THE ISLAMIC FINANCE AND MARKETS LAW REVIEW

THIRD EDITION

Editors
John Dewar and Munib Hussain

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Chapter 10

TURKEY

Sera Somay and Gözde Kayacık[1]

I LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Products

In Turkey, Islamic finance products are regulated under the legislation that applies to conventional transactions. Nonetheless, issuance of *sukuk* certificates is specifically regulated under Lease Certificates Communiqué No. III-6.1 (Official Gazette dated 7 June 2013) and the issuance process has been detailed thereunder.

The Islamic banking industry, which is known in Turkey as 'participation banking' (*katılım bankacılığı*) and its various Islamic banking products, such as *murabahah*, *mudarabah* and *musharakah*, are regulated under:

a the Banking Law No. 5411;

b the Financial Lease, Factoring and Financing Companies Law No. 6361;

c the Regulation on Banks' Transactions Subject to Permission and Indirect Shareholding; and

d other secondary legislation published by the Banking Regulation and Supervision Authority of Turkey, more specifically the Regulation on the Principles and Procedures Related to the Determination of Qualifications of the Loans and other Receivables by Banks and the Provisions to be Set Aside In Relation Thereto (Official Gazette dated 1 November 2006), the Regulation on Equities of Banks (Official Gazette dated 5 September 2013) and the Regulation on Procedures and Principles of Preparation and Publication of Annual Activity Reports by the Banks (Official Gazette dated 1 November 2006), among others.

The applicable legislation for issuance of lease certificates (*sukuk*) as an Islamic capital markets product, are (1) Article 61 of the Capital Market Law No. 6362 and the Lease Certificates Communiqué covering the procedure to be followed by corporates and public authorities as to issuance of lease certificates (*sukuk*); and (2) Article 7/A of the Public Finance Law No. 4749 covering the issuance of lease certificates (*sukuk*) by public authorities, including the Turkish Treasury.

1 Sera Somay is a partner and Gözde Kayacık is a senior associate at Paksoy.

Insurance

There are a number of *takaful* companies operating in Turkey. While their establishment and existence are based on the Insurance Law No. 5684, the Turkish Treasury[2] has introduced a new regulation, the Regulation on Working Procedures and Principles of Participation Insurance, which came into force on 20 December 2017 (the Takaful Regulation), and which aims to set out the procedures and principles regarding participation insurance or *takaful*. In addition to elaborating on management models (i.e., *mudarabah*, *wakalah* or hybrid management models) for participation insurance companies, the Takaful Regulation has imposed on participation insurance companies the obligation either to establish an advisory committee or to outsource the monitoring of their activities to ensure compliance with the applicable participation insurance and Islamic (participation) finance principles.

Following the entry into force of the Takaful Regulation, the General Directorate of Insurance of the Turkish Treasury issued the Decree Regarding Implementation of Participation Insurance on 21 December 2017, to further detail the implementation of the Takaful Regulation.

Funds

In terms of funds, the Communiqué on Principles of Investment Funds No. III-52.1 (published by the Capital Markets Board of Turkey in the Official Gazette dated 9 July 2013) allows Islamic funds to be composed of Islamic finance products, including Islamic pension funds, and allows conventional funds to invest in lease certificates (*sukuk*).

ii Regulatory and supervisory authorities

There is no particular authority that has been established for the purposes of implementing Islamic finance legislation or that has a supervisory role over Islamic finance practice in Turkey.

As in conventional financing, the Banking Regulation and Supervision Authority of Turkey has the authority to supervise and enact secondary legislation applicable to Turkish banks, including participation banks.

The Capital Markets Board of Turkey also has the authority to supervise and enact secondary legislation applicable to a certain Islamic finance product (lease certificates (*sukuk*)), which are issued in accordance with Article 61 of the Capital Market Law and the Lease Certificates Communiqué.

Pursuant to Article 80 of the Banking Law, Turkish participation banks are obliged to become a member of the Participation Banks Association of Turkey, the responsibilities of which include, among others:

a improving the participation banking sector;
b determining professional ethics for participation banks;
c taking any measure to prevent unfair competition among participation banks; and
d filing lawsuits where necessary in the interests of participation banks.

2 Prime Ministry Undersecretariat of Treasury of the Republic of Turkey (i.e., the Ministry of Treasury and Economy).

II COMMON STRUCTURES

The common Islamic structures that are used in the Turkish market are *murabahah*, *ijarah*, *musharakah* and *mudarabah*. The Banking Law refers to *salam*, *istisnah*, *mudarabah*, *murabahah*, *ijarah* and *musharakah*.

