

**FINANCIAL DISTRESS AND BANK FAILURE:  
LESSONS FROM CLOSURE OF  
IHLAS FINANS IN TURKEY**

**SALMAN SYED ALI\***

**ABSTRACT**

*Islamic banks are expected to be more stable. In practice, however, some Islamic banks have shown signs of financial distress and few were forced to close their operations. What are the causes of financial distress for Islamic banks? To what extent these are unique or similar to those identified for the conventional banks? What lessons can be learned by the stakeholders of Islamic banking from the episodes of financial distress? These and other related questions are important academic and policy concerns for Islamic banking. The banking and financial crisis of 2000-2001 in Turkey provides a natural experiment to gauge the stability of Islamic banks and to analyze the channels and factors that can contribute to their financial distress during a crisis. This paper utilizes this natural experiment by studying the factors that lead to the closure of one Islamic finance house in Turkey during which more than twenty conventional banks collapsed. The study draws some lessons for Islamic banks, their regulators, and other stakeholders in such institutions.*

**1. INTRODUCTION**

Banking crises are particularly harmful for the economy and detrimental for the health of financial sector. Its fiscal burden is only a redistribution of resources within the economy. But the real cost of a banking crisis is the deadweight loss and the consequent diversion in macroeconomic policy forced by the crisis. The issue acquires another significance in the context of Islamic banking, as it can potentially inflict a reputation damage to the nascent industry. This would result in a slow down of the progress towards interest-free alternatives, and consequent loss in the form of non-realization of the potential benefits of Islamic finance to the economy.

---

\* Islamic Research and Training Institute, Islamic Development Bank.  
Email: [ssyedali@isdb.org](mailto:ssyedali@isdb.org)  
All tables and figures referred to in the paper are placed in Appendix.

Albeit, threat of a milder level crisis has some long-run advantages too, as it may improve the efficiency of the banking sector by shaking out the inefficient banks. By keeping the banking industry vigilant and on its toes, it forces the practitioners and researchers to come up with better approaches to run the financial system. Thus, on one hand it may be costly in the short-run, on the other hand it can be beneficial in longer-run in averting a bigger and more costly crisis as well as in motivating progress of the financial sector.

The literature on banking crises identify that the conventional banking structure is inherently unstable and, therefore, itself contributes to the occurrence of crisis (e.g. Bryant 1980; Diamond and Dybvig 1983). Being a deposit taking institution the liabilities of a bank, at any given point in time, are fixed and a fixed interest is promised on them. Whereas its assets are in the form of loans earning variable interest and subject to credit risk. This also leads to interest rate risk. Similarly, its demand deposits by nature are of shorter maturity while its loans are for longer duration. Therefore, there always exists a risk of maturity mismatch. These features of the assets and liabilities render the banking sector prone to crisis in wake of any shock or decreased confidence of the depositors.

As opposed to this, the theoretical literature on Islamic banking show Islamic banks to be more stable. According to this literature (e.g., Khan and Mirakhor 1987, Ahmed 2002, etc.), the endogenous linking of returns on deposits with returns on assets of an Islamic bank serves as a disciplinary device and increases the efficiency of the bank and the financial system. It also serves as a stabilization device saving the banks from deposit runs in crisis situation. When the value of assets of the bank decline due to some shock, the liability of the bank also decreases correspondingly by the profit sharing nature of the deposit contracts. This, preserves the net-worth of the bank. The profit sharing feature on the asset and liability sides add to the stability of individual banks, and by avoiding a domino effect also adds to the stability of the financial system as a whole.

In practice, however, some Islamic banks have shown signs of financial distress and few were forced to close their operations.<sup>1</sup> The question is why Islamic banks come into financial distress. To what extent the causes of financial distress and failures identified for the conventional banks are relevant for Islamic banks? In this respect what factors are unique to Islamic banks? What lessons can be learned by the stakeholders in Islamic banking from these episodes? These and other related questions are important academic and policy concerns. To the best of our knowledge, however, there has been no systematic study or analysis on Islamic banks failure. This study is an attempt to fill this gap. The paper tries to bring forth

---

<sup>1</sup> For example, Ihlas Finance House, an Islamic financial institution, in Turkey was closed in 2001 due to liquidity problems and financial distress. Bank Taqwa was closed in 2001. Faisal Islamic Bank closed its operations in the UK for regulatory reasons.

some lessons for all stakeholders – the bankers, regulators, depositors, and shareholders in the Islamic financial industry.

Admittedly, there can be many ways to approach the questions raised above. But considering the scarcity of data on distressed Islamic banks our choice of approach is reduced to the case study of one Islamic bank, namely Ihlas Finans House, which collapsed in Turkey during the 2000-2001 financial crisis.<sup>2</sup> Though our choice of Ihlas Finans House (IFH) is directed by availability and access to information, it does provide a fairly good case for such a study for the following reasons:

1. The financial crisis that engulfed the banking sector in Turkey was a generalized crisis which had affected all banks; a number of them failed. However, Islamic banks as a group had fared differently in their performance and stability than conventional banks during that crisis. Thus, its analysis can point to the relative importance (un-importance) of some causes of bank failure for Islamic banks.
2. Within the group of Islamic banks Ihlas Finans was not the only member. There were five other Islamic banks and all survived the crisis except Ihlas Finans. Thus the analysis can help find the differentiating factors that caused it to fail.

Therefore, the study will be able to draw some lessons for Islamic banks, their regulators, and other stakeholders in such institutions. However, being a study of only one bank in one crisis it has limitations, As such not all conclusions would be open to generalization.

In the absence of any standard technique to identify the causes of bank failure from a limited amount of data afforded by a case study, we here adopt a ‘listing approach’. Whereby, we first list all the plausible causes of bank failures identified in various other studies in context of conventional banks and relate them to how, why, and to what extent they are relevant for Islamic banks. This will provide us a framework for evaluation. The analysis of the role of each of these factors in the context of Ihlas Finans will then provide us some lessons for strengthening Islamic banks.

### **1.1 Structural Context of Crisis in Islamic Banking**

Before we embark on our task it seems appropriate to briefly look into the nature of Islamic banks and possible causes of financial distress in them.

---

<sup>2</sup> It was a systemic crisis that affected the entire financial sector. The estimated net cost of this crisis to the State as percent of GDP was 30.5% by June 2002 (Hoelscher and Quintyn, 2003, p. 44).

Islamic banks are financial institutions characterized by:

- Commitment to shun interest based transactions.
- Commitment to promote *riba*-free alternatives.

Further, from the view point of their operations, they are:

- Deposit taking institutions, which are neither the lending institutions nor simply a reseller of commodity on credit. While it does *murabahah*, it also involves itself in investment banking and financing on profit sharing principles.
- Have two types of deposits, namely demand deposits and investment participation deposits. While Islamic banks' demand deposits are loans from the depositor to the bank, its investment deposits are unsecured, capital-uncertain claims. Instead of a fixed promised return, the bank shares its profits and losses with its investment deposit holders. It therefore implies a strong element of trust and sound business judgment.

Profit and Loss sharing on the liability side and a portfolio mix of profit and loss sharing and fixed mark-up contracts on the asset side is a unique feature of Islamic bank that directly links its asset and liability sides. This feature is thought to make it more stable entity than a conventional bank in which deposits constitute capital certain fixed liability while the asset side is value uncertain.

However, 'Islamic banking' has evolved in modern times in particular circumstances and often in environment unsupportive of its growth. A combination of religious, economic, political and other historical factors have influenced the development of its structure. The structural evolution of Islamic banking itself has bearing upon the issue of financial distress of Islamic banks. Initially the blueprint of Islamic banks was based on a two-tiered *mudarabah* contracts: one between the depositors and the bank, the other between the banks and entrepreneurs (see e.g. Siddiqi (1983)). This required a different regulatory and support environment. But in the marketplace they were governed by regulations made for conventional banks. This and various other factors (such as asymmetric information, agency problem, and human capital deficiency etc.), identified elsewhere in the literature, gave rise to particular structure of the assets of Islamic banks; i.e., concentration of their assets in fixed return *murabahah* contracts. This exposes them to various risks leading to instability. However, they still retain the sharing feature on the deposits side which is a cushion for their stability.

Another evolutionary feature is that the Islamic banks have been few and their competition with the well established conventional banks was intense. They were formed with community efforts. In most cases their capital were small and the scale

and the scope of operations limited. Thus they were not able to diversify and also could not bank on each other. Due to tax advantage as well as legal reasons a few of them were established as off-shore banking institutions and hence, subject to different regulations than the jurisdictions that they served.

Moreover, in many countries while the desire for interest-free banking was from the masses, the efforts for its practical implementation did not come from the governments but from individuals or small groups. Since the practical efforts were only from relatively few individuals – i.e., those who could put up large amounts of wealth in establishment of new institutions – Islamic banks tended to become closely owned entities. And in many instances owned and governed by only one or very few wealthy people. In such circumstances, instead of the collective wisdom or professional management, a third party's ability to influence the owner (or chairman) of the bank started to matter in decision making. This opens them to risks emanating from lack of sound corporate governance and contributes to their susceptibility to financial distress.

Further, the structure of the conventional banking sector also has bearing on the stability of the Islamic banks. While an ideal Islamic bank operating on profit and loss sharing basis both on its asset and liability sides may be more stable than a conventional bank, a crisis that may develop in the conventional banking sector can potentially affect Islamic banks through contagion effect as well as through a general loss of confidence in the banking sector.

Finally, despite the distinction, there are many features in Islamic banks that are similar to conventional banks both in theory and in practice. Therefore, along with some differentiating factors we also expect to see many causes of financial distress in Islamic banks that are in common with those identified for conventional banks. Future evolution and stability of Islamic banks and financial institutions is likely to be influenced by the trend of financial liberalization; development of support institutions; financial innovations; and development of complementary financial infrastructure.

## **1.2 Causes of Financial Distress and Crisis in the Conventional Banking Sector: Literature Survey**

There is a vast literature comprising of competing theories on micro and macro level causes of banking crisis. Caprio and Klingebiel (1996) point out the microeconomic reasons for the delayed realization of individual bank's troubles. Diamond and Dybvig (1983) explain bank failures (bank runs) arising from game situation between depositors and the bank with inefficient equilibrium. The inefficiency arises when there is a coordination failure among the depositors and

they loose confidence in their bank.<sup>3</sup> A bulk of other theoretical literature traces the macroeconomic causes and addresses the issue at aggregate level (the generalized crisis). One strand of this literature explains the crises in the macroeconomic imbalances.<sup>4</sup> The policy implication is to adjust the macroeconomic fundamentals through prudential fiscal and monetary measures.

A second generation of macro models to explain financial crises suggests the central role of expectations and coordination failure among creditors, so the crisis can occur independent of soundness of economic fundamentals.<sup>5</sup> These models are deficient from policy perspective in two ways. First, they do not predict why and when a crisis may strike because it is based on some random event generating a sudden coordination of expectations. Second, they do not inform us what to do to contain the crisis. A third generation of theoretical models attempts to overcome the above shortcomings by redefining the fundamentals more broadly to include also the micro incentives and policies<sup>6</sup>. Some other models allow interaction between fundamentals and beliefs so that a crisis is triggered by both factors working together not by any one in isolation. A branch of this literature deals with twin crises (exchange rate crisis and banking crisis). For example, Kaminsky and

---

<sup>3</sup> For example, Diamond, D. W., and P. H. Dybvig. 1983. "Bank runs, deposit insurance, and liquidity", *Journal of Political Economy*, Vol.91(3), pp. 401-419.

Brynat, J. 1980. "A model of reserves, bank runs, and deposit insurance", *Journal of Banking and Finance*, Vol.4, pp. 335-344.

Von Thadden, E. L. 1995. Optimal liquidity provision and dynamic incentive compatibility. Working Paper, Centre for Economic Policy Research, European Science Foundation, London.

Anderlini, L. 1989. "Theoretical modeling of banks and bank runs" in *The Economics of Missing Markets, Information and Games*, edited by F. Hahn. Oxford: Oxford University Press.

Postlewaite and Vives 1987.

<sup>4</sup> For example Krugman, Paul. 1979. "A model of balance of payments crisis", *Journal of Money, Credit and Banking*, Vol.11, pp. 311-325.

Flood, R. P. and Garber, P. M. 1984. "Collapsing exchange rate regimes: some linear examples", *Journal of International Economics*, Vol.17, August, pp. 1-13.

<sup>5</sup> For example, Obstfeld, M. 1996. "Models of currency crisis with self-fulfilling features", *European Economic Review*, Vol.40, pp. 1037-1047.

<sup>6</sup> For example, Krugman, Paul, 1999, "Balance sheets, the transfer problem and financial crisis", *mimeo*, MIT.

Chang, Roberto and Velasco, A. 1999. "Financial crisis in emerging markets: a canonical model" in Bernanke, B and Rotemberg, J. (eds), *NBER Macroeconomics Annual 1999*, Vol.14, MIT Press, Cambridge, Mass.

Morris, Stephen and Shin, H. 1998. "Unique equilibrium in a model of self-fulfilling currency attacks", *American Economic Review*, Vol.88(3), pp. 587-597.

Chui, Michael; Prasanna Gai and Andy Haldane. 2000. "International financial crisis and public policy: some welfare analysis" *Journal to be found downloaded from internet*, International Finance Division.

Reinhart (1999) who analyze links between the two crises and find them independent in 1970s but entwined in 1980s. The causal relation is not unidirectional, however when both crises occur the banking crisis was normally found preceding a currency crisis and aggravated by it.

In this paper we approach the subject with policy perspective in identifying the causes of financial distress and banking crisis, and highlight the differences and similarities in importance of these causes for Islamic banks. We therefore take a more basic (fundamental) approach.

Fundamentally, four important economic agents take part in shaping the banking environment. Namely, the government; the central bank or the supervising authority; banks themselves; and bank customers—be they depositors or clients who borrow. Since government decision making can affect the macroeconomic situation directly, while actions of other agents shape it only through their aggregate behaviour. Therefore, the causes of financial crisis in the conventional banking industry can be classified accordingly into following categories:

1. Those emerging from macroeconomic situation and policies which can be influenced to some extent by the government or planners.
2. Those emerging from micro-economic factors. This can further be divided between (i) what is internal to the bank (i.e., bank's control) and (ii) what is external to the bank, which includes the banking environment, regulatory factors, and behaviour of bank customers.

