilities is 91 days except outright purchase and sale. These facilities are Open Market Operations (OMOs) and Lender of Last Resort (LOLR) Facilities.



### a. Open Market Operations Tools

**Table 9 Open Market Operations Tools**

Liquidity Injecting OMO Tools	Liquidity Absorbing OMO Tools
Outright Purchase	Outright Sale
Repurchase (Repo)	Reverse Repurchase (Reverse Repo)
Deposit Lending	Deposit Borrowing
	Liquidity Bills

Source: CBRT

### b. Outright Purchases/Sales

The CBRT can inject/sterilize liquidity permanently into/from banking system in case of a liquidity deficit/surplus via outright purchases/sales of domestic (Turkish Lira denominated) sovereign debt securities/sukuk issued by the Undersecretariat of Treasury and its Special Purpose Vehicle (SPV, Asset Leasing Company of the Treasury).

#### • Repurchase (Repo) and Reverse Repurchase (Reverse Repo)

The CBRT can inject/sterilize liquidity temporarily into/from banking system in case of liquidity deficit/surplus via repo/reverse repo of domestic (Turkish Lira denominated) sovereign debt securities issued by the Undersecretariat of Treasury and its SPV. Repo/reverse maturities can extend up to 91-days. In recent years, while repo maturities have varied from O/N to 3-month maturities depending on liquidity conditions, reverse repo is typically O/N.

The CBRT has O/N repo funding at its marginal lending rate (upper bound of the interest rate corridor) and 1-week repo funding at its 1-week repo rate. Reverse repo is conducted at borrowing rate of the CBRT (lower bound of the interest rate corridor).

Outright purchases/sales and repo/reverse repo transactions are based on sale contracts and contains a bilateral trade between the CBRT and its counterparties. Repo has been a main OMO tool since mid-2008 due to the existing liquidity deficit within the Turkish banking system.

Marginal Lending/Borrowing O/N Repo/Reverse Repo Facilities are available under Borsa Istanbul Organized Repo-Reverse Repo Market for conventional banks. Since participation banks do not have an access to this market, the CBRT allows these banks to do O/N repo against TRY Treasury Lease Certificates under its own Turkish Lira Market.

The CBRT currently conducts 1-week repo quantity auctions at its 1-week repo rate, which is its main funding rate. Only Turkish Lira Turkish Treasury securities are repurchased and reverse repurchased and all other eligible collaterals can be used only for the purpose of margin management.

#### • Liquidity Bills

In case of a permanent liquidity surplus within the banking system, the CBRT can issue liquidity bills with a maximum maturity of 91 days to sterilize excess liquidity. But this practice has not been in use since 2006, as there is liquidity deficit within the system. Outright purchase/sale, repo/reverse repo and liquidity bills are regulated through the Open Market Operations Contract.

• **Turkish Lira Deposit Facilities**

The CBRT lends O/N deposit at its marginal lending rate of the CBRT, while the CBRT borrows O/N deposits at its borrowing rate. Deposit facilities are based on loan contract, typically O/N, though its maximum maturity is 91 days. Deposit facilities (including LOLR Facilities) are regulated under the CBRT Interbank Agreement.

• **Lender of Last Resort Facilities:**

**Table 10 Lender of Last Resort Facilities**

Liquidity Injecting LOLR	Liquidity Absorbing LORL
Late Overnight Liquidity Window Lending	Late Overnight Liquidity Window Lending
Intraday Limit Transactions	

Source: CBRT

• **Late Liquidity Window Lending/Borrowing**

LOLR Facilities are emergency facilities that can be used by the banking system in case of a liquidity deficit or surplus and a lack of alternative resource of funds/credible counterparty to place excess funds. Punitive rates are applied in this mechanism.

These facilities used to be the only deposit facilities based on loan contract and typically O/N facilities. As of May 2016, the CBRT started to allow participation banks to use late liquidity facilities based on repo/reverse repo contract if deemed necessary. These facilities are not regularly used and the usage is an exceptional case.

• **Intraday Limit (Liquidity) Facilities**

Any bank that is in need of an emergency intraday liquidity can make use of this facility; borrows from the CBRT and pays back prior to close of payment system at the end of the day. It is a kind of deposit facility based on loan contract and it's a commission-charged facility.

• **Loan-Based Deposit Facilities vs Sale-Based Open Market Facilities**

Main differences between deposit facilities based on loan contract and repo facilities based on sale contract are the collateral flexibility, day convention to calculate interest, and taxation.

Deposit Facilities: For every one unit of borrowing from the CBRT, at least 30 percent of the collateral required must be Turkish Lira government securities. Remaining part can be made up of other eligible collaterals which are Eurobond and Eurosukuk (Securities issued in FX denomination) issued by Turkish Treasury, IILM Sukuk, FX deposits and banknotes (only USD and EUR). Day convention is actual/360. Banking and insurance transactions tax applies, which is a kind of expense tax. Participation Banks signed the Interbank Agreement that is a precondition to access to the CBRT Liquidity Facilities but avoid using deposit facilities since they are based on loan contract.

Repo/Reverse Repo: For every one unit of borrowing from the CBRT, equivalent amount of Turkish Lira government securities are purchased and sold back. Only for margin management purposes, other types of eligible collaterals aforementioned are accepted. Participation Banks, after the amendment made in OMO contract in May 2013, started to use sale-based repo facilities and outright purchased facilities comfortably.

## SUMMARY TABLES

Table 11 Actions of the CBRT to facilitate Liquidity Management for Participation Banks: Timeline

Action	Time
Establishment of IILM as a founding member and shareholders	October 2010
Membership of PBs to CBRT Liquidity Facilities	May 2011
Acceptance of Lease Certificates issued by Treasury as collateral	October 2012
Amendments in CBRT OMO Contract to ensure the compliance with participation banking principles	May 2013
Repo facility at marginal lending rate of the CBRT under markets department against Treasury TRY lease certificates	December 2013
Acceptance of IILM Sukuk as collateral	October 2014
Simplification and reduction in discount/haircut rate of collaterals	August 2015
Reduction of minimum compulsory share of TRY-denominated government securities in a certain amount of collateral pool for deposit facilities form 50% to 30%	January 2016
Late Liquidity Facility with Repo	May 2016

Source: CBRT

Table 12 Liquidity Facilities: Actively or potentially used or not\*

Liquidity Facility	Conventional	Participation
Outright Purchase	✓	✓
Repo	✓	✓
Deposit Lending	✓	✗
Intraday Liquidity	✓	✗
Late Overnight Liquidity-Depo	✓	✗
Late Overnight Liquidity-Repo	✓	✓

\*Facilities used or that can be used in case of liquidity deficit which is the case in Turkey

Source: CBRT



#### Box 4 Central Bank of Republic of Turkey and International Islamic Liquidity Management

One of the important challenges for current Islamic finance is the absence of liquid instruments for liquidity management of Islamic banks. The efficiency and effectiveness of Islamic Banks is related with having a deep, active and efficient interbank market for Islamic banks in which they can interchange short term instruments for efficient management of liquidity. This is also one of the important conditions for financial stability of the country.

The IILM is a supranational institution established with this specific perspective on 25 October 2010 by central banks, monetary authorities and multilateral organizations to develop and issue high quality, short-term, interest-free finance principles compliant financial instruments to facilitate effective cross-border liquidity management for institutions that offer Islamic financial services.

The IILM was established in conjunction with the 2010 Global Islamic Finance Forum held in Kuala Lumpur, Malaysia by the following central banks and multilateral organizations:

- Bank Indonesia
- Central Bank of Kuwait
- Banque central du Luxembourg
- Bank Negara Malaysia
- Bank of Mauritius
- Central Bank of Nigeria
- Qatar Central Bank
- Central Bank of the Republic of Turkey
- Central Bank of the United Arab Emirates
- Islamic Development Bank (IDB)

The Central Bank of the Republic of Turkey (CBRT) is actively involved in the management boards and working groups of the IILM. In this sense, the CBRT is member of the Governing Board, Board Executive Committee, Board Risk Committee and chair of Board Audit Committee.

The primary objectives of the IILM are to facilitate cross-border liquidity management among the Institutions offering Islamic financial services by making available a variety of interest-free finance principles compliant instruments, on commercial terms, to address the varying liquidity needs of the Islamic financial services; and foster regional and international co-operation to build robust liquidity management infrastructure at national, regional and international levels.

These objectives necessitate regularly and frequently issuing of financial instruments that are compliant with interest-free finance principles. The IILM's efforts to promote efficient and effective liquidity management are vital to safeguarding the long-term growth of the Islamic financial services. The IILM's issuances of high quality, liquid, short-term, tradable Sukūk denominated in an international reserve currency help to extend level playing field to Islamic banks.

Furthermore, the short-term, highly liquid, tradable IILM Sukūk assist the Islamic financial institutions to meet the liquidity coverage ratio requirement under Basel III regulatory standards.

The IILM Sukūk that have been issued and reissued since 2013 are backed by sovereign assets, denominated in an international reserve currency, US dollar, rated "A-1" by Standard & Poor's Ratings Services.

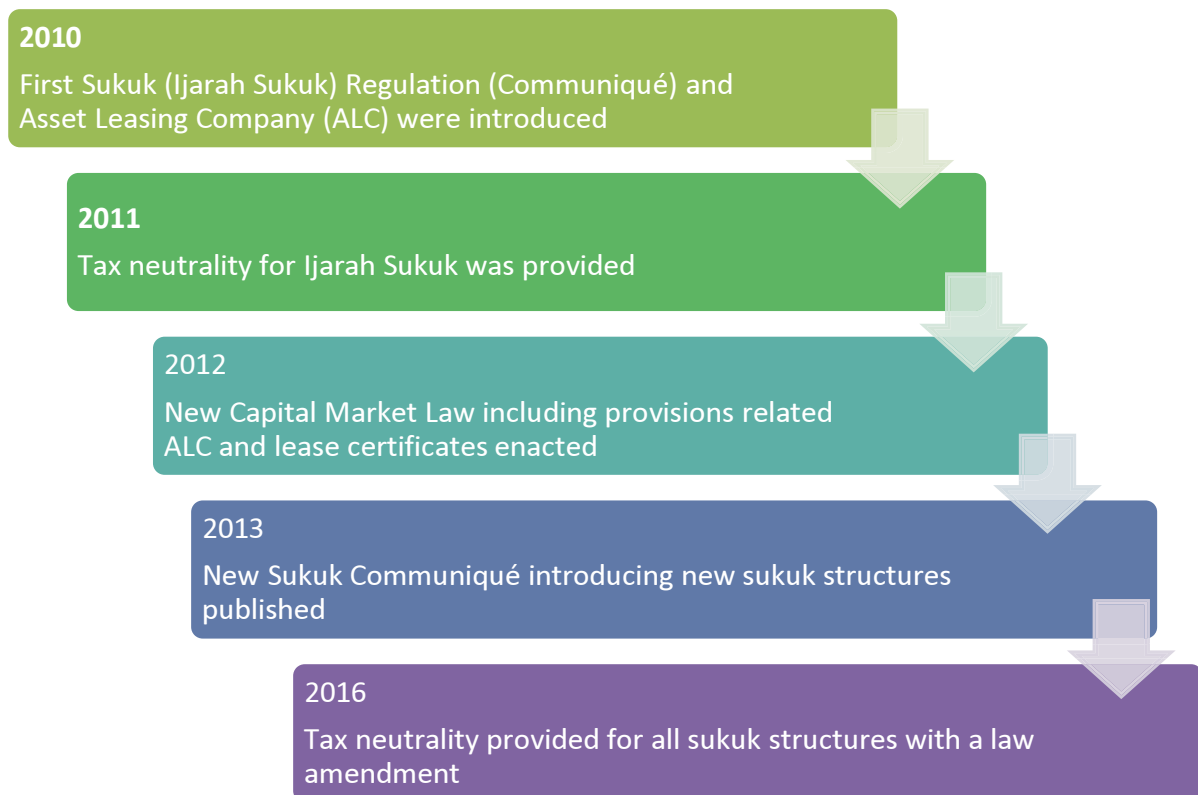
The IILM Sukūk are allocated and distributed in an auction through a network of primary dealers (PDs). Currently there are 11 PDs, including Albaraka Turk Participation Bank of Turkey. As of August 2016, the IILM outstanding Sukūk have reached USD 2.45 billion in size.



