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Global Islamic Capital Markets: Current Trends and Future Opportunities

Introduction

Global Islamic Capital Markets: Current Trends and Future Opportunities

2014 was an exceptional year for the international Islamic capital markets and will be remembered as the year in which the Islamic capital markets transitioned beyond the traditional hubs of the Gulf and South East Asia to new markets including Europe and Africa.

In this briefing we bring together for the first time contributions from our lawyers in the London, Dubai and Istanbul offices that were originally published at the end of last year. We hope that these articles may be of some interest to you sharing our experience of some recent high profile transactions.

The first article explores current trends and opportunities in the global Islamic capital markets, offering some insight into how new entrants might approach this market and what the immediate future might hold for the global *sukuk* market. The second article analyses the first UK sovereign *sukuk* and the possibilities that this ground-breaking issuance may bring.

The third article considers the first ever South African *sukuk* and whether this could be the catalyst for an African *sukuk* market to emerge. The final article explores recent Turkish legislation that is going to allow new entrants and structures to enter the Turkish *shari'a sukuk* market.

The motivations for different entrants to the global *sukuk* race vary widely and the challenges for establishing a foothold similarly differ for each jurisdiction. However, the immediate future for the *shari'a* compliant fixed income securities market looks positive with many new sovereigns confirmed or rumoured to be entering the market and with the barriers to corporates issuing *sukuk* in such jurisdictions falling away.

The transition beyond the traditional hubs of Islamic finance in South East Asia and the Gulf could be seen as the point at which the *sukuk* market begins to mature and establish *shari'a* compliant fixed income securities as one of the main types of global asset finance.

Building on our experience in Asia, the Middle East and Europe, Clifford Chance has been at the forefront of shaping this transition having recently advised on a number of groundbreaking transactions, including the first UK sovereign *sukuk*, the first South African sovereign *sukuk* and the first sovereign *sukuk* of Senegal. Similarly, Clifford Chance has in recent years been at the cutting edge of the development of the Turkish *shari'a* compliant fixed income securities market, including recently advising on the Republic of Turkey's $1 billion sovereign *sukuk*.

At the back of this briefing we have included details of our global Islamic capital markets team should you wish to get in touch with us.

contents

Recent trends and new perspectives in global Islamic fixed income capital markets

This article tracks the evolution of the global *shari'a* compliant fixed income capital markets with a particular focus on Turkish market developments.

Key points

- Turkish market developments illustrate how policy tools may be created to support *shari'a* compliant fixed income securities and attract foreign investors from the Gulf region.
- Legal techniques from securitisation and asset – backed finance may help to access *shari'a* compliant capital markets for funding infrastructure projects in developing countries.
- Recent trends may transform *shari'a* compliant fixed income securities into a significant source of funding for asset finance.

Introduction

As 2014 draws to a close we are now at the time of year when looking to the future for market trends is almost unavoidable. So, as part of our end of year forecast, we would like the reader to join us in considering the year's developments in global cross-border *shari'a* compliant capital markets, trying to draw some lessons from the recent past while casting our eyes to the future. Certainly, in particular for those more directly involved in this part of the global capital markets, 2014 has been a remarkable year, with the inaugural issuances of the first sovereign *sukuk* by the UK and Senegal in June, by the Republic of South Africa and the Hong Kong Special Administrative Region of the People's Republic of China in September, by the Duchy of Luxembourg in October and the return to the markets of the Republic of Turkey in late November. With these sovereign issuers entering into (or confirming their presence in) the market it is difficult to avoid the impression of having witnessed in recent months a momentous transformation in the landscape of *shari'a* compliant global fixed income capital markets. Not only has the offering of *shari'a* compliant fixed income instruments available to investors in the markets been substantially diversified (both in terms of currency denominations, geographical exposure and credit standing), but the same dynamics that have so far shaped international *shari'a* compliant fixed income instruments in the global capital also markets also appear to have been transformed.

Recent trends

Shari'a compliant fixed income securities are part of the modern Islamic finance which has developed in South East Asia and the Middle East in the second half of the 20th century to reflect the local political demands to create financial systems more aligned with the ethical values of countries with a predominantly Muslim population. In the last decade, however, as a result of the globalisation of the financial markets, a global international market for this type of securities has gradually emerged, growing well beyond the domestic confines of those original markets. In the last few years, Islamic finance has spread well beyond South East Asia and the Middle East and the target of making the domestic financial systems more "inclusive" in order to improve the access to funding irrespective of religious or ethical beliefs and to create a level playing field between conventional and Islamic financial institutions has started being pursued also in countries with secular or non-Islamic legal systems such as Turkey and the UK. This has led not only to new opportunities for Islamic financial institutions emerging but also the creation of *shari'a* compliant fixed income instruments as an integral component of the domestic capital markets of an increasing number of countries. Several European countries, including the UK, France and Turkey, have explored this option and some have already enacted regulatory and tax legislation to equalise the treatment of *shari'a* compliant instruments with conventional fixed income. The presence of sizeable Muslim minorities and the current demographic trends are likely to sustain the expansion of these financial products across Western Europe and farther.