Not all causes can be classified into mutually exclusive categories mentioned above therefore there is bound to be some overlap. A number of causes of bank failures are listed by various authors. However, Later (1997) provides a very comprehensive list of causes and explains each in clear ways, which we summarize in Table-1. With this framework we turn to evaluate the causes of failure of Ihlas Finans in the next part of the paper.

It should be noted that the role of bank customers (depositors and clients) is also important in bank failure. However, being large in number, the depositors decisions are not coordinated (except in situations of panics and mania when actions get coordinated in the form of a herd behaviour). Therefore, for the time being we can abstract away from the role of bank depositors as cause of banking crisis. As for the clients, the financial structure of the corporate sector and assumption of risky financial obligations by the firms does have implications for a crisis. Such a situation was experienced during the Asian financial crisis of 1997. But we are not studying them here as a separate cause because if the risky financial structure behind a crisis is built up through financing from the domestic banks the causes listed under the control of banks will cover it. While if it is affected through raising

funds from foreign markets it is either covered under macroeconomic situation or by the headings listed under microeconomic factors external to the bank.

## 2. CASE OF IHLAS FINANS

### 2.1 Background

The banking sector in Turkey consists of state owned commercial banks, private commercial banks, investment and development banks, foreign banks, and special finance houses (SFHs). This last category, which is a sub-sector of the banking sector in Turkey, was created in 1983 by a government decree (no. 83/7506 dated December 16, 1983) that allowed the institutions registered under it to collect funds for investment on interest-free, profit-loss sharing basis.

Ihlas Finans, a special finance house, was a subsidiary of Ihlas Holdings. The parent company was started in 1970s as a social oriented business organization. It started with launching of a daily newspaper ‘*Turkey*’. The company gradually grew into a large holding company with its core business in construction, health care and education; and having a number of subsidiary businesses ranging from manufacturing of household appliances, news media, to providing financial services and insurance of various kinds. Ihlas Finans was one of its subsidiaries started in 1995 with the objective of providing interest-free investment opportunities to investors and small savers. Registered under the category of Special Finance House with the Central Bank of Turkey – a category under which all Islamic financial institutions are classified – it grew into largest of its class.<sup>7</sup> In 1996, its nominal capital was over 1 trillion Turkish Lira (TL),<sup>8</sup> which was equivalent to US\$12.3 million.<sup>9</sup> As of July 5, 1996 it raised funds of over 682 billion TL through IPO by issuing more than 150 million shares and reached a market capitalization of 6.5 trillion TL (US\$80 million approximately) in the same year.<sup>10</sup> The size of its balance-sheet assets had grown from 9,206,711 million TL (US\$17 million) in 1995 to 633.56 trillion TL (US\$1173 million) by 1999.<sup>11</sup>

All of its forerunners (Al-Baraka Türk O. F. K. A. S., Faisal Finans Kurumu A. S., Kuveyt Türk Evkaf O. F. K. A. S., and Andolu Finans Kurumu A. S.) were foreign entities in Turkey. Ihlas Finans was the first domestic Islamic finance

<sup>7</sup> The Turkish Banking Law has changed since then. Under the new Banking Law 5411 (November 1, 2005) the Special Finance Houses are called Participation Banks, they are now under the supervision of BRSA (Banking Regulation and Supervision Agency).

<sup>8</sup> Turkish Treasury, Table-General Information about Special Finance Houses, obtained from [www.hazine.gov.tr/english/bak/ofk/ofkgeneling.htm](http://www.hazine.gov.tr/english/bak/ofk/ofkgeneling.htm)

<sup>9</sup> Converted into US\$ using average daily exchange rate of TL in 1996; 1US\$=81282TL.

<sup>10</sup> Meridian Securities website listing IPOs by Istanbul Stock Exchange.

<sup>11</sup> We have used US\$ guichet buy rate of 31-12-1999 which was 1US\$= 540,098TL to convert the value of assets for both years 1995 and 1999.



institution. It rapidly increased its branches all over the country giving tough competition to the incumbent Special Finance Houses who had to follow suit by expanding their branches as well. See Table-2 for relative position of Ihlas Finans.

Like all Special Finance Houses (SFH) in Turkey the deposits of Ihlas Finans were not protected by the Central Bank's insurance system. Further, being an Islamic financial institution it would not, and could not by law, invest in government securities. There was no other liquid investment opportunity except for holding cash. Thus, a major proportion of the investments of Ihlas were in illiquid assets and projects as compared to other domestic and foreign commercial banks who could hold very liquid government securities. This proved to be beneficial for the stability of Ihlas and other SFHs in the initial period of the crisis when other conventional banks were failing. It is elaborated later in this analysis.

Ihlas Finans faced a run on its deposits in the wake of the banking crisis that developed in Turkey between the last quarter of 2000 and early 2001. The Banking Regulation and Supervision Agency (BRSA) stepped in and cancelled the license of Ihlas Finans on February 10, 2001 citing paragraph (6) of Article 20 of the Banking Law No. 4389. The liquidation process of Ihlas Finans started which is continuing to this date. Ihlas Finans's failure requires identification of the factors that contributed to the problems of the institution. Since the generalized crisis had also affected other SFHs and the fact that all of them survived except Ihlas Finans, it also requires identification and explanation of the differentiating factors. In an attempt to answer these questions we will move from broad to narrow factors. We will first examine the state of the macro-economy, the weaknesses in the banking sector, and the nature of shock that precipitated into the banking crisis. We will then evaluate the factors related to the SFH sub-sector and finally the factors internal to Ihlas Finans that contributed to its collapse. This funnelling approach towards autopsy of the collapse from macro to micro factors is expected to answer the above questions and reveal some lessons for strengthening the Islamic banking industry.

## **2.2 Macroeconomic Factors External to the Banking Sector**

On the macroeconomic side Turkey's troubles were old. It was experiencing a sustained double digit inflation that was not getting under control despite efforts by the country's economic managers. The debt burden (both internal and external) was very high. The red alert situation was obvious in 2001 by the fact that foreign debt was 197 per cent of export proceeds from goods and services and government budget deficit was 14.5 per cent of the GDP. The heavy borrowings by the government had raised the interest rates, and high rate of inflation was encouraging dollarization of the economy. While there was a small current account surplus the

real exchange rate<sup>12</sup> was under pressure to increase from its artificially pegged value. The projected GDP growth rate was below negative 4 per cent in 2001 as compared to 2000.<sup>13</sup> The planned privatization of state owned enterprises was also getting delayed for various reasons. It was thus hampering the quick availability of funds and was increasing the losses by prolonging the government ownership of inefficient enterprises. In these circumstances Turkey was on the verge of default on its international obligations. In short, macroeconomic situation dictated larger and diverging set of policy goals but with limited policy instruments. An IMF rescue plan was available but on very tough conditions and high social costs. In such situation, any shock in the economy would create an immediate need of liquidity, like in the form of recall of debt by foreigners, and could have generated a crisis.

It has been recognized in the literature that precarious macroeconomic conditions are themselves a potential source of financial crisis even for an otherwise sound banking system. Further, as Hoelscher and Quintyn (2003, p.4) point out macroeconomic imbalances also effect the weak banking sector in other ways, weakening it further: (i) They can change the incentives in favour of risky behaviour thus weakening the banks' defences. For example, by encouraging large exposure to government. (ii) They can produce financial strain on banks affecting their solvency. A similar thing was observed in case of Turkey, where the banking sector was already weak.

The unstable macroeconomic situation also affects the behaviour of regulators, as it increases regulator forbearance and delays corrective action for reasons such as: (i) increased difficulty in disentangling the controllable and non-controllable causes of weaknesses of the financial institutions; and (ii) acquiesce with the government's fiscal and monetary policies. Thus the lenity leads to higher costs of corrective action which further delays the action. Table-3 gives the macroeconomic picture in terms of GNP. It may be noted that bank recapitalization accounted for 35.6 per cent of the domestic debt. We now turn to the analysis of the banking sector and analyze how it was effected by the macro-economy and how it itself contributed to the crisis.

### **2.3 Factors Internal to the Banking Sector Excluding Excluding Special Finance Houses**

The banking sector was also in bad shape facing financial repression, accumulation of bad debt, and lax regulation. The root cause of this state was the

---

<sup>12</sup> Exchange rate is defined as domestic currency price of foreign currency, TL/US\$.

<sup>13</sup> Data in this paragraph is obtained from "How the bug can spread", Special Section on Emerging Markets, *The Economist*, July 19, 2001.  
[www.economist.com/PrinterFriendly.cfm?Story\\_ID=701377](http://www.economist.com/PrinterFriendly.cfm?Story_ID=701377).

prevalence of politically motivated lending and lending to connected businesses, coupled with corruption at all levels. Full guarantee of the bank deposits offered by the state after the earlier 1994 banking crisis is said to be another factor behind accumulation of bad loans. This law made banking a lucrative business for the corrupt entrepreneurs with political connections who set up banks that siphoned off money.<sup>14</sup> Lack of decisive action against failing banks on the part of the regulators also contributed to building up of the problems. Another factor that contributed to over lending by the banks was high demand for consumer credit during the high inflation years.

Under the advice of the IMF Turkey had embarked on a financial liberalization plan and a fiscal adjustment and anti-inflation program since 1999. By taking a severe contractionary fiscal and monetary stance the government was able to curtail inflation for the first time since 1985, from a rate of more than 70 per cent in 1999 to below 40 per cent in 2000<sup>15</sup>. The anti-inflationary policy was based on tying the monetary expansion to a nominal exchange rate anchor, and the Turkish Lira was pegged to dollar which was set to appreciate on a pre-defined exchange rate path. As mentioned earlier, the government was already indebted and it needed more borrowing just to roll over its existing debt. All these factors resulted in shortage of domestic credit. This also had resulted in offering of high interest rates on the treasury bills. For example, average nominal interest rate on treasury bills was 106.2% in 1999 which remained high at 38% in 2000.<sup>16</sup>

Given a pre-announced increasing exchange rate path that was crawling pegged to dollar, the domestic and foreign interest rate differential had created an interest rate arbitrage opportunity for the banks. All banks, and particularly those who could cheaply raise funds in foreign currency, took large positions in TL denominated treasury bills while most of their liabilities were in foreign currency. The state owned banks also had large exposure to government securities for reasons of interest arbitrage, state influence, and the fact that the government had used treasury bills as capital injection device to keep the problem banks afloat.<sup>17</sup> In sum, the whole banking sector was channelling resources towards public sector and little towards financing of private enterprises. In so doing, it had taken huge interest rate risk and foreign exchange risk. It is to be noted that the gross foreign

---

<sup>14</sup> Economist, December 7th, 2000 issue. "Turkey and the IMF: take ten billion."

<sup>15</sup> Data from Central Bank of Turkey, Annual Report 2000, Section II, Table 11.4.1, page 59. <http://www.tcmb.gov.tr/yeni/evds/yayin/yillik/00ing/sectionII.pdf>

<sup>16</sup> Source: IMF Annex-A. See also Central Bank of Turkey Annual Report 2000, Section II, p.42, Table-II.2.7

<sup>17</sup> Note that domestic debt taken for recapitalization of problem banks in 2000 was 17.4 percent of GNP.

currency open position of the banking sector was already USD12.8 billion in January 2000, which further increased to USD18.2 billion in September 2000<sup>18</sup>.

Government owned commercial banks were among the first ones to fail. By November 2000, ten banks had failed, eight of them state owned. They were transferred for liquidation or re-floatation to Saving Deposit Investment Fund (SDIF) – which was previously an arm of the Treasury now an independent body.<sup>19</sup>

In this precarious environment the financial and banking 'crisis' was triggered in late November 2000 when criminal investigations against these banks were started that led to the arrest of several prominent bankers and businessmen. Foreign investors started to exit by selling off both the treasury bills and shares. "This put the squeeze on the banks that had borrowed large amounts of money to finance lucrative government-bond purchases. Their appeals to healthier banks were turned down and there then followed rumours of further bank failures. Even more capital then fled and the liquidity crunch sent overnight inter-bank lending rates to giddy 1,950%."<sup>20</sup>

As a result of the liquidity crisis and the falling prices of TL denominated treasury bills many more conventional banks failed, these included the Demirbank, which was one of the primary dealers that failed on December 06, 2000.<sup>21</sup> The banking license of Park Yatyrym was also cancelled by the same date. However, the SFHs (Islamic financial institutions) were saved from the direct hit of the crisis in the initial period because they did not have any government securities in their portfolios. The value of their assets did not evaporate immediately and they remained solvent.

Around this time (December 06, 2000) when many banks were failing the announcement of ten billion dollar rescue package to Turkey by the IMF provided a temporary relief to the financial sector. However, it could not reverse the tide as high degree of uncertainty had already been created in the economy and the stability of the government had become doubtful that direction of economic policy was lost.

---

<sup>18</sup> Banking Regulation and Supervision Agency. 2001. "Towards a Sound Turkish Banking Sector," May 15, 2001. p.7. Available at [www.bddk.org.tr/english/publicationsandreports/brsareports](http://www.bddk.org.tr/english/publicationsandreports/brsareports). The gross open position excludes currency derivatives.

<sup>19</sup> IMF, Letter of Intent from The Government of Turkey to IMF dated December 18, 2000, paragraph no. 49. (The letter describes the policies that Turkey intends to implement in return for financial support from IMF).

<http://www.imf.org/external/NP/LOI/2000/tur/03/index.htm>

<sup>20</sup> "Turkey and the IMF: take ten billion", *The Economist*, December 7<sup>th</sup> 2000, [www.economist.com/PrinterFriendly.cfm?Story\\_ID=446106](http://www.economist.com/PrinterFriendly.cfm?Story_ID=446106)

<sup>21</sup> Central Bank of Turkey. 2000. *Annual Report*.

The liquidity crunch and eroded depositor confidence in the banking system along with the then existing possibility of exchange rate shock are more likely factors that contributed in sinking of Ihlas Finans. BRSA cited the inability of Ihlas Finans to keep its promises and obligations to the public and violations of banking rules for the cancellation of its license on February 10, 2001. In conclusion, we can say that the problem of Ihlas Finans was less likely to be insolvency, which was the case in many conventional banks, but liquidity crisis along with the then looming currency depreciation and run on its deposits. A time-line of events given in appendix-II also supports this view.