## 4. Capital Markets

Since 2010, several amendments have been made regarding the legal and regulatory framework in order to develop Sukuk market. In this regard, timeline of the sukuk regulations are summarized in the Figure 36.

**Figure 36 Timeline of the Sukuk Regulations**



Source: Undersecretariat of Treasury, Capital Markets Board

In the Lease Certificates (sukuk) Communiqué, lease certificates are defined as a security issued by an asset leasing company for the purpose of financing all kinds of assets and rights, and which enables its holders to get a proportionate share from the revenues derived out of such assets and rights.

ALC's principles of foundation, kinds and characteristics of assets and rights of which they may acquire, activities, management, documentation and recording systems, and liquidation thereof are also regulated in the Communiqué.

The five contract types based on which Sukuk shall be issued are listed in the Communiqué as ownership, management agreement, trading, partnership and EPC (engineering, procurement and construction) contracts. Nonetheless, these contracts are not restrictive and depending on CMB approval, issuance of Sukuk's with different underlying contracts may be granted.

## a. Lease Certificates (Sukuk)

Until redemption of lease certificates, the assets and rights included in the portfolio of an ALC cannot be disposed of for any purpose other than collateralization, even in the case of transfer of management or supervision of ALC to public authorities, and cannot be pledged, or shown as a collateral, or attached for any purpose including the collection of public receivables, or included in bankrupt's estate, or be subject to an interlocutory injunction.

Holders of lease certificates are proportionately entitled to have the revenues obtained from base assets and rights for the issuance of the certificates. If required so in the issuance process, at the end of maturity, the assets and rights are sold by ALC to originator or to third parties and the proceeds of sale are distributed to lease certificate holders in proportion to their shares therein.

Lease certificates are redeemed within the frame of the principles set forth in the prospectus or in the case of sales without public offering, in the agreement relating thereto.

### • Ownership-Based Lease Certificates (Ijarah)

Ownership-based lease certificates are lease certificates issued to finance the assets and rights to be acquired by ALC from originator in order to be leased to originator or third parties or to be managed in the name of ALC. A total of 90 percent of fair value of assets and rights is determined as an amount of issue limit.

### • Management Agreement-Based Lease Certificates (Ijarah/Wakalah)

Management agreement-based lease certificates are issued for the purpose of transfer of revenues obtained as a result of management of assets or rights owned by the originator in favor of ALC, also including their lease until the end of maturity, to ALC within the framework of provisions of the management agreement.

### • Trading-Based Lease Certificates (Murabahah)

Trading-based lease certificates are issued to finance the purchase of certain assets or rights by ALC in order to be sold on deferred payment basis to companies.

ALC is under obligation to purchase the base assets or rights from the spot market and to resell them on deferred payment basis at a price above their cost following the date of transfer of the funds collected from issuance to its account. Additionally, the assets or rights on the basis of which lease certificates are issued are required to be traded in Borsa Istanbul or in other liquid markets.

### • Partnership-Based Lease Certificates (Mudharabah/Musharakah)

Partnership-based lease certificates are issued by ALC for the purpose of partnership in a joint venture. Two types of joint ventures are permitted with the communiqué:

- i) Capital is provided exclusively and solely by ALC,
- ii) Cash capital is provided by ALC, but capital other than personal labor or goodwill is provided by other partners.

90 percent of fair value of assets and rights is determined as an amount of issue limit additionally to the requirement of establishing a pledge in favor of ALC on properties of the joint venture for the interests of lease certificate holders by the issue amount are set as measures of protection of certificate holders in case of a default.

### • EPC (Engineering, Procurement and Construction) Contract-Based Lease Certificates (Istisna)

EPC contract-based lease certificates are issued for the purpose of creation of works pursuant to an EPC contract to which ALC is a party as the owner of works. ALC enters as the owner into the EPC contract in its own name and in the account of lease certificate holders. As part of EPC contract-based lease certificate issues, in addition to EPC contract, other agreements fit for the intended purposes, such as service contract, contracts of construction in return for flats or lands, or partnership agreement may also be signed.

ALC may make the resulting works the subject matter of a sale contract either by leasing first or directly without leasing. As of the end of maturity of lease certificates, the sale price should be fully collected by ALC, and the proceeds of sale should be paid to lease certificate holders.

The amount of issue of EPC contract-based lease certificates cannot exceed 90 percent of fair value and where the price of work is paid in advance by ALC, the contractor is required to establish a pledge on movables or real properties or give similar other guarantees in favor of ALC in order to ensure precise and timely completion of the work.

Lease certificates may be issued by sales through or without public offering. Sales without public offering may be in the form of private placement or sales to qualified investors and lease certificates to be offered to public must be listed and traded in the exchange, and an application must be filed to the exchange for this purpose.

#### *i. Sovereign Sukuk*

The Turkish Treasury has a strategic goal of broadening the investor base. In this context, the Treasury has been developing sukuk (lease certificate) as a financial instrument for public borrowing to broaden the investor base by reaching investors sensitive to interest and manage risks in an active manner.

To reach this goal, the necessary legislation passed by the Parliament in June 2012 within the Law on Regulating Public Finance and Debt Management dated March 28, 2002 numbered 4749 Article 7/A (Undersecretariat of Treasury, 2002).

- The new legislation allows for the establishment of Public Asset Leasing Companies (SPV).
- The Sovereign is able to transfer public assets to the Asset Leasing Company in the sale-and-lease-back model.
- Assets held by the central government, state-owned enterprises and local administrations can be used.
- Allows the Asset Leasing Company to issue lease certificates both in domestic and international capital markets.
- Tax regime was set in a similar fashion to conventional sovereign issuances.

#### Government Sukuk Issuance Structure

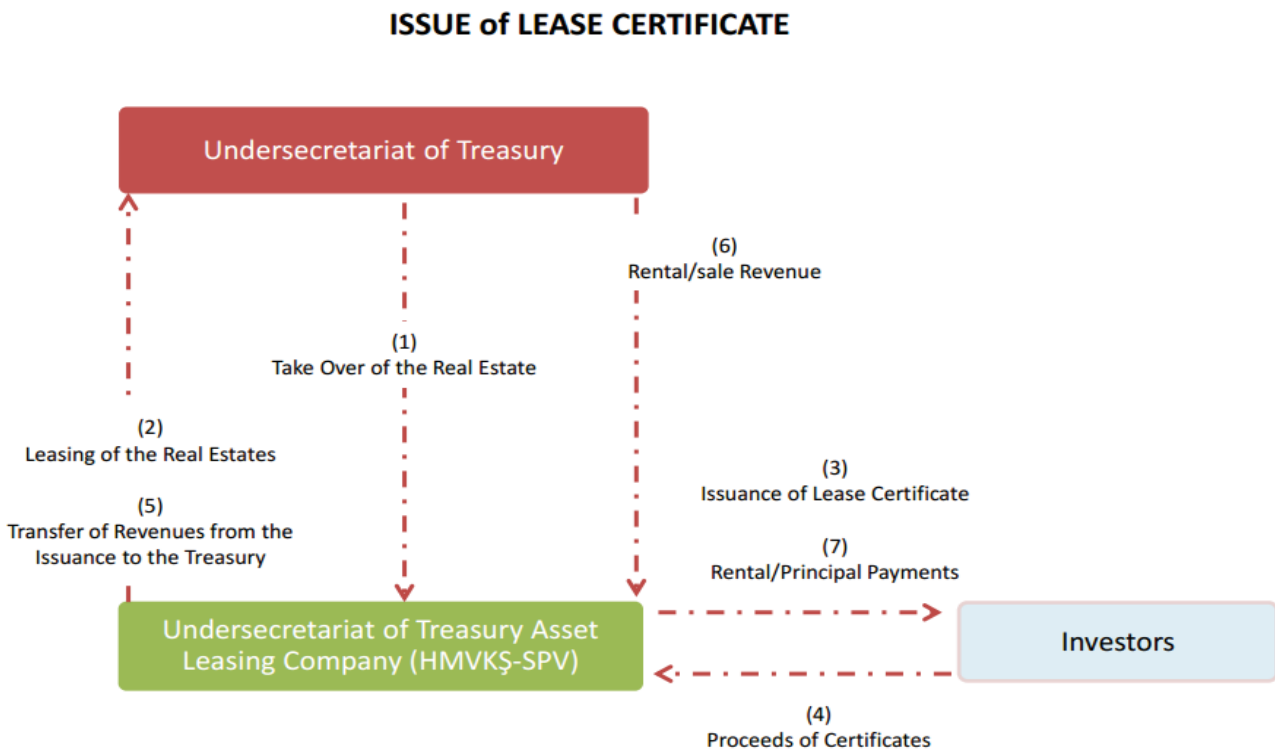
In this context, the steps of a lease certificate issuance are explained below in details:

1. Within the context of Article 7/A of Law Number 4749 on Regulating Public Finance and Debt Management, takeover of the public real estates through sale to the Hazine Müsteşarlığı Varlık Kiralama Şirketi (HMKVŞ, Undersecretariat of Treasury Asset Leasing Company) (SPV) is realized. At the same time, the immovable are registered to deed in the name of HMKVŞ.

2. Provided that the beneficiary institutions continue to utilize the assets that are taken over by the HMKVŞ, a lease agreement, apart from the deal of takeover through sale stated in Article 1, is signed between the Undersecretariat of Treasury and the HMKVŞ. Moreover, a letter of a purchase undertaking of these assets Treasury at the end of the lease period is committed by The Treasury. On the other hand, before the issue, HMKVŞ issues a declaration to address the preservation of the aforementioned assets on its own name and on its own behalf and for the account of and the benefit of certificate holders.
3. In return for the leasing of the assets purchased by the HMKVŞ to the Undersecretariat of Treasury, lease certificates are issued that provide investors to merit rental proceeds from assets on a pro-rata basis.
4. The amount of payment by the investors in return to the lease certificates is transferred to HMKVŞ.
5. Proceeds of lease certificates are transferred to the Undersecretariat of Treasury from the HMKVŞ in return for the asset takeover.
6. In the context of the lease agreement and the purchase undertaking between the Undersecretariat of Treasury and the HMKVŞ, rental payments are fulfilled by the Undersecretariat of Treasury to the HMKVŞ during the life of lease contract and a payment is made in return for the repurchase of immovable by the Undersecretariat of Treasury at the end of the lease agreement period.
7. Rental proceeds on a pro-rata basis and the redemption of the lease certificates are allocated to the certificate holders by the HMKVŞ.

A simplified structure diagram of the lease certificates issued by the HMKVŞ

**Figure 37 Issue of Lease Certificate Scheme**



Source: Undersecretariat of Treasury

## Issuances

After legal environment was made available, the first lease certificate was issued in September, 2012. This was an international debut issue. Although it was the first issuance of Turkish sovereign, this issue attracted a strong demand from market. It was in Ijarah structure, and public land and buildings were used in the asset pool.

In this first issuance, 58 percent of the bond was sold to the investors in the Middle East region. This investor base was previously untapped territory. Since they do not participate in the Treasury's conventional bond issuances, a great diversification opportunity was generated.

15 sukuk issuances were carried out until 2016 September. Eleven of them were TL denominated local market issuances and four of them were in US Dollar denominated international issuance. All these issuances were based on standard ijara sukuk model. Total amount of funds raised by sukuk issuances so far is approximately 26.8 billion TL.

In order to form a benchmark yield (or Sukuk) curve and enhance market liquidity, the Treasury started to issue longer term maturity sukuks (5 years) in the domestic markets for the first time in July 2016. Another important development was a 5 year CPI linked sukuk which was also issued in the domestic market in September 2016 in order to support the market.

