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The emergence of the Turkish sukuk market

As one of the new MINT economies and the 17th biggest economy in the world, the Republic of Turkey has in recent years begun utilising *shari'a* compliant *sukuk* issuances as a means of attracting some much sought after capital investment into the country, particularly from the Middle East where the demand for *shari'a* compliant securities is far outstripping supply. Recent legislation in the Republic of Turkey has broadened the number of *sukuk* structures that are permitted, to allow the Turkish *sukuk* market to expand. For the first time these new structures will permit corporates and other non-financial institutions to issue *sukuk* and may attract investment into areas such as infrastructure projects, which is becoming one of the key areas of focus for the Turkish government. This article considers the new structures and the legislative framework.

In 2011, the participation bank Kuveyt Türk (after issuing a pioneering first Turkish *sukuk* in 2010) issued the first *sukuk* pursuant to newly enacted legislation entitled the Principles on Lease Certificates and Asset Leasing Companies (the "First Legislation"). The Republic of Turkey then issued its first US$1.5 billion sovereign *sukuk* in September 2012 which was followed by a US$1.25 billion sovereign *sukuk* issuance in October 2013. The Republic of Turkey also tapped the local *sukuk* market by issuing Turkish Lira denominated *sukuk* in 2012 and 2013, which proved to be another very important milestone in the growth of the Turkish *sukuk* market. These issuances mostly followed a traditional sale and leaseback model known as an *ijara* structure.

The First Legislation allowed the formation of asset leasing companies which are special purpose vehicles regulated by the Capital Markets Board of Turkey (the "CMB"). Under the First Legislation the asset leasing companies issuing certificates under an *ijara* structure are incorporated specifically to be able to issue certificates bought by investors (known as "certificateholders") so as to purchase assets and lease them back to the originator. In essence, the asset leasing company finances the acquisition of such assets using funds raised by the issue of certificates, and the lease rental payments from the originator mirror the profit distributions due under the certificates. The cash flows from the lease rentals are therefore used to service such profit distributions to certificateholders.

The framework in which Turkish *sukuk* are issued uses deliberately different terminology, such as "asset leasing companies", as opposed to "*sukuk* trustees" used in typical non-Turkish *sukuk* structures. The asset-based as opposed to asset – backed *ijara* structure was originally the only type of structure allowed under the First Legislation. This opened the way for *sukuk* issuance in Turkey, and while highly useful, the *ijara* structure is not suitable for certain types of financings, such as infrastructure projects, as an asset leasing company cannot purchase and create a lease over an asset before it is built. The sovereign *sukuk* issuances were sought as the benchmark by which to establish the Turkish *sukuk* market as a global hub for Islamic finance. In addition to Kuveyt Tü□rk, the three other Turkish participation banks (AlBaraka Bank, Bank Asya and Tu□rkiye Finans Bank) also issued *sukuk* both in the domestic and international markets. The global capital markets community has followed the first sovereign and participation bank *sukuk* issuances with great interest and the desire to allow non-financial institutions to

issue their own *sukuk* was given legislative support, in the recent Communiqué on Lease Certificates (III-61) issued on 7 June 2013 (the "Second Legislation") partly thanks to the CMB's great effort and willingness to improve and develop the *sukuk* market in Turkey. The Turkish government has also announced that it hopes to grow the participation banks' market share and has announced its intention to grant a participating bank licence to at least one of the state – owned banks, which demonstrates the growing importance of Islamic finance in the country's wider fiscal strategy and the Turkish government's desire to bring new players into the market.

In addition to the by now established ownership or *ijara* structures allowed under the First Legislation, the Second Legislation also allowed asset leasing companies to issue lease certificates based on management (*mudaraba*), purchase and sale (*murabaha*), partnership (*musharaka*) and contractor agreement (*istisna*) structures. While it is expected that the initial *sukuk* issued following the Second Legislation will follow the *ijara* model, the Second Legislation allows the possibility to finance a much wider range of projects and businesses.

Under the management, or *mudaraba,* structure certificates are issued for the purpose of transferring the income generated from the management of the assets of an originator, including via a lease of assets owned by such originator, to certificateholders during the term of the *sukuk*. In this structure an agreement will be executed between the originator and the asset leasing company to govern the management of the assets of the originator without transferring the ownership.

