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Turkey's expanding Islamic bond market

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Banks using Islamic finance models in Turkey started their activities as early as 1984, although the sector witnessed a significant boost only recently, in line with the increase in the worldwide application of Islamic finance transactions. Since 2005, these institutions have been referred to as participation banks, by virtue of the Turkish Bank Code (dated October 19 2005 and numbered 5411). As of May 2012, there are four participation banks either fully established, or operating through a branch office, in Turkey, namely Albaraka Turk, Bank Asya, Kuveyt Turk and Turkiye Finans (formerly the Faisal Finance Institution). Turkish participation banks follow global practices, using various financing models approved by the *shariah* scholars, such as *sukuk al ijara, mudarabah, musharakah* and *murabahah*. With the recent increase in activity, their aggregate transaction volume has multiplied over the years, reaching $700 billion as of May 2012 (according to The Participation Banks Association of Turkey).

Among these, *sukuk al ijara*, a type of *sukuk* where the underlying transaction is a sale and leaseback arrangement, is gaining significant importance with the recent legislative changes facilitating its implementation. Until 2010, Turkish legislation gave very few incentives for the issuance and sale of *sukuk*. Moreover, the financial institutions, the originators (as asset owners) and investors (as *sukuk* holders) in a*sukuk al ijara* transaction were subject to various tax implications applicable to a regular sale and leaseback transaction, as will be explained below. One such setback was the value added tax ("VAT") incurred on each separate transaction constituting a one and single*ijara* (Article 28 of the VAT Code numbered 3065 and dated October 25 1984).

With the recent regulation forming the backbone of *sukuk al ijara* offerings and private placements in Turkey and the amendment to the tax regulations that took place in early 2011, the Turkish *sukuk al ijara* market can now be deemed to be functioning. A very recent development that will push forward the progress is the omnibus bill which entered into force on June 29 2012, that enables the issuance of Treasury *sukuk al ijara*. These regulations as a package, aim to encourage the use of Islamic finance tools and to strengthen the *sukuk*market in Turkey.

Introducing lease certificates

The first recent activity in an otherwise dormant *sukuk* market was the enactment of the Capital Markets Board's (CMB) Communiqué on the Principles Regarding Lease Certificates and Asset Lease Companies ("Communiqué") in April 2010. By way of this

Communiqué, lease certificates were introduced to the Turkish market for the first time. While the term lease certificate is used in the Communiqué, it also uses the term lease-backed *sukuk*, in other words *sukuk al ijara*.

The Communiqué focuses on lease certificates, particularly the issuance and sale of *ijara* certificates. It also regulates the structure of financial institutions – special purpose vehicles ("SPV"), and their principles of incorporation and activities. Setting out the mechanism for*sukuk al ijara* and enabling the trade of lease certificates at the exchange market, the Communiqué is pivotal in enabling asset lease SPVs to actively issue and sell *ijara* certificates in Turkey. In that respect, the asset lease SPVs can be established by banks, intermediaries or the originators and can only be incorporated as a joint-stock company. The Capital Markets Board and the Banking Regulation and Supervision Agency (BRSA) both have supervisory authority over the SPVs. The CMB is granted the authority to approve the Articles of Association of an asset lease SPV with consultation to the BRSA. The main supervisory authority remains the CMB, subject to the provisions of the Turkish banking regulations.

The Communiqué outlines the rules for a *sukuk al ijara* public offering and the content of the offering circular. With that, the public offer can only be made through an intermediary institution with a license to that effect and these intermediaries are the sole participants authorised for the payment of profits over the *sukuk*. Private placement is regulated as an alternative to the public offer in the Communiqué, in which case an offering circular is not required. Both the private placement and the public offering are subject to the strict scrutiny of the CMB as outlined in the Communiqué.

The Participation Index

One of the most significant recent developments is the establishment of trade of the Participating Index Investment Fund on Istanbul Stock Exchange on May 16 2012. This trade is sponsored by Albaraka Turk, Bank Asya, Kuveyt Turk and Turkiye Finans through an intermediary. The Participation Index is a stock market index consisting of stock certificates issued in accordance with the principles of participation banking. Selection of stock certificates would be made based on Index Rules created in this direction. In addition, companies that would operate in the Participation Index are required to comply with certain financial ratios.

Tax exemptions

Taking into account the tax barriers in this field, an omnibus bill was passed on February 13 2011, providing certain tax exemptions for*sukuk al ijara* transactions. Among other unrelated legislative amendments, the omnibusbill brought changes to various taxation aspects relating to the *ijara sukuk* through amendments made to various Turkish tax regulations, as described below.