During the crisis the central bank lost more than USD10 billion of foreign exchange reserves in trying to maintain the crawling peg exchange rate regime that was part of the IMF fiscal adjustment and anti-inflation program. Finally the program was abandoned after a row between the President and the Prime Minister. The Turkish Lira was put on free float on February 22, 2001; it depreciated by over 40 per cent in just three days. This sharp depreciation directly worsened the balance sheets of banks, including the then surviving Special Finance Houses. It also affected their balance sheets indirectly through deteriorated quality of the assets of the businesses that they had financed. However the remaining SFHs survived.

#### **2.4 Factors Internal to the Special Finance House Sub-Sector**

Financial crisis is not new phenomenon in Turkey. The country had been hit by a series of such crises in the past decade. During the crisis of 1994 Islamic banks were not much affected.<sup>22</sup> The financial crisis of 2001 was much sever and eventually became an economic crisis. The nature of the Islamic banks was same as before: they used to offer separate investment accounts and current accounts one draw-able on maturity and the second draw-able on demand. However, the market environment was a little different from before:

- (a) The share of Islamic banks (SFHs) in the total banking industry of Turkey had increased from before to 3.3 per cent, meaning that a turmoil in the industry was not likely to pass without touching them. But the market segment of the Special Finance Houses (SFHs) was still small in

---

<sup>22</sup> This probably because they were not in the mainstream and also probably due to the different nature of that crisis. The previous banking crisis of 1994 took place in the environment characterized by dollarization of deposits (about 46%) where sovereign downgrade and depreciation of TL served as the triggers for that crisis (Gulde, *et al.*, 2003). While in the crisis of 2001 many more factors played roles simultaneously. As discussed in this paper macroeconomic imbalances, political instability, weak supervisory structure, and accumulated problems in the banking sector, poor stabilization strategy all contributed to the crisis.

comparison with the entire banking sector — SFHs constituted only 3.1 per cent of the total banking sector deposits and their investment allocations were only 4.7 per cent of the total banking sector investment allocations.<sup>23</sup> The small size limits the shock absorption capacity of this sub-sector and leaves the individual SFHs prone to collapse.

(b) There has been an increased competition among the Islamic banks not only for making inroads into the market served by the conventional banks, which is good, but also between themselves to capture each other's market share. This second kind of competition can sometimes lead to risky and uncalculated decisions. In the absence of support institutions for Islamic banking, individualistic behaviour of Islamic banks reduces their survival capacities otherwise possible through mutual support.

(c) The legal and regulatory environment of the financial sector was also changing. Some major changes in banking laws in 1999 required the SFHs to adapt to them rapidly but without requisite support institutions<sup>24</sup>. As mentioned earlier, unlike other banks the deposits of SFHs were not protected by SDIF. While this situation may have a potential advantage of keeping the SFHs careful in their investment decisions ex-ante to the crisis it works to their disadvantage during the crisis. Fearing a run and knowing the uninsured status of their deposits the worried depositors can precipitate a run much earlier.

State owned banks and the banks under the control of SDFI for restructuring were among the first ones hit by the crisis because they already had larger proportions of bad debt as well as large portfolio positions in government securities whose prices were now falling while the interest rates were rising. The next ones getting affected were the private banks on account of their positions in government securities as well as eroding confidence of the depositors. As mentioned before, the SFHs had no portfolio positions in the government securities, which worked to their advantage in preserving the value of their portfolio for some time. But they were next in line to bear the domino affect of collapse of other banks. The domino affect hypothesis is corroborated by following two observations:

---

<sup>23</sup> According to *Annual Report 1998* of the Central Bank of Turkey, Section III.1.2.C, Special Finance Houses constituted 2.3 per cent of total assets of the banking sector. Total loans (financing) extended by SFHs constituted 4.7 per cent of total bank loans. Total funds collected by the SFHs were 3.1 per cent of the total comparable deposits. Total net worth and the profits of the SFHs constituted 1.3 per cent and 0.7 per cent of the banking sector's net worth and profit. The information can be accessed at [www.tcmb.gov.tr/yeni/evds/yayin/yillik/98ing/report3.html](http://www.tcmb.gov.tr/yeni/evds/yayin/yillik/98ing/report3.html)

<sup>24</sup> Previously, SFHs were required to keep only 10 per cent of their current accounts and 1 per cent of their investment accounts as required reserves. They were exempt from the general banking provisions and their supervision was under the office of the Prime Minister.

- i) The aggregate claims of conventional banks (Deposit Money Banks and Investment Banks) on SFHs show a sharp decline between September and November 2000 until reaching a minimum in end January 2001 (See Figure-1). This suggests that conventional banks withdrew whatever amounts of money they had in SFHs to meet their liquidity needs, thus transferring part of the shock. But the affect was small on account of the meagreness of their claims.
- ii) Chronologically the big fall in deposits of SFHs came about in January 2001, two months after that of conventional banks, when SFHs lost more than 900 trillion TL worth of deposits (See Figure-2).

Examination of the SFH sub-sector through the lens of financial stability indicators (or financial ratios) can provide some more insights into the reasons for the failure of Ihlas Finans, which was the largest member with 40 per cent market share in this sub-sector. The sector level data can be gleaned from the reports of the Central Bank of Turkey and from annual reports of the SFHs. Data collected and described in a recent study on efficiency of Turkish banking system by El-Gamal and Inanoglu (2002) came handy for our purpose. Those authors have divided the banking sector into five sub-sectors namely, SFHs, Foreign-, Private-, State-owned-, and SDFI-banks. They converted the raw data which was in nominal Turkish Lira (TL) into real 1995 USD.<sup>25</sup> Summary of six performance and stability indicators is given below:

- a) *Capital Adequacy*: The ratio of equity capital -to- total assets is used here as proxy for capital adequacy due to practical deficiency of data that is needed for risk weighting. This ratio was low for SFHs and state-owned-banks in comparison with private-, foreign-, and SDFI-banks in all years from 1990 to 1999. However, it increased after SFHs sector was subject to banking laws in 1999 which resulted in improvement of its capitalization bringing it at par with foreign banks. This ratio for SFHs rose from 3 per cent in 1999 to 5.6 per cent in 2000.
- b) *Asset Usage*: As reflected by the ratio of Loans-to-Total Assets, the asset usage by SFHs was significantly higher (70 per cent on average) during the decade 1990-2000 while conventional banks had a lower usage ratio (39 per cent on average) with foreign banks making least use of their assets for private sector loans. This substantiates the above description that foreign banks in particular and conventional banks in general were borrowing

---

<sup>25</sup> It was done by first using Turkish Consumer Price Index (CPI) with base year 1995 to convert the data in real terms. Then using the real exchange rate for 1995 to convert the data into real 1995 USD. The authors also note that the base year for Turkish CPI and US CPI is 1995. The data set covered period from 1990-2000 and took account of only those institutions that operated throughout this period. Thus in the SFHs category it includes only 4 Islamic banks excluding Ihlas Finans and Asya Finans that started operations in 1995 and 1996, respectively.

(from abroad) in foreign exchange and investing in lucrative TL denominated government securities. Consequently, asset mismatch (currency mismatch) increased for the banking system as a whole. On the other hand SFHs were channelling investments in private sector businesses.

- c) *Asset Quality*: Ratio of non-performing loans to total loans is a good indicator of loan quality. Smaller the ratio, better the quality. On average over the last decade this ratio for SFHs was slightly higher than that of foreign and private banks but increased above 10 per cent in the year 2000 indicating deteriorating quality of their assets. The ratio was still much lower than that for SDFI banks.
- d) *Management Efficiency*: As measured by ratio of employee expenses –to- total assets (lower the better), it was lowest for SFHs in the beginning of the decade but gradually increased after 1995 to converge with that of conventional banking sector.<sup>26</sup>
- e) *Earnings*: Ratio of net income –to- total assets (ROA) was very low, almost zero in real dollar terms, for SFHs and less than ROA of other foreign and private sector banks. More deeper analysis would be required to know the exact reasons for this difference. However, it may be noted that the banking sector was thriving on income from speculative financial inflows which were high until the crisis while the SFHs were financing the private real sector which was suppressed in the economy.
- f) *Liquidity*: Ratio of liquid assets –to- total assets reveal that this ratio was the lowest for SFHs in comparison with foreign, private and state owned conventional banks over the period 1990-2000 and it never exceeded 18 per cent. This shows that SFHs sector was prone to liquidity shortages in case of a liquidity shock.

## 2.5 Factors Internal to Ihlas Finans

We now turn to the factors internal to Ihlas Finans that might be responsible for its collapse while the other SFHs were able to sail through the difficult time. In this context a comparative study of the balance sheet of Ihlas with other SFHs as well as comparison of management, organization, and ownership structure with other SFHs would prove to be useful.

### 2.5.1 Balance sheet/financial analysis

*Asset Size*: In terms of Assets, on the close of year 2000, Ihlas Finans was the largest among the SFHs. Its assets were 2.7 times as much as that of its closest competitor Kuwait Turkish Evkaf Finance House (KTEFH) and more than three times the size of other SFHs.

---

<sup>26</sup> Though it is not a very good indicator of management efficiency it does indicate SFHs were not overspending on employees.



*Capital Adequacy:* Using shareholders' equity (consisting of basic paid-in capital + disclosed reserves from post tax earnings – adjustments to share capital) as proxy for tier-1 capital we find that just two months before its closure and about a month after the beginning of financial crisis in Turkey (i.e., on 31-12-2000) Ihlas Finans had a capital adequacy ratio of 5.39 per cent<sup>27</sup> (see Table-4). It was less than the ratio of above 7 per cent maintained by other SFHs, and much below the prudential measure of 8 per cent recommended by Basel Committee. While other SFHs increased the proportion of shareholders' equity in 2000 from a year before, IFS maintained its capital adequacy ratio roughly at the same level. This, coupled with other ratios discussed later is indicative of the expansionary strategy that the Ihlas Finans had followed in the past through leveraging of capital. It shows that Ihlas Finans expanded its business more than what its core capital could support.

Theoretically, a low proportion of shareholders' equity in total assets should not be a problem for Islamic banks because of the nature of their investment deposit accounts is different from those at conventional banks. Since the participation or investment account holders of the Islamic bank share in its profits and losses; the principal amount is not guaranteed by the bank; and the depositors are also bound to carry these deposits to maturity, therefore lesser protection would be required in the form of owners' equity. Nevertheless, some proportion of shareholders' equity would be needed to maintain and align the interests of the owners of the bank with the interests of investment deposit holders.

Another indicator to measure likelihood of survival of a bank is gross-income to total assets ratio. In a recent article Estrella et al. (2000) suggest using two simple ratios that can be readily calculated from balance sheet and income statements of banks. Namely, (i) the ratio of capital to gross revenue and (ii) leverage ratio. Using the frequency distributions of bank failures and each of these ratios including the risk weighted capital ratio, they demonstrated that "risk-weighted ratio does not consistently outperform the simpler ratios, particularly with short horizons of less than two years." We report the gross income to asset ratio for Ihlas Finans and other Special Finance Houses in Table-5.

We find that the gross income to asset ratio of IFH was 18.5 per cent in 2000 which was better than most SFHs except Asya Finance House which had it at 20.6 per cent. As the data in Table-5 indicates, in the previous years too this ratio for IFH remained in the range in which other SFHs were operating. Thus, in isolation, it does not shed any light why other SFHs survived and IFH collapsed.

---

<sup>27</sup> We are using (Shareholders' Equity/Total Assets) as proxy for capital adequacy because the information is lacking to allow for calculation of risk weighted assets.

*Composition of Deposits:* Deposits constitute an important source of capital for IFH, which had more than 200,000 depositors. Interestingly enough, the proportion of participation (or investment) accounts in total deposits with the IFH was very high around 96 per cent. By the same token the ratio of current accounts in total deposit was only 3.71 per cent, which was much lower than that found at other SFHs in Turkey where it ranged between 8 to 13 per cent (see Table-6). It was also lower than that found at Islamic banks in other parts of the world.<sup>28</sup> The high proportion of participation accounts imposes a need for greater utilization ratio otherwise the returns on these deposits will be low. While this may explain the high average fund utilization ratio of 86 per cent<sup>29</sup> by Ihlas Finans, it has implications for increasing the liquidity-, credit-, and economic-risk by over investment in the limited number of investment opportunities.

*Liquidity Ratio:* The purpose of this measure is to assess the availability of liquidity to the bank from its own sources in case of lost access to outside sources of liquidity. If we define liquidity of bank as cash in its vaults + cash with other banks + reserves with the Central Bank, then the ratio of liquid assets to total asset of IFH was only 4.22 per cent in 1999 which sharply deteriorated to 0.53% by the end of 2000 during the crisis. This ratio had gone further down to 0.27% on the day of cancellation of its license, February 10, 2001 (see Table-7). In contrast, the liquidity position at other Special Finance Houses (SFHs) was much better both before and during the crisis. For example, the liquidity to asset ratio was 11.01 per cent at Kuwait Turkish Evkaf Finance House in 1999 which slightly reduced to 10.39 per cent during the crisis. Similarly, at Asya Finans House this ratio was 15.8 per cent before the crisis and reduced to 7.5 per cent by end of December 2000. This shows that the liquidity position of Ihlas Finans was weak before the crisis.<sup>30</sup>

In the event of a systemic crisis, a bank's access to its cash kept with other banks and even to its reserves with the central bank may also be lost, at least temporarily. In such situations cash in its vaults can serve as liquidity. Therefore, we have also reported in the Table-7a second liquidity measure – ratio of cash in vaults to total assets. It was also low for IFH.

---

<sup>28</sup> According to the data in a study by Ahmad (1997) the proportion of demand deposits varied considerably among Islamic banks in various parts of the world. The proportion of demand deposits in total deposits was on the decline but generally remained above 7 per cent during 1985-1994. Ahmad, Ausaf. 1997. *Structure of Deposits in Selected Islamic Banks: Implications for Deposit Mobilization*. Research Paper No. 48 Jeddah: IRTI, Islamic Development Bank

<sup>29</sup> Based on calculations from data in Ihlas Finans Annual Report 1999. Utilization ratio is defined as (Funds utilized/Total Assets)x100. The number given above is average of last 5 years. In 1998 and 1999 this ratio was 89 and 86 per cent respectively.