The *musharaka* model is in essence a joint venture structure between the originator and the asset leasing company whereby the originator retains a role as managing agent and shares in the loss and profits of the structure with the certificateholders. The Second Legislation regulates the financing of the joint venture through the issuance of certificates whereby the asset leasing company exclusively contributes capital and other parties contribute other tangible capital.

The *murabaha* model can be used in situations where there are no tangible assets in the underlying structure and the proceeds of a certificate issuance can be used to fund the purchase of commodities and the asset leasing company can on-sell the commodities to the originator to generate revenue from the deferred purchase price which is then distributed periodically to the certificateholders during the term of the *sukuk*.

Of particular interest is the *istisna* structure, which could be used to finance infrastructure projects such as airports or motorways. The *istisna* structure works by means of a forward lease agreement, whereby capital is provided to purchase the initial raw materials or land involved in a project and the forward lease agreement provides that the eventually complete asset is sold and leased back to the originator and such profit distributions from the asset are distributed to certificateholders much like in an *ijara* structure. While there is some debate among *shari'a* scholars as to whether certificates can be used before the project is finalised, it is clear that this particular structure has great potential to be used to finance some of Turkey's future infrastructure projects.

The need for a valuation report under certain structures is one of the most important aspects that the Second Legislation has introduced, which is especially important for originators to consider, in that it regulates the value of the asset portfolio on which the issuance is based. The Second Legislation provides that the issuance amount of lease certificates based on ownership (*ijara*), partnership (*musharaka*) or contractor agreement (*istisna*) structures may not exceed 90% of the fair value of the underlying assets determined under a valuation report prepared by a valuation company. This ensures that such issuances are sufficiently covered by the assets upon which they are based, and affords some reassurance for certificateholders should such a structure go into default. Originators considering entering the Turkish *sukuk* market will therefore need to ensure that they have sufficient assets on which to base their issuance. Not only will such originators need to satisfy the requirements of the valuation report, they will also need to ensure that the assets on which the issuance is based are *shari'a* compliant.

The asset leasing companies at the centre of the Turkish *sukuk* market are unlike special purpose vehicles found in traditional securitisations or in other *sukuk* markets, in that they can issue multiple *sukuk* and can issue certificates for companies other than the company which was incorporated to issue them. However, the Second Legislation makes it clear that the entities listed in (d), (e), (f) and (g) below can only establish asset leasing companies if they are actual fund users and cannot establish on behalf of third parties. The Second Legislation has listed the entities being allowed to establish an asset leasing company as:

(a) banks;

(b) intermediary institutions engaged in one of the following: (i) portfolio intermediation; (ii) general custodian service; or (iii) underwriting;

(c) mortgage financing institutions;

(d) real estate investment trusts listed on the stock exchange;

(e) public companies in the first and second groups determined in accordance with corporate governance regulations of the CMB;

(f) companies issued with a long – term investment grade rating; and

(g) companies of which 51% or more is owned by the Undersecretariat of the Treasury.

The Second Legislation does not clarify if the investment grade referred to in limb (f) above needs to be obtained from an international rating agency, although the CMB has approved local Turkish rating agencies' ratings on recent *sukuk* issuances, in respect of this requirement. It is also assumed that the rating only applies at the moment of issuance, as the Second Legislation is silent as to whether such investment grade rating needs to be maintained by such asset leasing company.

The asset leasing companies are also unlike other special purpose vehicles in that they are heavily regulated by the CMB.

The Second Legislation principally requires the CMB to approve the articles of association of an asset leasing company before it can issue *sukuk*. In addition, the CMB's approval is required in the following circumstances:

- where the asset leasing company is party to a merger and de-merger transaction and amends its articles of association;
- where any acquisition of shares that results in the acquisition of shares by one person directly or indirectly, representing 10% or more of the capital of an asset leasing company or where by virtue of a share acquisition the shares held by one shareholder exceed or fall below certain percentages of the asset leasing company's capital; and
- where there is a transfer of shares granting management or voting privileges.