Islamic banks in Turkey collect their deposits based on the *mudarabah* structure. *Murabahah* is the one of the most commonly used structures and is used by Islamic banks in Turkey for corporate, consumer and credit card loans. Furthermore, Islamic banks in Turkey obtain their own funding from international markets in the form of *murabahah* syndications. The same applies to Turkish corporates for their syndicated financings to the extent that they make use of Islamic products. *Ijarah* is used for the financing of machinery, equipment and other investment tools by companies. Islamic banks in Turkey can sell leasing products directly whereas conventional banks can only perform financial leasing through their financial leasing arm. *Musharakah* in Turkey is used to finance construction contracts. *Istisnah*, on the other hand, is used to finance housing projects and *qard hasan* for cash withdrawals under credit card contracts.

The initial introduction of *sukuk* in the Turkish market was in 2010 through lease certificates, which are asset-based instruments. The lease certificates followed the *sukuk al-ijarah* structure whereby the special-purpose vehicle purchases the underlying assets and then leases those assets to the obligor. The sale of the lease certificates is possible via private placement where no prospectus is required, as well as via public sale. The market has since been enhanced by new regulations that permit not only *sukuk al-ijarah* but other *sukuk* structures such as commodity *murabahah*, *wakalah*, etc. as well as certain tax incentives that are analysed in detail in Section III. All privately owned Islamic banks in Turkey have issued *sukuk* in international and domestic markets.

Sovereign *sukuk* were first introduced to the Turkish market through a change in legislation in June 2012, following which the Turkish Treasury issued domestic and international *sukuk*.

Furthermore, there are Islamic indexes in Turkey – the Participation 50 Index, Participation 30 Index and Model Portfolio Index – which are comprised of shares of *shariah*-compliant companies with different conditions based on the index. There are also participation funds in Turkey sold by Islamic and conventional banks, and investment institutions consisting of equity and debt products as well as gold. Equity products are mostly the Participation Indexes referred to above, whereas the debt products are mostly *sukuk* issued by the Republic of Turkey and other Islamic banks in Turkey.

Takaful (Islamic insurance) is also available in Turkey and there are a number of *takaful* companies (i.e., participation insurance companies) active in the market. The Insurance Association of Turkey reports on data related to *takaful* and participation insurance, showing total contributions generated.

III TAXATION

There is no specific regime to encourage or promote utilisation of Islamic financial products and structures in Turkey. Rather, the local tax administration intends to 'equalise tax treatment for equivalent financial activities of commercial and Islamic finance institutions', as noted in its statements given in relation to recent legislative amendments. Pursuant to these amendments to the tax regulations, which have brought welcome clarifications (through exemptions and allowances) to a number of long-standing uncertainties in the tax laws, there has been solid improvement in the practicability of a specific type of product (namely *sukuk al-ijarah*).

Pursuant to exemptions and allowances introduced in 2016, corporate taxpayers could enjoy corporate income tax and value added tax exemptions in sale and leaseback structures (i.e., *sukuk al-ijarah*) not only for immovable properties but also for movable assets. Moreover, the transfer of underlying immovable assets under the lease certificates will not reset the holding period (e.g., in the event that the sale and leaseback are followed by a potentially taxable disposal in the future), and the documents executed for the transfer of any underlying asset under the lease certificates will be exempt from stamp tax.

IV INSOLVENCY

There is no separate insolvency regime for Islamic finance participants.

The only special treatment is applicable to the assets of an asset leasing company (ALC), which acts as the issuing entity of lease certificates. Turkish law ring-fences the assets of an ALC to protect the rights of the holders of the lease certificates. Pursuant to Article 61 of the Capital Market Law and Article 3 of the Lease Certificates Communiqué, *sukuk* assets pertaining to an issuance cannot be disposed of, pledged, posted as collateral, attached (including for the purpose of collecting public claims) or added to a bankruptcy estate, and cannot be subject to a precautionary injunction until the payment of all the obligations to the certificate holders relating to the issuance is made in full. If an issuer cannot fulfil its obligations under lease certificates in a timely manner, its management or audit may be transferred to public institutions and its activity licence may be cancelled. Likewise, if it becomes bankrupt, (1) the income generated from the *sukuk* assets shall first be used in the payments to be made to lease certificate holders; and (2) the Capital Market Board will be authorised to take any measures to protect the rights of certificate holders, among other things, to initiate a bankruptcy or liquidation proceeding of the ALC and to ultimately have recourse to shareholders of the ALC holding at least 10 per cent of the share capital and to the board members of the ALC (subject to a number of conditions) if any shareholder or board member can be held responsible for the non-payment.

