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The IFN Turkey Report 2016

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Turkey shining bright despite overcast

It is with great delight that we launch the inaugural IFN Turkey Report, an insightful review of the Turkish Islamic finance landscape exploring its performance, prospects, challenges and opportunities for future growth and development.

Turkey has always been a bright spot for Islamic finance and the Republic continues to demonstrate strong political will to advance its participation finance industry by supporting development with various legislative and regulatory initiatives and top-down measures. Yet, it has not always been an easy journey for the Eurasian country, with 2016 bringing unexpected and unforeseen difficulties.

Viewed as one of the more promising emerging nations, commanding one of the world's 20 largest economies, Turkey is for the first time since 2009 facing negative economic growth; and has to yield to limiting growth factors moving into 2017 as it wrestles with political instability at home and abroad, with multiple terrorist attacks and a failed coup staining the country's economic, social and political fabric.

But not all is lost, particularly for its interest-free finance market. Development may have been slow since its inception three decades ago, but the pace has changed dramatically in recent years as both regulators and market participants strive to push the industry forward: new regulations are being issued, new players are entering the participation banking scene and there is a general consensus that more corporates are considering tapping the Shariah compliant capital markets to raise funds.

In this report, we are pleased to present a series of informative and analytical articles by the leading lights of the industry who share their discerning views on the Turkish participation banking sector, Sukuk market and legal landscape. We also provide you with key insights from our high-level IFN Turkey Dialogue designed to lay the foundations for a roadmap for the country's participation finance industry as well as exclusive interviews with market stalwarts including the chairman of Borsa Istanbul.

It was a pleasure producing this report and we wish you an insightful and enjoyable read, and we look forward to continue supporting the Turkish participation finance industry.

Most sincerely,

Vineeta Tan
Editor
Islamic Finance *news*

Impetus toward Islamic finance in Turkey remains strong

On the 28th September, Borsa Istanbul hosted another highly successful incarnation of the IFN Turkey Forum, which was characterized by vibrant debate and enthusiastic attendance from both local and international players keen to leverage on the opportunities within the country's nascent Islamic finance industry.

Although Turkey has struggled with political and economic turbulence over the past year, the authorities have not let these challenges interfere with their commitment to support and develop a robust Shariah compliant market. With over 160 attendees, the IFN Turkey Forum 2016 was supported by key regulators and institutions, and attracted leaders and practitioners from across the Islamic world keen to learn more about upcoming opportunities and discuss the challenges and complexities unique to this market.

Introduced with a keynote speech from Himmet Karadog, the chairman of Borsa Istanbul, the event focused on the positive opportunities within the industry despite recent setbacks. "The effect of the recent downgrade is expected to be limited, especially due to the wide range of capital market instruments," confirmed Himmet. The opportunities in the Islamic debt capital market were a key theme, with current outstanding Sukuk at US$3.8 billion and US$1.3 billion in trading value on the Borsa, according to the Borsa Istanbul chairman. With double taxation recently removed, there are high expectations for the corporate market and a huge opportunity for infrastructure financing.

Other topics included the importance of innovation, strategies for capital-raising, opportunities for entrepreneurial start-ups and the role of participation finance in Turkey's Vision 2023. Notable speakers included Ahmet Bicer, the executive director and head of the Banking and Financial Institutions Department at the Central Bank of the Republic of Turkey; Aysegul Eksit, the executive vice-chair of the Capital Markets Board of Turkey; Mohammed Dawood, the managing director of global Sukuk financing at HSBC; Hulusi Horozoglu, the managing director and head of wholesale banking at HSBC Turkey; Ahmed Al Qassim, CEO of Emirates NBD Capital; Fehmi Tutulmaz, the head of financial institutions and investment banking at Ziraat Participation Bank; Metin Tekeci, the head and general manager of Turkiye Finans, Bahrain; Dr Serdar Sumer, CEO of Aktif Bank; Rizwan Kanji, a partner with King & Spalding; Tayfun Ozkan, CEO of KT Asset Management; and many more.

The day was completed by the second annual IFN Turkey Dialogue, a high-level, closed-door, invitation-only discussion featuring leading players and senior regulators within the Turkish market to build a roadmap toward future progress.

IFN is proud to support Turkey in its ongoing journey toward a strong, vibrant and well-regulated participation banking sector and is delighted to have hosted yet another exceptional event demonstrating the firm commitment toward progress from all stakeholders in the industry.

IFN Turkey Dialogue 2016

In September 2016 in conjunction with the IFN Turkey Forum 2016 and supported by Borsa Istanbul, REDmoney Group held the second Turkish edition of its groundbreaking series of high-level, closed-door industry dialogues. Designed to establish a working roadmap for the progression and evolution of Islamic finance in Turkey, the invite-only event comprised a distinguished array of senior regulators and market leaders, along with a select group of international representatives.

The closed-door discussion centered around Turkey's ambitions to become a global capital for the Islamic economy, and the challenges faced by the industry on its path toward progress – both economic, fiscal and political.

Covering a wide range of topics from regulation and legislation to participation and expansion, the role of state-owned banks and the encouragement of the retail sector to the development of the Islamic capital market and the importance of tax barriers and legal framework, the detailed discussion was characterized by a keen urgency to enact change and improve the current climate. Industry practitioners engaged in fruitful debate with market regulators and international observers to achieve a thorough understanding and analysis of where Turkey is now, where it wants to go and how it can get there.

Rewarding for both organizers and participants alike, the discussion followed Chatham House rules to encourage free and open debate. As such, no comments are attributed.

Participants:

Ahmet Bicer — *Executive Director, Head of Banking and Financial Institutions Department, Central Bank of the Republic of Turkey*

Avsar R Sungurlu — *General Manager , BPY Asset Management*

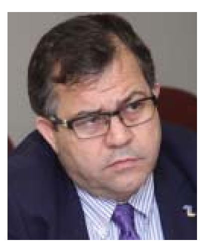
Ayse Akkin — *Managing Director, Debt Finance and Advisory, UNLU & Co*

Eda Tanyel — *Group Manager of Structured Finance, HSBC Turkey*

Eser Sagar — *Deputy Head of Corporate Finance Department, Capital Markets Board of Turkey*

Hakan Audogan — *EVP-Financial Cooordination and HR, Ziraat Participation Bank*

Hakan Uzun — *Executive Vice-President, Treasury, Turkiye Finans*



Mahmut Kayacik – *CEO, Takasbank*

Rizwan Kanji — *Partner, King & Spalding, the UAE*

Saleh Jelassi — *Resident Representative, IDB Group, Country Gateway Office, Turkey*

Selim Elhadef — *Partner and Country Advisory Leader, EY Turkey*

Sera Somay — *Partner, Paksoy*

Tevfik Kinik — *EVP - Capital Markets, Aktif Bank*

Tayfun Ozkan — *CEO, KT Asset Management*

Moderator

Lauren McAughtry Group Managing Editor, REDmoney Group

Executive Summary

Participation banking

- We have seen a weak performance from the participation banking sector compared to the conventional banking sector over the past year.
- Development in Turkey since inception 30 years ago has been relatively slow – but things have speeded up over the past five years.
- There is a large underbanked community in Turkey, especially in rural areas, and participation banks should be focusing on this segment.
- The current market share is just 5% and a target of 15% is unfeasible in the short term. A 15% share equals around US$300 billion in assets – and currently the total assets of all participation banks amount to around US$40 billion. The industry needs more attainable goals.
- Product diversity and distribution channels are key to developing the industry further. Channels such as ATMs and payment points should be used as well as banks.
- State-owned banks are working together with standalone banks to build the pie – they are not competing as most customers are new rather than captured from other institutions.
- Participation banking is not a substitute for conventional banking. They should exist side-by-side rather than competing.
- Participation banking should focus on the ethical principles and benefits rather than promote its religious Islamic foundations.
- Participation banking is the right brand – as an industry, calling it Islamic is just backing ourselves into a corner.
- The participation banking sector needs a separate law and separate regulation to differentiate itself.
- BRSA expects to release new rules next year.

