

Turkish Interest-Free Capital Markets: Sukuk

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Agenda

Islamic Banking: A Snapshot For Recent Developments

Sukuk : A Milestone in Islamic Banking

Sukuk Market : An Update

Case Study : Turkish Experience

Key Considerations & Future of Sukuk



Islamic Banking : From niche to critical mass

- **Increasing market presence**

- Growing at 15 to 20% per annum
- Size estimated more than USD 1 trillion globally
- New markets welcoming Islamic banks and products

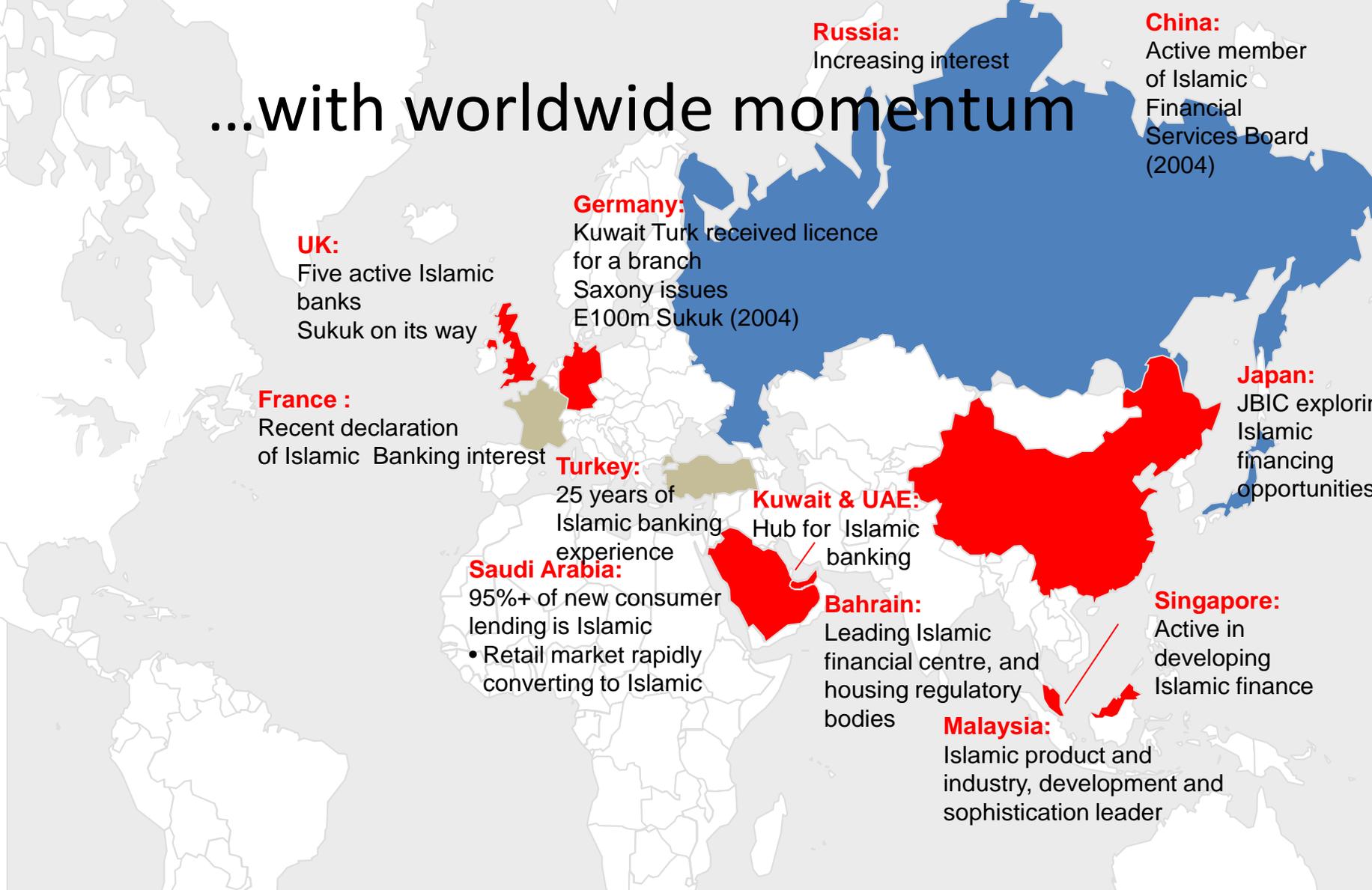
- **Market-driven proposition**

- Retail demand has historically the backbone of the industry
- Sensitivities to principles more visible on retail deposit
- But corporates and even sovereigns showed appetite for the products
- Market-driven product development proved to be successful
- Self-regulating organisations accompanied global Islamic banking boom

