

The Macrotheme Review

A multidisciplinary journal of global macro trends

Turkish Experience in Bank Shareholders' Fraud and Bank Failure: Imar Bank and Ihlas Finans Case

Ayse Hayali*, Selin Sarili**, and Yusuf Dinc***

Marmara University*, İstanbul Şişli Meslek Yüksekokulu**, Marmara University***, Turkey
ayse_hayali@yahoo.com*

Abstract

In the last two decades, Turkish economy experienced a number of financial intermediaries' failures due to bad governance, shareholders' fraud and limited regulative structure. These financial intermediaries include not only the banks but also the financial institutions such as special finance houses which were excluded from the regulative field. The failures of these financial intermediaries were costly enough to damage Turkish economy. Thus, it was then an obligation to take proper actions, such as making new regulations and reconstructing entire financial system. It was inevitable to establish a new regulatory body to create a stronger and more resilient banking system, while solving problematic banks and special finance houses. For these purposes, Banking Regulation and Supervision Agency (BRSA) was established in 2000 as a fully independent government authority in order to obtain financial stability and recover safety and robustness of the system. The main purpose of this research is to explain measures taken against the bank failures by analyzing how fraud and corruption were made by the bank shareholders and why the special finance houses included into regulative environment. The new structure of Turkish banking system is explained by using two important failures which are Imar Bank and Ihlas Finance cases. The research also analyses the regulative actions and their benefits to the Turkish banking system with contribution to today's Turkish economy.

Keywords: *Bank Failure, Fraud, Special Finance House, Shadow Bank*

1. Introduction

The main purpose of this paper is to research the causes of the bank failures in order to prevent the new ones in the light of both Turkish experiences and regulations. In this case a fraud based bank failure and a limited regulation based failure are analyzed with defining the supervisory acts and institutions. Banks are at the center of the economy. That is why the supervision focuses on them. If the supervision is sufficient enough, outlook of the sector seems better. An active supervision and well-organized regulation framework over the sector supports sustainability of the banking system and prevents bank failures. However, the financial system has changed over the last three decades and the financial institutions and instruments have developed in years. With the globalization, the balance sheet of whole financial system links to each other and makes system fragile as seen with the global financial crisis. Even tough, the supervision culture did not adjust itself to these rapid developments. The other players of the

money and capital market kept out of regulative environment. To have a healthy financial system, it is inevitable to have a good regulation and active supervision for both banks and non-bank institutions like Special Finance Houses. It is important to identify the main causes of the bank failures because banks are at the heart of financial crisis in bank-based economies like Turkey. There can be many reasons of bank failures. In this research the experienced failures in Turkish banking system are explained at the basis of the shareholders' fraud, poor management and insufficient regulations. The two experienced failures; Imar Bank and Ihlas Finance cases are good examples for this research. Imar Bank can be regarded as a good example for poor management and organized fraud committed by bank shareholders. In the case of Imar Bank, there was a chain of corruption, irregularity and fraud that affected the entire financial system of the country. Ihlas Finance House that failed with a run was the other example of irregularity with a poor management. Turkey's Special Finance Houses were not bank and regulations were limited over them but the Ihlas FH failure had huge impact over regulations and SFHs counted as bank with new Banking Act.

2. Literature Review

Recent financial crises in the world highlighted the importance of well-functioning and healthy banking sector for macroeconomic stability. Stocia & Capraru (2009) argues that bank failures have more important consequences, than compared with an ordinary company failure. This is why it is important to identify the main causes and costs of the bank failures. Safakli (2005) argues that analysis of the bank and other financial institution failures in different parts of the world shows that the ethical issues are the most important reasons behind these failures. In addition to the ethical issues; Das, Quinty & Chenard (2004) analyzing the financial crisis concluded that common cause was the weak regulation and supervision. Honohan (2000) considers the causes of bank failures as poor management. Aktas et al. (2005) identifies the causes of bank failures and come to the conclusion that these are; bad management practice, fraud and lack of adequate regulations and supervision.

Gunay and Hortacsu (2011) argues that when a bank is involved in fraud, corruption or any other illegal or improper activity, this may threaten the reputation not only of the bank concerned but also of the whole banking system. In the context of banking, fraud and corruption have been defined by Aguilar, Gill and Pino (2000) as follows: "fraudulent and corrupt practices include the solicitation, payment or receipt of bribes, gratuities or kickbacks, or the manipulation of loan decisions of banks or finance institutions through any form of misrepresentation". Lamb (2000) also argues that financial institutions are vulnerable to ethical abuses and corruption more than any other industry is. Cowton (2002) describes three aspects of ethics in banking which are integrity, responsibility and affinity. Moreover, Knights & O'Leary (2005) identify unethical leadership that emphasized financial and individual performance as the cause of the corruption. Yildirim (2008) analyzed the role of corporate ownership and moral hazard in bank failures during the 2000-2001 currency and financial crises in Turkey. The findings suggest that ownership and control variables are significantly affecting the probability of failure. Privately owned Turkish commercial banks were more likely to fail. Moreover, among the privately owned Turkish commercial banks the existence of family involvement on the board increased the probability of failure. Aktan et al. (2009) argues that business ethics is considered critical for the reputation and competitive power of banks but banks are sometimes culpable of unethical behavior that costs to taxpayers billions such as the Imar Bank case in Turkey. This unethical