Capital markets

- The new tax change should have a big impact on the market.
- Corporates will need to start looking at other means of fundraising, and they will consider Sukuk because banks are not able to provide the same levels of funding going forward.
- However, tax issues still exist – a big one is that there is still no tax exemption for real estate companies that want to issue Sukuk, and that is a major problem.
- Barriers to the creation and function of ALCs are preventing corporates from issuing Sukuk.
- The capital market in Turkey will not grow just from participation bank issuances. The corporates have to get involved.
- There is an issue between asset-based and asset-backed Sukuk. With 98% asset-based, the ALC rules of recourse do not apply and that is a problem for investors.
- There is a disconnect between BRSA and CMB legislation in terms of subordinated issuances, especially Tier 2 issuances, that needs to be resolved as it is driving issuers abroad.
- To have a more sustainable Sukuk market, new structures must be considered.
- The foreign currency restriction on issuance is problematic and should be addressed. However, the Treasury is already working on it so a solution may be forthcoming next year.

Infrastructure

- PPPs are a big opportunity, and Turkey has huge infrastructure requirements that the participation banking industry could benefit from financing.
- The IDB has invested billions in supporting Turkish PPP projects, with at least three deals due to close before the end of 2016.

Asset management

- Liquid products and Islamic instruments are urgently needed by portfolio managers. Most Sukuk do not meet this criteria.
- Pension funds are growing very rapidly, and they need things to invest in.
- The Islamic market share of the Turkish asset management industry is tiny.
- Conventional managers hold over half of Islamic pension fund assets under management. There need to be compliance rules that ensure Islamic/participation asset managers manage these assets instead.
- There is a huge necessity for a central Shariah board to ensure compliance.
- Turkey has a growing secondary market, which is unusual. It should leverage this to become a global hub for buying and selling Sukuk and other Islamic instruments.
- Turkey needs a separate licensing system for Islamic non-banking financial institutions.
- Turkey also needs to be more involved with the international market and create product teams that are able to develop and apply that knowledge.

An overview of interest-free investment finance in Turkey

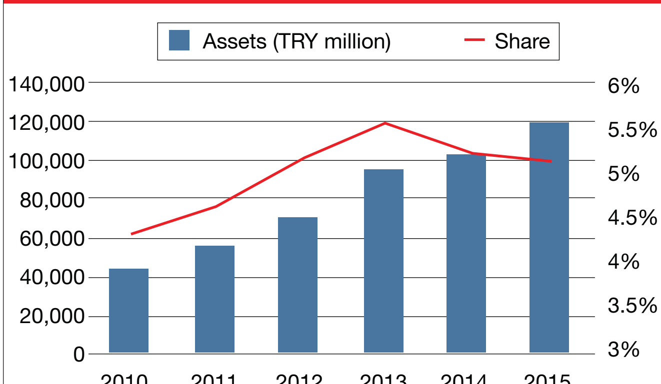
When we talk about Islamic finance in Turkey (also commonly referred to as interest-free finance), participation banks come to mind. It is because participation banking focuses on interest-free financial products and services mainly based for production and asset financing, and also because these are the organizations that offer interest-free finance products in banking and other areas of finance. As a matter of fact, an interest-free banking license is given only to participation banks under current regulations AVSAR RADI SUNGURLU writes.

When we look at the participation banking sector which was founded in 1985, it can be seen that it has a market share of 5.2% in the total banking system as at the end of 2015 in terms of the total asset size. Despite the potential in Turkey, the sector has always been criticized for not showing a serious development in this market share for many years.

These sizes, of course, represent deposit banking, ie fund collection and disbursement. Given the other areas of finance, however the development of interest-free financing is unfortunately far behind. For example, in the field of investment banking and capital markets, the activity of participation banking has remained very limited.

However, interest-free finance and participation banking are in essence based on partnership, partnership financing and profit-loss sharing. This is the understanding that forms the basis of capital markets. In spite of this, participation banking in Turkey operates not based on partnerships such as Musharakah or Mudarabah, but works with a funding system

Chart 1: Participation banking share



Source: Author's own

that is predominantly based on 'buy in advance/sell in terms', ie Murabahah. There are similarities for interest-free capital market products in world applications. However, when we look at investment products and services, the market share of interest-free finance practice in Turkey falls well below 1%.

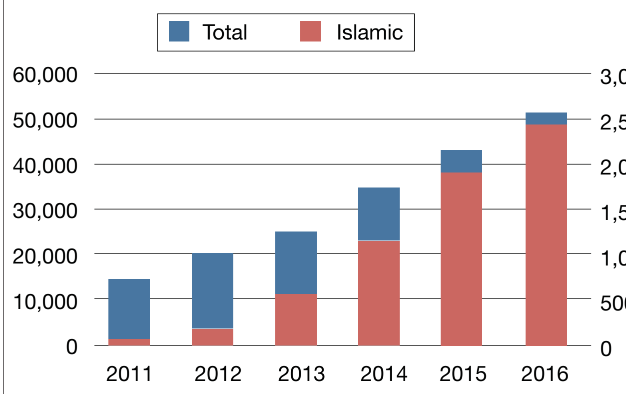
As a matter of fact, the situation of participation banking in general has been discussed in recent years and the government has taken the initiative to develop interest-free financing in Turkey to a certain extent as part of the Istanbul Finance Center Project. This is also why public participation banks are on the agenda. Ziraat Participation Bank and Vakif Participation Bank have started operations and Halk Participation Bank is planning to be active soon. The aim here is to bring dynamism to the sector with more competitive and fast-acting public players and thus increase the share of the sector. Of course, in order to be able to do this, it is necessary for new public players to concentrate on the growth of the sector with new products and services rather than on competition with existing ones, and to work on bringing foreign funds to Turkey with domestic project financing. Otherwise, this will not do much more than to break up the existing market. When it comes to new products and services, partnership-based financing and investment products are the most important for participation banks and in general for the interest-free financing industry in Turkey.

One of the projects that has recently aimed at a faster development of interest-free finance in Turkey is the creation of the Interest-Free Finance Coordination Board which consists of the Ministry of Development; the Ministry of Finance and Treasury Undersecretaries; the presidents of the central bank, the Banking Regulation and Supervision Agency, the Capital Markets Board and the Participation Banks Association; and the general-director of Borsa Istanbul under the chairmanship of the Ministry of Treasury. The aim of the establishment is to develop and raise awareness of the interest-free finance system.

When we look at these developments, we can see that the public is spending a lot of effort in the development of interest-free financing, and from time to time we witness the authorities' effort to trigger this development. In recent months, meetings between World Bank officials and representatives of institutional investors were part of this process. The World Bank cooperates with the government of Turkey in the development of alternative financing methods such as project bonds and Sukuk, asset-backed securities for the deepening of capital markets and the financing of long-term infrastructure investments. Within the scope of this cooperation, they are also seeking information on the supply, demand, legislation, infrastructure and tax dimensions and will provide recommendations to government authorities based on international experience, and will be meeting with interested parties. The interviews with institutional investors are aimed at assessing the demand for different Sukuk structures to be issued, in particular for the financing of public, municipal and private infrastructure projects by institutional investors.

