

2015

Secularism, Sharia, and the Turkish Financial Markets

J. Robert Brown Jr.

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Brooklyn Journal of International Law, Vol. 40, No. 2, 2015

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SECULARISM, SHARIA, AND THE TURKISH FINANCIAL MARKETS

*J. Robert Brown, Jr.**

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* Professor of Law, University of Denver Sturm College of Law. Director, Corporate & Commercial Law Program. Funds to support this research were provided by the Hughes Research Fund. I very much appreciated comments received from Timur Kuran, Murat Cokgezen, Hamada Haider, Ali Polat, and Jumana Hamed. Some were provided with only a portion of the article. In addition, many bankers, government officials, and academics in Turkey and elsewhere provided interviews and were otherwise generous with their time. Any opinions and certainly any mistakes in the articles are nonetheless solely those of the author.

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INTRODUCTION

Three times the size of France, Turkey rests on the cusp between Europe and the Middle East. Most of the more than 80 million people are Sunni Muslims.¹ Yet almost unique for an Islamic country, Turkey professes to be a secular state.²

It did not start that way. For almost 500 years, the Anatolian peninsula was the center of Islam. The sultans of the Ottoman

1. *E.g.* CIA, THE WORLD FACTBOOK 51, 709 (2013) (noting that 99.8 percent of Turkey is Muslim, mostly Sunni). The site estimates the population as 80.69 million as of July, 2013. *Id.*

2. There are fifty-two majority Muslim states. Adrien K. Wing & Ozan O. Varol, *Is Secularism Possible in a Majority-Muslim Country?: The Turkish Example*, 42 TEX. INT'L L. J. 1, 3 (2006). Only two—Turkey and Senegal—have declared themselves secular in their constitution. Niyazi Oktem, *Religion in Turkey*, 2002 BYU L. REV. 371, 371 (2002). Ethiopia, which is approximately half Muslim, *see id.*, also has a constitution announcing that it is a secular state. *See* ETHIOPIAN CONST. art. 11 (Aug. 21, 1995), available at http://www.africa.upenn.edu/Hornet/Ethiopian_Constitution.html.

Empire assumed the title of Caliph³ and reigned as the spiritual and temporal leaders of much of the Muslim world.⁴ Despite this religious role, the Empire was, for much of its history, a menagerie of different faiths.⁵ A series of wars in the nineteenth century, however, stripped away large swathes of territory, including those containing most of the non-Islamic populations.⁶ As Islam strengthened demographically, paradoxically, so did secularism, with reforms introducing law codes from the west.

But it was Mustafa Kemal, or Atatürk, who founded the republic and institutionalized secularism. Relying on a policy of laicism, the government saw its role with respect to religion as less a separation of mosque and state and more a matter of control. Islam would be subject to the oversight of the secular authorities. Mosques and religious education were assigned to the designated ministry; imams received government salaries. Islamic practices and symbols were exorcised from most public institutions.

The system largely remained in place until the election of the Justice and Development Party or AKP in 2002. With more overt religious leanings, the AKP lessened restrictions on some Islamic practices. At the same time, the military lost its traditional role as the guardian of secularism.

The policies of the AKP generated contradictory interpretations. To some, they suggested a weakening of secularism and a rise of conservative Islamic influence. To others, they represented less a fundamental reconfiguration than a recalibration

3. Salim I became the first Sultan to assume the title of Caliph in 1517. LORD KINROSS, *THE OTTOMAN CENTURIES: THE RISE AND FALL OF THE TURKISH EMPIRE* 10 (1977).

4. As part of that shift, the Sultan moved various artifacts associated with the Prophet Mohammed from Cairo to Istanbul. They included a lock of his hair, a letter he wrote to a Coptic official, a footprint, and some of his personal swords. These items are currently on display in the Topkapi Palace in Istanbul. See *Topkapi Palace, 3D Virtual Tour*, TOPKAPI PALACE, <http://www.3dmekanklar.com/en/topkapi-palace.html> (last visited Oct. 26, 2014).

5. See generally Erik-Jan Zürcher, *The Ottoman Empire 1850-1922, Unavoidable Failure?* TURKOLOGY UPDATE LEIDEN PROJECT, at 4–5 (2007) <http://menadoc.bibliothek.uni-halle.de/menalib/content/titleinfo/1303850>.

6. See *id.* (“Until 1878, Christians and Jews made up close to forty percent of the population.”).

of the secularist philosophy, one that better reflected the demands of a pluralistic and open society.⁷

The financial markets in Turkey provide a laboratory to help resolve these competing views. Islamic law or *Sharia* contains a number of proscriptions that directly affect financial practices. The payment and receipt of interest is prohibited; so are most kinds of commercial insurance. These interpretations provided the impetus in the Islamic world for the creation of a class of banks that sought to offer *Sharia* compliant services.

For much of the post Ottoman period, Turkey made no effort to incorporate religious principles into the financial system. Banks were instead used as instruments of government policy, designed to funnel capital to designated businesses and industrial complexes. With interest rates subject to government control and set at levels below inflation, the financial system remained undersized but profitable.

Islamic banks entered Turkey in the 1980s, a consequence of broader reforms designed to open the financial markets and attract capital. These financial institutions were intended to draw deposits from religious Turks and capital from foreign investors. Indeed, funds for the first Islamic banks came mostly from the Middle East.

Their entry was initially tepid, in no small part because of secularist principles. Islamic financial institutions could not overtly advertise their religious orientation. The country had no "Islamic" banks, only finance houses. They were not *Sharia* compliant but "interest-free." Moreover, the government left them in an uncertain regulatory status and subjected them to restrictions on growth. In this environment, the Islamic banks remained a peripheral part of the financial system.

With the election of the AKP in 2002, however, the environment for Islamic banks in Turkey changed. Limitations on branch networks and capital raising were lifted. The government removed restrictions on the issuance of *Sharia* compliant bonds. Officials from the Islamic banks were appointed to the highest levels of government.

7. Thus, the repeal of the ban on the headscarf in government buildings and higher education, *see infra* note 163, and the adoption of restrictions on the sale of liquor, *see infra* note 164, have been seen as either advancing religious principles or imposing prudent policies.

In shaping the banking sector, however, the government did not wholly embrace *Sharia*, particularly where religious principles conflicted with the safety and soundness of the financial system. This was particularly true with respect to the system of deposit insurance. The AKP integrated the Islamic banks into a system of deposit insurance that applied to all financial institutions and did not explicitly comply with the requirements of *Sharia*.

Similarly, the Islamic banks in Turkey found themselves with greater freedom to compete. While experiencing significant growth, they nonetheless remained small, suggesting a modest demand for religiously based financial services. At least some of the Islamic banks sought to break out of this niche by competing more directly with traditional commercial banks. In doing so, however, they confronted the limits imposed by *Sharia*. This could be seen most clearly in connection with the development of credit cards.

This Article will do several things. First, it will examine principles of Islam that affect banking practices, with a particular emphasis on deposit insurance and credit cards. Second, the Article will discuss the emergence of secularism in Turkey and the introduction of Islamic banks into the Turkish financial markets. The Article will then examine their evolution, with particular emphasis on the changes implemented by the AKP. Finally, the Article will examine the impact of these reforms, and what that impact says about Islamic influence in Turkey.

I. ISLAM AND FINANCE

An Islam-based banking system applies principles derived from *Sharia*.⁸ *Sharia* encompasses all aspects of Islamic law and “is, in essence, a set of guiding principles rather than unbending rules.”⁹ With respect to financial markets, *Sharia*, among other things, prohibits both the payment and receipt of interest. As a result, Islamic banks have developed a number of *Sharia* compliant alternatives, to these restrictions.

8. Some use the term “Islamic banking.” See, e.g., Chibli Mallat, *Commercial Law in the Middle East: Between Classical Transactions and Modern Business*, 48 AM. J. COMP. L. 81, 90 (Winter 2000).

9. Paul H. Robinson, et al., *Codifying Shari'a: International Norms, Legality & the Freedom to Invest New Forms*, 2 AM. J. COMP. L. 1, 10 (2007).

A. Deposits

Sharia prohibits the payment of *Riba*, a ban that appears in the *Koran*.¹⁰ Despite the occasional voice of dissent,¹¹ the term has generally been applied to all forms of interest, not only those viewed as usurious.¹² Borrowers cannot pay interest; lenders cannot receive interest.¹³ Even broader, the ban extends to other types of return, including penalties charged in the event of a default.¹⁴

The prohibition applies to interest paid on all forms of debt, including deposits.¹⁵ To comply with *Sharia*, Islamic banks can accept deposits that provide the security of the vault but offer no guaranteed return.¹⁶ Islamic banks can also accept deposits that

10. Gulberna Ozcan & Murat Cokgezen, *Trusted Markets: The Exchanges of Islamic Companies*, 48 COMP. ECON. STUD., 132, 133 n.1 (2006) (“What the *Koran* clearly prohibits is *Riba*, a pre-Islamic practice of doubling the debt of a borrower who is unable to repay his loan. The definition and content of usury, and the applicability of verses on *Riba* to the term ‘interest’ are problematic issues among Islamic scholars.” (internal citations omitted)).

11. See Nico P. Swartz, *Can the Model of the Riba—Free Islamic Commercial Bank Provide a New Paradigm for the Future of Global Banking?: A Theoretical Review*, 2 J. GLOBAL BUS. & ECON. 86, 89 (2011) (*Riba* encompasses “excessive, exorbitant, and exploitative rate of interest.”).

12. In fact the term has a much wider connotation and can apply to “all forms of exploitation and excessive charges in business dealings.” Shahnaz Naughton & Tony Naughton, *Religion, Ethics and Stock Trading: The Case of an Islamic Equities Market*, 23 J. OF BUS. ETHICS 145, 145 (2000).

13. As one writer puts it, “Islamic law prohibits interest because it fosters the accumulation of wealth that is not a product of work.” Hesham M. Sharawy, Note, *Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation Between the Islamic and Western Worlds*, 29 GA. J. INT'L & COMP. L. 153, 161 (2000).

14. See MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCE 91 (2002). See also Shaykh Muhammad ibn Adam al-Kawthari, *Monetary Penalties on Late Payment: If a Customer Delays in Paying, Can We Charge Him For This*, QIBLA (Oct. 29, 2014, 7:25 PM), http://qa.sunnipath.com/is-sue_view.asp?HD=1&ID=1725&CATE=119

15. An exception sometimes exists for Muslims living in the west, where qualifying financial products are unavailable under the doctrine of *darurah* or hardship. As a result, some products, such as conventional mortgages, have been allowed where a viable Islamic alternative did not exist. See *Mortgage for a Home*, MUSLIM INVESTOR (Mar. 13, 2001, 1:00 PM), <http://muslim-investor.com/answers/mortgage-for-a-home.html>. In other circumstances, exceptions are made where the product is required by secular law. This has applied, for example, to car insurance requirements.

16. MUHAMMAD AYUB, UNDERSTANDING ISLAMIC FINANCE 189 (2007). The banks may, however, provide a return, so long as it is discretionary. *Id.* From

pay a return based upon the investment yield of the funds. Funds are deposited for a defined period of time,¹⁷ and incur the risk of gain¹⁸ or loss on any investment.¹⁹ Return may, however, be spread among all of the participation accounts.²⁰ Studies

the perspective of *Sharia*, deposits are treated as an interest-free loan to the bank, often under the principle of *qard hassan*. See Mohammad O. Farooq, *Qard Hasan, Wadiah/Amanah and Bank Deposits: Applications and Misapplications of Some Concepts in Islamic Banking*, 25 ARAB L. Q., no. 2 (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418202.

17. Professor Hamoudi, however, suggests that in fact this is not what the banks do. See Haider Ala Hamoudi, *Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance*, 40 CORNELL INT'L L. J. 89, 116 (2007) (noting that "this model is commercially unworkable as an alternative to the conventional bank system because it offers neither the liquidity nor the minimal risk of loss that would be expected of a bank.").

18. Thus, for example, one of the participating banks in Turkey provided for a 70 to 30 percent split. See BANK ASYA, DEPOSIT STRUCTURE 10 (2012), http://www.bankasya.com.tr/en/_pdf/bank_asya_presentation_2012.pdf (defining participation accounts as "a profit sharing account, whereas 70% of the revenue generated from this account is contributed to the account holders and 30% remains with the bank").

19. It is not clear that any Islamic bank has ever passed on losses to account holders. They have, however, reduced the rate of return. See Masood Ahmed, *Did Islamic Banks in the Gulf Do Better Than Conventional Ones in the Crisis?* IMF DIRECT (Oct. 14, 2009), <http://blog-imfdirect.imf.org/2009/10/14/islamic-banking/>. ("[S]ome Islamic banks have [demonstrated a] flexibility to mitigate the impact of asset losses through a temporary reduction in the rates of return to investors.").

20. At least some banks apparently maintain a reserve fund to protect principal, making the payments on a "voluntary" basis. See Mohammed Khnifer, *Towards a Universal Islamic Deposit Insurance System* (pts. 1& 2) ISLAMIC BUS. & FIN. 20, 22 (2010) ("[W]e know that banks retain a fraction of the yearly shareholders' income in a special account for shareholders which would be used to compensate the depositors for any loss of their principal amount that may occur when taking risks with their money. For instance, a Saudi bank sustained large losses around the same time and its Board of Directors decided to have the bank's owners bear this loss on behalf of the owners of the investment accounts."). Depositors in investment accounts, therefore, continue to have the risk of loss, with the risk spread among all such depositors. See ISLAMIC FINANCIAL SERVICES BOARD, ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 130 (2013), [http://ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%20TEXT%20FINAL%20\(OUTPUT\).pdf](http://ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%20TEXT%20FINAL%20(OUTPUT).pdf) [hereinafter ISLAMIC FINANCIAL SERVICES BOARD]. ("In addition, the Takāful approach does not eliminate the risk-sharing substance of Muḍārabah contracts but shifts the risk from the individual IAH to the collective of all IAHs.").

show that returns in these accounts roughly equal the interest paid by conventional banks.²¹

B. Loans

With respect to loans, Islamic banks may not charge interest. *Sharia*, however, permits a number of mechanisms that allow banks to provide financing, while earning an adequate return. Under *murabaha*, or cost plus financing,²² the financial institution buys the desired goods, takes title—incurring the risk of

21. See HANDBOOK OF ISLAMIC BANKING 130 (M. Kabir Hassan & Mervyn K. Lewis eds., 2007) (“[T]he return on Islamic deposits is roughly kept in line by management decisions with interest earned on conventional deposits.”). Islamic banks typically match the return of commercial banks, but use means other than conventional interest payments. See Timur Kuran, *Islamic Economics and the Islamic Subeconomy*, 9 J. ECON. PERSP. 155, 161 (Autumn 1995) (noting that, for the most part, returns on interest-bearing accounts and returns in participation accounts are approximately the same as those with commercial banks). See also Ergeç Etem Hakan & Bengül Gülümser, *Impact of Interest Rates on Islamic and Conventional Banks: The Case of Turkey* 5 (MPRA Paper No. 29848, 2011), http://mpa.ub.uni-muenchen.de/29848/1/MPRA_paper_29848.pdf. (“It was found in many empirical researches that the change in interest rates may affect not only the deposits in conventional banks but also the deposits reserved in Islamic banks.”). To the extent that rates in participation accounts are similar to interest paid in traditional deposit accounts, the amount would not include a premium that reflected the risk of loss. See HANDBOOK OF ISLAMIC BANKING, *supra* note 21. (noting that returns paid by Islamic deposits do not “take into consideration the different risk positions of insured conventional and uninsured Islamic depositors, and it does not reflect the risk profile of the assets of the Islamic bank.”).

22. Walid S. Hegazy, *Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism*, 7 CHI. J. INT'L L. 581, 598 (2007) (“Today, murabaha represents more than 70 percent of all financial structures used by” Islamic financial institutions.). See also Hamoudi, *supra* note 17, at 119 (noting that approximately 80 to 95 percent “of the funds of Islamic financial institutions are employed in Murabaha transactions.”).

loss²³—then sells them to the client.²⁴ The sales price includes both the cost of the underlying asset and the bank's profit.²⁵

Cost plus sales traditionally occurred in a single transaction.²⁶ In modern financial systems, *murabaha* has commonly been used to permit repayment through installments. As a result, they function in a manner similar to interest-bearing loans. Moreover, banks can provide for rapid conveyance of title to the customer, thereby significantly reducing the period of ownership, as well as reducing the risk of loss.²⁷

II. ISLAM AND CREDIT CARDS

A. Overview

Credit cards illustrate the complexities involved in applying *Sharia* to modern financial products. Traditional credit cards typically offer interest-free loans during a short grace period. Thereafter, banks charge interest on any outstanding balance and impose penalties for late payments. Some, but not all, credit cards impose an annual fee, although the amount is usually

23. See Usmani, *supra* note 14, at 12. ("It is one of the basic requirements for the validity of murabahah that the commodity is purchased by the financier which means that he assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he assumes.").

24. The commodity or good must be in existence at the time of the sale. See *Risk Management in Murabaha*, PAKISTAN'S BANKS' ASS'N (2005), http://www.pakistanbanks.org/career_development/am/articles/08-05-01_01.html. ("One disturbing trend is the use of murabaha for financing non-commodity needs, such as holidays, house renovations and other similar financial needs which fall under the grey definition of commodities.").

25. The bank must disclose its actual cost to the buyer. See Usmani, *supra* note 14, at 65–66.

26. HANDBOOK OF ISLAMIC BANKING, *supra* note 21, at 174 ("Originally, murabaha was not conceived of as a mode of finance, since it was not necessarily concluded on the basis of deferred payment. Murabaha sale for cash was the rule rather than the exception. The shift to credit murabaha, or murabaha with deferred price, is a first requisite for its transformation into a technique of finance.").