"Inclusiveness", however, has not been the only driving factor and, with the increasing volume of international *shari'a* compliant fixed income instruments issued in the market, several financial centres have started jostling for position to claim the title of centre for global *shari'a* compliant fixed income capital markets. The interest in attracting the lucrative service industries supporting and operating around the main financial markets and retaining or increasing their

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share of these markets has led to active public and political support for promoting the development of the existing global or regional conventional financial centres as new Islamic financial centres. The recent sovereign issuances of the UK, Hong Kong and Luxembourg (and on a regional level, South Africa and Turkey) are clearly also aiming to promote the international standing of London, Hong Kong and Luxembourg, as well as Istanbul and Johannesburg, in an increasingly competitive environment. However, while pursuing these objectives, the recent issuances are also raising new political aims and concerns. Attracting foreign capital and targeting in particular the liquidity existing in the Middle East is increasingly seen as a fundamental public policy aim by many governments across the globe and the availability of tools and strategies that are suitable to attract such foreign capital is at the forefront of such governments' consideration. The recent sovereign issuances of Senegal, South Africa and Turkey, for example, reflect these political ambitions in different ways.

The concurrence of all of these trends, however, is also having a broader and deeper impact on global *shari'a* compliant fixed income capital markets and seems to be refashioning this type of debt securities. To appreciate fully this evolution, it may be helpful to consider how the more recent issuances differ from the traditional *shari'a* compliant fixed income securities issued in the Gulf region and, in this respect, the Turkish market developments and the related legislative enactments in the last three years offer a useful insight. The recent Turkish market developments also help to illustrate how policy tools may be developed and what issues need to be addressed as a result.

Developing suitable policy tools: the Turkish example

With a long presence in international capital markets as an issuer of conventional debt instruments and a secular constitution, the Republic of Turkey, despite its predominantly Muslim population, did not appear to be the most obvious candidate for issuing *shari'a* compliant sovereign fixed income instruments in 2012; particularly considering that the yields on conventional Turkish bonds were then still pricing inside yields expected from a *sukuk*. Primarily borne out of the political desire to support the opening of the domestic market to participation banks and to promote Istanbul as a regional financial hub, the approach adopted by the Republic since 2011 is, therefore, an interesting case study.

The issuance of *shari'a* compliant instruments was first made possible in Turkey by the introduction in 2010 of a form of asset – backed debt instruments (known in the Turkish legislation as lease certificates) through covered bond style legislation which made it possible for participation banks to tap the market via a regulated entity (known as an asset leasing company) which is subject to the supervision of the Capital Markets Board of Turkey ("CMB"). This was followed by the introduction of appropriate amendments to the tax legislation intended to make it more attractive for foreign investors to invest in these products. To begin to win the confidence of investors in the product, the Republic of Turkey decided to enter the market and issue lease certificates in 2012. Since 2012, the Republic has repeatedly tapped the market issuing its own lease certificates both in the domestic and the international capital markets and in so doing has established a clear benchmark for foreign investors. These sovereign issuances have helped foreign investors become familiar with this market, have established a yield curve for lease certificates and have contributed to make it possible for the participation banks to access directly the international capital markets themselves.

The success of this policy – clearly reflected in the ability of all the Turkish participation banks to access the international (as well as the Turkish domestic) capital markets in recent years – has led the CMB to attempt to open these sources of funding well beyond the still narrow participation banks sector. In 2013 the CMB enacted a bold amendment of the regulatory framework intended to make the lease certificates also available to other institutions, including corporate groups and project financing for local infrastructural projects. Though it is too early to assess the impact of the new legal framework, which, notwithstanding the interest by several Turkish corporates, has not yet been tested in the market, it is interesting to note how the new legislation is reshaping the nature of the lease certificates.

Asset-based versus asset – backed instruments

Though a typical international *shari'a* compliant fixed income instrument issued in the Gulf region is usually structured as a beneficial interest in an English law governed offshore trust, the income generating asset forming part of the trust property (typically located onshore) is not segregated from other assets (as the transfer of the asset is typically not required to be perfected under the law of the relevant jurisdiction). The profit return

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on the certificates is only linked to the performance by the obligor of its contractual arrangements entered into with the trustee, which also forms part of the trust property. The return on the investment is "based" on the asset – rather than being "backed" (or in other words secured) by it – and the value of the asset is only intended to provide the parameters for determining the size of the capital issue and the financial performance of the instrument and is not calculated on the basis of its real market value. As a result, an investor investing in such an instrument practically invests in the credit risk of the obligor rather than in the value of the income generating asset.

