Central Bank of the Republic Of Turkey

ISLAMIC FINANCE:
DURING AND AFTER THE GLOBAL FINANCIAL CRISIS

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Distinguished Guests,

I want to begin my speech with expressing my heartfelt condolence to the loss of lives by earthquake in Indonesia.

I am honored to address such a distinguished audience in Istanbul. It is a great pleasure for us to host this conference. In my presentation today, I will address the growing interest in Islamic finance, which has been proven to be relatively immune to financial crisis during the current episode, especially compared to the conventional financial institutions.

Increasing popularity of Islamic finance can be attributed first to the enormous volume of loanable funds that accumulated in geographies that host Islamic practices of living. Islamic finance as yet another alternative to mainstream finance can be mentioned as a second reason. It is by now a de facto practice and this makes enough motivation to study, talk about and assess Islamic finance.

Dear Guests,

Islamic financial institutions have started to emerge in the second half of the twentieth century and become one of the fastest growing segments in the global financial system over the past three decades. Although, Islamic finance institutions are mainly founded in the Middle East and South-east Asia, the interest has extended to Europe and the United States. Today, the size of Islamic banks around the world is estimated to be more than USD 250 billion and expected to grow by about 15 percent annually.

Due to the growing importance of the Islamic finance, the Islamic Development Bank (IDB) was established in December 1973. The purpose of the Bank is to foster economic development and social progress of Muslim communities individually as well as jointly in accordance with the principles of Islamic Law. The number of members to the Bank is steadily enlarging and currently consists of 56 countries.

The primary functions of the IDB are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other form for economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to mobilize financial resources through Shari'ah compatible modes. It is also charged with the responsibility of assisting in the promotion of foreign trade especially in capital goods, among member countries; providing technical assistance to member countries; and extending training facilities for personnel engaged in development activities in Muslim countries to conform to the Islamic Law.

Ladies and Gentlemen,

In the Turkish context, the Islamic finance practices are embodied in a uniquely defined compartment of the banking system. These banks are called as the “participation banks” in Turkey and they constitute an integral part of the Turkish banking system. There are four Islamic banks categorized as participation banks, and 45 conventional banks in Turkey as of September 2009. It is crucial to highlight that the participation banks are not considered as an alternative to the conventional banks. While they are functioning similar to deposit banks, their fund collecting and lending processes differ significantly.

Participation banks are authorized by the Turkish Banking Act to collect funds from the public under the ‘profit and loss participation accounts’ and the ‘special current accounts’. The profit and loss participation accounts are essentially a version of the Islamic financial instrument, where the bank utilizes the funds deposited by account holders to fund specific business activities. Any profits earned are shared between the account holder and the bank, in proportion to an agreed ratio.

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 first contract involves a bank client requesting the bank to undertake a Murabaha transaction and promising to buy the commodity specified by him or her if the bank acquires that commodity. The second contract involves the client purchasing the commodity acquired by the bank on a deferred payment basis and agreeing to a payment schedule. The second type of financing is financial leasing or Ijara, with terms similar to those offered by other leasing companies.

Participation banks currently constitute only a small part of the Turkish banking sector, accounting for 3.7 percent, 4.2 percent, and 5.2 percent of total banking sector assets, deposits, and loans, respectively, at the end of 2008. However, they have been expanding rapidly in recent years. The share of participation banks’ assets in total banking sector rose from 1.9 percent in end-2002 to 3.7 percent in end-2008. They have provided finance to mainly small and medium size dynamic firms. At present, participation banks are regulated according to the same standards as conventional banks. Accordingly, they are regulated and supervised by the Banking Regulation and Supervision Agency.

Distinguished Guests,

While Islamic finance is well settled as a mode of operation, with already living examples, there is no consensus view on the role of Islamic finance on price and financial stability.