**Table 13 Lease Certificate Issuances**

ISIN Code	Value Date	Maturity Date	Maturity	Rental Rate (%) (*)	Rental Payment Period	Sale Amount (million, original currency)	Sale Amount (million TL)
US421790AA42	29.09.2012	26.03.2018	5Y	2.80	6M	USD 1,500	2,678
TRD011014T17	03.10.2012	01.10.2014	2Y	3.70	6M	TRY 1,624	1,624
TRD180215T17	20.02.2013	18.02.2015	2Y	2.85	6M	TRY 1,515	1,515
TRD190815T10	21.08.2013	19.08.2015	2Y	4.50	6M	TRY 1,817	1,817
US421790AB25	10.10.2013	10.10.2018	5Y	4.56	6M	USD 1,250	2,472
TRD170216T17	19.02.2014	17.02.2016	2Y	5.30	6M	TRY 1,333	1,333
TRD280916T17	01.10.2014	28.09.2016	2Y	4.84	6M	TRY 1,840	1,840
US421790AC08	25.11.2014	25.11.2024	10Y	4.49	6M	USD 1,000	2,221
TRD150217T18	18.02.2015	15.02.2017	2Y	3.90	6M	TRY 1,802	1,802
TRD160817T11	19.08.2015	16.08.2017	2Y	4.98	6M	TRY 1,589	1,589
TRD140218T18	17.02.2016	14.02.2018	2Y	5.32	6M	TRY 1,900	1,900
US421790AD80	08.06.2016	08.06.2021	5Y	4.25	6M	USD 1,000	2,889
TRD140721T18	20.07.2016	14.07.2021	5Y	4.70	6M	TRY 908	908
TRD260918T17	28.09.2016	26.09.2018	2Y	4.40	6M	TRY 1,103	1,103
TRD220921T16 (**)	28.09.2016	22.09.2021	5Y	1.12	6M	TRY 1,067	1,067
<b>ALL ISSUANCES</b>							<b>26,757</b>
<b>TL ISSUANCES</b>							<b>16,497</b>
<b>USD ISSUANCES</b>							<b>4,750</b>

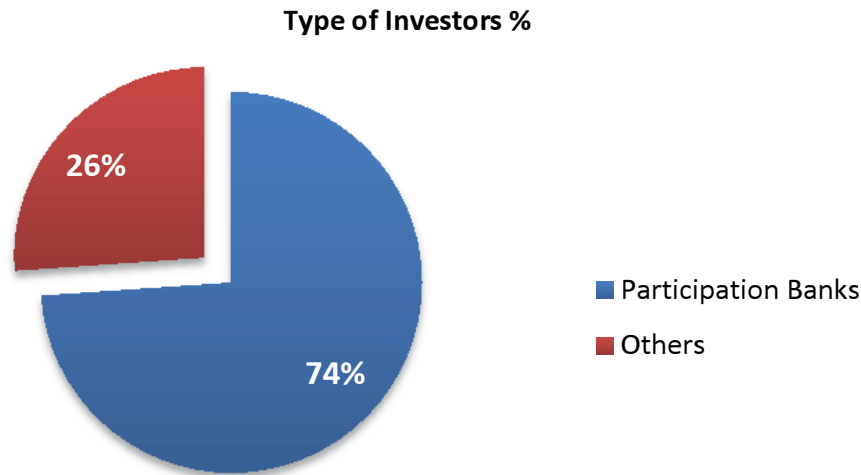
(\*) For local issuances rental rates are 6 month period (term) and for external issuances rental rates are annual term.

(\*\*) Inflation Indexed Lease Certificate.



On domestic side, the majority of total issuances are sold to Turkish participation banks. These sovereign sukuk issues provided some advantages for the participation banks as well. The sovereign sukuk issuances are subject to repo transactions with the CBRT so that participation banks can implement better cash management. Moreover, in May 2013, the rules for repo agreements with participation banks were amended and the CBRT enjoyed the right to withdraw from the agreement in order to comply with Islamic rules.

**Figure 38 Investor Composition of Domestic Issuances**



Source: Undersecretariat of Treasury

### Future Agenda

In order to diversify the financing tools of the Treasury as a strategic goal, the Treasury announced two regular domestic sukuk issuances each in 2013, 2014, 2015 and 2016 in its annual Treasury Financing Programs and these issuances are planned to be continued in the future on a regular basis. However, in order to meet additional demand from the market, the number of issuances can be increased. This issuance strategy is also important to transform Istanbul into an international finance center.

Achieving a more active secondary market for sukuk instruments is on the Treasury's agenda as a strategic goal. Additionally, the Treasury's another plan is to issue sukuk to finance Turkey's infrastructure and superstructure constructions.

### *ii. Corporate Sukuk Market in Turkey*

Table 14 shows Turkey's Corporate sukuk issuance trend from 2011 to 2015. Issuance limit references the limit given to the corporates and authorizes sukuk issuance within one year by Capital Markets Board.

Table 14 Corporate Sukuk Issuance Limits and Issuances\*

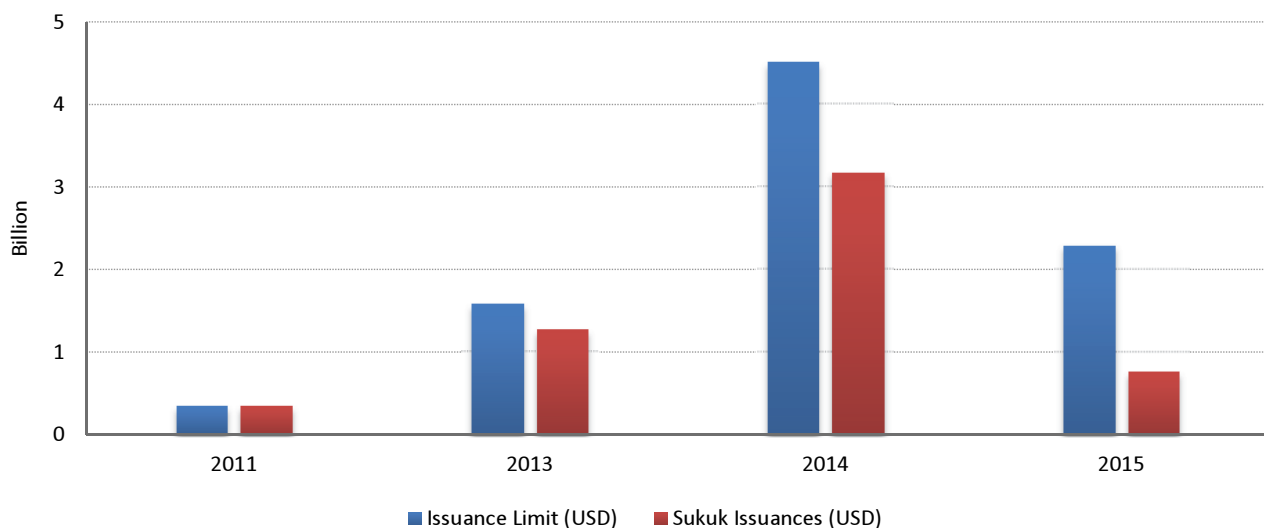
Period	Issuance Limit (USD)	Sukuk Issuances (USD)
2011	350.000.000	350.000.000
2013	1.573.012.228	1.272.344.749
2014	4.510.038.180	3.173.620.607
2015	2.295.000.684	762.260.116
<b>Total</b>	<b>8.728.051.092</b>	<b>5.558.225.472</b>

\*Sukuk issuance currency data converted with related end of year currency.

Source: CMB

In 2011, a relatively low issuance limit was set and all of the sukuk issued were sold cross-border. Subsequently, 2012 was a dead year in terms of sukuk issuances. Until the amendment in the Capital Markets Law, only ijara types of sukuku were issued. The first corporate wakalah sukuk was issued in 2015.

Figure 39 Annual Sukuk Issuance



Source: CMB

As seen in Figure 39, there is a noteworthy increase in 2014. However, in 2015, both the issuance limit and issued amount decreased due to several factors such as the global market conditions, the USD/TL parity and domestic political issues such as the general elections.

Sovereign and corporate sukuk issuance amounts and maturities from 2011 to the second quarter of 2015 are given in Table 16 and Table 17. As is the case in most of the economies, sovereign Sukuk issues exceed the corporate ones and have longer maturity. Furthermore, sovereign Sukuk secondary market transactions dominate the market whereas there are only a few corporate Sukuk transactions.

**Table 15 Corporate Sukuk Issuances\***

	PUBLIC OFFERING		QUALIFIED INVESTORS-PRIVATE PLACEMENT		CROSS-BORDER	
	Issuance Limit (USD)	Sold (USD)	Issuance Limit (USD)	Sold (USD)	Issuance Limit (USD)	Sold (USD)
<b>2011</b>	-	-	-	-	350.000.000	350.000.000
<b>2013</b>	140.561.308	117.134.423	726.233.425	459.824.251	706.217.495	695.386.075
<b>2014</b>	536.227.532	136.845.266	1.180.773.026	800.028.741	2.793.037.622	2.236.746.600
<b>2015</b>	855.197.893	259.980.159	938.323.128	450.909.588	501.479.663	51.370.369
<b>Total</b>	1.531.986.733	513.959.848	2.845.329.579	1.710.762.580	4.350.734.780	3.333.503.044

\*Sukuk issuance currency data converted with related end of year currency.

Source: CMB

**Table 16 Corporate Sukuk Issuances (2011-2015)\***

	Issue Amount (Mil. USD)	Average Maturity (Year)
<b>Cross Border</b>	3,333	5
<b>Domestic</b>	2,225	1
<b>Total</b>	5,558	

\*Sukuk issuance currency data converted with related end of year currency.

Source: CMB

**Table 17 Sovereign Sukuk Issuances (2011-2015)**

	Issue Amount (Mil. USD)	Average Maturity (Year)
<b>Cross Border</b>	3,750	7
<b>Domestic</b>	5,386	2.14
<b>Total</b>	9,136	

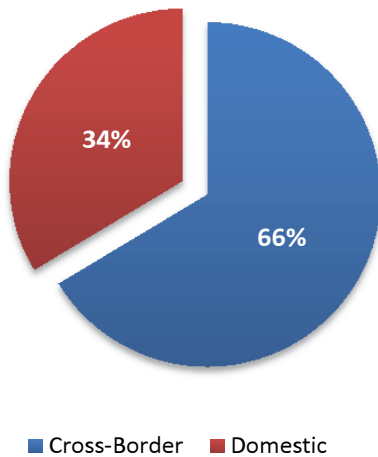
Source: CMB

As for corporate sukuk issues, the cross-border issues exceed the domestic issues while the opposite is observed in sovereign Sukuk issues. The ratio of domestic corporate sukuk issues to total corporate Sukuk issues is 34 percent.

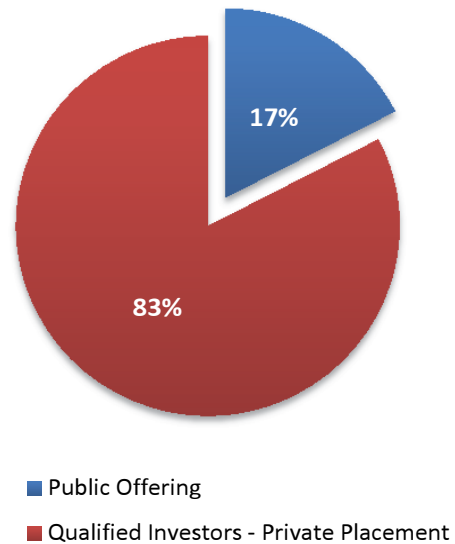
Figure 40 shows that private placement and sale to qualified investors is a more favored issuance method over public offering.

**Figure 40 Domestic vs. Cross-Border Private Sukuk Issuance and Sukuk Issuance by Method**

Domestic vs. Cross-Border Private Sukuk Issuance



Sukuk Issuance by Method



Source: CMB

## b. Participation 50 Index

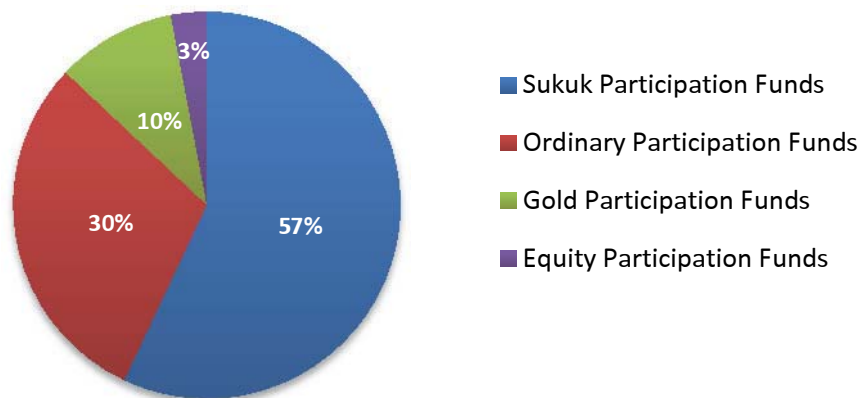
Borsa Istanbul offers index calculation services to Participation 50 Index and other Indices in Participation Index Family (Participation 30 Index and Participation Model Portfolio Index). These indices were created by an investment firm, one of the members of Borsa Istanbul, to measure price and return performances of stocks selected based on Participation Banking principles. These indexes are highly correlated with other BIST indexes. In the first half of 2016, the return of Participation 50 Index was 6.62 percent, while the return of BIST 50 was 9.35 percent.

