

**THE REPUBLIC OF TURKEY
BAHÇEŞEHİR UNIVERSITY**

**TREASURY AND CAPITAL MARKETS IN
PARTICIPATION BANKS**

Master's Thesis

KENAN DEDE

ISTANBUL, 2015

**THE REPUBLIC OF TURKEY
BAHÇEŞEHİR UNIVERSITY**

**GRADUATE SCHOOL OF SOCIAL SCIENCES
CAPITAL MARKETS & FINANCE**

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Supervisor: ASSIS. PROF. AYSE ALTIOK YILMAZ

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ABSTRACT

TREASURY AND CAPITAL MARKETS IN PARTICIPATION BANKS

Kenan Dede

CAPITAL MARKETS AND FINANCE

Thesis Supervisor: Assistant Professor Ayse Dilara ALTIOK

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As a result of participation banks' growing more than tenfold and increasing its sector share in the last 10 years, there was a heavy increase in the number of scientific studies in this area.

However, it has been observed that most of the finance applications in the world are not available in our country, that the studies made so far are not sufficiently applicable as long as they are conducted by the people from the sector and that those studies repeat the similar things. Therefore, the aim of this study is to increase the few number of applicable information sources through introducing specifically the products of treasury and capital markets in participation banks. The products of treasury and capital markets has gained importance in consequence of the boom in Islamic finance sector. Among these products, the lease certificate which is developed to increase the amount of funds and customer demands, to lower risks, and to facilitate the asset-liability management has a particular importance. It has been showed with studies that this product has brought dynamism and innovation to the Islamic finance sector and it is intensively used in the treasury and capital markets area. It can be estimated that the mutual funds issued based on this product will also be as important as lease certificate. With the sector's growth, there has been a rapid increase in the transaction volume of the other currently used products.

Key Words: Sukuk, Islamic Capital Markets and Treasury Products, Mutual Funds, Islamic FX and Money Market Instruments

ÖZET

KATILIM BANKALARINDA HAZİNE VE SERMAYE PİYASALARI

Kenan Dede

SERMAYE PİYASALARI VE FİNANS

Tez Danışmanı: Yrd. Doç. Dr. Ayşe Dilara ALTIOK

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Katılım Bankalarının son 10 yılda 10 kattan fazla büyümesi ve sektör payını hızla artırması sonucunda, bu alanda ki bilimsel çalışmaların sayısında hızlı artış görülmüştür. Ancak dünyadaki İslami finans uygulamalarının birçoğunun ülkemizde uygulanmadığı ve bu alanda yapılan bilimsel çalışmaların sektör içinden yapılmadıkça uygulamaya yönelik çok kısıtlı kaldığı ve şu ana kadar yapılan bilimsel çalışmaların benzer şeyleri tekrar ettiği gözlemlenmiştir. Dolayısı ile bu çalışmanın amacı spesifik olarak Katılım Bankalarında hazine ve sermaye piyasası ürünlerini tanıtarak bu alanda uygulamaya yönelik az olan yazılı kaynak sayısını arttırması amaçlanmıştır. Katılım Bankalarında ki hızlı büyüme sonucunda hazine ve sermaye piyasası ürünleri önem kazanmıştır. Bu ürünler içinde, yönetilecek fon miktarının büyümesi, müşteri talepleri, riski azaltmak ve aktif pasif yönetimini kolaylaştırmak için geliştirilen kira sertifikası çok önem kazanmıştır. Bu ürün İslami finans sektörüne bir canlılık ve yenilik getirdiğini ve hazine/sermaye piyasası alanında çok yoğun şekilde kullanıldığını yapılan çalışmalar ile gösterilmektedir. Bu ürüne dayalı çıkarılan yatırım fonlarının da kira sertifikası kadar sektörde önemli olacağı tahmin edilebilir. Hâlihazırda kullanılan diğer hazine ürünler ise, sektörün büyümesi ile o ürünlerdeki işlem hacmini çok hızla artış göstermiştir.

Anahtar Kelimeler: Sukuk, Katılım Bankacılığı Para ve Sermaye Piyasası Ürünleri, İslami FX ve Para Piyasası Ürünleri, Yatırım Fonları

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ABBREVIATIONS

AAOIFI	: Accounting and Auditing Organization for Islamic Financial Institutions
ABS	: Asset Backed Security
ALC	: Asset Lease Companies
BBA	: Bai Bithaman Ajil
BIST	: Borsa Istanbul
BITT	: Banking and Insurance Transaction Tax
CBRT	: Central Bank of Republic of Turkey
CCS	: Cross Currency Swap
CMB	: Capital Markets Board
CML	: Capital Market Licening
CRA	: Central Registry Agency
DFC	: Dubai Financial Center
ETF	: Exchange Traded Fund
IILM	: The International Islamic Liquidity Management Corporation
MYR	: Malaysian Ringit
OMO	: Open Market Operations
OTC	: Over the Counter
PDP	: Public Disclosure Platform
PPS	: Private Pension System
PRS	: Profit Rate Swap
RIS	: Revenue Indexed Securities
SME	: Small and Medium-Scaled Enterprises
SPV	: Special Purpose Vehicle
TEFAS	: Turkey Electronic Funds Distribution Platform
VAT	: Value Added Tax

1. INTRODUCTION

The arising growth in the financial sector in 2002 had significant effects on the side of Islamic finance sector. Because participation banks were small before and they have been growing over 35% for 15 years, the impact of portfolio management, that is the funds that treasury departments manage on banks has got larger. As a result of excessive growth in funds, treasury departments of participation banks have been in search of different alternative products in order to minimize their risks. In an attempt to increase the number of client and to diversify the product range supplied to the client they gradually began to enter the capital market sector. Both for diversifying the product range and for meeting the customer satisfaction and also for minimizing the risk of fund management the importance of and pursuit for the products in this field has risen. This is because financial markets namely treasury departments have been the scope in which the product development departments of participation banks have mostly difficulty in terms of sectoral principles. Because the existing financial structure is built on the interest system both in Turkey and in the world, it is much more difficult for the sector to get out of this system.

When we analyze financial institutions in business in the world with regard to Islamic financial principles, any consistency is not seen among these institutions. The reason is that both the practices in countries are different and the members of advisory boards in these institutions make different interpretations on products. That is why whereas there is an opportunity of modelling the commercial and investment banking sectors in USA or in Europe and applying them in our country, the situation is not the same in the Islamic finance sector. For instance, to apply improving Islamic banking structure in Malaysia hereinto seems very difficult. It can be said that the current discussions on the sector will get larger and the debates over the belief in the system may increase along with taking Malaysian model. Progressing a newly field in our country and limited studies done on it conducted me to study in this field.

In this study participation banks' treasury products, capital market products and sukuk which are common point of the two will be described in detail. Together with starting of the government's issuance of the lease certificate and formation of legal infrastructure

for the lease certificates participation banks have attained a very important product both in the treasury and capital market areas. Based on this product, many diverse products have been developed and it continues to be developed. The share of this product in the bank assets gradually increases and its usage area is expanding much. In relation to that, an empirical study has been done through comparing historical development of sukuk in bank assets, its transaction volume in BIST and participation banks' asset size. With that empirical the ever increasing significance of sukuk for participation banks and how it is a vital product for participation banks' asset-liability management namely treasury and capital markets department. Hereby due to the importance of sukuk in the sector, sukuk structures and sukuk markets both in Turkey and in the world will be explained. Stocks and mutual funds in Islamic finance which nearly entered the capital markets together with sukuk will be examined in accordance with participation banks principles.

