

## LEASING (IJARA) CONTRACT AND ITS APPLICATION IN THE PARTICIPATION BANKS IN TURKEY

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### Abstract

Leasing (ijara), which is most widely used instrument after murabahah, is an excellently fit product to the functions of participations banks as it is asset-based. The biggest shares in leasing volume by type of asset are “heavy equipment and construction machinery” and “real estate”, which supports its asset-based attribute. The purpose of this article is to shed a light on the performance of participation banks in Turkey in terms of leasing and leasing contracts shall be evaluated if bearing any Shariah risk or not. It is proven by empirical data that regulatory support has direct effect on growth rate of leasing. Our method is descriptive, qualitative and revision of literature and balance sheets of participation banks.

**Keywords :** *Leasing, Ijara, Participation Banks, Turkey*

### Introduction

Islamic finance in Turkey dates back to 1985, with establishment of two special finance houses. At the end of 2005, the new Banking Act No. 5411 came into force and “Special Finance Houses” were transformed into “Participation Banks”, gaining the “bank” status which has enabled this system to grow more rapidly. Despite the global financial crisis, participation banks have benefited from the rise of the AKP and the regulatory changes. As of the year 2017, the number of full-fledged Islamic banks has reached to 5 namely: Albaraka Türk Katılım Bankası A.Ş., Kuveyt Türk Katılım Bankası A.Ş., Türkiye Finans Katılım Bankası A.Ş., Ziraat Katılım Bankası A.Ş., Vakıf Katılım Bankası A.Ş. (the last two are state-owned ones). In the last three decades, the market share of participation banks has reached to 5%.‡

The contracts used by the participation banks are not so diversified, unlikely to Malaysia. Acc. to (ORHAN, 2015), “Loans are the dominant use of funds for Turkish Islamic banks with changing ratios between 60-75% for the period of December 2005-June 2015 and the main method used for loans is murabahah with 99.7% as of June 2015”.§

Additionally, ijara is used as an alternative product. In its current application, ijarah occurs in two types, namely: operational lease and financial lease. Moreover, there is no legal title for ijara in Turkey. Participation banks uses the term “financial leasing” like conventional banks. Durable goods and equipment such as ships, aircraft, plants, heavy machines, vehicles, medical devices, airplanes can be leased. Statistically, ijara used by manufacturing industry up to 55% (heavy machines and equipments 26%), secondly by service sector up to 37% (vehicles 19%) by the end of 2017 acc. to TKBB. In the other hand Operational Leasing is not being used by participation banks.

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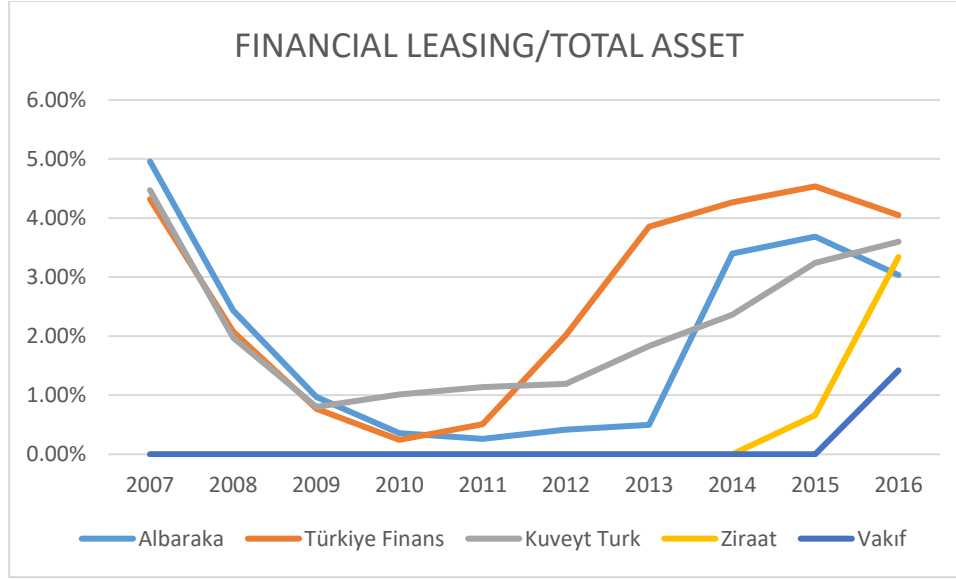
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**Table 1** Ratio of Financial Leasing to the Total Asset of the Participation Banks\*\*



Total share of participation banks in leasing market witnessed a significant growth trend as per table 2 below.