27. Hegazy, *supra* note 22, at 600. ("Notice that, however, in terms of risk and profit sharing, the bank or lender/seller in the *murabaha* transaction only holds the risk in between the two sales. Of course, the bank can (and does) **minimize** this **risk** by conducting the two sales within a short period or even simultaneously.").

modest. Issuers also receive fees from the merchants that accept the cards.²⁸

Islamic compliant credit cards confront a number of limitations under *Sharia*. *Sharia* generally prohibits both the payment of interest and the imposition of penalties. Moreover, extensions of credit can encourage profligate spending and the accumulation of debt, something Islamic law discourages.²⁹ Initial forays into this area, therefore, often involved debit³⁰ or prepaid cards.³¹

28. For a discussion of credit card practices, see U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS, GAO-06-929 (2006), <http://www.gao.gov/new.items/d06929.pdf>. See also AYUB, *supra* note 16, at 379.

29. Some assert that credit cards are inconsistent with *Sharia* because they encourage unnecessary consumption. ILHAM REZA FERDIAN, ET AL., THE PRACTICE OF ISLAMIC CREDIT CARDS: A COMPARATIVE LOOK BETWEEN BANK DANAMON INDONESIA'S DIRHAM CARD AND BANK ISLAM MALAYSIA'S BI CARD 1, 10 (2008), <http://staff.ui.ac.id/system/files/users/miranti.kartika/publication/200808iaeiconferenceislamiccreditcard.pdf> ("Some of them argued that the issuance of Islamic credit card will support the consumerism which is not allowed in Islam."). See also Salman Ahmed Shaikh, *Islamic Credit Cards: A Necessity or Luxury?* (Dec. 28, 2011), http://islamicfinanceandbanking.blogspot.com/2011_12_01_archive.html. ("Some financial institutions in Islamic countries have developed Islamic Credit Cards for consumer financing. Problems arise due to the fact that credit cards could be used for impulsive buying or even the fulfillment of one's needs while not involving a tangible asset."). Others point to the propensity of cards to encourage debt. See SHOCHRUL ROHMA, ISLAMIC CREDIT CARDS: A COMPARISON STUDY BETWEEN ITS APPLICATION IN MALAYSIA AND INDONESIA, 1, 20, available at http://www.academia.edu/3148093/islamic_credit_cards_a_comparison_study_between_its_application_in_malaysia_and_indonesia (last visited Mar. 31, 2015) ("In addition, some Indonesian Muslim scholars reject the issuing of Islamic credit card[s] because the credit card is [the] same as a debt, whereas [a] debt is one thing which is not recommended in Islam.").

30. See Rodney Wilson, *The Development of Islamic Finance in the Gulf Cooperation Council* 16 (Kuwait Program on Development, Governance and Globalization in the Gulf States, Working Paper, 2009), <http://www.cimaglobal.com/Documens/Islamic%20finance/2011/Press%20cuttings/development-of-IF-in-the-GCC.pdf> ("Initially Islamic banks only offered debit cards to their current-account customers.").

31. Even with respect to these types of cards, limits may exist. Banks cannot provide "rewards" that result in the violation of Islamic law. AYUB, *supra* note 16, at 381 (noting that cardholders may not be awarded gifts inconsistent with *Sharia*, including "conventional life insurance, entrance to prohibited places or prohibited gifts.").

Nonetheless, *Sharia* generally permits banks to issue cards, so long as they are structured in a manner consistent with Islamic principles.³² In doing so, banks confront three main issues. First, the card cannot be used to make *haram*, or “sinful,” purchases. Second, the card cannot impose interest. Third, the card must address the problem of late payments in the context of *Sharia*’s prohibition on penalties.

B. Impermissible Purchases

Sharia compliant credit cards cannot be used to make “sinful” or *haram* purchases.³³ Other types of restrictions may also exist. For example, the purchase of gold, silver, and foreign currencies cannot be done on credit,³⁴ although this position is not uniformly accepted.³⁵

To prevent improper purchases, Islamic banks rely on two basic approaches. Sometimes they reject a charge at the point of sale.³⁶ This can be done on a business-by-business basis. Thus, cards commonly will not work at casinos and bars.³⁷ A blunt approach, businesses often sell a mix of sinful and nonsinful

32. See THE COUNCIL OF THE ISLAMIC FIQH ACADEMY, RESOLUTION NO. 108 (2/12), ON “CREDIT CARDS” 249 (2000), <http://www.irtipms.org/PubText/73.pdf> [hereinafter THE COUNCIL] (“It is permissible to issue credit cards that do not carry a condition of imposing interest on the credit.”).

33. See FERDIAN, ET AL., *supra*, note 29, at 2 (“The holders of the card are only permitted [to] carry out *halal* transactions, which exclude transactions related with six categories that [do not] meet *Shariah* requirements. These categories are bars, discos, night clubs, purchase of beers, escort and massage services and gambling.”).

34. The Fiqh Academy has also indicated that they may not be used for the purchase of certain precious metals. See THE COUNCIL, *supra* note 32.

35. See Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Faculty of Islamic Studies, (Dec. 6, 2011) (on file with author) (noting that, in connection with the purchase of gold, silver, or currencies, “no delay is permissible” but that “it is permissible to buy gold with a credit card because payment is now credited electronically at the time of the sale and delivery.”).

36. See Posting of Adrian Chan, *Beware of HSBC Amanah Credit Card*, LOWYAT.NET (Feb 9, 2010), <http://forum.lowyat.net/topic/1323270/all> [hereinafter, Chan Comment].

37. See e.g., MASHREQ AL ISLAMI, MASHREQ AL ISLAMI CREDIT CARDS FAQs, <http://www.mashreqislami.com/en/mashreq-al-islami-credit-card/images/Mashreq-Al-Islami-credit-cards-FAQs.pdf> (last visited Feb. 15, 2015) (“Yes; since Mashreq Al Islami Platinum Credit Card is based on Shari’a principles, then it cannot be used for transactions prohibited by “Islam” such as gambling, liquor, and transactions at clubs, Pubs and Casinos etc. Such transactions will not be considered and declined immediately.”)

goods.³⁸ Purchases at grocery stores and hotels can involve products that are both *haram* and *halal*.³⁹ In these cases, Islamic banks typically rely on self-enforcement. Cardholders agree, as part of the account opening process, to avoid sinful purchases. The bank reserves the right to cancel the card in the event of noncompliance.⁴⁰

Self-enforcement presupposes that individuals are fully aware of the distinction between proper and improper transactions. Descriptions contained in account opening agreements, however, can lack specificity.⁴¹ Moreover, while banks can cancel a card for improper use, this suggests a willingness to rigorously monitor purchases and devote the resources to effective enforcement. To the extent that this occurs, it can increase the costs associated with the issuance of an Islamic compliant credit card.

38. For a threaded discussion contending that an Islamic credit card did not process transactions at Domino's Pizza because the nature of the business did not comply with *halal*, see Chan Comment, *supra* note 35.

39. Some music is considered *haram*. See *Fatwa: Is Music Haram?*, ISLAMAWARENESS.NET, http://www.islamawareness.net/Music/music_fatwa005.html (last visited Mar. 31, 2015) ("The subject matter of songs should not be against the teachings of Islam. For example, if the song is in praise of wine, and it invites people to drink, singing or listening to it is *haram*."). Barring purchases from iTunes would, presumably, generate consumer resistance.

40. See AAOIFI Standard No. 2, definition 2/3(b) ("The institution must stipulate that the cardholder may not use the card for purposes prohibited by the Shari'a and that the institution has the right to withdraw the card in case such a condition is violated."). As the account agreement for RHB Islamic Bank provides, the card may be cancelled "[i]f the Cardholder uses the Card for any unlawful activities or non-halal activities including but not limited to illegal online betting or purchase of non-halal goods at non-halal businesses and premises." RHB ISLAMIC CREDIT CARD, RHB CARDHOLDER AGREEMENT 13 http://www.rhb.com.my/islamic_banking/cards/pdfs/RHBiB_CC_TnC.pdf (last visited Feb. 15, 2015).

41. The credit card agreement for Ajman Bank in the UAE provides that the card cannot be used "for any unlawful purpose, including the purchase of goods or services, prohibited by Islamic *Sharia* or any applicable laws wherever the Card is used" and cannot be used "to commit any act, which is against Islamic Shari'a principles." AJMAN BANK, CREDIT CARD CARDHOLDER AGREEMENT 13 <http://www.ajmanbank.ae/SiteCollectionDocuments/Ajman%20Bank%20Credit%20Card%20Terms%20and%20Conditions.pdf> (last visited Feb. 15, 2015).

C. Prohibition on Interest

In addition to the prohibition on improper purchases, Islamic credit cards cannot charge interest.⁴² The restriction represents the most significant challenge in structuring a *Sharia* compliant credit card. Islamic banks have sought to find interpretations of *Sharia* that allow a credit card to be cost effective and profitable but do not result in the imposition of interest.

1. Ujrah

While Islamic banks cannot charge interest, they can impose fees, *ujrah*, for services provided.⁴³ Banks may, therefore, charge merchants a fee for accepting the card.⁴⁴

With respect to cardholders, however, matters are more complicated. Fees are permitted so long as they compensate Islamic banks for the services provided and are not a form of disguised interest. As a result, annual and renewal fees are permitted.⁴⁵ In addition, Islamic banks may impose fees on transactions designed to recoup the administrative costs of the transaction.⁴⁶ In

42. See THE COUNCIL, *supra* note 32, at 249–50. (“It is permissible in *Shari’ah* to issue Credit Cards that do not carry a condition of imposing interest on the debt.”).

43. See AYUB, *supra* note 16, at 381 (describing credit card issued by Emirates Islamic Bank and noting that it included “yearly service charge” that was “payable on a quarterly basis.”).

44. See THE COUNCIL, *supra* note 32, at 250 (stating that “[p]ermissibility for the issuer to take a commission on the goods or services purchased by the bearer, provided that such goods or services are sold at the same price whether in cash or credit” is taken under consideration.). See also Wilson, *supra* note 30, at 16 (“There can be no interest charges on debit balances with Islamic credit cards, but, as with conventional credit cards, the issuers, in this case Islamic banks, receive a commission from the retailer proportionate to the amount of the transactions in return for a guaranteed payment.”).

45. See THE COUNCIL, *supra* note 32, at 250 (considering the “[p]ermissibility for the issuer to take from the bearer a specific amount of money at the time of issuing or renewal of the Card, which] [] constitutes the actual fee that the issuer deserves according to the services it provides to the bearer.”).

46. Mohammad ‘Ali Elgari ibn Eid, *Unsecured Installment Credit Cards*, 3 J. ISLAMIC FIQU ACAD. OIC 95, 98 (2006), <http://uaelaws.files.wordpress.com/2012/05/unsecured-installment-credit-cards.pdf> [hereinafter Elgari] (“One of the alternative structures adopted by some Islamic banks is issuance of a card that allows the client to pay the debt created by the use of the card on a monthly basis in twelve installments without any attendant interest The issuance and the renewal fee are higher than normal. And then a special fee is added with each use of the card. This is fixed and not linked with the

general, however, the charges must be fixed in amount and cannot be calculated as a percentage of the outstanding balance.⁴⁷

Some credit cards using this approach charged substantial annual fees.⁴⁸ In these cases, credit was limited in amount and mandatory repayment schedules were short, with as much as one-third of the balance required to be repaid each month.⁴⁹ These features tended to make the cards unpopular with consumers.⁵⁰

2. Tawarruq and Bay'al inah

Some Islamic banks, particularly in Saudi Arabia, rely on the principle of *tawarruq*, sometimes referred to as a commodity *murabaha*, a three party transaction. Under this approach, the bank takes the unpaid balance and purchases an asset, often a

tenure or amount used. And there are some other fees associated with a cash withdrawal from the machine . . . and so on.”). The fee itself cannot be tied to the amount borrowed.

47. Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Qatar Faculty of Islamic Studies (Sept. 27, 2011) (on file with author) (noting that some credit cards charge fixed “administrative fees” for “managing the credit card account” with unpaid balances and noting that this approach is “not permissible according to the OIC Fiqh Academy and all [respected] Shari’ah scholars.”). See also ZAHARIM YAAKOB, ISLAMIC CARD BASED ON MUSHARAKAH MUTANAQISAH 1, 4 (Aug. 2011), available at http://www.academia.edu/1015645/Islamic_Card_based_on_Musharakah_Mutanaqisah [hereinafter YAAKOB] (“Islamic Credit Cards may also operate on the *Ujrah* concept which is based on a fixed fee structure, meaning that only fixed fee will be charged to the customer. The Card would not be levied with any floating percentage fee dependent upon the outstanding balance.”).

48. In other cases, interest is avoided by extending credit only during the grace period. See Elgari, *supra* note 46 (describing “single pay” credit cards and noting the amount charged “must be paid in one payment, usually within three weeks”).

49. For a description of a credit card using this model, see AYUB, *supra* note 16, at 383 (describing the Al Tayseer Credit Card issued by the Kuwait Finance House).

50. Elgari, *supra* note 46 (“This card did not achieve the success hoped for it. The reason is that most people carry a credit card just in case, i.e. in order to have the means of payment ready if needed. Considerable time may pass without using it; therefore, they prefer a card where a fee is charged only upon its use, but the fee of this card is linked to the issuance itself, and the card holder must pay it whether he uses the card or not.”). See also Wilson, *supra* note 30, at 16 (“Some banks charge an annual fee, but, given the competition from other card issuers, Al Rajhi Bank and Dubai Islamic Bank no longer charge fees.”).

commodity, from a third party then resells it at a loss.⁵¹ Monthly charges on unpaid balances are treated not as interest but as an investment loss.

Other Islamic banks, particularly in Malaysia,⁵² have relied on *bay'al inah*, a two party transaction that involves the purchase of an asset, often land, by the account holder directly from the bank.⁵³ The land is then resold to the bank at a loss. To the extent the card balance is not repaid within the grace period, the bank recovers a portion of the loss.⁵⁴

Bay'al inah and *tawarruq* allow Islamic banks to issue credit cards that charge a percentage of the unpaid balance carried over from month to month.⁵⁵ Both approaches, however, have been criticized and are not widely accepted by *Sharia* scholars.

51. Often these transactions occur in the London Metal Exchange. See Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Faculty of Islamic Studies (Sept. 27, 2011) (“[T]he contract allows the bank to buy copper from LME for the unpaid balance and sells it to the holder due next month at a marked up price, then sells it on behalf of the customer to pay the balance. This is repeated every month on the moment the holder makes a partial payment.”).

52. Most in Malaysia adhere to the Shafi'i school of Islamic jurisprudence. See ABU UMAR FARUQ AHMAD, *THEORY AND PRACTICE OF MODERN ISLAMIC FINANCE: THE CASE ANALYSIS FROM AUSTRALIA* 79 (2010). The use of *bay'al inah* is accepted by this school of Islamic jurisprudence, but not the others. See Amir Shahrudin, *The Bay'al-Inah Controversy in Malaysian Islamic Banking*, 26 ARAB L. Q. 499 (2012), available at http://www.academia.edu/5167368/The_Bay_al-Inah_Controversy_in_Malaysian_Islamic_Banking.

53. Shahrudin, *supra* note 52, at 5. The use of *bay'al inah* illustrates the differences in the Islamic schools of jurisprudence. This interpretation arises out of the Shafi'i school of thought, one of the four schools recognized by Sunni Muslims. Although not limited to Malaysia, it is the predominate school of thought in that country. See *id.* (“The Malaysian shari'ah scholars had favoured the opinion of al-Shafi'i in accepting the bay'al-Inah contract in creating a number of Islamic banking products.”). The interpretation of *bay'al inah* is not, however, recognized by most other schools of Islamic jurisprudence. See *id.*

54. For a description of the approach, see AYUB, *supra* note 16, at 382.

55. One significant difference, however, is that the monthly charge is not typically compounded. See Louise Baxter, *How Does an Islamic Credit Card Work?*, SOUCQALMAL.COM (Nov. 7, 2013) <http://www.souqalmal.com/blog/creditcards/how-does-an-islamic-credit-card-work/> (“Other Islamic banks, however, may choose to levy a profit rate on outstanding balances with preferential rates awarded to customers whose salary transfers into the bank. Unlike conventional banking, the profit rate levied is non-compounding.”).

Bay'al inah has, for the most part, been rejected by Islamic scholars in the Middle East.⁵⁶ Similarly, *tawarruq* has been criticized by the OIC Fiqh Council.⁵⁷

3. Al-Kafalah

Other approaches have been used in developing *Sharia* compliant credit cards. Relying on the recognized right to collect a fee for services, some banks, particularly in Malaysia and Brunei, guarantee payment to the merchant each time a transaction occurs.⁵⁸ The fee is charged to the card holder in return for this service. The fee is expressed as a percentage of the item purchased.⁵⁹

56. See Mohd Zulkifli Muhammad, et al., *Comprehensive Approach for Sharia Compliance E-Commerce Transaction*, 16 J. INTERNET BANKING & COMM. 1, 11 (2011) ("But the doctrine of *Bay al-Inah* is not recognized by some scholars from Middle-East."). See also RAFIDAH AZLI & AZMAN MOHD NOOR, ISSUANCE OF ISLAMIC CREDIT CARD IN MALAYSIA: A CRITICAL ANALYSIS 2 (2009) ("The majority of scholars reject bay' al-'inah as a valid mode of sale."). See YAAKOB, *supra* note 47, at 3 ("The majority of the jurists were of the opinion that *Bai Inah* was not permissible because it was the way or *hilah* (legal excuse) to legitimize *Riba*. The Maliki and Hanbali School rejected *Bai Inah* and considered it invalid.").

57. The Fiqh Council of the Organization of Islamic Countries issued a *fatwa* challenging this use of *tawarruq*. See Resolution 179 (19/5). A copy of the resolution is attached as an appendix to *Fatwa in Islamic Finance*, ISLAMIC SHARI'AH RESEARCH ACADEMY FOR ISLAMIC FINANCE, BLOOMBERG, Sept. 2013, <http://www.ifikr.isra.my/documents/10180/16168/blp-isra%20sep%20bulletin%20Tawarruq.pdf>. For a discussion of this ruling, see Nikan Firoozye, *Tawarruq: Shariah Risk or Banking Conundrum*, OPALESQUE.COM (July 3, 2009), http://www.opalesque.com/OIFI12/Featured_Structure_Tawarruq_Shariah_Risk_orBanking438.html.