behavior often takes the form of false financial statements to the creditors and misleading reports to the supervisory authorities. Rajhi & Hassairi (2011) touch the point of bad management practices in Islamic banking sector. Banking and financial crisis of 2000-2001 provides a context to consider the stability of the Turkey's Islamic banking sector. Turkey's Special Finance Houses (SFHs) offered Sharia-compliant financial services based on a decree of December 1983 on the "Establishment of Special Financial Houses". Okumus (2005) defines Special Finance Houses (SFHs) as the institutions providing financial products and services based on Islamic principles. Following the liberalization process of the Turkish economy in the early 1980s, the financial sector was reconstructed through a deregulation that also brought in innovations to those markets. In this context, the Special Finance Houses (SFHs), providing financial products and services based on Islamic principles, were introduced to the Turkish financial markets. This constituted a "dual banking" system in Turkey in which interest-based banking and interest-free banking run their operations side by side.

Syed Ali, (2007) studies the Special Finance Houses (SFH) in Turkey. In the research, the causes of the failures in Special Finance Houses in Turkey examined and the results analyzed. Some of the causes of SFH's failure were bad management and fraudulent activities. The consequence of prolonged control and management failures emerge in the form of financial problems for the banks. The institutions then indulge in fraudulent practices to hide their financial problems hoping to rectify the problems soon. Starr & Yilmaz (2004) argues that the crisis resumed in February 2001, in part sparked by an unexpected problem in a Special Finance house. Over the weekend of February 10, the largest Finance House, Ihlas Finance, had its license revoked by the Banking Regulation and Supervision Agency (BRSA) and abruptly closed its doors.

3. Banking System in Turkey Before 2001 Crisis

With the financial liberalization that has started in 1980 in Turkey, the interest rates have been liberalized and it has been aimed to flow in foreign currency in to the country through the application of high interest rates. However, banking sector had been dragged on the threshold of new crises for reasons of insufficient regulations that had been applied and this has resulted in five of the banks to go bankrupt (Chambers, 2004:6). Saving Deposit Insurance Fund (SDIF) had been set up and the Banking Act had been passed at the end of the crises that had been gone through in order to eliminate the insufficiencies within the banking system and to reconstitute the confidence within the financial system.

During the 90's, effective foreign exchange transactions had been started in Turkey and the TRL had been made convertible and some developments had been achieved for the perception of the banking as foreign banks had entered in to the market. However, even the persons, who do not possess sufficient experience and knowledge had been able establish banks since an effective regulation and auditing had still not been implemented for the banking system. In addition to this, the fact that banks did not have an effective risk management, this had made it difficult to foresee the crises and had caused great losses for the country through the banking system. It had been difficult to take risks in a form to protect melting down of the equity of banks and to protect the capital adequacy of the banks since risk management departments did not function. Even though all of the indicators had been pointing towards the foreign exchange crises following the crises that had taken place in 1994, this crises had been called as the one that

was not expected (Chambers, 2004:9). A solution has been found out for the crises that had taken place as to have the guarantee of the SDIF for all of the bank deposits. But, this would have provided the foundation for the crises that had taken place in 1999, rather than being a solution (Colak, Yigidim, 2001:56).

SDIF had been in the position to pay for all of the depositors, who have had bank accounts in bankrupted banks during the crises. The banking system had been caught unguarded against shocks due to insufficient regulations. It has been understood that the regulations, which had been put forward after the crises in question, was insufficient and Council of Banking Regulation and Supervision Agency has been set up and the Banking Act has been renewed.

Mergers of banks, which had taken place in Turkey, has been the ones, where these mergers had been mandatory since the bank, which has been in difficult situation, has been restrained to move out of the market. The party, which has bought the problematic bank during the mergers that had taken place, has generally been a public bank. Since there was not any effective supervision system until the pre - 2001 crises, it was impossible to intervene with the banks early and high levels of debts had been undertaken by public banks (Erdogan, 2002:133-134).

It has been put forward that monitoring of the banks by an independent institution was important as the banking act was structured again. Full amounts of the deposits had been ceased to be guaranteed under the cover of the insurance and only the amount that is equivalent to TRL 50.000 had been made to be covered under the guarantee of the SDIF. It has been made difficult to establish a bank and to own a bank and it has been made mandatory for the banks to establish risk monitoring departments.

The supervision process had been enriched with the addition of supervision as being risk oriented and the CAMELS analysis had been started to be applied, where this has been based on factors such as, profitability, quality of their actives and the liquidity of the banks (BRS, 2009:27).

