An Evaluation of Special Finance Houses:
A Case Study on Turkey

Savas Alpay[*]

Turkey presents an interesting combination of interest-based economy and interest-free sytem since 1985. As interest-based economy is the norm in almost all countries around the world, the experiences of Turkey will be very useful for countries considering to make transition towards interest-free system. In today's world, it is clear that no country will endeavour to change their economic system from interest-based to interest-free abruptly. Such a change, if any, will be done in several stages, which would include the operation of both systems simultaneously for a certain period of time. Therefore, it will be very useful to understand and examine the current economic system in Turkey from this perspective.

1. Introduction

The Turkish banking system has three main players: Commercial Banks (private and state-owned), Investment Banks, and Special Finance Houses. Special finance houses (SFH), the name given to financial institutions based on interest-free principles, started to operate in Turkey in 1983 after a government decree allowing their operations. In 1984, Al-Baraka Turk and Faisal Finance House were established. Kuveyt-Turk Finance House was the third institution operating in this sector. These three SFHs were established with large foreign capital, and the first SFH with 100% domestic capital, Anadolu Finance House was established in 1991. In 2000, the Faisal Finance House has been purchased by a large Turkish company, Ulker, and has been renamed as Family Finance House. Today, there are 5 special finance houses operating on the interest-free principles, which is widely known as profit-loss sharing in the general public. The general motivation for the foundation of such institutions is to attract the funds from people, who do not want to deal with interest-based financial institutions for religious reasons. Today, it is clearly observed that these institutions are attracting funds not only from those people but also from others, and their overall performance as compared to other financial institutions is conspicuous.

Under the 1983 government decree, the status of the SFHs were different from those of the conventional banks, and this caused some competitive disadvantages for them. With the entry of fully-domestic-owned special finance houses into the market, the complaints regarding the weaknesses in legal structure, became more

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[*] Department of Economics, TOBB Economy and Technology University, Ankara, Turkey, E-mail: salpay@etu.edu.tr, salpay@tapdk.gov.tr

pronounced. As a result, in 1999, special finance houses became subject to the new Banking Act. After a revision in this act in 2001, the competitive position of the SFHs has been improved in terms of the legal infrastructure. In 2001, the Association of Special Finance Houses has been established, and the legal status of these institutions has been strengthened with the passage of the enabling legislation from the Parliament.

In Turkey, the overall volume of the banking sector is very low, and is less than what it should be as compared to similar countries in the developed world. There are different reasons for this. Firstly, the propensity to save of the Turkish people is not high and this results in a very low savings pool. Moreover, the share of the funds directed to financial sector from this savings pool is also low. It is estimated that the share of deposits is around 14 % in the total savings. This share is less than those of the foreign exchange holdings, gold and real estate. There are different reasons why the share of deposits and so the size of the banking sector is low in Turkey. After 1990s, succesive big budget deficits accumulated a very high public debt. Financing of this debt through government bonds resulted in very high real interest rates, which exceeded 50 % in some years. Such high real interest rates on government bonds naturally attracted the funds in the national savings pool, and thus caused a significant decline in deposits at the banking sector. Recently the real interest rates have been decreased to around 10 %, and so, the government bonds' alternative role against deposits is changing.

Another important reason for the low volume of the banking sector, is the chronic inflation problem since 1970s. Turkey experienced a very long inflationary period, and inflation rate was stubbornly above 40 % for a very long period of time (sometimes more than 100 % inflation rate was observed with an average of 77 % for the 1990s). Turkish people reacted to these inflationary periods by moving away from the domestic currency and holding their savings mostly in foreign currency or gold. Recently, after a successful and stable economic policy, this trend is also changing surprisingly very rapidly. At the moment, the inflation rate is below 10 % for the first time in the past 40 years. The confidence to domestic currency is being recovered, and there is a rapid transfer back from foreign exchange holdings to Turkish Lira.[1] These positive changes are also expected to result in an increase in the volume and the size of the banking sector, both for conventional banks and the special finance houses.

In this paper, we will analyze the performance of the special finance houses in Turkey in the last 20 years, both in the times of economic crisis and normal times. This will increase our understanding of the problems faced by these institutions, their performance as compared to other financial institutions, and their contribution

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[1] A successful domestic currency transformation has been realized in 2005 and new Turkish Lira is introduced into the market. In 2005 both the new and the old currency will be in circulation, and starting in 2006, only the new currency will be allowed in circulation.

to the financial and real sectors of the economy. The interest-free and interest-based financial systems are, to some extent, alternative systems to each other. In the long run, the one with better performance will be the dominant system. At this time, the size of interest-free system in the overall financial sector is very little. This is not surprising as it has been introduced in a systematic manner in the usual financial environment only very recently. Countries like Turkey present an experimental environment where both alternatives coexist, and where people make their choices on where to hold their savings. Thus, the Turkish experience will be very useful in identifying the advantages and disadvantages of the interest-free system in order to make its survival and expansion more likely.