## c. Participation Funds

Participation fund is an important investment tool for investors who choose to avoid interest revenue. In Turkey, participation umbrella funds are regulated by the Communiqué on Principles of Investments Funds (Nr. III-52.1).

In the Communiqué on Principles of Investments Funds, (Nr. III-52.1), participation umbrella funds are defined as funds, where at least 80 percent of the net asset value of the fund is permanently invested wholly and permanently in lease certificates (Sukuk), participation accounts at participation banks, corporate shares, gold and other precious metals and other non-interest money and capital market instruments deemed appropriate by the CMB.

In addition, according to the Guideline for Investment Funds, if at least 80 percent of the net asset value of a fund is permanently invested in a specific asset group, sector, or geographical region, that must be reflected in the fund name.

**Figure 41 Participation Funds (NAV Distribution according to the Types)**

Source: CMB

In this legal context, there were 29 participation funds and the total net asset value of these funds was about USD 75 million, by June 2016. The total net asset value of participation funds constitutes only 0.54 percent of the total net asset value of the total mutual funds in Turkey. Hence, participation funds in Turkey have a big potential to realize in the coming years.

Figure 41 shows the net asset value distribution of participation funds according to the type of participation funds. The figure indicates that about 57 percent of the participation funds are Sukuk participation funds, where at least 80 percent of the net asset value of funds is invested in Sukuk (formally named as lease certificates).

The ordinary participation funds, where 80 percent of net asset value is not dedicated to any specific permissible asset, comes in second with a 30 percent share. Gold participation funds constitute 10 percent and equity participation funds represent 3 percent of the total net asset value of all participation funds.

Moreover, in the pension system, there are also participation funds and other non-interest based funds (i.e. gold funds) for interest sensitive contributors. The total amount of participation funds (including the government contributions) is about USD 355 million. Including the gold funds, interest-averse funds reach USD 660 million.

#### **d. Real Estate Mutual Funds (REMF)**

A real estate mutual fund is a type of mutual fund that primarily focuses on investing in securities offered by public real estate companies. The majority of real estate funds invest in commercial and corporate properties, although they also may include investments in raw land, apartment complexes and agricultural space. This type of fund can invest in properties directly or indirectly through Real Estate Investment Trusts (REIT).

In Turkey, real estate investment funds are regulated by the Communiqué on Real Estate Investment Funds (Nr. III-52.3). Real estate investment fund (real estate mutual fund, REMF) is a pool of assets, which does not have a legal entity and is permanently or temporarily established within the fund rules by portfolio management companies and real estate portfolio management companies, which hold an operating license duly received



from the CMB in order to manage the portfolio comprised of assets and transactions, with money collected from qualified investors in return for fund units. The minimum real estate investment (investments in real estates, shares and debt instruments of REITs, real estate certificates and the units of other REMFs) by a REMF must account for at least 80% of the net asset value of the fund.

Despite the fact that there is no formal regulation on REMFs setting categories compliant with interest-free finance principles, the regulation allows to establish REMFs that are compliant with interest-free finance principles in practice.

As of October 2016, 14 REMFs have been established in Turkey; and 2 REMFs have issued their units.

### e. Real Estate Investment Trusts (REIT)

REIT is a type of investment trust or investment company, which mainly invests in income-producing real estates, such as offices, flats, car parks, warehouses, hospital buildings, lands, shopping malls, plantation estates and hotel buildings. Rent revenues collected from the tenants of these properties, leasing revenues, the revenues from sales of these properties and the increase in the values of the properties held are the main earnings for REITs.

The regulation on REITs in Turkey dates back to the end of 1998, when the first CMB Communiqué on REITs was launched. After the enactment of the latest Capital Market Law (Nr. 6362) at the end of December 2012, the regulation on REITs (the Communiqué on Principles of Real Estate Investment Companies Nr. III-48.1, -the REIT Communiqué-) was issued in May 2013. Finally, the REIT Communiqué was amended to regulate the second type of REIT, which is the REIT that solely invests in infrastructure investments and services.

At least 51 percent of the total assets of the REITs in the first type shall be composed of investments in real estates, real estate projects and real estate rights. On the other hand, at least 75 percent of the total assets of the REITs in the second type shall be composed of infrastructural investments.

There are 32 first-type REITs, whose shares are traded on Borsa Istanbul. There is only 1 second-type REIT established, but its shares have not been sold to public yet.

Despite the fact that there is no formal regulation on REITs setting categories compliant with interest-free finance principles the regulation allows to establish REITs that are compliant with interest-free finance principles in practice.

### f. Private Equity/Venture Capital Investment Fund

Private equity can be defined as investing in companies with a potential for exponential growth but also in need of finance. Private equity investments create value in the enterprise by improving its operational, production or sales performance and thereafter exiting the investment through a sale of the enterprise, in an expectation of profit. While venture capital commonly invests in the start-up or early stage of the life cycle of a business, private equity focuses on financial involvement in more mature stages. Private equity/venture capital investment funds give investors an opportunity to realize huge returns upon sale of the investee company.

In Turkey, private equity/venture capital investment funds are regulated by the Communiqué on Principles of Venture Capital Investment Funds (Nr. III-52.4) published in January 2014. Private equity/venture capital investment fund is an asset with no legal entity, established by portfolio management companies and venture capital portfolio management companies which hold an operating license received from the Capital Markets Board in order to manage the portfolios with at least 80 percent of fund net assets to be composed of one or more venture capital investments.

As of June 2016, one private equity/venture capital investment fund has been founded in Turkey.

Despite the fact that there is no formal regulation on private equity/venture capital investment funds setting categories compliant with interest-free finance principles, the regulation allows to establish REMFs that are compliant with interest-free finance principles in practice.

### **g. Venture Capital and Private Equity Investment Trusts (VCPET)**

Venture capital and private equity investment trust is a form of collective investment scheme, directing issued capital toward venture capital investments which are defined as long-term fund transfers, through investing in capital market instruments issued in primary markets by the entrepreneur companies already established or to be established, with the aim of obtaining capital or interest gains. VCPETs' shares can be sold either to public or solely to qualified investors.

VCPETs may;

- Purchase stocks and borrowing instruments issued by the entrepreneur company.
- Issue borrowing instruments.
- Participate in the active management of the entrepreneur company.
- Invest in other venture capital investment trusts.

Moreover, VCPETs are exempted from corporate tax, which makes VCPETs more preferable for investors.

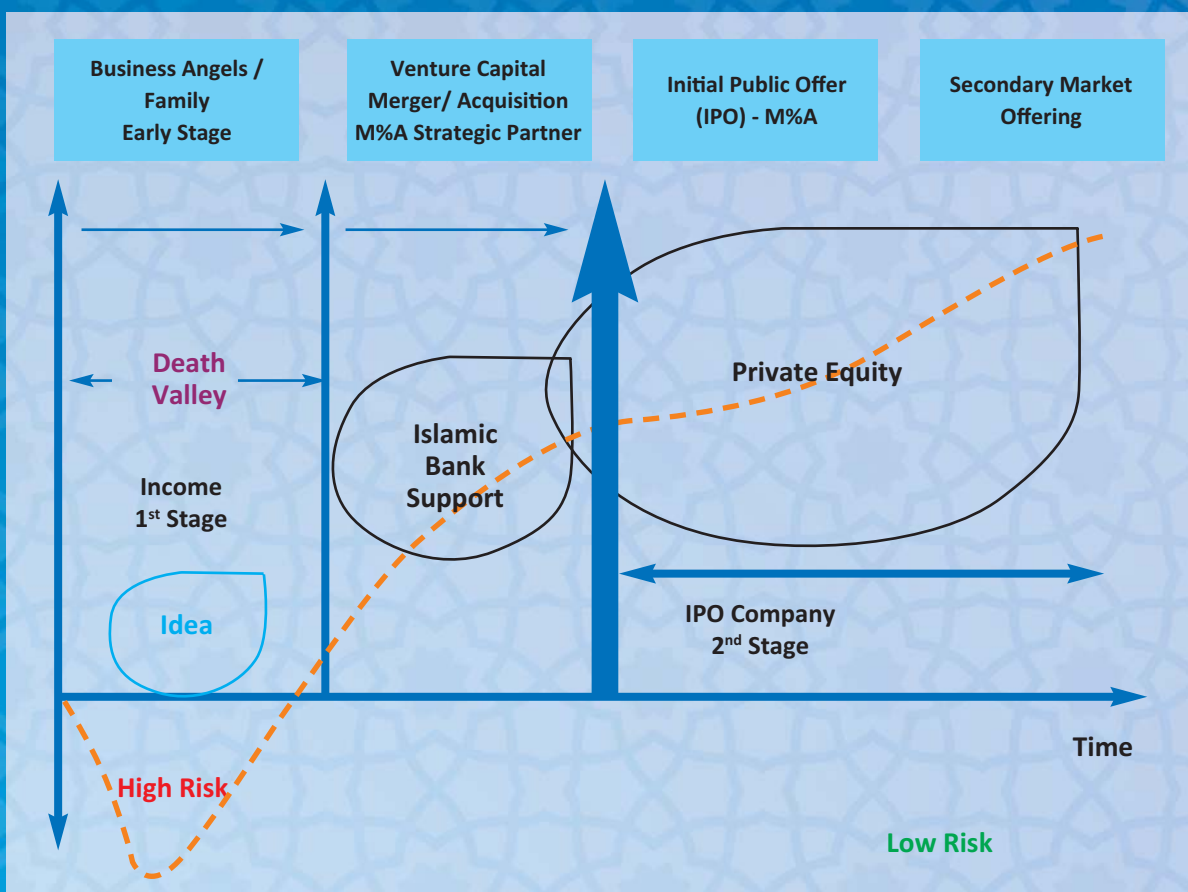
There are currently 13 VCPETs, 8 of which are traded on Borsa Istanbul, 3 are sold to only qualified investors and remaining 2 have not been sold to public yet.

Despite the fact that there is no formal regulation on VCPETs setting categories compliant with interest-free finance principles, the regulation allows to establish VCPETs that are compliant with interest-free finance principles in practice.

### Box 5 Turkey's Angel Investment Scheme

Business Angel scheme provides a mechanism for licensing business angels which will ease access to finance for entrepreneurs, increase professionalism and improve business culture and ethics in the angel investment market. In this respect, licensing mechanism provides a new instrument for those enterprises in early stage development which have funding difficulties with conventional financing. Furthermore, it makes Business Angel investments an institutionalized and trustworthy financial market and eligible for state support.

Business Angels have almost same principle with mudarabah and musharakah financing. In business angel scheme, one party would take part with the entrepreneurship and the other one with the capital.



Turkey introduced a new system to encourage angel investments in Turkey. The law regarding the promotion of angel investments was enacted in Turkey in 2012 and the system was launched in 2013 with the secondary legislation.

Licensed angel investors can deduct 75 percent of the capital they invest in some SMEs from their annual tax base. This deduction ratio will be applied as 100 percent for those angel investors who invest in the SMEs whose projects are supported by Ministry of Science, Industry and Technology, The Scientific and Technological Research Council of Turkey and Small and Medium Enterprises Development Organization.



As of August 2016, 400 business angels have been licensed and 13 business angel networks have been accredited in Turkey. In the same period 27 investment applications were made by the licensed business angels and 15 of them, amounting to TL 7.1 million were benefited from the current program. Although it is a new scheme started on February 15th, 2013 the results obtained so far are promising.