3.1. Regulatory Structure of the Turkish Banking System

Regulations have great deal of importance for effective functioning of the markets. Failure might take place in markets when markets are left on their own without any intervention. Crises had shown spread out effect after the failure that has been seen in markets in Turkey after the financial liberalization and after the banking crises that had taken place around the world and this taken its toll for the real sector in short time. Regulations are put forward as preventive regulations and protective regulations. It is aimed to avoid crises that might take place with the preventive regulations and to protect the depositors after a possible crisis through protective regulations. (ITO, 2001:65)

“Provision of confidence and stability for the financial markets, functioning of the loan system in an effective way and protection of rights and interest of depositors” has been indicated as the aim of the Banking Act, Number 5411, which has become valid in 1999 and which has been rearranged in 2005 (Banking Act No: 5411). Banking Regulation and Supervision Agency (BRS), Saving Deposit Insurance Fund (SDIF), Central Bank, Association of Banks of Turkey and the Undersecretary of the Treasury are responsible for the organization of the financial

markets in Turkey. BRSA, which has been established as an independent structure in 2000, is responsible for organization, supervision and regulation of banks. SDIF, on the other hand, continues with its duties within the organization of the BRSA. With the Banking Act and with the process of managing the banking system through centralized organization, it has been aimed to be in harmony with the European Union and with the international accounting and auditing standards (ITO, 2001:123).

Banking Act has been constituted in order to bring back the confidence of the public, which had been shaken with the malpractices that banking directors had performed. Banking Regulation and Supervision Agency (BRSA) has been constituted with the renewed act with number of 4389, which has become in force on 19th of June 1999. This act has been rather important turning point for the banking system of Turkey. BRSA has been a autonomous organization within the act that had been in force for the issue of regulating and supervising of banks as being in harmony with the international field (DPT, 2003:16-17).

As it has been stated in article 3 of the act, the “Banking Regulation and Supervision Agency” which is public entity and which has administrative and financial autonomy, has been established in order to provide for the application of this act and other related legislations within the framework of the authorities indicated in the act, also the performing of regulations being inclusive, to supervise the application and to bring to a conclusion, to provide for the deposits to be under guarantee, to perform other duties as these are stated within the Act and to use its authorities.

The establishment is liable and is authorized to prevent every kind of transactions and applications, which could endanger the rights of depositors and which could endanger the regular and assured functioning of banks and which could cause for serious amount of loss within the economy and to take and apply the required decisions and precautions for effective functioning of the loans system (Banking Act:1999). In the case, when the permission for the bank to perform banking services and to accept deposits is terminated, then the management and supervision of that bank is delegated to the fund (Banking Act,1999:16.1) One of the functions of the Saving Deposit Insurance Fund (SDIF) is insurance underwriting for deposits. However, SDIF is also responsible within the organization of the BRSA for management, supervising and to re-function the problematic banks, which had been delegated to the fund, back to the economy (Bumin, Ates, 2008:51).

Duties and powers of Savings Deposit Insurance Fund according to the provisions of Law No: 5411 are as follows: (tmsf.org.tr)

- To insure the savings deposits and participation funds in the credit institutions belonging to real persons, (Article 63)
- To determine the scope and amount of the savings deposit and participation funds which are subject to insurance with the opinion of the Central Bank, BRSA and Treasury Undersecretaries, (Article 63)
- To determine risk based insurance premiums timetable, collection time and form and other issues in cooperation with the opinion of BRSA, (Article 63)

- To pay the insured deposits and participation funds from its resources, in the credit institutions whose operating permission has been revoked, directly or through another bank, (Article 63)
- To fulfil the necessary operations regarding partially or fully transfer, sale and merger of the banks whose shareholder rights except dividends and management and supervision transferred to the Fund by BRSA, with the condition that the losses of the partners will be deducted from the capital, (Article 71)

3.2. Developments and Reconstruction Period in Turkish Banking System

Insufficiencies for the issue of supervising can sometimes cause crises within the financial markets. For this reason, independent internal and external auditing of the banks and making public of the balance sheets of banks have come into forefront. Make up of balance sheets in relation to the inflation and for them to be in harmony with internationally accepted standards, transparency of the activities of the banks and supervising of them in effective way (Chambers, 2004:5).

The capital adequacy ratio, which is applied in Turkey during the harmonization process with the Basel II, is 8%. The capital adequacy has a function of being the bumper both against the losses that banks may face and to prevent the losses that depositors might suffer (Iseri, 2004:78). Nevertheless, BRSA has started to apply the capital adequacy ratio as 12%, with reserve differential of 8% +4% following the fluctuation that has been lived through in 2006 by considering the unfavorable conditions, which might take place within the international markets. By this way, stronger capital base is constituted and therefore the flexibility of the banking system is provided. Sanctions have been imposed on banks that could not comply with the capital adequacy requirements and permission has not been granted for them by the BRSA for opening of new branches (BRSA, 2009:40). The banks, which have been delegated to the BRSA, have been the ones that had problems in meeting with their responsibilities. Banks, whose permission for activity had been terminated and whose rights for partnership, except for dividends, whose managements and supervision had been delegated to the fund, are included amongst the banks that had been delegated.