The primary task of treasury department is to manage a bank's liquidity and price risks. Because all assets and liabilities of a bank have both liquidity and price risks, all transactions that the bank carries out is under the responsibility of treasury department. Primarily there are 3 tasks of fund management-treasury department¹:

Position: In accordance with given targets and restrictions, through making the required risk definitions, it is responsible for profit-oriented trading.

Risk Management: It provides the risk exposed to be described, measured, monitored, and controlled via policies, implementing procedures and restrictions for monitoring the risk-return structure the cash flows of the firm in the future contain, keeping it under control and changing it if necessary.

Economic Research: It is to observe and analyze economic developments, to play an important role in the bank's asset-liability management informing the top managers of the firm, and to set price policies of the firm.

All products explained in this context are used or organized by treasury departments of participation banks.

¹ <http://mdn-tr.com/documents/FonY%C3%B6netimi.pdf>, [accessed 27 February 2015]

Treasury departments of participation banks are also divided into two sections. The first section is the asset-liability or money markets department which contains the transactions of money and capital markets. The other is treasury department that is established to manage forex and precious metal transactions. Based on these two main sections there can be different subunits of treasury according to the size of the bank and transaction types. Because treasury and capital market products in participation banks are not improved enough there exists a few treasury subunits. Contrarily, as this area is developed so much in commercial banks there are many subunits such as derivatives, bonds and bills trading, marketing.

The basis of capital markets stocks, mutual funds and stock market operations are carried out either under the retail sector unit or dispersedly under distinct business units. For instance, while sale and publicity of stocks are carried out by a different unit, the relations and negotiations with capital market institutions such as BIST, CMB, CRA and intermediary firm are carried out by another unit. It applies to the new entrant to the market the product of the lease certificate or the sale and publicity of mutual funds via TEFAS platform as well. This also indicates that capital markets are not improved sufficiently in participation banks. The commercial banks have a reverse situation. Almost every commercial bank has an intermediary and a portfolio management firm and these kind of works are done by these companies which these operations are carried out in a professional, fast and proper way.

The fast growthiness of participation banks in terms of asset size and profitability in the last 15 years raises the importance of treasury and capital markets further and it continues to raise. To be able to do business in the market more actively and lastingly it is important to develop the products in the treasury side.

In this study, treasury and capital market operations and the products used in participation banks will be introduced in detail.

Before explaining the topics, I have tried to emphasize the importance of the topics that are described showing some graphs containing the growth and some sector data. As it is understood from these graphs, the sector is growing and increasing its market share in a fast way. When we look more closely, we see that together with sukuk's entrance, participation banks transferred some of the funds they collected to the securities namely sukuk in order to ease the liquidity management, to lower the risk and to make product diversification and that this share will gradually increase.

Table 1.1: Sector asset size

Year	Participation Banks' Asset Size (million TL)	Change %	Deposit Banks (million TL)	Participation Banks / Sector
2008	25,770	36,4	732536	3,52
2009	33,628	30,5	773,357	4,03
2010	43,339	28,9	923,371	4,31
2011	56,148	29,6	1,119,911	4,61
2012	70,279	25,2	1,247,699	5,13
2013	96,086	36,7	1,566,190	5,55
2014	104,132	6,82	1,860,606	5,12

Table 1.2: Security ratio - comparative

Security/Asset Size	2011	2012	2013	2014
Participation Banks	2.65%	2.52%	3.60%	5.17%
Commercial Banks	25,50	21,60	18,44	16,27