<sup>30</sup> It is surprising how the Central Bank allowed such a low levels of liquidity. It may be noted that the reserve requirements for Special Finance Houses were set at 2 per cent of their deposits from the very beginning. This ratio was raised to about 10 per cent in 1999 (8 per cent for TL deposits and 11 per cent for foreign currency deposits).

*Liquidity Risk or Maturity Mismatch:* The liquidity risk is measured by analyzing the net gap between assets and liabilities in each maturity class. Table-8a and Table-8b show the maturity structure of IFH's investments and leases with corresponding maturity structure of its deposit liabilities during 1998 and 1999, respectively.<sup>31</sup> Column 4 in each of these tables reports the maturity gap. These data show a general excess of short-term liabilities and long-term assets. This is not surprising as some degree of mismatch is expected in a banking institution. However, what is important to gauge is the severity of the mismatch, and whether it was increasing or decreasing over time. For this purpose and in absence of any good benchmark, we used maturity **gap ratio**—defined as the ratio of gap to total assets (expressed in per cent). This ratio is expected to control for the affect of high inflation for comparison over time, and control for difference in amounts of assets for comparison across SFHs.

Figure-3 shows the distribution of the maturity gap ratio of IFH, for 1998 and 1999, using 5 maturity classes. We find that the maturity structure of IFH improved between 1998 and 1999 in that the concentration of the gap ratio shifted from tail end classes towards the central classes of maturity (1 month and 1-3 months), this is observable in Figure-3.

In order to compare the mismatch at IFH with the mismatch at another SFH which survived the crisis, we used Kuwait Turkish Evkaf Finance House. The selection of KTEFH is made only because its asset liability maturity structure is available from its annual reports. It is reported in Table-9 and Table-10 respectively for 1999 and 2000. However, this data is available only in 4 maturity classes. Therefore, we converted the data for IFH accordingly into four classes and compared. Figure-4 shows the maturity gap ratio of IFH vs. KTEFH for 1999. It reveals that maturity mismatch of assets and liabilities were high at IFH as compared to KTEFH. Assets of up to 90 days maturity period were far more than the liabilities of the corresponding maturity; while liabilities of shorter term maturity (less than 30 days) far exceeded the assets of corresponding maturity. The data on maturity structure of the assets and liabilities of Ihlas Finans is not available to us for the year of the crisis.

*Duration Analysis:* Timings of cash in- and out-flows are also an important source of liquidity and maturity risk, particularly if the assets and liabilities have interim cash flows before maturity. In order to capture the relative sensitivity of assets and liabilities to changes in interest rate a measure called 'duration gap' is used. In this paper we do not calculate the duration gap as such for the Islamic banks, but device a similar metric to capture the distribution of maturity gap in a single number. We are still calling it duration gap but define it as:

---

<sup>31</sup> Maturity data for 2000 on Ihlas Finans is not available to us.

$$\text{Duration gap} = (\text{Value weighted average maturity of assets}) - (\text{Value weighted average maturity of liabilities}) \times (\text{Total liabilities/Total assets})$$

Where the value of the asset is taken as its accounting or face value. We performed a comparative duration gap analysis between IFH and KTEFH which are reported in the last rows of Table-8a, -8b, -9 and -10. For lack of data on monthly cash flows we assumed cash flows are timed to maturity, therefore the calculated duration gap is actually a maturity gap in number of years. The advantage of this measure is that it reduces into a scalar number that can be compared across institutions and across time. We find that the duration gap for IFH was +0.567 years in 1988, which came down to +0.432 years in 1999. These were much larger than the duration gap of +0.261 years for KTEFH in 1999. In our context, a positive duration gap suggests that the average maturity of assets were larger than the average maturity of liabilities.

*Currency Risk:* The degree of currency mismatch between assets and liabilities can be measured by foreign currency open position, defined as foreign currency asset minus foreign currency liabilities. For Ihlas Finans, the foreign currency open position was US\$-29.12 million in 1998 which reduced to US\$-20.56 million in 1999.<sup>32</sup> This amounts to only -4 per cent and -2.4 per cent of the total foreign currency assets in 1998 and 1999, respectively.<sup>33</sup> However, this small percentage assumes greater importance when it is noted that the foreign currency deposits constituted larger portion of the total deposits; and their maturity structure was predominantly short-term.<sup>34</sup> These factors increase the likelihood of triggering of the currency risk.

In comparison, at KTEFH the foreign exchange open position as percentage of its total assets was +3.9 per cent and +2.6 per cent in 1998 and 1999, respectively which is more comfortable position in an environment of depreciating TL. Particularly given the fact that in this SFH too the foreign currency accounts constituted greater proportion of total deposits; and that a large proportion of it was of short-term maturity.<sup>35</sup>

<sup>32</sup> Data source: Note 17 to Financial statements in the Annual Report 1999 IFH.

<sup>33</sup> Such data for the year 2000 was not available to us.

<sup>34</sup> For example, the foreign currency deposits (evaluated in terms of TL) at IFH were 11 times and 4 times than that of its domestic currency deposits in 1998 and 1999, respectively. Similarly, foreign currency current deposits and foreign currency investment deposits of 30-day maturity constituted 51 per cent and 58.6 per cent of its total foreign currency deposits in 1998 and 1999, respectively.

<sup>35</sup> In KTEFH the foreign currency deposits were 10.3 time and 13.8 times that of TL deposits in 1998 and 1999, respectively. Similarly, foreign currency current deposits and foreign currency investment deposits of 30-day maturity constituted 57.4 per cent and 60.6 per cent of its total foreign currency deposits in 1998 and 1999, respectively.

We find that some<sup>36</sup> of the Ihlas Finans funds went to finance the businesses of its parent company, Ihlas Holdings, which had its core business in construction, health care, education, and media; it also held significant participation shares in various other companies (39 in total) which were diversified over different sectors (see Table-11). Ihlas Holdings was a successful and financially stable enterprise. But most of Ihlas Holdings business in the construction sector were in large scale residential housing projects or in time-sharing vacation housing facilities at tourist resorts and hot-water spring spas. These projects tie up large investments and usually are the first to suffer demand contraction and cost escalation during uncertain economic and financial conditions. Such occurrence would have drastically reduced the revenues as well as asset values of the construction arm of Ihlas Holdings, which would have adversely affected the payment of dues to the financial arm Ihlas Finans.<sup>37</sup> The continuously depreciating Turkish Lira would also have resulted in cost overruns in the construction business. Since the financial crisis was accompanied by an economic crisis in Turkey other subsidiary and affiliated business too were adversely affected.<sup>38</sup> As a result, we find that the gap between US dollar denominated currency payables and receivables had become 39.33 million USD in 2000 for Ihlas Holdings.<sup>39</sup> In short, the financial crisis was accompanied by an economic crisis in Turkey with negative growth rate of GDP. Two of the hard hit sectors, construction and media, were prominently represented in the areas of core business of the parent company of Ihlas Finans to which it had provided substantial finance.

*Degree of Profit and Loss Sharing:* Role of profit and loss sharing investment deposits during the crisis period is important. In theory, a unique feature of Islamic banks is the profit and loss sharing nature of their investment deposits. This feature provides shock absorbing capacity from the liability side of the balance sheet. Thus, increasing the solvency and stability of the bank in adverse economic

---

<sup>36</sup> Exact amounts of funds that were used to finance subsidiaries of the Holding company and allocation to each subsidiary firm were not available to us at the time of writing.

<sup>37</sup> We do not have any data on this aspect for Ihlas Finans, but it is a likely case given the nature of construction sector.

<sup>38</sup> For example, the heavily invested media sector showed sharp reduction in return on investment. Most of the media companies were owned by various financial conglomerates in Turkey and competition between them resulted in overstretch and over investment. The sector has been one of the large employer of educated labor force. During the financial crisis the media companies responded to low returns by firing large number of employees and closing down many projects which resulted in substantial sunk cost and social disruptions. Ref: Dr. L. Doğan Tılıç, AEJ Vice-President, "Turkey 2001: Crisis Of The Country, Crisis Of The Media, 4000 Turkish Media Workers Lost Their Jobs In The First Three Months of 2001" undated memo.

<sup>39</sup> Calculated from data in Ihlas Holdings Annual Report 2001. We defined the foreign currency gap = FX with banks + FX cash – FX bank credits payable – FX payable + FX receivables.

conditions. Therefore, in examining the causes of financial distress of Islamic banks the actual degree of non-sharing in profit-loss with their depositors should be treated as an independent cause and it should be measured.

In case of IFH we find that investment deposits were substantially sharing in the actual profits and losses of investments made by the bank. This inference is based on following three facts:

1. The investment deposit contract did not promise a fixed return to the investment deposit holders. Rather, it informed that the returns can vary.
2. According to the regulations governing SFHs, eighty per cent of the gross income from funds invested out of investment deposits were to be distributed as profit share to the investment account holders. This guarantees the sharing of the actual returns with the investment account holders. Additionally, it provides a separation between use of investment and current accounts on one hand, and on the other hand reduces the moral hazard problem for the investment account holders. To confirm the implementation of this rule at IFH we calculated the ratio between amount of 'distributed profit to the investment account holders' and the 'income from funds invested from profit-loss sharing accounts'. We found that it was always eighty per cent or a little higher in each year from 1995 to 2000 (see Table-12, row 5).
3. Further, the rate of return on investment deposits defined as 'amount of profit share distributed' divided by 'amount of total investment deposits' varied substantially from year to year. It was 12, 14.5, 12.5, and 16 per cent respectively in 1996, 1997, 1998, and 1999 (see Table-12, row 4).

These data show that the degree of actual profit sharing was significant at IFH, hence its shock absorbing capacity (solvency support) was high. In order to combine the above three features in a scalar measure we construct an index, call it Profit-Loss-Sharing-Shock-Absorption-Capacity (PLSSAC) Index", defined as:

$$\text{PLSSAC} = (\text{Profit share ratio of investment depositors}) \times (\text{Ratio of Investment Deposits in Total Deposits}) \times 100.$$

Higher this index, higher is the degree of profit sharing with depositors in total operations of the bank. This index for IFH was 82.95 in 1999 which was reduced to 77.03 in 2000, which was still a high number.<sup>40</sup>

In this section we analysed the balance sheet of Ihlas Finans House for Asset

---

<sup>40</sup> It was reduced due to both reduction in profit share and reduction in ratio of investment deposits to total deposits.

Size, Capital Adequacy, Composition of Deposits, Liquidity Ratio, Maturity Mismatch, Duration Gap, Currency Risk, and Degree of Profit and Loss Sharing. The analysis revealed two financial weaknesses of Ihlas Finans House: (i) there was high maturity mismatch of assets and liabilities and (ii) very low level of liquidity.

Usually, financial weaknesses are not the only source of bank failures. Often the financial weaknesses develop due to other factors such as the economic environment in which the bank operates, weaknesses in internal controls, poor management, regulatory failures, weaknesses of outside support institutions, and the attitude of the monetary authorities. All these get reflected both in the financial weaknesses and eventual failure of a bank. Below we study these other factors that contributed to the fall of Ihlas Finans.

### **2.5.2 Role of ownership structure**

*Ownership Structure:* Ihlas Finans probably had the most diversified ownership structure among the SFHs as over 28 per cent of its shares were publicly held. Another 10 per cent and 5 per cent stakes were held respectively, by Islamic Development Bank and the Turkish Religious Affairs Foundation. And a little over 2 per cent by other investors. However, its parent company—Ihlas Holdings retained more than 54 per cent (54.77%) ownership share.<sup>41</sup> The ownership structure of the parent company was skewed in favour of one large shareholding individual, Mr. Enver Ören, who owned 40.85 per cent of Ihlas Holdings.<sup>42</sup> Therefore, the ownership structure of the subsidiary in combination with the ownership structure of the parent, placed the effective control of Ihlas Finans in the hands of one individual. This risked rendering the corporate entity behave like a proprietary business.

*Local vs. Distant Owners:* Ihlas Finans was domestically owned. In contrast other SFHs (with the exception of Asya Finans) were foreign owned with highly concentrated ownership. The particular ownership structure of other SFHs relative to Ihlas Finans may have worked in their favour enabling them to survive. First, owing to concentrated ownership, the decision making during the crisis might have been quick and easy; however this could also result in bad decisions. Second, being foreign owned and always administered from abroad for all decisions (e.g., Kuwait Turkish Evkaf Finance and Albaraka Turkish Finance House) they had elaborate operational and monitoring procedures in place for exercising of the remote control. This feature might have helped during the crisis. Third, all the foreign SFHs had long experience in Islamic banking elsewhere while IFH was relatively

---

<sup>41</sup> Ihlas Finans, Annual Report 1999.

<sup>42</sup> Istanbul Stock Exchange website and Ihlas Holdings Annual Report 2001. Ownership structure of Ihlas Holdings was: Publicly offered 54.94%, Mr. Enver Ören 40.85%, other shareholders 4.21%.

new. Forth, other SFHs had deeper pockets than Ihlas Finans. They had access to a larger foreign capital base of their parent companies having operations in many different countries. In contrast, Ihlas Finans was relying predominantly on local capital.

### **2.5.3 Control failures**

Control failure refers to failures in corporate governance and lack of internal checks and balances. It arises when decision making is too much centralized, when there is a rubber stamp board of directors, when the board members are ignorant of financial and economic facts and working of the company, when board members are not motivated, when the bank staff lack relevant experience and training, and when things are run on trust without proper systems of internal control.

We do not have complete information on internal control systems, if any, that were in place at Ihlas Finans. But instances of weaknesses in carrying out the responsibilities of governance can be found. The records show that the members of the Board of Directors showed a lax attitude towards governance. Some members appointed to the Board did not have requisite experience and not enough motivation for their job. While some other members had conflict of interest owing to their dual role as Board members as well as clients/recipients of finance from IFH. There was only one institutional member – Islamic Development Bank (IsDB)—which was a minority shareholder with 10 per cent ownership and which was a foreign investor. Thus it was easy to manipulate the Board by small group within it.