A corporate tax of 20% applies to the earnings of a company under the Turkish Corporate Tax Code (numbered 5520 and dated June 13 2006). Particularly, through the *sukuk al ijara* process, the sale of the asset from the originator to the *sukuk* SPV and sale of the asset back to the originator by the *sukuk* SPV create earnings. Ordinarily, such corporate earnings would have been subject to the 20% corporate tax. The omnibus bill now exempts corporations from this obligation.

Pursuant to the Turkish VAT Code, a 1% to 18% VAT is applied to sale and/or leasing transactions. In this regard, sale of the asset by the originator to the *sukuk* SPV and vice versa, leasing of the asset by that SPV to the originator, as well as issuing of lease certificates would have been subject to VAT. With the amendments brought by the omnibus bill, VAT will no longer be applicable to the sale and leaseback transaction nor to the lease certificate issued for that underlying transaction.

Under the Turkish Stamp Tax Code (numbered 488 and dated July 11 1964), for each document or agreement issued in relation to the sale and leasing of assets, an 0.825% stamp tax applies on the value indicated in the relevant document. The omnibus bill also exempts the documents prepared for the sale transactions of the asset between originator and the *sukuk* SPV, mortgage transactions in relation to the immovable underlying assets, the leasing of the assets and even the issuance of *sukuk* from any stamp tax otherwise incurred.

Pursuant to the Turkish Income Tax Code (numbered 193 and dated January 6 1961), income tax applies to earnings from movable properties, including conventional bonds. Although the amendments of the omnibus bill includes *ijara* certificates among such bonds, it also amends the Turkish Income Tax Code (Article 80 of the omnibus bill amends Article 75 of the Turkish Income Tax Code), setting a varying rate of 0 to 10% applicable on income generated from the issuance of offshore *sukuk*. This range depends on the maturity of the*ijara* certificates. Earnings from *ijara* certificates issued offshore with a maturity of five years are exempt from income tax. Earnings from*ijara* certificates issued offshore with a maturity of one year will be subject to 10% income tax. A rate of 7% applies, if the maturity is between one and three years. Finally, earnings from offshore *sukuk* with a maturity of three to five years will be taxed at a rate of 3%.

The amendments of the omnibus bill exempt the underlying transactions in a *sukuk al ijara* (the transfer of assets from the originator to the*sukuk* SPV and from that SPV back to originator and establishment of any mortgage in relation with these transfers) from administrative fees ordinarily applicable to these transactions in accordance with the provisions of the Turkish Act of Fees. For instance, real estate registry fees, cadastral survey fees, notary public fees will be exempt for *sukuk al ijara* transactions.

Treasury *sukuk*

On June 29 2012, an omnibus bill entered into force which, among other things, enables the issuance of Treasury *sukuk al ijara* (The Code numbered 6327 and dated June 13 2012 Amending the Individual Pension Savings and Investment System Law and Certain Laws and Statutory Decrees and hereinafter referred to as "Code numbered 6327 and dated June 29 2012").

The Code numbered 6327 and dated June 29 2012 added a new article to the Turkish Public Finance and Debt Management Lawregarding the issuance of lease certificates, in the section setting forth domestic and foreign debts. With this addition, Treasury *sukuk*certificates can be issued onshore or offshore where the underlying assets will be state-owned movable and/or immovable properties. Only assets owned by state-owned, publicly-traded companies are excluded from this scope. Another form of assets which can be the basis of a Treasury *sukuk al ijara* is the intangible assets of such institutions, such as their usufruct rights or operational privileges. For instance, the Treasury will be able to issue *sukuk* certificates whereupon the income is generated from the operation of state-owned bridges, dams, railways, highways, airports and so on. The revenue generated from the issuance of Treasury *sukuk* will be diverted to the Treasury (Preamble of Article 29 of the Code).

The Code numbered 6327 and dated June 29 2012 provides that the Minister of S tate in charge of the Undersecretariat of Treasury will authorise the Treasury to establish asset lease SPVs or instruct public capital institutions to establish such SPVs, for the sale, purchase, sell-back, lease, leaseback and transfer (with or without payment) of state-owned movable, immovable or intangible assets. These SPVs are exempt from complying with the standard legislative requirements on establishment, registration, operation and liquidation (such as real estate registry changes and official form requirements according to the reasons referred to in the Preamble of Article 29 of the Code). The wording relating to this exemption is very vague and broad and, at this stage, it is hard to predict exactly which requirements will be exempt. However it may be assumed that further regulation detailing such general aspects will be issued in the forthcoming days.