Figure 1.1: The growth trend of participation banks in the last decade

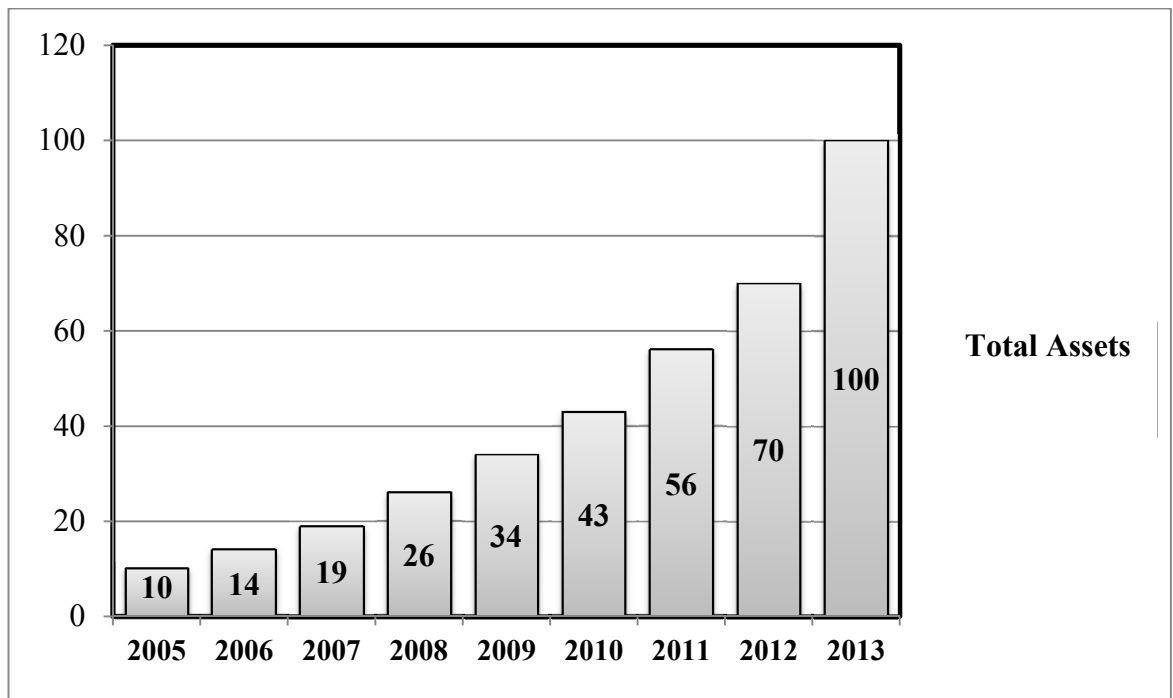


Figure 1.2: Share trends of participation bank in the sector in the last decade

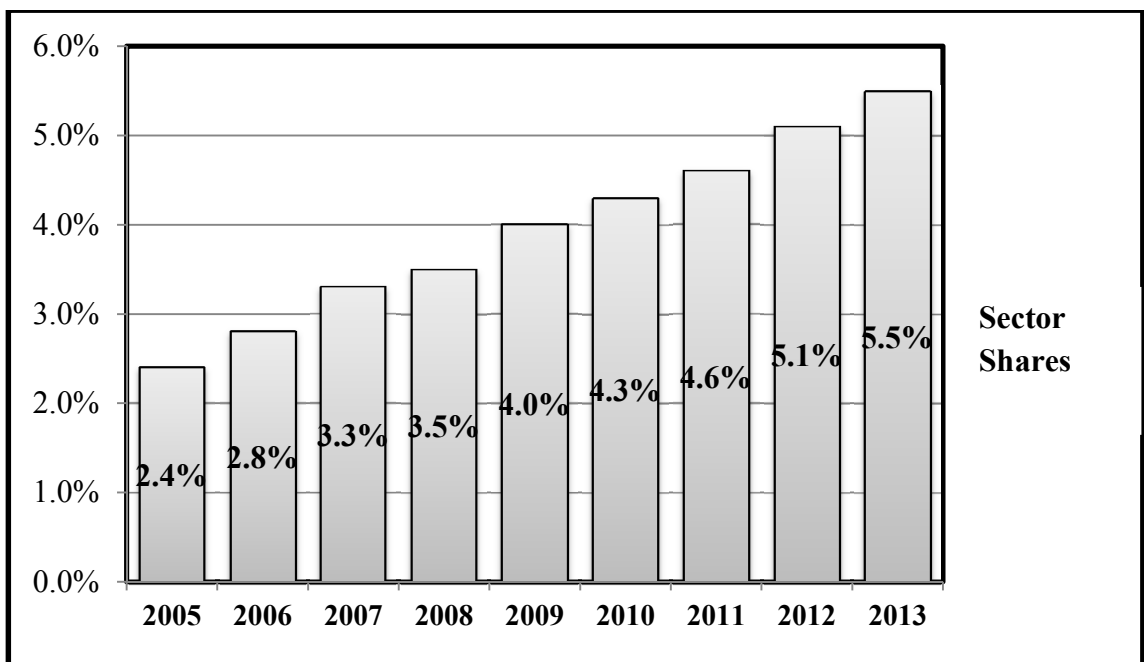
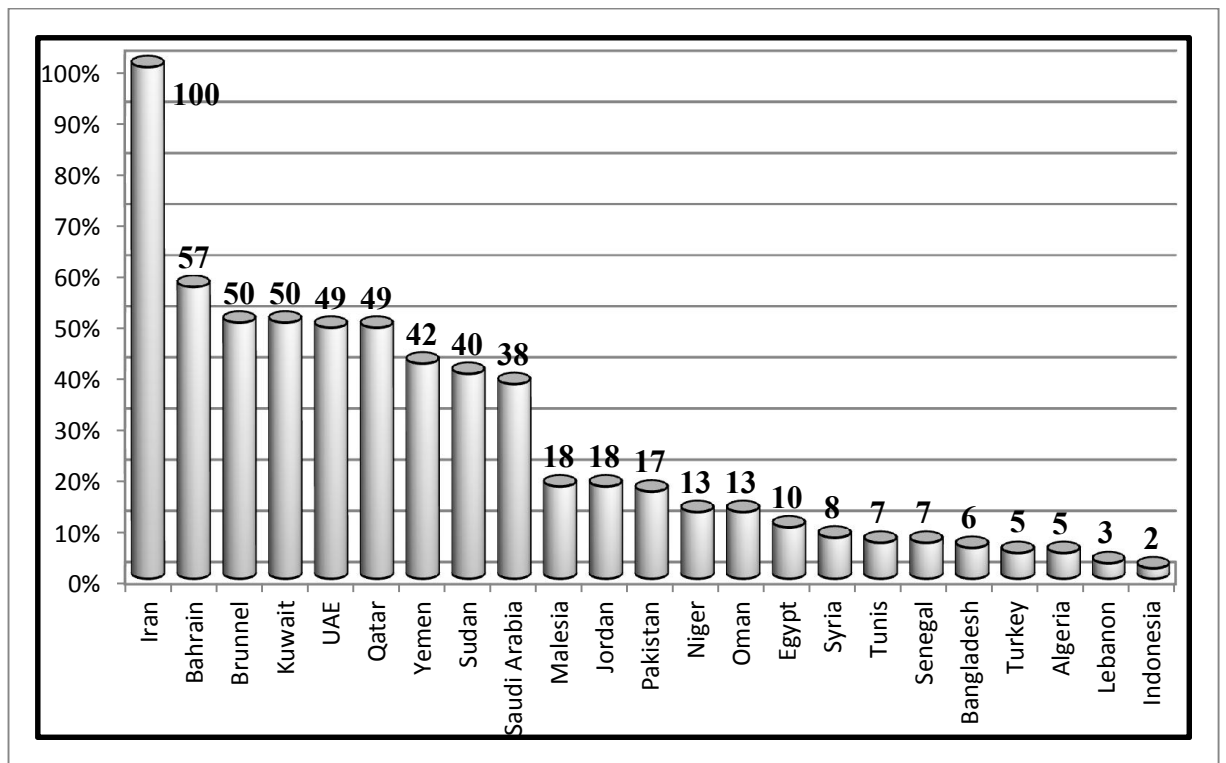


Figure 1.3: Islamic banking in the world



Source: <http://www.islamicbanker.com>, [accessed 10 December 2014]

2. MONEY MARKET PRODUCTS

2.1 MONEY MARKETS

In money markets short term excess funds holders and those who need funds transact. Excess fund holder demands some returns against the money he gives and the other part pays back that money with interest. The transactions in money markets has less than one year maturity whereas in capital markets the maturity is more than one year.

Money markets are divided into two parts as organized and unorganized:

- i) Organized Markets: CBRT repo and reverse repo operations market, BIST Debt securities markets, Settlement and Custody Bank Stock Exchange Money Market
- ii) Unorganized Markets: Interbank Free Money Market, Interbank Debt Securities Markets

The main institutions for these markets are commercial banks. However finance companies, insurance companies, bankers and factoring institutions are also the other players of the markets. Likewise the firms and individuals having liquid assets can gain a place in the market using their money on hand.

It can be easily said that participation banks almost never take part in these markets as a matter of their principles. This is because of two reasons. Firstly, because bonds and bills are issued without asset backed or asset based, participation banks never buy those bonds and bills. Furthermore, the contracts and business principle between parties are important in these transactions. The second reason is that participation banks cannot borrow money at certain ratio if there is no commodity in the transaction. Due to these reasons participation banks have developed their own specific money market products.

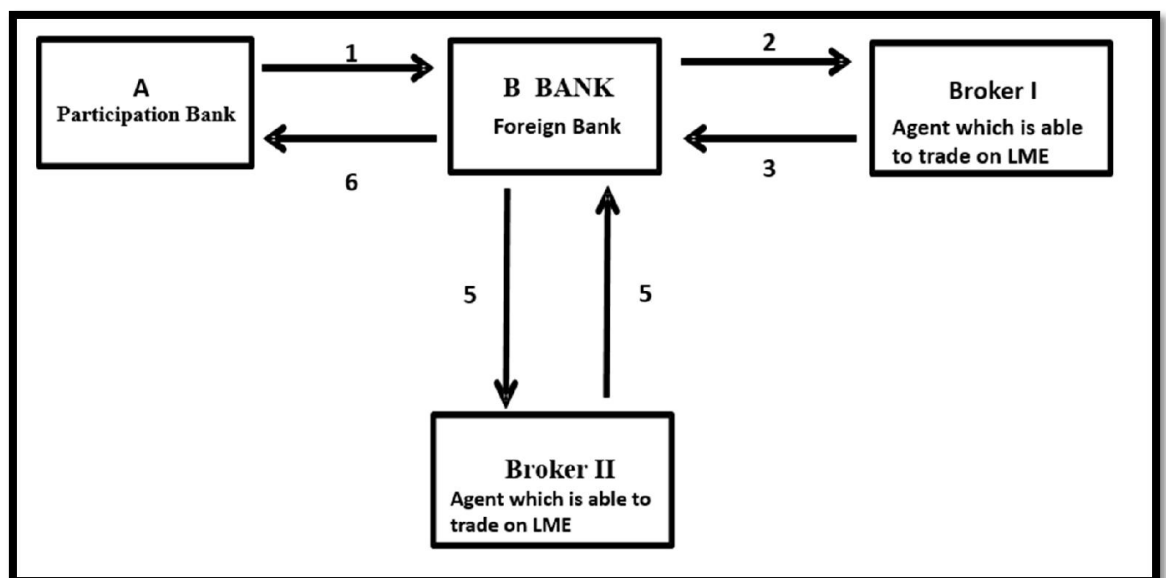
2.2 MONEY MARKET PRODUCTS IN ISLAMIC FINANCE

- a) Commodity Murabaha Transaction
- b) Collateralised Commodity Murabaha
- c) Swap Transaction
- d) Profit Rate Swap ve Cross Currency Swap
- e) Lease Certificates
- f) CBRT Certified Open Market Operations (Lease Certificates)
- g) Sale of Lease Certificate with Repurchase Agreement
- h) Commitment Transactions of Lease Certificates
- i) Wakala
- j) IILM

2.2.1 Commodity Murabaha Transaction

It is a product that enables participation banks, public institutions, investment companies, corporate and individual investors to use their excess liquidity. The commodities traded in the commodity markets (London Metal Exchange, London Platinum & Palladium Exchange etc.) via brokers bring returns depending on the maturity of murabaha transactions.