Though generally compared in the market to a similar asset – based *sukuk al ijara* as issued in the Gulf region, the Turkish lease certificates present quite distinct legal features. The Turkish lease certificates benefit from statutory segregation and (after the reforms enacted in 2013) are subject to a statutory debt to asset ratio based on the real market value of the underlying assets. As such, the Turkish lease certificates are much closer to an asset – backed instrument than a typical *sukuk* originated in the Gulf region.

These characteristic legal features do not seem to have played a significant role in the market assessment and pricing of these instruments which still seem to be perceived by the market primarily as asset – based instruments. However, it is difficult to imagine that this will remain the case if the aim of the CMB to promote lease certificates as a source of funding for project finance is to succeed. The segregation of the assets for the benefit of the investor is such an important credit enhancement factor that it can hardly be ignored in structuring any such future project finance bond.

Asset finance in sub-Saharan Africa: replicating the Turkish model?

Whether the approach pursued by the Republic of Turkey may provide a roadmap suitable for other countries is difficult to say. However, it is already possible to note certain similarities between the Turkish lease certificates and the inaugural issuances of international *shari'a* compliant fixed income instruments recently completed by the Republic of Senegal and the Republic of South Africa.

The Senegalese issuance has been structured using securitisation legal principles, with a transfer of assets – including a *usufruct* over governmental building complexes – to a securitisation fund which then leased back the buildings to the Senegalese government and funded the purchase of the assets by issuing to investors units in the securitisation fund. As the securitisation fund is a form of co-ownership of the underlying assets under Senegalese law, the units are equivalent to a beneficial interest in a trust and the structure is consistent with *shari'a*. However, the use of securitisation techniques results in an instrument which structurally is an asset – backed (rather than an asset – based) debt security.

Similarly, in the inaugural South African issuance, the certificates represent beneficial interests in an onshore trust created over certain assets located in South Africa, including a personal *usufruct* right over government – owned infrastructure assets. As the trust has been perfected in accordance with South African law, notwithstanding the apparent similarities with an asset – based *sukuk al ijara* as issued in the Gulf region, the underlying assets are segregated through the trust.

In both the Senegalese and South African issuances, due to the sovereign nature of the debt securities, these structural legal features may appear rather academic and pale into commercial insignificance. Notwithstanding the legal segregation of the assets, any return for the investors depends purely on the timely performance of the sovereign rather than on the real performance of the assets (the local government, in each case, is the only debtor of the securitised receivable or is the only entity entitled to own the relevant assets). Therefore, in the context of these sovereign issuances, any distinction between asset – backed and asset – based securities is of little practical consequence. However, should these legal structures be replicated in the context of non-sovereign *shari'a* compliant fixed income securities, these aspects would have a much greater relevance, as the financial product would

appear closer to the Turkish lease certificates than to standard issuances originated in the Gulf region. This conclusion is very significant given the declared intention of each of these countries to use Islamic finance to attract foreign investment in their respective economies, either to fund publicly by owned businesses or private companies or to fund infrastructure projects.

This, of course, does not spell the imminent end of the *shari'a* compliant asset – based fixed income securities which have been issued so successfully in the Middle East and South East Asia. Sovereign issuers and corporate entities in these regions having a financial standing sufficiently strong to approach the international capital markets are likely to be able to tap the markets with traditional instruments. In many emerging markets, however, the use of asset – backed structures may be necessary.

The utilisation of legal models based on domestic legal frameworks for asset – backed products as in Senegal is also highly significant as it may allow potential avenues for structuring fixed income instruments to be identified in line with the requirements of *shari'a* law using well understood legal concepts in the local jurisdiction. Many civil law countries exploring how to allow domestic issuers to tap the international *shari'a* compliant capital markets may prefer using or adapting such existing legal frameworks instead of using offshore trust structures such as those used in the Gulf region. In particular, when recognition of foreign trusts may be an issue, such an approach would have the benefit of retaining the legal certainty of well-known domestic legal principles. Such an outcome would seem to be more likely if these countries were to try to access the international *shari'a* compliant capital markets for funding infrastructure projects.

When used within secular legal systems with a predominantly non-Muslim population, form over substance is inevitably likely to be less attractive and a gradual shift towards more typical asset finance is likely to occur.