Another important factor emphasized by regulators, today known as the participation banks, is the Special Finance Houses. First time in Turkey in 1985 and began operations as SFH, interest-free banking took the name of participation banks in 2006, as a result of the failure and the intensive demands of industrial managers and started to have the same regulations and liabilities of conventional banks with a dual-banking system. Participation banks in Turkey until 2006, was not subject to the Banking Law. Banking Law No. 5411, adopted in 2001, along with the participation banks are included in the scope of the bank and the banks have been subject to the provisions that apply (Banking Act, 2001:2). Thus, participation banks have had the same characteristics as the conventional banks, the banks need to fulfill the required actions to perform has occurred.

Participation banks, the Banking Law; 'private, current and participation accounts and credit through the use of property for the purposes of funding organizations, as described. (Banking Act, 2001:3) With the participation banks subject to the Banking Law, the control

structure can be attained in an editable. Thus, by eliminating problems in the area outside the regulative system, this deficiency has been corrected. Participation banks deposits before the law is not covered by the warranty, there was the issue of trust in these organizations. With the law, participation banks deposits up to the amount of TRL 50.000 has been covered by the warranty by SDIF. With the law, participation banks introduced with financial reporting standards. Together with other organizations within the scope of the law, participation banks have been subject to supervision of the BRSA (Banking Act, 2001:65).

Bankruptcy of the bank, whose permission for activity had been terminated, is asked to be declared, amount of the deposits are determined and payments for the depositors are made. Resolution process continues for the banks, whose management had been taken over and the banks are brought back to economy by transferring resources to the banks (BRSA, 2010:42). Total of 11 banks have been delegated to the fund together with the experience of twin crises that have taken place between the years of 2000 and 2001. Another reason for delegation of banks was the malpractice of the directors of the banks besides their financial structures being insufficient.

The greatest malpractice was performed by Imar Bank amongst the banks, whose permission for activity had been terminated. Some of the reasons, for which the Imar Bank had been delegated to the fund, are malpractices like; receiving of unrecorded deposits, loans for the ruling partners, Imar Off-Shore Warehouses, transfer of resources over front company, back payments to the deposit accounts from Off-Shore accounts (BRSA, 2010:43).

Following large scale malpractices that had taken place within the banking system, new practices have been implemented for the banking system by BRSA. Some of the new practices are; tightening of the auditing of the bank branches, enlargement of the scope of the supervision, supervising of the banks by having access for the data systems of the banks, and constituting of effective internal audit, internal control and risk management and it was tried to provide the transparency. In addition to these, processes to establish a bank has been made difficult, tight regulations have been imposed for the issue of banking licenses, which had been easier before the crises (BRSA, 2010:50).

Looking at the structures of banks which have been delegated to the fund, it can be seen that they have many common features. It can be seen that the principle activity of the banks in question had not been the banking, except for 3 of them, as the macro economic instability that had been lived through during 2000's had damaged the balance sheets of banks, which were not so strong (Bumin, Ates, 2003:70). Without any doubt, the ease of obtaining banking licenses until the period previous to the reorganization had its effects on this matter. Another common feature of the banks that are in question that they also had activities in sectors like, tourism, construction, outside of the banking sector and it was the problem that the deposits collected had been granted as loans for their own establishments.

4. Turkish Bank Failure Experiences

4.1. Case of Imar Bank

The Imar Bank scandal, which took place during the 2001 economic crisis, was one of the greatest banking corruption cases in the history of the Turkish Republic. Imar Bank can be

regarded as a good example for operational scandal and organized fraud committed by bank shareholders. The sum of the fraud was amounted to about \$7.2 billion in the Imar Bank scandal. What happened in the Bank was a chain of corruption, irregularity and fraud that was set to disrupt the entire financial system of the country (Erturk, 2008). While this scandal occurred in Turkey, owners fled from the country.

Imar Bank was found as a privately owned deposit bank in 1928. The initial problem in the bank was approval of the change of control of it in 1984 that was acquired by Uzan Group. Although downfall of the bank did not embarrass those, following the sector closely, it is very interesting considering the way to downfall and the great financial loss caused by it. (Aktan et al., 2009: 31) All things considered about Imar Bank, whose banking license revoked due to unbelievably designed fraud methods, the story of the bank failure is rather interesting and different.

It is clear that where a controlling shareholder of a bank can design and implement a control system that serves his interests at the expense of those of the bank's creditors then there is a powerful incentive to use the bank for the shareholder's own purposes. In the case of Imar Bank, the only lending business of the banks was to other affiliated companies. It did no arms length lending at all. (Fort & Hayward, 2004: 4) According to Banking Regulation and Supervision Agency, many unauthorized and illegal transactions were done.