Figure 2.1: Commodity murabaha process



- i) Participation Bank A deputises Bank B in Europe for doing murabaha transaction in order to benefit from its excess funds. Participation Bank A transfers its excess funds to Bank B. For example let's say Participation Bank A has USD 1,000,000 excess fund
- ii) Bank B buys a specific commodity with USD 1,000,000 from Broker I in the spot market on behalf of Participation Bank A.
- iii) Bank B transfers the money to Broker I and takes the commodity.
- iv) Bank B purchases this commodity for itself at a specific forward price depending on the maturity and return rates.
- v) Bank B sells the commodity purchased forward to Broker II in the spot market and converts the money into cash.
- vi) Bank B makes the payment to Participation Bank A when the commodity arrives at maturity

For murabaha transactions Murabaha Framework Contract should be signed by parties in advance.

Moreover, brokerage contracts should be signed with intermediary broker firms. These intermediary firms get also commissions at highly low amounts. Provided that at least USD 100, 15 out of 1 million commission is paid.

As a matter of working principles, banks have to hold a certain amount of liquid asset in order to avert great risks they may face with. As they cannot make bond, bill and repo transactions, participation banks find an opportunity of being able to appreciate the liquid assets in their hands at the market averages thanks to this product. The monthly transaction volume of participation banks in Turkey is USD 5 billion on average. All of those transactions are carried out via London Metal Exchange.

This is because London Metal Exchange provide service to every Islamic bank around the world and it has sufficient economic scale due to its developed financial infrastructure. When doing this transaction, Islamic banks must be able to receive the commodity subject to commerce physically if necessary as a matter of their working principles. The parties making murabaha transaction should include the provisions

about physical reception in the contracts they sign with each other. That is to say, the platinum, palladium or any other commodity subject to commerce should be preserved physically and must be able to be given to the Islamic bank that makes the transaction if necessary. However, because the parties make this transaction in order to appreciate the cash assets they have physical reception is not taken place. Yet, since London market is highly developed and provides service both Islamic and commercial banks, the custody and processing costs of the relevant metals are in the minimum level. For example; for a 100 million dollar commodity murabaha transaction only 1,500 dollar transaction cost is paid. As the commodity subject to transaction does not go to the stock exchange, these transactions can be made with minimum costs.

2.2.1.1 Making commodity murabaha transactions in BIST

In accordance with the law no. 32 regarding the protection of the value of Turkish currency, the commercial banks are free for trading precious metals. According to the current law, gold, silver, platinum, and palladium are counted as precious metals and there is no any legal barrier for banks to trade these precious metals. Consequently, we can derive the idea that there is no any legal barrier for commercial and participation banks to trade platinum and palladium which are considered as commodity by the members of advisory board (Shari'a Board) of participation banks.

As gold and silver are accepted as money in accordance with the Islamic jurisprudence, it is not appropriate to buy and sell for account the gold and silver. In contrast, platinum and palladium are considered as commodity not money. Therefore, participation banks can make platinum and palladium subject to future deliveries in accordance with their principles. Platinum and palladium are within the intersection set of commercial and participation banks according to the Islamic and written law.

However, because of the following data these transactions both shift to abroad and are made on other alternative products.

a. Article 28th of the expense accounts law no. 6802:

With the exception of the transactions that banks and insurance companies make, the money they take because of all the rest transactions are subject to the banking and insurance transaction tax. In case buying, purchase and delivery take place abroad it is obvious that the money taken in favor is subject to the banking and insurance transaction tax. Because the transactions made both in domestic and abroad are subject to % 5 BITT, transaction cost also increases 5 percent. Therefore participation banks prefer to make swap transactions instead of commodity murabaha.

b. There are the following provisions in the article 57th of the banking law no. 5411:

Banks shall not engage in trading property and commodity for commercial purposes, excluding the contracts based on property and commodity under the Capital Market Law No. 2499 and the trading of precious metals to be deemed appropriate by the Board, and shall not participate in undertakings whose main field of activity is property trading except for mortgage financing institutions and real estate investment trust.

The transactions on property and commodity regarding of the liabilities undertaken by participation banks due to activities of procuring property, equipment or commodity, financial leasing, profit or loss sharing investment, or activities of providing financing through joint investments and similar activities shall not be considered within the scope of activities prohibited under this article.

c. Article 14/4/g of VAT law no. 3065:

The delivery of bar gold, bar silk and precious metals is exempt from Value Added Tax. To be subject to VAT, the transaction must take place in Turkey.

Due to the articles mentioned above, in case the commerce and delivery of banks and participation banks' platinum and palladium transactions are carried out entirely abroad, VAT will not be in question. Therefore, the 18% VAT transaction cost will be avoided on the condition delivery abroad.

If the commodity murabaha transactions are accepted as the Islamic money market products and Banking and Insurance Transaction Tax (BITT) is set to zero, making these transactions within the country will be paved the way. In case both the transaction volume increases and a market service will be provided to the Near East, the possibility of establishing low transaction costs within BIST may gain strength.

In order for the market to be able to function:

- i) BIST must be able to provide physical custodian service on platinum and palladium
- ii) The BITT for all Islamic money market transactions must be zero
- iii) If necessary, the transactions should be subject to physical delivery but in that case VAT rate must be 0% instead of 18%.
- iv) The intermediary firms carrying out these transactions should establish their infrastructures and implement low transaction volume to the client.
- v) Transaction costs must be very low.
- vi) It must reach to economy of scale, for this it must be provided that both commercial banks and Islamic banks in the Near East and North Africa can transact in this market.

While some firms like Eiger, DD&Co, and Ricmond provide this service to the Islamic banks in the London Metal Exchange, most of the transactions are not registered in the market. Besides, because the buyer and seller are clear, the risk level is low as well. Hence, these intermediary firms implement very low transaction costs. It is estimated that the daily transaction volume of an intermediary firm having 30 percent of the market share in this area in the London market is about 3 billion US dollar. Because these transactions are not registered in the market, the records remain only as confidential information of the relevant intermediary firms.

2.2.2 Collateral Commodity Murabaha

With the Collateral Commodity Murabaha, participation banks create source of fund for themselves via giving security the lease certificates in hand. Because Clup Deal use lease certificates in the Syndicated Loan or Collateral Commodity Murabaha transactions the risk ratio decreases, hence it can find loans with more appropriate ratios.

Participation banks borrow at fixed or variable rates in a way that coincide with the lease payments due of the lease certificates through using commodity murabaha transactions with the organizations/banks. Against this borrow, the lease certificates in the portfolios of participation banks are transferred to the custodian bank of the lender organization.

The lease certificates used in the Collateral Commodity Murabaha transactions are transferred to participation banks at the date of maturity of the borrowing. Even though the lease certificates are given to the counter party as security, the profit shares of the certificates are belonged to the participation bank that gives the security and when the due date of the profit shares comes they are transferred to the participation bank. When making these transactions, some certain amount of cash outflow take place from the participation to the counter party. For the lease certificates given as security some amount of cash inflow with certain maturities take place. That is, the transaction date of commodity murabaha and the maturity date of the lease certificates are the same. Reducing the two transfer transactions into a single one both operational and costwise, the “netting” transaction is made and money transfer transactions are performed. The payback amortization transactions of the lease certificates are carried out in the party which is given the security. In the maturity date, over the capital of the lease certificates and the capital of the debt taken via commodity murabaha, a separate netting occurs apart from the profit shares. All of these transactions are performed in OTC markets.