In addition, pursuant to the Second Legislation, an asset leasing company may not:

- engage in any activities other than those indicated under its articles of association as approved by the CMB;
- grant any property rights in favour of third parties over its assets and rights other than as permitted under its articles of association;
- dispose of such assets and rights in any way which prejudices the interests of the certificateholders; and
- use any loans, be indebted or use any assets except for such activities set out in its articles of association.

The CMB also provides that the asset leasing company is to have at least three board members, one of which must be an independent board member who satisfies the CMB's independency criteria and certain decisions are subject to the vote of such board member. The board of directors of the asset leasing company is required to prepare quarterly investor reports which shall include revenues and collections made from the relevant assets and payments made to the certificateholders.

As asset leasing companies can issue multiple *sukuk*, the importance of segregating assets to minimise the insolvency risk and the risks of cross-default is paramount. The Second Legislation also sets out that separate records are to be kept in respect of the assets which are subject to each issuance, including the revenues generated, the collections made and the expenses incurred with respect thereto. The assets, rights and liabilities of each issuance for each company are separately monitored in the records of the asset leasing company and until certificates are redeemed, assets in the portfolio of an asset leasing company may not be disposed of, collateralised or seized. It is important to bear in mind, however, that unlike special purpose vehicles used in non-Turkish *sukuk*, the asset leasing companies are not entirely insolvency remote by virtue of the fact that they hold assets on behalf of different companies. However, under the Second Legislation, until the redemption of the certificates occurs, the assets and rights included in the portfolio of the asset leasing company cannot be included in the insolvent company's estate nor can they be subject to an injunction order.

Along with the First Legislation, amendments in the tax legislation have also afforded certain tax

advantages on *sukuk* which means that corporates wishing to raise finance through the *sukuk* market will be able to raise finance in a way which is competitive with traditional finance raising and could open them up to a currently unavailable investor pool, such as certain investors from the Middle East who can only purchase *shari'a* compliant securities. Below are some of the key tax advantages of the *sukuk* that have been recently passed pursuant to Turkish tax legislation:

- Pursuant to the Corporate Tax Law (Law No 5520), any capital gains to be derived by an originator from the sale of an asset portfolio to an asset leasing company and from an asset leasing company to an originator are exempt from corporate tax on the condition that such sales are only made for the issuance of the certificates by the asset leasing company. In order to benefit from such exemption, the capital gains derived from such sales must be reserved in equity as a fund which is not to be distributed for five years and the sale proceeds must be collected in cash within a two-year period.

- Under the VAT Law (Law No 3065), the delivery of certificates is exempt from VAT. In addition, the transfer of assets to an asset leasing company as well as the lease of assets by an asset leasing company and transfer to the originator are exempt from VAT.

- Pursuant to the Charges Law (Law No 492), the sale of the asset portfolio in a *sukuk* is exempt from the Title Deed Registry Fee and other fees.

- The Income Tax Law (Law No 193) requires withholding tax from the interest income received under the certificates issued abroad. However, the rate of such withholding tax is reduced to 0% for such certificates with a maturity of five years, as is typical for a *sukuk*.

- Pursuant to the Stamp Tax Law (Law No 488), the transfer of assets to an asset leasing company, the transfer of such assets by an asset leasing company to the originator, documents issued with respect to the lease and the certificates are all exempt from Turkish stamp tax. A non-resident holder will also not be liable for Turkish inheritance, registration or similar tax or duty with respect to its investment in lease certificates.

Currently, the tax legislation has mainly been applied to the *ijara* structured *sukuk* and it may be that further tax legislation will need to be enacted to encourage the use of the other structures that have been introduced by the Second Legislation.

The Turkish government is very keen to use Islamic finance as a means of attracting investment into the country, particularly from the Middle East, and the initial sovereign issuances were many times oversubscribed. There are certain tax advantages of using *sukuk* to raise finance and both the First Legislation and the Second Legislation have been enacted to create a framework by which different *shari'a* compliant structures can be utilised and are specifically designed to allow new players to enter the market. While it is clear that there are excellent opportunities in the Turkish *sukuk* market, there are a few challenges that new entrants into the market may face, including understanding the scope and limitations of Islamic finance and the difficulties in reconciling the new structures with existing Turkish capital markets and tax legislation. Once these obstacles are addressed and the new structures become tested and established, Turkey is perfectly placed to become a global hub of Islamic finance.

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