On the financial stability side, although there has been a wide consensus that the establishment of a powerful regulation and supervision system is vital to resume financial stability, there are contradictory views on the support of the Islamic financial institutions to financial stability. On the other hand, the role of Islamic finance on price stability has not been fully covered by the recent empirical studies.

The views supporting Islamic finance state that Islamic financial institutions are more resilient to external shocks. Profit and loss sharing feature of the transactions in Islamic finance provides a protection to these institutions, apart from the capital. This feature of the Islamic financial institutions could transfer a negative shock on the asset side to the liability side.

Furthermore, due to the fact that the investors (depositors) take on some part of the risk and do not have deposit insurance, they have more incentives to exercise tight oversight over these institutions. In addition, as compared to conventional banks, they have held a comparatively larger share of their assets in reserve accounts for the liquidity management. Thus, even if Islamic financial institutions have risky investments, these buffers make them more resilient to the negative external shocks.

On the other hand, the opposing views claim that Islamic finance does not need to improve the financial stability. According to this view, profit and loss sharing feature of Islamic finance transfers the credit risk from Islamic institutions to their depositors, and therefore, motivates the excessive risk taking incentive of Islamic banks.

While capital value and earnings of customers are not guaranteed in Islamic finance, this feature may increase moral hazard and motivation for excessive risk taking without adequate capital.

During the recent financial crisis, Islamic financial institutions have demonstrated significant resilience. They have been less affected compared to the conventional financial institutions thanks to prohibitions on excessive leverage. The transfer of risks related with the debt is prohibited in Islamic finance. Therefore speculative transactions such as derivative are non-existent. Transferring the risk related with the debt and speculative financial activities could cause unnecessary booming of the financial transaction volume well above the size of the real economy.

Moreover, linking credit supply to growth rate of the economic activity, Islamic finance acts as a natural hedging scheme. In other words, financing extended by means of Islamic institutions can be used only with the real economic activity, and thereby, help restrict excessive credit boom. Credit is mainly extended for the purchasing of the real goods and services. In Islamic finance, Islamic financial institutions should own and possess the real goods and services and the buyers of the real goods and services should want to take delivery. Therefore, stakeholders share profits in good times, and losses in bad times.

Distinguished Guests,

There is ample room to improve Islamic financial system, more specifically on regulatory and supervisory side. While the high growth rate of the Islamic financial institutions is expected to continue in the coming years, they maintain certain market risks such as reputation and liquidity risk. Liquidity management is difficult under Islamic finance rules as practical instruments in accessing liquidity are limited. However, Islamic financial institutions, being aware of the limits in liquidity management, sustain higher liquidity ratios compared to conventional banks. Similar case is valid for their capital ratios. Moreover, the lack of technical and contract standardization seems to weaken the potential of Islamic finance, as an alternative financing against the conventional financial institutions. Besides, the customer base needs enlargement including household services. The regulation and supervision framework of Islamic financial institutions should also be improved.

In conclusion, the current crisis has given an opportunity to Islamic financial institutions to prove their potential. As their products limit the excessive leverage and the disruptive financial innovations, they have confirmed their products' advantages to ensure macroeconomic stability. This may lead the way for Islamic financial institutions to expand and improve.

Dear Guests

As you may know, the Central Bank Governors of the Organization of Islamic Conference gathered yesterday in Istanbul upon the invitation of the Central Bank of Turkey on the 40th anniversary of the OIC and 25th anniversary of the Standing Committee for Economic and Commercial Cooperation of OIC. The purpose of that meeting was to make a meaningful contribution to the ideal of reaching a sustainable and stable global order based on the principles of justice, equity, participation and freedom fort he humanity to reach peace and prosperity that embraces differences between the civilizations as a source of richness and not as a reason for clash. Our objective is to make these meetings permanent that convenes regularly every year to stipulate our common views and decisions regarding the issues that concern the member countries.

Once again I extend my warm welcome to all participants. I also want to thank the distinguished participants for their valuable contributions. I hope you enjoy both the conference and your stay in Istanbul.

Thank you.