The public infrastructure projects are indeed an important opportunity for capital markets. Given the current state of the sector in recent times, such as the stagnation in public offerings and the problem of trust in private issuances, capital market products based on public projects are alternatives to the perception of investors. Moreover, these projects cannot be financed only within the banking system due to their size. For example, the third airport project was funded by domestic bank credit, but immediately followed by refinancing from a foreign bank consortium. Of course, due to their size, these and similar projects may not also be funded solely by the capital markets at this time, but some portion of them may be served by the Sukuk issuances as well. Actually, the fact that the World Bank officials are examining alternative financing models gives the impression that the public is at least also looking for such alternatives.

Chart 2: Pension fund net asset values (TRY million)



Source: Author's own

These financial instruments are also important in terms of participation banking and interest-free finance. Participation banks are limited in the asset portfolios if they want to issue Sukuk. We can see that the Sukuk issued by the participation banks recently have started to be 51% based on management (leasing receivables) and 49% on Murabahah, a condition which is not sustainable. Because Murabahah-based Sukuk is a controversial issue, they are used in limited quantities of issuances that are rolled out in certain periods. However, Sukuk based on infrastructure projects are suited to the nature of interest-free financing due to their partnership nature, as well as enabling larger and longer-term issuances.

On the other hand, if we look at the issue in terms of institutional investors, there are different implications here. Turkish legislation has exclusively authorized participation banks for interest-free finance in banking. However, this is not the case on the investment side and the conventional players can manage and sell the interest-free investment funds or pension funds. Also, the fastest-growing area in the interest-free market is the area of pension investment funds. These pension investment funds need appropriate financial products that they can invest in. Therefore, there is a serious growth potential here. However, one of the most critical issues hindering progress is the establishment of interest-free finance standards in the sector to avoid problems related to Islamic compliance in the future.

Avsar Radi Sungurlu is the general manager at Bizim Portfoy Yonetimi. He can be contacted at avsar.sungurlu@bizimportfoy.com.tr.

Sukuk in Turkey: The story so far and future prospects

The Sukuk market in Turkey has evolved substantially over the last few years. The evolution has been comparatively quick and helpful. In this article, RIZWAN KANJI and HAMED AFZAL will review some of the key milestones in the development of the market and, going forward, the key challenges and prospects for the market to further grow and evolve.

The story so far

Sukuk were introduced to the Turkish market in 2010 when the Turkish participation bank, Kuveyt Turk Katilim Bankasi (Kuveyt Turk), undertook a US$100 million debut issuance which it listed on the London Stock Exchange. Given the lack of legislative infrastructure to facilitate Sukuk issuance at the time, the transaction relied on numerous tax and regulatory exemptions by Turkish authorities.

This successful issuance led to the Capital Markets Board of Turkey (CMB) adopting a proactive approach to develop the legal infrastructure in Turkey to foster the growth of the Sukuk market. This resulted in the CMB issuing a communiqué in April 2011 (the CMB Communiqué) which provided the regulatory framework for the establishment of asset leasing companies (ALCs). The CMB Communiqué provided that such companies would be able to issue and sell 'rental certificates' (ie Sukuk) utilizing lease (ie Ijarah)-based structures. The omnibus bill 2011, Law number 6111 followed in February 2011, and provided for the various tax and levy exemptions applicable to ALCs and Sukuk cash flows. These changes prompted Kuveyt Turk, through KT Sukuk Varlik Kiralama, an ALC incorporated in Turkey pursuant to the CMB Communiqué, to issue its second benchmark Sukuk.

These issuances prompted further Sukuk issuances by other leading participation banks in subsequent years and, in September 2012, Turkey issued its first sovereign benchmark sukuk.

Further legislative reforms followed, most notably through the Lease Certificates Communiqué (Serial No. III/61.1) in June 2013 (the Revised Communiqué). The Revised Communiqué allowed, among other things, ALCs to undertake multiple issuances and introduced a broader range of approved structures for Sukuk issuance. The Revised Communiqué prompted a spate of further Sukuk issuances from the various participation banks shortly thereafter and in the following years.

To date, up until the end of 2015, international Sukuk issuances by private institutions out of Turkey have raised more than US$5.7 billion, according to the IIFM Sukuk database. In addition, the sovereign has issued eight Sukuk between 2011 and September 2015, with an approximate total value of US$7.7 billion.

Corporate issuance gap

While the Turkish Sukuk space has seen considerable growth, this growth has been limited to issuances by participation banks and the sovereign. Among the key challenges in creating a deeper capital market is encouraging Turkish corporates to issue Sukuk. At the time of writing this article, despite apparent drivers such as the large infrastructure funding gap in Turkey and the growth of the Islamic institutional investor base, only a small number of Turkish corporates have issued domestic Sukuk and none have issued Sukuk internationally. The following are some of the factors which have arguably resulted in the lack of corporates issuing Sukuk.

ALC regulatory framework

The regulatory framework governing the formation and ongoing operation of ALCs renders such entities unlike SPVs incorporated in offshore markets (such as the Cayman Islands) for the purpose of issuing Sukuk.

Firstly, under the Revised Communique, only certain limited entities are permitted to incorporate an ALC, which include financial institutions, certain intermediary institutions and companies which have been assigned a long-term investment grade credit rating. While corporates which are not rated may, as a technical matter, arrange for a financial institution to incorporate an ALC on their behalf or arrange to use an existing ALC set-up by a financial institution for the purposes of issuing their Sukuk, there has been a general reluctance on the part of some financial institutions to offer these services (due to, for example, uncertainties around the requirement to consolidate the ALC's assets with those of the entity establishing it and issues around insolvency remoteness).

In addition, the operation of ALCs is heavily regulated by the CMB, for example, the CMB's consent is required for a number of matters relating to an ALC (including any amendment to the ALC's articles and where there is a transfer of shares granting management or voting privileges), there are prohibitions on an ALC undertaking certain activities (including engaging in any activities other than those indicated under its articles of association) and certain corporate governance and reporting requirements apply to an ALC on an ongoing basis. In relation to corporate governance, the CMB provides that an ALC

must have at least three board members, one of which must be an independent board member who satisfies the CMB's independency criteria, with certain board decisions requiring the vote of such a board member.

These requirements are much more onerous and burdensome compared to the equivalent regimes in other jurisdictions in which SPVs can be incorporated for structured finance and/or Sukuk transactions, such as the Cayman Islands. Consequently, many originators in Turkey (including corporates) have felt that the cost and administrative burden of using an ALC under the existing framework to issue Sukuk has been unduly high.