58. See *Credit Card*, BANK ISLAM BRUNEI DARUSSALAM, <http://www.bibd.com.bn/consumer/cards/credit-card/> (last visited Oct. 23, 2014) ("In Kafalah, the customer gives the bank collateral and pays a fee to the bank as security in exchange for the bank's guarantee/surety. This guarantee or surety issued by the bank whereby the bank guarantees to discharge the liability of a customer should the customer default in fulfilling his obligations.").

59. FERDIAN, ET AL., *supra* note 29, at 8 ("The Dirham Card holder has to pay 3% administration cost of the total amount of transaction That practice is different with a conventional credit card. The conventional card holder will not be charged with the interest fee if he/she is able to pay before the due time.").

The payment of these fees differs from traditional interest in a number of respects. The full amount of the charge is owed at the time of the transaction but can be repaid in installments. There is no grace period and no automatic reduction for early repayment.⁶⁰

Not all *Sharia* scholars agree, however, that the imposition of fees in return for a payment guarantee is an appropriate interpretation of Islamic law. Fees in general may be recovered to the extent designed to provide reimbursement for actual costs. The charges paid for guarantees, however, are often expressed not as a flat fee but as a percentage of the amount charged. More importantly, many scholars interpret *Sharia* as prohibiting charges for a guarantee.⁶¹

4. Murabaha

A number of banks, particularly those from countries in the Gulf Cooperation Council,⁶² rely on the principle of *murabaha* in structuring their credit cards.⁶³ Under this approach, the cardholder is designated as an agent, or *wakil*, of the bank. As a result, the bank, not the customer, acquires title to the goods at the time of purchase. The bank then resells the goods to the card

60. Banks can, however, voluntarily forego portions of the fee in the event of repayment.

61. Elgari, *supra* note 46 (discussing the different positions on the right to accept a fee for a guarantee of repayment to a merchant).

62. Mohammed Khnifer, *Maslaha and the Permissibility of Organized Tawarruq*, 8 OPALESQUE ISLAMIC FIN. INTELLIGENCE 6 (2010) (noting that *murabaha* is the “the basis of many credit card transactions (primarily in the GCC region”). The GCC consists of the countries on the Arabian Peninsula, excluding the Republic of Yemen. They include Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates, and the Sultanate of Oman. *Gulf Cooperation Council*, BRITANNICA, <http://www.britannica.com/EB-checked/topic/249154/Gulf-Cooperation-Council-GCC> (last updated Feb. 18, 2014).

63. See AYUB, *supra* note 16, at 383. Some credit cards also rely on *Ijhara*, or leasing. See also Baytik *Ijhara*, *Card-Retail Banking*, KUWAIT FINANCE HOUSE, <http://www.kfh.bh/en/retail-banking/baytik-ijara-card.html> (last visited Oct. 30, 2014) [hereinafter *Baytik Ijhara Card*]. See also *Giving Credit to Islamic Payment Cards*, BANKING & PAYMENTS ASIA (Oct. 1, 2009), <http://www.bankingandpaymentsasia.com/news/giving-credit-to-islamic-payment-cards-1811735539> (“Kuwait Finance House in Bahrain has an *Ijhara*-based card, in which the customer is allowed to purchase consumer durable goods on the bank’s behalf. The bank subsequently leases the goods purchased back to the customer.”).

holder at a price that includes both the cost of the goods and the bank's profit. The card holder repays the amount in installments.

Murabaha as a basis for a credit card raises a number of issues. The card holder agrees to repurchase the goods in the account opening documents, before the bank has title. As a result, the transfer takes place instantaneously at the time the credit card is used. Banks, therefore, do not incur any meaningful risk of loss.⁶⁴ *Murabaha* also generally requires payment of the bank's profit even if the balance is repaid before the expiration of the installment period.⁶⁵

Murabaha cannot be used for all items. *Murabaha* applies to the sale of tangible assets.⁶⁶ This does not include, for example, the payment of taxes and certain utility bills.⁶⁷ Nor can the approach be used for cash withdrawals.⁶⁸ Islamic banks allowing cash withdrawals, therefore, cannot add "profit" to the amount and are, for the most part, limited to a "flat service fee" that cannot be related to the amount borrowed.⁶⁹

64. See AHMAD, *supra* note 52, at 200 (noting that one criticism of *Murabaha* transactions is that "in *Murabaha* the customers accept the offer of the bank, in which they bind themselves to purchase the goods before the bank has approached the supplier.").

65. AYUB, *supra* note 16, at 232 ("the majority of contemporary Shari'ah scholars do not allow remission for earlier payment in *murabaha* operations by banks."). Nonetheless, some banks voluntarily forego the additional monthly charges upon early repayment.

66. A credit card using *Murabaha* may also use other Islamic principles such as *Ijhara*, or a lease to permit additional purchases. *Ijhara* can, for example, be used for services. See Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Faculty of Islamic Studies, to author (Aug. 28, 2013) (on file with author).

67. Water is considered tangible but electricity and phone are not. See Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Faculty of Islamic Studies, to author (Sept. 4, 2013) (on file with author). See also DALLAH AL-BARAKA GROUP, DEPARTMENT OF RESEARCH AND DEVELOPMENT, SHARIA OPINIONS (FATWA) ON MURABAHA, 455-56, <http://www.albaraka.com/media/pdf/Research-Studies/RSMR-200706201-EN.pdf> (under *murabaha* profit may be calculated on the basis of goods "plus other costs" including service related to the good). Likewise, *murabaha* cannot be used to pay the "cost of labor." *Id.* at 451.

68. See AYUB, *supra* note 16, at 381 (noting that cash withdrawals are permitted "provided no interest is charged").

69. *Id.* Other interpretations of *Sharia* are occasionally used as a basis for credit cards issued by Islamic banks. *Ijhara* allows the bank to purchase the good at the point of sale and lease it back to the customer for an agreed amount.

D. The Problem of Late Payments

Islamic credit cards also confront the problem of late payments. Conventional financial institutions impose penalties on late payments. *Sharia*, however, prohibits the practice.⁷⁰

Islamic banks can respond to late payments by cancelling the card, blacklisting the customers, or accelerating the amount due.⁷¹ None of these methods, however, ensure repayment. Banks may also establish a lien against the cardholder's salary or require collateral.⁷² Collateral usually takes the form of a separate account with funds that can be tapped in the event of a failure to make a payment.⁷³

Nonetheless, Islamic banks do in fact sometimes impose penalties for late payments. Because the practice is generally viewed as inconsistent with *Sharia*, the proceeds cannot be

For a card based upon this principle, see *Baytik Ijhara Card*, *supra* note 63. As the terms specify, title reverts to the card holder at the end of the lease period.

70. COUNCIL OF THE ISLAMIC FIQH ACADEMY, *Resolution No. 109 (3/12): On "Penalty Provisions,"* in RESOLUTIONS AND RECOMMENDATIONS OF THE COUNCIL OF THE ISLAMIC FIQH ACADEMY 1985-2000, at 200, 251 (2000) (reaffirming that upon delay in due installments "no additional charge should be imposed" because such "a practice amounts to a commitment of prohibited usury.").

71. See Khidr Al-Marhoun, *Saudi Banks Blacklist Over 100,000 Clients*, ARAB NEWS, <http://www.arabnews.com/node/212302> (last updated July 7, 2012, 4:28 PM) ("Over 106,000 Saudis and expatriates were blacklisted by Saudi banks until the end of Nov. 2000."). See also ISLAMIC CREDIT CARD AGREEMENT, NATIONAL COMMERCIAL BANK, http://www.sib.ae/media-files/2011/07/12/20110712_Credit-Card-TCs-English-Final-30-06-2010-as-per-Sharia-Legal.pdf (last visited Oct. 27, 2014). ("Collateral is required in many cases; most banks require an underlying deposit or undated check.").

72. Abu Dhabi Islamic Bank (ADIB) requires an account that contains the amount of the credit limit for the card. Purchases are taken from this account. See COVERED CARDS: TERMS AND CONDITIONS, ABU DHABI ISLAMIC BANK, <http://www.adib.ae/sites/default/files/u7/adib-terms-and-conditions.pdf> (last visited Oct. 27, 2014). See also *Al-Tayseer Platinum Standard Package*, KUWAIT FINANCIAL HOUSE, <http://www.kfh.com/en/banking-services/credit-cards/al-tayseer-platinum-standard-package.aspx> (last visited Oct. 27, 2014) (requiring a "salary account" or a deposit account with the bank as a condition for receiving a credit card). A mandatory deposit does not violate *Sharia*, although profit from the account should be shared between the bank and cardholder. AYUB, *supra* note 16, at 380.

73. See Lisa Rogak, *Shariah-compliant Credit Cards become More Common*, CREDITCARDS.COM (July 29, 2008), <http://www.creditcards.com/credit-card-news/shariah-compliant-credit-cards-1273.php>.

treated as profit and must be donated to charity.⁷⁴ Not everyone, however, agrees with this approach.⁷⁵

E. Observations

Sharia scholars have, for the most part, approved of the issuance of credit cards by Islamic banks, so long as they otherwise conform with religious precepts. The attributes of the cards and their basis in Islamic law have varied. Moreover, the requirements of Islam at least sometimes limit the use of these cards. The widespread availability of credit cards issued by traditional banks provides cardholders with a mechanism to avoid these limitations.

III. DEPOSIT INSURANCE

A. Overview

Financial systems commonly rely on deposit insurance. Insurance increases confidence in the financial system by guaranteeing repayment to depositors in the event of a bank failure. These systems are often self-funded through premiums paid by banks. Deposit insurance, however, raises concerns under *Sharia*.

Islam prohibits the practice of *gharar*, something typically translated as excessive uncertainty or risk. Risk exists on a continuum. Matters of pure chance such as gambling are prohibited.⁷⁶ Other areas of uncertainty such as market risk from investment in corporate stocks are typically allowed. *Gharar* has generally been interpreted to prohibit commercial insurance, whether property or life.⁷⁷

74. See Ayub, *supra* note 16, at 454 (noting that *Sharia* scholars have allowed the imposition of penalties for default but “the penalty amount has to be spent on charity and cannot become part of the income of the bank.”).

75. See *Taking A Fine On Delayed Credit Card Payments*, ISLAMAWEB (Aug. 8, 2006), <http://www.islamweb.net/emainpage/index.php?page=showfatwa&Option=FatwaId&Id=92320> (“As for taking a fine on delayed payments, it is forbidden as it is clear *Riba* (interest and/or usury). The excuse of the banks that they will spend this amount in charity does not justify their practice. Any loan that avails benefit is *Riba*. Signing the contract of a credit card is not allowed if it contains paying a fine on delayed payments.”).

76. See Umar Moghul & Arshad Ahmed, *Contractual Forms in Islamic Finance Law*, 27 FORDHAM INT'L L. J. 150, 170–72 (2003). The prohibition extends to some forward contracts. *Id.*

77. AYUB, *supra* note 16, at 418–19.

With elements of uncertainty, deposit insurance must overcome the prohibition on *gharar*.⁷⁸ *Sharia* has been interpreted to permit the use of deposit insurance under the Islamic principle of *maslahah* or public interest.⁷⁹ Such a system provides benefits to the public and improves the competitive position of Islamic banks.⁸⁰

B. Deposit Insurance and Participation Accounts

Assuming deposit insurance is acceptable under *Sharia*, a system that covers deposits in demand accounts raises few concerns. Systems that seek to cover funds in participation accounts, however, raise more complex issues. Paid a return based upon investment performance, these deposits must bear the risk of loss. To the extent that they are covered by insurance, the risk is eliminated, at least in the case of a failed bank.

An Islamic compliant approach could simply exclude these deposits from any insurance scheme.⁸¹ Such an approach, however,

78. See INT'L ASSOC. DEPOSIT INSURERS, *Deposit Insurance from the Shariah Perspective* 9 (Islamic Deposit Insurance Group of the International Association of Deposit Insurers, Discussion Paper, 2010), http://www.iadi.org/docs/DI_from_Shariah_Perspective.pdf [hereinafter Discussion Paper] ("The uncertainty element exists in deposit insurance in respect of the failure of a bank. Nevertheless, such uncertainty may not be prohibited as it is unavoidable and naturally embedded in deposit insurance.").

79. *Id.* at 3. ("Deposit insurance contains the element of public interest, and therefore is permissible under *Shariah*.").

80. See ISLAMIC BANKING & TAKAFUL DEPARTMENT, RESOLUTIONS OF SHARIAH ADVISORY COUNCIL OF BANK NEGARA MALAYSIA, available at http://www.academia.edu/526031/Shariah_Resolution_-_BNM [hereinafter SHARIAH ADVOCACY COUNCIL] ("In Islamic banking, the implementation of a deposit insurance scheme is equally important to ensure that the Islamic banking deposits are able to compete with the conventional deposits in attracting customers."). See also Email from Prof. Dr. Monzer Kahf, Islamic Finance and Economics, Faculty of Islamic Studies, to the author (Dec. 1, 2011) [hereinafter Prof. Dr. Monzer Kahf email] (noting that there is "agreement that current accounts deposits" can be guaranteed by an Islamic *Takaful* insurer where the Islamic bank "pays the insurance premium").

81. See Discussion Paper, *supra* note 78, at 5. ("Since losses are borne by the PSIA holders, some have argued that PSIA holders should not enjoy protection."). At least one system apparently excludes these deposits. See Blake Goud, *Islamic Finance Complexity (Part IIc)*, SHARING RISK (Nov. 20, 2011), <http://investhalal.blogspot.com/2011/11/islamic-finance-complexity-part-iiic.html> ("Bahrain's [law] covers deposits, not including mudaraba deposits or other deposits not involving safekeeping or custodianship where the depositor

can pose significant risks to the financial system. Most deposits at Islamic banks are in participation accounts. Excluding them, therefore, would leave much of the deposit base unprotected.⁸² This would reduce investor confidence and create systemic risk, including the possibility of mass withdrawals.⁸³

Some Islamic scholars have taken the position that the deposits can be insured but that the risk of loss must remain with the account holders.⁸⁴ Thus, premiums are to be paid at least in part by account holders.⁸⁵ In this manner, depositors are simply sharing the risk of loss in a collective fashion. The deposit insurance system in Sudan provides that the premium is collectively paid by the account holder, the financial institution, and the central bank.⁸⁶ Each insures the portion of the risk of loss attributable to their own behavior.

would be entitled to share in profits and losses.”). Britain allows for their exclusion but leaves the choice to depositors. In chartering the Islamic Bank of Britain, the deposit insurance system was altered to permit customers to waive this protection. As a result, “[d]epositors who sign this waiver would not be eligible to receive insurance of their deposit in accordance with Britain’s insurance scheme.” Michael Silva, *Islamic Banking Remarks*, 12 L. & BUS. REV. AM. 201, 209 (2006).

82. They are the largest segment of deposits held by Islamic banks. See Khnifer, *supra* note 20, at 21. (“The profit and loss sharing (PLS) or Mudarabah forms the bulk of Islamic deposits.”).

83. Thus, the failure of an Islamic financial institution in Turkey resulted in a loss of confidence for the entire segment and a massive withdrawal of funds by depositors. See *infra* notes 153–58.

84. Prof. Dr. Monzer Kahf email, *supra* note 80 (noting that *murabaha* based deposits “are not guaranteed and cannot be insured by the IB [Islamic Bank]” but they can “be insured by owners (the depositors). The matter thus centers on who pays the premium in addition to the *Takaful* and the avoidance of interest issue.”).

85. Some systems address this concern by requiring that any premium for insurance be paid from the returns allocated to investment accounts. See *Deposit Insurance for Islamic Banks*, JORDAN DEPOSIT INSURANCE CORPORATION, http://www.dic.gov.jo/index.php?option=com_content&task=view&id=90&Itemid=9 (last visited Feb. 16, 2015) [hereinafter JORDAN DEPOSIT INSURANCE] (“The Council reinforces the draft Law stipulating that premium fees paid to the Corporation against insuring the credit accounts shall be borne by the Islamic Banks, whereas the investment accounts’ annual premium fees shall be borne by depositors with Islamic Banks.”).

86. Prof. Dr. Monzer Kahf email, *supra* note 80 (discussing deposit insurance system in Sudan and noting that the demand deposit premium was paid by Islamic banks while the premium for investment accounts was paid 50% by depositors with investment accounts, through a deduction in their share of profit, 25% by the Islamic Bank, for its potential responsibility in any banks

Other scholars have attempted to devise a system that insures participation accounts without contributions from depositors. In Malaysia, banks, not depositors,⁸⁷ pay the premium and, in return, receive a guarantee of repayment from a third party, the Malaysian Deposit Insurance Corporation,⁸⁸ under the principle of *kafalah bi al-ajr* (guarantee with a fee).⁸⁹ In the event of a bank failure, deposits in participation accounts are given a lower priority in the repayment hierarchy.⁹⁰

Reliance on this structure is controversial. The problem is not the guarantee, but the fee. Islamic law permits guarantees but

failure, and 25% by the central bank or ministry of finance, for their potential role in any bank failure).

87. See Prof. Dr. Monzer Kahf email, *supra* note 80 (“In Malaysia a law was enacted in 2005 with full premium charged” to the Islamic bank; “This is objected to by most Scholars in Malaysia and abroad.”).

88. Khnifer, *supra* note 20, at 24 (“Under the Mudharabah contract, the entrepreneur is not allowed to guarantee the principal amount of PLS accounts. However, in 2003, Elgari issued a fatwa for the permissibility of such guarantees as long as it came from an unrelated third party. After that, the *Shariah* Advisory Council resolved that a third party guarantee is allowed to protect Mudharabah investment accounts”).

