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The Growing Prominence of Turkey in the Global Sukuk Market: An Overview

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Abstract

Recent developments have shown that sukuk (Islamic bond) is one of the most noteworthy driving forces behind the growth of the Islamic capital market and Islamic finance as a whole. Unlike conventional bonds, sukuk offers the investor ownership of tangible assets, usufruct of an asset, or sometimes ownership of certain projects or investment activities. With the purpose of obtaining the needed financing through the Islamic capital market for operations, several organizations around the globe, especially in Southeast Asia and the Middle East, utilize sukuk as the Islamic financial instrument. While countries in the Southeast Asia and the Middle East are leading the sukuk market, Turkey is currently one of the most promising markets for sukuk worldwide. Going forward with this, the present study aims at giving a comprehensive overview about the development of sukuk and its opportunity for growth in Turkey. It also gives an account of the legal and regulatory issues pertaining to the Turkey sukuk. In general, the study is an attempt to create more awareness about the developments in sukuk and the recent active role Turkey plays in the sukuk market.

Keywords: *Islamic finance, Sukuk (Islamic bond), Shari'ah, Turkey, legislation*
JEL Classification: *G 12, G 14, G 18*

1. Introduction

Sukuk (Islamic Bond) is the plural of the Arabic word Sakk. It literally means a written document. Historically, Sukuk was used by the Muslims to signify financial obligation in the form of a document, emanating from commercial dealings. In this modern time, Sukuk is however, used to represent the similitude of conventional bonds in Islam (Rohmatunnisa, 2008). According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Sukuk can be defined as: *"*Certificates of equal value representing, after closing subscription, the receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity." In general, Sukuk has to do with the transfer of certificates which represents a share in the ownership of a particular asset, usufruct or service that gives privilege to the Sukuk holders to be given periodic fixed returns and complete redemption at maturity of the Sukuk (Dusuki 2012). To put it clearly and short, Sukuk involves a fund provider (Sukuk holder) taking ownership of real assets and then getting a return that is earned from those assets. This is completely the opposite of conventional bond which involves a debt instrument and payment of Riba (interest). Riba in any of its forms is frowned upon in Islam (ACCA Global , 2013).

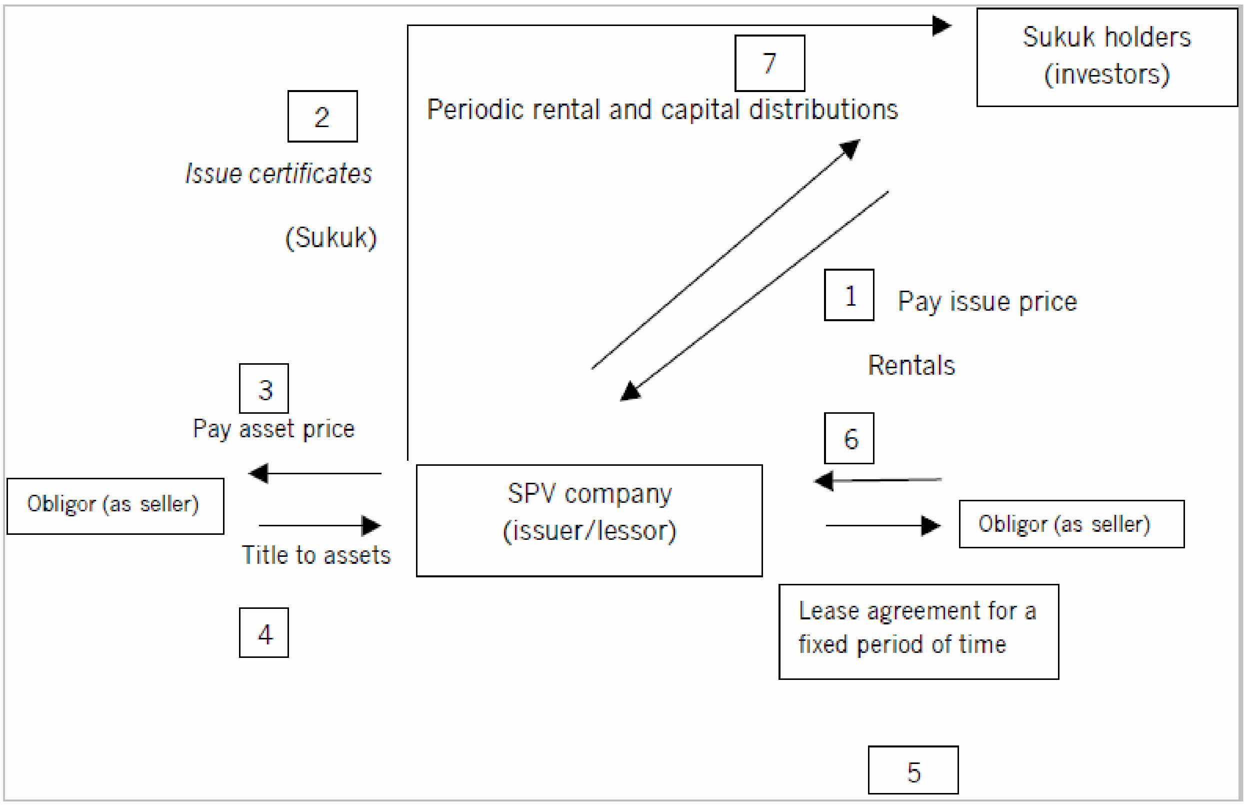
Sukuk may be structured based on the philosophy of contracts of exchange and participation such as Ijarah, Murabaha, Mudaraba, Musharaka and Istisna. To present a further understanding about Sukuk, it is very necessary to highlight some two types of Sukuk that are becoming popular in the Islamic capital market nowadays. These include asset-backed Sukuk and asset-based Sukuk. A distinction of these two as given by Moody's is as follow:

"In an asset-backed Sukuk, investors enjoy asset-backing, they benefit from some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the note-holders would be able to recover their exposure by taking control of and ultimately realizing the value from the asset(s). It also requires the element of securitization to be present – true sale, bankruptcy remoteness and enforceability of security." On the other hand, "In asset-based Sukuk, the originator undertakes to repurchase the assets from the issuer at the maturity of the Sukuk, or upon a pre-defined early termination event, for an amount equal to the principal repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the Sukuk note-holders, as the amount is defined to be equivalent to the notes. In this case, note-holders have no special rights over the asset(s) and rely wholly on the originator's creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable to honor his or her obligation to repurchase the assets, the note-holders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor stressing the importance that the purchase undertaking ranks pari passu with any other of the originator's senior unsecured obligations" (Dusuki, 2012).

Diagrammatic presentations of these two terms are given below:

2. Asset-based *Sukuk*

The case of financing the purchase of asserts or raising funds through sale and leaseback.



Source: ACCA Global

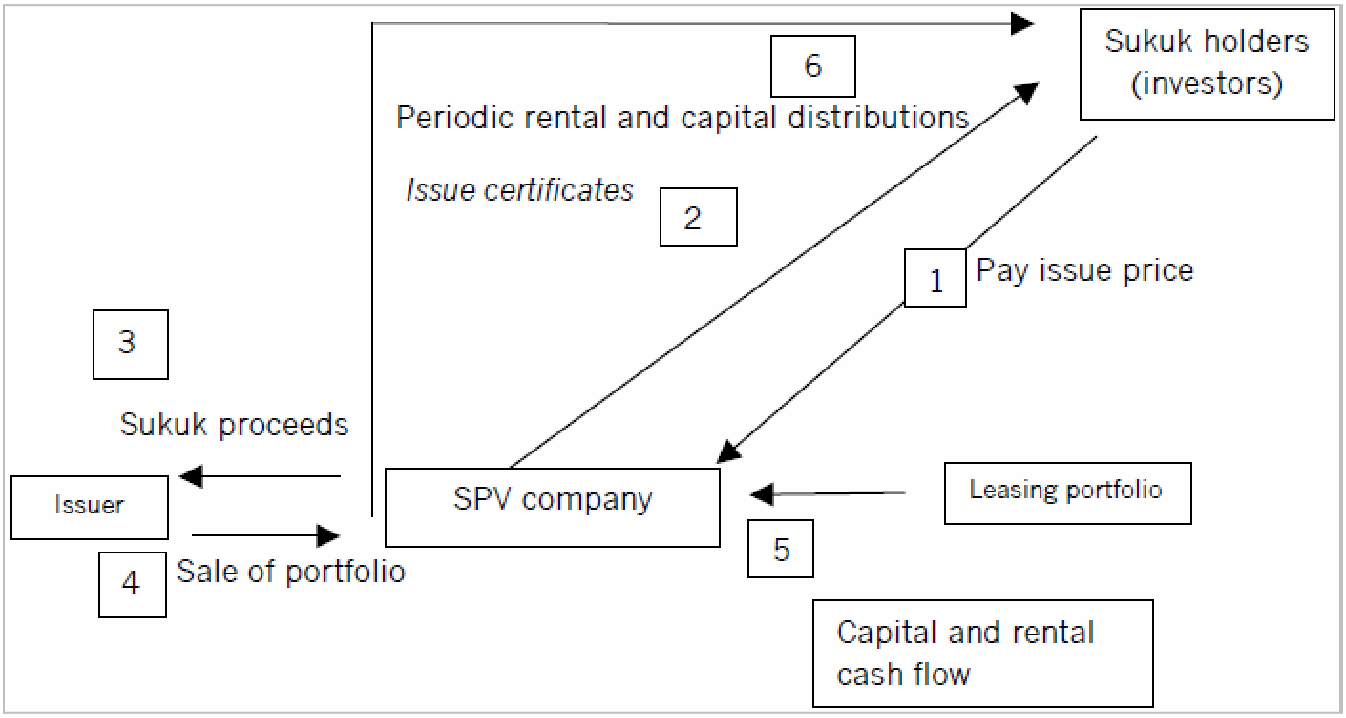
Outline of the steps involved:

1. Sukuk holders subscribe by paying an issue price to a special purpose vehicle (SPV) company.
2. In return, the SPV issues certificates indicating the percentage they own in the SPV.
3. The SPV uses the funds raised and purchases the asset from the obligor (seller).
4. In return, legal ownership is passed to the SPV.
5. The SPV then, acting as a lessor, leases the asset back to the obligor under an Ijarah agreement.
6. The obligor or lessee pays rentals to the SPV, as the SPV is the owner and lessor of the asset.

7. The SPV then makes periodic distributions (rental and capital) to the Sukuk holders. (ACCA Global , 2013).

2.1 Asset-backed *Sukuk*

The case of securitization of leasing portfolio



Source: ACCA Global

Outline of the steps involved:

1. Sukuk holders subscribe by paying an issue price to a SPV company.
2. In return, the SPV issues certificates indicating the percentage they own in the SPV.
3. The SPV will then purchase a portfolio of assets, which are already generating an income stream.
4. In return, the SPV obtains the title deeds to the leasing portfolio.
5. The leased assets will be earning positive returns, which are now paid to the SPV Company.
6. The SPV then makes periodic distributions (rental and capital) to the Sukuk holders. (ACCA Global, 2013).

2.3 Sukuk Structure that is yet to enter the Turkish Sukuk Market

Sukuk may also be structured based on a combination of several contracts such as Ijara together with Murabaha and Istisna. This type of Sukuk is known as hybrid Sukuk. Although it is yet to enter the Turkish *Sukuk* market, an analysis of how it operates will be of much importance to potential issuers in Turkey.