Another reform that is crucial for entrepreneurship ecosystem is Fund of Funds scheme of Turkish Treasury, which is also adopted to support business angel scheme. The law regarding capital contribution of the Turkish Treasury to funds of venture capital funds (fund of funds) was enacted by the Parliament, on 3 April 2013. Secondary legislation came into force on 14 March 2014. The purpose of secondary legislation is to regulate the selection criteria, investment areas, auditing and the upper limits of all fees and expenses pertaining to the resources committed and other related issues regarding the fund of funds receiving resources from Turkish Treasury. Fund of funds is structured to support venture capital funds and other legal persons providing financing to full-fledged taxpayer companies in Turkey through equity injections via sub-funds formed under this fund of funds as well as co-investment funds, which provide co-financing to target companies along with angel investors. As of today, €60 million has been committed to European Investment Fund and TL 50 million to KOBİ A.Ş. by Turkish Treasury. Furthermore, the Fund of Funds mechanism is expected to attract foreign investors as well as to facilitate exit process of angel investments. These major reform areas will help a start-up easily access to finance in every phases. Our ultimate objective is to eliminate all possible financial gaps that start-ups and SMEs may face during their dynamic growth process.

The other planned reform is the regulation on crowdfunding, which is an important financial instrument for start-ups and entrepreneurship ecosystem.

## 5. Takaful

Turkish government supports diversification of the financial products and services including Islamic finance instruments such as takaful in the financial system. Although there is no specific definition of takaful in Turkish jurisdiction yet, there is no prohibitive provision and obstacle in insurance legislation for the takaful application.

According to Turkish insurance legislation, takaful companies are subject to the same rules with conventional insurers in Turkey. In other words, takaful sector in Turkey is treated with the same regulatory and supervisory framework as conventional insurance sector.

Besides, Turkish jurisdiction does not oblige any specific takaful model such as separate company model or window model. For instance, in 2015, there were three insurance companies operating in separate company model and five insurance companies operating in window model.

It should be noted that structurally takaful undertakings can be distinguished from conventional insurers. Thus, the insurance authority in Turkey considers making the definition of takaful in the Insurance Law (Nr. 5684) shortly to provide a clear legal business environment for the takaful sector.

### a. Takaful Undertaking in Turkey

Takaful sector in Turkey has developed in the last few years. Table 18 demonstrates the number of takaful providers in Turkey by years. In 2013, there were three firms offering Islamic insurance products: Neova Sigorta and Işık Sigorta in general takaful and Asya Emeklilik in family takaful. In 2015, there were eight takaful companies (four of them from general side and four of them from family side) operating in Turkey. There is no re-takaful company operating in Turkey yet.

Takaful Companies (Including Window)	2009	2010	2011	2012	2013	2014	2015
<b>General Takaful Companies</b>	2	2	2	2	2	2	4
<b>Family Takaful Companies</b>	0	0	0	0	1	2	4
<b>Total Takaful Companies</b>	2	2	2	2	3	4	8

Source: Undersecretariat of Treasury

Table 19 shows the market share of takaful providers in Turkish insurance sector. Takaful companies in Turkey made up 2.13 percent and 3.74 percent of total gross written premiums in 2014 and 2015, respectively. The market share of takaful in the GCC states and Malaysia is 15 percent and 10 percent, respectively. Thus, compared to the other Muslim countries such as Malaysia and the GCC states, takaful activity in Turkey is miniscule currently.



While general takaful companies represented 4.18 percent of the total non-life insurance, family takaful companies represented 0.64 percent of the total life business in 2015. The share of participation insurance in terms of life business is quite low. The small size of the takaful sector demonstrates that takaful sector is a very small segment of the insurance market in Turkey and there is a big potential for the takaful sector in Turkey.

**Table 19 Gross Written Premiums (GWP) (TRY)**

General Takaful	Gross Written Premiums (GWP) (TRY)	
	2014	2015
GWP by General Takaful Companies (Including Window)	544.770.560	1,139.224.098
GWP by All Non-life (General) Sector	22,709.549.092	27,264.328.716
Market Share of General Takaful Companies	2.40%	4.18%
Family Takaful	Gross Written Premiums (GWP) (TRY)	
	2014	2015
GWP by Family Takaful Companies (Including Window)	6.027.009	23.895.811
GWP by All Life (Family) Sector	3,209.966.592	3,761.410.459
Market Share of Family Takaful Companies	0.19%	0.64%
Market Share of Takaful (Overall)	2.13%	3.75%

Source: Undersecretariat of Treasury

Therefore, the insurance market and takaful are still underpenetrated compared to peer countries and will provide significant potential as new insurers set up shop and acquire a share of the relatively untapped Turkish market.

## b. Recent Developments

Association of Participation Insurance was established in June 2014 to gather the insurance companies operating with takaful principles in Turkey under the roof of an association and to promote and expand the interest-free insurance according to international standards.

The establishment of the Association of Participation Insurance is an important step for Islamic insurance in Turkey. It is acting on behalf of takaful companies on establishing additional and supportive legal infrastructure for takaful in the insurance sector, promotion and providing of international connections. The Association of Participation Insurance has been selected as a member of Interest-Free Finance Coordination Board with the Prime Ministry Circular (Nr. 2015/17).

Furthermore, legal process continues for inserting the article regarding definition of takaful and its main principles into the Insurance Law (Nr:5684) to provide clear legal business environment for the takaful sector. Besides, studies for secondary legislation are under way whose aim is to increase transparency and eliminate uncertainties for international investors and policy holders.

### **Box 6 Realizing the Value Proposition of Takaful Industry for a Stable and Inclusive Financial System**

IFSB, The World Bank Group and the Undersecretariat of Treasury of the Republic of Turkey have successfully organized a joint conference focusing on the takaful sector. This conference, themed “Realizing the Value Proposition of Takaful Industry for a Stable and Inclusive Financial System” was held in Istanbul, Turkey on May 30-31, 2016. This Conference aimed to provide a platform for global practitioners and stakeholders in the takaful industry – including senior representatives of multilateral development institutions, insurance supervisors, takaful and re-takaful undertakings and academics – to discuss selected emerging issues faced by this sector.

The Conference offered an open platform for global professionals and participants in the takaful sector to discuss recent developments and expectations regarding the sector.

The first session of the Conference was about Global Overview of the Takaful Sector: Trends and Policy Developments. The second session was themed Regulatory Developments and Implications for the Industry: Contrasting the Various Approaches to Regulating Takaful. The Role of Microtakaful in Financial Inclusion was the third session of the Conference. The fourth session of the Conference was related Risk Management and Governance in Takaful. The fifth session was titled Challenges in Developing the Retakaful Sector and the final session of the Conference was a Panel Discussion on Taking Takaful to the Next Level.

The Conferences gathered over 100 attendees such as market players, Shariah scholars, academia and other interested parties from the public regulatory bodies, IFSB member and non-member countries, and international organizations. The Report of the Conference is planned to be published in the coming days.

### c. Future of Takaful in Turkey

In the longer term, takaful sector in Turkey offers wider upside potential with its demographic, economic and financial structures. Turkey's financial sector is traditionally dominated by banking activities. The share of takaful sector in Turkish interest-free financial system is low. But it is expected that market share of takaful in Turkey would increase at least as much as the share of participation banks. Demand for insurance products is expected to increase with the growth in participation banking and Islamic capital markets. In other words, asset growth of participation banks in Turkey and market share of takaful in other countries show that Turkey has growth potential for Islamic insurance.

To conclude, there are two important points to fulfill the potential of takaful sector. First, participation banking and takaful sector should be more integrated with each other. Participation banks should consider takaful companies as a main partner. In this regard, participation banks and takaful companies may jointly concentrate on new product development towards common target group by taking into account the demand conditions. Secondly, takaful sector needs more experts, who have interdisciplinary perspectives and education, in both finance and Islamic understanding.



**Box 7 Takaful Mechanism**

According to IFSB, “Takaful is the Islamic counterpart of conventional insurance, and exists in both family (life) and general (non-life) forms. Takaful is derived from an Arabic word that means joint guarantee, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks. In a takaful arrangement the participants contribute a sum of money as a Tabarru commitment into a common fund that will be used mutually to assist the members against a specified type of loss or damage.”

Takaful has five main principles, which are joint risk sharing, segregation of funds, donated contributions, interest-free loan, and Islamic investment criteria. In addition to these, takaful operators are generally expected to form Islamic Advisory Board to get their operations supervised.

The first modern takaful company was set up in Sudan in 1979. In 1985, the Grand Council of Islamic Scholars of the Organization of the Islamic Conference formally allowed the use of takaful as the Islamic alternative to conventional insurance. Conventional insurance was deemed to be incompatible with Islamic law and was to be avoided by Muslims, unless there was no alternative. The objections to conventional insurance were based on the Islamic principles of not allowing uncertainty or any interest-bearing assets, both of which are inherent factors in conventional insurance business.

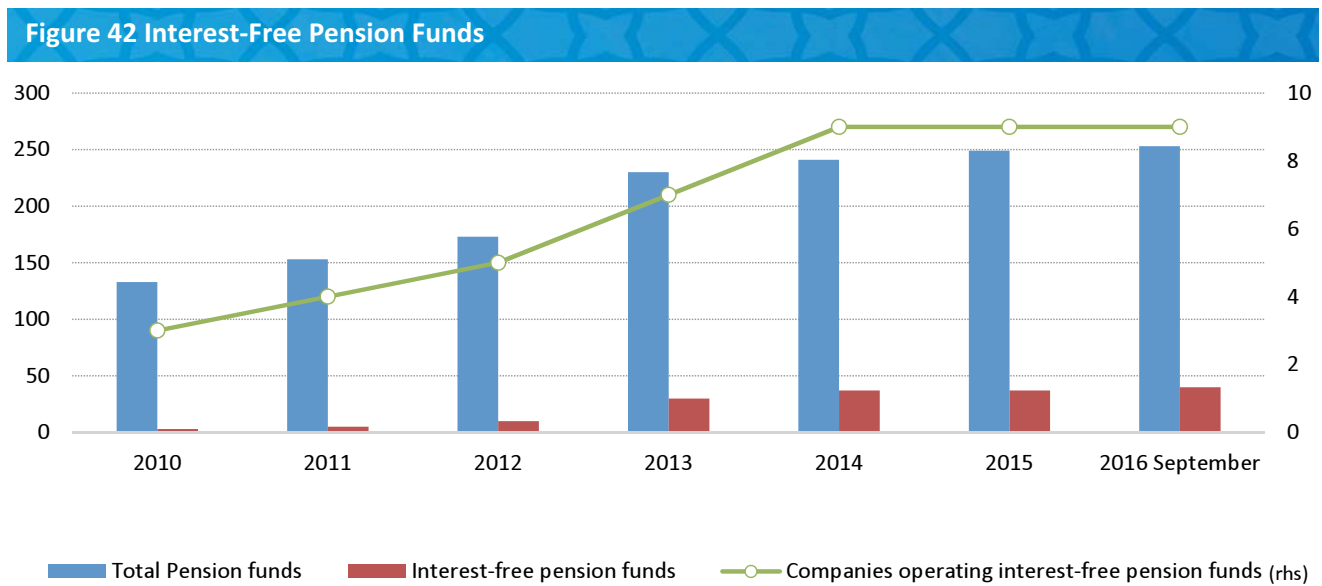
Since conventional insurance is deemed to be inappropriate to Islamic principles by many scholars, takaful has grown particularly in the Muslim geographies like South East Asia, Middle East and North Africa. In future, takaful is expected to have a promise in these regions due to their low level of insurance penetration. In addition, as takaful is one of the components of the Islamic finance, it is expected to improve its market share in line with the Islamic finance growth dynamics.

Moreover, since takaful brings a new approach to the insurance market and with the advantage of return of the premium to the contributors and highlighting the name of ethical finance, takaful may reach a significant market share not only among Muslims but also in the rest of the world. Takaful has become an indispensable and complimentary element of Islamic financial system. Takaful could also enhance inclusion by providing coverage and protection to those who have voluntarily excluded themselves from conventional insurance due to their beliefs.

### d. Interest-Free Pension Funds in Individual Pension System

As stated above, in order to boost domestic savings and enable healthier financing with long-term resources to capital markets, Turkey has launched a new individual pension system based on 25 percent state contribution.