89. See Bank Negara Malaysia, *Shariah Resolutions in Islamic Finance: Part IV: Shariah Issues in Relation to the Operations of Supporting Institutions*, in ISLAMIC FINANCE 175 (2d ed., 2010), http://www.bnm.gov.my/microsites/financial/pdf/resolutions/10_part04.pdf. Malaysia originally structured the system around *tabarru* and *kafalah*. Premiums were treated as a “donation” and the deposit insurance fund provided a guarantee. As one commentator noted, however, the concept of a “donation” suggested that there was no legal obligation to make the payment. ABDUL KARIM ALDOHNI, *THE LEGAL AND REGULATORY ASPECTS OF ISLAMIC BANKING* 197 (2012).

90. Discussion Paper, *supra* note 78, at 13 (“Islamic deposits that are eligible to be insured include savings, demand and investment deposits accepted under *mudharabah* (profit-sharing) and non-*mudharabah* contracts (e.g. *wadiah*, *qard*, and *murabahah*). Participation interests, however, have lower priority in the repayment hierarchy. See *id.* at 14 (“respect of Islamic deposits, the priority of payments is based on the underlying contracts of the deposits, whereby non-*mudharabah* deposits are given priority over *mudharabah* deposits.”).

considers them an act of benevolence.⁹¹ As a result, the guarantor is generally not entitled to charge for the service.⁹² Moreover, some have noted that the guarantee for a fee approach creates a system that is largely indistinguishable from traditional deposit insurance.⁹³

Other countries eschew the use of guarantees and instead rely on *takaful*, or self-insurance.⁹⁴ The concept of *takaful* allows participants to pool their funds under a system of mutual guarantee.⁹⁵ *Takaful* is not intended to be a commercial endeavor but an agreement among participants of cooperation in the sharing of risks. Premiums are considered a donation (*tabarru*) to a

91. See *id.* at 11 (“There is an ongoing debate about the adoption of the guarantee contract in any financial transaction, owing to the existence of the fee element in the contract. On the one hand, a number of classical *Shariah* scholars are of the view that charging a fee for a guarantee is not allowed, based on the argument that the contract is voluntary in nature. On the other hand, some *Shariah* scholars recognize the need to allow it, based on the current needs of the community.”). See also HANDBOOK OF ISLAMIC BANKING, *supra* note 21, at 156 (“Although some Islamic banks also use commercial guarantees, the general *fiqh* understanding goes against their use. In accordance with the *fiqh* only a third party can provide guarantees as a benevolent act and on the basis of a service charge for actual expenses. Owing to this lack of consensus, therefore, the tool is not effectively used in the Islamic banking industry.”).

92. AZMAN MOHD NOOR & MUHAMAD NASIR HARON, CHARGING FEE FOR GUARANTEE (AL-KAFALAH BI AL-AJR) AND ITS APPLICATION BY DEPOSIT INSURANCE CORPORATION MALAYSIA (PIDM) FOR TAKAFUL BENEFITS PROTECTION SCHEME (2011), <http://conference.qfis.edu.qa/app/media/316> (“The great majority of Islamic jurists have always considered it unlawful to charge a fee for a guarantee. They are the jurists from Hanafites, Shafiites, Malikites and also Hanbalites who claimed that it is unlawful to charge fee against a guarantee. They hold that it is permissible to give guarantee; however, to take any rewards from it is prohibited.”).

93. *Id.* at 13 (“But as far as *Shariah* compliance is concern, the structure of *kafalah bi al-ajr* contract perhaps needs reconsideration since it may look like conventional insurance model.”).

94. See Discussion Paper, *supra* note 78, at 14 (“To ensure a *Shariah*-compliant system, BDSF [Bank Deposit Security Fund of Sudan] adopted the *takaful* contract for its deposit insurance.”). By characterizing the contribution as a donation, the product also avoids the prohibition on *gharar*. See Oliver Agha, *Tabarru in Takaful: Helpful Innovation or Unnecessary Complication?*, 9 UCLA J. ISLAMIC & NEAR E.L. 69, 83 (2009-2010) (“The incorporation of *tabarru* is intended to circumvent the absolute prohibition on *gharar* in commercial and commutative contracts by making it a unilateral donation and not in fact a bilateral contract.”).

95. For a criticism of the use of *takaful* in place of insurance, see Hamoudi, *supra* note 17, at 122–23. For a discussion of *takaful*, see Agha, *supra* note 94.

pool.⁹⁶ The pool is managed by an operator who acts as an agent for the participants and provides compensation to depositors whenever a bank fails.⁹⁷

This approach also raises concerns under *Sharia*. First, as a “donation,” premiums generally must be paid without the expectation of any specific return.⁹⁸ Islamic banks, however, anticipate repayment to depositors in the event of a failure. As a result, the motive is not entirely charitable but “conditional,” a practice that is arguably inconsistent with the “fundamental objective of *tabarru*.”⁹⁹

Second, *takaful* suggests voluntary participation.¹⁰⁰ Insuring the integrity of the financial system may, however, dictate that participation be mandatory. Jordan, which created a system of

96. NOOR & HARON, *supra* note 92, at 13 (“The *takaful* benefit is actually a mutual guarantee and indemnity made by the participants among themselves. The strength lies in their agreement and promise as stated in the *takaful* contract to provide the financial assistance to the participating members during misfortune.”).

97. Discussion Paper, *supra* note 78, at 11 (“Under an IDIS that operates based on the donation contract, an IBI agrees to pay premiums in the form of donations or voluntary contributions to a fund (deposit insurance fund). The deposit insurer, acting as manager of the fund, will use the fund to reimburse depositors of any IBI that suffers a failure.”).

98. Agha, *supra* note 94 (“Once a donation is made there can be no expectation of return.”).

99. See Asyraf Wajdi Dusuki, *Revisit The Principle of Tabarru’ in Takaful Structure*, ASYRAFWAJDI (Mar. 15, 2013), <http://www.asyrafwajdi.com/index.php/home/k2-categories/item/20-revisit-principle-tabarru-takaful-structure> (“[T]he *tabarru* is not merely for charity but conditional upon certain consideration, namely the right to claim *takaful* benefits in the event of loss. Without such a right, he will neither participate nor perform the *tabarru*’. This is deemed to be a violation of the fundamental objective of *tabarru*.”) (emphasis added).

100. Discussion Paper, *supra* note 78, at 11 (“Donating (*tabarru*) is defined as the voluntary transfer of an asset or its usufruct from one party to another without stipulating any counter value This contract is suitable for a deposit insurance system in which membership is not mandatory.”).

insurance premised upon *takaful*,¹⁰¹ originally made participation voluntary,¹⁰² with the result that no Islamic banks joined.¹⁰³ The government has since proposed making participation mandatory¹⁰⁴ on the basis of *Maslahah 'ameh* or the public interest.¹⁰⁵

Third, the operator of the deposit insurance system will pay depositors in the event of a failed bank in accordance with instructions from participants in the insurance scheme.¹⁰⁶ Nonetheless, as a gift, the operator in theory has discretion over the use of the funds.¹⁰⁷ To the extent that payments do not occur,

101. Jordan also has a system based upon *takaful*. See JORDAN DEPOSIT INSURANCE, *supra* note 85.

102. See LAW NO. 33, art. 3(b) (2000) (Jordan), available at http://www.dic.gov.jo/index.php?option=com_content&task=view&id=13&Itemid=17 (deposit insurance does not apply to “Islamic banks licensed to operate in the Kingdom, unless any one of them decides to join the Corporation in order to insure the deposits held by it.”).

103. Announcement by Jumana Hamed, Dir. Gen., Jordan Deposit Ins. Corp., to IADI Participants, http://www.iadi.org/docs/Announcement_JODIC.pdf (last visited Feb. 16, 2015).

104. *The Cabinet Approved the Draft of the Amended JODIC's Law*, JORDAN DEPOSIT INSURANCE CORPORATION, http://www.dic.gov.jo/index.php?option=com_content&task=view&id=96&Itemid=9 (last visited Feb. 16, 2015) [hereinafter *JODIC*].

105. Under the Jordanian system, the insurance fund is considered to have been created by donation (*tabarru*) and managed as an agreement based on cost (“*Wakalah bil Ujrah*”). See INT'L ASSOC. DEPOSIT INSURERS, *Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems* (Islamic Deposit Insurance Group of the International Association of Deposit Insurers, Discussion Paper, 2014), http://www.iadi.org/docs/Shariah_Approaches_for_IDIS-for-publication-Nov_2014-FINAL.pdf

106. See Agha, *supra* note 94, at 84 (“The participants in the insurance plan agree to make contributions to a common fund for the purpose of mutual support. They also promise that a gift from the fund will be made to contributors who suffer certain specified losses.”). See also Mark Cammack, *Islamic Finance: Prospects and Significance*, 18 SW. J. INT'L L. 113, 120 (2011) (“The participants in the insurance plan agree to make contributions to a common fund for the purpose of mutual support. They also promise that a gift from the fund will be made to contributors who suffer certain specified losses. The funds paid into the plan are managed and invested by an insurance company. The company pays claims according to the promises made by the participants.”).

107. See Agha, *supra* note 94, at 84 (“The prohibition on conditional *tabarru* means that the operator would have free and unfettered discretion in the operation of the *takaful* fund.”).

issues of enforcement may arise, creating uncertainty and potentially raising concerns among depositors.¹⁰⁸ Indeed, this was one of the reasons Malaysia rejected the approach in devising its scheme of insurance.¹⁰⁹

C. Deposit Insurance and Riba

Islamic compliant deposit insurance must meet other obligations under *Sharia*. In particular, the system must be interest free. The premiums paid by Islamic banks cannot be invested in interest bearing instruments.¹¹⁰ This requires that premiums from Islamic and traditional commercial banks be segregated,¹¹¹ with the former invested in a *Sharia* compliant manner.¹¹²

Likewise funds generated from the payment of interest cannot be used to bail out a failed Islamic bank. A deposit insurance corporation cannot, therefore, rely on funds from commercial

108. *See id.* (“Once a donation is made there can be no expectation of return. Therefore, there are critical issues of enforceability of the tabarru structure under a rigorous and legalistic shari’a analysis.”).

109. Khnifer, *supra* note 20, at 22. (“[T]he MDIC stressed that Tabarru’ might not be sufficient to convince central banks that Islamic institutions could provide a guarantee as a voluntary rather than an obligatory act.”).

110. The prohibition applies to any kind of transaction involving interest. They can arise in a number of circumstances. *See* Discussion Paper, *supra* note 78, at 7 (“The interest element could also exist in deposit insurance when the deposit insurer is involved in interest-based transactions or activities. This can happen when the deposit insurer protects deposits, invests the deposit insurance funds, lends to troubled banks, and obtains external funds (when in deficit), in which all these activities are based on interest.”).

111. *See* SHARIAH ADVOCACY COUNCIL, *supra* note 80 (“[T]here is a need to separate the funds in the operation of deposit insurance scheme for Islamic banking to ensure that the fund of Islamic deposit insurance scheme are invested in *Shariah* compliant instrument.”). *See also id.* (“Nevertheless, there is a need to separate the funds in the operation of deposit insurance scheme for Islamic banking to ensure that the fund of Islamic deposit insurance scheme are invested in *Shariah* compliant instrument.”).

112. They also cannot be invested in businesses that engage in sinful activities. *See* Discussion Paper, *supra* note 78, at 8 (“In addition to interest, uncertainty and gambling, *Shariah* also does not allow certain other elements to exist in a deposit insurance system. For instance, the deposit insurance fund must not be used for the purchase of liquor and pork, or for any activities that are prohibited under *Shariah*.”).

banks—including any investment income—in repaying depositors of an Islamic financial institution.¹¹³ To the extent, therefore, that the Islamic banks represent only a small portion of the financial system, the funds available in the event of a failure may be very modest and inadequate to repay all depositors.¹¹⁴

Malaysia structured its system of deposit insurance to meet these principles. Premiums from Islamic banks are segregated¹¹⁵ and can only be invested in *Sharia* compliant instruments.¹¹⁶ In the event that these funds prove insufficient to repay depositors from a failed Islamic bank, the deposit insurance fund is prohibited from using premiums from commercial banks and must seek additional amounts from the market or the government.¹¹⁷

113. The investment issue can be avoided through a system that collects premiums only after a failure has occurred. Bahrain has used this type of system. See Goud, *supra* note 81 (noting that the system in Bahrain is “post-funded (i.e., deposit insurance assessments are only collected from banks when there is a failure), so there are no issues with how the deposit insurance premiums are invested (although the CBB website does indicate that a new deposit insurance program is under construction that would shift it to being pre-funded raising the issue of investing the premiums collected by the Central Bank).”). Nonetheless, the country is likely to abandon the approach. See Blake Goud, *Bahrain Changing Its Deposit Insurance Fund*, SHARING RISK (Nov. 6, 2012), <http://investhalal.blogspot.com/2012/11/bahrain-changing-its-deposit-insurance.html> (discussing an initiative in Bahrain to create a prefunded system of deposit insurance).

114. Issues can also arise with respect to the disposition of funds in a deposit insurance system that undergoes liquidation. The *fatwa* approving the deposit insurance system in Jordan mandated that, in the event of liquidation of the fund, “the outstanding balance shall revert to Zakat Fund at the Ministry of Awqaf, Islamic Affairs and Holy Places.” JORDAN DEPOSIT INSURANCE, *supra* note 85.

115. Discussion Paper, *supra* note 78, at 2 (“Both [Islamic and commercial] systems [of deposit insurance] are administered under one roof by the Malaysia Deposit Insurance Corporation, which was given the mandate pursuant to the Malaysia Deposit Insurance Corporation Act 2005.”). See also INT’L MONETARY FUND, IMF COUNTRY REPORT NO. 13/60, MALAYSIA: PUBLICATION OF FINANCIAL SECTOR ASSESSMENT PROGRAM DOCUMENTATION—DETAILED ASSESSMENT OF OBSERVANCE OF CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS 6 (Mar. 2013) (“The funds for conventional and Islamic deposits are separately administered with the Islamic deposit insurance fund administered in accordance with *Shariah* principles.”).

116. See Discussion Paper, *supra* note 78, at 13 (“MDIC is required to invest in *Shariah*-compliant instruments.”).

117. See *id.* at 14 (“In the event of a shortfall in the Islamic fund, MDIC would use the credit line from the government or funding from the market, which would be structured in a *Shari’ah*-compliant fashion.”). See also Khnifer, *supra*

These requirements can, however, raise concerns. Efforts to invest premiums from Islamic banks in a *Sharia* compliant manner may confront an insufficient supply of acceptable instruments.¹¹⁸ Moreover, segregating premiums from Islamic and commercial banks can create systemic risks by reducing the funds available in the event of a bank failure.

D. Observations

Sharia scholars generally agree that deposit insurance is permissible. Nonetheless, *Sharia* imposes a number of requirements that affect the applicable structure. As a result, governments creating compliant systems of deposit insurance confront serious choices. They can rely on approaches that conform to *Sharia*, but also raise the possibility of systemic risk. A system, for example, that excluded deposits in participation accounts would in some cases provide these depositors with an incentive to withdraw funds when concerns arose over the solvency of the financial institution, something that could result in runs on the bank. This occurred in Turkey in 2001.¹¹⁹

The difficulties associated with an Islamic system of deposit insurance may explain their relative rarity. Only Malaysia and Sudan have such systems in place,¹²⁰ with Jordan likely to become a third.¹²¹ Other Islamic countries have deposit insurance

note 20, at 27 (“Payments in the event of the failure of member institutions are similarly separated and no transfer of funds between the IDI and conventional IDI are permitted. Instead, MDIC is statutorily permitted to increase funding from the government should there be a need.”).

118. Discussion Paper *supra* note 77, at 16 (“[D]eposit insurers face difficulties in investing surplus deposit insurance funds, as there are limited Islamic instruments.”).

119. See *infra* note 153–58.

120. Discussion Paper, *supra* note 78 (“Currently, only Malaysia and Sudan have set up an IDIS, while some other countries provide protection for Islamic deposits under their conventional systems.”).

121. Jordan permits Islamic banks to join voluntarily the deposit insurance scheme. See LAW NO. 33, art. 3(b) (2000) (Jordan), available at http://www.dic.gov.jo/index.php?option=com_content&task=view&id=13&Itemid=17. There are proposals, however, to make the system mandatory. See *JODIC*, *supra* note 104,

systems¹²² but rely on conventional systems that do not appear to be *Sharia* compliant.¹²³

IV. THE EVOLUTION OF ISLAMIC BANKS IN TURKEY

A. *Early Development*

The Republic of Turkey arose out of the ruins of the Ottoman Empire. In establishing a republic, Ataturk deliberately sought to reduce the public influence of Islam. He did so through the implementation of a strategy of laicism. Laicism entailed not so much a separation of mosque and state but the establishment of government hegemony over religion.

Under the approach, the Caliphate was abolished,¹²⁴ religious schools and mosques were subjected to government control, and

122. Discussion Paper, *supra* note 78, at 4 (“Other countries that also provide protection for Islamic deposits include Bosnia and Herzegovina, Jordan, Kuwait, Singapore and the United Kingdom. These countries (except Jordan) use the model that protects Islamic deposits under the country’s conventional deposit insurance system.”).

123. See Discussion Paper, *supra* note 78, at 3 (“Also in 2005, Indonesia introduced protection for Islamic deposits under the Indonesia Deposit Insurance Corporation Act 2004. Similar to Turkey, Islamic and conventional deposits in Indonesia are protected under a conventional deposit insurance system, which is administered by the Indonesia Deposit Insurance Corporation (IDIC).”). See also Mohammed Khnifer, *Featured Structure: Towards a Universal Islamic Deposit Insurance System*, USNAZRI (Dec. 16, 2010), <http://usnazri.blogspot.com/2010/12/featured-structure-towards-universal.html>. (“Indonesia has one pool where all the premiums and returns out of purchasing securities are mixed. Hence, the paid capital of the IDI fund has been contaminated with conventional funds.”).

