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Turkey and Islamic Banks

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Abstract: This study aims to present and review the specifics of Islamic banking system in Turkey, Islamic finance and the major differences between Islamic and conventional banks. The spread of Islamic banks, their differences from conventional banks has increased interest for their activities. Global financial crisis impacted Islamic banks less than the conventional banks which explained the profit and loss sharing system, the lower leverage and the prohibition of speculation. Islamic banking is considerably different from conventional banking system since the Muslim religion forbids giving or receiving interest. The Islamic finance is based on the Muslim religion and the Sharia, Islamic religious law, whose basic rules are hidden behind all form of financing.

Keywords: Islamic banking system; Islamic finance; Turkey

1. Introduction

Due to its geopolitical position, Turkey has played a special role in global politics recently. Its „involvement“ in the affairs of Europe, the Balkan Region, the Middle-East, the Mediterranean and the Black See Region provides a splendid opportunity to analyse the economic, financial, political and other factors of these countries and regions, to identify their common features and their differences and to explore the unique oriental Turkish and Islamic characteristics.

Turkey is a special mixture of East and West traditions due to its location and also its history, religion, culture and political-economic relations. The link to the West was provided by the expansion of military occupation at the age of the Osman Empire. This era was closed by the failed siege of Vienna in the 17th century. The empire that started to lose its territory could not catch up with the political and economic development as a consequence of the internal contradictions, rigidity of the religion, and it was hit by a series of crises being called „the sick man of Europe“. Although the intension of Western orientation could be traced in the modernization efforts of the „Tanzimat“ era[1] and the young Turkish revolution in the 20th century, the efforts to establish modern Turkey as a democratic and secularized country only bore fruit under the administration of Mustafa Kemal Atatürk in the 1920s and 1930s. From the foundation of the Republic of Turkey in 1923, a series of reforms followed: the separation of the state and the church, „westernization“ of the legal system and the political domain, improvement in female rights, etc. The geostrategic position gained a lot of importance after WWII and the establishment of the bipolar world. The country received a lot of aid under the Marshall Plan and the Truman Doctrine from the USA. It joined the NATO in 1952, it also became the member of IMF and OECD and formed a customs union with the EU in 1995. Although it launched an application for accession in as early as 1963, the membership has not been granted so far, probably hindered by the Muslim religion (Balázs, 2009) apart from political and economic issues.

99.8 % of the population in Turkey is of Muslim religion, most of them belong to the Sunnis. The original name of the Sunnis is „the followers of the orthodox tradition and community“. It means that they follow the customs, courses and tradition of Prophet Muhammad and they belong to the community. The regulations of Islam is not divided into a religious and secular sphere but it embraces all the aspects of life. Saria, the ethical and religious principle relies on four sources: the Qur'an, the teachings and normative example (called the sunnah, composed of accounts called hadith) of Muhammad, the consensus of the Imams and the argument and conclusion with analogies [Wikipedia, 2015].

[1] “Tanzimat” (reconstruction) covers the Turkish reform age (1839-1876).

The number of the followers of Islam exceeded that of Christians and thus, became the most supported religion regarding their followers in 2008. It is the second largest religious community in Europe and America (Balázs, 2009).

2. Literature review

2.1 The economic situation of Turkey

The economy of Turkey is a mixture of modern industry, trade and traditional agriculture. Its private sector is on the increase but the state has a dominant position in industry, transport, telecommunication and the banking sector (Wikipedia, 2015).

When Turkey was hit be a serious financial crisis in 2001, monetary and fiscal reforms were made as part of an IMF program reinforcing the country's economy (MKIK Institute of Economic and Religious Research, 2015).

Table 1 and 2 shows the economic performance of the country between 2006 and 2014 by some macroeconomic data.