### **2.5.4 Management failures**

*Not preparing enough for changing regulations:* IFH did not prepare itself fast enough for the changing legal and regulatory environment that had started to emerge with financial liberalization. In 1999 Turkey embarked on a new disinflation plan under an IMF package and several banking laws and capital market laws were amended. According to the new Banking Act No. 4389 as amended by Act No. 4491, Special Finance Houses were required to comply with the Banking Law. They were given a temporary relaxation for Article 7 and Article 9 which were to be implemented within 2 years starting from December 19, 1999.

Given the kind of asset structure of IFH that was in place in 1999 it was hard to change. Moreover, the institution was slow in transforming itself to comply with the rules. For example, the new rules required banks to increase their paid-up capital to at least twenty trillion TL (Article 7-2.d). The contribution in the Fund for joining the (banking) system was set to be ten per cent of the minimum required paid-up capital (Article 7-4.b). Qualification, experience, and other conditions were specified for members of the Board of Directors and executives of the bank (Article 7-2.b and Article 9). The minimum capital adequacy ratio was raised to eight per cent from the previous two per cent for SFHs. They were required to



increase the reserves from 10 per cent. It also limited the investment in subsidiaries to 10 per cent. Lending limits to a single party through direct and indirect funds was set not to exceed twenty five per cent of the Special Finance House's equity. It also required the banks to adopt a new reporting system with more detailed and disaggregated financials.

*Connected Lending and Investment Concentration:* By enactment of the Banking Act of 1999 limits were imposed on SFH's investment in equities of subsidiaries and related companies as well as on trading of commodities and real estate transactions through Article 12-1 of the Banking Act. For example, (a) now banks may acquire shares only in non-financial companies and for any single company these shares should not exceed 15 per cent of bank's own funds; while total amount of such shares shall not exceed sixty per cent of bank's own funds. (b) A financing limit to firms (related to the bank, its shareholders or its executives) through direct and indirect funds was set not to exceed twenty five per cent of the Special Finance House's equity.

Complying with these restrictions was difficult given the financial structure of the IFH that was in place. Report of the external auditors for the 41 days operation period from January 01, 2001 to February 10, 2001 examined the records of 231 credit customers, which constituted 95 per cent of total fund placements. It found that the amount invested with each of these customers ranged between TL.2,500 billion to TL.3,500 billion, where as their average capital ranged between TL.1.5 billion to TL.5.0 billion and their average annual profit ranged between TL.10 million to TL.20 million. This shows that these credit customers were predominantly dependent on Ihlas Finans for their operations thus increasing the credit risk for Ihlas Finans. Fourteen out of these 231 had the same shareholders indicating the extent of single-party exposure. The report further shows that due diligence for evaluation of credit requests were not performed. Similar concerns were shown in another report by the external auditors for the earlier period covering January 1, 2000 to December 31, 2000.

Thus the management failed to anticipate the regulatory risks it ran by not complying to the new regulations. It tried to raise capital by retaining the entire profits for the year 2000 and then again doing the same in 2001. It also tried to increase its share capital, but could not meet all the requirements. The risk proved to be a real, as the decision of BRSA against IFH have cited the violation of the connected lending limits as one of the reasons for cancellation of its license.

*Executive Selection:* Another example of management failure is that it hired a senior executive from a previously failed bank. The executive came under scrutiny by BRSA in connection with a then ongoing investigation of the failed bank. It negatively affected the confidence of IFH's customers in the wake of the financial

crisis that had already enveloped other conventional banks. The incident created a withdrawal pressure on IFH.

*No Crisis Management Plan:* It appears (from the interviews of people now involved in liquidation process) that Ihlas Finans did not have any crisis management plan from before the crisis. Decision making during the crisis was also ad-hoc and uncoordinated internally as well as without coordination with other SFHs. As opposed to this, other SFHs had some degree of planning for adverse scenarios. Moreover, their management teams remained in their offices throughout the crisis for decision making; and to some extent they also coordinated with other SFHs for their crisis management strategy.

### **2.5.5 Fraud**

The consequence of prolonged control and management failures emerge in the form of financial problems for the banks. The institutions then indulge in fraudulent practices to hide their problems hoping to rectify the problems soon. Similar incidents took place at Ihlas Finans. Some of the (*mudarabah*) agency financing was done in the name of fictitious parties while the funds were in fact used for solving internal financial problems.<sup>43</sup>

### **2.5.6 Strategic failures**

*Allowing Withdrawals from Investment Accounts:* When the general banking crisis developed in November 2000 it initially precipitated a run on conventional banks. As a consequence the depositors also started to recall their deposits from Islamic banks (SFHs). As for the investment deposits, the SFHs were under no legal obligation to pay its holders until maturity. Ihlas Finans had full right to refuse immediate payments to investment deposit holders and ration the withdrawals of the current account holders. But apparently either for advertisement purposes of its financial strength and to appear better than its competing Islamic financial institutions or to cool down the confidence crisis that was developing against Ihlas Finans on account of drawing-in one of its executives in a ongoing inquiry about a failed bank, it entertained the request of withdrawals of its depositors perceiving that the crisis will be over in a few days. No serious assessment of the magnitude of the problem was made. Thus, more than US\$200 million worth of most liquid assets were lost in paying for the depositors' demand and yet the withdrawals were not abating. Then the Ihlas Finans realized the gravity of the situation and immediately stopped further payments. This impacted adversely on the customer confidence and brought in calls for its liquidation and the BSRA stepped in for inquiry. On finding irregularities in investment procedures and in investments the license of Ihlas Finans was cancelled and liquidation

---

<sup>43</sup> Information gathered by IDB mission.

process started. For example, Ihlas had made substantial investments in its subsidiaries or with the agents of its subsidiaries.

On the contrary other SFHs which survived the crisis did not en-cash the investment deposits and advised their clients to hold them to maturity. As for the current accounts they initiated a rationing procedure for withdrawals during the crisis and started paying in full after about a month.

## 2.6 Regulatory Failures

The Banking Act 4389 through its Article 20.6 put the supervision of Special Finance Houses under Banking Regulation and Supervision Agency (BRSA, its acronym in Turkish is BDDK). But it seems that BRSA did not provide the appropriate help in the form of advice and necessary in time for correction. The supervision was lax in the beginning. Problems were let to accumulate and magnify, then suddenly rules were applied drastically. Other alternatives to provide liquidity support were not considered seriously. The regulators cancelled the license and, effectively, simultaneously forced liquidation.

*Drastic application of rules:* The Article 14 of the Act specifies the authority of BRSA if, as a result of supervision, it finds a Finance House not in compliance to the Act or insolvent or involved in fraud. The paragraphs 1, 2, 3, and 4 of Article 14 empower BRSA to exercise its sole discretion to decide what measures to take among a menu of various possibilities. In case of Ihlas Finans it took the extreme measure of cancelling its license. While among the other possible measures, that were not taken, one was to transfer it to the SDIF which would decide whether to liquidate or re-float the problem institution as is done in case of other conventional banks.

*Lax supervision:* BRSA in its decision to revoke the license of Ihlas Finans cited that the "conditions which are defined in the 3<sup>rd</sup> and 4<sup>th</sup> paragraphs of Article 14 of the Banking Act 4389 were observed to have been realized, such as, the House has failed to honour its obligations on time; had the House continue operating it should pose a danger against the rights of holders of current accounts and participation accounts; those shareholders of the House who control its management and auditing have directly or indirectly utilized the resources of the House in their own favour endangering safe circulation of said resources."<sup>44</sup> This points to the fact that if the regulation was on a continuous basis the financial problems and mismanagement would have surfaced much earlier allowing a chance for correction.

*Lacuna in supervision law:* The incident also reveals a legal lacuna that the law

---

<sup>44</sup> BDDK Banking Regulation and Supervision Agency (BRSA), Decision Number 171 in *Official Gazette*, February 11, 2001. (English translation from original in Turkish).

was silent on what to do next in case a SFH is found to be in violation of the Banking Act. In case of conventional banks the laws stipulated governmental support, or its take over by SDIF. But in case of SFHs since there was no deposit insurance from the Central Bank, BRSA stopped short of transferring it to SDIF and did not provide any other alternate solution. Therefore, when the license was cancelled and Ihlas Finans was barred from taking further deposits and from continuing its investment operations, its board had no alternative but to file for bankruptcy. Thus effectively, the BRSA revoked the license and simultaneously forced the liquidation. No help was provided to resolve the liquidity problem. This strategy of the regulators proved to be more costly for the deposit holders.

*Unclear scope of deposit protection law and confusion on who is the authority:* The deposits of SFHs were not protected by insurance. But at the time of crisis conflicting statements came from various quarters including the Prime Minister of Turkey as if deposits of all banks were insured. The source of confusion probably was the changes in laws and regulatory structure that had taken place about two years ago.

The SFHs were established by a Decree of Council of Ministers dated 16/12/1983. Supervision of this sector rested with Central Bank of Turkey and Undersecretary of Treasury. Due to their special nature, the deposits of SFHs were not protected by the Central Bank hence, they were not required to contribute towards KKDF (Resource Utilization Support Fund). But this changed from 26-08-1998 when by the Decision No. 98/11498 of Council of Ministers the SFHs were taken into the scope of KKDF and required to pay 6 per cent Resource Utilization Support Fund which later was reduced to 3 percent. It is not clear if payment of the contribution brought IFHs into the deposit insurance net or it was only a revenue collection move by the Government. Then, in 1999 the supervision of SFHs and all banks was transferred to the newly formed independent institution BRSA. The new laws subject to IFHs to same capital requirements and resource mobilization and utilization controls as conventional banks, which may have given rise to the impression that the deposit protection has also been extended to SFHs while it was not.

## **2.7 Support Failures<sup>45</sup>**

Individual financial institutions cannot survive without active support from within the financial system and enabling environment provided by the legal system and other institutions. We find lack of active support for Special Finance Houses or at least an indifferent attitude towards them by the institutions supposed to provide support. For example, when the new banking laws were being formulated that proposed a higher limit of capital base for the financial institutions, Ihlas Finans applied for permission to raise capital from the market. But it encountered

---

<sup>45</sup> Information in this section is obtained from non-public domain private sources.

considerable delays in approval and procedural hurdles by the relevant institutions in its efforts to increase its capital base.

To be more specific, on December 25, 1998 Ihlas Finans applied to the Capital Markets Board (CMB) for permission to increase its registered capital base. The CBM returned the application without considering it on the grounds that the Office of the Undersecretary of Treasury, who was the supervising authority for SFHs, had not replied to the letter asking opinion and over six months have passed from the date of its application.

On 21<sup>st</sup> December 1999, the registered capital ceiling was increased to TL150 billion from TL10 billion. Following this another application was made on June 20, 2000 to the CMB to increase the paid-up capital from TL10 billion to TL50 billion.

On November 01, 2000 the BRSA stated a positive view to the CMB regarding IFH (BRSA had now become the supervising agency for SFHs). In spite of this the CMB did not answer the letter until in February 2001 when the IFH's license was cancelled. The CBM replied to the application on June 21, 2001 (more than four months after the halt of IFH's operations) informing IFH to disregard the application because of the initiation of liquidation process.

While IFH tried to raise the capital domestically to meet the capital adequacy requirements with only a little success, how the other SFHs met the requirements? Other SFHs raised their capital from their foreign shareholders.

### 3. CONCLUSIONS AND LESSONS

Bank failures and financial crises are economic hazards. While their direct economic costs are the dead-weight loss. The indirect costs in the form of derailed economic policies and damage to the growth of Islamic banking and finance are even greater. Islamic banks are thought to be more stable, at least in theory, owing to the profit sharing nature of contracts on both the liability and assets sides of their balance sheet. However, in practice their assets are more skewed towards fixed income debt type finance in the form of *murabahah* contract and its variants; and some Islamic banks have faced financial distress and a few have failed or closed their operations due to various reasons.

While some causes of financial distress in Islamic banks are unique to the nature of Islamic banking contracts and the historical circumstances in which the modern practice of Islamic banking evolved, there are many other causes that are common with conventional banking industry. The analysis of the macro- and micro-economic factors in the episode of failure of Ihlas Finans House in Turkey during the banking crisis of 2001 reveal the following:

Exchange rate shock coupled with liquidity crunch and eroded depositor confidence in the banking system were among the external factors that precipitated a run on Ihlas Finans before it collapsed. Regulatory authorities cancelled its license on February 10, 2001 citing Ihlas' inability to keep its promises and obligations towards the public. In contrast to the case of many other conventional banks, the problem of Ihlas Finans was not insolvency but an economy wide liquidity crisis and a loss of confidence in the banking sector. Weak regulatory system for Special Finance Houses (SFH) and lack of official support also contributed to its collapse.

But most of the above factors had also affected other SFHs. Therefore, they insufficiently answer why Ihlas Finans failed while other SFHs survived the crisis. In order to find clue to this question we compared its balance sheet, various financial ratios, management policies, and business strategies with that of other SFHs. We found weak internal management, imprudent financing within the group, and poor crisis management strategy as some of the differentiating factors.

There are a number of general and specific lessons obtained from the experience of Ihlas Finans which are of interest to the regulators, Islamic bankers, and institutional investors like IDB. We itemize them below:

***Lessons for Islamic Banks:***

1. As the size of Islamic financial industry grows its exposure to macro-level shocks also increases. Islamic banks should carefully monitor these developments and prepare in advance as much as they can to ride over the anticipated developments and problems.
2. Since the deposits of Islamic banks are not protected by the Central Bank guarantee they need to be more careful in raising funds as well as prudent in investing them. This can be done by: (i) trying to avoid reliance on volatile funding sources; and (ii) by increasing the fund utilization ratio but not at the expense of investing in low-return and high risk projects.
3. They also have to be careful not to invest in any interest bearing asset, even if this means foregoing lucrative short-term investment opportunities. This will not only ensure their stability at the time of financial crisis but also increase their credibility with the depositors.
4. Islamic banks should keep a prudent portion of assets in liquid form to be able to cater to some withdrawal requests. This proportion should be determined based on behavioral maturity of deposits not their contractual maturity. The competitive pressure to deliver higher returns than the conventional banks pushes the utilization ratio higher. Sometimes to the extent that banks incur risk of liquidity shortage. This problem is less severe in those banks that have greater proportion of demand deposits as they are flush with short-term

liquidity but it is an important concern for banks with greater portion of investment deposits.