2. Operations of Special Finance Houses

The operations of special finance houses are based on interest-free system. Transactions based on interest in the conventional banks are usually performed by profit-loss sharing principle. One can group different operations of the SFHs into corporate services and retail services. We briefly summarize each category in turn. In general, according to Islamic terminology, *muḍārabah*, *murābaḥah* and mushārakah are the main forms of the operations; however, we will here mention the very own terminology used by the special finance houses operating in Turkey.

2.1 Corporate Services

1) *Leasing*: Fixed assets, which are subject to depreciation, can be leased to investors on the condition that the ownership of the leased belongs to the lessor according to Turkish financial leasing law. Minimum period for financial leasing is 48 months except for computers and some other specified consumer goods, which may be leased for the period of two years. At the end of the leasing period, the leased equipment is transferred to the lessee at a price stipulated in the agreement. Leasing is more commonly used in the SFHs as compared to conventional banks.

2) *Financial Support for Production*: Businesses and manufactureres continuously need raw materials, semi-products, final products, machinery and other equipments to maintain production. Special finance houses provide support to its corporate customers, and purchase any goods in advance, and resale it to the customers on Instalment basis. After delivery of the requested goods, customer businesses become indebted to the SFHs according to a previously agreed price, profit rate and payment term.

3) *Profit and Loss Sharing Funds*: This is a special type of funding provided for customer businesses, which need to be financed to realize their short term projects. This kind of transactions starts with signing a contract between the SFHs and the customer businesses, and this contract is based critically on the feasibility of the project, and it mentions the agreed rates of profit and loss between the parties. At the end of the project, generated profit is distributed between the parties with the rate stipulated in the agreement, and the project is concluded.

Other most commonly used operations are mainly related to the international trade. The SFHs provide services such as letters of guarantee and counter-guarantees, avalization, foreign remittance (outgoing and incoming money transfers), letter of credits, export and import services.

2.2 Retail Services

In this group, different types of consumer financing transactions are offered to individual customers. In essence, with this service, special finance houses purchase goods in advance and, after adding a certain profit margin, sell them to their customers on payment by Instalment. These transactions are performed according to principles of interest-free banking and obviously, no cash credit is given.

In general, the SFHs are financing final consumer goods such as residence, automobile, long-lasting consumption goods, computer, office equipment, house equipment, second-hand cars and commercial vehicles, etc., within the principles of interest-free banking and with favourable rates. Usually, customers are presented with a payment calendar of 36 months in every product except residence financing, which can go up to 60-month Instalments. The payment currency can be chosen as Turkish Lira, US Dollars or Euro for the transaction periods up to 36 months. For longer term financing, only foreign currencies such as USD or Euro are used.

In real estate financing, customers are usually required to make a % 25-advance payment, and the SFHs finance only 75 % of real estate's value. In real estate financing, initially the sellers transfer the residence to the SFHs, and after adding a certain profit, it is sold to customer. Special finance houses keep the residence under mortgage until the total debt is cleared by the customer. All expenses and taxes generated by this operation are borne by the customer.

3. Performance of Special Finance Houses During the Economic Crisis

In different parts of the world, financial institutions operating on the interest-free principles have shown their strength and reliability. Instead of using conventional interest-based system due to religious preferences or other reasons, these instituitons operate on essentially the profit-loss share system. They have been on the market for a reasonable period of time enough for testing their stability and long-run survival. The past experience reveals that such financial institutions exhibit a success story; in fact, a story which demonstrates a better performance as compared to conventional banks despite their inferior legal status in some cases. Furthermore, the performance of these institutions in the economic crisis periods are much better than those of the conventional banks as seen in various real life experiences. During the 1997 East Asia crisis, many banks went bankrupt in the region, whereas majority of the institutions working on the interest-free principles managed to survive the crisis. Similarly, in 2000 and 2001 economic crisis in Turkey, the operations of more than 20 banks were terminated; due to state

warranty on the deposits at banks, these banks were transferred to Savings Deposits Insurance Fund, with a considerable increase in the amount of public debt. In the same period, special finance houses managed to survive even though they experienced a considerable amount of withdrawals (sometimes as high as 50 %).[2] It should be noted that the legal environment was such that all deposits in the conventional banks were under state warranty whereas the deposits at the special finance houses were not under any warranty.[3] So even under a legal environment disfavouring special finance houses, they showed superior performance. Now, we can explore the reasons for the superior performance of the SFHs.