V JUDICIAL FRAMEWORK

i Courts

There are no courts specialised in disputes involving *shariah*-compliant products and structures. Commercial courts would have jurisdiction over such matters.

ii Cases

A lawsuit was filed in April 2013 before the Constitutional Court of Turkey,[3] the high court overseeing constitutional jurisdiction, on the partial cancellation of Article 7/A of the Public Finance Law, which is a specific article for issuance of lease certificates (*sukuk*) by public authorities only, including the Turkish Treasury.

3 Constitutional Court decision; case No: 2013/72, decision No: 2013/126, dated 31 October 2013, published in the Official Gazette dated 24 January 2014, No. 28892.

Article 7/A authorises the relevant minister to sell, lease, transfer, etc. the assets of non-listed entities covered by this legislation. The second part of the Article, which was requested to be cancelled, sets forth that the minister may also carry out similar transactions, which, in each case, would be exempt from certain formal requirements.

The cancellation request was made on the basis that the Article had been drafted in a broad manner by shifting the legislative power to the executive branch of the government. The Constitutional Court rejected the lawsuit on November 2013 on the grounds that the legislature submits the technical and administrative aspects of the transactions to the executive branch and the legislation aims to develop local capital market and financial instruments.

It should also be noted that the Turkish Treasury has undertaken a number of international and local *sukuk* issuances based on this legislation.

VI OUTLOOK

Following the opening of two state-owned Islamic banks – Ziraat Katılım Bank and Vakıf Katılım Bank – on 12 May 2015 and 11 February 2016 respectively, and the establishment of the public wealth fund of Turkey with the mission to develop the Islamic finance practice in Turkey, the number of *sukuk* issuances has increased. The two *sukuk* issuances made in international markets in 2017 and 2018 by Ziraat Katılım Varlık Kiralama and Aktif Bank Sukuk Varlık Kiralama total US$618.4 million. Moreover, following amendments to the applicable legislation, the Turkish Treasury, which can now issue *sukuk*, started issuing gold bond and gold indexed *ijara sukuk*, in October 2017, in order to bring idle gold into the economy, to broaden investor base and to diversify borrowing instruments. The number of issuances has reached a total of 2.47 tonnes; consisting of 1.15 tonnes of gold bond and 1.32 tonnes of gold indexed *ijara sukuk*.[4] Another recent development in the *sukuk* market is the issuance of Turkey's first real estate investment trust (REIT) *sukuk* with a nominal value of 100 million Turkish lira in February 2018 by Halk REIT. These developments in the market indicate the market's and the government's continuing goals for the growth of Islamic finance products.

4 Treasury Financing Programme: 2017 Developments and 2018 Projections – press release by the Prime Ministry Undersecretariat of Treasury of the Republic of Turkey, dated 31 October 2017.

Appendix 1

ABOUT THE AUTHORS

SERA SOMAY

Paksoy

Sera Somay is the partner heading the banking and finance practice at Paksoy, with a specific focus on Islamic finance transactions.

She works on syndicated and club loans for financial institutions and corporates, acquisition financing, secured financing and other structured financings.

Sera advised on the first international *sukuk* issuance by the Republic of Turkey and the first *sukuk* issuance by a Turkish Islamic bank. She also works on *murabahah* syndications of Turkish participation banks as well as their annual *sukuk* issuances.

Sera also advises on regulatory mergers and acquisitions across a variety of sectors with a focus on banking M&A transactions.

GÖZDE KAYACIK

Paksoy

Gözde Kayacık is a senior associate and specialises in banking and finance transactions.

She has a special focus on infrastructure and project finance transactions (including gas, thermal power, renewables, water and waste, mining, airports, roads and bridges, ports and social infrastructure).

Gözde advises various types of clients (e.g., banks, multilaterals, leading corporates, SMEs, state-owned entities and regulatory bodies) on syndicated and secured lending, project financing and Islamic finance.

PAKSOY

Orjin Maslak
Eski Büyükdere Caddesi
No. 27 K. 11 Maslak 34485
Istanbul
Turkey
Tel: +90 212 366 4700
Fax: +90 212 290 2355
ssomay@paksoy.av.tr
gkayacik@paksoy.av.tr
www.paksoy.av.tr

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