Example: The currently made murabaha transactions: Kuveyt Turk (KT) gives the procuration to Credit Suisse (CSI). CSI buys the commodity from DD&Co and sells to Condor by procuration.

The Collateral Commodity Murabaha transactions are carried out as the following:
This structure is more appropriate for the Islamic finance jurisprudence.

Explanation:

Kuveyt Turk and CSI make a deal for the commodity murabaha transaction in a way that the price and profit will be definite. The process flow is like the following:

- i) CSI buys the commodity for cash from DD&Co and makes the payment.
- ii) It sells the commodity to KT with forward price via murabaha transaction.
- iii) KT sells that commodity to Cordon for cash and receives the payment.
- iv) As brokers and KT have their accounts at CSI, the netting of money transfer transactions is performed at Credit Suisse.
- v) As for the commodity transfer transactions, the netting operations are performed at DD&Co as the commodity accounts are at DD&Co.

Figure 2.2: The process of commodity murabaha transaction

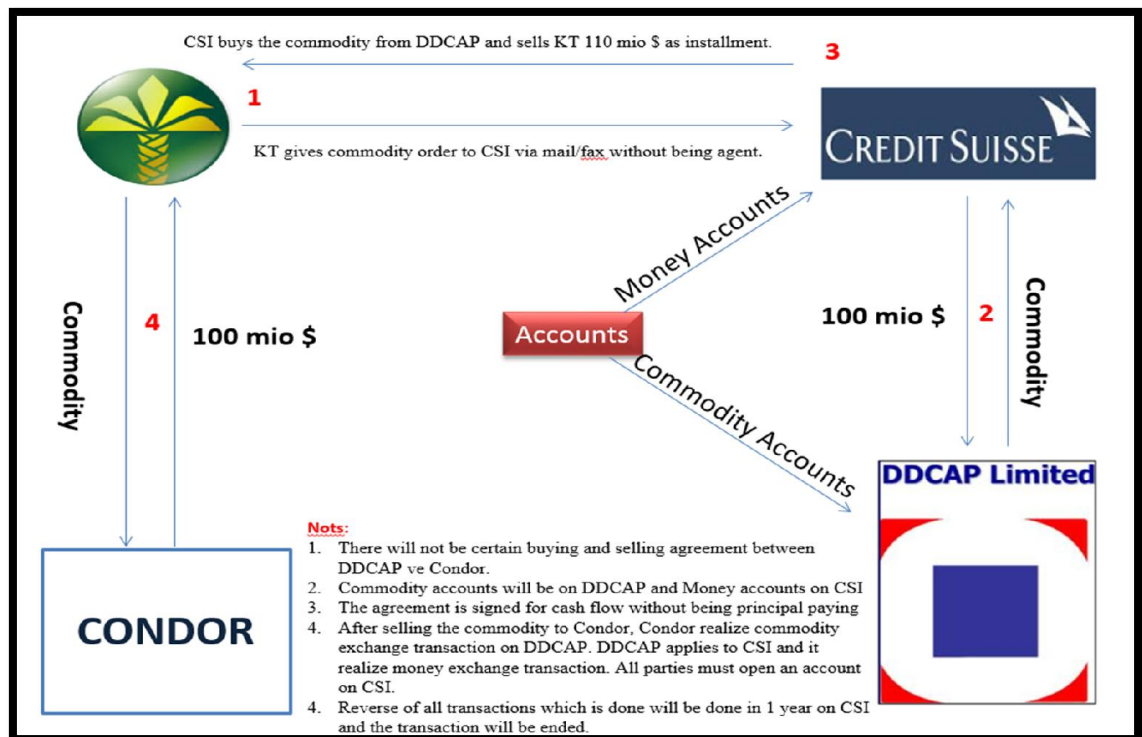
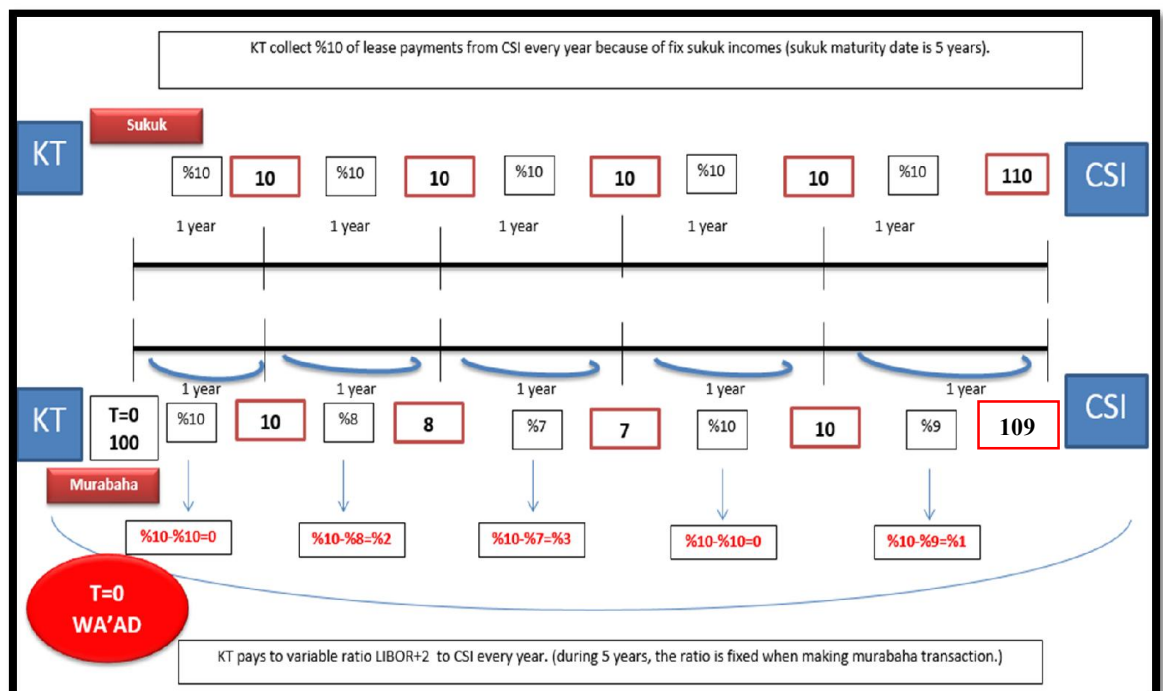


Figure 2.3: Murabaha and sukuk transaction



- i) The first figure above shows the cash flow of the lease certificates with five-year maturity in Kuveyt Turk portfolios. These cash flows include both the profit rate and the principal at the end of the maturity.
- ii) The second figure shows the cash flow of the commodity murabaha transaction. Kuveyt Turk promise to make commodity murabaha transaction for five years and in the every end of year. Commodity murabaha transactions can be either floating or fixed return. The example above is indexed to Libor that is floating.
- iii) Every end of year, money transfer is performed once and for all through netting the cash coming from the commodity murabaha and from the lease certificates.
- iv) In the beginning of the transaction, the exchange of the lease certificate and money is occurred. At the end of five-year maturity, the principal and profit coming from the lease certificates and from the commodity murabaha are exchanged and the transaction is closed. However, since the transaction period can be by the time of the lease certificate maturity, the payback amortization of the lease certificates are made by the corporation which KT give securities. CSI performs the money transfer and the netting transactions after dropping the principal of the lease certificates from the debit given to KT.