- **Global scale**

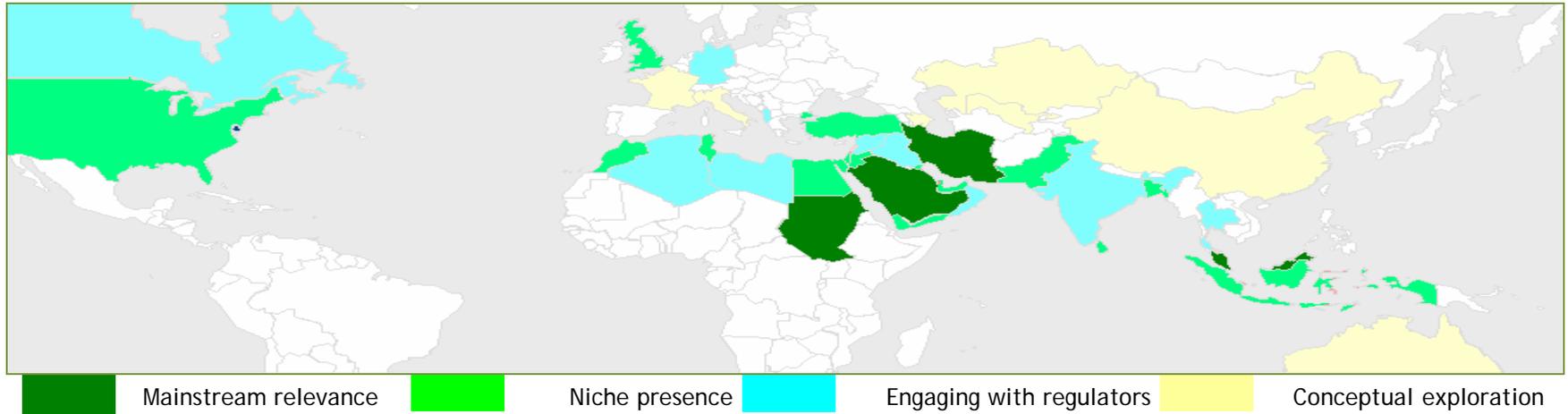
- More than 250 Islamic banks worldwide operating in over 75 countries
- A wide range of interest varying from U.K. to Singapore
- Widening customer base including sovereigns to top global corporates to tap Islamic finance markets

...with worldwide momentum

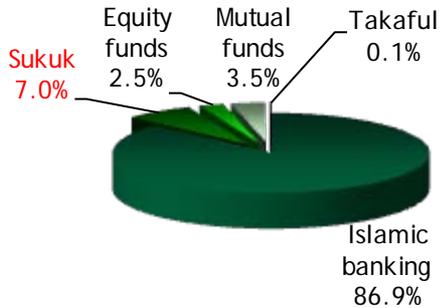


Each region is contributing in a unique way

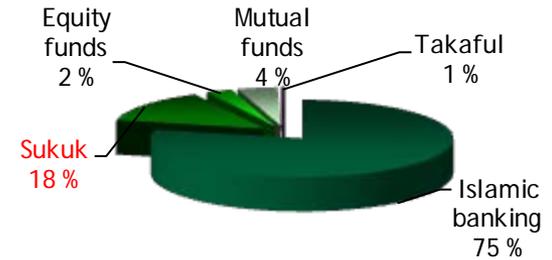
Global Deployment of Islamic Products



Breakdown of Islamic Banking Principles Compliant Assets Worldwide (2003)



Breakdown of Islamic Banking Principles Compliant Assets Worldwide (2010)



Source: KFHR Global Islamic Finance Directory

The industry has not yet reached its potential

- Still new markets exist that did not yet meet with Islamic banking and finance
- The global Islamic insurance (Takaful) market is estimated to expand
- Most Islamic financial institutions are highly liquid, and seek new asset classes and markets to diversify
 - New treasury products and investment securities are to emerge
 - Capital markets developments: New Sukuk issuances expected to tap the market
- Islamic finance has also gained popularity in Muslim-minority countries
 - Germany issued the first Islamic Eurobond (2004)
 - Five Islamic banks in UK
- Trends of convergence and conversion
 - Islamic banks introducing new products and services to compete with the conventional banks,
 - Conventional banks aiming to tap Islamic banking markets and expand their product base

Why Islamic financing is flourishing



Industry is driven by fundamental factors

Tested strength in the financial crisis

- Islamic banking, a booming \$US1 trillion global industry that prohibits speculation and high levels of debt, has been relatively unscathed by the credit crunch.
- Islamic banking model's basic principles of
 - financing “real” trade and economic activities,
 - no financing of speculation
 - No engagement in debt trading
 - Asset backed and project-financing approach to help hedging risks
- As a result, the lessons from the crisis;
 - Islamic banking is inherently stable
 - Islamic banks outperformed the conventional financial institutions

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What is Sukuk?