As the SFHs operate with the interest-free instruments, they avoid the interest risk during the economic crisis. As a principle, most of the funds of the SFHs are used to finance the real sector of the economy. The loans, for example, are not given directly to the firms, but are paid to the suppliers from which the firms are buying machines, raw materials etc. Thus, the use of the loans in speculative, short term, risky investments instead of their intended areas, are automatically not permitted. Indeed, most of the default loans of the conventional banks have been resulted from the ones which were used outside the areas stated in the application process, and in the speculative and short term investments. Banks do not control (and do not want to control) where their loans will be used. On the contrary, the process of distribution of funds as loans to individual firms in the SFHs guarantees that the loans are directed to their actual investment projects.

A second important source of failure especially in the developing countries is the exchange rate risk. Conventional banks used to borrow from abroad in foreign currency, and then converted them into domestic currency, which were then utilized in purchasing government bonds. This was a very famous way of operation in the late 1990s. Such a practise costed a lot to banks during the economic crisis of 2000 and 2001 in Turkey. A very high devaluation experienced during the crisis played a big role in the bankruptcy of many banks, which ultimately resulted in big increases in the government debt. Essentially by failing to control such risky transactions in the first place, the government had a big responsibility in huge increases in public debt after the bank failures. On the other hand, the SFHs were also immune to exchange rate risk. The operating principles of the SFHs do not permit the conversion of foreign exchange deposits into domestic currency loans.

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[2] The reason for those withdrawals cannot be attributed only to the economic crisis; it was partially due to the mismanagement of one of the domestically owned special finance house. This institution used the deposits in financing the other companies of the same group and thus, control principles of the profit-loss share system have not been incorporated into the channelling of the funds to the right direction. Instead, almost all deposits were given as loans to and by the same people.

[3] This warranty scheme has been changed starting in July 2004. Now, the state warranty to deposits in conventional banks is limited and for deposits at special finance houses are insured by a fund collected under a recent organization established by the name of Association of Special Finance Houses.

Foreign exchange holdings can only be used as foreign exchange in whatever operation the SFHs choose to use. Thus, during the crisis the SFHs were not affected from high devaluation of the domestic currency as their assets and liabilities in foreign exchange matched each other.

A further superiority of the SFHs stems from the harmony in the maturity of the assets and liabilities. In general short term deposits have been used in the short term loans. Therefore, the liquidity risk was also not a big concern for the SFHs. Long term loan demands have been accommodated through the leasing option. Such an approach is in harmony with the credit techniques, and it not only proves useful for the SFHs but also for the firms which can pay their instalments with the cash flows from their financed operations. Thus, special finance houses in Turkey operated in a framework in which they avoided interest, liquidity and exchange rate risks, which made them more resistant to economic crisis as compared to conventional banks; the SFHs were only subject to standard market and credit risks.

The superior performance of the SFHs during the economic crisis in Turkey indicates that their existence should be supported and strengthened. Nevertheless, the present legal infrastructure puts them in an uncompetitive position as compared to conventional banks. As mentioned above, the deposits at the SFHs are not under state warranty whereas the deposits at the banks were fully insured by the state until very recently. Because of this, the share of deposits at the SFHs has only reached to 2.6 % in 20 years. This performance could be much better if they were also taken under state warranty. There is not a convincing reason for their exclusion from the state warranty. After very recent legal changes, now this ungrounded discrimination has been partially resolved with the enactment of laws which limit the state warranty for the deposits at the conventional banks and which require deposit warranty at the SFHs through the Association of Special Finance Houses. However, this does not change the discriminative situation very much. Firstly, the limitation on the state warranty for deposits at conventional banks only puts upper limit for an individual's deposit at a specific bank; by opening up accounts at different banks one can still accommodate a 'full' state warranty on the personal savings. The limitation should have been based on individuals and not on the banks. Secondly, the Association of Special Finance Houses is financed by the individual SFHs. Thus, legally required contributions for the warranty fund from each SFH generate an additional burden for them, and essentially force them to finance the loss of their competitors had they gone bankrupt. Naturally, such a warranty scheme brings confidence to their operations, but still in the eyes of the public, the state warranty is much stronger. Therefore, the warranty problem continues to persist in a different dimension.

Another disadvantage for special finance houses lies in the non-existence of short-term assets and thus, short term investment for them is very limited. Conventional banks may purchase government bonds and thus, can use their short

term funds in a profitable way. The SFHs choose not to invest in government bonds as their operations are based on interest-free system. Thus, it will be very important to introduce *şukūk* bonds[4] not only for the SFHs but also for the government as they will constitute an alternative to the costly government bonds. This may also attract new funds from especially the Gulf region. Since 2004, works on legal infrastructure are being undertaken by the Treasury Department but they are not finalized yet.