**Table 2** Total Share of Participation Banks in Leasing Segment (2009-2016) ††

Year	Segment (000 000 )TL	Total	Participation Banks Total (000 000) (TL)	Participation Banks Share (0000 000) (TL)
2016	21.741		4.089	18,81%
2015	20.515		3.934	19,18%
2014	20.543		2.889	14,06%
2013	16.437		1.875	11,41%
2012	19.049		1.010	5,30%
2011	16.693		658	3,94%
2010	11.932		276	2,31%
2009	12.878		365	2,83%

\*\*Sources: <https://www.fkb.org.tr>; <https://www.kuveytturk.com.tr>; <https://www.albaraka.com.tr>; <https://www.turkiyefinans.com.tr>; <http://www.ziraatkatilim.com.tr>; <https://www.vakifkatilim.com.tr>

††MUCAHITOGLU, N. (2015). *Türkiye'de Katılım Bankalarının Finansal Kiralamadaki yeri, Diğer Finansal Kiralama Şirketleriyle Karşılaştırılması ve Sektörde Sukuk Uygulaması Beklentileri*. İstanbul: T.C. MARMARA Üniversitesi.

In 2007 and 2011 the leasing sector was introduced with legislations related to VAT as follows:

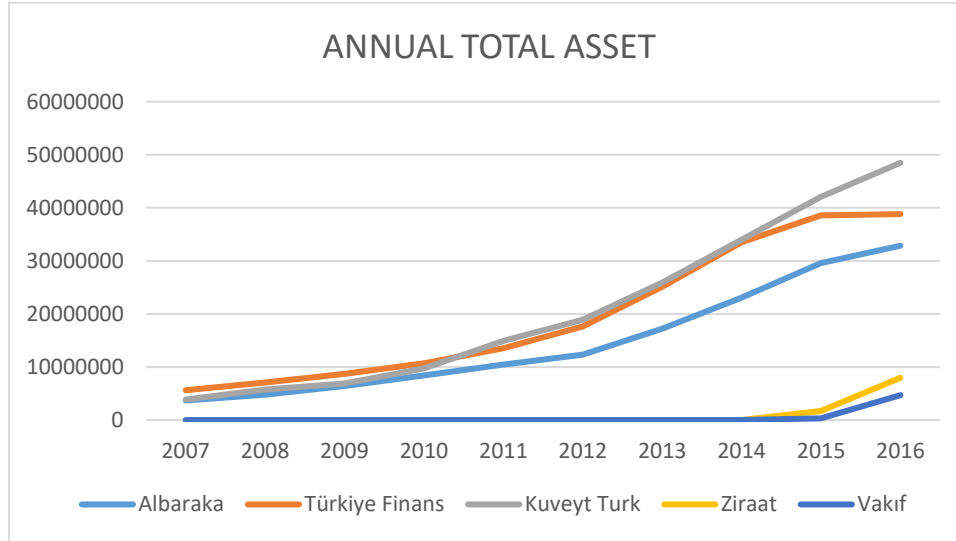
**2007** 1% VAT application for financial leasing transactions has been terminated as of 30.12.2007.

**2011** For some goods subject to the financial leasing transactions, the VAT rate has been reduced to 1% on 27.12.2011.

The data on **Table 1** also stands as empirical evidence that legal regulations are directly affecting the sector in positive or negative way. Incentives, like VAT reduction has led the sector grow.