- “Sukuk”s are (as per AAOIFI definition):
 - Certificates of equal value
 - Representing undivided shares in ownership
 - Of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity



What is Sukuk?

- “Sukuk”s equate to ‘certificate of entitlement’
- Generically, viewed as an Islamic equivalent to a conventional bond
- Better described as an asset-based investment
- Evidences the holder’s ownership in underlying assets and a clear link with the asset
- Underlying assets are typically segregated into a special purpose vehicle (SPV)



What is Sukuk?

- Gives entitlement to returns generated from the assets
- Rank pari-passu with other senior obligations of the obligor
- Can be listed or unlisted, rated or unrated
- Can have a fixed pricing or a floating rate benchmarked against an index (LIBOR etc.)



Is it a “Bond” ?

- A “BOND” is a certificate of debt under which the issuer agrees to pay interest (if any) and to repay the principal to the bondholder on specified dates.
- SUKUK
 - Economic characteristics has similarities to that of a conventional bond
 - Key difference : Sukuk is not a debt instrument. It represents a proportionate beneficial ownership in the underlying asset, giving the holder the right to the benefits of the income stream of the underlying asset. The yield is usually linked to a return on an underlying asset through an Islamic structure e.g. lease. It is priced, listed and rated as a bond, although it is more akin to a participation in a collective investment scheme.



Is it a “Bond” ?

	SUKUK	BONDS
Nature	Not a debt but undivided ownership share or rights in specific assets/projects/services	Debt of Issuer
Asset Backed	A minimum of 51% Tangible Assets (or their contracts are required back issuance of Sukuk al Ijara)	Not required
Claims	Ownership claims on the specific underlying assets, project, service etc.	Creditors claims on the borrowing entity, and in some cases liens on assets.
Security	Secured by Ownership rights in the underlying assets or projects in addition to any additional collateral enhancements structured	Generally unsecured debentures except in cases such as first mortgage bonds, equipment trust certificates and so on
Principal and Return	Not guaranteed by Issuer	Guaranteed by Issuer
Purpose	Must be issued only for Islamically permissible purposes	Can be issued for any purpose
Responsibility of Holders	Responsibility for defining duties relating to the underlying assets/projects limited to the extent of participation in the issue.	Bondholders have no responsibility for the circumstance of the issuer

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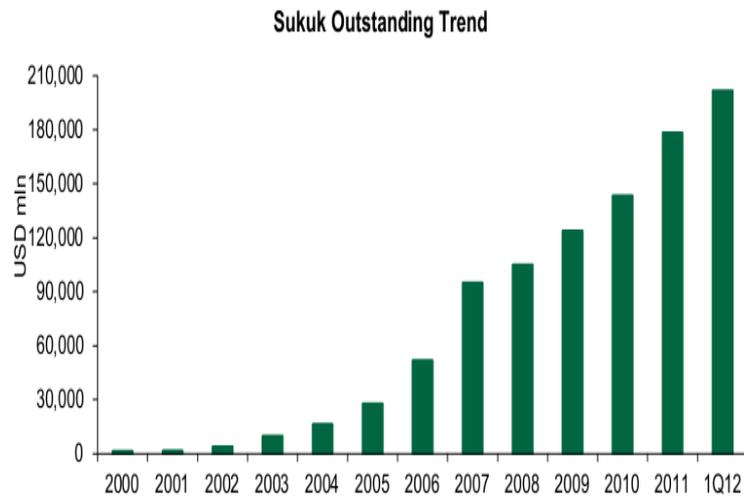
Sukuk Market

- The global sukuk market entered 2012 on record highs in terms of amount issued, with more than USD85.1bln issued in 2011, as well as in terms of the amount outstanding, reaching USD178.2bln at the end of the year.
- The first quarter of 2012 has continued this strong growth trend with new issuances rounding up at USD40.5bln while the secondary market grew to USD201.7bln, representing a y-o-y growth of 48.2% and 31.9%, respectively.
- Among the countries that have been at the forefront of the primary sukuk market growth are Malaysia, the UAE, Saudi Arabia, Qatar, Indonesia and Bahrain. At the end-1Q12, these countries have issued a combined worth of more than USD306.8bln to date. In 2011, these countries made up 96.3% of the primary market and 98.7% in 1Q12.
- The sectors driving sukuk issuances during the 1Q12 include both government and transportation, accounting for 44.7% and 34.8%, respectively, while there have been a considerable number of issuances in the GCC and Malaysia from the power and utilities sector.
- Having already grown by 42.0% y-o-y at the end-1Q12, the sukuk market looks set to have another bright year ahead. The main drivers of growth continue to stem from the sovereign and quasi-sovereign issuers who constitute 60.3% of the primary market.