Benefits of the product for participation banks

- i) Participation banks have gained an easy way to access to a different source of funds with proper rates.
- ii) Together with this product, an opportunity is found to transform the lease certificates into liquid sources without writing the bank's off balance sheet.

- iii) Because the money gained thanks to this product can be long term, it can be used in long term operations such as project finance.

Risk Analysis of the Product: Since participation banks give the lease certificates in their portfolios as securities to the counter party and in return, obtain funds via commodity murabaha, the risk limits are different from the usual borrowing. Therefore, it is subject to a different risk coefficient evaluation. When performing this process, the amount of funds obtained against the lease certificates given as security is determined by the treasury department. Negotiating between each other, the international banking and treasury departments make the calculations of the risk coefficient which is to occur as a result of the performed operations. For instance, if 60 million dollar fund is obtained via commodity murabaha and in return lease certificates valuing 80 million dollar is given to the counter party, the total amount of risk in the counter party can be calculated as $80 - 60 = 20$ million dollar.

2.2.3 Swap Transactions

Swap is a contract to lower the return and maturity risks of an asset back payments of two parties in a specific time period.

It will be beneficial firstly to introduce forward product before defining swap transaction. Forward is an agreement to buy or sell an asset at a certain date at a certain price. In order for forward product to be transacted by participation banks, one of the parties must have the withdrawal right. Otherwise, the use of forward product in participation banks is not appropriate. With the condition that the withdrawal right is of one party, it can be done with corporate and retail customers. However, the members of advisory board do not allow this sort of transactions to be made with the purpose of speculation or manipulation. Instead they suggest these transactions must be made with the exporter and importer firms which are really in need of foreign exchange. The given fetwa formally opens the doors for everybody to be able to make the transaction. Nonetheless, participation banks have still preserved some drawbacks about using the

widespreading leverage products in Turkey and in the world. Currently used and highly profitable forward product is transacted only with limited number of customers.

Example:

- i) Customer wants to buy \$ 50,000 with 20 day maturity
- ii) Spot rate: 1.80
- iii) USD return rate: %4; TL return rate: %10
- iv) Calculated Forward Rate: $1.80 * [(1 + 0.1 * (20/360)) / (1 + 0.04 * 20/360)] = 1.806$
- v) This means that the customer accepts to give TL 90,300 at the due date in exchange for taking \$ 50,000.

Swap is to buy and to purchase a certain amount of currency with two different delivery dates at the same time. It is a widespreading product that participation banks use with foreign banks via treasury departments to manage their liquidities. At this stage, swap is used only by treasury departments of banks and it is rarely transacted with large corporate customers.

Example:

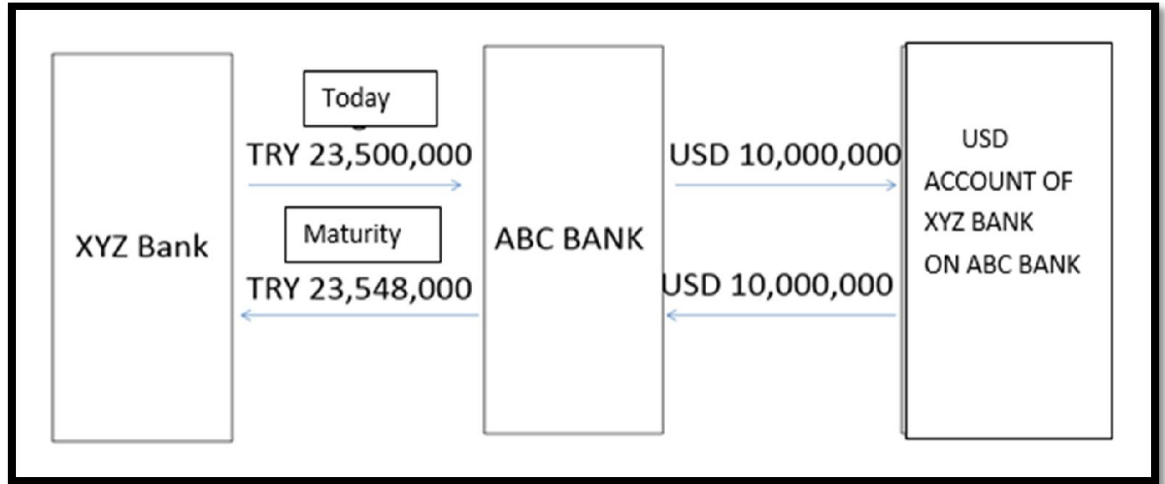
- i) ABC Bank gives TL 23,500,000 to XYZ Bank in exchange for \$ 10,000,000 today with the exchange rate of USD/TL= 2.35
- ii) ABC Bank blocks \$ 10 million in its accounts in XYZ bank until the maturity date.
- iii) ABC and XYZ banks also agree upon a forward rate from today.
- iv) Let forward rate be 2.3548. Accordingly at the maturity, XYZ Bank repays 23,354,800 to ABC Bank in exchange for the USD amount in its account.

Example:

USD/TL Swap Point= 47.57 Spot USD/TRY Rate = 2.3500

Forward USD/TRY Rate = 2.35480 Maturity = 7 days Amount = 10 Million USD

Figure 2.4: Swap transaction



2.2.4 Profit Rate and Cross Currency Swap

Profit rate swap is a product rarely used by participation banks to lower return and maturity risks.

It is designed to minimize the risk according to the fixed or floating returns in long term funds transactions side and the costs in expense side. Whereas, the revenue side can be fixed or floating and long term, the expense side can be floating and generally short term. With this product maturity and return are accorded with each other, the risk is minimized and profit rate is determined at the beginning.

When profit rate swap is used return rate will be fixed and the possible gains and losses are specified at the beginning of transactions.

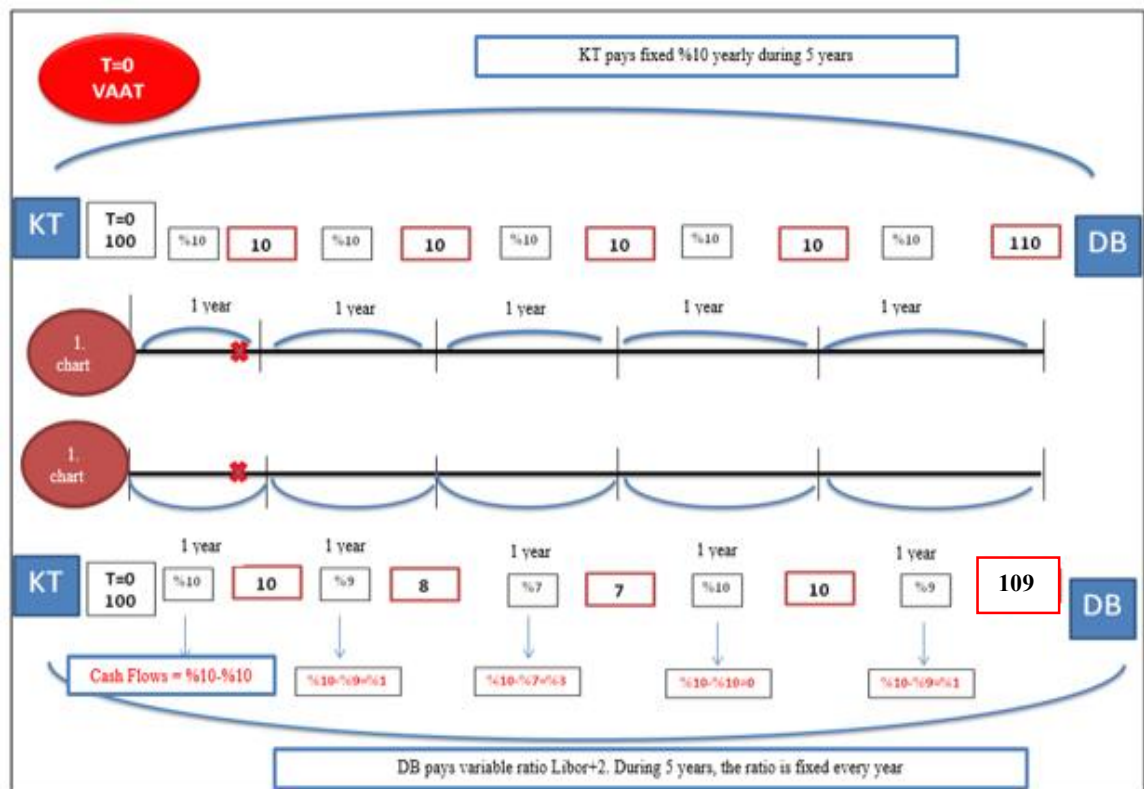
The difference between Cross Currency Swap and Profit Rate Swap is that different foreign currencies are used. Besides profit rate swap, with CCS swap is made at the rate which determined for different currencies in the first day of the underlying transaction and at the end of maturity swapping these currencies transaction of principal is carried out. Apart from these transactions