The net asset value of pension funds has more than tripled between 2010 and 2016 in TL terms and the number of participants has increased by 3 million in the same period. By the end of 2015, there were 7,040,375 contracts in force. The number of participants has grown around 19% and exceeded 6 million when compared to the end of the 2014. In the same period, the total net asset value of the funds (including state contribution) reached TL 48 billion. The latest figure for the net asset value of the funds (including state contribution) is TL 57.9 billion by the end of 2016 September.



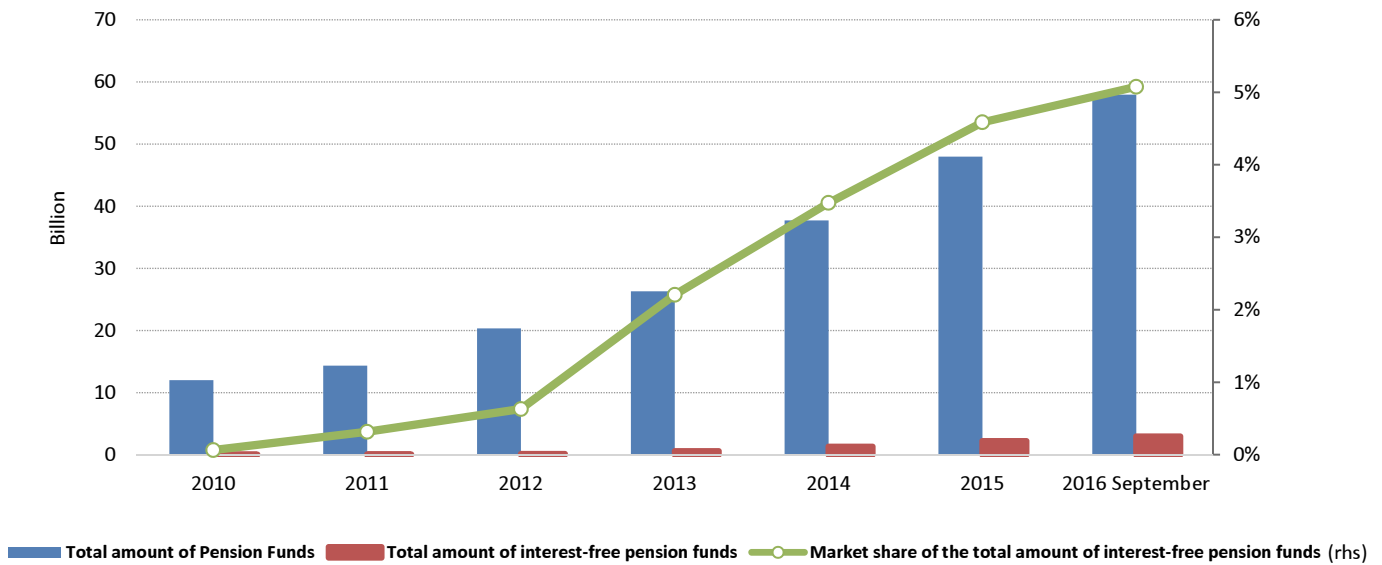
Source: Undersecretariat of Treasury

Figure 42 shows the total number of pension mutual funds, the number of interest-free pension funds and the number of companies operating interest-free pension funds by years. As seen in Figure 42, there has been a significant increase in the number of interest-free pension funds and the number of companies operating interest-free pension funds in recent years.

While the total number of pension mutual funds was 133 and the number of interest-free pension funds, which were offered by 3 different companies, was 3 in 2010; the total number of pension mutual funds reached 253 and the number of interest-free pension funds, which were offered by 9 different companies, reached 40 in September 2016.



Figure 43 Comparison of Total Pension Funds &amp; Interest-Free Pension Funds (TL)



Source: Undersecretariat of Treasury

As seen in the Figure 43, the interest-free pension funds gradually increase its share in total amount of interest-free pension funds in the last decade. While the total amount of pension funds was TL 12 billion and total amount of interest-free pension funds was just TL 10 million in 2010; the total amount of pension funds reached TL 57.9 billion and the size of interest-free pension funds reached TL 2.94 billion in September 2016.

In other words, the market share of the total amount of interest-free pension funds, which was 0.06 percent of the total amount of pension funds in 2010, increased to 5.08 percent by the end of the September 2016.

Lastly, in order to boost participation in the individual pension system, the efforts towards auto-enrollment in individual pension system have recently been finalized, and the auto-enrollment system will start in January 2017. Therefore, it is expected that the number of interest-free pension funds and the market share of interest-free pension funds will rise in the upcoming period in line with auto-enrollment system.

## C

# Turkey as an Islamic Finance Center

## 1. Global and Regional Position

Turkey's strategic geographical position allows easy access to 1.5 billion customers in Europe, Eurasia, the Middle East and North Africa due to its favorable position as a bridge between east and west, north and south.

Turkey plays an important role in the world economy as a G20 member, a candidate for European Union (EU) membership, OECD founding member, and member of the IDB as well as being a member of international economic and financial institutions such as the IMF, the World Bank and the WTO.

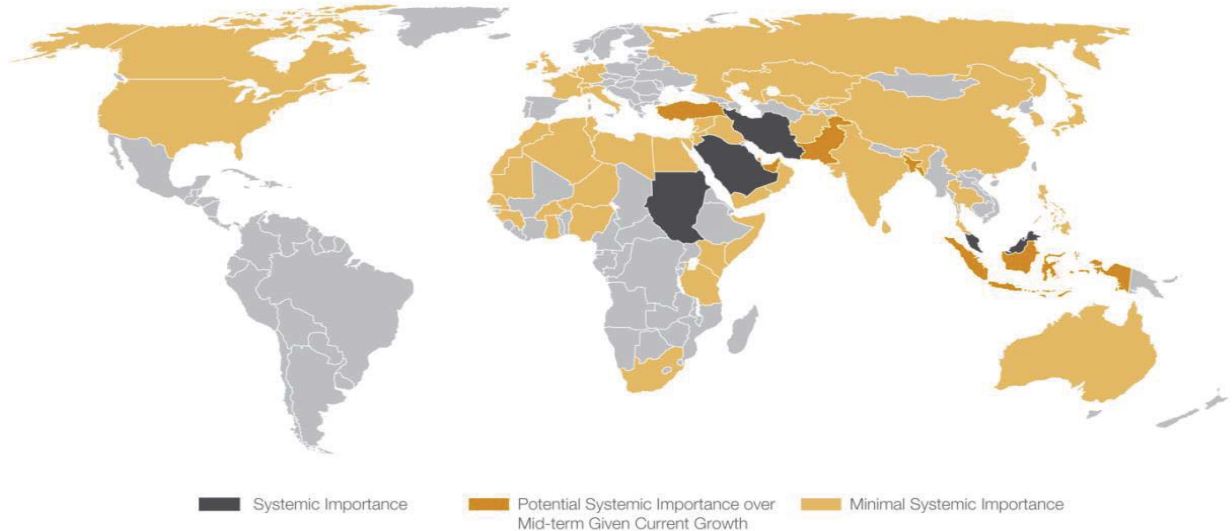
**Table 20 Top 15 Largest Islamic Finance Economies (2014)**

Rank	Country	Islamic Finance Assets (USD Mln.)	Islamic Banking Assets (USD Mln.)
	Global	1,814,086	1,345,891
1	Malaysia	415,418	173,956
2	Saudi Arabia	412,955	325,394
3	Iran	345,447	328,777
4	UAE	161,443	127,281
5	Kuwait	97,576	87,749
6	Qatar	86,524	71,62
7	Bahrain	72,825	68,367
8	Turkey	53,883	44,597
9	Indonesia	40,396	21,711
10	Bangladesh	23,15	22,471
11	Pakistan	18,279	12,563
12	Egypt	13,487	12,869
13	Sudan	10,651	10,651
14	Jordan	8,219	7,872
15	Switzerland	6,885	

Source: ICD – Thomson Reuters Islamic Finance Development Report 2015

Turkey's Islamic financial sector is still at a developing stage when compared to countries such as Malaysia and the United Arab Emirates (UAE). However, the share of participation banking and issuing of lease certificates (sukuk) are expected to further increase in Turkey, as plans and strategies are being put in place to attract investors worldwide.

Turkey was the 8th largest country in the global Islamic finance system in 2014 with around USD 54 billion asset value, and based on projections, (Islamic Corporation for the Development of the Private Sector; Thomson Reuters, 2015) Islamic finance would be systemically important in the country in the medium (Islamic Financial Services Board, 2015).

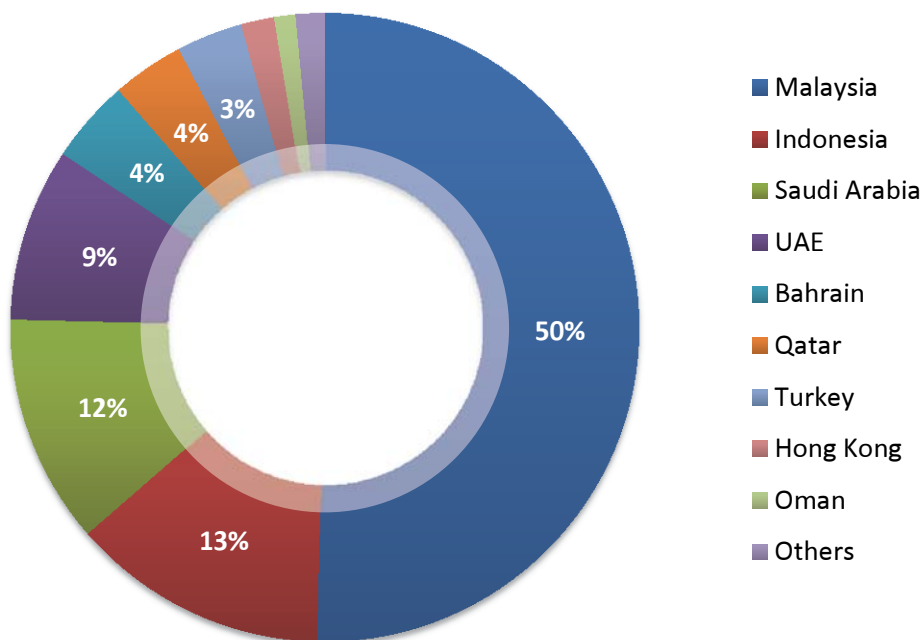


Source: Islamic Financial Services Industry Financial Stability Report 2015

The State of the Global Islamic Economy Report of Thomson Reuters in 2013 indicates that the value of Turkey’s potential Islamic finance assets were around USD 775 billion which was almost twenty times of the actual asset size in 2012 (Thomson Reuters; Dinar Standard; Dubai Islamic Economy Development Centre, 2014).

IFSB’s “Stability Report 2016” indicates that Turkey had 3.2 percent share in the global Islamic banking assets while the Turkish sukuk sector accounted for 3 percent of the global sukuk issuance volume in 2015 (Islamic Financial Services Board, 2016).

Figure 44 Sukuk Issuance Share, 2015



Source: IFSB Islamic Financial Services Industry Stability Report 2016

Turkey's strong, historical and increasingly important economic ties with the Middle East have offered impressive opportunities for Islamic finance since the Gulf Cooperation Council (GCC) investors are looking for new investment opportunities while Turkey needs new financial sources to fund growing infrastructure investments. Turkey's diverse and deep trading strategy has been creating leveling playing field for financial services expansion with MENA region.

Additionally, Turkey is in the center of the main trade and flight routes between the west and the east. Major European capital cities and financial centers are three to four hours flight away from Turkey. Turkey has historical, strong and improving links with western countries and is a candidate member of the European Union.

Western countries such as United Kingdom, Luxemburg and Germany as well as Russia put enormous efforts to tap into Islamic financial sector with their developed infrastructures and experiences in the conventional financial sector.

Turkey has a growing reputation as an emerging financial center with the ongoing long-term Istanbul International Financial Center Program that aims at positioning Turkey as one of the most important global and regional Islamic finance hubs. Turkey has the ability to attract both retail and institutional investors to all segments of Islamic finance (banks, sukuk, and funds) from all over the world.

A young, dynamic and mainly Muslim population is demanding interest-free products and Turkish government's new initiatives to support the sector such as sovereign sukuk issuances, regulatory improvement, state-owned participation banks and growing economic and financial ties with the MENA region and European countries as well as the rest of the world will contribute to position Turkey as one of the important Islamic finance centers in the world in the upcoming years.