Tax disadvantages

To foster growth in the Sukuk market in Turkey, the CMB has, over the past several years, reformed applicable tax legislation to create a level playing field for Sukuk Ijarah structures, so that:

- pursuant to the Corporate Tax Law (Law No 5520), any capital gains derived from the sale of an asset portfolio by an originator to an ALC, and vice versa, were made exempt from corporate tax
- pursuant to the VAT Law (Law No 3065), the delivery of Sukuk to holders was made exempt from value-added tax (VAT), as was the transfer of assets to an ALC and the subsequent leasing of those by an ALC and transfer back to the originator
- pursuant to the Charges Law (Law No 492), the sale of an asset portfolio was made exempt from applicable land transfer fees, such as the title deed registry fee
- under the Income Tax Law (Law No 193), any Sukuk facility with a maturity of five years or more was made exempt from withholding tax in respect of income earned by the Sukukholders, and
- under the Stamp Tax Law (Law No 488), stamp duty exemptions were applied on documents covering the transfer and lease of assets between an originator and an ALC

The aforementioned exemptions applied mainly to Sukuk Ijarah, and remained silent on the applicable tax treatment in respect of other Sukuk structures. There was also concern about the application of the exemptions to Sukuk Ijarah itself, including in relation to the scope of the stamp duty exemption.

To overcome these issues and to further encourage corporate issuances, the Turkish Tax Bill Regarding Improvement of Investment Environment (the Omnibus Bill) was introduced in August 2016. Pursuant to the Omnibus Bill, the Stamp Tax Law, the Value Added Tax Law and the Law on Charges were amended to grant stamp tax exemption to all Sukuk transaction documents, VAT exemption to all types of Sukuk transactions and exemption from duties to be levied on all Sukuk transactions involving the establishment of security, mortgage, pledge and other similar transactions.

Asset eligibility

As with other Islamic finance structures, in the context of Sukuk, returns to Sukukholders must originate from underlying assets or ventures. The returns must also be Shariah compliant and, accordingly, cash flows used to pay Sukukholders must flow from Shariah compliant assets and/or ventures. While, according to Shariah principles, only 33% of the issue amount of the Sukuk will need to be supported by tangible assets for the Sukuk to be tradeable in the secondary market at a premium or discount, finding sufficient eligible assets still presents a significant problem for some corporates. This is particularly the case given that, both from a Shariah perspective and as a matter of Turkish law (by virtue of the Revised Communiqué), all such assets underlying the Sukuk are required to be free of any encumbrances (such as mortgages or other security interests).

The path forward

The tax reforms introduced under the Omnibus Bill have brought much-needed clarity to originators, particularly corporates, looking to issue Sukuk in the Turkish market. The numerous stamp tax, VAT and duty exemptions, which now apply to all types of Sukuk structure transactions, are likely to help create a level playing field for originators compared to the conventional funding space, and it is hoped that this will encourage corporates to come to market.

Nevertheless, challenges remain, particularly given the highly regulated legal framework applicable to ALCs. For example, the cost, administrative burden and control issues around corporate governance requirements applying to the formation and ongoing operation of an ALC may continue to prove too onerous for many Turkish corporates looking to issue Sukuk.

Despite this, given the strong demand for alternative finance in the Turkish market (particularly to fund the country's growing infrastructure funding requirements) and the willingness on the part of the Turkish regulators and authorities (including the CMB and Borsa Istanbul) to make Turkey a regional hub for Islamic finance, the outlook for the deepening of the Sukuk market in Turkey seems positive. This will however, in our view, require continued dialogue and feedback among all market participants, including regulators, banks, corporates, law firms and others to ensure an enabling environment is created in Turkey to foster the development of the Sukuk market.

Rizwan H Kanji is a debt capital markets partner at King & Spalding based in Dubai. He has broad experience advising arrangers, issuers and sovereigns. He has considerable experience in the Turkish Sukuk market having pioneered the first international Sukuk issuance out of Turkey in 2010. He has a sizeable market share of issuances out of Turkey according to Chambers and Partners. He can be contacted at rkanji@kslaw.com.

Hamed Afzal is a senior associate in the debt capital markets team at King & Spalding based in Dubai and has broad experience advising issuers and arrangers on the full spectrum of debt capital markets and structured financed transactions, both conventional and Shariah compliant. He can be contacted at hafzal@kslaw.com.

Istanbul stock exchange strengthens its commitment to Islamic finance

Turkey has demonstrated a sustained commitment to building up its Islamic finance capabilities and despite the recent political uncertainty; this support has not only remained firm but has been scaled up as the authorities seek to cement the country's position in the global arena through sovereign issuance, corporate support and an improved regulatory framework. Group Managing Editor LAUREN MCAUGHTRY speaks exclusively to the chairman of Borsa Istanbul, HIMMET KARADAG, to learn what the exchange intends for the future of Islamic finance.

International opportunity

Turkey has been the coordinator of the OIC Member States' Stock Exchanges Forum since 2005, and since 2013 it has also played host to the World Bank Global Islamic Finance Development Center, the World Bank's only representation office on Islamic finance. In late 2013, Borsa Istanbul also signed an agreement with NASDAQ to deliver market-leading technologies including source codes and selling rights to 25 countries in the region. Through this agreement, NASDAQ acquired a 7% equity stake in exchange for the technological transfer and advisory services. In late 2015, the European Bank for Reconstruction and Development (EBRD) also acquired 10% of Borsa Istanbul shares, with a representation on the Board of Directors. "The long-term investments of these leading firms demonstrate their confidence in the potential of Borsa Istanbul and the Turkish economy as a whole," commented Himmet.

> "As part of our vision to become a regional hub, we launched an initiative, Eurasia Data Dissemination Project (EDDN), which envisages disseminating data of all the regional exchanges"

As an investor on the other side, the exchange became a shareholder in LCH Clearnet (majority-owned by the London Stock Exchange (LSE)) in early 2015, and also received the right to disseminate the market data of London Metal Exchange (owned by the Hong Kong Exchange). In 2015 the bourse launched trading in futures and options on the BIST 30 index, consisting of leading Turkish stocks, on the

LSE, to improve its global network. "As part of our vision to become a regional hub, we launched an initiative, Eurasia Data Dissemination Project (EDDN), which envisages disseminating data of all the regional exchanges," Himment told IFN. "To this end, we are currently disseminating Sarajevo Stock Exchange, Montenegro Stock Exchange, Macedonia Stock Exchange market data and also have discussions with other exchanges to expand the coverage. We are planning on making further strategic partnerships in order extend our global presence."

Islamic ambitions

So where does Islamic finance come in? There is no doubt of the focus and commitment from the authorities to growing Islamic finance – highlighted by the recent removal of double taxation from Islamic transaction and the latest sovereign Sukuk issued just last month. But the work goes beyond that, extending far into the future as the administration works to develop both its capabilities and its capacity. In order to encourage Islamic finance, Borsa Istanbul in particular has been both increasing its listing of Shariah compliant products and engaging in a wide range of activities: from research to secretariat.

The outstanding value of Sukuk listed on the exchange currently stands at US$3.8 billion, with a US$1.3 billion trading value for 2015. The exchange is working with the Turkish Capital Market Association to launch an international Shariah Board, as well as working on a wide range of innovative new products including Islamic real estate certificates to be used in urban transformation projects, developed in collaboration with leading Turkish real estate firms.

> A rebranding of participation banking in Turkey will contribute to reach this potential and appeal to other regions in the world for foreign investment

Sukuk ambitions

Perhaps most excitingly, Borsa Istanbul is also working on a revolutionary new type of asset-backed securities based on the revenues from large infrastructure projects. We asked Himmet to tell us more.