3. Hybrid Sukuk

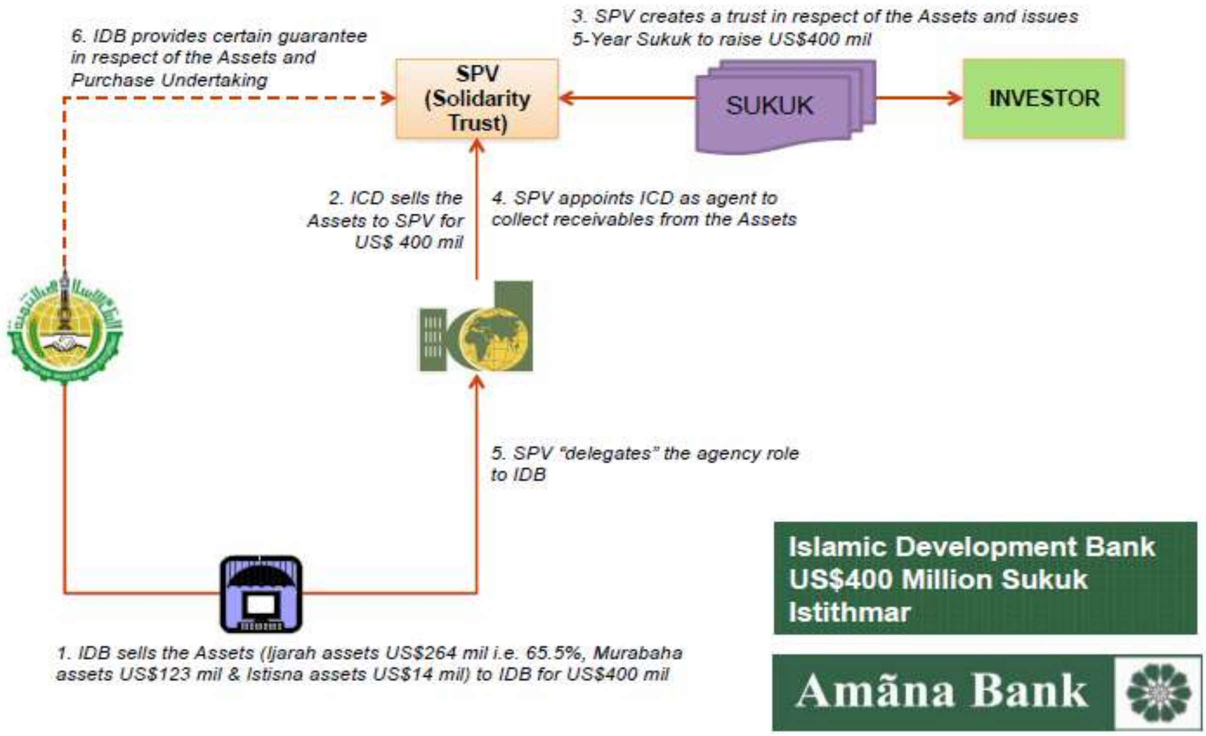
For the purpose of diversification of investment, experts in the Sukuk market have come out with a type of Sukuk structure known as hybrid Sukuk. This is a mixed asset Sukuk comprising of different assets in one instrument. The different assets may include a combination of Ijara, Murabaha receivables as well as Istisna. By combining these different classes of assets in a portfolio, the advantage is that, it allows for a larger mobilization of funds. It should be noted however, that due to the fact that Murabaha and Istisna contracts are not appropriate to be traded on the secondary market as securitized instruments, Sukuk that is tradable in the secondary market like Ijara Sukuk must form at least 51% of the pool in the hybrid Sukuk. The return on this type of instrument must be a prearranged fixed rate of return because the pool of assets also includes Murabaha and Istisna receivables (Nisar, 2007).

3.1 Hybrid Sukuk in Practice (The Case of Islamic Development Bank's Sukuk Al-Istithmar[1])

When it comes to the topic of hybrid Sukuk, the Islamic Development Bank (IDB) is worth mentioning as it pioneered the issuance of hybrid Sukuk in the global Islamic capital market. The IDB issued the first ever hybrid Sukuk which was made up of 65.8% Sukuk assets in the form of Ijara, 30.73% Sukuk assets in the form of Murabaha receivables and 3.4% Sukuk assets in the form of Istisna receivables. The Shariah Board of the IDB gave a regulation that the proportion of Ijara (tangible assets) in the mixed portfolio of assets must be at least 51% as compared to the receivables (murabaha and istisna) in order to meet the Shariah requirements to be tradable in the secondary market. The Ijara portion in the Sukuk asset should not fall below 25%. For the purpose of rating and securing international marketability, the IDB gave a guarantee for the issuance of this Sukuk. Solidarity Trust Services Limited (STSL), as the Special Purpose Vehicle (SPV) incorporated in Jersey, issued an amount of US$400 million Sukuk. The Islamic Corporation for the Development of Private Sector (ICD) acted as the intermediary and purchased the mixed portfolio from the IDB and then sold the asset to the issuer (STSL) at the combined net asset value. IDB declared that it will hold the asset in trust for the Sukuk holders. ICD was then appointed by STSL to manage the portfolio while CCD then delegates this duty to the IDB (Nisar, 2007).