## 2. Turkey's G20 Presidency and Islamic Finance



A particular focus was attached to incorporating Islamic Finance to mainstream global finance under Turkey's G20 Presidency. With its emphasis on risk-sharing and asset-based financing, Islamic finance has the potential to foster investment and infrastructure, and thus, to support the G20 strategy for raising global economic growth. For this potential to be realized, a number of challenges need to be addressed, which require policy actions at the national and global level.

In this regard, G20 has worked on identifying policy issues related to Islamic finance and key actions at the national and international level to address these challenges. The IMF and the World Bank have prepared a note, which presents policy recommendations to national and international authorities towards building an enabling environment and better integrating Islamic finance into the global system. G20's strong emphasis on this topic is triggering a much-needed attention from the international fora.

At the G20 summit held in Antalya in November 2015, Turkey indicated the potential role of sukuk in financing and it was included in the final communiqué — it was the first time that Islamic finance was mentioned by the G20.



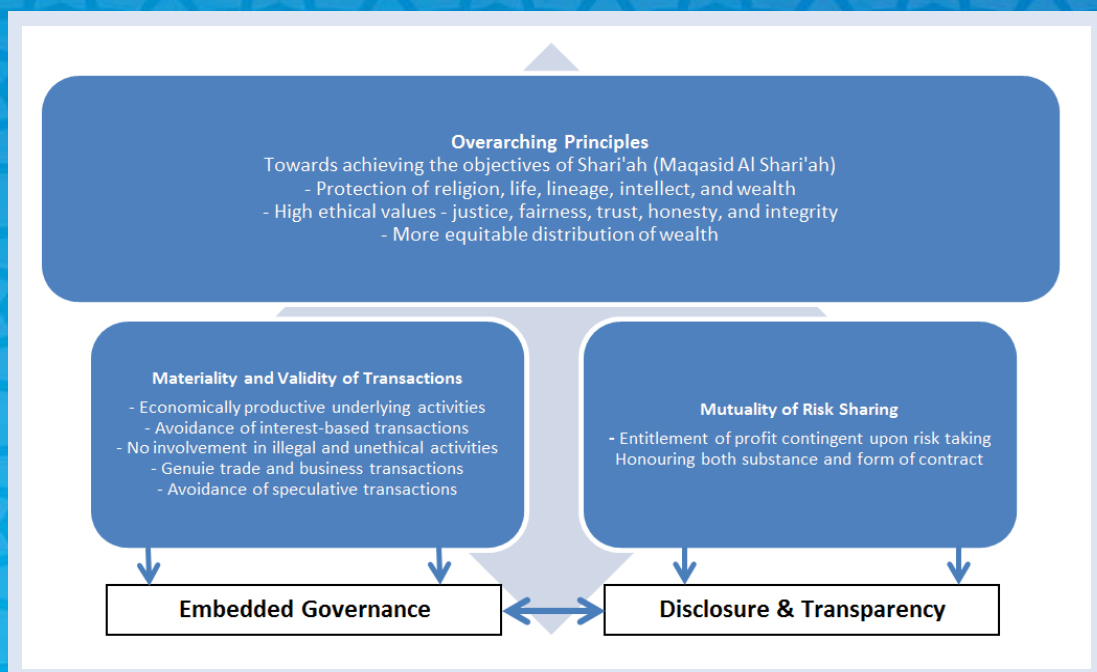
### Box 8 Financial Stability and Islamic Finance

The financial stability and resilience outranked especially after the global financial crisis of 2007-09. In the aftermath of the financial crisis, the global community has devoted considerable efforts to construct a more resilient international financial architecture. To create and sustain financial stability, the global community has taken measures to limit the risk taking of banks and turn them into their basic function – to provide financial services supporting the real economy by creating sources. This approach also overlaps with the essence and the principles of Islamic finance. As shown in the table, essential features of Islamic Finance can be defined in three pillars:

- Compatibility with the Islamic Law,
- Materiality and Validity of Transactions,
- Mutuality of Risk Sharing

In the meantime, the Islamic finance contributed to financial stability during the financial crisis via showing a better performance compared to conventional banks. Islamic finance has also stronger links to real economy and can produce a better diversification with superior financial inclusion (The Islamic Financial Services Board; Islamic Development Bank; Islamic Research and Training Institute, 2010).

Additionally, Ahmed Belouaf, from King Abdulaziz University, claims that risk-sharing and asset-backing principles of the Islamic finance assume the major significance for Islamic finance to be inherently stable upon his analyzes and analytical review of fifteen theoretical investigations that had examined the stability of the Islamic Financial System vis-à-vis its conventional interest-based counterpart. On the other hand, he asserts that the interest-bearing debt modes of financing are the primary source that feed instability, and the like of equity and participatory modes of financing may help the system to enhance its resilience to financial shocks and turbulences (Belouaf, 2014).



Source: *Islamic Finance and Global Financial Stability* – April 2010



Although the Islamic finance contributes to financial stability during the crises times more, it does not necessarily mean that the Islamic finance is totally immune to all kind of risks. The study of Mohamed Amin Chakroun and Mohamed Imen Gallali upon 136 banks (50 Islamic and 86 conventional) from Gulf countries shows that small Islamic banks tend to be financially more stable than small conventional ones; large conventional banks tend to be financially more stable than large Islamic ones and small Islamic banks tend to be financially more stable than large Islamic banks. One another important finding is that Islamic banks have not been directly affected by the financial crisis at the first stage especially, but they were indirectly affected by the economic downturn, lately (Chakroun & Gallali, 2015).

Islamic finance continues to demonstrate its evolution and strong growth even in current challenging international financial environment. Indeed, Islamic finance as an integral part of the international financial system has the potential to contribute to global financial stability and to enhance the prospects for global growth (Aziz, 2009).

Lastly, Moazzam Farooq and Sajjad Zaheer from the IMF suggested that Islamic banks are less exposed to deposit withdrawals in the financial panic times based on the Pakistan data. They also claim that Islamic banks provide more credit to real sector during financial panic (Farooq & Zaheer, 2015).

Another study from the IMF, finds out that Islamic banks have been affected differently than conventional banks, during the stress times. On the one hand, in 2008, the business model of Islamic banks performed better in terms profitability. On the other hand, weaknesses in risk management practices in some Islamic banks led to a larger decline in profitability in 2009 compared to conventional ones. In terms of credit growth, asset growth, and external credit rating, Islamic banks generally performed better in 2008 and 2009 (Hasan & Dridi, 2010).

### 3. Relationship with Global Islamic Financial Institutions

Turkey is a member of the IDB and several institutions are members of IFSB where the BRSA is a member of Council as well. CBRT, CMB, BRSA have been full members of the IFSB since 2013. Additionally, the Turkish Treasury has initiated IFSB membership process in 2016. BRSA is a full-member of the AAOIFI and aims to implement the international standards of these institutions by 2018. To enhance the cooperation, BRSA and IFSB organized a productive Technical Assistance program on capital requirements, interest-free financial and liquidity standards of IFSB in Istanbul in the end of May 2016.

The Central Bank of the Republic of Turkey is actively involved in the management boards and working groups of the IILM. In this sense, the CBRT is a member of the Governing Board, the Board Executive Committee, the Board Risk Committee and the chair of Board Audit Committee.

The Capital Markets Board of Turkey acts as the Chairman and the Secretariat of the COMCEC Capital Markets Regulators Forum (Forum) established in 2011. The Forum's Islamic Finance Task Force (chaired by the Securities Commission, Malaysia) works in cooperation with the Forum Secretariat and the Forum member authorities for providing technical assistance, preparing questionnaires and reports in order to enhance cooperation on various Islamic Finance topics.

#### COMCEC Financial Cooperation Working Group

Financial cooperation was one of the six cooperation areas of the COMCEC Strategy adopted in the 4th Extraordinary Session of the Islamic Summit Conference held on 14-15 August 2012 in Makkah Al-Mukarramah, Saudi Arabia. In the context of the Strategy, COMCEC Financial Cooperation Working Group became operational in 2013 to bring together the Member Countries regularly for producing knowledge, sharing experiences and best practices and developing a common understanding as well as approximating policies (Standing Committee for Economic and Commercial Cooperation).

Member countries of the Working Group meet twice in every year in Ankara, Turkey with a predetermined theme for each meeting. An analytical study specifically related to the theme is prepared and presented to the Member Countries' representatives. Moreover, the Financial Outlook of the OIC Member Countries Report is prepared once a year by the COMCEC Coordination Office to be presented in the meetings. Member countries' representatives may share their knowledge and experiences on the subject of theme. Furthermore, policy advices, which are set in accordance with the main findings of the analytical study, are discussed by the Member countries' representatives.

In this regard, the first meeting of the working was held in Ankara in December 2013 and member countries have so far met six times for the following themes:

- 1) Enhancing Capital Flows in the COMCEC Region
- 2) Enhancing Financial Inclusion in the COMCEC Member States
- 3) Risk Management in Islamic Financial Instruments
- 4) Improving Banking Supervision Mechanisms in the OIC Member Countries
- 5) Retail Payment Systems in the OIC Member Countries
- 6) Developing Islamic Finance Strategies in the OIC Member Countries

### Box 9 Report-Developing Islamic Finance Strategies in the OIC Member Countries

The sixth meeting of the working group was held on March 2016 with the attendance of 28 member countries and 7 non-governmental organizations. Professor Dr. M. Kabir Hassan from the University of New Orleans prepared an analytical report on “Developing Islamic Finance Strategies in the OIC Member Countries” for the meeting.

The study emphasized that the development of the Islamic finance industry brings many opportunities to further develop industry regarding human capital, infrastructure, regulation, and market expansion. These topics were evaluated with the help of SWOT analysis and in a survey that was conducted by Mr. Hassan by collecting responses from a sample of over 100 people, comprised of academics, scholars, researchers, and industry professionals involved in the Islamic Finance industry throughout the world.

In light of these studies, some challenges and problems were diagnosed in the implementation of the Islamic Finance Strategies in the Member Countries:

- Weak regulatory systems,
- Lack of Sharia governance infrastructure,
- Lack of necessary institutional infrastructure,
- Lack of Islamic financial instruments and services,
- Lack of specialized Islamic finance academic and training programs,
- Lack of initiatives, i.e. campaigns on increasing public awareness, to promote Islamic finance.

## 4. Strategies and Initiatives

### a. IFC Program and Progress

In order to unleash Turkey’s potential in interest-free market; Istanbul International Financial Center Program has a vital role. By fulfilling the proposed actions under the Istanbul Finance Center Program, Turkey aims to place Istanbul in the top 25 among global financial centers and Turkey to enter the top 30 in terms of financial development.

“Istanbul International Finance Center Program Action Plan”, which covers the period of 2014-2018, encompasses seven components and more than 100 actions (Ministry of Development). One of those components is “Strengthening Interest-Free Finance and Participation Banking” in Turkey, which is coordinated by the BRSA. In order to make Istanbul not only a regional but also an international Islamic financial center, the component focuses on four main policies under this component within the program;

- Improving the current perception towards interest-free finance system,
- Improving human resources in the interest-free finance sector and enriching the literature,
- Developing the corporate structure and the legal infrastructure of the interest-free finance system,
- Increasing the diversity of interest-free financial products and services.



In this respect, the legal infrastructure will be revised to improve interest-free finance for designating standards and ensuring uniformity of practices in the sector. In order to diversify and improve interest-free financial products, new laws and tax regulations will be adopted.

According to the Action Plan, Islamic economics and finance courses will be added to the curriculum of undergraduate and master programs at universities to increase human resources needed in interest-free financial sector.

Furthermore, to improve public awareness for interest-free finance social responsibility projects and conferences, panels and workshops will be organized both in national and international level. Some of the achievements of the Istanbul International Financial Center Program are as follows:

- The necessary budget for campaign in order to promote interest-free finance system in Turkey has been created by the participation banks and the agreement was signed with the consultancy company. In this context, more than 10 national and international events were organized in 2014 and 2015, annually.
- Ziraat Katılım Bank was opened in May 2015 and the General Directorate of Foundations established Vakıf Katılım Bank in February 2016.
- "Interest-Free Finance Coordination Board" was established in 2015.
- BRSA is conducting researches on standards published by the AAOIFI and the IFSB and academic literature on standards published by the AAOIFI and the IFSB and academic literature.
- To diversify lease certificates traded on the Borsa Istanbul, amendments on the law were accomplished and the listing fees are decreased or set to zero.
- Essential tax regulations entered into force to facilitate tax-neutrality for lease certificates and provide a level playing field.