As soon as that bank was acquired by the Saving Deposits Insurance Fund (SDIF), data processing centre destroyed by the bank's managers. In addition to this, all of the legal books and main and auxiliary records were either shifted away or destroyed. As a result of this destroying process, it was proved rather difficult for the government officials to investigate and audit the bank's records. Investigations carried out under such difficult circumstances showed that the documents and records submitted by the bank to government officials were simply manipulated by the former administrative officers of the bank and that the bank had collected from the ordinary folk, under the name of deposits and treasury bond sale, much more than it was initially recorded in the bank's financial books and records, and that the taxes collected from such depositors by means of stoppage were not at all passed on to fiscal authority (SDIF, Imar Bank, 2009: 51).

Recording system was manipulated in a very interesting way in the procedures conflicting with the regulations. All transactions executed in the branches were transferred to the main memory in the general directorate the bank in general was produced by manipulating the data taken from the branches through software programs. Two programs were used in manipulating data. One of them was used for showing deposits, taxes to be paid and expenditure accountings lower by giving fictitious debit-receivable records. The other one was used to delete bond transactions from subsidiary records. Legal ledger samples such as subsidiary ledgers, balance, book of final entry etc., which were produced by using manipulated data, were delivered to the branches. (Aktan et al., 2009: 32-33)

Basically, Imar Bank's shareholders collected unregistered deposits. Bank managers did not authorized enough; bank shareholders (Uzan family) hold the power. Investigations and audits held into the Imar Bank's records showed that all such transactions were simply left unregistered or partially registered and declared. Therefore the amounts of actual deposits

collected were kept secret from the government authorities. Since the right of execution of authority granted for the branches of that bank were rather inadequate, even the most basic banking transactions, as well as reporting and information flow and exchange, were kept subject to initial approval or consent of the headquarters which in turn enabled Imar Bank's management to have all initiatives in terms of operations, as well as handling, controlling and execution of all transactions, also including the fraudulent ones, under a single authority (Fort & Hayward, 2004: 4).

Additionally, as a result of the investigations; it was found that, during 1999 – 2003 period, income tax and fund deductions, which are applicable to interest earned on money deposited with the banks pursuant to usual banking practises, were made, but the actual amounts of such income tax and fund deductions initially realised by the branches were later recorded in the bank's financial records and books in greatly reduced amounts reduced on records by the headquarters of the bank by reverse entries and interventions (Pehlivanli, 2011: 104).

Imar Bank credit facility transactions, too, as it was the case for many other transactions, were handled under a single hand and all approvals in connection with such credit facilities were adopted by the shareholders (CEO Kemal Uzan and other family members) of the bank. Responsibilities of the credit department personnel in general were kept limited to operational matters and transactions likewise the personnel in other departments. Additionally, credit facilities extended without the knowledge of the branches and branches were only left to handle and execute the relevant paperwork. Investigations held into the financial affairs of that bank proved that all of the credit facilities as cash injections, as of July 3 2003, were exclusively extended to Uzan Group alone (BRSA ,2010:43).

One other important fraudulent act realised by the shareholders of the Imar Bank is illegal collection of deposits and extension of credit facilities by an offshore bank which resulted in that bank's making huge unduly profits. Imar Offshore was an offshore bank established by Uzan Group based in Turkish Republic of North Cyprus. Due to its special legal status, Imar Offshore was bound to realise its banking business practises outside the national borders of Turkish Republic of North Cyprus. Imar Bank was the sole exclusive corresponding bank of the Imar Offshore which in turn means that Imar Offshore must and should only realise its usual banking activities, such as, collecting deposits and extending credit facilities, via Imar Bank. While a portion of the resources that were transferred by the said bank to Uzan Group were never recorded in the books and financial records of the Uzan Group companies, another portion of such transfers were recorded as "Imar Offshore Credits".

In line with the investigations carried out by the Bank's Independent Certified Auditors, it was also found that, by depositing the funds at Imar Offshore, funds were wire transferred abroad for the name of Uzan Group and that funds were accumulated in the accounts of real persons and companies who were under the umbrella of Uzan Group, and so that Imar Offshore accounts were exclusively used as a tool for the purposes of transferring funds to Uzan Group. (SDIF, Imar Bank, 2009: 59)

In brief, there were a huge number of fraudulent act of various types executed within and by the Uzan Group companies. The main purposes of such fraudulent transactions were to derive benefits for Uzan family through the bank. In order to cover up the fraudulent transactions, all of

the fraudulent transactions were deliberately made to involve many different companies by means of rather complex transactions and routing. Moreover, such fraudulent transactions, made all the more complicated by other transactions by the group companies in order to covert the real transactions, and even bubble companies were established and ledger journals and other legal records were manipulated.

4.2. Case of Ihlas Finance House

Turkey's Special Finance Houses (SFH), predecessors of participation banks, served as Sharia-compliant interest-free financial institutions. The SFHs' costs of found collections and returns of founding were based on risk participation, rather than interest. The liberalization process off 80s restructured financial sector through a deregulation that also brought in innovation to the market (Okumus, 2005:53). In this context, the SFHs firstly founded in 1985 in secularized Turkey, presumably under "external influence and pressure" finally allowed Islamic banks to operate in the country though the authorities refused to recognize officially the Islamic character of these institutions and referred to them as "Special Finance Houses" (Azarian, 2011:266).