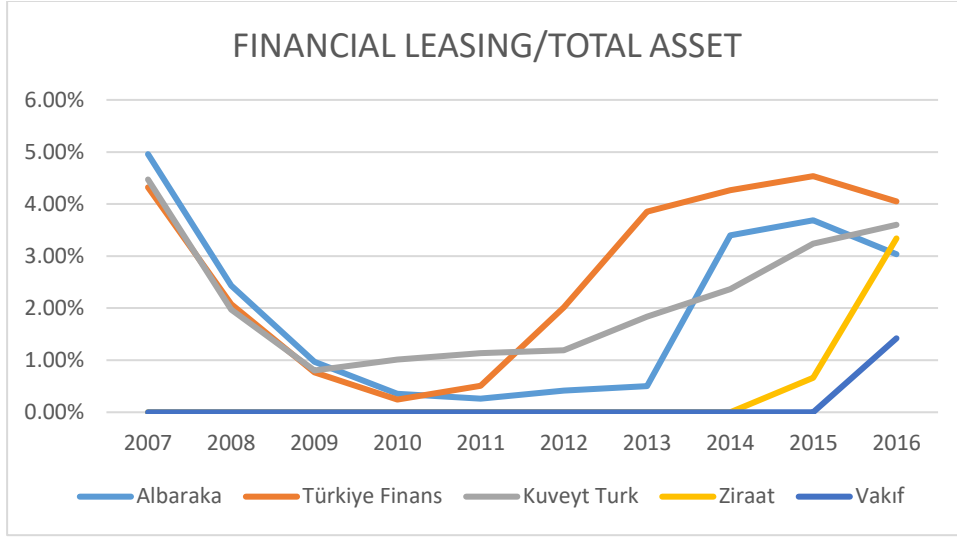
Moreover, the sector has a potential to grow since the growth rate in the sector does not linearly connected to asset growth of participation banks, as it can be seen in Table 2 and Table 3.

**Table 3** Annual Rate of the Financial Leasing to the Total Asset in the 5 Participation Banks in Turkey (2007-2016)<sup>††</sup>



<sup>††</sup>Sources: <https://www.fkb.org.tr>; <https://www.kuveytturk.com.tr>; <https://www.albaraka.com.tr>; <https://www.turkiyefinans.com.tr>; <http://www.ziraatkatilim.com.tr>; <https://www.vakifkatilim.com.tr>

**Table 4** Ratio of Financial Leasing in Total Asset of Participation Banks<sup>§§</sup>



**Table 5** Rate of financial leasing receivables in total asset of Participation Banks<sup>\*\*\*</sup>

Bank	Year	Financial Leasing Receivables (000 000) (TL)	Total Asset (000 000) (TL)	Annual Rate
Albaraka Türk	2007	182940	3690029	4,96%
Albaraka Türk	2008	116610	4789108	2,43%
Albaraka Türk	2009	62132	6414914	0,97%
Albaraka Türk	2010	29849	8406301	0,36%
Albaraka Türk	2011	27298	10460885	0,26%
Albaraka Türk	2012	51494	12327654	0,42%
Albaraka Türk	2013	85893	17216553	0,50%

<sup>§§</sup>Sources: <https://www.fkb.org.tr>; <https://www.kuveytturk.com.tr>; <https://www.albaraka.com.tr>; <https://www.turkiyefinans.com.tr>; <http://www.ziraatkatilim.com.tr>; <https://www.vakifkatilim.com.tr>

<sup>\*\*\*</sup>Sources: <https://www.kuveytturk.com.tr>; <https://www.albaraka.com.tr>; <https://www.turkiyefinans.com.tr>; <http://www.ziraatkatilim.com.tr>; <https://www.vakifkatilim.com.tr>

Albaraka Türk	2014	782612	23046424	3,40%
Albaraka Türk	2015	1090063	29561999	3,69%
Albaraka Türk	2016	996206	32850738	3,03%
Türkiye Finans	2007	242701	5616687	4,32%
Türkiye Finans	2008	147443	7104156	2,08%
Türkiye Finans	2009	66832	8699643	0,77%
Türkiye Finans	2010	26058	10691860	0,24%
Türkiye Finans	2011	68765	13528353	0,51%
Türkiye Finans	2012	354710	17616504	2,01%
Türkiye Finans	2013	968225	25126629	3,85%
Türkiye Finans	2014	1429078	33494790	4,27%
Türkiye Finans	2015	1749576	38576299	4,54%
Türkiye Finans	2016	1570602	38807717	4,05%
Kuveyt Türk	2007	172962	3868318	4,47%
Kuveyt Türk	2008	113850	5768034	1,97%
Kuveyt Türk	2009	55412	6904526	0,80%
Kuveyt Türk	2010	98725	9727117	1,01%

Kuveyt Türk	2011	169214	14897592	1,14%
Kuveyt Türk	2012	225658	18910513	1,19%
Kuveyt Türk	2013	474868	25893542	1,83%
Kuveyt Türk	2014	803896	34008175	2,36%
Kuveyt Türk	2015	1363000	42052507	3,24%
Kuveyt Türk	2016	1745190	48476955	3,60%
Ziraat	2015	11217	1691228	0,66%
Ziraat	2016	265785	7959507	3,34%
Vakıf	2015	0	313277	0,00%
Vakıf	2016	66493	4681933	1,42%

Last but not least, it has been found that contracts, which are vitally important acc. to Islamic economy, are not fully Shariah-compliant.