4. Comparative Performance of Special Finance Houses against Conventional Banks

Previous studies on the empirical investigation of the financial institutions operating on the interest-free principles are very limited. The existing ones are mostly descriptive, and focus on the simple financial ratios. A few studies have undertaken a comparative analyses and explored the performance of the conventional banks and banks based on interest-free system. Among these, one can mention Samad (1999), Iqbal (2001) and El-Gamal and Inanoglu (2002) and (2004). Iqbal (2001) analyzed a sample of 12 interest-free banks and 12 conventional banks from 10 different countries for the period 1990-1998. His findings suggest that interest-free banks are not necessarily inefficient in their operations. El-Gamal and Inanoglu (2002) present almost the most rigorous econometric study in this literature. Furthermore, their empirical study is based on the Turkish financial sector. We will briefly summarize the methodology and the findings of their papers here due to their pertinence to our subject.

El-Gamal and Inanoglu (2004) aim to analyze the dual banking system in Turkey, and investigate the relative efficiency position of special finance houses for the period 1990-2000.

This study is very much related to their earlier work El-Gamal and Inanoglu (2002). In this earlier study, they make use of a fully parametric stochastic frontier analysis in order to utilize the likelihood-based EC-estimator[5] of El-Gamal and Grether (1995) for modelling unknown heterogeneity in bank types and ownership structures especially important in Turkish banking sector. The separation of heterogeneity effects from efficiency has been shown to be important by many studies on U.S. and European banking (for example, Elysiani and Rezvanian (2002) and Altunbas et al. (2001)). El-Gamal and Inanoglu (2002) examine the heterogeneity in the banking industry and then study the relative efficiencies in the sector.

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[4] Recent introductions of so-called Islamic bonds in the form of *ijāra şukūk* and *salam şukūk* in Malaysia and Bahrain suggest that banks based-on interest-free system in other countries may soon have access to bond-like securities that would allow them to have the asset-composition similar to conventional banks, in particular with respect to short term investment options.
[5] EC stands for estimation–classification.

The data set is a a panel data set that includes most of the institutions operating in the Turkish banking sector. Their data includes all banks that were in operation throughout the 1990s. Of the 49 conventional banks in the sample 13 were foreign banks (or branches of foreign banks), 23 were domestically owned, 4 were state-owned, and 9 were failed private banks that were transferred to Savings Deposits Insurance Fund (SDIF). This sample comprised of more than 93% of total assets of the conventional banking system. On the other hand, their data set includes 4 special finance houses (SFHs); these four special finance houses accounted for more than 90% of the total assets of all special finance houses in Turkey during the sample period.

Firstly, El-Gamal and Inanoglu (2002) undertake a stochastic frontier analysis of Turkish banking sector for the period 1990-2000. This analysis comprises estimation of a best-practice frontier, and comparison of the individual banks or SFHs with that frontier. They assume that each firm in the sample wants to maximize output (proxied by loans) for any given level of inputs, ignoring the multiproduct structure of the banks. This assumption is also necessiated by the fact that the SFHs in their sample issue virtually no securities during their sample period. Additionally, as SFHs did not distinguish between short and long term loans, they were urged to use aggregated loans as the single output of the banks in the sample. Using the duality, instead of analyzing the profit maximization process they focus on the cost minimization for any given level of output, and represent the production technology of firms by a dual cost function, which is associated with the minimum expenditure needed to produce a given output with given input prices. In such an approach, bank (or SFH) inefficiency is measured by the difference between each bank's (SFH's) realized costs of production, and the theoretical minimum at the estimated frontier. The cost frontier is obtained by estimating a total cost function, which is assumed to be the sum of interest expense, employee and fixed assets expenses. The estimated cost function also allows for differences in quality and risk factors. By making use of the El-Gamal and Grether (1995) estimation-classification procedure and a translog cost function specification, they obtained an endogenous (data-driven) classification of Turkish banks into two groups (heteregoneity part).[6] After these estimations, domestic banks including the SFHs are grouped together, and small and foreign banks (with two exceptions) are grouped together for further analysis. For each group inefficiency scores are computed separately. In the first group, the SFHs claimed the top ranks among 40 institutions. Faisal Finance House (now operating as Family Finance House) ranked 1st, Al-Baraka ranked 2nd, Kuveyt-Turk ranked 6th and Anadolu Finance House ranked 8th. When averages of inefficiency scores for

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[6] They find no evidence of heterogeneity between special finance houses and conventional banks. Homogeneity tests were rejected along the small vs. large and foreign vs. domestic dimensions. However, as foreign banks were mostly small, these two results are combined into small-and-foreign vs. domestic.

different types of banks are taken, the SFHs ranked first as compared all other types, including State Banks, Private Banks, Banks transferred to Savings Deposits Insurance Fund (SDIF), and all conventional banks as shown in figure 1.