5. Since Islamic banks are individually small, they need to support each other instead of getting involved in cut throat competition. In this regard creation of an association of Islamic banks can play an important role in improving coordination and cooperation among them. Such mutual support measures are necessary at least in the transitory phase until Islamic banking acquires a dominant proportion of the banking sector. The need for cooperation between Islamic banks (for example for liquidity support) becomes even greater during a banking crisis.
6. Each Islamic bank should have some crisis management plan. It should specify the chain of authority, and should cover various possible scenarios.
7. Measures taken by individual Islamic banks for ensuring its liquidity needs may not be enough during the time of crisis. Collective efforts, pooling of liquidity, and outside institutional support is required. For that there should be contingency plans at the group- or association-level among Islamic banks long before the crisis.
8. In equity based financing it is natural for the funds to flow where monitoring costs are lowest. Therefore banks tend to invest in their affiliated and connected companies where their control is greatest. In doing this the banks should be careful not to increase maturity and currency mismatch between assets and liabilities. It is very easy to increase such risks because the banks' interests get locked in with these firms.
9. Even if Islamic banks are intrinsically more stable, they can be affected by the collapse of other conventional banks. The episode of the banking crisis in Turkey showed that since SFHs had no government securities in their portfolios they were able to preserve the value of their portfolios for a longer duration. Particularly, at a time when the conventional banks were failing due to abrupt fall in the price of government securities and a sharp increase in interest rate. But Islamic Banks eventually suffered a run on their deposits due to the domino affect of collapse of so many conventional banks that eroded depositor confidence and created gross economic uncertainties.
10. Islamic banks have to be vigilant about the changing economic and regulatory environment and they should be careful in their hiring of senior staff members ensuring their competency, trustworthiness as well as reputation.

***Lessons for Bankers as well as Regulators:***

11. Financial weaknesses are not the only source of bank failure. They arise due to economic environment in which the bank operates; weaknesses in internal controls; poor management; regulatory failures; weaknesses of outside support institutions; and the attitude of the monetary authorities which reflect both in

the financial weakness and eventual failure of a bank. All these factors contributed to the fall of Ihlaz Finans.

12. There should be some criteria for membership in the Board of Directors of Islamic Banks so that only those are selected who have sense of responsibility towards improving corporate governance and who are sympathetic to promotion of Islamic finance. They should not be a rubber stamp members and should have knowledge of the financial and economic facts and experience of working in the financial sector. They should also be well informed of the country specific and international regulatory rules and laws which have implications for the bank.
13. Ihlaz Finans had a low capital adequacy ratio as compared to conventional banks as well as within the SFH sub-sector. Theoretically, a low proportion of shareholders' equity in total assets should not be a problem for Islamic banks because of the nature of their deposit accounts which is different from those at conventional banks. Since the participation or investment account holders of the Islamic bank share in its profits and losses; the principal amount is not guaranteed by the bank; and the depositors are also bound to carry these deposits to maturity, therefore lesser protection would be required in the form of owners' equity. Nevertheless, some proportion of shareholders' equity would be needed to maintain and align the interests of the owners of the bank with the interests of investment deposit holders. What should be the optimal ratio is still an unsettled question.
14. Another lesson for both the regulators and the Islamic banks themselves is that while Islamic banks can be more stable from within due to the use of risk sharing contracts that link their asset and liability sides, their stability is still at risk by the unstable nature of conventional banks. If a large number of conventional banks experience financial distress or fail then by the domino affect Islamic banks will come under stress. Therefore, in economies where dual banking system has been adopted the stability of both conventional and Islamic banks is required for the stability of Islamic banks.



***Lessons for Regulators:***

15. Laws and banking regulations should be clearly specified without ambiguity in its interpretation. The chain of authority should be clear and explicit, defining the scope of jurisdiction of each authority in the regulatory process.
16. There is a strong need for easy access to liquidity by Islamic banks be it in the form of lender of last resort facility or through mutual cooperation or a market among Islamic banks where liquidity surplus of one bank can be utilized to cover liquidity shortages at the other bank. Since the number of Islamic banks within any country are very few, such cooperation or a market is needed to be established at a global level for Islamic banks. TMCL arrangements, reciprocal loan arrangements, and liquidity rationing can be possible mechanisms for such cooperation. These issues involve cross border transactions and therefore require active involvement of Central Banks of various countries to come up with a viable framework.
17. The episode of Ihlas Finans highlights the importance of internal reporting and control mechanisms and the lack of incentives generally on the part of the institutions to invest in such a system. In the present context the ownership pattern affected the incentives for such a system: negatively at Ihlas Finans, and positively at other SFHs. Ihlas Holdings, the parent company of Ihlas Finans, had more than 50 per cent (50.27%) ownership share in Ihlas Finans, which skewed the investments of the finance house in favour of the group it belonged. Ihlas Finans was domestically owned while the other SFHs were foreign owned and administered from abroad for all their decisions (e.g., Kuwait Turkish Evkaf Finance and Albaraka Turkish Finance House). The foreign owners had this need which resulted in elaborate operational and monitoring procedures that were put in place for exercising of the control from abroad. This feature might have helped foreign owned SFHs during the crisis, whereas such systems at Ihlas Finans were weak. Moreover, all the foreign SFHs had long experience in Islamic banking elsewhere while IFH was relatively new. Further, the foreign SFHs had deeper pockets than Ihlas Finans. At the time of crisis they had access to a larger foreign capital base of their parent companies having operations in many different countries. In contrast, Ihlas Finans was relying predominantly on local capital.

***Lessons for Institutional Investors:***

18. There is a useful role for institutional investors in development, growth, smooth running and avoidance of crisis in Islamic banking industry. As opposed to numerous small shareholders the institutional shareholders hold a significant minority share which avails them a chance to influence the decision making at the bank through their representation in the board of directors. Since the institutional investors usually possess more diversified shareholding in various other banks and companies the motivations for their actions are

different from other shareholders. As opposed to small shareholders they are financially stable. As opposed to majority shareholders their interests are not tied only with this bank but with the success of the Islamic banking industry in general where they also hold stakes. Therefore, their influence on decision making could prove to be beneficial. A very important lesson, similar to what has been stated earlier for the other board members, is that the representatives or members appointed by the institutional investors to the board of directors of Islamic banks should have requisite knowledge and experience. In this context knowledge of the local and international banking regulations and experience in investment and finance should be given priority over other factors.

***Lessons and tasks for researchers:***

19. There are a few more lessons and some food for thought for researchers in Islamic banking. There is a need to think and have a clear understanding of the nature of Islamic banking. Investment deposits in Islamic banks ought to be an investment commitment by the depositors, Islamic banks should not try to imitate conventional banks in making these accounts drawable on demand like current deposits. It was a strategic mistake of Ihlas Finans to allow withdrawals from investment deposits as well as the current deposits without any rationing during the time of crisis. In this regard every Islamic bank should have a contingency plan and crisis management strategy in place long before any crisis. There is also the issue to rethink whether banks should follow the sequential servicing of withdrawal requests at the time of financial distress or crisis. After all, investment accounts are capital uncertain claims whose value can be determined when the actual assets are liquidated. An important area of research could be optimal liquidation rules for partnerships and *mudharabahs*. This area will help design rules for handling of withdrawals requests and rules governing compulsory liquidation of underlying assets of the investment deposits at the time of need.

**REFERENCES**

- Ahmed, Ausaf (1997), "Structure of Deposits in Selected Islamic Banks: Implications for Deposit Mobilization" Research Paper No. 48, Islamic Research and Training Institute, Jeddah: Islamic Development Bank.
- Ahmed, Habib (2002), "A Microeconomic Model of an Islamic Bank" Research Paper no. 59, Islamic Research and Training Institute, Jeddah: Islamic Development Bank.
- Ali, Ahmed Muhammad (2002), "The Emerging Islamic Financial Architecture: The Way Ahead" Keynote speech at the Fifth Harvard University Forum on Islamic Finance, Cambridge Mass., April 6-7, 2002.

- Anderlini, L (1989), "Theoretical modelling of banks and bank runs" in *The Economics of Missing Markets, Information and Games*, edited by F. Hahn. Oxford: Oxford University Press.
- Barth, James R., Gerard Caprio, and Ross Levine (undated), "Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability?" mimeo (World Bank). An earlier version presented at NBER Conference on Prudential Supervision: What Works and What Doesn't, January 13-15, 2000, Islamorada, Florida.
- BDDK Banking Regulation and Supervision Authority (BRSA) (2001), *Official Gazette*, Decision Number 171, February 11, 2001.
- Brynat, J. (1980), "A model of reserves, bank runs, and deposit insurance", *Journal of Banking and Finance*, Vol.4, pp. 335-344.
- Calomiris, C. W. and C. M. Kahn (1991), "The Role of Demandable Debt in Structuring Optimal Banking Arrangements" *American Economic Review* 81: 497-513.
- Caprio, Gerard Jr. and Daniel Klingebiel (1996), "Bank insolvency: bad luck, bad policy, or bad banking?" in *Annual World Bank Conference on Development Economics 1996*. Washington D.C: The World Bank.
- Central Bank of Turkey (1998), *Annual Report*. Section III.1.2.C. Also available at [www.tcmb.gov.tr/yeni/evds/yayin/yillik/98ing/report3.html](http://www.tcmb.gov.tr/yeni/evds/yayin/yillik/98ing/report3.html)
- \_\_\_\_\_ (2000), *Annual Report* Section II. Also available at <http://www.tcmb.gov.tr/yeni/evds/yayin/yillik/00ing/sectionII.pdf>
- \_\_\_\_\_ (2001), *Annual Report*. Section III. Also available at <http://www.tcmb.gov.tr/yeni/eng/> and at <http://www.tcmb.gov.tr/research/yillik/01ing/sectionIII.pdf>
- Chang, Roberto and Velasco, A (1999), "Financial crisis in emerging markets: a canonical model", in Bernanke, B and Rotemberg, J (eds), *NBER Macroeconomics Annual 1999*, Vol.14, MIT Press, Cambridge. Mass.
- Chapra, Umer and Habib Ahmed (2002), "Corporate Governance in Islamic Financial Institutions" Occasional Paper no. 6, Islamic Research and Training Institute. Jeddah: Islamic Development Bank.
- Chapra, Umer and Tariqullah Khan (2000), "Regulation and Supervision of Islamic Banks" Occasional Paper no.3, Islamic Research and Training Institute. Jeddah: Islamic Development Bank.
- Chui, Michael, Prasanna Gai and Andrew Haldane (2000), "International Financial Crisis and Public Policy: Some Welfare Analysis" *Bank of England Quarterly Bulletin*, November 2000.

- Diamond, Douglas W., and P. H. Dybvig (1983), "Bank runs, deposit insurance, and liquidity", *Journal of Political Economy*, Vol. 91(3), pp. 401-419.
- Diamond, Douglas W., and Raghuram G. Rajan (2000), "A Theory of Bank Capital" *Journal of Finance*, vol. 55 (December), pp.2431-2465.
- Diamond, Douglas W., and Raghuram G. Rajan (2001), "Liquidity Shortages and Banking Crisis" University of Chicago, memo.
- Economist (1999), "The business of banking", on the Opinion page of *The Economist*, October 28<sup>th</sup> 1999.  
[http://www.economist.com/PrinterFriendly.cfm?Story\\_ID=254485](http://www.economist.com/PrinterFriendly.cfm?Story_ID=254485)
- \_\_\_\_\_ (2000), "Turkey and the IMF: take ten billion", *The Economist*, December 7<sup>th</sup> 2000,  
[www.economist.com/PrinterFriendly.cfm?Story\\_ID=446106](http://www.economist.com/PrinterFriendly.cfm?Story_ID=446106)
- \_\_\_\_\_ (2001), "How the bug can spread", Special Section on Emerging Markets, *The Economist*, July 19, 2001.  
[www.economist.com/PrinterFriendly.cfm?Story\\_ID=701377](http://www.economist.com/PrinterFriendly.cfm?Story_ID=701377).
- \_\_\_\_\_ (2003), "The trouble with banks," Research Tools Surveys. *The Economist*, May 1<sup>st</sup> 2003. [www.economist.com/PrinterFriendly.cfm?Story\\_ID=1730399](http://www.economist.com/PrinterFriendly.cfm?Story_ID=1730399).
- \_\_\_\_\_ (2003), "No pain, no gain," Economic Focus. *The Economist*, December 11<sup>th</sup> 2003.  
[www.economist.com/finance/PrinterFriendly.cfm?Story\\_ID=2282464](http://www.economist.com/finance/PrinterFriendly.cfm?Story_ID=2282464).
- El-Gamal, Mahmoud and Hulusi Inanoglu (2002), "Efficiencies and Unobserved Heterogeneity in Turkish Banking Sector: 1990-2000" memo.
- El-Gari, Muhammad Ali (2001), "Credit Risk in Islamic Finance" Paper presented in Conference on Regulation of Islamic Banks, 24-26 April, Khartoum, Sudan.
- El-Hawary, Dahlia A., Wafik Grais and Zamir Iqbal (2003), "Regulating Islamic Financial Institutions: The Nature of the Regulated" Paper presented in International Conference on Islamic Banking: Risk Management, Regulation and Supervision, organized by IRTI, Bank Indonesia, and Ministry of Finance Indonesia, Jakarta: October 2003.
- Estrella, Arturo, Sangkyun Park and Stavros Peristiani (2000), "Capital Ratios as Predictors of Bank Failure" *Federal Reserve Board New York Economic Policy Review*, July, pp 33-52.
- Flood, R. P. and P. M. Garber (1984), "Collapsing exchange rate regimes: some linear examples", *Journal of International Economics*, Vol.17, August, pp. 1-13.