3.2 The Structure of IDB Sukuk Al-Istithmar:

[1] *Sukuk Al-Istithmar* is known as investment *Sukuk*



Source: Bank Islam Malaysia Bhd

Despite the fact that Turkey is comparatively new in the global Sukuk market, it demonstrates a promising growth in the market. About $1.5 billion worth of Sukuk *was issued by the Turkish* Treasury in September 2012, earning an order of $1.9 billion from more than 90 investors globally. The world's leading underwriter of Sukuk, HSBC Holdings Plc, revealed that in May 2013, Turkey Sukuk sales had reached $1 billion and by the end of the year, they are expected to triple. Within the next 10 years, Turkey has a major aim to compete with Malaysia as the world's top *Sukuk* issuer as well as gain access to the huge pool of *Sukuk* investors worldwide. The holdings of the Sukuk market worldwide amounts to $100 billion at present (Bilmen, 2013).

Turkey has started to make its participation banks powerful as they are the financial institutions responsible to handle the sale of Islamic financial instruments in the country. This is part of its strategy to gain access to the Sukuk market which is currently very profitable and on the increase. The total banking asset share of participation banks increased from 2% to 6% in the last decade. In the next 10 years, it is expected to reach 15%. In proportion to this development, two public banks in Turkey, Halk Bank and Ziraat Bank are preparing to open participation banks of their own so as to manage Islamic financial instruments such as Sukuk. Along the lines of this growing attention in the market, the Turkish government has announced regulatory and legislative amendments in order to boost up the development of a sound and stable *Sukuk* market (Bilmen, 2013).

The growth potential for Turkey Sukuk (see table 1 below) is globally significant and progressively more considered as one of the new thrilling prospects in the Islamic finance sector, given the size of the economy and its reputation of stability and resilience (Thomson, 2013). Even though there is currently some political unrest in the country, it is expected to be transitory and not to have much impact on the Islamic finance sector. Good examples in this regard are countries like Tunisia and Egypt which are performing well in the Islamic finance sector despite the challenges created by the Arab Spring. Accordingly, given the high demand for Turkey Sukuk and the broader investor base, a study about Turkey Sukuk and its potential for growth is very essential in order to create more awareness about the developments in Sukuk and the recent active role Turkey plays in the Sukuk market.

4. Historical Background and the Development of Sukuk in Turkey:

Turkey is the seventeenth largest economy in the world and also considered as the most heavily populated nation in Europe consisting of more than 72 million Muslims. The successful economic development process, coupled with the Turkish authorities' commitment to improve the Islamic finance sector in the economy, has brought about a great boost in GDP per capita (current prices) which was US$ 4,146 in 2000 to US$ 10,666 as of 2012 (Thomson, 2013).

Islamic banking is known as participation banking in Turkey and currently there are only four participation banks which represent just about 5.1% of the total financial assets in 2012. The growth in assets within the participation banking sector is however better (25%) as compared to the conventional financial sector (13%) in 2012. Despite the fact that the banking industry in Turkey is competitive because it is traditionally conquered by conventional banks, there is still a substantial unexploited demand for *Shariah*-compliant products. Subsequent to a long custom of firm secularism ever since the institution of the republic, there is now a favorable change in attitude towards Islamic finance. Due to the global financial crisis, the Islamic finance sector has gained an advantage from an increasing search for a substitute to the conventional system. This is a progress that has by and large benefited Islamic finance worldwide (Thomson, 2013).

The growth of participation banks in Turkey played a pivotal role in the early development of Turkish *Sukuk* (known locally as Lease Certificates). Participation banks started to become known in the middle of the 1980s as a result of the influx of Islamic institutions from the Middle East. A small number of local institutions followed in the 1990s. With the Banking Law of 2005, the formal regulation for the development of the industry was established and in 2010, the first ever *Sukuk* was issued following the issuance of a Communiqué in April 2010 by the Capital Markets Board of Turkey (CMB) which allows Lease Certificates to be issued. With the declaration of the latest *Sukuk* regulation in June

2013 allowing new *Sukuk* structures, the growth in the Islamic finance sector in Turkey is expected to persist since there will be a boost up in the Islamic capital market (see tables 2 and 3 below) (Thomson, 2013).