Given these interesting results of El-Gamal and Inanoglu (2002), El-Gamal and Inanoglu (2004) provide some insights into these findings through some of the familiar financial ratios. The financial ratios used in their analysis include capital adequacy ratio (the ratio of equity capital to total assets), asset quality (the ratio of total loans to total assets), loan quality (the ratio of nonperforming loans to total loans), management-efficiency (the ratio of employee expenses to total assets), earnings performance (the ratio of net income to total assets) and liquidity ratio (the ratio of liquid assets to total assets).

With respect to capital adequacy ratio, SFHs have been less capitalized as compared to both domestic and foreign conventional banks during the 1990s; however, the capital adequacy ratios of the SFHs have been on the rise since 1995, and in 2000 it has been higher than those of the conventional banks. As regards to loans-to-assets ratio, which is an indicator of asset quality, the performance of the SFHs is notably different from the conventional banks both domestic and foreign-owned. Over the 1990s, the average loans-to-assets ratio of the SFHs was as high as 70%, whereas the averages were 40% and 30% for domestic and foreign conventional banks, respectively. This difference is highly associated with the willingness to invest of conventional banks in high-interest-paying government bonds, and the avoidance of investing in such bonds by the SFHs as an operating principle. The reflection of such behavioural differences on the post-crisis outcomes should also be noted. A very related ratio is the loan quality ratio, which indicates the extent of default credits. There is a rising trend in the ratio of nonperforming loans to total loans (NPL/TL) for the SFHs especially after 1994 mini cirisis with a maximum of 12% in 2000. In this respect, the performance of domestic conventional banks seem similar to that of the SFHs.

With respect to management-efficiency, measured by the ratio of employee expenses to total assets, a converging trend is observed between conventional banks and the SFHs; this ratio declines for conventional banks, and increases for SFHs during 1990s. Nevertheless, this comparison may not be done on healthy grounds as the period under investigation coincides with the early stages of openning-up of the SFHs; in fact, two new SFHs have openned up during the period under consideration. Finally, the earnings performance of the domestic conventional banks fluctuates around 2% and becomes negative after 1999. Foreign conventional banks and SFHs managed to sustain profitability during the entire period, with foreign banks being the most profitable in the sector.

El-Gamal and Inanoglu (2004) investigate the performance of the SFHs between 1990 and 2000. We will now update their analysis on financial ratios for the period 1999-2004. This period is especially important as two very important economic crisis hit Turkey in 2000 and 2001. This extension is very useful for both

the individual and the comparative performance of the SFHs during the economic crisis. In the appendix, table 2 presents the new values of the financial ratios mentioned above for 1999-2004, and figures 2 to 5 present the graphical representation of the same values.

It is clearly observed that the capital adequacy ratio of both the conventional banks and the SFHs are rising in the entire period, and reaching to around 14% for the banks and 12% for the SFHs (figure 2). These increases are mainly due to the provisions of the new Turkish Banking Act, which made the regulations in this sector stronger, and urged increases in the equity capital. Furthermore banks experiencing problems in this dimension are transferred to the State Deposit Insurance Fund (SDIF), and the SDIF improved their conditions through mergers and significant capital injections by the state. The rising trend in the capital adequacy ratio of the SFHs continued during, before and after the crisis. In regards to asset quality, the performance of the SFHs continues to be better than that of the conventional banks. After a decline in the ratio of total loans-to-total assets in 2001, this ratio increased steadily until 2004 and reached to more than 80% for the SFHs and around 40% for the conventional banks, respectively (figure 3). Both special finance houses and conventional banks have higher asset quality for the period 2000-2004 as compared to 1990-2000.

With respect to loan quality, the SFHs and the conventional banks show similar trends. In 2001, due to a large increase in the amount of non-performing loans during the crisis, there is a big deterioration in the loan quality for both special finance houses and the banks (the ratio of non-performing loans to total loans reached to more than 20 % in 2001); however, after 2001, a continous improvement is being observed in this dimension and in 2004 the share of non-performing loans in total loans falls below 5 % for both institutions (figure 4). Finally, we compare the earnings performance. As shown in figure 5, conventional banks' profits were negative before and during the crisis. This can be associated with the mismanagement of the 20 banks, transferred to the State Deposit Insurance Fund during the same period. After the enactment of the new Banking Law and structural transformation in this sector, banks have recovered and their profitability increased. In 2004, the ratio of net earnings to total assets was 2 %, slightly above that of the SFHs. Special finance houses managed to generate positive profits during the entire period with the exception of 2001.