Table 1. Major macroeconomic indicators of Turkey

	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP (billion USD)	530.9	647.2	730.3	614.6	731.2	774.8	788.9	823.2	799,5
the growth rate of the GDP (%, y/y)	6.9	4.7	0.7	-4.8	9.2	8.8	2.1	4.2	2,9
Inflation (consumer prices, %)	9.6	8.8	10.4	6.3	8.6	6.5	8.9	7.5	8,9

(Source: http://data.worldbank.org/country/turkey)

Table 2. Foreign trade balance in Turkey

	2006	2007	2008	2009	2010	2011	2012	2013	2014*
Exports (billion USD)	85,6	107,3	132,0	102,1	113,9	134,9	152,5	151,8	157,6
Imports (billion USD)	139,6	170,1	202,0	140,9	185,6	240,8	236,5	251,7	242,2
Balance (billion USD)	-54,0	-62,8	-70,0	-38,8	-71,7	-105,9	-84,0	-99,9	-84,6

* Not yet final (Source: http://www.turkstat.gov.tr/Start.do)

The Turkish economy has grown at a high rate until 2008 and then it decreased due to global economic problems and a strict budget control, but the country could recover from the crisis due to its well-regulated financial markets and the banking system. Although the economy grew by more than 8 % and exports reached their pre-crisis levels in 2010-2011, growth has declined very much in the recent years. The growth rate of 2.9 % in 2014 – though better than the analysts' expectations of 2.7 % – does not reach the government's target (3.3 %). Possible reasons for the declining rate of growth are the crisis in their the Euro zone (export markets) and the war at the borders with Iraq and Syria (MKIK Economic and Business Research Institute and Napi Gazdaság Online, 2015).

After ruling for 13 years, the Justice and Development Party (AKP), which has Islamic roots and boasts of the economic successes of the recent years, received the majority of the votes in the second parliamentary elections last

year. With one eye on the elections, the Central Bank of Turkey resisted the pressure on decreasing interest rated to boost economic development and it adopted a conservative interest policy due to the high level of inflation (8.9 % in 2014, while the target was only 5 %). A massive devaluation of the Turkish lira and a fluctuation in the financial markets could be seen last year (Napi Gazdaság Online, Portfolio, 2015).

Although the GDP in Turkey basically increased – despite the economic troubles in Europe – in the recent years, a number of factors such as the balance of trade deficit, the uncertainty around the monetary policy and the setup of the new government with the geopolitical risks continue to keep the economy in a vulnerable state depending largely on the level of investors‘ trust.

2.2 A short history of the Islamic banks and the banking system of Turkey

The Islamic world is basically characterised by a „mixed banking system“, which means that there are also Islamic banks in addition to the traditional commercial banks. It is the proportion of the Muslim population, the per capita income and the macroeconomic stability with the distance to the two major Islamic financial centres (Malaysia and Bahrein) and the level of trade with the countries in the Middle East that determines what kind of role these banks play in a country (Pálfi, 2010 and Ligeti, 2011).

The Islamic banks started to spread in Egypt in the 1960s with the microfinancing institutions in small villages operating under the principles of Islam. Dubai Islamic Bank, the first interest-free financial institution in the world was founded by an equity capital of 17 million USD in 1973, followed by the foundation of the Islamic Development Bank in Jeddah, Saudi Arabia in 1975. Several other Islamic banks were established in other countries in the 1970s and 1980s and as a second stage of development, these banks replaced traditional bonds with the so-called sucus. The rapid development of Islamic banks was largely supported by the rising oil prices in the early millennium years as they produced enormous revenues for the oil producing countries. The average annual growth rate of Islamic banks exceeded 15 % from 2000 and they were less hit by the global financial crisis in 2007 since they did not deal with second-class mortgage loans, credit derivatives and had a lower capital leverage ratio compared to traditional banks. As of today, the about 300 Islamic financial institutions possess of more than 100 billion dollar in assets with two thirds of these banks operating in the Middle East and North Africa while the rest mainly in South-East Asia and Sub-Saharan Africa[2] (Ligeti, 2011).

Most of the capital market activities are carried out by traditional commercial banks in the Turkish „mixed banking system“. Banking dates back to the beginning of the 1800s, reflecting most of all the deals of currency exchangers. Following the Crimean War[3] and the deterioration of financial position of the Osman Empire, the involvement of external financial resources was now required, and as a consequence, foreign banks set foot in Istambul financing the Empire in return for high interests. The Ottoman Bank, which took the position of a central bank, and the Central Bank of Turkey (*Türkiye Cumhuriyet Merkez Bankası*), which has branches in New York, London, Frankfurt and Zurich, were established in 1856 and 1930, respectively. The state-owned banks in the banking system were mainly established to finance certain industries – for instance, Ziraat Bank was founded to support the finances of agriculture –, but private banks also have tight links with economic actors.