A new road map

The recent experience of the Turkish market confirms that, in order to attract foreign capital by targeting the liquidity existing in the Middle East, the role played by the state is likely to be critical. A clear legal framework is necessary and it must be capable of reconciling the requirements of *shari'a* law, as required by Islamic scholars, with the demand of legal certainty from investors. This may be achieved using legal principles borrowed from securitisation and asset – backed finance without the need to enact specific legislation for Islamic finance. This may allow potential avenues for structuring the investment to be identified so as to fit both the expectations of traditional investors familiar with asset – based *sukuk* and the more demanding requirements of full asset segregation, and therefore reducing the potential risk of legal uncertainty inevitably associated with the adoption of new legal principles. Introducing a favourable tax regime is also important. However, the significance of the sovereign issuances in winning the confidence of the markets cannot be underestimated, as the support of the government is vital to create an environment which may attract foreign capital.

Introducing a legal framework suitable for issuing *shari'a* compliant fixed income instruments is not going to be the panacea for all the funding problems of every country. Unrealistic expectations should be discouraged. The market developments in Turkey may help to understand the potential obstacles limiting the growth of *shari'a* compliant finance. Notwithstanding the recent legislative development, lease certificates remain a form of asset finance and the availability of *shari'a* compliant assets is a prerequisite for issuing any such lease certificates. Outside those countries where all the economic activities have to comply with *shari'a*, drawing a neat line between *shari'a* compliant and *shari'a* non-compliant assets within any business organisation may be problematic. In many countries, therefore, the availability of suitable assets is likely to be a major constraint and it may be difficult to see how Islamic finance may become a general source of funding for all types of businesses. However, most infrastructure assets are likely to create no such problems and the use of *shari'a* compliant capital markets to fund (or refund) projects is more

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promising. International investment is unlikely to be attracted unless sufficiently strong credit ratings can be achieved. Investor appetite is likely to remain focused on investment grade securities and by itself a *shari'a* compliant structure would not be sufficient to mitigate concerns regarding the low credit rating of the obligor. The availability of Islamic finance may therefore be limited as a result of the low sovereign rating of the relevant jurisdictions. Conversely, in order to achieve a more attractive rating, structuring the securities as asset – backed (rather than asset – based) *shari'a* compliant fixed income instruments – along the lines of the Turkish lease certificates or using securitisation techniques as in Senegal – may become a prerequisite for accessing these markets.

In any case, the active role played by local governments in issuing *shari'a* compliant fixed income instruments is manifest.

Conclusion

In the years to come it is not unlikely that 2014 will be seen as a turning point in the development of the global international market for *shari'a* compliant fixed income securities. With the issuance of *sukuk* by the UK, Luxembourg and Hong Kong, some of the main global financial centres have entered the race to position themselves as the key markets for these products. These sovereign issuances are likely to provide useful benchmarks for investors interested in investing outside the core Islamic markets in the Middle East and South East Asia. Developed economies are increasingly keen to find ways to attract foreign investment. At the same time, there is an increasing focus on how to attract investment in infrastructure projects, particularly in emerging markets where there is a higher demand for such investments and potentially higher long-term returns. The time seems ripe for an increased sophistication of this financial product to accomplish the several roles it can play. These trends are likely to transform *shari'a* compliant fixed income securities into one of the main types of asset finance.

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Dissecting the UK Government *sukuk*

The ground-breaking *sukuk* issuance by the UK Government last year, the first of its kind by a European sovereign state, seeks to position the UK as an international hub for Islamic finance and tap *Shari'a* compliant investors.

Introduction

The global Islamic financial services market is estimated to be worth somewhere in the region of US$1.14 trillion. Its potential for continued growth has made it attractive to investors who are looking to take advantage of all the opportunities it presents. As a result, raising finance through Islamic financial instruments has become increasingly popular throughout the world.

July 2014 saw the first sovereign *sukuk* issuance in the United Kingdom. The UK government made its inaugural issuance with a £200 million *sukuk* due in 2019. The *sukuk* offer a competitive periodic distribution amount set at a rate of 2.036 per cent per annum. The issuance was very well received by investors and was heavily oversubscribed.

The UK has sought to position itself as an international hub for Islamic finance and this issuance embodies that commitment. Being the first of its kind by a European sovereign state, the transaction was truly ground-breaking and has laid the foundation for further Islamic financing in the UK. The transaction has set a precedent for entities wanting to draw on this largely untapped pool of *Shari'a* compliant investors. It opens up and provides a guideline for a whole new source of funding available to issuers within Europe.