## 1. LITERATURE REVIEW

(KAMALI, 2005) gave basic information about the concept and definition of ijarah, conditions of validity of ijarah acc. To the leading schools of fiqh. Moreover he briefly discussed two forms of ijarah, namely operational lease and financial lease, drawing attention that financial leasing does not find a precedent in the works of fiqh.

(KAYAR, 2011) explained legitimacy of ijara acc. to Quran and Sunnah. Only definiton and giving information about validity of financial leasing.

(MUCAHITOGLU, 2015) discussed the financial leasing in the participation banks in Turkey. Legal framework, types of leasing, segments, market share of participation banks are dicusseded in detail. However, he did not discuss the conracts of participation banks, whether they are Shariah compliant or not.

(BAYKARA, 2012) measured the efficiency and productivity of The Participation Banks in Turkey which witnessed a rapid growth between 2005-2011. Leasing is included as one of the instruments used by the participation banks.

(FAHAD, 2012)indicated that when the amount of down payment is more than 40 per cent, a customer can misuses the system.

(GHANI, 2015) aimed to describe the application of the financial leasing in *Bank Muamalat Malaysia Berhad (BMMB)* and to identify ways to overcome the difficulties in managing it.

The common perception amongst customers, based on past findings, indicates that it is similar to the conventional product. Therefore, their study also tries to increase the understanding and knowledge of the product amongst the public, particularly in terms of its operation and other related issues.

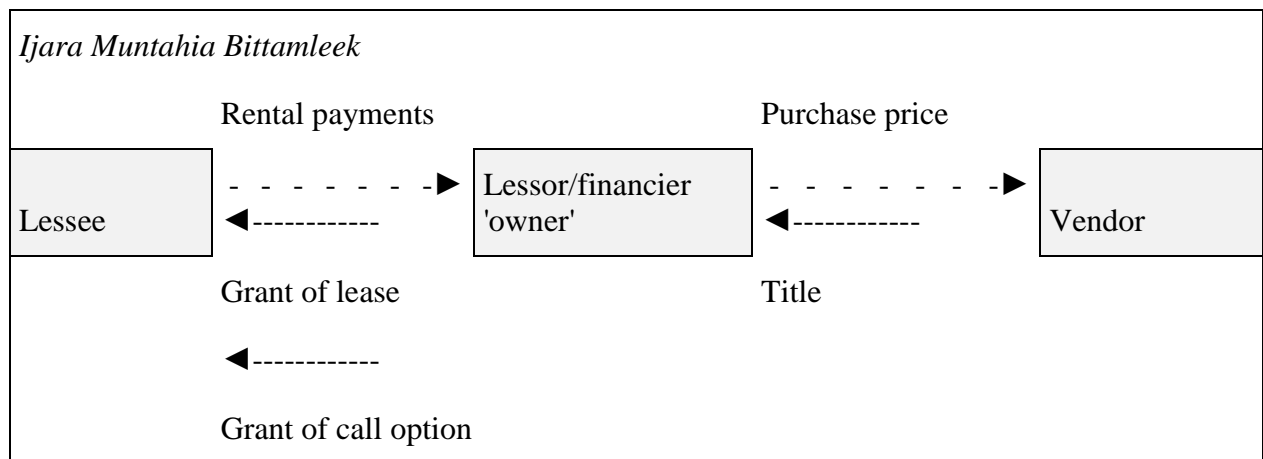
(KETTEL, 2011) compared Ijara Muntahia Bittamleek with its conventional counterpart very comprehensively.