124. See HAYDAR KAZGAN, ET. AL., 2 TURKISH FINANCIAL HISTORY, FROM THE OTTOMAN EMPIRE TO THE PRESENT 9 (1999) (the last Caliphate was Abdulmecit Efendi).

imams became employees of the state.¹²⁵ The Latin alphabet replaced Arabic script¹²⁶ and a secular civil code was introduced.¹²⁷

Under Ataturk, the financial system was guided, not by principles of *Sharia*, but the philosophy of statism.¹²⁸ Banks were mostly used as conduits to finance the industrial policy promoted by the government. A closed, inward-looking system, wherein foreign banks were marginalized or eliminated¹²⁹ and interest rates were set at uncompetitive rates,¹³⁰ effectively limited the size of the financial system and the funds available for lending.¹³¹

125. Oktem, *supra* note 2, at 387 (“The DI[B] appoints religious officials, including imams, pays the stipends of religious officials, and directs the administration of more than 70,000 mosques.”). They are regulated by the *Diyanet İşleri Başkanlığı*, or Directorate of Religious Affairs. See ANGEL RABASA & F. STEPHEN LARRABEE, RAND CORP., THE RISE OF POLITICAL ISLAM IN TURKEY 11–12 (2008), http://www.rand.org/pubs/monographs/2008/RAND_MG726.pdf.

126. Use of the Arabic script became illegal on January 1, 1929. Even fashion was unable to escape Ataturk’s reforming zeal. The Hat Law banned the fez, promoting the use of western clothing styles, and the veil was discouraged. Surnames were introduced. See Benjamin D. Bleiberg, *Unveiling the Real Issue: Evaluating the European Court of Human Rights’ Decision to Enforce the Turkish Headscarf Ban in Leyla Şahin v. Turkey*, 91 CORNELL L. REV. 129, 134–35 (2005).

127. The Code was largely borrowed from Switzerland. For a discussion of the decision to adopt the Swiss Code, rather than the one in place in France and Germany, see Arzu Oguz, *The Role of Comparative Law in the Development of Turkish Civil Law*, 17 PACE INT’L L. REV. 373, 380–82 (2005). A new code was adopted in 2002. *Id.* at 385.

128. The absence of Islamic influences was also apparent during the Ottoman period. See SEVKET PAMUK, THE EVOLUTION OF FACTOR MARKETS IN THE OTTOMAN EMPIRE 1500-1800, at 18 (2005), <http://www.iisg.nl/hpw/papers/pamuk05.pdf>. (“Neither the Islamic prohibitions against interest and usury nor the absence of formal banking institutions prevented the expansion of credit in Ottoman society.”).

129. See DERYA GULTEKIN-KARAKAS, GLOBAL INTEGRATION OF TURKISH FINANCIAL CAPITAL 72 (2009) (noting that, between 1924 and 1945, foreign banks share of deposits fell from 78% to 19%).

130. See *id.* at 78 (noting that “almost all private deposit banks became subject to the control of certain conglomerates”). By paying negative interest rates, deposits were a cheap source of funding that could be lent profitably to these industrial complexes. *Id.* at 80.

131. The approach provided an incentive to expand branch networks in order to maximize the deposit base. See CEVDET DENIZER, THE EFFECTS OF FINANCIAL LIBERALIZATION AND NEW BANK ENTRY ON MARKET STRUCTURE AND COMPETITION IN TURKEY (1997), <http://www.econturk.org/Turkisheconomy/wbank3.pdf> (“Rising inflation during the late 1960s and throughout the

The financial and political crisis of 1979 largely brought an end to these inward-looking policies. The government sought to encourage economic growth by attracting additional funds into the financial system, whether domestic deposits or foreign capital. Controls on interest rates were loosened and eventually eliminated and, for the first time, the government provided a role for Islamic banks in the Turkish financial markets.¹³²

B. The Introduction of Islamic Banks into Turkey

Within days of taking office in 1983, Prime Minister Ozal allowed the opening of Islamic financial institutions.¹³³ Ozal was motivated, at least in part, by a desire to attract capital into the financial system. Islamic banks could generate additional domestic deposits, particularly from those motivated by religious beliefs,¹³⁴ and foreign investment, particularly from the Middle East.¹³⁵

Ozal's intuition proved accurate. In addition to attracting religious based depositors, the first three Islamic banks, Al Baraka

1970s also provided another strong incentive [for] banks to expand their branch networks. With interest rates becoming increasingly negative in real terms, opening new branches to collect deposits and investing them into real assets was highly profitable. In fact, as deposit rates became increasingly negative in real terms, the number of branches of both public and private banks increased.”).

132. See TURKEY: A BUSINESS AND INVESTMENT REVIEW 28 (Marat Terterov & Philip Rosenblatt eds., 2006).

133. The decree was adopted three days after Turgut Ozal became prime minister, replacing Bulent Ulusu, the prime minister appointed after the military coup in 1980. See YENER ALTUNBAS, ALPER KARA & OZLEM OLGU, TURKISH BANKING 33 (2009).

134. The banks might induce the religiously conservative to deposit funds otherwise kept in the proverbial “mattress.” Filis Baskan, *The Political Economy of Islamic Finance in Turkey: The Role of Fethullah Gülen and Asya Finans*, in THE POLITICS OF ISLAMIC FINANCE 225 (Henry, C. M. and Wilson, R. eds., 2004) (“A third motive was to attract the savings of conservative people into the Turkish economy.”). These may not have been the only motivations. *Id.* at 225 (noting that Ozal “may have had a personal interest” in the financial institutions since two of them apparently had some connection to his brother).

135. *Id.* (“Second, it is claimed that the main aim of the special finance houses was to attract capital from Gulf countries to Turkey.”).

Finance House,¹³⁶ Faisal Finance House,¹³⁷ and Kuveyt Finance House,¹³⁸ received funding primarily from foreign sources. Only in the 1990s would domestic sources fund finance houses, including Anadolu Finans in 1991,¹³⁹ Ihlas Finans in 1994,¹⁴⁰ and Asya Finans in 1996.¹⁴¹

136. Al Baraka formed in 1985. See Ayse Yuce, *Islamic Financial Houses in Turkey*, 1 J. ACAD. BUS. & ECON., 153, 155 (2003). The bank was founded by the Albaraka Banking Group based in Bahrain. The shareholders consist of Albaraka Banking Group, 54 percent, the Islamic Development Bank, 7.84 percent, and the Alharthy Family, 3.46 percent. There were some Turkish shareholders, however. See Liam Hardy, *The Evolution of Participation Banking in Turkey*, AL NAKHLAH 1, 6 (Winter 2012), http://fletcher.tufts.edu/~media/Fletcher/Microsites/al%20Nakhlah/archives/Winter2012/Hardy_Final.pdf (While 11.4% comes from local Turkish investors, nearly 22.5% is publicly traded on the Istanbul Stock Exchange.”).

137. The financial institution incorporated in October, 1984, with 5 billion TRY contributed by Prince Muhammad al-Faisal al-Saud. MUHAMMAD AKRAM KHAN, ISLAMIC ECONOMICS AND FINANCE: A GLOSSARY 59 (2004). About 10 percent of the capital came from Turkish investors. See Yuce, *supra* note 136, at 155.

138. Kuveyt Finance House was formed in 1989. See KUYEYT TURK PARTICIPATION BANK ANNUAL REPORT 2009, at 9 (2009), http://www.kuveytturk.com.tr/pdf/financial_information/annualreports/2009_Annual_Report.pdf (“In accordance with the authorization issued by the Turkish Central Bank on February 28, 1989, Kuveyt Turk Katilim Bankasi A.S. began banking and finance operations on March 31, 1989.”). According to the 2009 annual report, the Kuwait Finance House held slightly more than 62 percent of the shares, with the Kuwait Social Security Institution and Islamic Development Bank each holding 9 percent. The Directorate General of Foundations of Turkey owned 19 percent. *Id.* at 9.

139. *Turkiye Finance Prospectus, U.S. \$500,000,000 Certificates due 2018*, at 74 (April 30, 2013), <http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/15534/Prospectus%20-%20Standalone%20-%20302623.PDF> (noting that Anadolu Finans Kurumu A.Ş. “obtained permission from the Central Bank of Turkey on 24 October 1991 and commenced operations on 4 November 1991.”).

140. IHLAS FINANS, CORPORATE PROFILE, REPORT OF THE LIQUIDATION BOARD 5 (2008), <http://www.ifk.com.tr/2008-operating-period-ROTLB.pdf>.

141. See BANK ASYA, ASYA SUKUK COMPANY LIMITED, U.S. \$250,000,000 FIXED RATE RESETTABLE TIER 2 CERTIFICATES DUE 2023 ISSUE PRICE: 100 PER CENT 84 (Mar. 26, 2013), <http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/15221/Prospectus%20-%20Standalone%20302454.PDF> [hereinafter ASYA SUKUK PROSPECTUS] (noting that Bank Asya was incorporated as Asya Finans Kuruma A.Ş. “as a joint stock company on 24 October 1996 pursuant to the decree of the Council of Ministers No. 96/8041 on 11 April 1996 and as published in the Official Gazette on 25 April 1996.”). Faisal Finance became domestically owned when it was

Initially dubbed “finance houses,” these intermediaries introduced a different model of banking into the Turkish system. Interest was not paid on deposits or charged on loans. Instead, deposits were invested, primarily into transactions based upon principles of mark ups (*murabaha*) and leasing (*ijhara*).¹⁴² A portion of the profits were allocated to depositors based upon a formula set by the finance houses. The short term nature of the loans,¹⁴³ the standard split in profit and loss,¹⁴⁴ and the presence of security,¹⁴⁵ made the returns generally safe and largely predictable.

Although allowed into Turkey, the Islamic finance houses were subjected to significant restraints. They incurred political hostility¹⁴⁶ and their regulatory status was left uncertain.¹⁴⁷ They

purchased by Kombassan Holding, a Turkish holding company, in 1998. See *infra* note 159.

142. Durmus Yilmaz, Governor of the Central Bank of the Republic of Turkey, Opening Speech at Conference on Islamic Finance: During and After the Global Financial Crisis (Oct. 5, 2009), <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB+EN/Main+Menu/Announcements/Remarks+by+Governor/2009/gov-1> (“Participation banks in Turkey mainly offer two types of lending. The first type of financing is Murabaha, which is a transaction consisting of two sales contracts The second type of financing is financial leasing or Ijhara, with terms similar to those offered by other leasing companies.”).

143. See Wassim Rajhi & Slim Ahmed Hassairi, *Unconventional Banking System in Distress*, 3 INT'L J. ECON. & FIN. 70, 76 (2011) (“SFH held 90% of their assets in short-term facilities (typically four to five months in duration) provided notably to small and medium-size companies. This sort of financing was extended in the form of *murabaha*.”).

144. See MARTHA STARR & RASIM YILMAZ, BANK RUNS IN EMERGING-MARKET COUNTRIES: THE EXPERIENCE OF TURKEY’S ISLAMIC BANKS IN THE 2001 CRISIS 4–5 (Feb. 11, 2005), <http://www.luc.edu/orgs/meea/volume7/starr.pdf> (“The SFH keeps 20% of income from lending activities and 80% is distributed to account holders.”). See also *supra* note 18.

145. STARR & YILMAZ, *supra* note 144 (“The main use of funds by SFHs is short-term loans (typically 4-5 months in duration) provided to small- and medium-sized companies needing capital. . . . This sort of financing . . . represents 90% of the SFH’s total use of funds; . . . the concentration of lending in this low-risk form implies that returns, if not guaranteed, are highly predictable”).

146. *Id.*, at 5 (noting that the finance houses “had variable political support and were periodically threatened with closure by critics in Parliament for their blending of religion and business”).

147. The financial institutions were allowed into the country under a decree of the council of ministers. See Decree No. 83/7506, (Dec. 16, 1983) (Turk.); see also RODNEY WILSON, ISLAMIC FINANCIAL MARKET 38 (2012). A decree issued could just as easily be revoked. Legislation confirming the status of these financial institutions would only be adopted in 1999.

could not advertise their religious affiliation. Products were not *Sharia* compliant but “interest-free.”¹⁴⁸ Informal restrictions limited the size of their branch network, preventing expansion and reducing the ability to attract deposits.

Legislation adopted in 1999 sought to bring the finance houses more completely into the banking system.¹⁴⁹ Integration, however, was incomplete. Finance houses were not made part of the system of deposit insurance¹⁵⁰ but merely given the right to create one of their own.¹⁵¹ Likewise, the absence of Islamic compliant securities issued by the Turkish government deprived finance houses of a critical source of liquidity.¹⁵²

These structural weaknesses became apparent in 2001 with the collapse of *Ihlas*, the largest of the finance houses.¹⁵³ The absence of insurance meant that depositors could not immediately

148. There was also some uncertainty about the degree of compliance with *Sharia*. See *Market Share of Participant Banks on the Rise in Turkey*, TODAY'S ZAMAN (May 8, 2011, 12:42 PM), <http://www.todayszaman.com/news-243159-market-share-of-participation-banks-on-the-rise-in-turkey.html> (“Participation banks in Turkey were initially suspected by some of not really operating on completely interest-free terms.”).

149. See Rajhi & Hassairi, *supra* note 143 (“Although SFHs were initially governed by a separate regulatory framework from that applying to conventional banks, the 1999 bank law brought them under the same regulatory umbrella. They were required to meet the same minimum capitalization as conventional banks, the same required reserve ratios, and the same liquidity ratios. SFH had similar reporting requirements to the central bank as commercial banks, notably on foreign-currency positions.”).

150. *Id.* (“However, SFH were not covered by deposit insurance, with the rationale that profit-and-loss accounts involved no guarantee of return of principal to be *Sharia* compliant. Also unlike commercial banks, a failed SFH would not be transferred to the Saving Deposit Insurance Fund for reconciliation.”).

151. The Banking Act gave to the Association of Special Finance Houses the authority to create and manage the insurance system for the Islamic banks. See Banks Act No. 4389, 18.6.1999, art. 20-1(6) and Act No. 4672, provisional art. 2(b) (Turk.), reprinted at http://www.bddk.org.tr/websitesi/english/Legislation/63671889banks_act_4389.pdf. At least one commentator suggested that this was designed to ensure conformity with Islamic practices. See STARR & YILMAZ *supra* note 144, at 7 (“the Special Finance Houses were not covered by deposit insurance, with the rationale that profit-and-loss accounts involved no guarantee of return of principal”).

152. See Hardy, *supra* note 136, at 4. (“Because the deposits of *Ihlas Finans* were not protected by the Central Bank’s insurance system, and *Ihlas* could not invest in government securities, a major proportion of the investments were in illiquid assets and projects.”).

153. *Ihlas* had almost 40% of the deposits held by the finance houses. See STARR & YILMAZ, *supra* note 144, at 5. See also Rajhi & Hassairi, *supra* note

recover their funds.¹⁵⁴ The failure caused a run on the other Islamic banks¹⁵⁵ and the withdrawal of a majority of the deposits,¹⁵⁶ nearly causing the segment to collapse.¹⁵⁷

With the collapse of Ihlas, five finance houses remained: Al Baraka Türk, Asya, Kuveyt Turk, Anatolia Finans, and Family Finans, the successor to Faisal Finance. That number would fall to four in 2005, when Anadolu Finans and Family Finans merged, forming Turkiye Finans.¹⁵⁸ That financial institution would eventually be acquired by the National Commercial

143 (“Ihlas Finance House (IFH) was Turkey’s largest SFH with close to 38% of the total deposits collected by the six SFH at the end of 2000.”).

154. The liquidation of Ihlas would drag on, with current account holders not entirely repaid until 2007 and at least some participation account holders still unpaid in 2012. The payout schedule can be found here: <http://www.ifk.com.tr/detay.asp?ContentID=749&lang=eng>. Participation accounts were fourth in line for repayment after amounts owed to the government, employees and current account holders. See *Payment Plan*, IHLAS FINANS, <http://www.ifk.com.tr/detay.asp?ContentID=747&lang=eng> (last visited Nov. 10, 2014).

155. See ISLAMIC FINANCIAL SERVICES BOARD, *supra* note 20, at 122. (“That Islamic banks are not immune to contagion effects became apparent in the 2001 run on the participation banks (at that time called “special finance houses”) in Turkey.”).

156. Sixty-three percent of all deposits exited, although the percentage is a less dramatic 36% when Ihlas was excluded. See Conference Report, Ahmet Erturk, Islamic Banking: Case Study of Turkey, 6th IADI Annual Conference, slide 5 (Nov. 1–2, 2007), <http://www.scribd.com/doc/6340565/Islamic-Banking-Case-of-Turkey>. This was true despite the fact that participation accounts were time deposits and not susceptible to immediate withdraw. See also Rajhi & Hassairi, *supra* note 143 (“Many depositors sought to withdraw their funds before maturity, and initially the SFHs accommodated such requests. But as the runs continued, some had to restrict early withdrawals.”).

157. In addition, the acquisition of Faisal Finans by Ülker, a Turkish conglomerate, apparently staved off another collapse. See Hardy, *supra* note 136, at 4 (“The crisis had a major negative effect on the entire banking sector, and the participation banks also suffered. Turkish holding company Ülker purchased Faisal Finans in 2000, changing its name to Family Finance House.”).

158. See PAUL WOULTERS, TURKEY 2005: “CROSSING THE BOSPORUS” 60 (Islamic Fin. News Guide 2006), http://www.islamicfinancenews.com/guidepdf/Turkey_2005.pdf. (“In December 2005, the voluntary merger of Family Finans Kurumu and Anadolu Finans Kurumu into the Türkiye Finans Katilim Bankasi was announced, thereby creating the largest participation bank in Turkey.”).

Bank of Saudi Arabia,¹⁵⁹ leaving Asya as the only finance house majority owned by Turkish investors.

The crisis demonstrated the risks arising from the exclusion of the Islamic financial institutions from the system of deposit insurance. Reforms adopted in 1999 had given the entities the authority to set up their own system of deposit insurance. The authority, however, remained dormant until the collapse of Ihlas in 2001.