Sukuk Market

- Drivers of the primary sukuk market in 2011 were the financing needs of governments, implementation of infrastructure projects to boost economic growth, the need of working capital for businesses in line with global economic recovery as well as financial institutions capital raising activities.

Sukuk issuance trend (2000-2011)



Source: Bloomberg, Zawya, IFIS, KFHR

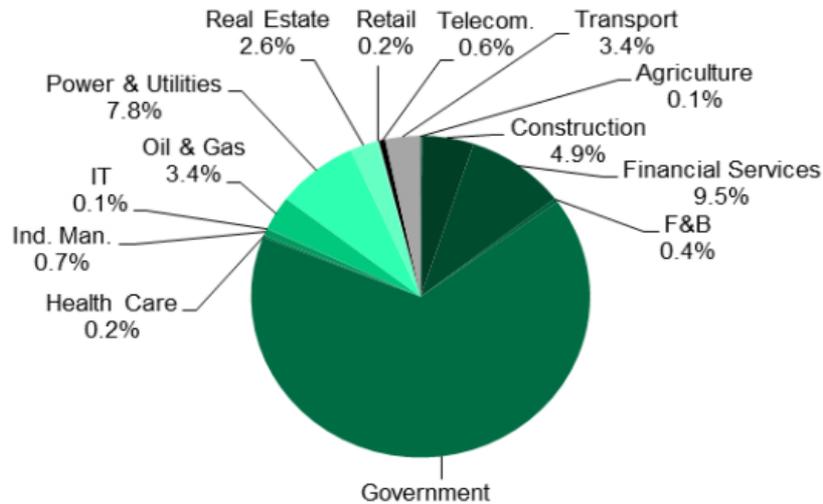
Sukuk Issuance by Key Market (USD mln)

Country	2011 Issuance	2011 y-o-y Growth	1Q12 Issuance	To Date Issuance
Malaysia	60,921.23	86.1%	28,277.38	208,285.65
UAE	9,277.70	212.7%	1,700.00	38,846.33
Saudi Arabia	4,084.50	-8.0%	6,416.60	23,334.92
Qatar	9,277.70	336.8%	-	12,972.80
Indonesia	4,084.50	-32.8%	3,389.73	12,832.52
Bahrain	2,763.70	283.2%	298.33	10,557.77

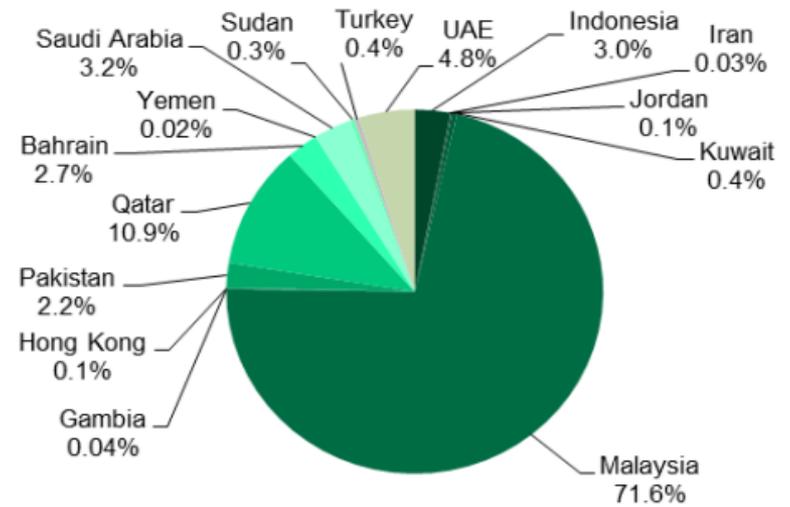
Source: Bloomberg, Zawya, IFIS, KFHR

Sukuk Market At a Glance

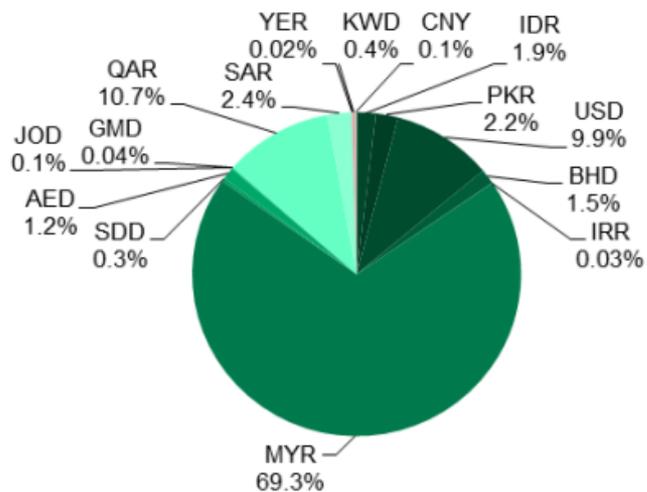
Sukuk Issuance by Sector (2011)