**2.1 Definition of Ijara Muntahia Bittamleek acc. to AAOIFI**

Ijarah is a sale of benefits, or usufruct, usually of durable goods. Leasing is used as a mode of financing by the Islamic financial institutions with the purpose of enabling customers to use durable goods and equipment without having to buy them. Ijarah has two types: operational lease and financial lease. The main difference between them is that operational lease does not offer an option to the lessee to buy the leased asset.<sup>†††</sup>

Acc. to AAOIFI , *Ijarah Muntahia Bittamleek* is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the *ijarah* period or by stages during the term of the contract by one of the means specified in the Standard.<sup>‡‡‡</sup>

**Figure 1 : Ijara Muntahia Bittamleek<sup>§§§</sup>**



According to (KETTEL, 2011), *Ijara Muntahia Bittamleek* and the Standard formulated by International Accounting Standard 17 (IAS 17 ) for conventional leasing differ in many aspects.<sup>\*\*\*\*</sup>

The risk transfer to the lessee is a prerequisite for a conventional lease under International Accounting Standards. Whereas acc. to Accounting & Auditing organization for Islamic

<sup>†††</sup> KAMALI, M. H. (2005). *A Shariah Analysis of Issues in Islamic Leasing*. International Islamic University of Malaysia.

<sup>‡‡‡</sup> KETTEL, B. (2011). *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance*. John&Wiley Sons.

<sup>§§§</sup> KETTEL, B. (2011). *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance*. John&Wiley Sons.

<sup>\*\*\*\*</sup> KETTEL, B. (2011). *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance*. John&Wiley Sons.

Financial Institutions (AAOIFI), in *Muntahia Bittamleek*, the risks and rewards incidental to ownership remains with the lessor.<sup>††††</sup>

The key distinction between *Ijarah Muntahia Bittamleek* and the conventional finance lease is that in the Islamic version the lessor undertakes full ownership risks of the corpus of the leased asset.<sup>††††</sup>

AAOIFI also embodies the additional condition that the benefit should be Sharia'a compliant. Thus *Ijara* and a conventional lease differ regarding the requirement to comply with Sharia'a.<sup>§§§§</sup>

As per AAOIFI Juristic Rules on fulfilment of a promise, for the transfer to be effective, a contract distinct from the *Ijara* contract should be executed. The lessee has an option, which he may or may not exercise. Thus *Ijara wa Iqtina* would have the characteristics or the substance of a conventional lease only if the lessee exercises the option. In the absence of such exercise, *Ijarah Muntahia Bittamleek* for all intents and purposes is an operating lease. Hence in legal form and in concept, *Ijara wa Iqtina* and a conventional finance lease are not identical.<sup>\*\*\*\*\*</sup>

In *Ijara*, the risk must follow the legal title unless any damage is caused by the negligence or misconduct of the lessor. As IAS 17 looks at the substance over the form for the accounting purposes, on the transfer of the risks and rewards of the asset to the lessee, the asset is recorded in the books of the lessee coupled with the right to claim depreciation. Major repairs, maintenance and insurance remain to the account of the lessor, whereas these costs are transferred to the lessee in a conventional lease.<sup>†††††</sup>

The comparison of *Ijara* is made clearer over its conventional counterpart when it concerns the asset being faulty due to major defects. During the period in which the asset is out of order, *Ijara* rentals would be suspended so that the lessee, who can not benefit from the use of the assets, is provided with financial relief. Shariah also prohibits the levy of a penalty in an *Ijara* arrangements for the delayed payments, unlike in a conventional lease.<sup>†††††</sup>

The issue of delayed payments may be addressed in an *Ijara* contract by various means such as inclusion of a donation clause, by acceleration of installments or the cancellation of the contract. The compassionate attitude towards charging rent from the lessee is manifested at the commencement of the charge itself. In a conventional lease the payment obligation may commence from the date of execution of the contract for funding. But in *Ijara* the obligation for the payment commences only upon the delivery of the asset to the lessee or upon enabling the use thereof by him.<sup>§§§§§</sup>

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<sup>††††</sup> KETTEL, B. (2011). *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance*. John&Wiley Sons.

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In the case of Turkey, there is no legal title for Islamic form of leasing. In Turkey financial leasing means operational leasing ending with ownership (Ijara Muntahia Bittamleek) when it is applied by participation banks in Turkey.