Thereafter, the finance houses used the authority to create a system that was arguably interest free and *Sharia* compliant.¹⁶⁰ The trade association for the finance houses managed the assets, effectively segregating them from the commercial banks. Insolvencies were to be handled by the same fund, avoiding the use of premiums paid by commercial banks.¹⁶¹ Limited to premiums from the Islamic banks, however, the system had a reduced pool of funds available in the event of any future bailout.

159. *Türkiye Finance Prospectus*, *supra* note 139, at 5. The Ülker Group purchased Faisal Finance in 2001 from Kombassan Holding at a time when the Islamic bank looked like a possible candidate to fail. The gamble turned out to be a good one. In 2008, 60 percent of the bank's shares were acquired by The National Commercial Bank, the largest bank in Saudi Arabia. WOUTLERS, *supra* note 158. Ülker sold a portion of its shares in the bank for \$600 million, while retaining a minority interest in the participation bank. ISMAIL YURDAKOK, CULTURE OF ISLAMIC ECONOMICS IN TURKEY 163, 173, available at <http://www.kantakji.com/fiqh/Files/Research/op48.pdf> (last visited Mar. 31, 2015); see also *Bibd Marks Milestone With Türkiye Finans Katilim Bankasi In A Usd75m Murabaha Financing Facility*, BIBD, http://www.bibd.com.bn/index.php?option=com_content&view=article&id=231:bibd-marks-milestone-with-tuerkye-fnans-katilim-bankasi-in-a-usd75m-murabaha-financing-facility&catid=39:general-news&Itemid=73 (last visited Nov. 10, 2014) (noting that Türkiye Finans was owned 64.68% by NCB, 21.36% by the Boydak Group, and 13.79% by the Ülker Group).

160. Sefer Yuksel, *Turkey at the Crossroads-Islamic Banks Resist Central Bank Sin*, SHARIAH FINANCE WATCH (July 7, 2008), <http://www.Shariahfinancewatch.org/blog/2008/07/07/turkey-at-the-crossroads-islamic-banks-resist-central-bank-sin/> (noting that the "liquidation of a participation bank whose authorization of operation is withdrawn should be carried out by a committee of liquidation to be appointed by the Participation Banks Association").

161. Discussion Paper, *supra* note 78, at 2 ("In 2001, Turkey developed an IDIS that operated alongside the conventional system—the first country to establish a dual deposit insurance system. Unlike the conventional system, which was administered by the government, the IDIS was administered by Participation Banks of Turkey to protect Islamic deposits in participation banks").

C. Islamic Banks and the AKP

The rise of an Islamic oriented government in 2002 altered the environment for the finance houses.¹⁶² Under the leadership of Recep Tayyip Erdogan, the Party tested the traditional boundaries of secularism. Erdogan engineered a repeal of the ban on headscarves on university campuses,¹⁶³ restricted the sale of alcohol,¹⁶⁴ and instituted a foreign policy that tilted toward Islamic

162. Although the AKP won just 34 percent of the vote, only one other party obtained the 10 percent threshold needed to be represented in the Parliament. As a result, AKP received about two thirds of the seats, with the remainder assigned to the Republican People's Party. See Soner Cagaptay, *The November 2002 Elections and Turkey's New Political Era*, 6 MIDDLE EAST REV. OF INT'L AFFAIRS 42 (2002), <https://www.washingtoninstitute.org/uploads/Documents/opeds/4225defa40e83.pdf>

163. The policy was, struck down by the Constitutional Court. See Gunes Murat Tezcur, *Judicial Activism in Perilous Times: The Turkish Case*, 43 LAW & SOC'Y REV. 305, 310 (2009) ("The Court also vetoed a piece of parliamentary legislation that would revoke the ban on headscarves on university campuses in June, 2008."). Only in 2013 did a partial repeal of the ban go into effect. See Roff Smith, *Why Turkey Lifted Its Ban on the Islamic Headscarf*, NATIONAL GEOGRAPHIC (Oct. 11, 2013), <http://news.nationalgeographic.com/news/2013/10/131011-hijab-ban-turkey-islamic-headscarf-ataturk/>.

164. The government, however, disclaimed any religious motivation. See Cinar Kiper, *Muslim Light: What's Behind Turkey's Islamization and the Protests Against It*, ATLANTIC (June 5, 2013), <http://www.theatlantic.com/international/archive/2013/06/muslim-light-whats-behind-turkeys-islamization-and-the-protests-against-it/276576/> (noting that, according to the government, regulation of alcohol is necessary for the "public health").

countries.¹⁶⁵ He weakened the military¹⁶⁶ and Constitutional Court,¹⁶⁷ both traditional guardians of secularism.¹⁶⁸

The Islamic banks benefited from the rise of the AKP. Officials from these financial institutions were, for the first time, appointed to important government positions.¹⁶⁹ Restrictions on branch networks eased.¹⁷⁰ Legislation adopted in 2005¹⁷¹ jettisoned the term “finance house” in favor of participation bank and more fully integrated Islamic financial institutions into the banking system.

165. For a discussion of Turkey’s foreign policy and orientation toward the east, see Piotr Zalewski, *The Self-Appointed Superpower, Turkey Goes It Alone*, 27 WORLD POL’Y J. 97 (Winter 2010-2011).

166. According to one commentator, “[t]he days of military coups in Turkey are officially over.” Omer Taspinar, *Turkey’s General Dilemma*, FOREIGN AFFAIRS (Aug. 8, 2011), [http://www.foreighaffairs.com/articles/68019/omer-tas\[inar/turkeys-general-dilemma](http://www.foreighaffairs.com/articles/68019/omer-tas[inar/turkeys-general-dilemma). The military directly displaced a civilian government on three occasions. See Susanna Dokupil, *The Separation of Mosque and State: Islam and Democracy in Modern Turkey*, 105 W. VA. L. REV. 53, 62–70 (2002). In 1997, the military forced out the government of Prime Minister Erbakan in what has been labeled a “soft” coup. See Patrick R. Hugg, *The Republic of Turkey in Europe: Reconsidering the Luxembourg Exclusion*, 23 FORDHAM INT’L L.J. 606, 629 n.132 (2000).

167. See EUROPEAN COMMISSION, COMMISSION STAFF WORKING DOCUMENT: TURKEY 2010 PROGRESS REPORT 7–8 (2010) (“The government put forward a number of amendments . . . approved in a referendum in September The key provisions of the package change the composition of the Constitutional Court and of the High Council of Judges and Prosecutors, restrict the authority of military courts, [and] allow appeals against expulsion decisions by the Supreme Military Council to be brought before civilian courts.”).

168. The policies proved popular, with the AKP winning reelection in 2007 and 2011. See Ashleigh Hebert, *The Likelihood of Turkey’s Accession into the European Union: A Controversial Inquiry*, 13 CHI.-KENT J. INT’L & COMP. L. 1, 9 (2013) (noting that, in 2011, AKP won 327 out of 550 seats with 49.83 percent of the vote; in 2007, 341 out of 550 seats with 46.58 percent).

169. Kemal Unakitan, a board member of both *Turkiye Finance* and *Al Baraka*, became the finance minister. The general manager of *Al Baraka*, Adnan Buyukdeniz, was slated to become the head of the central bank until the appointment was blocked by the president of Turkey. The appointment, however, was rejected by Ahmet Nejdet Sezer, the country’s president. YURDAKOK, *supra* note 159. When *Al Baraka* opened its new headquarters in 2011, the Prime Minister attended. See *Al Baraka Turk HQ Opened by Turkish PM*, CPI FINANCIAL (Jan. 6, 2011), <http://www.gulfbase.com/news/al-baraka-turk-hq-opened-by-turkish-pm/178744>.

170. As a result, the number of branches for participation banks increased significantly. See *infra* notes 193–94 and accompanying text.

171. See generally Banking Law No. 5411 (2008) (Turk.), reprinted at www.tbb.org.tr/english/5411.doc.

The AKP did away with the system of deposit insurance operated by the participation banks. The government brought the Islamic banks under the umbrella of the Savings Deposit Insurance Fund (SDIF), the same system used by commercial banks.¹⁷² Article 63 of the Banking Law extended insurance coverage to deposits in participation accounts.¹⁷³

Premiums were to be risk-based and paid by the bank, not the customer.¹⁷⁴ The Law did not require the segregation of premiums from commercial and Islamic banks, nor require the investment of premiums from participation banks into Islamic compliant instruments. Funds to assist the bailout of a failed Islamic bank were not confined to the premiums paid by participation banks.¹⁷⁵

The ability to raise long term capital also improved.¹⁷⁶ Reforms in 2010 permitted the issuance of Islamic compliant bonds.¹⁷⁷

172. Discussion Paper, *supra* note 78, at 2 (noting that in 2005, “the Islamic system was absorbed by the conventional system, and it is now administered by the Savings Deposit Insurance Fund”).

173. Banking Law No. 5411, art. 63 (2011) (Turk.), *reprinted at* www.tbb.org.tr/Dosyalar_eng/Yasal_Duzenlemeler/Banking_Law_No_5411/Banking_Law_March_2011.doc.

174. *Id.* (noting that credit institutions shall “insure their . . . participation funds” and “shall pay the premium.”). The provision does not legally mandate a *Sharia* compliant system. Presumably a system could be implemented in practice that seeks to meet the constructs of *Sharia*. Whether such a system would be sufficient is unclear.

175. Yuksel, *supra* note 160 (“According to the former law, whereas it was not possible to transfer the distressed participation banks to the Fund, subject to the article 71, Banking Law No. 5411, it is allowed, in case of existence of the conditions, that participation banks can be transferred to the Fund as in the deposit banks.”).

176. The main source of long term capital was from public offerings. Asya Bank went public in 2006. *Id.* (“In 2006, the bank floated 23 percent of its shares on the Istanbul Stock Exchange in the first initial public offering for a participation bank in the country since Ihlas Finans collapsed. By 2010 it floated 52.5% of its shares.”).

177. This included changes to the tax code. See Mushtak Parker, *Turkish Parliament Passes Tax Neutrality Law for Sukuk Al-Ijhara*, ARAB NEWS (Mar. 7, 2011), <http://www.arabnews.com/node/370280>. The Capital Markets Board issued regulations in 2010 that permitted sukuk bonds based upon the principle of *Ijhara* (leasing). In 2013, the Board issues regulations that permitted other types of Islamic bonds. For a discussion of these changes, see Burak Gencoglu, *Communique on Lease Certificates*, JD SUPRA BUSINESS ADVISOR (June 10, 2013), <http://www.jdsupra.com/legalnews/communique-on-lease-certificates-sukuk-80116/>. For a discussion of these changes, see *Taxation of Sukuk*

Kuveyt Turk took quick advantage of the authority, issuing bonds the same year,¹⁷⁸ with *Turkiye Finans*¹⁷⁹ and *Bank Asya*¹⁸⁰ doing so the following year, raising \$500 million and \$250 million respectively. *Al Baraka* likewise indicated plans to enter the bond market.¹⁸¹

The ability to issue Islamic compliant bonds reduced dependency on short term deposits¹⁸² and provided greater access to capital from outside the country.¹⁸³ The instruments facilitated longer term loans and capital improvements, including the expansion of branch networks.

The Erdogan government also took steps to ease the liquidity concerns of the participation banks. Unable to invest short term funds in interest bearing securities issued by the government,

(*Leasing Certificate*) in Turkey, TURKISH GOV., http://www.gep.gov.tr/tmp/_Gep4.pdf (last visited Feb. 16, 2015).

178. The participation bank raised funds in 2010, see PROSPECTUS, KT TURKEY SUKUK LIMITED (Aug. 19, 2010), <http://www.londonstockexchange.com/specialist-issuers/islamic/kt-turkey-prospectus.pdf>, and again in 2011. See PROSPECTUS, KT SUKUK VARLIK KIRALAMA A.Ş. (Oct. 27, 2011), <http://www.londonstockexchange.com/specialist-issuers/islamic/ktsukuk31102016.pdf> [hereinafter KT SUKUK].

179. *Turkiye Finance Prospectus*, *supra* note 139, at 5. See also *Türkiye Finans' \$500 mln Sukuk Sale Lures Investors*, HURRIYET DAILY NEWS (May 7, 2013), <http://huriyetdailynews.com/turkiye-finans-500-mln-sukuk-sale-lures-investors.aspx?pageID=46325&NewsCatID=346>.

180. See ASYA SUKUK PROSPECTUS, *supra* note 141.

181. *Al Baraka Türk Works on USD200 mil Sukuk*, AMILIN.TV (June 20, 2013), <http://www.amilin.tv/news/al-baraka-turkish-works-to-issue-usd-200-mil-sukuk/>.

182. See Parker, *supra* note 177, at 2 (official at Kuveyt Turk noting “a major problem for participation banks in terms of long-term borrowing requirements. The conventional banks can borrow through bond issues on a three-year or five-year basis and the taxation side was cleared a long time ago. The same is needed for the participation banks and there is only one way this can be done which is the sukuk route.”). See also *Turkiye Finance Prospectus*, *supra* note 139, at 115 (“Deposits are *Turkiye Finans*’ main source of debt funding. Deposits of *Turkiye Finans* comprise customers’ current and profit sharing accounts.”).

183. Alaa Shahine & Sibel Akbay, *HSBC Sees 2013 Sukuk Sales Doubling to \$3 Billion: Turkey Credit*, BLOOMBERG NEWS, May 7, 2013, available at <http://www.bloomberg.com/news/2013-05-07/hsbc-sees-2013-sukuk-sales-doubling-to-3-billion-turkey-credit.html> (“*Turkiye Finans* . . . said yesterday it received \$1.9 billion in bids, with the Middle East accounting for 51 percent of demand.”).

the Islamic banks struggled to find safe and liquid *Sharia* compliant instruments.¹⁸⁴ In 2009, the Turkish government issued index bonds that tied the return to the revenues from certain state institutions.¹⁸⁵ Several of the participation banks invested in the securities¹⁸⁶ but reversed course after concerns were raised about the compliance of the instruments with *Sharia*.¹⁸⁷

Following a resounding electoral victory in 2011, the AKP authorized the government to issue bonds that were, for the first time, explicitly designed to comply with *Sharia*. A year later, the government raised \$1.5 billion in Islamic compliant securities that were reviewed and approved by *Sharia* scholars.¹⁸⁸ Moreover, the government indicated that it would issue the securities

184. At least some of the participation banks were forced to invest short term funds in instruments located outside of Turkey. These included purchases of commodities in the London Metal Exchange. See KAREN HUNT-AHMED, CONTEMPORARY ISLAMIC FINANCE: INNOVATIONS, APPLICATIONS AND BEST PRACTICES 126 (2013).

185. REPUBLIC OF TURK., UNDERSECRETARIAT OF TREASURY, REVENUE INDEXED BONDS: INVESTORS GUIDE 1, <http://www.iefpedia.com/english/wp-content/uploads/2010/05/REVENUE-INDEXED-BONDS.pdf> (last visited Feb. 16, 2015).

186. *Turkish Cleric's Article on Bonds Disturbs Islamic lenders*, HURRIYET DAILY NEWS (Mar. 30, 2012), <http://www.hurriyetdailynews.com/turkish-clerics-article-on-bonds-disturbs-islamic-lenders.aspx?pageID=238&nID=17247&NewsCatID=346> [hereinafter *Turkish Cleric's*] ("According to data released by the Participation Banks' Union, as of March three participation banks held a total of 984 million Turkish Liras worth of revenue-linked bonds."). Kuvvet Turk did not purchase the bonds because of concern regarding compliance with *Sharia*. See AHMET FARUK AYSAN, TURKISH SUKUK MARKET AND RECENT DEVELOPMENTS 32 (2012), http://www.iib.yildiz.edu.tr/login/sys/admin/news/img/1337775713_Turkish%20Sukuk%20Market%20and%20Recent%20Developments_15%20Mayis%20showcase.pdf.

187. See *Turkish Cleric's*, *supra* note 186.

188. See REPUBLIC OF TURK., UNDERSECRETARIAT OF TREASURY, US \$1,500,000,000 LEASE CERTIFICATES DUE 2018, at 2 (Sept. 19, 2012), http://www.ise.ie/debt_documents/Prospectus%20-%20Standalone_91ba3b58-eaaa-4a87-a992-a95fee49c1f3.pdf ("The transaction structure relating to the Certificates (as described in this prospectus) has been approved by the Islamic Finance Advisory Boards of the Joint Lead Managers and Dar Al *Sharia* Legal and Financial Consultancy LLC."). Most of the securities were sold to investors in the Middle East. Nevzat Devranoglu, *UPDATE 1-Turkey's Debut Sukuk Attracts High Gulf Demand*, REUTERS, Sept. 19, 2012, available at <http://in.reuters.com/article/2012/09/19/turkey-sukuk-idINL5E8KJ25L20120919> ("The 5-1/2 year bond attracted an order book of nearly five times the issue size, the

on a regular basis,¹⁸⁹ making the instruments a dependable component of the capital markets and a permanent source of liquidity for the participation banks.¹⁹⁰

The removal of restraints on operations and the integration into the deposit insurance system provided participation banks with a more favorable operating environment. Likewise, the public appeared more comfortable with the presence of *Sharia* compliant financing.¹⁹¹ The result was significant growth. The percentage of deposits increased significantly.¹⁹² The number of branches jumped from 110 in 2000, to 829 in 2012, to 966 in

Treasury said late on Tuesday, with Middle Eastern accounts taking 58 percent of the issue. European investors bought 13 percent and Asian accounts 12 percent, while 9 percent was sold in Turkey and 8 percent to U.S. investors.”).

189. Nevzat Devranoglu, *Mideast Money: Turkey Steps Up Islamic Finance Push as Sensitivities Ease*, CNBC (May 29, 2013), <http://www.cnbc.com/id/100773006> (“The Treasury aims to issue lira-denominated Ijarah sukuk at least twice a year, one each February and the other each August or September, to build a healthy lira-denominated sukuk curve. Each issue is expected to be around 1.5 billion lira.”).