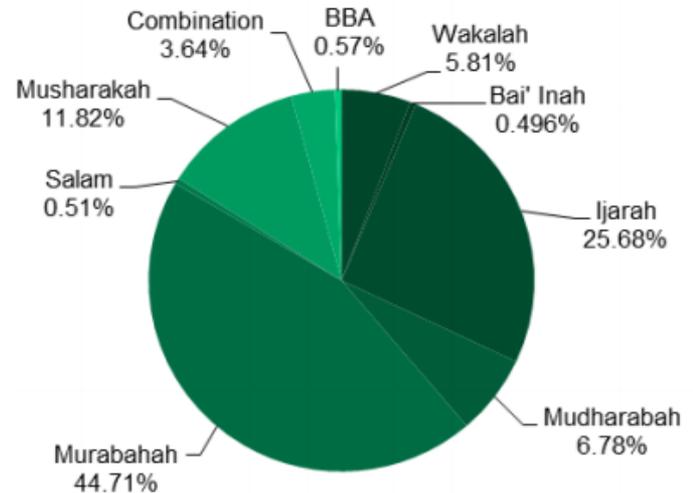
Sukuk Issuance by Domicile (2011)



Sukuk Issuance by Currency (2011)



Sukuk Issuance by Structure (2011)



Source: Bloomberg, IFIS, Zawya, KFHR

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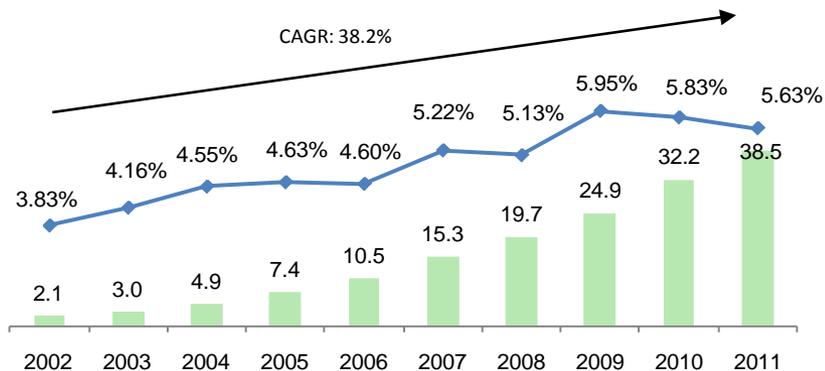


Participation Banking

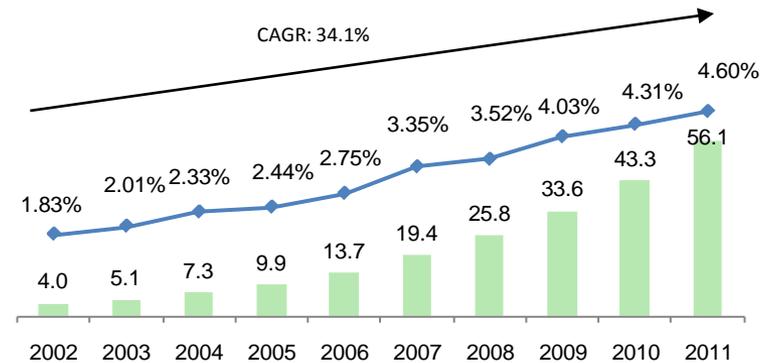
Ample Room for Growth

- Prior to 2005, Banks operating under interest-free (Islamic) banking principles were named “Special Finance Houses”. In November 2005, the Banking Law No.5411 was put in place and “Special Finance Houses” label has been transformed into “Participation Banks”, gaining the “bank” status
- Today, Participation banks are subject to Banking Law of Turkey and supervised by Banking Regulation and Supervision Agency (“BRSA”) like any other conventional banks in Turkey
- Market share of participation banks in Turkey has been constantly increasing
- As of today, there are only four participation banks operating in Turkey – one being Kuveyt Turk

