

Analysis of Participation Banks in Turkey in Terms of Agency Theory and a Model Proposal

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Abstract

The agency theory considers the problems between agents and principal and aims to reduce the agency costs arising from these problems. The theory could be applied in various fields and in many different areas where principal-agent relations occur. Participation banks in Turkey operating banking services based on Islamic principals are able to implement many different banking facilities. They could be regarded as supplementary alternatives to the conventional banks and thus, participation banks provide depth and financial product range in the banking sector. There are many different studies on several fields and subjects about participation banks and Islamic banks both in national and in international literature. However, the studies discussing the fatwa structure in the context of agency theory are very rare especially for the participation banks in Turkey. Thus, this study examines the Shariah advisory board mechanism of the participation banks in particular within the scope of agency problems and it focuses on a model proposal that could resolve agency cost. In Turkey, there is not a nationwide nor a Shariah agency or institution which control, regulate and/or supervise the services, operations, and activities of the participation banks, in accordance with Islamic concepts. In this context, the establishment of an independent Islamic Supervisory Council will help to reduce agency costs. Furthermore, sustainability and stability of Islamic financial markets will increase together with issuing appropriate financial products in compliance with Shariah principles and thus the Council will help Istanbul to achieve the goal of being the financial center.

Keywords: Participation Banks, Interest-Free Banking, Agency Theory

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Introduction: Agency Theory

Today, gradually increasing the separation of management, firm ownership and capital ownership from each other in the companies and especially in such firms whose stocks are traded publicly requires the delegation and transfer of the authority in order to enable to execute the activities for the firms' goals (Fama and Jensen, 1983). On the other hand, transferring the authority bring about agency problems.

Proxy or agency theory is regarded as a new application of considering self-interested behavior policy which is one of the basic principles of financial management. According to the self-interest principle, individuals behave for considering their own financial interests. The decision made by individuals while they behave in the most advantageous way eliminates the possibility of other alternatives' applications. The situation that is called as the opportunity cost is the difference between the value of the selected choice and the value of the best alternative one. Therefore, the opportunity cost is an indicator of the relative importance of the decisions taken.

Jensen and Meckling's study named as "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure" is regarded as one of the most important milestones for the origin and development of agency theory in literature. Agency problem is defined as a situation where the activities are not fully controlled by the agent or the control process is so costly when the contracting party employs an agent for execution of the business activities (Jensen and Meckling, 1976). "The Economic Theory of Agency: The Principal's Problem" article by Ross in 1973 is also considered to be one of the cornerstones of the theory which tries to explain mutual relationships of principals and agents in essentially all types of contractual engagements.

Agency theory is a generally accepted paradigm with the potential to be applicable to many points of the social sphere. The basic concepts of principal-agent approach are developed and incorporated in different fields of the area such as economics, political science, and in other disciplines generally concerned with the topics of organization, motivation and information flow in the companies. Then the different approaches have been aggregated with that of agency theory (Mitnick, 2006). The theory has been applied in many fields of social sciences. For example, Cooper (1949, 1951) examined the agency concept under the theory of the firm subject in the

accounting literature. The study named as “An Economic Theory of Democracy” of Downs (1957) addressed the agent term in economics. Arrow (1963) mentioned the topics of agent and principles and transferring with the study of “Uncertainty and the welfare economics of medical care” in the health sector. In political sciences, Piktin (1967)’s study of “The concept of representation” and “Obligation and the Body Politic” written by Tussman (1960) made a mention of the principal and agent terms. Also in sociology, Swanson (1971) tried to explain the collective society by using these terms. In general, different disciplines have made significant contributions to the agency theory. Many scientists in various fields such as accounting, economics, finance, politics and sociology applied the theory (Eisenhardt, 1989).

The theory is related to the settle the conflict of interests between principals and agents. Agency theory also expressed as agency problem is defined as possessing different goals and work distribution of the actors who in fact should be in collaboration (Jensen and Meckling 1976). Basically, the principal-agent problem arises when one of the two actors in cooperation is appointed as an agent who conducts the activities on behalf of the counterparty with a given authorization to be able to make decisions that impact the another party called as principal. Examples related to agency relationships are widespread. Essentially, all arrangements based on contracts like samples of workers employers and the state citizens involve important agency problems (Ross, 1973).

The theory includes the effects of the factors that compose the sphere of the relations based on contractual engagements. These factors are uncertainty, different level of knowledge, preferences of the agents and principals regarding the topics of risks and efforts, capital intensity, concentration degree in firm’s assets, capital markets, characteristics of internal and external labor markets, compensation and warranty provider tools, and monitoring costs. These mentioned agency costs are categorized under three headlines; the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss (Jensen and Meckling, 1976). In other words, agency costs are the costs borne by the principal in order to prevent the agent’s own benefits while the agent is maintaining the principal’s activities.