The Turkish banks such as Garanti Bank or Akbank are mainly based in the heart of the country in Istambul, and almost all of the large foreign banks have their main offices here (Wikipedia, 2015 and TBB, 2015).

The large Turkish commercial banks are well-managed companies with an adequate level of capital, they are efficient institutions with a good quality of assets and making effort to ensure transparent operation (loki, 2013).

The Islamic financial institutions could start their operation in Turkey following the financial liberalization under Prime Minister Turgut Özal in 1983. These banks aimed at involving internal and external sources in the economy. These sources were excluded from the economic circulation due to the adherence to the ban on interests and were accumulated „at home“ and it was also typical that the Gulf states insisted on the financial forms that were regulated under the principles of Islam.

[2] A further development of Islamic banks can be supported by the fact that most of the 1.6 billion Muslim population worldwide does not have a connection to banks yet.
[3] The Crimean War took place between the Russian Empire and the Alliance of English-Turkish-Italian-French forces in 1853-1856.

The companies offering Islamic banking services could become the integral part of the banking system of the country with the new bank act in 1999 (Balázs, 2009 and Szigetvári, 2008).

Only a few percents of the assets in Turkish financial institutions have been provided by Islamic banks so far, but they are expected to increase their role in banking. Islamic banks are also called participatory banks since one of their major characteristics is – apart from the ban on interests – profit sharing and participation in the projects. Unlike traditional banks, Islamic banks do not promise an interest rate for the deposits of their clients. They only disclose the share of the profit, generally around 65-95 %, but sometimes 80-85 % that is going to be divided (loki, 2013).

The banks following the Islamic principles are much more than simple „factories of profit"[4]. Islamic banks have a social responsibility and all the employees of these banks must have the right conduct of behaviour that matches the religious principles. The Islamic principles only allow financial deals where the investor receives a pre-defined share of the returns – instead of interests, and all the parties bear the possible losses[5] of the business in the same proportion (Balázs, 2009).

In the world beyond Islam, it was Muassam Ali who started to establish the professional authority of the first Islamic conglomerate, the Muslim Financial Office (Dar Al-Maal Al-Islami) in 1985 and he also founded the Institute of Islamic Banking and Insurance in London.

The first independent bank under the Islamic principles, the Islamic Bank of Britain was opened in London in the autumn of 2007. The Board of Directors is made up of priests and the business is exclusively operated under Islamic legislation (Balázs, 2009).

And now let us review first the major aspects of the Islamic economic theory.

3. Data and Methodology

3.1 The core of the Islamic economic theory

The Islamic economic theory positions itself as a middle-of-the-road solution beside capitalism and socialism and cherish social and economic principles that it believes to lead to the establishment of a fair society. It attributes an important role to the state and to redistribution in the fight to diminish social inequalities and ensure justice for all. It strives to secure full employment and it regards the economy as demand-driven but it also condemns the consumption of luxury goods: „Allah does not like people excessively consuming goods" (Balázs, 2009 and Szigetvári, 2008).
The Muslim consumer strives to maximise utility by fulfilling the wishes of God beside satisfying their own needs. The utility curve is not made up of simple outputs, but it also contains the impact of „good deeds" such as contribution to the construction of schools, hospitals, mosques or support to the poor. An Islamic company does not simply aim at achieving maximum profit, rather a rational level of profit, which would support them achieve the most important aim: do something good that is in favour of the God. However, it cannot be deemed to be disadvantageous to the company since charity also adds to the company value and it is also builds up a good image (Gálosi, 2010).

The most important fundaments of the Islamic economic theory are the followings (Pálfi, 2010 és Gálosi, 2010):

- Sources are regarded as a present of God representing only credits to the people. One has to produce a maximal output by using these sources, fulfilling the wishes of Allah and incrasing global welfare. This conflicts the pursuit of self-interests of Western economic theory advocating market competition.
- It recognises private property but also subordinates it to state-owned or community property. Not only the owners but the whole community has to have a share in the utilisation of the property.
- It bans the accumulation of wealth in the hands of only a few. Public property is regarded in the broadest sense possible. Businesses related to the production of fresh water, mining and food production must be owned by the state, including energy sources.
- Profit is only acceptable beyond rational borders and the high prices of basic products are only acceptable in case of shortage.