190. See Interview with Derya Gurek, CEO of Türkiye Finans (2013), http://www.thebusinessyear.com/vip_interview/1505/v_-derya-gurek (“In the participation banking sector, there are challenges in terms of excess liquidity management. However, with the recent regulatory reforms and the lease certificate market growing, this will be resolved . . . [T]he lease certificate gives us the chance to gain improved returns on our overnight facilities. We can funnel our customers’ money into these overnight channels.”).

191. Devranoglu, *supra* note 188 (“Turkey has a strong secular identity. . . . But nervousness about Islamic finance has eased in recent years, helped by growth of the sector in Western economies.”).

192. See Risk Management in Participation Banks: Case of Turkey (Oct. 2014), slide 3, <http://www.comcec.org/UserFiles/File/WorkingGroups/Financial3/Presentations/6.TKBB.pdf> (“Beginning of the era 2000, while participation banks reach only 2% of the net assets, in 2010 the rate increased up to 4,3%. As a result of the momentum of high growth in the last 5 years, the rate increased up to 6, 1% with 90,7 billion TL asset in the third quarter of 2013.”).

2013,¹⁹³ and to 1083 by March, 2015,¹⁹⁴ with promises of additional expansion.¹⁹⁵ The larger branch network provided participation banks with greater access to those customers seeking interest-free financial services.¹⁹⁶

193. See SUNA AKTEN ÇÜRÜK, FACTORS EFFECTING THE DEVELOPMENT OF ISLAMIC FINANCE IN TURKEY, available at http://www.academia.edu/7722393/Factors_Effecting_The_Development_of_Islamic_Finance_in_Turkey (last visited April 1, 2015) (noting that participation banks went from 110 branches in 2000 to 685 in 2011, 829 in 2012, and 966 in 2013). Growth has been faster than traditional commercial banks. See Ferhat Sayım & Murat Alakel, *The Participation Banking and Its Comparison with Deposit Banking in the Turkish Finance Market*, 5 EUR. INTEGRATION STUD., 152, 162 (2011), http://www.ktu.lt/lt/mokslas/zurnalai/eis/05/Sayim_Alakel_2011_152-164p.pdf (“Putting three public banks aside, while 29 private deposit banks have 223 branches on an average, each of 4 participation banks has 140 branches on an average. However in terms of the increase rate of branches from 2008 to 2009, it is seen that participation banks reached a two times bigger increase rate of branch numbers than deposit banks.”).

194. PARTICIPATION BANKS ASSOCIATION OF TURKEY, <http://www.tkbb.org.tr/banks-and-banking-sector-information-member-banks> (last visited Mar. 31, 2015) (Kuveyt Türk had the largest number, 320, followed by Asya, 281, Türkiye, 280, and Al Baraka, 202).

195. See BANK ASYA, PARTICIPATION BANKING OVERVIEW 6 (Aug. 2012), http://www.bankasya.com.tr/en/_pdf/bank_asya_presentation_2012.pdf (noting Bank Asya’s goal of increasing the number of branches to 300 by 2015). See also AL BARAKA, ANNUAL REPORT 2012, at 34 (2012), http://www.albaraka.com/media/pdf/AnnualReports/ABG_AnnualReport_English_2012.pdf (“Al Baraka Turkey intends to maintain its steady expansion, including 20 new branches a year over the next 4 years”); *Türkiye Finance Prospectus*, *supra* note 139, at 73 (“Türkiye Finans plans to open 26 more branches in Turkey during 2013, which will result in a branch network comprising 246 branches at the end of the current financial year.”).

196. Religious reasons are a key factor in the selection of a participation bank. See H. Saduman Okumus & Elif Guneren Genc, *Interest Free Banking in Turkey: A Study of Customer Satisfaction and Bank Selection*, 9 EUR. SCI. J. 144, 155 (2013) (“it was noted that *religious reasons solely* was the most important criterion for choosing to deal with a PB.”). See also Delphine Strauss, *Islamic Finance: Ambitious Growth Targets Set by Country’s ‘Participation Banks,’* FINANCIAL TIMES (May 4, 2010, 4:47 PM), <http://www.ft.com/cms/s/0/43c9bcf4-5713-11df-aaff-00144feab49a.html#axzz1Xor9HWwB>

(“Mr. Utku estimates 70 to 80 percent of Albaraka’s depositors choose the bank for religious reasons and will not defect to commercial banks. This pattern could be reinforced, as more branches open in rural, conservative areas where many people previously shunned banks altogether.”); Baskan, *supra* note 134, at 234 (quoting official at Bank Asya who described customers as “conservative Turkish people, who are reluctant to deposit their money in conventional banks because of interest”). At least some customers have not opened accounts with participation banks because of

V. THE EFFECTS OF REFORM

Despite the Islamic leanings of the AKP, reform in the financial sector did not always appear to comport with the requirements of *Sharia*. This could be seen with particular clarity in the implementation of a system of deposit insurance.

Likewise, the participation banks found themselves more fully able to compete in the financial markets. At the same time, however, *Sharia* amounted to a layer of regulation that sometimes made financial products less convenient than those offered by traditional commercial banks. This could be seen in connection with the issuance of Islamic compliant credit cards.

A. Deposit Insurance

Participation banks gained competitively from changes in the system of deposit insurance. By integrating the Islamic banks into a system that combined the premiums from commercial and Islamic banks, the government made available greater expertise and a deeper pool of funds in the event of a failure of a participation bank. The change effectively eliminated a competitive disadvantage for the participation banks.¹⁹⁷ With memories of the failure of Ihlas still fresh, depositors gained greater assurance that they would be repaid quickly in the event of a bank failure.¹⁹⁸ At the same time, however, these benefits came through the implementation of a system that arguably did not fully comply with Islamic principles.

the lack of available branches. See Okumus & Genc, *supra*, at 152 (noting a study that concluded that “[m]ost of the respondents chose to deal with a conventional bank as well as a PB since the PBs did not have a widespread branch network.”).

197. See Okumus & Genc, *supra* note 196, at 161 (“Based on the sample data, it appears that customers; however, are well aware of that their PLS accounts with the PBs are guaranteed by the *Assurance Fund*, that is the one of the main criterion for the customers’ loyalty, though constituting contrary to the original Islamic banking paradigm.”).

198. Likewise no run occurred when banking authorities took over management of Asya Bank in 2015. See *BDDK Balks at Giving Up Control over Bank Asya*, TODAY’S ZAMAN (Mar. 9, 2015, 5:31 PM), http://www.todayszaman.com/business_bddk-balks-at-giving-up-control-over-bank-asya_374758.html The situation was not, however, a result of a financial failure. Banking authorities did so not because of financial insolvency but as a result over the failure to submit documents relating to ownership in the financial institution. *Id.*

B. Growth, Competition, and the Participation Banks

Despite more auspicious circumstances, Islamic banks in Turkey largely remained niche players. Total assets rose but, in 2013, remained slightly more than 5 percent.¹⁹⁹ Moreover, at least according to one study, these financial institutions remained less profitable than their commercial counterparts.²⁰⁰

While better able to reach customers who selected banking relationships primarily on the basis of religious compliance,²⁰¹ Islamic banks did not limit their activities to this modest segment of the market. They also competed for customers who relied on

199. See *Conventional Banks Assets Expand 4.2 Percent YTD by End Mar'13 Total Deposits Show Marked Increase*, ARAB TIMES, <http://www.arabtimesonline.com/NewsDetails/tabid/96/smld/414/ArticleID/196561/t/Conventional-banks-assets-expand-4.2-percent-YTD-by-end-Mar-%E2%80%9913/Default.aspx> (last updated Jan. 4, 2015) (noting study that found that participation banking assets accounted for 5.2 percent of all banking assets in Turkey as at end-March 2013). The market share of participation banks does not necessarily capture all of the demand by religious customers. Most noticeably, customers may deposit funds in non-interest accounts at commercial banks. Even among participation banks, these accounts are not uncommon. See H. Saduman Okumus, *Interest Free Banking in Turkey: A Study of Customer Satisfaction and Bank Selection Criteria*. 26 J. ECON. COOPERATION, 61, 73 (2005) (78 percent of those surveyed had demand deposits; only 36.6 percent had participation accounts).

200. Ali Soylu & Nazif Durmaz, *Profitability of Interest-Free Versus Interest-Based Banks in Turkey*, 46 AUSTL. ECON. REV. 176, 186 (2013) ("Our results from this Turkish sample showed that interest-free banks did have positive and reasonably strong rates of profitability, though their level of profitability was somewhat less than that of traditional banks"). This is reinforced by the fact that non-government owned commercial banks in Turkey have not sought licenses to operate participation banks.

201. Evidence suggests that the number of customers seeking banking relationships based on religious principles is not large. See ISTANBUL: KONDA RESEARCH GROUP, RELIGION, SECULARISM AND THE VEIL IN DAILY LIFE 26 (2009), available at <http://www.scribd.com/doc/158353673/KONDA-Religion-Secularism-and-the-Veil-in-Daily-Life#scribd> (discussing a study indicating that only four percent of Turks defined themselves as "fully devout" and that 52 percent considered themselves non-religious or non-believers). Moreover, customers at participation banks often have accounts at commercial banks. See Okumus & Genc, *supra* note 196, at 155 ("It appears that almost 45 per cent of the respondents held accounts and/or utilised the products/services offered by the PBs. 55 per cent, however, indicated that they banked in a conventional bank as well as a PB [O]f those who preferred dealing with both PBs and conventional banks, about 66 percent cited *some products not available at PBs* while almost 54 percent attributed *insufficient branch network* of PBs.").

the traditional commercial banks.²⁰² Success, therefore, depended upon an ability to match rates of return²⁰³ as well as the quality and variety of services.²⁰⁴ The need to do so was particularly important with respect to credit cards.

Credit cards represent an essential service for financial institutions in Turkey.²⁰⁵ The country has one of the highest rates of

202. Okumus & Genc, *supra* note 196, at 152 (“In recent years it seems that Islamic banks has been striving to capture the highest number of customers to compete with conventional banks by providing a large number of products as an alternative to commercial ones.”). Indeed, Bank Asya views its primary competitors not as the other participation banks but the large commercial banks. See ASYA SUKUK PROSPECTUS, *supra* note 141, at 101–02 (“Bank Asya faces competition primarily from large and medium-sized private banks operating in Turkey. Although these banks are not participation banks, Bank Asya, which has a market share in assets of approximately 1.6 per cent., considers its main competitors to be Garanti Bank, Yapı Kredi and Denizbank.”).

203. Customers at participation banks are not unaffected by changes in the rate of return. See Yunus Emre & Etem Hakan Ergec, *The Efficiency of Participation and Conventional Banks in Turkey: Using Data Envelopment Analysis*, 57 INT’L RES. J. FIN., 156 (2010) (“It has been found in many empirical researches that the change in interest rates may affect not only the deposits in conventional banks but also the deposits kept in participation banks.”). Thus, for example, rates of return paid to depositors in participation accounts have largely tracked the interest rate paid by commercial banks. See Serhan Cevik & Joshua Charap, *The Behavior of Conventional and Islamic Bank Deposit Returns in Malaysia and Turkey* 6–7 (IMF Working Paper No. 11/156, 2011) (noting that participation accounts with a one year maturity paid, from 1997–2010, an average return of 44 percent and a median return of 35 percent, while commercial banks paid an average of 44.6 percent and a median of 29.2 percent).

204. Participation banks have sought to introduce innovative products such as gold trading accounts. See ASYA SUKUK PROSPECTUS, *supra* note 141, at 95 (“Gold accounts enable customers to invest in gold (buy or sell).”); *Turkiye Finance Prospectus*, *supra* note 139, at 80 (“Turkiye Finans’ gold participation accounts are opened by customers depositing gold with the bank. . . . The collected gold can be deposited either to the customer’s gold current account to protect the gold from larceny or to a gold participation account, a new type of account which provides interest-free yield for account holders. Turkiye Finans trades the gold and at maturity of the account, returns the gold to the customer. If any profit is generated during the trading activity, part of the profit is passed onto the customer according to a pre-agreed ratio.”); AL BARAKA ANNUAL REPORT 2012, *supra* note 195, at 26 (“In keeping with current market trends, Al Baraka Türk introduced its ‘Gold Participation Account’, a product offered to customers as a way of putting their otherwise idle holdings of gold to work.”).

205. See AL BARAKA ANNUAL REPORT 2012, *supra* note 195, at 104 (“From among those who use financial services, most popular service used were credit

credit card use in the world and ranks second in Europe.²⁰⁶ Growth has been explosive, with credit card ownership rates more than doubling from 2003 to 2013 to approximately 54 million.²⁰⁷ As a result, they have been labeled an “indispensable tool[] of daily lives” in Turkey.²⁰⁸

Credit cards are, however, complex products. They are highly regulated,²⁰⁹ with limits on the number of installments²¹⁰ and the amount of available credit.²¹¹ *Sharia* compliance poses additional challenges. Adherence to religious principles can render credit cards less convenient than those issued by traditional

cards (82 percent). this was true for both participation and non-participation banking respondents.”).

206. G. Gulsun Akin, et al., *Credit Card Satisfaction and Financial Literacy: Evidence from an Emerging Market Economy*, 48 EMERGING MARKETS FIN. & TRADE 103, 103 (2012) (describing Turkey as “the second-largest market in Europe [for credit cards] after the United Kingdom.”).

207. In fact, Turkey is the second-largest user of credit cards in Europe. See *Turkey Second Largest Credit Card User in Europe*, DAILY SABAH (May 11, 2014), <http://www.dailysabah.com/markets/2014/05/11/turkey-second-largest-credit-card-user-in-europe> (as of May, 2014, Turkey had 54.3 million credit cards, second in Europe only to Great Britain).

208. Ahmet Faruk Asyan & Lerzan Yildiz, *The Regulation of the Credit Card Market in Turkey*, 11 INT'L RESEARCH J. FIN. & ECON. 141, 143 (2007) (“Credit cards have become one of the indispensable tools of daily lives in Turkey.”). See also *id.*, at 4 (“Turkish consumers skipped the personal check-account stage altogether and moved directly from cash to plastic in the mid-1990s.”).

209. The government regulates the “profit share” See BANK CARDS & CREDIT CARDS L. No. 5464 § 27 (2006) (Turk.), available at <http://www.tbb.org.tr/en/banking-legislation/other-regulations/16>.

210. See AMENDING & REVISING THE LAW ON BANK CARDS & CREDIT CARDS L. No. 5915, art. 1 (2009) (Turk.) (minimum payments must be at least 20 percent and as much as 40 percent of the debt accrued in the current period), available at <http://www.tbb.org.tr/en/banking-legislation/other-regulations/16>

211. BANK CARDS & CREDIT CARDS L. No. 5464, § 9 (2006) (Turk.), available at <http://www.tbb.org.tr/en/banking-legislation/other-regulations/16>.

commercial banks.²¹² Eliminating these inconveniences, in turn, can raise concerns about the religious credibility of the card.²¹³

1. *Sharia* Compliance

All of the participation banks rely on a *Sharia* advisory board to ensure compliance with Islamic principles.²¹⁴ Before issuing a

212. Consumers unhappy with the limits can avoid them by obtaining credit cards from traditional commercial banks in Turkey. Opinions are divided on whether it is permissible to use a credit card that charges interest even where balances are repaid before such a charge is imposed. See THE COUNCIL, *supra* note 32, (“It is impermissible in *Shari’ah* to issue a Credit Card or use it if its conditions include imposition of usurious interest. This is so even if the card bearer has the intention to pay within the moratorium period that precedes imposition of interest.”). Some scholars, however, take to opposite view and treat the acquisition of a card from a commercial bank as acceptable so long as balances are paid off before any interest charge is imposed. See Monzer Kahf, *Fatwa on Credit Cards: Signing Credit Cards’ Contract and Using It 8* (Aug. 8, 2001), http://monzer.kahf.com/fatawa/2000-2002/FATAWA_CREDIT_CARDS.pdf. Use of these cards in the Islamic community is apparently widespread. See Umar Mohammed Idris & Muhammad Tahir Jan, *Effect of Credit Cards on Customers’ Spending Behavior: A Comparative Analysis of Islamic and Conventional Credit Cards*, Third International Conference on Management, Malaysia, at 508 (June 10-11, 2013), http://www.internationalconference.com.my/proceeding/3rdICM_proceeding/034_117_3rdICM2013_Proceeding_p500.pdf (noting that the “[r]eligious factor seems to be significantly absent in influencing the decision of the consumers towards selecting the credit card of their choice. Hence, the reason they spend money using credit card is not related to religion but to the benefits, risk, and quality they avail.”).

213. *A Growth Model for Islamic Banking*, in THE MCKINSEY QUARTERLY 7 (Oct. 2005), <http://www.ibrahimm.com/Islamic%20Banking/ARTICLES/A%20Growth%20Model%20For%20Islamic%20Banking.pdf> (“although innovation offers customers greater choice, a bank’s credibility within the Islamic community could be put at risk if its products and services were to draw criticism from Islamic scholars.”). See AL BARAKA ANNUAL REPORT 2012, *supra* note 195, at 69 (noting that for participation banks, “[a]dhering to Islamic rules [is] a critical challenge to participation banking adoption”).