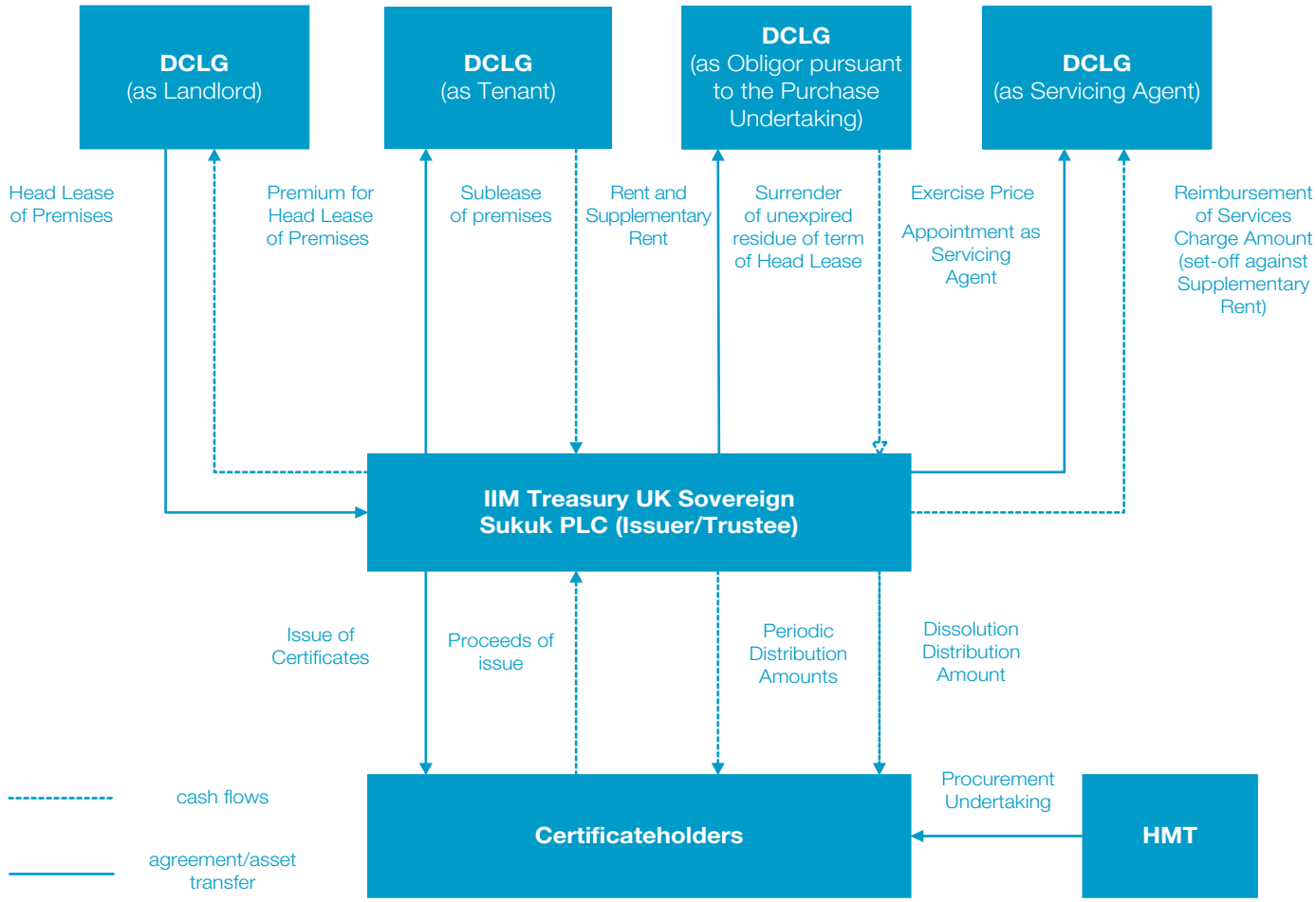
The transaction documents were held to be *Shari'a* compliant by Bait Al-Mashura Finance Consultations Company, Shariah Committee of CIMB Islamic Bank Berhad, The Executive Shariah Committee of HSBC Saudi Arabia Limited and Standard Chartered Bank Shariah Supervisory Committee.

As a *Shari'a* compliant instrument, the issuance uses an *ijara* structure. The proceeds of this specific issue were used to acquire the lease of certain land and buildings from The Secretary of State for Communities and Local Government (**DCLG**). The properties were then sub-leased back to DCLG in return for DCLG making periodic rental payments. These rental payments are to be used by the issuer to fund its distributions to the *sukuk* holders.

"The issuance was very well received by investors and was heavily oversubscribed"

Summary Of Terms & Conditions	
Issuer	HM Treasury UK Sovereign Sukuk PLC
Issue Date	2 July 2014
Scheduled Dissolution Date	22 July 2019
Issue Price	£200,000,000
Face Amount	£100,000 and integral multiples of £1,000 in excess thereof
Rate	2.036%
Currency	Pounds Sterling (£)
Form	Global Certificate in Registered Form
Principal Paying Agent, Registrar and Transfer Agent	HSBC
Exchange	London Stock Exchange
Governing Law	English Law

The following diagram (simplified for the purposes of this article) illustrates the principal relationships between the parties and the cash flows of the structure.