[4] Some scholars hold that the operation of banks and the Islamic principles cannot be harmonised.
[5] Banks have to waive of the repayment of a part of the loan in proportion to a loss of crops in the case of agriculutral investments.

- It forbids the production of profit through the manufacturing and trade of alcoholic beverages and pork, illegal trade, loan sharking, fraud and deliberate action of inflicting damage to others,
- It also forbids all forms of speculation, the transaction of deals that are related to contests, gambling, arms trade, pornography or futures contracts since it does not allow trades in goods that are not delivered immediately. All in all, it bans all activities that run a high level of risks with unpredictable consequences or buying or selling goods that are of unknown and insecure sources.

3.2 Islam and the banking system

As early as the Golden Age of Islam (the 8-12th centuries) we can see the traces of „Islamic capitalism", that is an early form of market economy and trade that was based on a stable and valuable currency, the dinar. A lot of reform concepts such as the contract, the bill of exchange, the term of partnership for distance trade were introduced and a plenty of new terms (credit, loan, debt, deposit, foreign exchange, profit, accountant, trustee, agency, transfer of ownership, loss, capital accumulation) were used within the framework of „Islamic capitalism". They were much more advanced than the medieval Europe (Balázs, 2009).

One of the most important features of Islamic capitalism was a ban on the demand for and payment of interests. By referring to the Qur'an, the saria says: Allah declares that all the wealth belongs to Allah and those who demand for interests or pay interests are „at war with God and Muhammad". The other source of saria, the prophetic sunna does not even know the term of interest. This is what modern Islamic movements used as a basis of their demands that banks should hold the rules of sunna too and abolish the institution of interests. And why should they do this? The Persian scientist Fakhr al-Din al-Razi, who died in 1209, provided us with a well-structured set of reasons (Gálosi, 2010):

- Interest (riba) means that we demand a part of other people's properties without them giving anything in return. It is a long debate whether the interest is a fair pay for the use of the lender's money. It is worthwhile to note that everybody has to pay interests while there is no guarantee for the success of the investment. It means that we demand a certain price after an uncertain income and thus, inflict damage to the borrower.
- The interest as an income made from money does not spur active work.
- If the interest is legal, people will borrow money even at high rates to satisfy their needs and this would lead to an increase in social differences.
- The concept of interest enables rich people to accumulate excessive amounts of capital, which is unjust and unfair. As a consequence, rich people become even richer and poor people get poorer.

The saria mentions five principles of investments (Pálfi, 2010 és Szigetvári, 2008). They are:

1. ban on interest payments[6],
2. ban on the production of goods or services that are in contradiction with the values of Islam ,
3. ban on taking unnecessary risks and speculative deals,
4. the mutual system of Profit and Loss Sharing,
5. spending money on charity[7], payment of a „religion tax"[8].

As it is not possible to extend loans for interests, investments can take the form of interest-free capital deposits such as interest-free bank deposits, cash, gold, silver and other jewels in Islam. People are still encouraged to invest since the tax is lower on investments than on unused and uninvested property (Gálosi, 2010).

The charity element (zakat) can take many forms in financing deals. It is one form when banks offer support to clients in difficulties with a special customised technique. This is something traditional commercial banks wouldn't do saying: „the client is not creditworthy". Another form is to spend the part of profit that was not planned or expected on charity. There is also a special form worth mentioning: charity can take the form of punishment. If the

[6] Islam does not prohibit waiver of a part of the profit as it is not against the Qur'an
[7] People with an income regularly support the mosques that use these amount to pay them to the poor and wealthy people usually dine the people in need at the end of Ramadan.
[8] If the wealth of an individual exceeds a certain minimum (the value defined in gold or silver), they have to pay an allowance for the poor.

client fails to fulfil their obligations under the contract, the bank may stipulate that the damages to be paid under the contract shall be spent on charity (Pálfi, 2010).