"The Sukuk that we are modeling, based on PPP projects, will cover bridges, toll roads, and other public revenue streams that generate stable and high-yield income. Revenues of the Bogaziçi, FSM, and Yavuz Sultan Selim bridges and Istanbul Airport are some examples of underlying assets for these products. The recent launch of the Turkish sovereign wealth fund is also supportive of these initiatives," he explained. "There is a high infrastructure investment capacity in Turkey and it needs alternative financing methods. Issuances for the public sector projects will serve as a model for the potential private sector and other public sector projects. There is also a strong support of the public sector in all phases such as the Treasury Guaranty."

Banking blues

Some of the valuable opportunities for these products include an expansion of investor base; increased awareness of the Turkish capital markets; boosting Borsa Istanbul revenues with the trade volumes of large scale public projects; increasing foreign demand, especially from the Gulf region; and attracting infrastructure investment, traditionally dominated by banking sector, to the capital markets. But the new Sukuk could also provide a compelling secondary benefit for the banking market. Turkey, like many other countries, has struggled to build up its Islamic banking sector for a number of reasons, one of which is the dearth of liquidity management tools.

"As opposed to conventional banks being able to invest their overnight balances in interbank money markets, participation banks in Turkey are struggling to find the right instruments for their surplus," noted Himmet. However, he hopes that the new Sukuk products will change that. "Because the returns of these innovative products will be able to be calculated on a daily basis (ie the daily revenue of a bridge based on the data from the electronic tolling system), participation banks are going to be able to make short-term investments using these instruments in order to meet their goals," he explained. 'Bridge' certificates will provide high and interest free return to participation banks, allow them to utilize their cash surplus within the country with efficient liquidity management in all terms."

A new look

This will support a growth trend that is already well on the way. According to the Participation Banks 2015 Sector Report, in 2015, the total assets of the Turkish participation banking sector increased by 15% to TRY120 billion (US$39.3 billion). With the recent entry of two new state-owned participation banks in the sector, the number of participation banks in Turkey has reached six, while the number of employees has grown to 16,554 and the number of branches to 1,080.

However: "Although the growth rate of participation banking in Turkey is higher than conventional banks, there is still a lot of room for improvement due to the size of potential," warned Himmet. One possible method of doing this could be to rebrand the sector, focusing both on its Islamic and ethical credentials and highlighting its wide range of possible applications.

"A rebranding of participation banking in Turkey will contribute to reach this potential and appeal to other regions in the world for foreign investment," agreed Himmet. "In a financial system where banking and capital markets products are more integrated than ever, both conventional and participation banking sectors need to explore products and services that capital markets are offering. The new approach could also include the new and innovative products and platforms such as PPP-based Sukuk and crowdfunding platforms."

A bright future

According to the Turkish Participation Banking Strategy Document for 2015-2025 put forward by the Participation Banks Association of Turkey, the industry vision is: "To raise the market share of participation banking sector to 15% by 2025 and to deliver world-class financial products and services".

One of the actions listed in this strategy document is "ensuring the physical exchange in the commodity transactions in the BIST markets" – marking a key area of potential participation for Borsa Istanbul, and one which the exchange appears firmly committed to undertaking. "We are going to be working with the sector in order to achieve a collaborative Islamic finance market in Turkey," Himmet assured IFN. With this level of commitment and support, the future looks bright for the industry in Turkey despite the current headwinds.

An audience with Mohammed Dawood (MD) and Hulusi Horozoglu (HH) of HSBC

We would like to begin by getting your insights on the global Sukuk market.

MD: The international Sukuk market has developed considerably since 2008, where longer tenors and a broader range of issuers are accommodated by the investor base. The average volume of annual issuances has been between US$15-20 billion over the last five years. 2016 has been a strong year with 18 issuances totaling US$15 billion to date and we expect this trend to continue and surpass last year's volume due to increased borrowing requirements of GCC and Asian countries.

What type of issuers are traditionally looking to access the Sukuk market globally and more specifically in Turkey?

MD: Internationally, the main issuers are sovereigns and banks. There are certain corporates that have issued as well from the UAE, Qatar, Saudi Arabia and Malaysia.

HH: In Turkey, the main issuers are sovereign and participation banks too. We have yet to see a corporate Sukuk issuance in the international markets. Only a very select and small number of corporates have expressed interest for Sukuk to date, but this number is expected to increase in the coming years with the development of the Islamic finance market in Turkey.

We are proud to say that HSBC is the leading international Sukuk house in Turkey. HSBC arranged all four international Sukuk issuances of the Turkish Treasury to date and seven issuances of Turkish participation banks including the first Malaysian ringgit Sukuk issuance out of Turkey. The total financing volume arranged through these 11 transactions reached US$7.4 billion since 2011.

What is preventing the supply of international corporate Sukuk in Turkey?

HH: The corporates that expressed interest in the product have either never issued a conventional eurobond before and would prefer to do that first or they had structural issues. For others, the decision to choose Sukuk over any other alternative financing solution comes down to pricing, terms and execution. Our experience so far indicates that bank financing in Turkey can be relatively cheaper than a Sukuk issuance with longer tenors provided by local banks.

Additionally Turkish corporates don't require a sizeable and bullet and benchmark financing in a single transaction unless there is a specific event-driven obligation to do so. There is, of course, a consideration for legal and regulatory angles of the execution process where corporates have to set up SPVs, apply for Capital Markets Board (CMB) approval and negotiate extensive legal agreements for Sukuk whereas they can borrow under straightforward general credit agreements from local banks.

MD: I would echo Hulusi's comments and want to add that Malaysian or GCC corporates can borrow up to seven to 10 years with much more favorable pricing. In Turkey, the longest tenor we have seen is 10 years and this is for sovereign and a single participation bank's Sukuk issuances. Also, GCC currencies are pegged to the US dollar unlike the Turkish lira and consequently, Turkish corporates take foreign currency risk which is certainly one of the challenges of the market.

How are CFOs positioning themselves in the short and long term under the current economic climate?

HH: Turkey, which went through two general elections in 2015 and 2016, has been volatile due to both foreign and domestic events, therefore we experienced a slowdown in new investments. Anticipating an interest rate increase by the Fed this year — although this may be postponed to 2017, CFOs are more concerned with managing their existing exposures and the impact of the Turkish lira's depreciation against hard currencies.

We are seeing corporates that borrow in the US dollar either refinancing their bank loans before the Fed rate increase or switching to euro funding in order to benefit from low rates. Foreign currency hedging is also another important concern as the Turkish lira depreciated 40% against the US dollar since August 2014 which had a significant impact on bottom line profits.

It is important to also underline that the local banking sector continues to have significant FX liquidity and has a risk appetite for long-term financing transactions, especially for clients with strong credit profiles and for the right projects, which still makes bank market funding an alternative compared to the capital markets. In an environment where executives need to react quickly to market volatility, the availability and quick access to bank funds are proving to be an alternative to capital market solutions.

What is the investor appetite from the GCC like for Turkey?

MD: There is a greater level of scrutiny for Turkish issuers following the recent events that took place in Turkey but interest is still there. Investors make the distinction between good and bad credit and those corporates benefiting from a strong credit profile can always access the market. When the political and economic uncertainties settle in the near future, we expect GCC investors to start actively looking for Turkish issuers.

After the 15th July and following the positive outcome of the FOMC meeting on the 21st September, Turkish sovereign spreads widened by 75bps and normalized at 20-25bps levels respectively; similarly for financial institutions' spreads, the initial widening was up to the 150bps level and stabilized to 40bps wider. These are positive indications that the market is returning to normal, but a sovereign/sub-sovereign conventional or Islamic issuance in a post-coup era will certainly provide more guidance to the private sector players on both the issuer and investor side.