## 2.2 The Application of the Financial Leasing in the Participation Banks\*\*\*\*\*

According to *Association of Financial Institution in Turkey* (Association of Financial Institution in Turkey, 2018), steps are applied in the following order:

- 1) The investment property is selected by the lessee company and accordingly a preliminary agreement is made with the vendor including the price and delivery terms.
- 2) At the phase of providing finance to the project, the investor company applies to a financial leasing company. The investor submits to the financial leasing company the required information and documents for analysis.
- 3) The financial leasing company makes an offer to the investor by making the required financial analysis. If the financial leasing company deems it necessary, it may request guarantee from the investment company.
- 4) The following kinds of guarantees are required in leasing transactions:
  - Personal or corporate guarantees
  - Security bonds / cheques
  - Mortgages
  - Establishment / machinery pledge
  - Assignment of receivables
  - Vehicle pledge
  - Cash blockage
  - Letter of guarantee
- 5) When the parties come to an agreement, the financial leasing contract is signed between the financial leasing company and the investment company.
- 6) In case that the investments have incentive, an application is made to the Ministry of Economy after signing the financial lease agreement, and it is defined with a letter which of the goods and properties identified in the goods list in the attachment of the incentive document, are to be purchased by the financial leasing company within the scope of financial lease contract. The financial leasing company benefits from the incentives related to the goods, with the capacity as the owner and reflects them to the lessee.
- 7) The financial leasing company pays the cost of the goods to the vendor company.
- 8) The goods subject to financial leasing are delivered to the lessee.
- 9) The lessee pays the rents identified in the financial leasing contract to the financial leasing company and uses the goods.
- 10) At the end of the leasing period, the goods are transferred to the lessee over a symbolic price that is identified in the contract. Although not very often encountered at practice, it may occur that the goods are returned to the lessor at the end of the contract.

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\*\*\*\*\* (2018). Association of Financial Institution in Turkey: <https://www.fkb.org.tr/sectors/financial-leasing/adresinden-alindi>

- 11) The leasing company has the ownership rights during the contract period.
- 12) According to contract conditions, the leased asset may be transferred to the lessee at the end of the contract.

The following items can be financed by financial leasing :

- Medical devices, computers and other information processing units
- Plant and communication devices
- Power plants
- Land transportation vehicles
- Air transport vehicles
- Dry cargo ships, tankers and other vessels
- Construction machinery, lifters, heavy equipments
- Printing machines
- All kind of counters and production machines
- Textile machines
- Entire factories
- Entire hospitals, hotels and office equipment
- Real estate
- Duplicate copies of computer programs

In general, every natural and legal person authorized to conduct legal proceedings can be a lessee. Accordingly; any individual company, all kinds of partnerships, self-employed and farmers can be lessees.

Institutional investors who wish to enlarge or modernize their existing facilities, to operate in new production areas, to expand their distribution network, to make energy- saving investments, to operate in new business branches and to increase their capacity. Self- employed and individual investors who want to create a balanced budget, to have new technologies and who plan to establish workplaces, office and clinics. Vendor companies who wish to go to a fast result as an alternative financing tool for the realization of a sales transaction and who want to increase their sales and structure their own cash flows. All these ones can use financial leasing transactions to attain their goal.

### 2.3 Advantages of Leasing<sup>†††††</sup>

According to Türkiye Finans (Türkiye Finans, 2018), advantages of leasing is listed below:

- First of all, the main advantage is for the lessor, as the ownership remains with lessor throughout the leasing period, and transfers to the lessee when rental payments are over.
- Leasing submits immediate delivery and long-term rent payments.
- Using the advantages of leasing the lessor can obtain 100% financing for the project, thus keeping their equity intact.

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<sup>†††††</sup> Türkiye Finans. (2018). <https://www.turkiyefinans.com.tr/en-us/commercial/cash-loans/Pages/leasing.aspx> adresinden alındı

- Financial leasing submits financial facility to SME (Small and Medium Entity)'s. If funds and borrowing means are limited, it is an advantage of realizing growth and investment.
- Financial leasing transactions can also be used for machinery and equipment to be purchased from abroad. Since in the financial leasing transactions, all the products are purchased by the financial leasing company, every kind of import transactions, customs procedures and relevant paperwork is performed by the financial leasing company. All leasing-related procedures will be followed up to conclusion by the specialists of financial institution.
- The payment plan is determined freely by the lessee and the lessor within the framework of the lessee's request. The lessee will be provided with ease of payment and an opportunity to remain liquid, as the rent payment plan and rent amounts are set upon mutual agreement of the lessor and the lessee.
- Since there is no legal regulation about the contract period, there should be no difference between the rental periods and the contract period/ the date of assignment of the asset to the lessee. However, there is no obstacle in determining different dates.
- Instead of 18% VAT, there is tax incentive which is reduced to 1% for some goods in the financial leasing.
- If the lessor company have incentives, it can have the Leasing company make use of the incentives awarded for the investment.
- Leasing gives the confidence of fixed period of rent and fixed rental amounts as a measure against inflation.
- Although lease expenses get the same treatment as that of interest expense, the lease itself is treated differently from debt. Leasing is classified as an off-balance sheet debt and doesn't appear on company's balance sheet.
- For businesses operating in the sector, where there is a high risk of technology becoming obsolete, leasing yields great returns and saves the business from the risk of investing in a technology that might soon become out-dated. For example, it is ideal for the technology business.
- Financial leasing allows to own the leased goods against an insignificant amount of payment at end of the lease period.