3.3 Operation of Islamic banks

Regarding their functions and tasks, Islamic banks operate the same way as traditional banks do with a few differences under Islamic regulation (Sundararajan-Errico, 2002):

- A precondition of operation of Islamic banks is the creation of Saria, an Islamic Consultancy Body, which is aimed to stand guard over the compliance with Islamic principles.
- The core feature of each deal is that there are a couple of loopholes for the banks to make up for collecting revenues like interests under different names. It is an important difference to traditional banks, however, that the bank and its clients share both the profit and the losses. Since the financial returns of an investment is not unknown before the deal, the principle of profit and loss sharing maintains that the rate of return can only be set ex post by looking at the real revenues of the deals.
- Investments are closely linked to real sector activities where the most important factor is the profitability of a financed project while creditworthiness continues to be an important aspect too.
- These banks primarily finance small enterprises, thus we can call them „financial institutions of the poor" as they also fulfil social functions..
- On the one hand, Islamic banks bear some resemblance to universal banks in contrast to commercial banks in Anglo-Saxon countries through the combination of profit sharing and Islamic financial methods; on the other hand, they operate in a similar way to investment companies as they professionally manage investments. It is a major difference, however, that Islamic banks take deposits from the people unlike investment companies that sell their capital. As a consequence, the shareholders of traditional investment companies possess a share of the company's equity and thus, they also have certain rights (they receive more information, have a vote and a say in the company's investment policy; but the client of Islamic banks are not entitled to a share of the net profit or loss of the bank, their investment deposits cannot be withdrawn before expiry – though they might do so upon the request of the banks in many cases –, they do not have a share in the bank's equity and they do not have a say in the bank policy without their right to a vote.

Let us see a few examples of the operation of an othodox Muslim financial institution. If it offers deposit facilities to their clients, it does not pay an interest but shares the profit or the loss of investing the clients' deposits. Clients with a morgage loan do not buy the property themselves, but it is the bank that buys the property and transfers it to them with a profit or leases it to the borrowers. While noone has to pay a penalty in case of a delay in payment, a bank still charges the client for additionary amounts of payment. In case of small enterprise loans, the banks buys a share in the enterprise and strives to „get back" the amount of the initial investment through the yields of the activities. There is real partnership between the bank and its clients including a special „joint venture" where the banks offer the capital and the partner offers their labour for the operation. In principle, banks guarantee for full security of the deposits with their deposit ratio of 100 %, but the practice sometimes differ very much from the theory (Balázs, 2009).

The following table shows the Islamic financing methods.

Table 3.

Financing methods based on profit and loss sharing

Mudarabah/Qiradh – Loan without participation in management:

- the bank provides all the capital and the client is responsible for the operation
- they agree on profit sharing before the deal
- the bank bears the losses arising from an acceptable business activity, the client only loses the anticipated

profit
- it has a wide spectrum from bilateral partnerships to multi-party deals where the bank raises capital from several investors and invests it in various businesses
- profit and loss is shared in portportion to the period of partnership and the amount of the invested capital

Musarakah – Partnership:

- the borrower makes a deal with the bank about joining the business and performing some operations for a pre-set period of time
- both parties contribute to the project capital
- they agree on sharing future net profit or loss

Muzar'ah – A traditional element of Mudarabah for deals related to agriculture:

- yields are divided between the bank and the entrepreneur
- the bank may provide the land or the capital for the business

Muszaqat – A traditional element of Mudarabah for deals related to orchards:

- yields are divided between the parners in proportion to their contributions

Direct investment – it is the same as for traditional banks but investment prohibitons are observed

Financing methods that are not based on profit and loss sharing

Quard Hasszán/Quard al-Haszanah – „Reasonable loan":

- simple interest-free loan
- the borrower may decide about offering extra payments over the borrowed capital to the lender

Bai'Muadzsal – Sales with a delay in payment:

- the seller may sell the product with a delay in payment or instalments of payment
- the parties agree on the price at concluding the deal, it may not include a charge for a delay in payment

Bai'Szalam/Bai'Szalaf – Sales contract:

- the client sells the product to be delivered later to the bank as in a forward deal
- the bank sells the product with an extra price on the market upon delivery

Idzsara/Idzsara wa Iqtina' – Leasing as for traditional banking:

- the bank purchases the object and leases it to the client – maybe with an additional charge –, and every instalment is deducted from the price of the product
- the client takes full possession of the product with the payment of the last instalment

Murabaha – Re-sales contract:

- the client commissions the bank to sell a product for a pre-defined price
- the price covers the costs and a marginal profit that has been agreed on by both parties

Dzsu'alah – Service fee:

- one of the parties is obliged to pay a certain fee to the other party for rendering services under the contract
- this method usually relates to transactions such as consultancy, expert services, etc.