It was a profitable and exponential business model which enjoyed religious belief over the forbiddance of interest. The SFHs was founded based on a decree (no. 83/7506 dated December 16, 1983) on the "Establishment of Special Finance Houses" and the number of the SFHs reached 6 till 2000, after the initial founding. Ihlas Finance House was founded in 1995 as the last SFH but soon became the biggest in the market in a 5 years period.

Ihlas Finance House was founded based on a decree (no. 94/6193 dated November 19, 1994) on the 'Establishment of Ihlas Finance House' and started its operations in April 1995. In the foundation, paid capital of the Bank was TRL 1 million, and 90 percent of the shares were belonging to Ihlas Holding. Ownership structure was changed significantly over time. As of 2008, 34.59 % of the total shares were publicly listed (<http://www.ifk.com.tr/detay.asp?ContentID=741&lang=eng>).

Some major figures extracted from the announced financial statements are listed here below (TRL);

Table 1: Figures from balance sheet.

Date	Asset Size	Collected Funds	Funded Credits	Net Profit
31.12.1995	9,206,711	6,766,380	7,660,526	166,030
31.12.1996	43,775,490	36,262,750	37,858,552	952,650
31.12.1997	122,853,042	105,926,592	103,219,035	2,202,341
31.12.1998	252,192,211	214,098,371	225,572,393	5,066,596
31.12.1999	633,561,397	543,669,411	542,312,870	9,762,342
30.09.2000	900,799,287	754,881,148	754,842,411	6,595,753

Source; Annual Report of Ihlas FH

(also <http://www.imkb.gov.tr/financialtables/companiesfinancialstatements.aspx>)

As can be seen on the above table, as of September 30th, 2000 total asset size of the Ihlas reached TRL 901 million. Total collected funds also increased to TRL 755 million in this period. Total assets rose by % 42.2 and total collected funds increased by 38.8% during nine month period December 1999 to September 2000. Despite the fast growth, asset quality and financial structure were deteriorated and official authorization of the Ihlas was abolished based on a decree. (no. 171 dated February 11, 2001). The given reasons behind this abolishment with the decree are here below:

- Levied on the EFT, swap account and blockade in the Central Bank of the Republic of Turkey, and day by day this foreclosures increased,
- Authority instituted legal proceedings on the Procedure of Collection of Public Receivables because Ihlas Finance was not able to fulfill of its legal obligations against Resource Utilization Support Fund.
- Could not meet the withdrawals of the collected funds belongs to participation and current account holders.
- Limited ability to meet its commitments due to deterioration in the financial structure.
- Unsuccessful attempts to solve liquidity problems though precautions to reinforce financial structure.
- Funding Group firms over legal limits.

Balance sheet deterioration caused poor financial structure and a steady run started. Ihlas could not meet the withdrawals and inevitably failed.

Ihlas' sell off was subject to the Turkish Commercial Code because it was not covered by Banking Law. The SFHs were the non-bank financial intermediaries that collect funds, give credits, and use leverage like today's shadow banks. Shadow banks are at the heart of the global financial crisis but one of the initial failure examples was seen in Turkey. If the Ihlas FH case has been investigated in every detail by FED or ECB since the days of fail, the global financial crisis could be prevented. Since the initial founding, authorities have taken actions to regulate them though these institutions were not subject to the Turkish Bank Law. It has importance for authorities not to being subject to the Banking Law because it meant limited ability for regulation.

Banks were at the center of the Turkish financial system and regulative actions was mostly focusing on them so the non-bank institutions were partially out of regulated environment and were not covered by deposit insurance. Main problem of Ihlas was liquidity and the most important reason for that was founding group companies up to 94 % of its total assets. Ihlas Finance had irregularly appropriated almost \$1 billion (practically the entire value of deposits) through connected lending to shareholders (Starr, 2007:9). Imprudence of managers and lack of confidence related to deposit insurance could be calculated as other important reasons. These could be prevented however it was placed out of regulative framework.

Deposit insurance could support trust and prevent it from a run though according to legal environment only the banks were subject to deposit insurance. Actually main problem of Ihlas was being out of standards and regulations. Other SFHs were not satisfied with the under-regulated environment. IFH difficulties induced runs on other SFH, resulting in a sizable loss of

deposits in the sector. Assets of all SFHs declined 63% in 2001; the assets of the five remaining houses fell by more than one-third (Rajhi, 2011:76).

The SFHs initially ruled by separate regulations from the conventional banks but attempts to regulate them was on the agenda. The SFHs wanted to be subject to regulations and standards, too. 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 and with the entry of fully-domestic-owned special finance houses into the market, the complaints regarding the weaknesses in legal structure, became more pronounced (Alpay, 2007: 370). As a result the 1999 bank law brought them under the similar regulatory framework but it was not enough. Capital adequacy ratio, required reserve ratios and liquidity ratios applied as obligation like conventional banks though they were still out of the deposit insurances and selection of managers who are prudent and able to manage was not standardized. Failure of Ihlas could not be prevented through some regulative actions. The exact need was an overall regulative implementation. There was one way to do an overall regulation; to class SFHs among banks. This action has been taken in 2006 Banking Law.