5. Conclusions

As of the end of 2004, the total amount of deposits at the conventional banks is 191 billion new Turkish lira. Only 52 percent of all these deposits is transferred to the real sector as credits. In the same year, the total amount of deposits at the special finance houses is 6 billion new Turkish lira, and 82 percent of these deposits is given as credits to the real sector. Although the share of special finance houses in overall deposits is 3 percent, their share in overall credits transferred into

the real sector is 5.7 percent. This kind of differences in the share of deposits and the share of credits between special finance houses and conventional banks is visible during almost entire existence of the SFHs in Turkey. This little piece of information clearly indicates that special finance houses are doing a better job with respect to what one expects from financial institutions in general; that is to say, they are performing better than banks in terms of financing the real sector of the economy, which is especially very critical for developing countries.

From another perspective, it is a common fact that most of the conventional banks are transferring a significant portion of their deposits into government bonds. In Turkey, as in many other developing countries, public debt is very high, and thus, most of the savings are directed towards government bonds, which offer real returns sometimes as high as 40 percent. The presence of the 'risk-free' and high returns on government bonds jeopardizes the amount of credits that could be directed towards the real sector, and this affects the real sector adversely, which in turn lowers the rate of economic growth, and starts a vicious cycle. The special finance houses, as a principle, do not invest in government bonds; their operations are directed towards the real sector, and thus, they make very important contributions to the economic growth of the country.

Another interesting experience is related to the comparative performance of the financial institutions in the times of economic crisis. Turkey experienced two consecutive economic crisis in November 2000 and February 2001. More than 20 private banks were in terrible conditions, and they had to be transferred to Savings Deposits Insurance Fund. Because of full state warranty on deposits in private banks, these transfers increased the public debt by around 50 billion US dollars. There were no bankruptcies in the special finance houses during the crisis, and they were able to survive despite the withdrawal of around 50 percent of their deposits. There is no state warranty on the deposits at the special finance houses. Thus, the performance of special finance houses was much better than those of the conventional banks during the times of economic crisis, at least because of the debt burden resulted from the mismanagement of banks. Currently, the government has abolished unlimited state warranty on deposits at the private banks, and limited it to a reasonable number; at the same time, new legislations require the special finance houses to insure their deposits through the Association of Special Finance Houses, which was established in 2001. The introduction of "Deposit Insurance Fund for SFHs," guarantees the deposits at the SFHs in a manner similar to deposits at conventional banks; however, this fund was to be directly managed by Association of Special Finance Houses, whereas conventional deposit insurance fund is managed by the state. These provisions allowed SFHs to give more confidence to their depositors, and thus, competitive disadvantage of the SFHs with respect to conventional banks was resolved to some extent.

Although there were big withdrawals from the financial sector in 2001 during the economic crisis, starting from 2002, special finance houses were able to

increase their equity capital, deposits, assets and credits considerably. Between 2002 and 2004, the average rate of increase in each of these values was more than 50 percent (see table 1 in the appendix). Net earnings of the SFHs also demonstrated notable increases in the same period. The mentioned increases in these important indicators were significantly more than those of the conventional banks. Therefore one can make an evidence-based claim that post-crisis performance of special finance houses is superior as compared to conventional banks in Turkey.

These observations are strengthened by a recent rigorous econometric study by El-Gamal and Inanoglu (2002). This paper analyzed the cost and labour efficiencies of foreign and domestic conventional banks and special finance houses during the 1990s. They show that special finance houses are no less efficient than their conventional counterparts; in fact, they found that the SFHs are more cost-efficient (measured in terms of credit extension) when controlling for size of operations. Their results were obtained based on a Turkish banking panel dataset, thus controlling for macroeconomic and other factors affecting the performance of all banks. The labour efficiency results for SFHs suggest that they are also more efficient in terms of their hiring practices; this study also shows that the SFHs are similar to foreign banks and different from domestic banks in this respect. This result is not surprising as both SFHs and foreign banks shared the characteristic of having small numbers of branches and employees relative to domestic banks. In conclusion, they state that to the extent the SFHs "draw customers away from the conventional sector, the current results suggest that their presence does not reduce overall banking efficiency. To the extent that they may also bring into the financial system individuals who had chosen not to deal with conventional banks, they may in fact serve a positive role, by increasing financial intermediation. Thus, the current policy allowing for the continued growth of this sector appears to be sound."