To sum up, the problems caused by managers, shareholders, bondholders and other lenders from the interest groups of the company in order to fulfill their own priorities for the distribution of rights perceived in the form of cash flow are defined as agency problems. The costs to be incurred in order to reduce conflicts between interest groups are defined as agency costs.

The presence of at least two actors is sufficient for the realization of agency theory. If an individual with his actions affects the other, they come across the agency relationship. The person that carries out the action is expressed as an agent. On the other hand, the person that is affected by the work is called as principal. For example; manager of a corporation is in a position of principal for subordinates and the subordinates are agents. In other respects, the same manager of the corporation is an agent for the shareholders of the company and the shareholders are kept in a position of principal (Zeckhauser and Pratt, 1985). In this context, adviser or consultants who express opinions about Sharia-related subjects for Islamic financial institutions –participation banks in general- operating in Turkey are agents and the banks are principals. Especially in cases where the agent serves more than one principal, the agency problems gets bigger (Zeckhauser and Pratt, 1985). In Turkey, the problems deepen further since the fatwa (Islamic religious law) advisors serve for more than one participation banks.

Agency theory could be applied in the various field mainly issues mentioned above and in many different areas where principal-agent relations occur. There are many different studies on several fields and subjects about participation banks and Islamic banks both in national and in international literature. For example; studies of Metawa and Almosawi (1998); Iqbal (2001); Bünyamin and Uysal (2012); Esen and Karabacak (2014) and Gün, (2015) are only some of these. However, the studies discussing the fatwa structure in the context of agency theory are very rare especially for the participation banks in Turkey. Thus, this study examines the Sariah advisory board mechanism of the participation banks in particular within the scope of agency problems and it focuses on a model proposal that could resolve agency cost.

1. Participation Banks in Turkey

The establishment of participation banks in Turkey as representatives of Islamic institutions has fallen in the 1980s. In consequence of economic

stability resolutions, taking necessary actions started in order to enhance the export and foreign currency inflow, to keep inflation under control and to expand the economy abroad thus to be able to have a stronger economic structure. As a result of these decisions, activities has been put into force for Islamic banking in order to be able to attract the savings of investors specifically from Gulf countries who concern about interest-free.

Apart from economic necessities, discharging under-the-mattress savings of the individuals who wish to keep away from interest-bearing instruments affected the improvement of interest-free banks or, in other words, participation banks formerly named as special financial foundations in Turkey.

As of the beginning of 2016, five institutions [Albaraka Turk Participation Bank, Türkiye Finans Participation Bank, Kuveyt Turk Participation Bank, Ziraat Participation Bank and Bank Asya Participation Bank] have been operating in the sector. According to the data of Banking Regulation and Supervision Agency and Participation Banks Association of Turkey, the participation banks in total banking sector have shares of 6.27 percent in funds collected, 5.83 percent in funds allocated, 5.27 percent for total asset size, 4.27 percentage for equity size and 3.57 percentage for net profit on the average for the last three years. The figures are shown in Table 1 below in detail.

Table 1: Share of Participation Banks in Total Banking Sector

	Dec.2012	Dec.2013	Dec.2014	Nov.2015
1- Sum of Funds Collected	6.1	6.5	6.2	5.9
2- Sum of Funds Allocated	6.0	6.1	5.4	5.2
3- Total Assets Size	5.1	5.5	5.2	5.1
4- Equity Size	4.1	4.6	4.1	4.1
5- Net Profit	3.9	4.3	2.5	1.6

In the interest-free system, participation banks collect the savings of investors in compliance with the Islamic guidelines via time deposit and checking accounts. Then the banks allocate these funds with the methods such as profit-loss participation and leasing in accordance with profit-loss principals (Participation Banks Association of Turkey).

Participation banks that operating banking services based on Islamic principals are able to implement many different banking facilities. In this

regard, participation banks are alternative to the conventional banks. However, participation banks are not entitled to conduct the transactions based on the interest that other traditional banks can fulfill. Consequently, participation banks could be regarded as supplementary alternatives to the conventional banks and thus, participation banks provide depth and financial product range in the banking sector.

2. Fatwa Mechanism in the World

The most important difference between the participation and banks ruled on Islamic principles and other banks are that these banks are serving compatible with laws of the Islamic religion. In this context, sharia management performs compliance with the Shariah law of the activities. The Shariah governance is an internal mechanism that ensures and controls the operations of Islamic financial institutions in accordance with Islamic principles and rules. This distinguishing characteristic of Islamic financial institutions is extremely important for both processing the system compatible with Islamic principles and the credibility of these organizations in terms of public consent and opinion. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) set the management standards related to the subject. In Islamic financial institutions, the most crucial component of Shariah governance is the Shariah Board. Shariah boards could be established at a level of national, international or only at the level of Islamic Financial Institution. This function sometimes is fulfilled by outsourcing services of sharia consultancy companies.