The SFHs named as ‘participation bank’ with the Law and all regulations and standards implemented to participation banks like conventional banks. System is secured and standards clearly defined. As a result Turkish interest free banking has one of the most advanced systems in the world in terms of laws, regulations and banking techniques (Ozsoy, 2010:19). Participation banking in Turkey is a more recent phenomenon now. Changes in government priorities and public sensibilities have allowed participation banking to gradually acquire legitimacy, particularly within the past decade (Hardy, 2012:1). After the failure of Ihlas Finance the market share of interest-free banking was under 2%. The market share reached 6% in 10 years period with an extra performance over conventional banking due to positive impact of regulations of BRSA.

5. Implications for Investors

This research shows the initial compact examples of today's global financial crisis. The number of such researches is increasing to define the exit from today's economic failure which is caused by similar problems.

The managers of Economies argue in well attended meetings (such as G8, G20) the regulative actions not only exit from the crisis but also prevent the global economic system from new failures. They are investigating failure experiences such as Turkish banking crisis and preparing for taking marginal actions.

It's inevitable to regulate the whole economic system. Turkey's successful regulative actions which are analyzed in this research can be benchmark. To know details what happened in Turkey and what are the consequences of its experiences is important for investors who looks cares about the economic conditions and looks forward to invest in financial sector. This research expresses the trend of global financial regulation and standardization.

6. Conclusion

Bank failures have more important outcomes than an ordinary company failure. To have a healthy banking system is very important for a strong and stable economy. Experienced financial

crises in the world, reveals the importance of well-functioning and healthy banking sector for macroeconomic stability. The impacts of the banking system through the whole economy have increased the importance of identifying the main causes and costs of the bank failures. Main causes of the bank failures can be summarized as the bad management practices, shareholders fraud and lack of adequate regulations and supervision.

2001 was a year which Turkey fought against the crisis and also a year which bank frauds and unhealthy structure of the bank balance sheets caused financial crises. After those crises causing enormous damages to the country economy and banking system, banking system gained a strong structure through the reorganization program.

With the Banking Act and with the process of managing the banking system through centralised organisation it has been aimed to be in harmony with the European Union and with the international accounting and auditing standards. Regulations have great deal of importance for effective functioning of the markets.

The measures taken not only related to the bank frauds but also strengthening of the bank capital structures, monitoring of the risks and strengthening of balance sheets became effective for strengthening of the banking system. After the modifications and amendments to the Banking Law and the establishment of the Banking Regulation and Supervision Agency, the global financial crisis did not cause any major negative impact on Turkish banking sector.

The two bank failure cases in this research show that a bank or a financial institution can easily fail with a collection of just a few mistakes that can damage its financial structure. There is no need to gather all fatal mistakes. Financial institutions should be fully regulated to not to cause a failure. Of course institutions should be fully regulated not to impede but to improve efficiency and effectiveness. Turkey experienced failure and huge costs in an under-regulated environment and one of them was a kind of shadow banking incident which global economy suffers in the recent crisis. Every economic failure should be analyzed carefully and preventive implementations should be made for similar problems in the overall system.

REFERENCES

- Aguilar, M. A., Gil, J. B. S., Pino, L. (2000). Preventing Fraud and Corruption in World Bank Projects, USA: The World Bank.
- Aktan B., Masood O., and Yilmaz S., (2009), “Financial Shenanigans and The Failure of Ethics in Banking: a Review and Synthesis of an Unprecedented Fraud, *Banks and Bank Systems*, 4(1).
- Alpay S., (2007), ‘An Evaluation of Special Finance Houses: A Case Study on Turkey’, *Advances in Islamic Economics and Finance*, 1
- Azarian R., (2011), “Outline of an Economic Sociology of Islamic Banking”, *International Journal of Businessand Social Science*, 2(17).
- Banking Regulation and Supervision Agency, (2010). From Crisis to Stability-Turkey Experience, Working Paper, 3 Revised Print, Ankara.

Banking Regulation and Supervision Agency, (2009). From Crisis to Stability-Turkey Experience, Working Paper, Revised Print 2. Baskı, Ankara.

Banking Regulation and Supervision Agency, (2012). Basel II Progress Report on Banking Sector, Ankara.

Banking Regulation and Supervision Agency, (2010). Questions on Basel III, the Risk Management Department, Ankara.

Banking Regulation and Supervision Agency, (2011). Banking Sector Restructuring Program, Ankara.

Banking Act, (2005). 5411, Array:5, Volume: 45.

BDDK Banking Regulation and Supervision Agency (BRSA), Decision Number 171 in *Official Gazette*, February 11, 2001.

Bozovic, J. (2007), “Business Ethics in Banking”, *Facta Universitatis Economics and Organization*, 4 (2).