## **b. Turkish Participation Banking Strategy Document**

The Participation Banks Association of Turkey (PBAT) published the "Turkish Participation Banking Strategy Document" in March 2015. The vision of the strategy is "to raise the market share of participation banking sector to 15 percent by 2025 and to deliver world-class financial products and services" (Participation Banks Association of Turkey, 2015). In addition, the PBAT has indicated the missions of the Turkish participation banking sector as:

- To develop and improve product range and service quality,
- To improve corporate communication, perception and expand reputation management,
- To improve training related activities, human sources and certification,
- To develop legislation, standards and regulations related to the principles of Islamic banking,
- To support all efforts to make Istanbul a leading financial center.

**Box 10 The PBAT at a glance**

In 2001, Association of Special Finance Houses was established as the first professional public institution with legal entity and an umbrella organization of the SFHs in Turkey. Then this association was transformed into the PBAT by the Banking Law of 2005.

The aim of the PBAT, headquartered in Istanbul, is to defend the rights and interests of participation banks within the framework of a free market economy and the principle of full competition in accordance with banking regulations principles and rules, to work for the healthy growth of the banking system and development of the banking profession, increase competitiveness, ensure necessary decisions are taken for the creation of a competitive environment and prevent unfair competition and implement and demand the implementation.

Participation Banks should be member of the PBAT in accordance with the Banking Law (Participation Banks Association of Turkey).

**Figure 45 Turkish Participation Banking Sector Strategy: Vision and Mission**

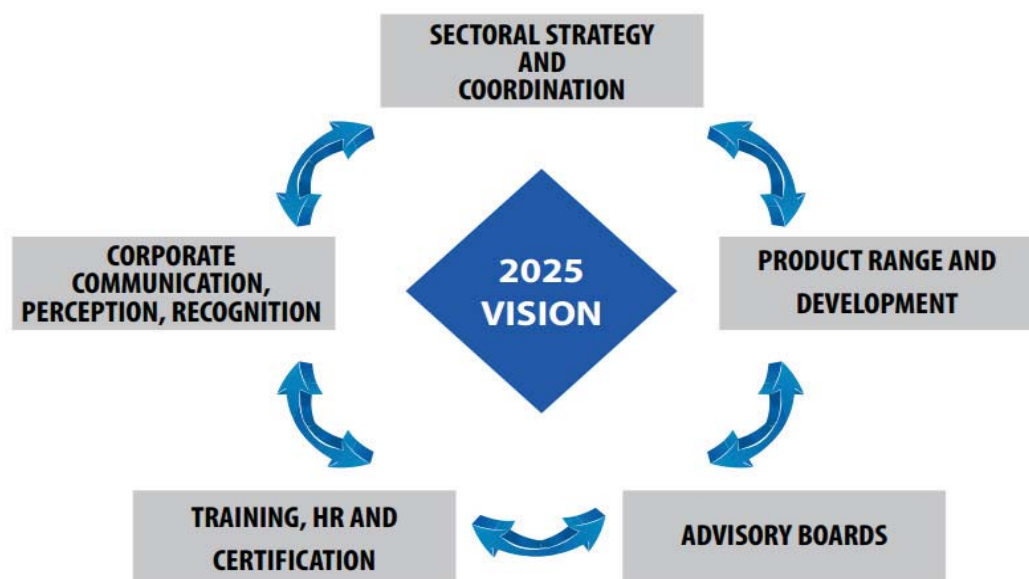




To fulfill these missions and to reach the highly-ambitious vision, the strategy document covered 84 activities, 42 actions, and 17 strategies under five main strategic goals. These strategic goals are as follows:

- Sectoral strategy and coordination,
- Product range and development,
- Advisory boards,
- Training, HR and certification,
- Corporate communication, perception, recognition (Participation Banks Association of Turkey, 2015).

Figure 46 2025 Vision



This strategy document is vital for the participation banking sector in Turkey. For the first time, the participation banking sector has a strategy document, which has an aspiring vision and lots of actions to be fulfilled. By 2025, the assets of the sector are expected to reach USD 300 billion, which will approximately carry the sector's share to 15 percent (Participation Banks Association of Turkey, 2015).

### c. Interest-Free Finance Coordination Board

Turkey established the Interest-Free Finance Coordination Board in order to coordinate all the activities and the institutions dealing with interest-free finance with a holistic approach. The Board is chaired by the Minister responsible for the Undersecretariat of Treasury and composed of:

- Undersecretary of the Ministry of Development,
- Undersecretary of the Ministry of Finance,
- Undersecretary of the Treasury,
- Governor of the Central Bank of the Republic of Turkey,
- Chairman of the Banking Regulatory and Supervision Agency,
- Chairman of the Capital Markets Board of Turkey,

- CEO of Borsa Istanbul,
- Chairman of the Participation Banks Association of Turkey,
- Chairman of the Participation Insurance Association.

This board has representatives from different institutions that are regulating, supervising and controlling the interest-free finance in the country. These entities have governmental or semi-governmental structure, and their authorities and roles in terms of Islamic finance in Turkey are summarized as follows:

**Turkish Treasury:** As the sole authority of issuing government bonds, treasury bills and other borrowing instruments, the Treasury is responsible for issuing and managing related activities of Turkey's sovereign lease certificate (sukuk). Moreover, Turkish Treasury is responsible for regulating and supervising the insurance and private pension sectors which cover takaful operators and participation pension funds. Furthermore, the Treasury is one of the main policy makers in the financial sector.

**Central Bank of the Republic of Turkey (CBRT):** The participation banks, like conventional banks, are under the regulation of the CBRT with respect to foreign currency operations, reserve requirements and liquidity regulation.

**Capital Markets Board of Turkey (CMB):** CMB has the authority to maintain fair, orderly and efficient capital markets, to ensure that investors are protected and receive full, accurate and timely information, and to safeguard investments in capital markets. CMB also develops regulatory framework for corporate sukuk.

**Banking Regulation and Supervision Agency (BRSA):** The participation banks, deposit banks, development and investment banks as well as the leasing, factoring and finance companies are supervised by the BRSA in Turkey.

**Turkey Participation Banks Association:** The Association is an umbrella organization as a professional public institution for Turkey's participation banks. The Association has duties including but not restricted to developing of the participation banking system, setting ethical professional principles and standards and preventing unfair competition among members.

**Participation Insurance Association:** The Association was established to bring together all the takaful operators of the country in order to develop and improve the newly emerging market in Turkey.

Additionally, the Ministry of Finance and the Ministry of Development have authorities on Islamic finance such as tax implications and developing policies in Turkey.

The Board convenes at the Chairman's request at least three times a year. In addition to the related ministries and governmental agencies; representatives from universities, non-governmental organizations, occupational groups and the private sector can be invited to participate in the Board meetings. Secretariat services of the Board are facilitated by the Undersecretariat of Treasury.

First meeting of the Board was held on 10 March 2016. In this meeting, outlook of the interest-free finance sector was elaborated; diversification of interest-free products and services, compliance of these products, improvement of maturity and liquidity structures were decided to be studied until the next meeting of the Board. Additionally, it was decided to carry on studies about taxation in order to provide tax neutrality for interest-free financial transactions.

Second meeting of the Interest-Free Finance Coordination Board was held on 21 October 2016. At the meeting, national and global outlook of the interest-free finance sector was elaborated. Effects of the new regulations



aimed at tax neutrality of interest-free finance products and services were assessed. Proposals to increase the diversification of interest-free finance products and services as well as liquidity facilities for participation banks were evaluated.

Progress in the action plan of 'Strengthening Interest-free Finance and Participation Banking' component of Istanbul International Financial Center (IFC Istanbul) Program was elaborated and it was decided that the Board would work on the issues raised at the meeting to develop the interest-free finance sector.

The Board will facilitate the role of the sector and create a level playing field for the Islamic financial system. Also, it is expected that the Board will make important contributions to Turkey's vision of becoming an international finance center.

#### **d. Megabank**

Turkey and other OIC countries undertake serious amount of infrastructure projects to improve their economy and the life quality of their citizens. Nevertheless, these projects need funding at reasonable rates and alternative financing models such as Islamic finance.

In this context, Turkey shares IDB's vision to establish a new Islamic Megabank. The bank will be functioning as an infrastructure bank with Islamic rules to finance projects of both government and private companies.

One of the bank's main aims is to create liquidity for the interest-free banking system, to provide funds for the infrastructure investments.

The Megabank will create new opportunities for interest-free financial sector to reach new regions and countries and mobilize potential of the interest-free finance.

#### **e. Certification Programs**

With growth expectations about Islamic finance in Turkey, participation banks may face qualified personnel shortage in the near future. To this end, the BRSA has been developing a certification program project with the PBAT for providing qualified personnel for participation banks. Marmara University's Technology and Innovation Transfer Office and Istanbul University and other universities which have Departments of Islamic Economy and Finance are estimated to be the supporters of the Project. Main function of the certification program is to issue certificates to verify certificate holders' ability and knowledge on Islamic banking. This project will provide core competency for future and prospective employees.

## D

## Conclusion

Turkey's financial system has evolved over the last decade by implementing widespread structural reforms for a more efficient, resilient and deeper financial system. During this transformation, interest-free finance has played a crucial role with its emphasis on risk-sharing and asset-based financing, socially responsible and inclusive-growth friendly structure.

The history of Islamic banking in Turkey dates back to mid-80's as Special Finance Houses. Special Finance Houses were transformed into "participation banks" in 2005 upon enactment of the new Banking Law, which allowed them to integrate fully into the financial system. After this transformation, participation banks have shown an impressive performance with an average annual growth rate of 28.7 percent in the first decade as banks. Participation banks succeeded not only in financial figures but also in organic growth in recent years and reached 5 percent of the banking assets in Turkey by 2015. The BRSA has dedicated a separate department to further develop the sector. The CBRT provides participation banks with several tools to meet the liquidity needs - one of the main challenges globally.

Turkey has been improving its regulatory framework in order to tap into global Sukuk market since 2010. In this regard, the Turkish Treasury issued 15 standard ijara sukuk until September 2016 at a total amount of TL 26.8 billion. The Turkish Treasury plans to continue sukuk issuances on a regular basis to diversify financing tools and broaden its investor base by reaching interest-sensitive investors. The corporate sukuk issuance between 2011 and 2015 was more than USD 5.5 billion.

The Turkish takaful market is a relatively new sector, and its share was 3.75 percent in total gross written premiums in 2015. The number of takaful service providers has reached eight. The takaful sector in Turkey is governed by the same regulatory and supervisory framework as the conventional one. Forward looking, Turkish takaful sector is a promising sector with its demographic, economic and financial structures. Turkey aims to increase the share of Islamic financial assets with the support of state-owned participation banks, further receiving takaful and capital market players.

Turkey launched the national financial inclusion strategy in 2014 and role of Islamic finance in enhancing financial inclusion will be important. In terms of Islamic social finance, Turkey has a good track record of waqf as well as zakat.

Turkey was among the ten largest countries in the global Islamic financial system in 2015 with an asset value of around USD 41.4 billion. It is expected that Islamic finance will be systemically important in the medium term in Turkey. The current size of the sector is far away from its potential.



To unleash the huge potential of the interest-free finance in Turkey, the Government has given a priority to developing the sector. The Tenth Development Plan outlines around 30 specific actions with a timetable to improve the interest-free finance sector.

Interest-free finance is elaborated as part of the financial system and as one of the main pillars of transforming Istanbul into an international financial center. In order to coordinate and facilitate all the activities and the institutions dealing with interest-free finance with a holistic approach, Turkey established an Interest-Free Finance Coordination Board, which is chaired by the Minister and comprised by heads of relevant institutions. The Board is expected to make significant contributions to develop the sector as well as to Turkey's vision of becoming an international finance center.

Leveling the playfield, innovation and diversification of products and services, providing liquidity facilities, strengthening regulatory and the institutional framework are the key areas that are worked on in order to develop the interest-free finance sector.

## E

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