Table 1: Global Aggregate Sukuk Issued Breakdown by Country (JAN 96 – SEP 13)

COUNTRY	NUMBER OF ISSUES	AMOUNT ISSUED ($ MILLION)
Malaysia	2438	324,576.9
UAE	73	47,876.4
Saudi Arabia	64	39,296.0
Indonesia	216	19,924.1
Qatar	19	19,245.6
Bahrain	273	13,918.5
Pakistan	57	6,348.9
Turkey	9	5,469.7
Brunei Darussalam	95	4,980.7
Kuwait	22	2,992.4
Singapore	9	984.2
United States	3	765.7
United Kingdom	5	279.1
China	3	274.7
Yemen	2	251.5
Sudan	3	220.9
Germany	2	190.9
Gambia	242	149.2
Iran	4	132.8
Jordan	1	120.3
Japan	1	100.0
Kazakhstan	1	73.3
France	1	0.7
GRAND TOTAL	3,543	488,172

Source: Turkey Islamic Finance Report 2014

Table 2: Timeline of Turkey Sukuk 2010 to 2013

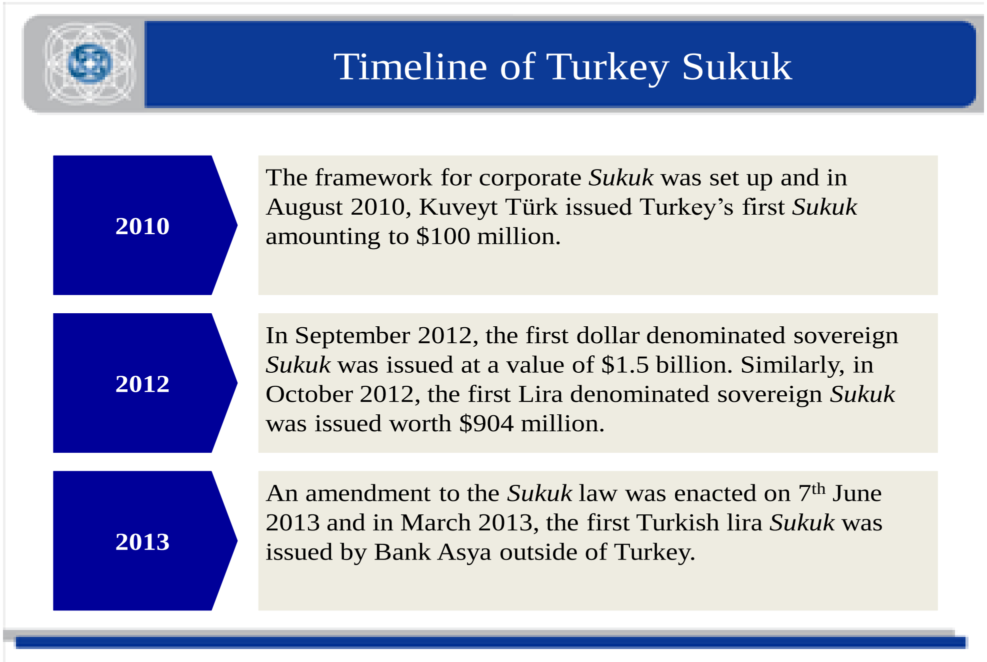


Table 3: Sukuk Issuance in Turkey 2010 to 2013

Sukuk name	**Kuveyt Turk Katilim banks**	**Kuveyt Turk Katilim banks**	**Turkey sovereign sukuk**	**Turkey sovereign sukuk**	**Bank AsyaKatilimBankasi**	**Bank AsyaKatilimBankasi**	**TurkiyeFinansKatilim Bankasi**	**Albaraka Turk KatilimBankasi**	**Turkey sovereign sukuk**
Structure	Wakala	Ijarah-Wakala	Ijarah	Ijarah	Ijarah	Murabaha	Murabaha	Murabaha	Ijarah
Currency	USD	USD	USD	TRY	TRY	USD	USD	USD	TRY
Tenor(years)	3	5	5.5	2	1	10	5	10	2
Closing Date	24 Aug 2010	30 Oct 2011	17 Sept 2012	20 Feb 2012	20 Feb 2013	26 Feb 2013	21 Mar 2013	30 Apr 2013	21 Aug 2013
Issue size	$100 million	$350 million	$ 1.5 billion	TRY 1.520 million	TRY125 million	$250 million	$500 million	$200 million	TRY1.82 million