These transactions can be used in qualified operations such as project financing and issue of lease certificates.

Figure 2.5: PRS Balance sheet effect

	PRS PAYMENTS			KT BALANCE SHEET				NET FINANCIAL BALANCE SHEET INCOME	
	Ratio		PRS Net Cash Flows	Asset 100 Mio USD (Fix, 6 Months, 5%)		Liability 100 Mio USD (Variable, Monthly, Libor+1)			
Libor	KT, Fix Pay	Receivin g from A Bank Libor+2	KT	Ratio	Amount	Ratio	Amount		
1.Month 3%	5%	5%	0 USD	5%	416,000 USD	4%	-333,000 USD		83.000 USD
2.Month 4%	5%	6%	83,000 USD	5%	416,000 USD	5%	-416,000 USD		83.000 USD
3.Month 1%	5%	3%	-166,000 USD	5%	416,000 USD	2%	-166,000 USD	83.000 USD	

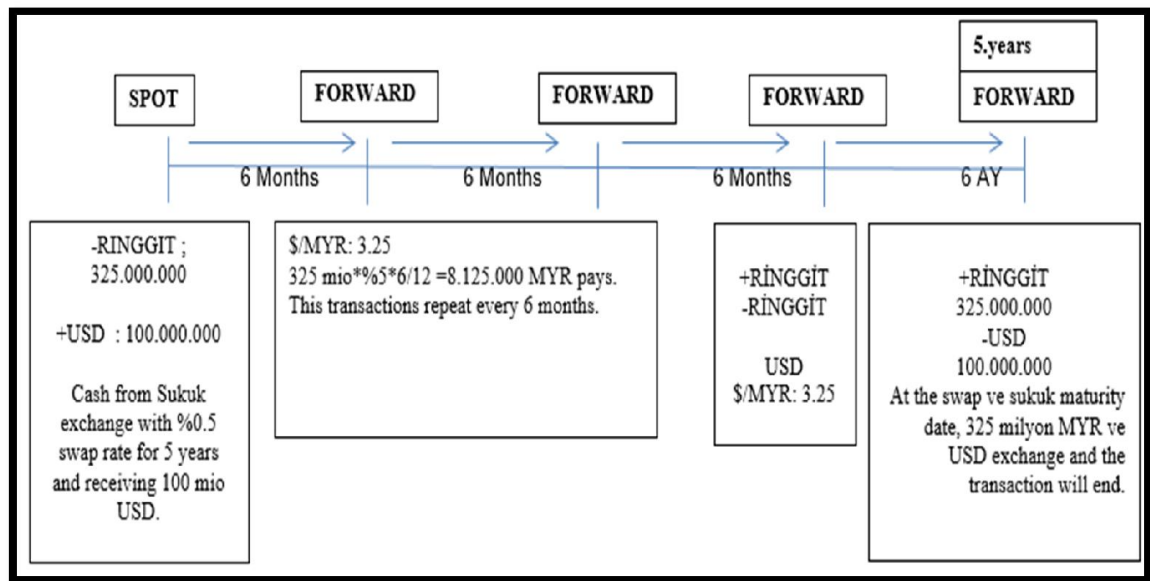
Figure 2.6: Example representaion of the product



Explanation:

- a) The first graph represents fixed return stage of transaction. For example, the profit shares gained from project financing that funded at the fixed return are constant. Like in project financing, in order to minimize funding risk commodity murabaha transaction is made in a way that it will be equal to annual returns of the project. Accordingly, the very day, 2 days before or any day at the rate of profit share return the commitment of making commodity murabaha transaction is given at the beginning of transactions. According to these commitments the maturity, period, and fixed profit rate with which murabaha transacted is determined. For example, if the annual return of a 5 year project is TL 10 million, at the beginning the commitment of commodity murabaha transaction with which TL 10 million is gained at the end of every year is given.
- b) The second graph represents the floating stage. The average maturity of participation funds is 3 months and cost item changes every 3 months on average. When deciding to make profit rate swap transaction, in every period the very day or 2 days before at the rate of profit share return the commitment of commodity murabaha transaction is given at the beginning. According to these commitments, the maturity, period, and $\text{libor} + \text{fixed rate}$ are determined.
- c) After two parties make commodity murabaha transaction in the first and second graphs, cash flows at the amount of difference between two transactions occur among the parties.
- d) Because cross currency swap transaction is made with different currencies, the forward and spot transactions like in the following graph carry out as well.

Figure 2.7: Example of CCS forward product



Example of cross currency swap:

Kuveyt Turk issues 5 year-sukuk based on 325 mio ringgit with 5 percent of yield ratio. Kuveyt Turk gets 100 mio dollar from counterpart in return of 325 mio ringgit by swapping 325 mio ringgit with 3.25 currency rate. Kuveyt Turk pays 8,125,000 ringgit to ones who buy the sukuk in every 6 months. Kuveyt Turk pays this payment with ringgit yielded from swap. If rate of return form counterpart is equal to yield ratio of sukuk, return form counterpart is directly paid to ones who buy the sukuk. Ringgit borrowing is 5 percent and dollar borrowing is 3.4 percent in Malaysia. Under these circumstances, swap rates of USD/MYR is positive with 0.5 percent. Sukuk is issued by entering in an account in every 6 months instead of one by one dollar borrowing.

- i) USD/MYR: 3.25
- ii) Kuveyt Turk Payment: $(100,000,000 \times 3.35\% \times 6/12) = 1,650,000 \text{ USD}$ in every 6 months
- iii) Yield Ratio: $(325,000,000 \times 5\% \times 6/12) = 8,125,000 \text{ MYR}$ in every 6 months
- iv) Swap Rate of USD/MYR: 0.5%. Since return of MYR is more, additional return is gained from swap. There will be one more payment which is calculated by swap rate, except from payments in every 6 months.

Key features of the product:

- i) At the beginning of the contract, each party commit to make commodity murabaha at the determined periods and maturities.
- ii) At the end of every period or before the parties make commodity murabaha transaction. The amount of commodity murabaha is not equal to principal but it can be equal to the amount of expected profit. In this way we abstain from possible high commissions that are paid to intermediaries.
- iii) At the end of commodity murabaha transactions cash flows occur at the amount of difference between rates.
- iv) Cash flows are based on commodity murabaha that made in every period until the end of maturity.
- v) In CCS transactions, because currencies are different to be able to netting the cash flows the currencies must be exchanged. At the beginning of transaction, forward rate is determined, currencies are changed and cash flows transaction is performed.