214. The Bank Asya Board includes: Professor Dr. Hayrettin Karaman, Professor Dr. Hamdi Donduren, Professor Dr. Hamza Aktan and Assoc Dr. Ishak Emin Aktepe. See ASYA SUKUK PROSPECTUS, *supra* note 141, at 129. The Board for Turkiye Finans includes: Dr. Hayrettin Karaman and Dr. Ishak Emin Aktepe. See *Turkiye Finance Prospectus*, *supra* note 139, at 111. Dr. Aktepe has written in this area. See İSHAK EMİN AKTEPE, *KREDİ KARTI SİSTEMİ VE İSLAM HUKUKU AÇISINDAN DEĞERLENDİRİLMESİ* (Credit Card System and the Evaluation of Islamic Law) (2010), available at <http://dergipark.ulak-bim.gov.tr/daad/article/viewFile/5000077085/5000071123>. Kuveyt Turk relies on a five person board that includes scholars from outside of Turkey. See KT

credit card, therefore, these advisors must review and approve the product, a process arguably made more complicated at some of these financial institutions by the diversity of expertise among the advisors.²¹⁵

All four of the participation banks issue credit cards, with Bank Asya having the largest share of the market.²¹⁶ Consistent with *Sharia*, the participation banks do so on an interest-free basis. Three of them rely on *Murabaha*,²¹⁷ or cost-plus, an approach approved by *Sharia* scholars in Turkey.²¹⁸ Under this approach, customers, as part of the account opening process, are designated as agents of the bank. At the time of the purchase, the bank acquires the goods and immediately resells them to the cardholder with a mark-up or “profit-share.”²¹⁹ This allows cardholders to maintain a balance and provides banks with a fixed return.

Sukuk, *supra* note 178, at 133 (including Associate Professor Anwar Shuaib Abdulsalam, Sheikh Shefik Karanfil, Associate Professor Yusuf Bayindir, Associate Professor Abdullah Durmus and Dr. Ertugrul Boynukalin). The four members of the advisory board for Al Baraka Turk can be found here: See AL BARAKA TURK ANNUAL REPORT 2012: ORGANIZATION CHART, <http://www.al-baraka.com.tr/rapor/pdf/en2-5.pdf> (last visited Mar. 31, 2015).

215. Some of the participation banks rely only on *Sharia* scholars from Turkey. Others, however, rely on scholars from outside the country. Thus, the advisory board at Al Baraka Turk includes two scholars from Turkey (Professor Karaman and Professor Donduren) and two scholars from outside of Turkey (Abdul Sattar Abu Guddah and Ahmed Mohyuddin Ahmed). See Annual Report 2012 ORGANIZATION CHART, *supra* note 214.

216. At the end of 2012, Bank Asya ranked eleventh in the number of credit cards issued. See BANK ASYA, ANNUAL REPORT 2012, at 15 (2012), http://www.bankasya.com.tr/en/_pdf/2012_Annual_Report.pdf. Credit cards have been described as “one of the most profitable products” offered by the bank. See ASYA SUKUK PROSPECTUS, *supra* note 141, at 95 (“Bank Asya considers credit cards to be one of its most profitable products across all of its business activities.”). The Bank was also, apparently, the first Islamic financial institution to issue a true credit card. See Murat Çokgezen & Timur Kuran, *Between Consumer Demand and Islamic Law: The Evolution of Islamic Credit Cards in Turkey* (ERID Working Paper No. 182, Jan. 19, 2015), available at <http://ssrn.com/abstract=2553445> (“The first bona fide Islamic credit card—one that allowed the holder to pay for purchases in installments—was issued by Bank Asya in 2002.”).

217. Al Baraka Turk does not rely on *Murabaha* and does not permit balances to be rolled over.

218. See AKTEPE, *supra* note 214.

219. *Türkiye Finans Credit Card*, TURKIYE FINANS, http://www.turkiye-finans.com.tr/en/retail_banking/credit_card/credit_card.aspx (last visited Feb. 17, 2015) (“The profit share rate applicable to the minimum payment option is

Al Baraka Turk does not rely on *murabaha*. Instead, the bank offers a “no interest” card that guarantees repayment to merchants but does not allow cardholders to roll over the balance. A card holder may purchase on installments only where authorized by the merchant.²²⁰ The card issued by Al Baraka, therefore, provides short term credit (i.e., the period between the due date for a payment by the customer and the due date of the payment to the merchant).

2. Sharia Limits

Sharia imposes at least two sets of restrictions that are not applicable to traditional credit cards. First, Islamic law limits the products that can be acquired. *Sharia* compliant credit cards in Turkey cannot be used to buy goods that are considered *haram*, or sinful. In addition, restrictions may also exist on the purchase of other products such as certain precious metals.²²¹

To enforce these requirements, at least some participation banks block transactions made at certain types of businesses.

2.34%, excluding taxes and funds, as from the last date for payment.”). *See also* Interview with Derya Gurek, *supra* note 190 (“We are launching a new credit card-driven product . . . We decide on the limit, expiration date, and the repayment schedule together with our customers. Upon utilization the customers will be billed throughout the installment period and at a rate agreed upon with the customer. This way, we know the customer spends that money on an invoice.”).

220. In these circumstances, it is the merchant, not the bank, that provides the right to pay in installments. AL BARAKA, ANNUAL REPORT 2011, at 34 (2011), http://www.albaraka.com/media/pdf/AnnualReports/Al_Baraka_Banking_Group_Annual_Report_2011.pdf. (Al Baraka “has also commenced the introduction to the market of credit cards payable by installments.”). Installment purchases require the permission of the merchant. Moreover, the merchant may limit the number of installment payments. Al Baraka has addressed this issue by cobranding its card with a large commercial bank. *See* YAPIKREDI, ANNUAL REPORT 2011, at 14 (2011), *available at* http://www.yapikredi.com.tr/ufiles/Investors/AnnualReports/74_YKB_FRAE_2011_130412.pdf (noting the credit card “co-branding partnership” with Al Baraka). As a result, the card can provide for installment sales at all of the merchants within the network belonging to the commercial bank.

221. Email to author from Bank Official #1 (April 15, 2015) (on file with author) (noting that some scholars oppose the financing of the purchase of gold through the use of *Murabaha* “as they view gold as currency and not as commodity”); *but see supra* note 35.

Casinos and bars are examples.²²² Not all prohibited purchases can, however, be prevented in this manner. Businesses such as grocery stores may sell a mix of proper and improper goods. In these circumstances, the Islamic credit cards do not block the transactions but rely upon cardholders to refrain from impermissible purchases.

Second, not all Islamic credit cards authorize cash advances.²²³ While this is not prohibited under Islamic law, mark-ups on the amount borrowed are not authorized. Instead, participation banks must rely on *qard al hassan*, or interest-free loans,²²⁴ and cannot charge a fee based upon the amount borrowed.²²⁵ As a result, cash advances are not permitted at all of the participation banks²²⁶ and, where they are allowed, are subject to significant limits.²²⁷

222. Kuveyte Turk blocks transactions for noncompliant merchants, including casinos, entertainment centers, adult shops, and bars. Email to author from Bank Official #2 (Sept. 30, 2011) (on file with author).

223. This has benefits consistent with *Sharia*. Without cash advances, the cards are likely to result in lower debit balances and, as a result, present less default risk for the bank. See UBS, *Turkish Participation Banks: UBS Investment Research*, at 30 (Jan. 9, 2009), http://dosya.ekibi.org/pdf/finans ekibi-net/imkb/hissera-por/200801/ALBRK_ASYAB_UBS_09012008_www.Finans.Ekibi.NET.pdf

("Of equal importance, credit card customers of participation banks avoid carrying large balances on their credit cards for many of the same reasons. In parallel with this behaviour, the level of problem loans in the credit card segment remains negligible.")

224. See *Qard al Hassan*, PRACTICAL LAW, <http://us.practicallaw.com/3-503-0057?q=&qp=&qo=&qe=> (last visited Feb. 17, 2015).

225. Turkiye Finans states that cash withdrawals will be done "without bearing any profit share, commission, fee and other extra charge on the amount you use." *Cash Advance*, TURKIYE FINANS, http://www.turkiye-finans.com.tr/en/retail_banking/credit_card/cash_advance.aspx (last visited Feb. 17, 2015). In addition, at least some banks may impose an inflation differential on the amount.

226. See *UBS Investment Research*, *supra* note 223, at 29 ("On the other hand, participation banks' credit cards can only be used for the purchase of goods/services, and not for cash advances.")

227. *Transaction Limits*, KUYEYTTURK, http://www.kuveytturk.com.tr/pages/transaction_limits.aspx (last visited Feb. 17, 2015) ("The amount of cash advance cannot be more than 10% of the card limit. The maximum limit is 500 TL both daily and monthly."). Turkiye Finans also allows cash advances. See *Cash Advance*, *supra* note 225. ("The cash advance limit is calculated over the card holder's shopping amount transferred to the account statement (excluding overseas expenses), meaning that each period

Third, Islamic compliant credit cards may involve additional administrative costs. Following a purchase, banks in Turkey may text the customer, either to provide notification of the transfer or to allow for an opportunity to select an installment period for repayment.²²⁸

3. *Sharia* Interpretations

Scholars in Turkey have adopted a number of interpretations of *Sharia* that allow Islamic credit cards to more closely mimic those issued by traditional commercial banks. These scholarly interpretations, however, are not universally accepted. In Turkey, it is permissible to impose a charge on cash advances or other extensions of credit²²⁹ designed to compensate for inflation,²³⁰ a practice that at least some scholars view as *riba*.²³¹

Perhaps the most difficult issue for participation banks concerns the imposition of penalties. *Sharia* in general prohibits the imposition of these charges. Scholars in Turkey, however, have indicated approval, so long as the bank gives these funds away.²³² The amount of the penalty is calculated as a percentage

it will vary according to the expense amount transferred to the account statement.”).

228. Çokgezen & Kuran, *supra* note 216, at 15, n.59.

229. See Çokgezen & Kuran, *supra* note 216 (noting that all Islamic banks in Turkey impose a charge reflecting the time value of *moen* “even though Turkey’s highest religious body (Diyanet İşleri Başkanlığı) has ruled the practice un-Islamic.”).

230. See e.g., Hayrettin Karaman, *There are So Many Banks that Claim to be “Islamic”, that is “Interest Free Banking”: Could you Explain Please Which Banks are Preferable*, QUESTIONS ON ISLAM (Sept. 22, 2009), <http://www.questionsonislam.com/question/there-are-so-many-banks-claim-be-islamic-interest-free-banking-could-you-explain-please-whi> (statement by Professor Karaman that “[w]hen the private finance house determines the deferred payment price, it takes some criteria into consideration; among those criteria are inflation, the probable yield of the money in the market when it is invested in other instruments, and some other things.”).

231. See Shaykh Muhammad ibn Adam al-Kawthari, *Is it Permitted to Take Inflation-adjusted Loans?*, <http://islamqa.org/hanafi/qibla-hanafi/34599> (last visited Oct. 26, 2014) (“The above and other evidences prove that when a loan is paid back then the rate of inflation is not considered according to Shariah. One can only claim back exactly the amount which was given as loan. Anything other than this will be considered as [*Riba*] and thus unlawful (Haram) and sinful.”). See also AYUB, *supra* note 16, at 51 (“Interest is sometimes legalized on account of inflation and decreases in the purchasing power of lent money. This is also not a valid argument.”).

232. See AKTEPE, *supra* note 214.

of the balance owed.²³³ Some of the participation banks represent that the funds are donated to charity.²³⁴

CONCLUSION

Turkey is an Islamic country that embraces secularism. The arrival of the AKP altered the traditional balance, with the government easing some restrictions on religious practices. With respect to the financial markets, the AKP brought Islamic banks more fully into the regulatory regime, allowing them to expand their branch networks and raise long term funds through the issuance of Islamic compliant bonds.

The implementation of a more favorable environment, however, does not support an intent to replace secularism with religious principles. Nor does it provide significant evidence that consumers in Turkey routinely elevate religious interests over economic substance and convenience.

For the most part, the government's approach entailed the removal of restrictions that limited the ability of the Islamic financial institutions to compete on equal terms with commercial banks. Moreover, notwithstanding an Islamic leaning, the government did not entirely embrace *Sharia* when implementing reforms. Where religious principles conflicted with the safety and soundness of the financial markets, the AKP opted for the latter.

This caution can be seen most clearly in the application of deposit insurance to participation banks, after the AKP terminated a system that arguably complied with *Sharia*, and integrated the Islamic banks into one that apparently did not. The approach may have avoided the mandates of *Sharia* but arguably

233. See *Credit Cards and Bank Cards, Product and Service Fees*, BANK ASYA, <http://www.bankasya.com.tr/en/credit-cards-and-bank-cards.aspx> (last visited Oct. 26, 2014) (specifying a 2.02% penalty rate). Kuvveyt Turk was apparently the last participation bank to impose the penalty.

234. Çokgezen & Kuran, *supra* note 216, at 17 (noting that KuvveytTürk represents that it gives the funds to charity). When banks received interest income from the central bank, at least some of them declined to reflect the payments in profit and income. See Yuksel, *supra* note 160 (noting that Al Baraka, “[w]e use the money for corporate social responsibility projects and sponsorship agreements. We certainly do not distribute them as dividends.”). These are also the participation banks that rely on Islamic scholars from outside of Turkey. A certain degree of *Sharia* risk exists in this area. At least one participation bank in Turkey withdrew a credit card after cancellation of approval by its *Sharia* Board. Email from Banker #2 to Jay Brown (July 31, 2013).

improved the safety and soundness of the banking system. The wisdom of the approach was apparent in early 2014 when massive withdrawals at Bank Asya generated no significant instability in the financial markets.²³⁵

Nor does the improved competitive position of the Islamic banks suggest a fundamental retreat from secularism by Turkish consumers. The participation banks obtained greater freedom to compete in the financial markets. They took the opportunity to expand the size of their branch networks and increase their market share. Nonetheless, they remained a modest component of the financial system, suggesting limits on the popularity of religious-based banking.

Even where participation banks have targeted segments dominated by the traditional commercial banks,²³⁶ they have had only modest success. For example, all four participation banks have issued credit card products. Moreover, they have adopted interpretations of *Sharia* that allow their credit cards to more closely mimic those issued by traditional commercial banks.²³⁷

235. Among the founders of Bank Asya were supporters of Fethullah Gulen, an Islamic cleric who opposed the Erogan government. According to published reports, “state-owned companies and institutional depositors loyal to Prime Minister Tayyip Erdogan have withdrawn 4 billion lira (\$1.79 billion), some 20 percent of the bank’s total deposits, over the last month to try to sink the lender.” See *Bank Asya Says Weathers Withdrawals in Turkey Crisis*, REUTERS, Jan. 22, 2014, available at <http://www.trust.org/item/20140122111631-ryrqv>. With the other participation banks covered by insurance, no panic occurred similar to the one that followed the collapse of Ihlis. See *supra* notes 153–58.

236. *Turkiye Finance Prospectus*, *supra* note 139, at 76 (“Management believe there is an opportunity for participation banks to increase growth in the consumer banking business and Turkiye Finans plans to tap the large and growing Turkish retail banking market by deepening its relationships with the “hidden affluent” segment, cross-selling lending products to mass customers and increasing its branch footprint as well as increasing penetration using alternative distribution channels.”).

237. Çokgezen & Kuran, *supra* note 216 (noting that credit cards issued by Islamic banks “perform[] the functions of its conventional counterpart”).

Nonetheless, restrictions arising from Islamic law remain, reducing the convenience of the cards.²³⁸ Perhaps as a result, these products have not proved especially popular.²³⁹

Indeed, the modest penetration of the markets by the four participation banks may explain recent government initiatives designed to stimulate activity in the sector. Three government-owned commercial banks have indicated an interest in operating a participation bank. In late 2014, bank regulators issued a license²⁴⁰ to Ziraat Bank,²⁴¹ with others following.²⁴²

The activities of the AKP and the Islamic banks in Turkey, therefore, suggest less a weakening of secularism and more a recalibration of the Turkish balance of religious and secular life.

238. The participation banks have also tried to compete on the basis of innovation. Bank Asya has been particularly aggressive developing products that are linked to transportation expenses. See Press Release, AsyaCard DIT and DIT Pratik Will Be Used for Transportation in Bolu (Nov. 12, 2011), http://www.bankasya.com.tr/en/_pdf/AsyaFinans_PressReleases_%282%29.pdf?nrzfkgedxlwksbj (describing ability to use Bank Asya credit card and debit card on buses in the Municipality of Bolu). The bank, for example, became the first in Turkey to require no annual fee on its credit card. See Press Release, Bank Asya's Net Profit for 2008 Has Increased 12% and Reached TL 247 Million Compared to Previous Year (Feb. 23, 2009), [http://www.bankasya.com.tr/en/_pdf/AsyaFinans_PressReleases_\(11\).pdf](http://www.bankasya.com.tr/en/_pdf/AsyaFinans_PressReleases_(11).pdf) (describing Asya Bank "as the first and only Turkish bank that does not charge an annual fee for the credit cards").

239. Although participation banks have more than 5% of the assets in the banking system, see *supra* note 200, they have only around 3% of the credit card market. See Çokgezen & Kuran, *supra* note 218 (placing the percentage of credit cards held by participation banks in Turkey at 3.2 percent or 1.8 million out of more than 56 million credit cards issued in the country).

240. *New Participating Bank Approval*, BASPINAR & PARTNERS, <http://www.baspinar.av.tr/UI/AnnouncementDetail.aspx?ID=YyNPJtZcfSA> (last visited April 1, 2015).

241. Ziraat has traditionally provided loans to the agricultural sector. See ZIRAATBANK, PROSPECTUS 17 (July 1, 2014), <http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/20893/Prospectus%20-%20Series.PDF> ("The Bank has been a consistent source of financial support for agriculture in Turkey throughout its history and has played a substantial role in both the development and the modernisation of the Turkish agricultural sector."). The participation bank will apparently begin operations in May, 2015. See *State-run Ziraat to Launch Islamic Unit in May*, DAILY SABAH (Mar. 17, 2015) <http://www.dailysabah.com/money/2015/03/07/staterun-ziraat-to-launch-islamic-unit-in-may>.

242. See *Vakifbank gets Approval for Participation Bank*, Daily Sabah (Mar. 3, 2015), <http://www.dailysabah.com/money/2015/03/03/vakifbank-gets-approval-for-participation-bank>.

The government has allowed participation banks greater freedom to provide interest-free services but has itself not always relied upon a *Sharia* compliant approach to reform. At the same time, participation banks have used the opportunity to compete for customers that do not seek banking relationships solely through a religious lens. These actions, therefore, have not fundamentally altered the modest role of the participation banks in Turkey or the secular nature of the financial system.