Source: Turkey Islamic Finance Report 2014

4.1 The Regulatory Framework of Turkey Sukuk

The regulation on Sukuk has just recently been developed in Turkey. In 2010, the first ever Sukuk was issued by Kuveyt Turk participation bank following the issuance of a Communiqué in April 2010 by the Capital Markets Board of Turkey (CMB) allowing lease certificates to be issued. The lease certificate stated in the Communiqué is an instrument representing Sukuk known as interest-free bond. The only Sukuk structures that were allowed at that time were particularly Ijarah and Murabahah certificates because the CMB expected that most Sukuk issuances should be based on the Ijarah structure. With this structure, only companies that have physical assets were allowed to issue Sukuk in order to meet the Shari'ah requirement of being tradable in the secondary market as agreed upon by a majority of Shari'ah scholars worldwide (Thomson, 2013).

Special purpose vehicles (SPVs), which are known locally as Asset Leasing Company (ALC), are used to set up all Sukuk issuances. The ALCs are created by the originator of the assets to be utilized for the Sukuk deal and they are under the control of the CMB for the purpose of regulatory and supervisory issues. Due to the tax implications in Turkey for the sale of assets, if there is any transaction that involves issuing of Lease Certificates, the Tax Amnesty Law of 2011 offers a tax exemption which includes sales tax, stamp duty and corporate tax on the transfer of assets between the originator and the ALC. In addition, depending on the maturity of the transaction, the CMB provides a graduated withholding tax ranging from 7 percent to 10 percent for the ALC to make the distribution. No less than 5 years withholding tax exemption is given for longer-term tenors. On 7th June, 2013, the Communiqué on Lease Certificates was released by the CMB. This is the latest Communiqué allowing Lease Certificates to be issued based on Ijarah (ownership), Mudaraba(management agreement), Murabaha (purchase and sale), Musharaka (partnership) and Istisna'(construction contract). This move has made it possible for all corporations including those who do not even have tangible assets, for the purpose of structuring, to be able to issue Lease Certificates in Turkey (Thomson, 2013, 97).

Another significant issue in the new Communiqué is the provision on the setting up and ownership of ALCs. It is now a prerequisite for the ALC to be a regulated financial institution because it is no longer adequate for the Originator to set up and own the ALC. The regulated financial institution may be a bank, a brokerage, a security agent, an exchange traded trust based on real property, a firm in Turkey that has attained a local investment grade rating or a corporation that is in the ownership of the Under secretariat of Turkey at least 51 percent. Also, the Communiqué imposes restrictions making the maximum issuance amount to asset value to be 90 percent forcontracts of Ijara, Musharaka and Istisna' and valuation have got to be done in accordance with international standards as well as the applicable policies of the CMB (Thomson, 2013, 97).

5. Analysis and Discussion:

From the above study, given the fact that the population of Turkey is nearly completely Muslim and there is a substantial on hand demand for Shariah-compliant products, it is clear that the potential for growth in the Turkish Sukuk market is really huge. A number of issues however, have to be taken into consideration to make this great potential a reality.

First of all, in order to give room for growth, the Turkish central bank should soften its restriction on opening of Islamic windows or offering of Islamic financial instruments by conventional banks. Currently in Turkey, conventional banks are not allowed to open Islamic windows nor offer Islamic financial instruments. Conversely, a number of conventional banks, which are usual issuers of debt, are willing to open participation banks in order to issue Sukuk to meet the demand of their customers. For the fact that the Turkish banking system is predominantly conventional, as there are 45 conventional banks as compared to only 4 participation banks, the participation banking sector will continue to be at a disadvantage if conventional banks are not given the chance to offer Islamic products. Appropriate guidelines should however be outlined to ensure that their activities meet the necessary Shariah requirements.