On the other hand, it has been seen that various models are implemented in Islamic countries in terms of whether the Shariah matters are subject to an upper supervision or not. Although the models applied in different classifications, it can be generally divided into four groups. These models are a centralized model, a hybrid model, voluntary participation model and free model (Grassa, 2013).

The centralized type of Shariah model implemented in Malaysia, Indonesia, Brunei and Far East Asian countries is established under the central bank and the central advisory committee has absolute authority in matters of Shariah. In addition, each Islamic Financial Institution (IFI) has its own council and secretariat consisting of at least three members. In this system, a specialist who is a member of the central Shariah Board is not able

to be a member of Islamic Financial Institution. For example, in Malaysia, that is the pioneer of this model, Shari'ah Advisory Council is dependent on the Central Bank of Malaysia (Bank Negara Malaysia) and is the highest decision-making body on all matters of Islamic finance and Islamic insurance sector relating to Islamic law.

The other model is a hybrid model. This model is being applied in Pakistan. Shariah Board incorporated within State Bank of Pakistan set the rules and standards. In addition to this, at least, one supervisor should exist in every Islamic Financial Institution. The difference from the previous centralized model is that members in central advisory committee are also able to participate in Islamic Financial Institutions.

On the other hand, the voluntary participation model emerged spontaneously in the United Arab Emirates; the Shariah boards of Islamic financial institutions in the country have formed a joint national council which named as National Council of the Shari'a Supervisory Committees of Islamic Financial Institutions.

Lastly, there is commonly used type is a free model. In general, there is not a supreme board or audit council for the subject of activities compliance with Islamic principle in the majority of Islamic countries. Each Islamic financial institution creates its own Shariah advisory board voluntarily and manages the services and facilities freely.

Turkey is also within the scope of the countries applying this type of free model. Unlike other countries, these boards are generally named as "advisory board" and act unofficially.

As it is seen that, in many countries including Gulf and Western countries the free type of Shariah applications is widespread and Shariah advisory boards are not controlled by and dependent on any supreme supervision. Therefore, whether the advisory committees functioning effective as compatible with Shariah principles or not is entirely an internal matter of Islamic financial institutions themselves. Thus, the single sanction of not having a proper corporate management consistent with Islamic regulations is a just loss of reputation for the Islamic financial institutions.

3. Assessment of Participation Banks in Turkey

In Turkey, there is not an agency or institution which control, regulate and/or supervise the services, operations, and activities of the participation banks, stating that they operate in the interest-free financial sector in accordance with Islamic concepts, in terms of Islamic principles. There are banks and institutions claiming to function in accordance with Islamic principles thus, an inspection body in the Islamic perspective should check these organizations.

In an academic sense, many studies and research projects have been developed about this subject. Chapra and Ahmed (2002) and Hasan (2008) discussed in detail the importance of Islamic monitoring and rules in their studies about corporate governance in Islamic financial institutions. Additionally, they focused on the procurement of external audit services for the Islamic monitoring would be more accurate. Rammal (2006) mentioned the importance and necessity of these supervisory authorities and focused the application problems in his study “The importance of Shari’ah supervision in Islamic financial institutions”.

The workbook of Hameed and Mulyany (2007) entitled “*Shariah Audit for Islamic Financial Institutions (IFIs): Perceptions of Accounting Academicians, Audit Practitioners, and Shariah Scholars*” refers to the importance of audit committee and gives advice on Shariah issues. In connection with this, the study also highlights potential risks and sectoral problems that the institutions will face while operating based on Islamic principles.

The study of Rahman (2008) that analysis the Shariah audit for Islamic financial services and their needs and challenges is also a notable research in the area of Islamic finance in terms of Shariah principles. The book “Introduction to Fatwa, Shariah Supervision, and Governance in Islamic Finance” written by Laḥasāsīnah in 2010 is also one of the important research that investigates the motives of Islamic banking.

The doctoral dissertation thesis of Z. Hasan at Durham University in 2011 is also an important study about the financial management of Islamic systems. The thesis evaluates and investigates the scope of Shariah governance practices in Malaysia, Gulf Cooperation Council countries and the United Kingdom. The study analyzes the subject governance approaches,

regulatory frameworks, functions and attributes of Shariah councils. The research recommends and formulates considerable policy suggestions in order to reform current practices.