Are mid-sized issuers, who are most in need of alternative sources of financing such as Sukuk, unable to access the market due to the required size of an issuance?

MD: The US$300 million level has traditionally been the minimum size sought by investors on any capital markets exercise for liquidity purposes so that the issue can be freely tradable in the secondary market. Anything below this threshold is achievable but with a select number of investors on a private placement basis. I would not categorize the size of an issuance as an obstacle for mid-sized issuers to access the market and there is definitely merit to consider Sukuk as a financing solution because of bullet repayment structures and the ability to tap a different investor base.

HH: There is a limited class of assets to be used for the structuring of Sukuk; only Ijarah and Murabahah-based structures have been used in Turkey so far. However, at HSBC, we held various workshops with regulators, corporates and financial institutions operating in different sectors to explore how we can implement alternative Sukuk structures in Turkey which are frequently used in Malaysia and GCC countries.

Unfortunately, we found out that the current tax and legal regime has to be revisited to enable the usage of non-real estate and intangible assets for Sukuk financing. Additionally, the requirement to have an external credit rating assigned by an internationally recognized credit agency will be another challenge that mid-sized issuers will face in the process.

What are Turkish authorities doing to develop the local Islamic finance market?

HH: The development of the Islamic finance market in Turkey is certainly a priority for the current administration. This is evident with the establishment of state-owned participation banks. The share of participation banks within the whole banking sector is expected to reach the 10-15% level by 2025 from the existing 5.5%. The participation banks will be at the forefront of this development and they will need to strengthen their capital structure to continue providing Shariah compliant liquidity to the market and to finance this expansion. Therefore, Basel III compliant Tier 2 capital Sukuk issues are expected to play an instrumental role in this space.

The CMB and Ministry of Finance (MOF) have spent considerable time to establish the Sukuk issuance framework and the relevant tax regime in the past. There are also ongoing initiatives to allow alternative Sukuk structuring tools in Turkey, such as Istisnah and forward Ijarah for construction projects under the 'Build Operate', 'Build, Operate and Transfer' and 'Build Lease' Frameworks; or Istisnah and Wakalah which are suitable for the 'Transfer of Operation Rights' Framework or other alternative structures such as menafae, etc.

Besides, as you may be aware, the Prime Ministry of the Republic of Turkey established an Islamic Finance Coordination Committee (Faizsiz Finans Koordinasyon Kurulu) back in December 2015 to accelerate the development of Turkey's Islamic finance markets and to assist regulatory bodies such as the MOF, the central bank, BRSA, CMB, Borsa Istanbul and Islamic Banks Association of Turkey to transform Turkey as an international financial hub for Islamic finance. The committee envisages facilitating the discussion between the relevant legislative bodies to improve the necessary legal infrastructure.

The establishment of state-owned participation banks is expected to expand the overall banking sector's client base through reaching out to the unbanked and/or underbanked population and consequently to grow the sector's asset size. One key element for the growth of participation banking in Turkey is to enable these players to access competitive financing from a cost of funding perspective.

Therefore, the central bank's recent action enabling participant banks to conduct open market operations is an important step in that direction. Moreover, Borsa Istanbul is working on enabling participation banks to do repo transactions using lease certificates, and this is expected to come into effect near the end of 2017, to create an alternative monetary policy instrument for these banks.

Turkey is also working to establish the Islamic Infrastructure Bank that will be located in Istanbul. So far, Saudi Arabia, Indonesia and the Jeddah-based IDB are prospective founding members of this institution.

MD: We are very excited with the steps taken by the Turkish government as explained by Hulusi. I would also like to highlight that JPMorgan recently decided to include Sukuk in its emerging market indices. We expect this decision to increase the liquidity of Sukuk instruments, including all four international Sukuk issued by the Undersecretariat of Treasury and the ones issued by Turkish participation banks.

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Turkish Sukuk market review: A look at corporate Sukuk

METIN TEKECI provides an analytical review of the Turkish corporate Sukuk landscape.

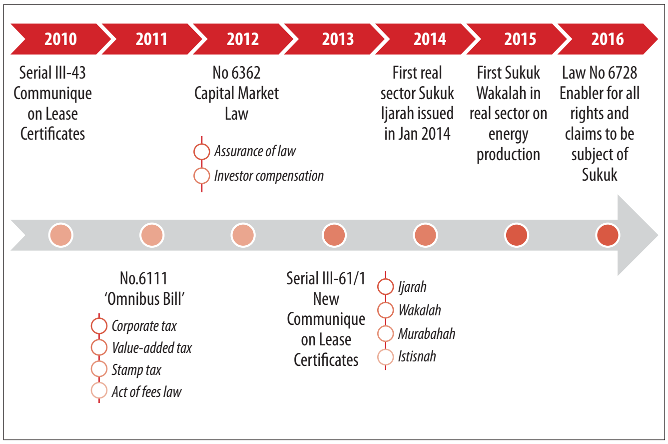
Despite 99.2% of its population being Muslim (according to Diyanet Report), Turkey was a latecomer to the global Islamic finance arena. The modern Turkish Islamic banking history goes back to the early 1980s and the legal infrastructure has been unified with that of conventional banking under the Banking Law No 5411 in 2005.

Turkey has received substantial support from the World Bank Group to develop its Islamic finance sector; the World Bank Group is also supporting the Republic's initiatives to position Istanbul as a finance center. The government is taking active steps to develop its treasury Sukuk markets to diversify sources of capital to channel it toward economic development.

Turkey's Sukuk legal framework was initiated under the capital market regulations, first of which is the Serial III-43 Communique on Lease Certificates in 2010.

This subordinate legislation remained inapplicable in the market until the enactment of Omnibus Bill No 6111 in 2011, which introduced tax neutrality on Sukuk Ijarah issuances. The first issuance registered under the Turkish Capital Markets Board (apart from the US$100 million issuance by Kuveyt Turk in August 2010 which was issued through an SPV in Cayman Islands) and sold out to foreign investors was the US$1.5 billion Sukuk facility by the Turkish Undersecretariat of Treasury (Hazine) in September 2012.

Diagram 1: Turkish Sukuk development timeline



At the end of 2012 and mid of 2013, the new capital Markets Law No 6362 and the new Communique in Lease Certificates (Serial 61.1) (the Communique, hereafter) were issued and provided the biggest leverage for market players to issue their own Sukuk.

Table 1: Sukuk issuance in the Turkish market

	EUR	MYR	TRY	USD	Total
MATURED					
Domestic			74		74
Foreign			1	4	5
OUTSTANDING					
Domestic			20		20
Foreign	1	6	2	7	16
TOTAL	1	6	97	11	115

The momentum of Sukuk issuances especially those observed in the domestic market until 2016, proved that Sukuk have significant potential to become a complementary solution to conventional bonds and loans in Turkey, both for the originators and investors. We have observed 115 issuances from 2010 until November 2016, and 36 of these are still outstanding today, corresponding roughly to US$8.7 billion-worth of Sukuk circulating in the market.

"The momentum of Sukuk issuances especially those observed in the domestic market until 2016, proved that Sukuk have significant potential to become a complementary solution to conventional bonds and loans in Turkey, both for the originators and investors"

We have observed that the outstanding Sukuk issuances of each issuer in Turkey are mainly denominated in US dollars with an average tenor of slightly above five years. TRY issuances are mostly used for short-term financing needs, generally in the size of TRY6 million (US$1.71 million).