(Source: Gálosi 2010, 22 and Sundararajan-Errico 2002)

The following table describes the similarities and differences between Islamic banks and traditional banks.

Table 4. Comparison of Islamic banks and traditional banks

Aspects	Islamic banks	Traditional banks
Guaranteed capital value of private deposits	Yes	Yes
Guaranteed capital value of investment deposits	No	Yes
ROI of investments	Undefined, not guaranteed for investment deposits; No guarantee for time deposits	Defined and guaranteed
Regulation mechanisms related to the return of deposits	It depends on the bank's performance and the profit of the investment	It does not depend on the bank's performance and the profit of the investment
Application of the principle of Loss and Profit Sharing	Yes	No
Use of Islamic financing methods	Yes	Not applicable
Requirements of a bailing	Generally they are not applicable to reduce credit risk for profit and loss sharing, but they might be applicable to reduce ethical risks in certain cases; They are applicable for methods different from profit and loss sharing	Yes, always applicable

(Source: Gálosi 2010, 30 and Sundararajan-Errico 2002, 24)

4. Results and discussion

Let us review now the arguments for Islamic banks, as based on Ligeti's study (Ligeti, 2011):

- There is a lower risk of the occurrence of insolvency with profit and loss sharing since part of the losses of financed businesses can be covered by the payments of depositors. Profit and loss sharing, however, does not protect the bank from solvency problems if assets and sources have different expiries.
- In case of profit and loss sharing, both the bank and the depositors are very much interested in the profitability of the borrowers.

- Islamic banks attract clients who do not resort to traditional banks for religious reasons, which adds to the opportunities of financial agent activities.
- Islamic finances are primarily based on financing real assets.

Arguments against Islamic banks:

- Although profit and loss sharing reduces the risk of insolvency of the bank, losses are consequently passed on to the depositors.
- Operation costs tend to be higher than those of conventional banks. Firstly, Murabaha (Re-sales Contract) is a basic product within Islamic finances, thus two contracts must be concluded, which increases administration costs, secondly, additional cost incur for the operation of Saria Committees, thirdly, Islamic banks have to keep more assets compared to conventional banks due to the shortage of interbank loan options.
- The commissioner-agent problem is even more serious than in case of conventional banks since there are less opportunities of indenisation (use of penalty clauses).
- Financial products in Islamic banking are more expensive than conventional consumption loans.
- In case of Islamic insurances (takaful) the amount of claims usually exceeds the available resources, which means that only parts of the losses can be covered as insurance companies are not required to build up a reserve.
- The prohibition of the use of forward deals and other derivatives may reduce risks but it also hinders the expansion of banking activities and economic growth.

Profit and loss sharing brings about a tighter contact to investors. On the basis of the Islamic principles, a share in the proportion of profitability is seen as much more fair than pre-defined interest rates. The approach of Islamic banks to conventional institutions is another issue which would require the establishment of new Islamic financial products. Some experts maintain that even the existing products do not fully comply with Islamic principles.

5. Conclusions

Although Islamic banks do not play a considerable role in „global banking“, or in Muslim countries or in Turkey[9] despite their positive features, Islamic finances have gone through an age of rapid development due to the economic growth of oil-producing Muslim countries, the improving infrastructure in these countries and the growing demand for financial products in harmony with saria recently. Such investment opportunities contribute to the inflow of capital from other Muslim countries such as the Gulf states in the case of Turkey.

Islamic banks could not avoid the harmful effects of the financial crisis of 2007-2008 either, but they were less hit compared to conventional banks owing to their tighter relations with the real economy, the shortage of second-class mortgage loans and lower capital leverage. The credit portfolio of Islamic banks is of better quality as a result of a strict process of credit assessment and the risk provisions for problematic loans are higher.

The Islamic banking techniques based on religions fundaments represent a sample of ethical banking activities nowadays and they may add to the spectrum of services for everybody and not only for Muslim clients (Balázs, 2009, Pálfi, 2010 and Ligeti, 2011).

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[9] Do not forget about the fact that Islamic banking is quite „young”, dating back to a past of 30 years while traditional banking dates back to several centuries, thus it would be unreasonable to expect that Islamic banks represented a market force equivalent to that of traditional banks.

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