Bumin M. & Ateş F. (2008). Sorunlu Bankaların Çözümlenmesi, Türkiye Deneyimi, ISBN:978-9944-341-96-7, Ankara.

Chambers, N., (2004). Kriz Dönemi ve Sonrasında Bankaların Finansal Yapısının Analizi, Avcılol Basım Yayın, İstanbul.

Cowton, C.J. (2002), “Integrity, Responsibility and Affinity: Three Aspects of Ethics in Banking”, *Business Ethics, A European Review*, 11 (4).

Çolak, F. & Yiğidim A., (2001). Crisis in Turkish Banking Sector, Nobel Yayın Dağıtım, Ankara.

Erdoğan, N. (2002). Dünya ve Türkiye'de Finansal Krizler, Türk Bankacılık Sektöründe Yeniden Yapılandırma Uygulamaları, Kamu Bankaları Deneyimi, Yaklaşım Yayınları, İstanbul.

Eriş, H. (2007). Türk Bankacılık Sistemi, Gelişimi, Durumu ve Sunduğu Seçenekler, Bildiriler, Konferanslar, Makaleler, Marmara Üniversitesi, Finansal Piyasalar Araştırma ve Uygulama Merkezi, Yayın No:1, İstanbul.

Ertürk, A. (2008),
http://www.todayszaman.com/newsDetail_getNewsById.action;jsessionid=E0D12A0A0CA2234A5FAA391D174CF8FB?load=detay&link=133912&newsId=133831.

Fort, J. L. & Hayward, P. (2004). The Supervisory Implications of the Failure of Imar Bank, (http://www.forecastturkey.com/Articles/Government/UT/rapor_20040831.pdf, 22.08.2012).

Günay, N.I., Hortaçsu, A. (2008), “Vignettes To Identify The Ethical Domain Of An Emerging Country's Banking Sector: The Experience Of Turkey”, *Business Ethics: A European Review*, 17 (2).

Günay, N.I., Hortaçsu, A. (2011). Bank Managers Perception of Ethical and Legal Conduct in Emerging Markets During the Post-Crisis Period:Evidence from Turkish Banking Sector, *BDDK Bankacılık ve Finansal Piyasalar*, 5(2).

Hardy, L., (2012), ‘The Evolution of Participation Banking in Turkey’, *Al Nakhlah Online Journal of Southwest Asia and Islamic Civilization*, (http://fletcher.tufts.edu/~media/Fletcher/Microsites/al%20Nakhlah/archives/Winter2012/Hardy_Final.pdf, 05/10/2012)

İşeri, M. (2004), Son finansal Krizler Ertesinde Türkiye’de Bankacılık, Türkmen Yayınevi, İstanbul.

Kaufmann, D. (1997), Corruption: Defects, *Foreign Policy*.

Knights D. and Majella O’Leary M. (2005), “Reflecting On Corporate Scandals: The Failure Of Ethical Leadership”, *Business Ethics: A European Review*, 14 (4).

Lamb R.B. (2000), “Ethics in financial services”, *Business and Society Review*, 104 (1).

Mitchell W., Lewis P.V. and Reinsch N.L.Jr. (1992), “Bank Ethics: An Exploratory Study of Ethical Behaviors and Perceptions in Small, Local Banks”, *Journal of Business Ethics*, 11.

Okumus, H.S., (2005), “Interest-Rate Banking in Turkey: A Study Of Customer Satisfaction and Bank Selection Criteria”, *Journal of Economic Cooperation* , 26(4).

Ozsoy I., Yabanli A., (2010) ‘The Rising Sector in Turkey: Participation Banking’, *Islamic Finance News Report*, (http://www.tkbb.org.tr/download/ISMAIL_OZSOY_AYDIN_YABANLI_ARTICLE_ISLAMIC_FINANCE_NEWS_NOV_2010.pdf, 05/10/2012)

Pehlivanlı, D. (2011). *Hile Denetimi Metodoloji ve Raporlama*, İstanbul: Beta Basım.

Wassim R. and Slim A. H., (2011) “Unconventional Banking System in Distress”, *International Journal of Economics and Finance*, 3(4).

Salman, S.A., (2007), “Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans in Turkey”, *Islamic Economic Studies*, 14.

Saving Deposit Insurance Fund (SDIF), (2009). İmar Bankası, Raf Temizliği, Ankara: Artus Basım.

Starr, M.A., Yilmaz, R., (2007) ‘Bank Runs-Market Economies: Evidence from Turkey’s Special Fianance Houses’, *Southern Economic Journal*, 73 (4).

Yıldırım, C., (2008), “Moral hazard, Corporate Governance, and Bank Failure: Evidence From the 2000- 2001 Turkish Crises”, 15th Annual Conference of the Economic Research Forum, Egypt.

<http://www.ifk.com.tr/detay.asp?ContentID=741&lang=eng>

<http://www.imkb.gov.tr/financialtables/companiesfinancialstatements.aspx>