First, the purchasers of the *sukuk* (Certificateholders) elect to pay the issue price to HM Treasury UK Sovereign Sukuk PLC (Issuer/Trustee). The Issuer/Trustee is a public limited company incorporated in the United Kingdom specifically to issue the *sukuk* and facilitate this transaction.

The Issuer/Trustee must then use the pooled capital to fund its acquisition of a 99 year lease over plots of land and buildings "(Sukuk Asset)" used for governmental purposes from DCLG.

After the purchase of the Sukuk Asset, the Issuer/Trustee has to hold the title to the asset on trust for the benefit of the Certificateholders. This ensures that the Certificateholders have an undivided beneficial ownership interest in the Sukuk Asset as declared by the Issuer/Trustee pursuant to a declaration of trust. This beneficial ownership of the Sukuk Asset along with certain other documentation provides the Certificateholders with a right to receive payments under it.

Next, the Issuer/Trustee shall sub-lease the properties back to DCLG. In consideration, DCLG is to make rentals payments to the Issuer/Trustee over the five year life of the *sukuk*. These rental

payments are the source from which the Issuer/Trustee will pay the Certificateholders the periodic distributions owed to them. The Certificateholders will be owed these distributions as profits through their beneficial interest in the Sukuk Asset which is generating this income.

Finally, on the scheduled dissolution date, the Issuer/Trustee has the right to require DCLG to purchase back the unexpired term that remains on the lease. The Issuer/Trustee is to use this payment by DCLG to pay back the dissolution distribution to the Certificateholders. Again, the Certificateholders will be entitled to this payment as consideration for the sale of the Sukuk Asset, to which they will have an undivided beneficial ownership interest.

As this is the first *sukuk* issuance of its kind in the United Kingdom, it has a few notable features:

- The UK has been very active for the last few years in creating a level playing field between conventional instruments and their Islamic equivalents. A critical aspect to this is the tax legislation for the issuance of *sukuk*-al-ijara which is reflected in Schedule 61 of the Finance Act 2009. A large amount of time was spent manoeuvring through the framework and ensuring the structure and documentation complied with these requirements so that the transaction benefited from the various tax reliefs. In effect the *sukuk* was therefore treated the same as a UK Gilt for tax purposes.
- Whilst the primary obligor was the DCLG, and DCLG was the entity that was responsible for payment of the rent under the ijara agreement and the exercise price under the purchase undertaking, HM Treasury agreed, through the procurement undertaking, that it would either perform the obligations of DCLG or would ensure that DCLG was put in sufficient funds for DCLG to discharge its obligations in a timely manner.
- Unlike a typical *sukuk* issuance, this transaction utilises a Deed of Covenant. This allows the Certificateholders to have direct recourse and enforcement rights against the HMT should the Issuer/Trustee fail to make payments on maturity. A Deed of Covenant was included because HMT wanted to ensure that the *sukuk* holders were treated the same as its UK Gilt holders, who do have direct recourse to HMT.
- Some governmental real estate issues needed to be addressed and therefore intensive legal analysis was carried out on whether or not the government had a qualifying interest that complied with both *Shari'a* and the legislation. The Government entity also had to have the capacity to deal with its assets in the manner envisaged by the transaction.

Conclusion

The UK Government's first *sukuk* issuance could be seen as a critical turning point for *Shari'a* compliant capital markets in Europe, extending *sukuk* issuances beyond the traditional hubs of the Middle East and South-East Asia. The Gilt structure used in this issuance means that this issuance can be readily benchmarked against conventional Gilt issuances though it will not be easily adaptable to corporate issuances. There is clearly a great demand for *Shari'a* compliant securities issued in Europe and further efforts from the UK Government may allow a UK corporate *sukuk* market to develop and truly establish the UK as an international hub for Islamic finance.

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Breaking new ground in Africa: South Africa joins the global *sukuk* race

On 24 September 2014, the Republic of South Africa (the "Republic") issued its inaugural *sukuk* – the first ever international sovereign *sukuk* offering from Africa. The US$500 million Trust Certificates (the "Certificates"), due 2020, were issued by ZAR Sovereign Capital Fund Proprietary Limited as Trustee of the RSA *sukuk* No. 1 Trust. They have been admitted to listing on the official list and admitted to trading on the regulated market of the Luxembourg Stock Exchange. This article considers the structure and key features of the issuance and draws a comparison with other recent sovereign issuances of *shari'a* compliant securities.