One other important contribution of the SFHs is that they help increase the size and the volume of the Turkish banking sector, which is a significant obstacle in front of economic growth. Turkish people keep a considerable part of their savings either in gold or in foreign currency due to periods of high inflation for a long time.[7] The unwillingness of some part of population to put their money into banks due to their avoidance of interest-based transactions also increases the desire to hold money in gold or foreign currency forms and outside the banking sector. Special finance houses are helping to overturn this tendency, and the amount of money being injected into the financial sector is increasing. The difficulty in increasing the size of the financial sector is one of the critical issues in most of the developing countries, and it seems that the special finance houses are contributing towards the solution of this problem. This contribution will be especially higher in

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[7] Foreign currency holdings are not always put in the banks, and a considerable portion of these savings in foreign currency is held outside the banking sector.

Muslim countries, as interest-based transactions are not desirable for a good number of their citizens.

A recent study by Uyan (2004), summarizing the present position of the SFHs and presenting future projections, indicates that there is high growth potential for the SFHs in Turkey. It is estimated that in 2005, the assets of the SFHs will be 6.2 billion US dollars with a market share of 3 percent in the overall assets of the banking sector. The projections indicate that this value will reach to 26 billion US dollars in 2014, with a market share of 10 percent. The average rate of increase in total assets of the SFHs is estimated to be 17 percent annually. As the share of the SFHs increases in the banking sector, our analysis indicates that this will effect the Turkish economy positively.

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APPENDIX

Table 1: Growth of selected variables (assets and liabilities)

		Percent Changes (%)					
		1999	2000	2001	2002	2003	2004
Total Credits	Banks	52	60	19	29	35	50
	SFHs	103	37	-38	96	49	55
Default Loans (On follow-up)	Banks	57	65	347	-43	-74	-29
	SFHs	127	136	368	9	-49	-10
Total Assets	Banks	96	44	67	23	17	23
	SFHs	96	35	4	68	33	39
Total Deposits	Banks	99	36	87	25	13	23
	SFHs	107	31	3	67	28	46
Total Equity Capital	Banks	29	70	154	40	38	30
	SFHs	79	58	26	97	68	35
Total Earnings	Banks	-140	-930	-234	127	95	13
	SFHs	18	-19	-308	170	326	54

Table 2: Selected financial ratios

		1999	2000	2001	2002	2003	2004
Capital Adequacy	Banks	0.059	0.069	0.106	0.121	0.142	0.150
	SFHs	0.061	0.071	0.086	0.101	0.128	0.124
Asset Quality	Banks	0.276	0.306	0.219	0.230	0.265	0.324
	SFHs	0.887	0.926	0.559	0.655	0.763	0.817
Loan Quality	Banks	0.044	0.046	0.172	0.076	0.015	0.007
	SFHs	0.016	0.028	0.209	0.116	0.040	0.015
Earnings Performance	Banks	-0.004	-0.030	-0.061	0.014	0.022	0.021
	SFHs	0.009	0.005	-0.010	0.004	0.014	0.013

Figure 1: Efficiency Scores for different types of financial institutions.
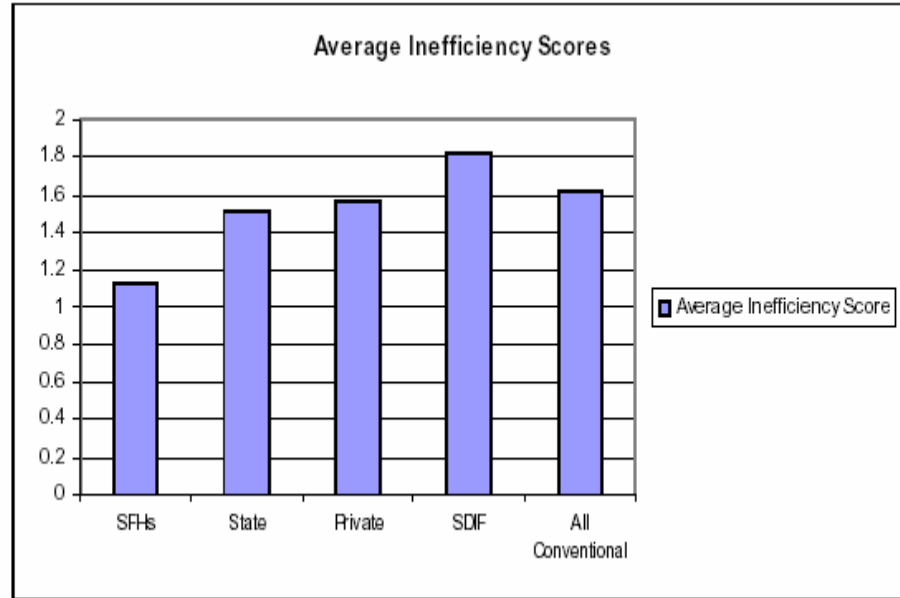
Source: El-Gamal and Inanoglu (2004).