Islamic financial audit and/or monitoring institutions serve the financial system under different names such as Shariah advisory council, Shariah supervisory board, or Shariah supervisory committee. Besides, accounting and auditing organizations for Islamic financial institutions at the international level like “Accounting and Auditing Organizations for Islamic Financial Institutions” (AAOIFI) and “Islamic Financial Services Board” (IFSB) make invaluable contributions by publishing guidelines containing management standards and principles. In particular, Shariah advisory board of Bank Negara Malaysia regulates, validates and supervise all financial instruments to ensure the compatibility with Islamic principles. At the same time, the bank formulates, structures and integrates the leading Islamic strategies and policies. In the meantime, the court should also refer to the Shariah board for making decisions, in any case, relating to Islamic financial businesses.

As well as Turkey is implementing the Islamic banking for many years, unfortunately, a written regulation about Shariah advisory and Shariah management is not available. Moreover, there are not any uniform practices about Islamic businesses in Turkey. Shariah advisory and Shariah management practices in Turkey are carried out freely by participation banks. The banks themselves and the advisors only know the details of these operations and transactions. It is from time to time reflected in the press that there are not uniform applications for the same service among participation banks. For example, some participation banks advertised and opened credit lines in order to buy out military services to be exempt while the other participation banks did not approve this application in terms of compliance with Islamic principles.

The credibility of the advisors, especially these are Islamic jurists, giving Islamic consultancy services can seriously be debilitated in the case of conflicts of interest between the advisors and the banks because consultants are providing fee-based services as agents and the banks are in a position of principals since they employ the consultants in the present system. Thereby, a conflict of interest and consequently agency problem is inevitable. Therefore, switching from “free models” to the models that ensure

standardization and centralized control and monitor seem essential for enhancing of Islamic financial system.

On the other hand, it is considered that Turkey does not attract and receive sufficient share of international Islamic fund investments due to the lack of Islamic supervisory board or council in participation banks representatives of Interest-Free Banking sector in Turkey. Therefore, an independent organization or an institution that has no direct and wage-salary relationships with the Islamic financial institutions should be established in order to minimize or eliminate the costs arising from the principal-agent relationships.

In this respect, Islamic Fatwa Council or Islamic Supervisory Board should be established by the Turkish Republic. This council or board should be able and has the highest authority to provide binding recommendations on any Shariah issue relating to Islamic financial business, transactions, and products of participation banks as well as other related institutions. This entity is also should be able to set necessary Islamic sensitivity judgments for the capital inflows especially from the Middle East and other Islamic countries and be able to meet all needs from advisory to compatibility with Shariah principles in banking, finance, economics and law applications.

It is expected that interest-free banking will support the improvement and deepening of the financial sector and strengthen the financial stability. The steps taken by the Turkish government in this regard are as follow: the establishment of "Interest-Free Finance Coordination Council" has been approved for the purposes of enhancing the interest-free financial system and contributing the vision of becoming the international financial center of Istanbul (Prime Ministry Circular, 2015/17).

Conclusion and Recommendation

There has been the rapid development of Turkey in trade and political relations with the oil-rich Middle East and other Islamic countries in recent years. However, the financial relations, joint activities and ventures cannot make the same rapid progress. The financial structures of the countries, as well as the economic innovations of the relations, play crucial roles in these differences.

Governing regulations should be put into practice incompatible with the Islamic principles in order to reduce these differences and to fasten the financial and direct investments of our Islamic neighbor countries that we have historical ties.

Compliance with the principles of Islamic law is not just responsibility of the advisory boards but the responsibility of the board of directors particularly and corporate management with all stakeholders. The functioning of Shariah boards or committees varies between Islamic financial institutions. Therefore, the establishment of Shariah boards in Islamic financial institutions, as well as a “centralized advisory board” at an upper national level, will be appropriate to be able to take ultimate binding decisions.

The presence of efficient Shariah management system will show the practices and activities in compliance with Islamic principles and so it will maintain the confidence of the shareholders and other stakeholders. To this end, Shariah management systems should be established based on the standards and guidelines of AAOIFI and IFSB institutions. Thus, many issues regarding the Shariah field of management can be resolved in effectively with these instructions.

In addition, Shariah management forms a whole system that does not just consist of issuing a fatwa for a product or transaction. In compliance with Islamic law, it should not be contented with the fatwa given previously; applications and activities should be tightly controlled and the cases in the courts concerning with these businesses should be resolved in accordance with Islamic principles through Islamic financial institutions’ lawyers. It should be concentrated on training the qualified individuals to have experience particularly in the areas of Islamic banking, finance, and

economics. This type of interdisciplinary education programs should be expanded in universities.

In conclusion, the agency theory considers the problems between agents and principals. The theory aims to find solutions to minimize the agency costs arising from these problems. In this regard, the establishment of an independent Islamic Supervisory Council will help to reduce such costs. Furthermore, sustainability and stability of Islamic financial markets will augment together with issuing appropriate financial instruments in accordance with Shariah principles and thus the Council will help Istanbul to achieve the goal of being the financial center.

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