Introduction

The RSA *sukuk* No. 1 Trust (the "Trust") was established in South Africa on 18 August 2014 by GMG Corporate Fiduciary Services Proprietary Limited as its founder. On 29 August 2014, a Letter of Authority from the Master of the High Court in Pretoria, South Africa (Letter of Authority) authorised ZAR Sovereign Capital Fund Proprietary Limited (the "Trustee"), a special purpose vehicle established in South Africa, to act as Trustee of the Trust in accordance with the South African Trust Property Control Act 1988. The Trust acts through the Trustee for the purposes of the issuance of the Certificates and the entry into the transaction documents.

Structure of the *sukuk* issuance

This issuance is structured as a participation in a sale and leaseback of government-owned infrastructure assets. The proceeds of the issuance of the Certificates were used by the Trustee to purchase from the Republic (acting through the Minister of Water Affairs) a personal usufruct right in certain infrastructure assets located in South Africa. These assets were leased back to the Republic (as lessee) by the Trustee (as lessor) for the term of the Certificates and are to be repurchased by the Republic upon redemption of the Certificates. The Certificates represent an undivided beneficial ownership interest in the Trustee's rights under the transaction documents, which includes the right to receive rental payments under the lease and the right to receive the purchase price for the repurchase of the assets upon redemption of the Certificates. Payments of rental under the lease are intended to fund the profit due under the Certificates on a bi-annual basis and the final rental payments under the lease, together with the principal amount payable by the Republic for the repurchase of the assets, are intended to fund the redemption amount payable under the Certificates.

The Certificates are redeemable on maturity, or prior to maturity upon the occurrence of an event of default. In addition, should the assets which underpin the structure be destroyed in whole, the Certificates shall be redeemed by the Trustee using the proceeds of insurance payable by the Republic (as service agent) pursuant to the terms of a service agency agreement. While it is arguable from a South African law perspective that the Trust may be a collective investment scheme, on the basis that it holds an interest in immovable property, the Financial Services Board of the Republic of South Africa (as the regulator of collective investment schemes in South Africa) confirmed that the Trust falls outside the regulatory remit of the Collective Investment Schemes Control Act, No. 45 of 2002 of the Republic of South Africa and, therefore, an

"This issuance could be the catalyst to allow an African asset-based securities market to develop."

Key points

- The Republic of South Africa has issued its first *sukuk* in the international capital markets.
- The *sukuk* has been issued in accordance with the provisions of South African tax law enacted to facilitate *sukuk* issuances.
- This issuance could be the catalyst for the development of an African asset-based *shari'a* compliant securities market.

exemption from registration under the Act was not required.

Role of the certificateholders' Representative

An interesting feature of the structure is the role undertaken by the Representative of the certificateholders (the "Representative"). Clearly intended to replicate the role of a bond Trustee in Eurobond or securitisation transactions governed by English law, or by a delegate in a typical *sukuk* originated in the Gulf, the Representative in this transaction is provided with certain rights and powers, such as the power to grant waivers and agree amendments on certain limited grounds (without the consent of the certificateholders), the power to make certain determinations and to call meetings of certificateholders, and the power to enforce the obligations of the Republic under the transaction documents in the interests of all of the certificateholders.

The Representative, however, is not a Trustee; its role is akin to that of a protector of the certificateholders' rights and is appointed to perform certain functions for their benefit through certain fiduciary powers vested in it under the Trust deed. The Representative is also granted a separate power of attorney by the Trustee to allow it to step into the shoes of the Trustee to enforce the rights of the Trustee under the transaction documents in a default scenario. Upon a default, the Republic is required under the purchase undertaking to repurchase the Trustee's personal usufruct right in the assets and to pay final rental amounts under the lease. The role of the Representative is similar to the role of the Representatives in respect of the lease certificates issued by Turkish *sukuk* issuers under the recent Turkish *sukuk* legislation. The role of the Representative in the South African sovereign *sukuk* issuance is, however, distinguishable from the *sukuk* recently issued by the Treasury of the UK which (in line with the gilts issued by the UK Treasury), does not provide for any collective representation of the interests of the investors.

Governing law of the *sukuk* issuance

The South African *sukuk* issuance is similar to the first sovereign *sukuk* of the UK, on the basis that both were structured using an onshore issuing Trust. The Trustee is an orphan special purpose vehicle and, like the founder of the Trust, is incorporated in South Africa where the underlying assets are located.

Establishing the Trust in South Africa and obtaining authorisation of the Trustee from the Master of the High Court in Pretoria, South Africa, meant that the Trust deed which established the Trust had to be executed before the issuance of the Certificates and was subject to automatic termination provisions if the Letter of Authority was not subsequently granted. The Trust deed was amended and restated prior to issuance, to provide for the final pricing information in the terms and conditions of the Certificates.

While the creation of the Trust in South Africa was required to be governed by South African law, the governing law of the Certificates (in line with international standards and expectations of international *sukuk* investors) is English law. Accordingly, there is a split governing law clause in the Trust deed, with the establishment of the Trust being governed exclusively by South African law, and the Certificates themselves and the sections establishing the role of the Representative being governed exclusively by English law.