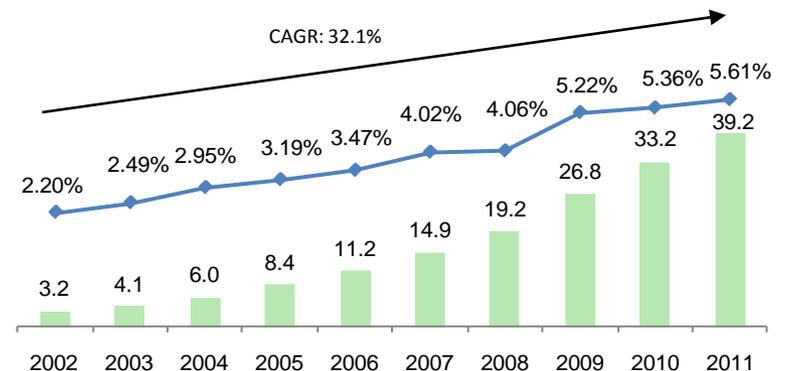
Total Participation Banks Loans (TL billion) and Market Share Development in Turkey



Participation Banks' Asset Size (TL billion) and Market Share Development in Turkey



Total Participation Banks Deposits (TL billion) and Market Share Development in Turkey



Case Study : Kuveyt Turk Sukuk

- Sukuk in Turkish market has long been discussed on the basis of a sovereign issuance
- Problems existed on several aspects (taxation, accounting, documentation etc.) as Turkish regulatory framework did not define “Sukuk” as a financial instrument
- Lack of a long-term funding instrument posed a problem for future growth prospects of Islamic banks in Turkey
- Kuveyt Turk succeeded in structuring a Sukuk within the framework of existing regulations based on a Wakale structure

Case Study : Kuveyt Turk Sukuk

- The issuance has been based on Wakale structure
- Included Ijara assets and murabaha receivables
- Listed in London Stock Exchange
- 3-year maturity and an amount of USD 100 million
- Rated BBB- (investment grade) by Fitch
- First and only FI Sukuk issuance in Turkey and Europe

Islamic Finance *news*
Awards
Deals of the Year
— 2010 —

Deal of the Year
KTPB Sukuk

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Sukuk Deal of the
Year
KTPB Sukuk

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Deal of the Year-
Turkey
KTPB Sukuk

Most Innovative
Deal
KTPB Sukuk



Rental Certificate Issuance in 2011

Kuveyt Türk Sukuk

USD 350 million RegS Sukuk due October 2016



On 20th October 2011, Kuveyt Turk Participation Bank (“Kuveyt Turk”) priced a USD 350 million 5 year Sukuk due 2016

This is the first benchmark debt capital markets issuance in sukuk format out of Turkey and the second transaction by Kuveyt Turk since its inaugural sukuk issuance in 2010

Kuveyt Turk was able to price its sukuk inside the current trading levels of conventional Turkish banks

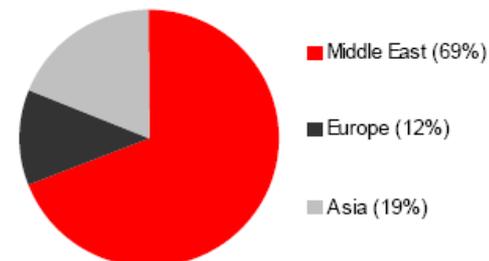
Transaction terms

Sukuk Issuer:	KT Sukuk Varlık Kiralama A.Ş.
Sukuk Obligor:	Kuveyt Türk Katılım Bankası A.Ş.
Sukuk Structure:	Sukuk Wakala (Rated BBB- by Fitch)
Format:	Regulation S (Registered), Fixed Rate
Spread over MS:	447.5bps
Profit rate:	5.875% - Priced at Par
Size:	USD 350 million
Maturity:	31 October 2016
Settle:	31 October 2011 (T+7)
Listing:	London Stock Exchange
Law:	English Law (Sukuk assets governed by Turkish Law)
HSBC Role:	Joint Lead Manager and Bookrunner

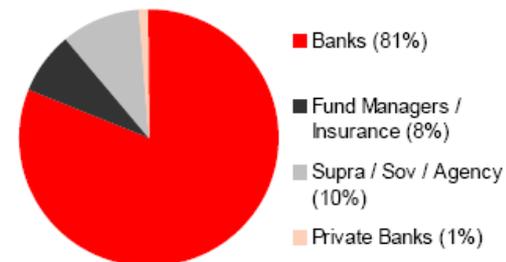
Transaction highlights

- Kuveyt Turk issued the first benchmark Sukuk in Turkey leading the way for other Turkish participation banks and corporates.
- Kuveyt Turk launched the Sukuk on the back of a successful international roadshow, visiting key investors in Asia, the Middle East and Europe
- The issuer was also the first to tap the Sukuk market since the Summer period and received a strong bid from Islamic investors in the Middle East and Asia
- The deal received an excellent reception from the market with an orderbook approaching USD 560mn translating into a 1.6x coverage for the offering
- Initial price thoughts were released on Wednesday 19 October morning at 6.00% area.
- Driven by the substantial momentum generated in the orderbook soon thereafter, the transaction launched at 5.875% on Thursday afternoon
- The transaction affirms Kuveyt Turk’s international appeal and the large acceptance by the Islamic investor community due to the credit and rarity value of Turkish Sukuk in the international markets