Moreover, the regulations are in the right direction towards promoting and boosting the Sukuk market in Turkey as more corporations can now issue Sukuk based on a variety of structures. Sukuk can now be issued based on Ijarah, Mudaraba, Murabaha, Musharaka and Istisna'. This has made it possible for all corporations, even those without tangible assets, to be able to issue Sukuk in Turkey. More interestingly, the legislative changes have made it possible for companies to benefit from tax exemptions and other fees associated with the issuance of Sukuk. In the case of Ijara Sukuk, corporations do no longer have to pay the corporate tax which, supposedly, should have been charged on the earnings resulting from the sale of asset by the originator to the SPV and the subsequent sale back by the SPV to the originator. Similarly, regardless of maturity, any earnings arising from Ijara certificates which are issued onshore will be subject to 0% tax in the case of corporations and 10% income tax on individuals. Treasury Ijara Sukuk certificates issued offshore will be charged 0% income tax. Also, corporations do no longer have to pay Value Added Tax since Lease certificates as well as the sale and lease-back contracts are now free from Value Added Tax. However, earnings from offshore Ijara certificates with less than five years maturity are still subject to income tax. For the reason that most corporations issue corporate Sukuk with short term profile, an amendment of the current regulation regarding this matter will help boost up the Turkish Sukuk market (Bilmen, 2013).

Furthermore, the provision on the setting up and ownership of ALC necessitates that an ALC be a regulated financial institution and thus the originator cannot set up and own the ALC unless the originator is one of the regulated financial institutions. This may create some challenges and deter potential issuers who may not be in the category of the regulated financial institutions because they will need to hire ALC from other financial institutions. Since by law, it is the duty of the ALC together with its owner to make sure that profit allocation and repayments are done in an appropriate way, a separation between the ALC and the originator will create some challenges in the event the originator is unable to do the necessary payments. This is because normally the issuer will be the ALC but with the current situation, the name of the ALC is different from the original credit of the contract. To solve this problem, it may be better to enter into an agreement to shift the responsibility of payment to the originator. Besides, the originator may be obliged to pledge a bank guarantee. It is important to note however, that a bank guarantee involves more expenses and thus have the possibility of deterring potential Sukuk issuers (Bilmen, 2013).

Another concern that is worth mentioning is the issue of Shariah professionals. The lack of professionals compels some participation bank to take professionals from the GCC for its advisory board making it different from other participation banks. Due to this situation, some opinions and judgments of one bank may not be acceptable by other banks. For example, while some of the participation banks do not use murabaha sukuk, Kuveyt Turk can use it. Similarly, knowledge of Islamic finance and its products in general are still very little in the country. For instance, many participation banks are eager to use istisna' arrangement but they are not familiar with it. Thus more education and awareness are needed in order to deepen the understanding of Islamic finance (specifically Sukuk) among the people and thus develop their confidence in using the various Sukuk structures.

6. Conclusion

In this research paper, the current Sukuk development and the regulatory issues of Sukuk in Turkey have been comprehensively discussed in the wake of the revolutionary role Turkey plays in the global Sukuk market.

Given the recent legislation with the accompanying tax incentives, coupled with the size of Turkey Muslim's population, the resilient economy together with rapid growth, the sturdy banking system, the increased number of investments in infrastructure, and the increasing diplomatic relationship between Turkey and the Middle East, there is opportunity for sturdy growth in the Turkish Sukuk market in the near future. This is inline with the argument by Herdem & Co (2013) in the article on "Turkey: New Opportunities for Sukuk in Turkey". Corporations without tangible assets can now be able to issue Sukuk in Turkey and companies can benefit from tax exemptions and other fees associated with the issuance of Sukuk.

It is evidenced in the study that, just like in many parts of the world, Ijara Sukuk is the first and most common Sukuk issued in Turkey till date. Though other Sukuk structures are now allowed, their frequency of use is still at infancy. Similarly, currently in Turkey, conventional banks are not allowed to open Islamic windows nor offer Islamic financial instruments. As many conventional banks are eager open participation banks, it is important for the Turkish central bank soften its restriction on this matter in order to open up the market for more growth. Furthermore, the provision that an ALC must be a regulated financial institution may have a negative impact on potential issues as this may create some challenges and deter the potential issuers who may not be regulated financial institutions.

There is lack of Shariah professionals in the Turkey Sukuk market. Training of professionals in the field of Islamic finance is of utmost importance to equip the participation banks in Turkey with the necessary skills needed in order to compete with Malaysia which is currently the world's largest Sukuk issuer.

This study only touches on the development of Sukuk and its potential for growth in Turkey. Further studies on the Turkish Sukuk may consider a more detailed analysis of this topic. I will also be interesting to do a critical analysis on the issues of Shari'ah pertaining to the practice of Sukuk in Turkey.

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