Figure 2: Capital Adequacy Ratio (Equity Capital / Total Assets) 1999-2004.
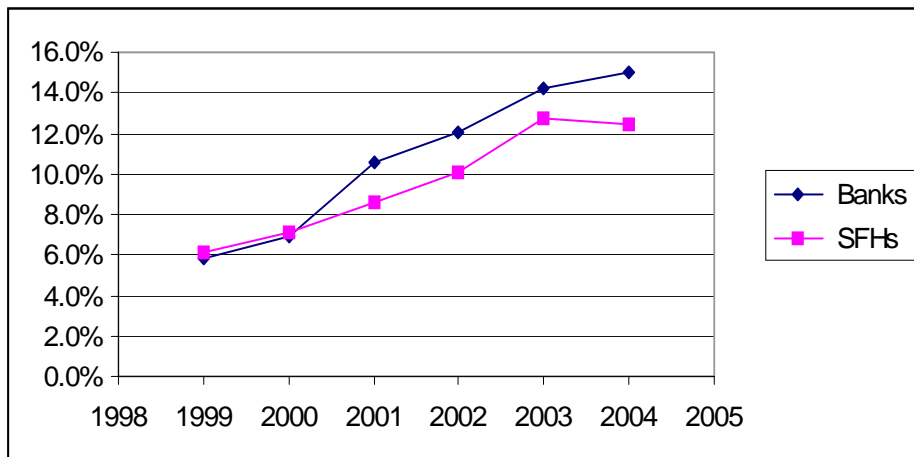
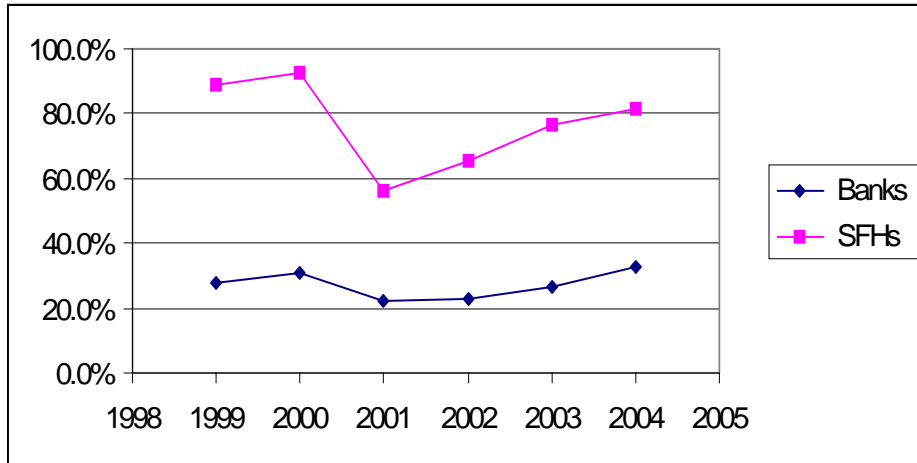*Figure 3: Asset Quality Ratio (Total Loans / Total Assets) 1999-2004.*

Figure 4: Loan Quality Ratio (Nonperforming Loans / Total Loans) 1999-2004.
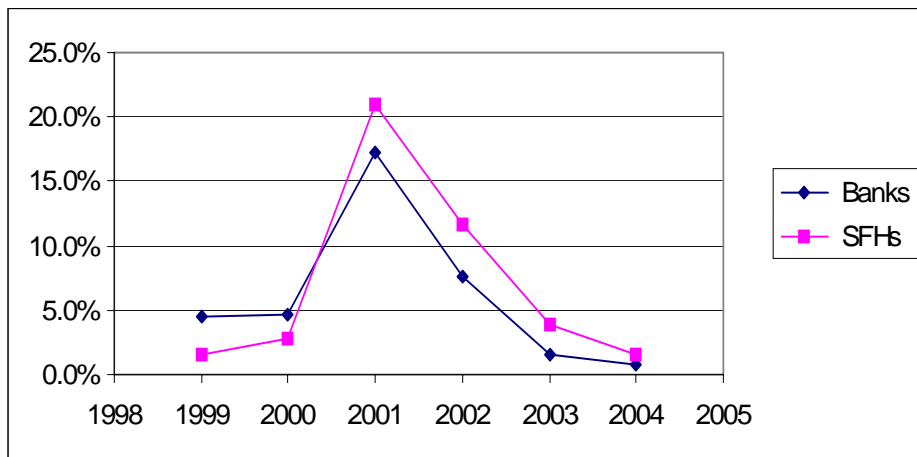
Savas Alpay

Figure 5: Earnings Performance (Net Income / Total Assets) 1999-2004.