#### **2.4 Shariah Issues related to the application of the financial Leasing used by Participation Banks**

The comparison of theory and practice of *Ijara Muntahia Bittamleek* in the participation banks requires a comprehensive study. But, the most remarkable issues are noted below.

Inside the document of 'Financial Leasing Contract' prepared by Turkish participation Banks, there are some controversial parts as follows:

- Failure to Deliver the Object Leased

Acc. to AAOFI Standard 9 - 5/2/2, the lessor's entitlement to the rental runs from the time when the lessee starts to benefit from the asset available to the Lessee, not from the date of signing the *Ijarah* contract.

However, participation banks requires that:

All responsibility arising out of delivery of the leased shall be borne by to the Lessee with the title of guarantor. The Lessee may not make any demand, may not fail to pay rents or may not pay later for that the producer/seller does not deliver the Leased, delivers it lately, the Leased does not meet the characteristics, quantity, type, and features determined.

- Maintenance and repair

As recommended by AAOIFI, the Lessor may not stipulate that the Lessee will undertake major maintenance of the asset. The Lessor may delegate to the Lessee the task of carrying out such maintenance at the Lessor's cost.

Participation banks requires that all sorts of ordinary and extraordinary maintenance and repair, preservation, and other similar expenses are to be covered by the Lessee.

- Insurance

As recommended by AAOIFI, the risk must follow the legal title, and thus the Lessor should be responsible to insure the Leased. He may also delegate to the Lessee the task of taking out insurance at the Lessor's expense. However, application in participation banks reveals that, the Lessee is responsible for insurance of the Leased on behalf of the Lessor and to pay all the premiums and expenditure taxes related to the insurance. On the contrary, the indemnities arising out of the insurance contract are directly paid to the Lessor.

- Default and results

Acc. to AAOIFI Standard 9- 6/3, no increase in the rental due may be stipulated by the Lessor in case of delay in payment by the Lessee.

On the contrary, in the event that the monthly lease amounts are not paid in any 3 (three) months during hte 1 (one) year period from the starting date of the contract or in the event that 2 (two), the Lessor may ammend the payment schedule.

### **Conclusion**

Leasing (both conventional and Ijara ), which is commonly used for medium-term financing of investments all over the world, has great advantages over the other financial methods in meeting the increasing working capital requirements of organisations, particularly in inflationist economies. With the advantages like 100% financing, flexible rental plan, make use of incentives, possibility to purchase the leased good, ensure confidence against inflation, tax benefit; financial leasing sector is expected to have a great potential to grow in Turkey.

The participation banks has to ammend the controversial parts in the contract such as maintenance and major repair costs and the issue of faulty/out of operation period. Without any improvement, the contracts would be void, not Shariah-compliant. Contracts should be reviewed and rectified.

When we evaluate the statistics, conventional leasing and ijara Muntahiaj Bittamleek (its Islamic counterpart) shows a decreasing trend between 2007- 2011.The main reasons for this case are the mortgage crisis and 1% VAT application for financial leasing transactions has been terminated as of 30.12.2007.

However it shows an increasing trend after year 2011 as for some goods subject to the financial leasing transactions, the VAT rate has been reduced to 1% by 27.12.2011 again.

Nevertheless, the market ratio of participation banks in Turkey still remains too lower than their asset growth ratios. Annual rate of financial leasing receivables in total asset is still in one digit percentage.

New regulations are expected with extension of scope of assets subject to financial leasing tax reductions.

Participation banks of Turkey has a long way to go in financial leasing sector.

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