Turkiye Finans (a subsidiary of Saudi giant National Commercial Bank) and Kuveyt Turk (the Turkish arm of Kuwait Finance House Group), and the Hazine are the leading originators of US dollar Sukuk issuances. Both Turkiye Finans and Kuveyt Turk are also the only Turkish issuers in the ringgit market to date.

Table 2: Outstanding Sukuk volume (in USD million)

Outstanding Sukuk	EUR	MYR	TRY	USD
BEREKET VKS			175	350
Hazine			9.48	2.75
KABTEK VKS	12			
KT VKS		800	550	1
TF VKS		1.16	394	1
TFKB VKS			314	
ZIRAAT KATILIM VKS			100	
Total	**12**	**1.96**	**11.02**	**5.1**

Sukuk are also of crucial importance in generating quasi-capital sources, considering the growth pressures on Islamic banking in Turkey. Tier 2 Sukuk issuances with 10-year tenors issued by Kuveyt Turk (US$350 million), Turkiye Finans (US$250 million) and Albaraka Turk (US$250 million), provided more capitalization opportunities for growth.

New Turkish participation banks such as Vakif Bank and Ziraat Bank are also expected to emerge as new players in the domestic and international Sukuk market, thanks to the political support of the government to increase Islamic banking share up to 15% from the current 4.7% (according to October 2016 figures by the Banking Regulation Supervisory Authority).

“A unique feature of Turkish Sukuk regulation against its global peers is that SPVs or asset leasing companies (ALCs) are permitted to issue multiple Sukuk concurrently on behalf of different originator companies, subject to the approval of the CMB”

In 2013, the legal framework was modified to permit the use of diversified Islamic financial instruments in Turkey, enabling Sukuk to be structured using:

1. Ownership (Ijarah)
2. Management contract (Wakalah)
3. Trade (Murabahah)
4. Partnership (Mudarabah)
5. Work of art contract (Istisnah)

All these types of Sukuk, or any hybrid types acceptable by the Capital Markets Board (CMB), may be issued through public offering, private placement or sales to qualified investors only. The most preferred issuance method is to qualified investors mostly due to the fact that the market is still premature. On the other hand, the CMB regulation does not require prospectus for private placement issuance.

Chart 1: Breakdown of Sukuk issuance methods

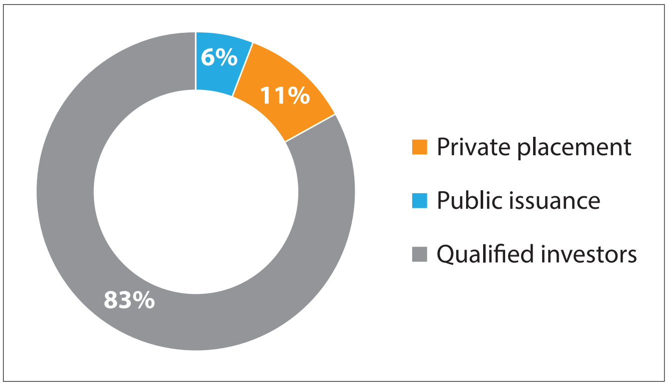
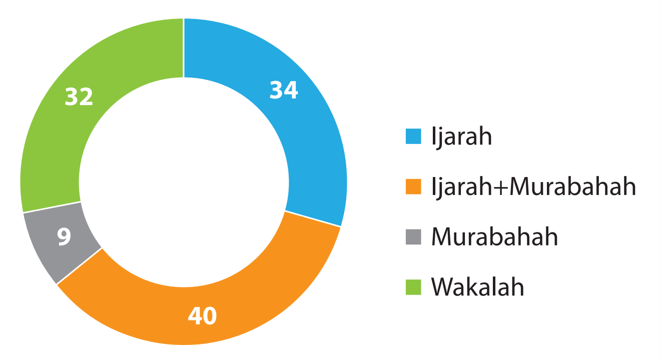


Chart 2: Number of Sukuk issuance by type



Ijarah is the most common Sukuk structure in the Turkish market. More than half of Turkish issuances are based on the Ijarah model or are based on an Ijarah-Murabahah combination. This has mainly stemmed from the opaque tax treatment on the Mudarabah and Istisnah models. The issuers, in response, are avoiding such tax risks.

A unique feature of Turkish Sukuk regulation against its global peers is that SPVs or asset leasing companies (ALCs) are permitted to issue multiple Sukuk concurrently on behalf of different originator companies, subject to the approval of the CMB. This permission mitigates cost of establishment and running an SPV, and concentrates knowledge base on the subject matter.

The financial reporting of asset base of different Sukuk issuances are segregated on the financial statements. Liquidation in case of a default is also defined to be managed and executed by the Investor Compensation Center, a public legal entity established under Capital Market Law.

The legal presence of ALCs in Turkish legislation has not been tested through a default case, however, the robust CMB supervision over each issuance provides comfort to investors. It is also worth to mention that ALCs are mainly used to fund their founder companies (except TFKB VKS).

TFKB VKS, differs in the market by functioning as a special Sukuk origination hub for customers of Turkiye Finans. Total issuance by TFKB VKS to date stands at TRY343 million (US$130 million, according to USD-TRY exchange rates during times of issuances) on behalf of four different originators operating in real economic sectors of Turkey, and Turkiye Finans remains the sole investor in these issuances. This model can set the groundwork for corporates looking to tap the Sukuk market.

Table 3: ALCs in Turkey

ALC	Type	Founder
HAZINE VKS	Sovereign	Turkish Treasury
AKTIF BANK SUKUK VKS	Investment bank	Aktif Investment Bank
ASYA VKS	Islamic bank	Bank Asya
BEREKET VKS	Islamic bank	Albaraka Turk
KABTEK VKS	Corporate	Kablotek AS
KT SUKUK VKS	Islamic bank	Kuveyt Turk
KT VKS	Islamic bank	Kuveyt Turk
TF VKS	Islamic bank	Turkiye Finans
TFKB VKS	Islamic bank	Turkiye Finans
ZIRAAT KATILIM VKS	Islamic bank – public	Ziraat Katilim

Non-bank financial institutions are playing an increasing role in the Turkish Sukuk market as an investor to these issuances however there is still plenty of room to reach to full potential. With the accelerating contribution of Turkish Takaful operators (eg, Katilim Emeklilik, Neova Insurance, Doga Insurance), Islamic investment firms (eg BMD Portfolio Management, Qinvest Portfolio Management), and conventional companies providing Islamic investment products to their customers (eg Ziraat Portfolio, Ak Portfolio, Vakif Emeklilik, Garanti Emeklilik) the Sukuk market is expected to generate stronger demand in domestic market. On top of this list, the inclusion of large real sector companies which are already active buyers in bonds market is promising higher growth potential for this sector.

With the new Omnibus Bill – Law No 6728, published on the 9th August 2016, less popular Sukuk structures such as Mudarabah, Musharakah and Istisnah were granted tax neutrality, and this is expected to boost the utilization of Sukuk as a financing tool.

With the amendment of the Stamp Tax Law, VAT Law, and Law on Charges, all types of Sukuk transaction documents, proceeds, transfer of assets between issuer/ALC and originator will be exempted from tax and charge burdens, as required in the previous regulation. The exemptions will be also be valid for construction companies providing corporate tax exemption, and supporting project financing legal infrastructure.