Any third-party transactions related to the underlying assets of the Treasury *sukuk* will be prohibited for the duration of the *sukuk*. This is to ensure that the asset and any legal right attached thereto remains intact and in compliance with the *sukuk*'s terms and conditions. In that respect, even a third-party transferee in good faith of such assets will not be protected (according to Article 763/2 of the Turkish Civil Code numbered 4721 and dated December 8 2001, the acquisitions of immovable properties by third parties in good faith are protected against claims of ownership). The maintenance, repair and construction of underlying assets of lease certificates will be under the responsibility of the originator public institution (Preamble of Article 29 of the Code).

For ease of implementation, Treasury lease certificates issued by the *sukuk* SPVs will be subject to same legislation pertaining to Treasury bonds, which are regulated under the Law on Central Bank of the Republic of Turkey (numbered 1211 and dated June 3 1986) and the Turkish Capital Markets Law (numbered 2499 and dated July 30 1981). For instance, Article 41 of the Law on Central Bank of the Republic of Turkey states that financial services for government's domestic debt certificates are to be provided by the Turkish Central Bank. This will apply to Treasury *sukuk* as well. Pursuant to Article 4 of the Capital Markets Law, debt certificates or securities issued by the general budget institutions and contributory budget institutions (which solely/partially produce public goods and services, respectively, and are financed by public sources) and/or the Turkish Central Bank are not required to be registered with the Capital Markets Board. The same will apply to *sukuk al ijara* issued and amortised by the Treasury's asset lease SPVs (Preamble of Article 29 of the Code).

An additional relief brought by the Code numbered 6327 and dated June 29 2012 which enables the issuance of Treasury *sukuk* is that the underlying transactions (the sale and leaseback arrangement, for instance, of state-owned assets), are outside the scope of the Turkish State Procurement Law (numbered 2886 and dated September 10 1983) and the Turkish Public Procurement Law (numbered 4734 and dated January 22 2002). Any sale and leaseback of the public institutions, in that respect, need not to comply with the cumbersome public tender procedures. Treasury *sukuk* can also be provided as security/guarantee in a public tender.

The introduction of the Code numbered 6327 and dated June 29 2012 will undoubtedly lead Treasury *sukuk* to become a significant tool in leveraging the financing of state-owned projects, including infrastructure and transport. This is expected to divest into state-sponsored (or co-sponsored) areas, such as health, transport, energy, education, telecommunication, public works and construction projects.

A last word

Without doubt the legislative developments (the Communiqué and the following amendments made by the omnibus bill regarding tax exemptions and the Code of June 29 2012 enabling the issuance of Treasury *sukuk*) provide incentives to *sukuk al ijara* issuers and holders and will bring further activity to this market. Reflections of these improvements can easily be observed. For instance, following the enforcement of the Communiqué and the tax incentives, an offshore *sukuk al ijara* was issued in 2011 by one of the four participation banks in Turkey. In fact, in August 2010, before the legislative improvements, the same bank issued an offshore *sukuk al ijara* of $100 million listed on the London Stock Exchange with a maturity of three years through its Cayman Islands SPV. A further *sukuk al ijara*amounting to $350 million with five-year maturity was issued and listed in London by the same bank, this time through its Turkish asset lease SPV, benefiting from the tax exemptions brought over the last year. Further information for both can be obtained from the related official circulars.

Turkey expects to attract further investment through the Gulf region and other jurisdictions where Islamic finance tools are more commonly used in addition to the mechanism of, and investors in, conventional finance schemes.

In addition to *sukuk al ijara*, the Turkish market has been active in other forms of Islamic finance as well. For instance, two participation banks were recently involved in *murabaha* syndications amounting to $350 million and $590 million, respectively.

With the recent legislative improvements, particularly the tax relief and the formation of the backbone for *sukuk* trade, Turkey is now paving the path for further inflow of investment as well as a more developed financial market. The Islamic finance market is likely to increase to grow, with new onshore and offshore *sukuk* issuances, as well as syndications. The recently enacted Code numbered 6327 and dated June 29 2012 enabling the issuance of Treasury *sukuk* will have a significant impact on the methods of finance and leverage for state-owned projects and attract investors beyond the conventional finance jurisdictions. As the Turkish Islamic finance market becomes more sophisticated, the legislation will too develop to accommodate more sophisticated mechanisms.

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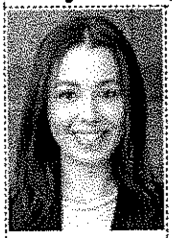

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