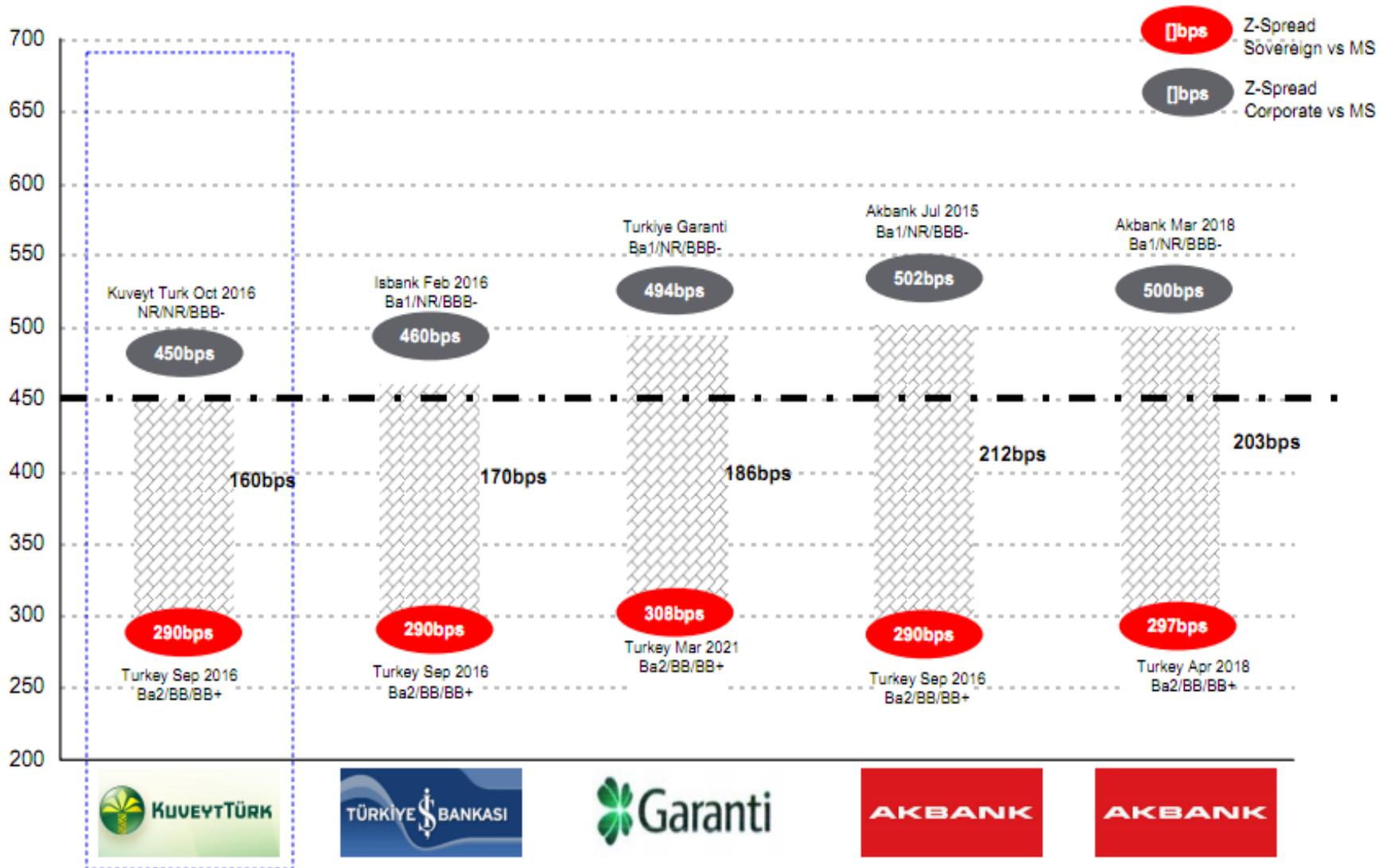
Breakdown by Geography



Breakdown by Investor Type

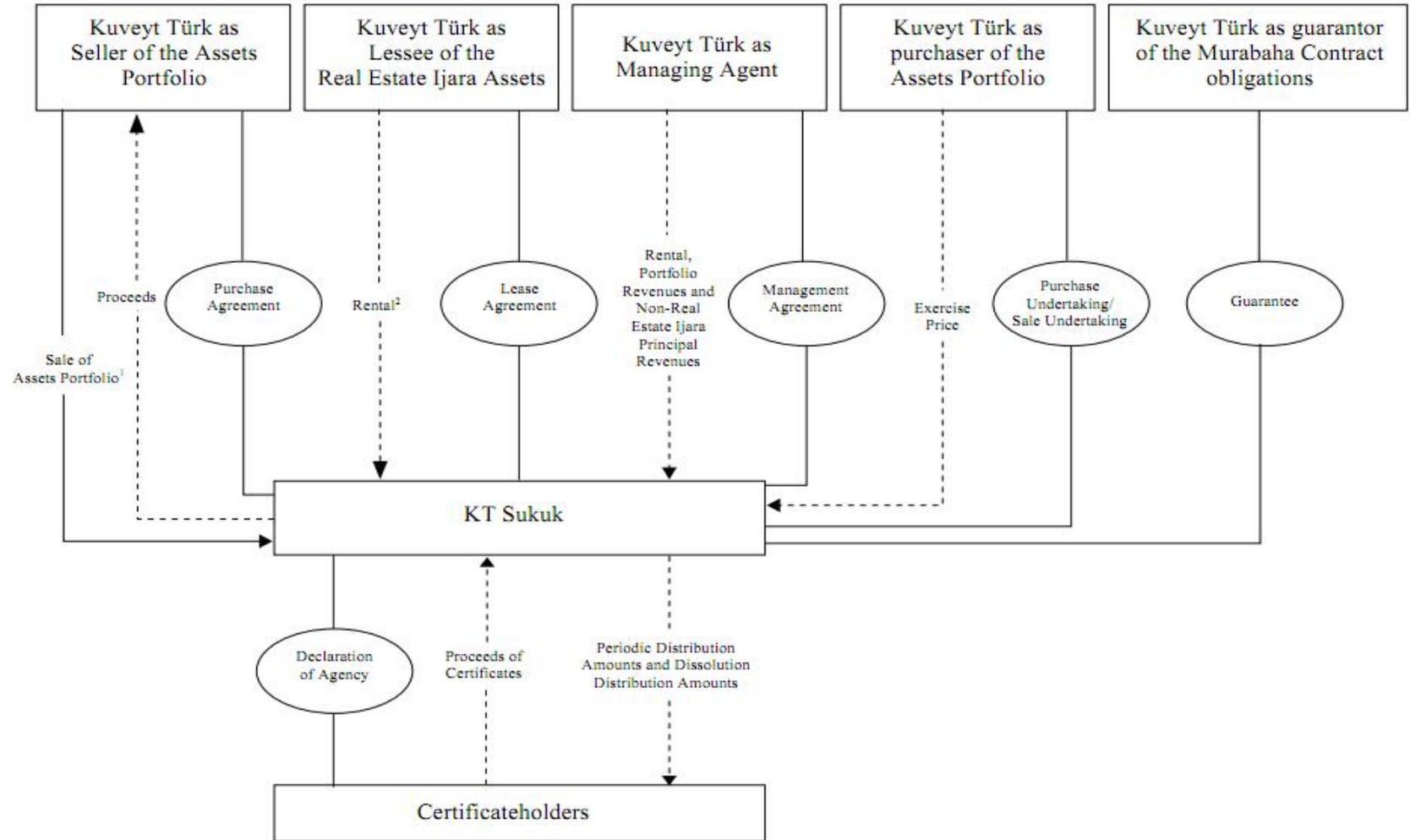


Pricing Comparison



The Structure of Rental Certificate Issuance

Structure diagram



¹ The Assets Portfolio will be comprised of Real Estate Ijara Assets, Non-Real Estate Ijara Assets and Murabaha Assets.

² Rental payable under the Lease Agreement will be paid to the Managing Agent on behalf of KT Sukuk as Lessor.

New Sukuk Regulation: Rental Certificates

- Capital Markets Board (Turkey) issued a Communique on 1st April 2010 called “Rental Certificates”
- Based on Sukuk Ijara structure
- Enables financial institutions and corporates to issue Sukuk within Turkey and/or abroad
- Tax exemptions provided as of January 2011 by law (in line with conventional bonds)

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Future Prospects: Sukuk

- Sovereign issuances are expected to pave the way and set the benchmark for FI& corporate issuances.
- Sukuk issuances in local currency (TRL) expected.
- Turkish corporates pursue issuance opportunities.
- Current Rental Certificates Communiqué is a very positive and successful move. But certain amendments may provide further developments with fine-tuning the structures.
- Listing in ISE is considered for our recent issuance. Some reputational issues exist but these are minor ones. Dual listing is expected to improve secondary market.

Key Considerations & Future of Sukuk



- Standardisation of structures and documents are critical
- Regulatory classification of Sukuk in various jurisdictions expected to support growth
- Sovereign issuances expected to pave the way and set the benchmark for FI& corporate issuances
- Secondary market tradability to improve