“With the new Omnibus Bill – Law No 6728, published on the 9th August 2016, less popular Sukuk structures such as Mudarabah, Musharakah and Istisnah were granted tax neutrality, and this is expected to boost the utilization of Sukuk as a financing tool”

Being an alternative financing source for Turkish corporations, the newly-relaxed tax framework facilitating Sukuk structures mentioned above would be useful for bridging the project financing gap in Turkey, particularly for infrastructure projects and public-private partnership projects such as airports, bridges, highways, and energy power plants.

The key challenges over the short to medium term, however, are the global and domestic macroeconomic challenges which have decelerated the growth of the Turkish economy. In order to increase the appeal of Islamic financial instruments, the government should consider introducing incentives for such products as in the case of Malaysia.

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Discussions on lease certificate (Sukuk) issuance in Turkey

In this article, UMIT AKKAYA intends to assess, from a legal perspective in the context of the provisions of the applicable legislation, the criticisms over the transfer of title to and pledge of the underlying assets in Sukuk practices in Turkey.

Lease certificates (Sukuk) are pretty new financial instruments first introduced in the financial/economic life of Turkey in 2010. A lease certificate is defined in Article 61/1 of the Capital Markets Law No. 6362 and Article 3/1 of the Lease Certificates Communiqué (III-61.1) as follows: "Lease certificates are capital market instruments the qualities of which are determined by the Board and issued by asset-leasing companies for the purpose of providing the financing of all kinds of assets or rights and securing that their owners obtain a right from the generated incomes in proportion of their shares."

Taking into account all the definitions and classifications, the 'Sukuk' term is apparently a financial legal institution in reference to the purpose of 'providing finance', and it is required not to disregard that raison d'etre of the Sukuk in making assessments and criticisms over this matter.

In this respect, our assessments over the title transfer and pledge issue, as one of the basic matters criticized and cited in Sukuk practices in Turkey (arguments that the asset or right has not been permanently and absolutely disposed of and that the power of disposition over the asset/right has been restricted by law, etc) are summarized in the following.

AAOIFI states that: "Sukuk, to be tradable, must be owned by Sukukholders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of Shariah, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI Shariah Standard (17) on Investment Sukuk".

Transfer of ownership

In terms of applicable legislation in Turkey, the Sukuk-related asset/right is transferred to the asset-leasing company (ALC) in accordance with the applicable law (Article 5/2 of the Communiqué Nob 61.1.III) and is kept in custody by the ALC for and on behalf of the investors unlit the same is redeemed (Article 61/3 of Law No. 6362). Therefore, the investors own the said asset/right perfectly and without any restrictions. The ownership right of the investors is willingly restricted under buy-back agreements executed by the parties and during the effectiveness of the buy-back right. Such a buy-back right is among the limited rights in rem as per our legislation and grants the rightholder to buy back the underlying asset within the period of time defined in the contract (not exceeding 10 years) (Article 736 of Turkish Civil Code). If the rightholder fails to exercise its buy-back right within such a period, the ownership becomes unlimited again and the owner (ie the ALC acting on behalf of investors) becomes entitled to enjoy a complete discretion over the asset/right.

At this point, in our opinion, it would be legally appropriate to consider the type of ownership the investors acquire over the asset/right as 'co-ownership' in accordance with Article 701 of Turkish Civil Code because in this case, a group came together to acquire the Sukuk to be issued (ie investors) and these investors have combined their capital in order to purchase (acquire) the asset/right to be issued and to derive income therefrom. It is quite possible the group so gathering together can also be considered as an ordinary partnership. As a matter of fact; Article 620 of the Turkish Code of Obligations reads: "Ordinary partnership agreement is a contract whereby two or more persons undertake to combine their labor and goods to reach a common goal. If a partnership does not have the distinctive qualifications of partnerships as regulated by law, such partnership is considered as one subject to the provisions of this section".

At this point, while the ordinary partnership is not a perfect qualification, it would be required to qualify that group as an ordinary partnership. Therefore, with reference to the provisions of Article 638/1 of the Turkish Code of Obligations which reads: "Goods, receivables and rights in rem which have

> In some debates and assessments, there is criticism that such sales/title transfers must be considered as a pledge/security, but such hypothetical criticism is not acceptable at all

been acquired for or transferred to the partnership belong to all the partners as the co-owners under the partnership agreement", it would be appropriate to say that the investors are the co-owners of the underlying asset/right.

Islamic scholars reviewing the problems related to the title transfer and buy-back in the case of Sukuk transactions have dealt with that matter within the scope of Bai Al-Wafa (Bai Bi-l-Istiglal). Bai Al-Wafa has been defined as a sales contract with the condition that, "when the seller pays back the price of the property sold, the buyer returns the property to the seller".

Pledge

In some debates and assessments, there is criticism that such sales/title transfers must be considered as a pledge/security, but such hypothetical criticism is not acceptable at all due to the pledge right is of a secondary nature and it merely grants the rightholder (creditor) the right to claim the foreclosure of the pledge. Again, the rightholder (creditor) is obliged to refund

to the pledgor (debtor) any sum that remains after the former has foreclosed the pledge and collected the amount owed to him and if the foreclosed sum is not sufficient to cover its receivable sum, the deficient portion can be claimed from the debtor.

Finally, the rule that states: "Any pledge agreement providing for the transfer of the title to the pledged movable asset to the creditor in case of failure to honor the debt is void and invalid" is known as the most fundamental principle and distinctive element of the pledge law where the creditor is not entitled to seize the pledged asset (lex commissoria prohibition). There is no such thing in the case of assets/rights transferred to investors by way of Sukuk where any profit/loss resulting from the foreclosure belongs to the investors because the ownership right (except for the limited right in rem that is granted to the rightholder, for a limited period of time, with the buy-back guarantee) is not subject to any restrictions.

In our opinion, one solution for this problem is any assessment must be made by considering the following particulars with respect to legislation and contractual relationships: In the case where the buy-back right is not or cannot be exercised, i) is the right of the buyer (investors) to acquire the asset/right being the subject of the issuance prohibited?; ii) is the sum in excess if the buyer forecloses the asset/right refunded to the seller (originator)?; iii) if the foreclosed sum is not sufficient to cover its receivable sum, is it possible to claim the deficient portion from the seller's (originator's) assets (guarantees)? If the answer is 'yes' to these questions, then such a relationship must indisputably be subject to the provisions of the pledge. If the answer is 'no' to these questions, then the provisions of the pledge cannot be applied, and the dispute is required to be settled by applying the sales terms.

It is observed in the practice that the buy-back right is exercised with the promise of the seller (originator) in the form of an 'acquisition undertaking or 'buy-back undertaking' which is, in our opinion, a fault (unlawfulness) that must be corrected because the 'buy-back undertaking' and 'buy-back right agreement' are not the same thing and as such, they do not give rise to the same effects. With respect to this problem, we believe that Sukuk are a more developed legal institution than the Bai Al-Wafa (Bai Bi-I-Istiglal) contracts with regards to Islamic law and applicable legislation in that the Sukuk perform the title transfer and sales agreements flawlessly.

Given the foregoing basic problems, we can conclude that it is regrettable that Sukuk, being indisputably one of the most important instruments of interest-free finance and a pretty new product in our country's practice, suffer extremely tough and fierce criticisms, whether rightful or not. More constructive and improving criticism (especially by Islamic jurists) would favorably contribute to the establishment of a sound and healthy interest-free finance structure.

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