Interestingly, the establishment of the Trust in full compliance with South African law also results in the local segregation of the assets. However, in the context of this issuance, this feature has not been used as a defining feature intended to strengthen the credit of the Certificates, as the Certificates are intended to replicate the classic asset-based (and not asset – backed) *sukuk alijara* typically issued in the Gulf and well familiar to Middle Eastern investors.

Increasing appetite for *shari'a* compliant securities

Following in the footsteps of Hong Kong and the UK earlier this year, South Africa is among the first predominantly non-Muslim countries to issue *shari'a* compliant securities in the international capital markets. The South African *sukuk* issuance was more than four times oversubscribed, mirroring the high investor demand seen earlier this year for the UK Treasury and Hong Kong issuances. This is indicative of the increasing appetite for both asset-based finance generally and sovereign *shari'a* compliant securities in particular. The issuance saw a particularly strong demand from Middle East investors, where the demand for *shari'a* compliant securities is currently far outstripping supply.

Like the recent UK *sukuk*, the South African *sukuk* represents a significant benchmark for future sovereign issuances of *shari'a* compliant securities in the international market. What remains to be seen is what this issuance will mean for South Africa and the wider African continent. Unlike the gilt-based structure used in the UK *sukuk*, the structure of the South African

sukuk is readily adaptable for use by other domestic issuers – including both banks and corporates – and is recognisable to foreign investors. Clearly, the continuing interest and support of the South African government will play a crucial role in achieving market growth in Islamic financing. It will also be interesting to see if this issuance will lead to other domestic players following the government's lead in accessing alternative methods of funding.

Conclusion

This issuance could be the catalyst to allow an African asset-based securities market to develop. Following the local currency issuances by Senegal and Gambia earlier this year, and now the South African international *sukuk* issuance, it is likely that other African governments may now consider *shari'a* compliant funding sources, looking in particular to investment from the Middle East. While the different legal systems across Africa may pose a challenge to achieving market consistency, and in the short term certain African governments may favour smaller local currency issuances, the South African *sukuk* issuance has gone a long way in demonstrating how flexible a *sukuk* structure can be in overcoming challenges under domestic law and in offering a platform for financing that is both competitive and in high demand.

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The emergence of the Turkish *sukuk* market

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

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

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

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

Key points

- Recent legislation in the Republic of Turkey has opened up the Turkish *sukuk* market to non-financial institutions, including corporate, for the first time.
- The recent legislation has also paved the way for new types of *sukuk* structures to be used, so as to attract new capital investment into the country.
- The Turkish government is keen for the Republic of Turkey to become a global hub of Islamic finance.

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

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

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

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

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

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

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

The asset leasing companies at the centre of the Turkish *sukuk* market are unlike special purpose vehicles found in traditional securitisations or in other *sukuk* markets, in that they can issue multiple *sukuk* and can issue certificates for companies other than the company which was incorporated to issue them. However, the Second Legislation makes it clear that the entities listed in (d), (e), (f) and (g) below can only establish

asset leasing companies if they are actual fund users and cannot establish on behalf of third parties. The Second Legislation has listed the entities being allowed to establish an asset leasing company as:

(a) banks;

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

(c) mortgage financing institutions;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Pursuant to the Corporate Tax Law (Law No 5520), any capital gains to be derived by an originator from the sale of an asset portfolio to an asset leasing company and from an asset leasing company to an originator are exempt from corporate tax on the condition that such sales are only made for the issuance of the certificates by the asset leasing company. In order to benefit from such exemption, the capital gains derived from such sales must be reserved in equity as a fund which is not to be distributed for five years and the sale proceeds must be collected in cash within a two-year period.
- Under the VAT Law (Law No 3065), the delivery of certificates is exempt from VAT. In addition, the transfer of assets to an asset leasing company as well as the lease of assets by an asset leasing company and transfer to the originator are exempt from VAT.
- Pursuant to the Charges Law (Law No 492), the sale of the asset portfolio in a *sukuk* is exempt from the Title Deed Registry Fee and other fees.
- The Income Tax Law (Law No 193) requires withholding tax from the interest income received under the certificates issued abroad. However, the rate of such withholding tax is reduced to 0% for such certificates with a maturity of five years, as is typical for a *sukuk*.
- Pursuant to the Stamp Tax Law (Law No 488), the transfer of assets to an asset leasing company, the transfer of such assets by an asset leasing company to the originator, documents issued with respect to the lease and the certificates are all exempt from Turkish stamp tax. A non-resident holder will also not be liable for Turkish inheritance, registration or similar tax or duty with respect to its investment in lease certificates.

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

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

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