- Freixas, X. and J. C. Rochet (1997), *Microeconomics of Banking*. Cambridge, Massachusetts: MIT Press.
- Gulde, Anne-Marie, David Hoelscher, Alain Ize, Alferdo Leone, David Marston and Marina Moretti (2003), "Dealing with Banking Crises in Dollarized Economies", in Charles Collins and G. Russell Kincaid edited *Managing Financial Crises Recent Experience and Lessons for Latin America*, IMF Occasional Paper No. 217. Washington D.C.: International Monetary Fund. 2003. pp.54-64.
- Hoelscher, David S. and Marc Quintyn (2003), *Managing Systemic Banking Crises*. Occasional Paper No. 224. Washington, D.C.: International Monetary Fund.
- Ihlas Holdings (2001), *Annual Report*.
- Ihlas Finans. (1998), *Annual Report*.
- \_\_\_\_\_ (1999), *Annual Report*.
- IMF (2000), Letter of Intent from The Government of Turkey to IMF dated December 18, 2000.  
<http://www.imf.org/external/NP/LOI/2000/tur/03/index.htm>
- International Institute of Islamic Economics (1999), *IIIE's Blueprint of Islamic Financial System*. Islamabad: IIIE, International Islamic University.
- Jacklin, Charles J. (1997), "Demand Deposits, Trading Restrictions, and Risk Sharing" Pp.26-47 in *Contractual Arrangements for Intertemporal Trade*, (eds) Edward C. Prescott and Neil Wallace. Minneapolis: University of Minnesota Press.
- Jang, Ji-Hyang (2003), "The Politics of Islamic Banks in Turkey: Taming Political Islamists by Islamic Capital" Paper presented at the 2003 Annual Meeting of the Midwest Political Science Association, Chicago, IL.
- Kaminsky, Graciela L. and Carmen M. Reinhart (1999), "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems", *American Economic Review*, Vol. 89, no. 3, June, pp.473-500.
- Khan, Mohsin (1987), "Islamic Interest-Free Banking: A Theoretical Analysis" In Mohsin Khan and Abbas Mirakhor (eds) *Theoretical Studies in Islamic Banking and Finance*, Texas USA: The Institute of Islamic Studies. 15-36.
- Khan, Tariqullah, and Habib Ahmed (2001), "Risk Management: An Analysis of Issues in the Islamic Financial Industry" Occasional Paper no. 5, Islamic Research and Training Institute, Jeddah: Islamic Development Bank.
- Krugman, Paul (1979), "A Model of Balance of Payments Crisis", *Journal of Money, Credit and Banking*, Vol.11, pp. 311-325.

- Krugman, Paul (1999), "Balance sheets, the transfer problem and financial crisis", *mimeo*, MIT.
- Kuwait Turk Evkaf O.F.K.A.S (1999), *Annual Report*.
- \_\_\_\_\_ (2000), *Annual Report*.
- Latter, Tony (1997), "Causes and Management of Banking Crises" Handbooks in Central Banking no. 12, Centre for Central Banking Studies. London: Bank of England.
- Maroun, Youssef Shaheed (2002), "Liquidity Management and Trade Financing" In Simon Archer and Rifaat Abdel Karim (eds), *Islamic Finance: Innovation and Growth*, London: Euromoney Books and AAOIFI. 163-175.
- Morris, Stephen and Shin, H (1998), "Unique equilibrium in a model of self-fulfilling currency attacks", *American Economic Review*, Vol. 88(3), pp. 587-597.
- Meridian Securities, website listing IPOs by Istanbul Stock Exchange.
- Obstfeld, M. (1996), "Models of currency crisis with self-fulfilling features", *European Economic Review*, Vol. 40, pp. 1037-1047.
- Peck, James and Karl Shell (2003), "Equilibrium Bank Runs". *Journal of Political Economy*, Vol. 111, no.1, pp.103-123.
- Siddiqi, M. Nejatullah (1983), *Banking without Interest*, Leicester: The Islamic Foundation.
- Sundararajan, V. and Tomas Balino (1991), "Issues in Recent Banking Crises" In V. Sundararajan and Tomas Balino, eds., *Banking Crises: Cases and Issues*, Washington, DC: International Monetary Fund, pp.1-57.
- Sundararajan, V., and L. Errico (2002), "Islamic Financial Institutions and Products in the Global Financial System: Issues in Risk Management and Challenges Ahead" IMF Working Paper, IMF/02/192. Washington: International Monetary Fund, November.
- Tılıç, L. Doğan Dr., AEJ Vice-President, (undated) "Turkey 2001: Crisis Of The Country, Crisis Of The Media, 4000 Turkish Media Workers Lost Their Jobs In The First Three Months of 2001" memo.
- Turkish Treasury, [www.hazine.gov.tr/english/bak/ofk/ofkgeneling.htm](http://www.hazine.gov.tr/english/bak/ofk/ofkgeneling.htm)
- Von Thadden, E. L. (1995), Optimal liquidity provision and dynamic incentive compatibility. Working Paper, Centre for Economic Policy Research, European Science Foundation, London.

**Appendix - I**

**Table-1: Causes Of Financial Distress And Banking Crisis**

Macroeconomic Factors	Microeconomic Factors	
<i>External to the Bank and the Supervisory Authority</i>	<i>External to the Bank (but in the direct control of the supervisory authority, central bank and government)</i>	<i>Internal to the Bank (i.e., in control of bank)</i>
<ul style="list-style-type: none"> <li>• Macroeconomic situation</li> </ul>	<ul style="list-style-type: none"> <li>• Supervision problems</li> <li>• Inadequate infrastructure</li> <li>• Financial liberalization policies</li> <li>• Political Interference</li> <li>• Moral Hazard due to deposit insurance</li> <li>• Lack of transparency</li> <li>• Fraud and corruption</li> </ul>	<ul style="list-style-type: none"> <li>• Banking strategy</li> <li>• Poor credit assessment</li> <li>• Taking interest rate or exchange rate exposures</li> <li>• Concentration of lending</li> <li>• Connected lending</li> <li>• Entering in new areas of activity</li> <li>• Internal control failures</li> <li>• Other operational failures</li> </ul>

**Table-2: General Information About Special Finance Houses**

	December 31, 1996	Establishment Date	Operation Date	Nom. Cap. (Billion TL)	Number of Branches (Dec. 31, 1996)	Number of Branches (Dec. 31, 2000)*	Number of Branches (Dec. 31, 2001)*
1.	Al-Baraka Türk O. F. K. A. S. (ABTFH)	1984	1985	750	16	22	22
2.	Faisal Finans Kurumu A. S. (FFH)	1984	1985	500	11	-	-
3.	Kuveyt Türk Evkaf O. F. K. A. S. (KTEFH)	1988	1989	1,185	10	25	30
4.	Andolu Finans Kurumu A. S. (AnFH)	1991	1991	350	13	-	-
5.	Ihlas Finans (IFH)	1995	1995	1,000	24	-	36
6.	Asya Finans Kurumu A. S. (AFH)	1996	1996	2,000	1	25	25

Data Source: Turkish Treasury, [http:// www.hazine.gov.tr/english/bak/ofk/ofkgeneleng](http://www.hazine.gov.tr/english/bak/ofk/ofkgeneleng). The data in last two columns for the year 2000 and 2001 are from various annual reports of the respective institutions.



**Table-3: Selected Macroeconomic Indicators of Turkey**

	1999	2000	2001	2002
<i>GNP (in billions of U.S. Dollars)</i>	187.4	201.3	150.3	165.6
	(In percent)			
<i>Real GNP growth rate</i>	-6.1	6.3	-8.5	3.0
<i>CPI (12 month, end-of-period)</i>	68.8	39.0	68.0	35.0
<i>Average nominal treasury bill interest rate</i>	106.2	38.0	99.7	69.6
<i>Average ex-ante real interest rate</i>	32.0	-9.4	32.4	33.2
	(In percent of GNP)			
<i>Central government budget balance</i>	-11.6	-11.6	-18.2	-15.2
<i>Net debt of public sector</i>	61.0	57.4	92.2	81.3
<i>Net external</i>	20.1	18.3	38.0	35.1
<i>Net domestic</i>	40.9	39.1	54.2	46.2
<i>Of which: Bank recapitalization</i>	...	17.4	35.6	28.4
<i>Current Account Balance</i>	-0.7	-4.9	1.3	-1.2
	Monetary Aggregates			
<i>Seignorage</i>	3.2	1.8	1.0	1.0
<i>Nominal growth of broad liquidity (in percent)</i>	96.9	40.2	75.1	40.2

Source: IMF.

**Table-4: Equity Ratio (a proxy to capital adequacy)**

Column No.	(1)	(2)	(3)	(4)
		31/12/1999	31/12/2000	10/2/2001
Capital Adequacy	IFH	5.32%	5.39%	-
	KTEFH	7.74%	7.90%	-
	AFH	6.92%	7.47%	-

For calculation of Capital Adequacy in this table ratio of shareholders' equity to total assets is used as proxy.

**Table-5: Gross Income to Asset Ratio**  
a proxy to capital adequacy to judge bank safety (higher the better)  
in percentage

Column No.	(1)	(2)	(3)	(4)	(5)	(6)
Year	1997	1998	1999	2000	2001	2002
IFH	19.0	16.6	18.9	18.5	0.5 *	-
KTEFH		17.8	18.9	17.0	21.8	-
AFH			16.9	20.6	13.9	-
ATFH-FF	12.4	15.0	13.7	15.9	19.9	29.2

Notes: \* This entry is as of 10/2/2001, it covers only about 40 days into the year before the cancellation of its license.

**Table-6: Percentage of Current Deposits in Total Deposits**

(0)	(1)	(2)	(3)
	Name / Year	31/12/1999	31/12/2000
Ratio of Current Accounts in total deposits	IFH <sup>1</sup>	1.25%	3.71%
	KTEFH	11.7%	9.77%
	AFH	13.26%	13.23%

Notes: 1. Balance sheet 1999 of IFH divides accounts in savings and institutional categories, therefore the calculated ratio for IFH does not reflect true proportion for 1999.

**Table-7: Liquidity Ratios**

(0)	(1)	(2)	(3)	(4)
		31/12/1999	31/12/2000	10/2/2001
Ratio of Liquid Asset to Total Assets <sup>1</sup>	IFH	4.22%	0.53%	0.27%
		0.55%	0.03%	0.013%
	KTEFH	11.01%	10.39%	-
		1.02%	1.4%	
	AFH	15.8%	7.5%	-
		1.48%	1.3%	

Notes: 1. The first ratio is (cash + cash with banks + reserves)/total assets, the second ratio is cash to assets.

**Table-8a: Maturity Structure of Assets and Liabilities – Ihlas Finans 1998**

**Panel A** (Millions of TL)

Maturity	Assets (Amount)	Liabilities (Amount)	Gap (Amount)	Gap/Asset Ratio (in Per cent)
On call	7,980,177	6,236,150	+1,744,027	+0.692
Up to 1 month	25,768,675	106,232,797	-80,464,122	-31.906
From 1 – 3 months	10,604,622	70,828,734	-60,224,112	-23.880
From 3 – 6 months	6,652,648	14,203,134	-7,550,486	-2.994
From 6 – 12 months	178,112,442	16,597,556	+161,514,886	+64.044
Longer than 1 year	3,517,618	0	+3,517,618	+1.395
No Maturity	19,556,029	21,530,163	-1,974,134	-0.783
Total	252,192,211	235,628,534	+16,563,677	+6.568

**Panel B** (Number of years)

Average Duration of Assets	Average Duration of Liabilities	Duration Gap
0.76645791	0.21337128	+0.567100591

**Table-8b: Maturity Structure of Assets and Liabilities -- Ihlas Finans 1999**

<b>Panel A (Millions of TL)</b>				
Maturity	Assets (Amount)	Liabilities (Amount)	Gap (Amount)	Gap/Assets Ratio (in Per cent)
On call	27,113,337	11,079,415	+16,033,922	+2.531
Up to 1 month	348,011	329,360,067	-329,012,056	-51.931
From 1 – 3 months	379,014,210	150,542,542	+228,471,668	+36.061
From 3 – 6 months	95,221,686	26,234,237	+68,987,449	+10.889
From 6 – 12 months	61,891,366	26,453,150	+35,438,216	+5.593
Longer than 1 year	5,837,597	0	+5,837,597	+0.921
No Maturity	64,135,190	62,500,208	+1,634,982	+0.258
	633,561,397	606,169,619	+27,391,778	+4.323

<b>Panel B (Number of years)</b>		
Average Duration of Assets	Average Duration of Liabilities	Duration Gap
0.85662944	0.444273	+0.431565

**Table-9: Maturity Structure of Assets and Liabilities of KTEFH in 2000**

Billions of TL					
All Assets		All Liabilities		Gap	Gap/Asset Ratio
Maturity	Amount	Maturity	Amount	Amount	Per cent
0 – 1 month	61,299	30 days	186,122	-124,823	-40.3
From 1 – 3 months	51,733	90 days	57,830	-6,097	-2.0
From 3 – 12 months	123,167	360 days	16,301	+106,866	+34.5
Longer than 1 year	28,666	Longer than 1 year	24,876	+3,790	+1.2
No maturity	44,725	No maturity	---	+44,725	+14.4
<b>Total</b>	<b>309,590</b>	<b>Total</b>	<b>285,129</b>	<b>24,461</b>	
				= Total Gap = (Share holders' equity)	
D <sub>A</sub> = Average Duration of Assets 0.6413 years		D <sub>L</sub> = Average Duration of Liabilities 0.3368 years			
Duration Gap = D <sub>A</sub> - D <sub>L</sub> x (Total Liabilities ÷ Total Assets) = + 0.3311 years					

**Table-10: Maturity Structure of Assets and Liabilities of KTEFH in 1999**

All Assets		All Liabilities		Gap	Gap/Asset
Maturity	Amount	Maturity	Amount	Amount	Ratio
0 – 1 month	77,127	30 days	167,621	-90,494	-30.2
From 1 – 3 months	42,697	90 days	59,917	-17,220	-5.7
From 3 – 12 months	97,357	360 days	17,048	+80,309	+26.8
Longer than 1 year	36,970	Longer than 1 year	32,074	+4,896	+1.6
No maturity	45,721	No maturity	---	+45,721	+15.2
Total	299,872	Total	276,660	+45,721	
				= Total Gap = (Share holders' equity)	

$D_A$  = Average Duration of Assets = 0.6282 years  
 $D_L$  = Average Duration of Liabilities = 0.3981 years

Duration Gap =  $D_A - D_L \times (\text{Total Liabilities} \div \text{Total Assets}) = +0.2611$  years

**Table-11: Subsidiaries and Affiliated Companies of Ihlas Holdings**

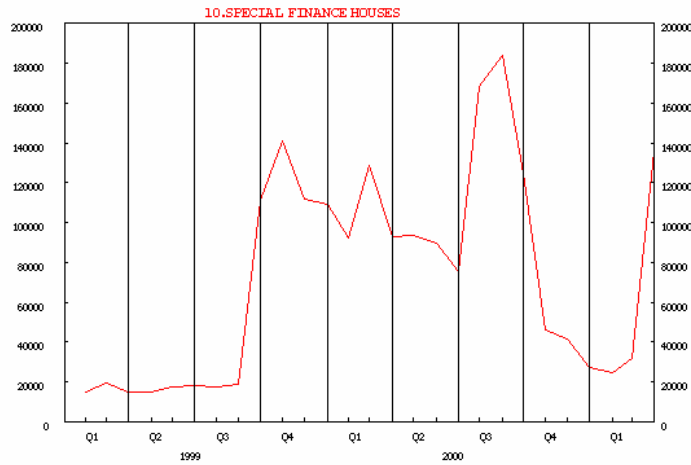
Company (Top 7 by amount of participation capital in year 2000)	Line of Business	Equity Share of Ihlas Holdings	Participation Capital (TL Million)
Ihlas Matbaacilik Gaz. Yay. San. A.S.	Publishing and Media	99.89%	14,983,333
Ihlas Finans Kurumu A. S.	Islamic Banking	50.27%	8,279,469
Ihlas Ev Aletleri Iml. San. ve Tic. A. S.	Home Appliances	66.08%	5,120,356
Ihlas Gazetecilik A.S.		8.33%	5,000,000
Ihlas Gayrimenkul Yatirim Ortakligi A. S.	Real Estate Investment Trust	40.54%	2,077,335
Ihlas Sigorta A. S.	Insurance	88.25%	1,881,250
Ihlas Hayat Sigorta A. S.	Life Insurance	81.00%	1,620,000

Source: Annual Report Ihlas Holdings 2001.

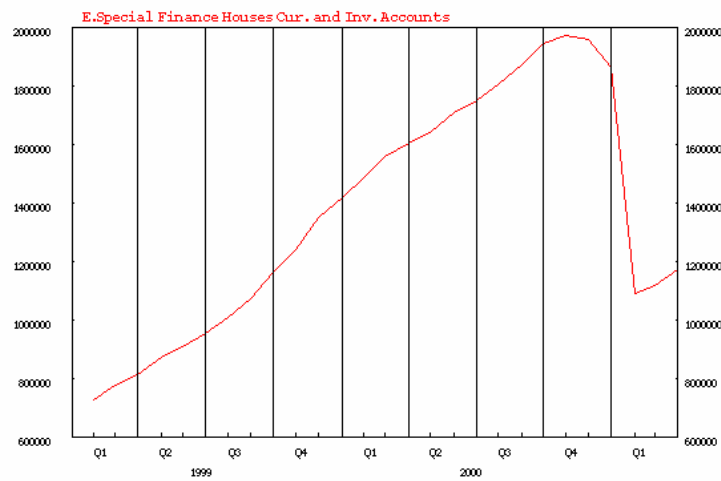
**Table-12: Returns to Investment Deposit Holders**

		Amounts in million TL				
Particulars	1996	1997	1998	1999	2000	
1.. Income from Funds Invested in P/L sharing Investment Accounts	5,185,297	18,516,130	32,274,613	101,472,440	142,004,963	
2. Profit Share Distributed	4,178,621	14,823,772	25,911,379	85,255,229	113,603,970	
3. P/L Sharing Investment Accounts	34,733,770	102,349,012	207,862,221	532,589,996	673,940,676	
4. Rate of Return on Investment Deposits = Row(2)/Row(3)	12.03%	14.48%	12.47%	16.01%	16.9%	
5. Index of Risk Sharing by Investment Account Holders = Row(2)/Row(1)	80.6%	80.1%	80.2%	84.0%	80.0%	

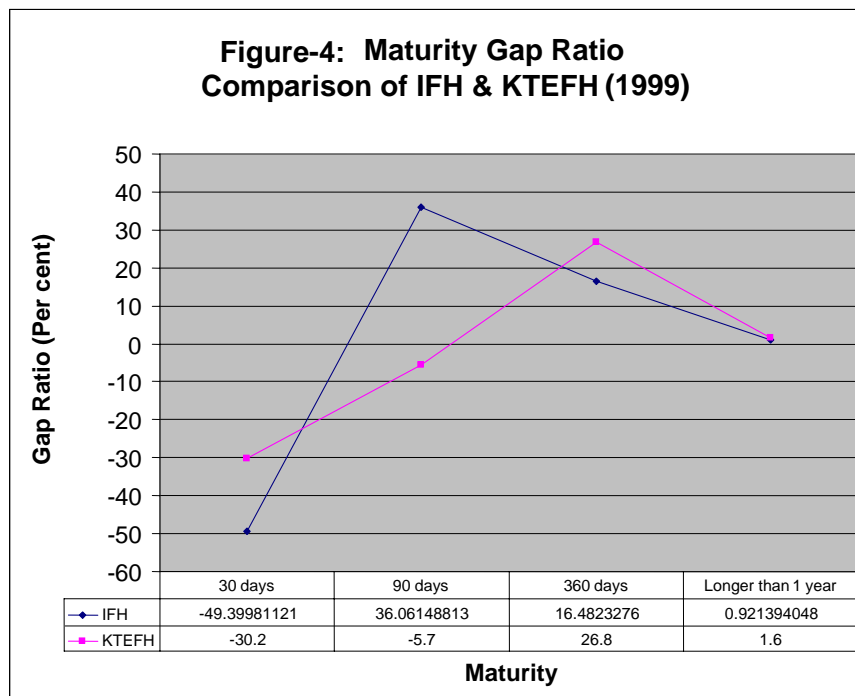
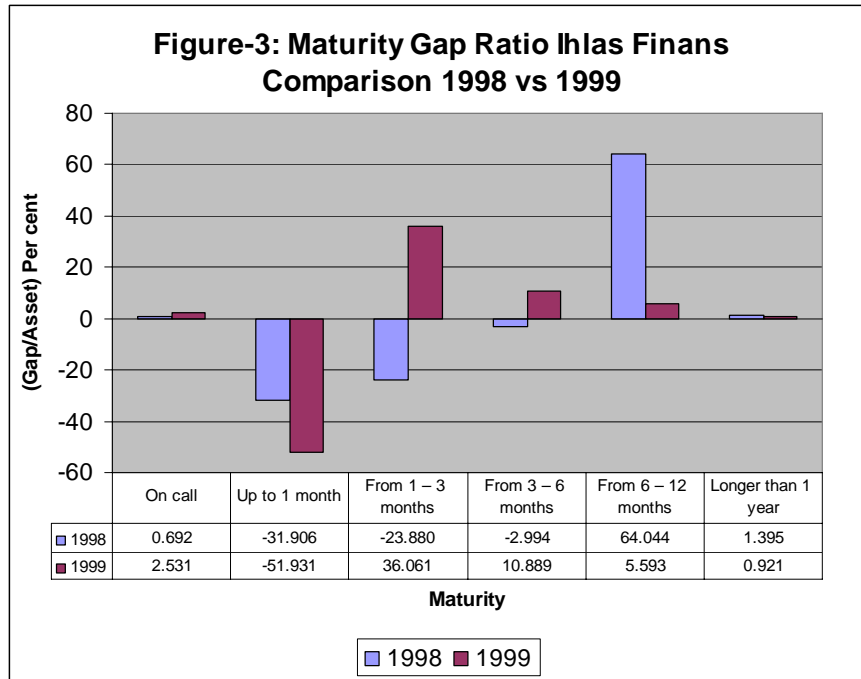
**Figure-1:** Aggregate Claims of Conventional Banks (Deposit Money Banks and Investment Banks) on Special Finance Houses (SFHs)



**Figure-2:** Quasi-Deposit Liabilities (Current and Investment Accounts) of Special Finance Houses (SFHs)







## Appendix - II

---

### IMPORTANT EVENTS THAT AFFECTED THE MARKETS IN THE YEAR 2000

**January 1, 2000:** The Disinflation Program was put into effect.

**March 10, 2000:** The 1<sup>st</sup> Additional Letter of Intent submitted to the IMF was declared to the public.

**March 27, 2000:** The Central Bank announced that the depreciation rate of the Turkish lira against the exchange rate basket would be 0.9 percent for the first quarter of 2001.

**April 25, 2000:** Standard & Poor's raised the long-term credit rating of Turkey.

**May 5, 2000:** The penalty for the net open foreign exchange position exceeding the pre-determined ratio of the capital base was raised from 8 percent to 100 percent of the exceeding part. This amount should be deposited with the Central Bank as a free deposit account.

**June 1, 2000:** For the calculation of the net general foreign exchange position/capital base, a standard ratio started to be used.

**June 1, 2000:** Saving Deposits Insurance Fund limited the coverage of insurance for savings deposits to TL 100 billion for 2000 and TL 50 billion for 2001.

**June 22, 2000:** The 2<sup>nd</sup> Additional Letter of Intent submitted to the IMF was announced.

**June 30, 2000:** The Central Bank announced that the depreciation rate of the Turkish lira against the exchange rate basket would be 0.85 percent for the second quarter of 2001.

**August 31, 2000:** The Banking Supervision and Regulation Authority started functioning.

**September 4, 2000:** No bid was tendered for the auction of the 20 percent block sale of Turk Telecom.

**September 26, 2000:** The President's Office returned the decree in lieu of law related to the privatization of state banks to the Prime Minister's Office.

**September 29, 2000:** The 3<sup>rd</sup> part of the loan that was to be given to Turkey was postponed by the IMF until December.

**September 29, 2000:** The Central Bank disclosed its monetary and exchange rate policies to be carried out in the second half of 2001. The depreciation rate of the Turkish lira against the exchange rate basket was determined as 0.85 percent and it would be applied for the second half of the year when the exchange rate band would be put into effect. The daily figures for the upper and lower values of the total band, which would reach 7.5 percent at the end of December 2001, were disclosed.

**October 27, 2000:** The Banking Supervision and Regulation Authority disclosed that Etibank A.Ş. and Bank Kapital T.A.Ş. had been transferred to the Savings Deposits Insurance Fund.

---

---

**November 3, 2000:** The Banking Supervision and Regulation Authority disclosed that government securities amounting to a total of US \$6.1 billion would be transferred by the Treasury to the Savings Deposits Insurance Fund for the rehabilitation of the 8 banks that had been taken over.

**November 16, 2000:** The Action Plan related to the rehabilitation of the banks transferred to the Savings Deposits Insurance Fund was disclosed.

**November 20, 2000:** The Istanbul Stock Exchange index decreased by 7.1 percent.

**November 21, 2000:** The Central Bank disclosed that, as of January 12, 2001, reserve requirement ratios would be decreased from 6 percent to 4 percent.

**November 22, 2000:** Because of the liquidity shortage in the markets, the Central Bank provided the market with TL 1.688 quadrillion through open market operations. This caused the net domestic assets performance band to be exceeded.

**November 27, 2000:** Liquidity Ratio Implementation was modified in favor of banks in order to ease the money market conditions.

**November 29, 2000:** The net international reserves item decreased below the US \$13.5 billion floor value that had been targeted for the end of the year.

**November 30, 2000:** The Central Bank disclosed that the net domestic assets would be fixed at its November 30<sup>th</sup> level and liquidity would be created only in return for foreign exchange.

**December 6, 2000:** Demirbank, which is one of the primary dealers, was transferred to the Savings Deposits Insurance Fund. The banking license of Park Yatırım was cancelled.

**December 6, 2000:** The Prime Ministry disclosed additional tax measures and announced that 33.5 percent of TELEKOM would be privatized and the strategic partner would be given administrative power. Moreover, 51 percent of THY would be sold. The IMF disclosed that it had provided US \$10.4 billion credit to Turkey and US \$7.5 billion of which would be Supplementary Reserve Facility.

**December 18, 2000:** The 3<sup>rd</sup> additional Letter of Intent submitted to the IMF, which included additional measures and brought the structural reforms calendar forward, was announced.

#### IMPORTANT DEVELOPMENTS AFFECTING THE MARKETS IN THE YEAR 2001

**3 January:** Debenture bonds amounting to TL 4 quadrillion and US\$ 750 million in foreign currency were given by the Undersecretariat of the Treasury to the Ziraat Bankası and Halk Bankası in order to balance the functional damages.

**10 February: Banking Regulation and Supervision Agency cancelled the license of Ihlas Finans.**

**19 February:** During the period prior to the payment of the cumulative internal debts, political tension and subsequent statements caused panic in the markets and this resulted in a crisis. Due to the dense domestic trading in foreign exchange, 7.6 billion at the exchange value of the succeeding day was realized.

---

---

**20 February:** In order to maintain its foreign exchange rate policy, the Central Bank lessened the liquidity. Owing to the hard up of the liquidity in the Turkish Liras, the portion amounting to US\$ 7.6 billion in total had been annulled and the quota proportion had simply heightened to 2.300 percent in the Interbank Monetary Market.

**21 February:** As a result of the continuation the demands for the foreign exchange, the Central Bank made a foreign exchange sale amounting to US\$ 3.5 billion. Some Banks having the higher short termed financing needs have confronted with the difficulty to meet their obligations.

**22 February:** The crisis has reached up to the dimensions threatening the functioning of the Banking system. Aiming to prevent the additional burdens to be brought in consequence of these developments on the economic structure, the value of the Turkish Lira before the foreign monetary units is decided to transform into a “floating” order.

**23 February:** Standard & Poor’s decreased Turkey’s credit rating from “B(+)” to “B” for long term loans and from ”B” to “C” for short-term loans.

**28 February:** Ulusalbank was transferred to the Savings Deposit Insurance Fund.

**2 March:** Changes were made in economy management; a new Minister for Economy and a new Central Bank Governor were appointed.

**15 March:** Iktisatbank was transferred to the Savings Deposit Insurance Fund.

**3 May:** A new Letter of Intent was signed with the International Monetary Fund and declared to the public.

---

Source: Central Bank of Turkey, *Annual Report* for the years 2000 and 2001 (with some deletions and additions to focus on the events of interest leading to the banking crisis and beyond).