Benefits of profit rate swap product to participation banks

- i) It provides to preserve the equilibrium of asset-liabilities of participation banks.
- ii) It provides protection against shocks in the market returns. The balance between funds and returns is established and rates of return is made fixed. With this product maturity and return risks are decreased.
- iii) The risk of increasing cost of funding is minimized.
- iv) Accessibility to different markets is provided.
- v) Effective risk management is ensured.
- vi) The opportunity of long term funding with different maturities is provided.

Although participation banks rarely use it in recent years, this product will be used at most one or two times in a year. The increase in project financing and lease certificate issue with different currencies will cause the demand for this product to rise. Moreover, it is a limited risk reducing product that participation banks will use against possible high fluctuations in market rates.

2.2.5 Sukuk – Lease Certificates

2.2.5.1 Sukuk definiton

Basically, and literally, sukuk means bonds. However, there are huge differences between how sukuk bonds are being issued and operated and how conventional bonds are being issued and operated.

Sukuk is a financial instrument which is used to gather financial sources. The word of “sukuk” is the plural form o Arabic word “sakka” which means certificate, or instrument. So, it would be a perfect definition, that *sukuk* is “Islamic investment certificate.”

As approved by many of Islamic Scholars, sukuk has been one of the most important elements to contrbiute to remerkable growth of Islamic financial services and Islamic banks.

The existence of sukuk – Islamic bonds- is a call to a necessity. Conventional bonds are issued by conventional banks and they yield interest, so that they are simply prohibited in Islam. However, it is a matter of fact that financial instruments such as bonds, coupons and bill of exchanges are such important in finance, so, Islamic scholars invented sukuk. Contemporary practices of sukuk are legitimate in Islamic financial principle.

2.2.5.2 Differences between sukuk and bonds

Table 2.1: Distinguishing sukuk from conventional bonds

	Conventional Bonds	Sukuk
Asset ownership	Bonds don't give the investor a share of ownership in the asset, project, business, or joint venture they support. They're a debt obligation from the issuer to the bond holder.	Sukuk give the investor partial ownership in the asset on which the sukuk are based.
Investment criteria	Generally, bonds can be used to finance any asset, project, business, or joint venture that complies with local legislation.	The asset on which sukuk are based must be sharia-compliant.
Issue unit	Each bond represents a share of debt.	Each sukuk represents a share of the underlying asset.
Issue price	The face value of a bond price is based on the issuer's credit worthiness (including its rating).	The face value of sukuk is based on the market value of the underlying asset.
Investment rewards and risks	Bond holders receive regularly scheduled (and often fixed rate) interest payments for the life of the bond, and their principal is guaranteed to be returned at the bond's maturity date.	Sukuk holders receive a share of profits from the underlying asset (and accept a share of any loss incurred).

Effects of costs	Bond holders generally aren't affected by costs related to the asset, project, business, or joint venture they support. The performance of the underlying asset doesn't affect investor rewards.	Sukuk holders are affected by costs related to the underlying asset. Higher costs may translate to lower investor profits and vice versa.
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2.2.5.3 Types of sukuk²

- a) Agreement-Based Classification
- b) Trading Function-Based Classification
- c) Asset Representation-Based Classification

2.2.5.3.1. *Agreement-based classification*

- i) Purchase Agreement Based Sukuk Types
 - a) Murabaha Sukuk
 - b) Selem Sukuk
 - c) Istisna Sukuk
 - d) Deferred Payment Agreement-Based Sukuk (BBA)
- ii) Lease Agreement Based Sukuk Types
 - a) Ijara Sukuk
- iii) Partnership Agreement Based Sukuk Types
 - a) Mudaraba Sukuk
 - b) Musharaka Sukuk
- vi) Attorney Agreement Based Sukuk Types

² Şensoy Necdet, 2013, Sukuk Workbook

2.2.5.3.1.1 Purchase agreement based lease certificates

a) Murabaha Sukuk: In the Islamic finance industry, the term murabaha is broadly understood to refer to a contractual arrangement between a financier (the seller) and a customer (the purchaser) whereby the financier would sell specified assets or commodities to the customer for spot delivery in the expectation that the customer would be able to meet its deferred payment obligations under the murabaha agreement³.

The deferred price would typically include the cost price at which the financier had purchased the assets/commodities, plus a pre-agreed mark-up representing the profit generated from its involvement in the transaction. The payments of the deferred price from the customer may be structured as periodical payments on dates specified at the outset, thus creating an income stream for the financier for the term of the transaction.

The same characteristics of the murabaha structure can also be adapted for use as the underlying structure in a sukuk issuance. Sukuk proceeds from investors may be applied by issuer SPV to acquire commodities and on-sell such commodities to the originator to generate revenue from the murabaha deferred price which would be distributed to the investors throughout the term of the sukuk al-murabaha.

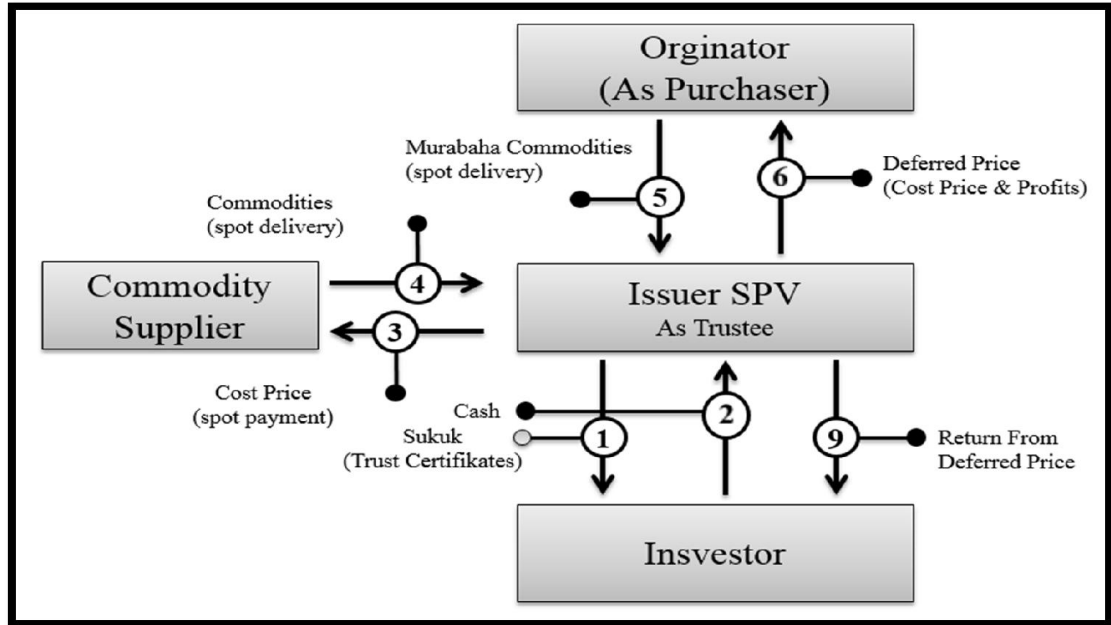
As the sukuk certificates in a sukuk al-murabaha essentially represent entitlements to shares in receivables from the purchaser of the underlying murabaha, they are not negotiable instruments that can be traded on the secondary market because Shari'a does not permit trading in debt except at par value. This reduces the popularity of sukuk al-murabaha for potential investors and is reflected by the limited number of sukuk al-murabaha issuances in the sukuk market.

Despite being debt securities, sukuk al-murabaha certificates may still be negotiable if they form a small part of a larger portfolio comprising mostly of other negotiable instruments such as sukuk al-ijara, sukuk al-musharaka, and/or sukuk al-mudaraba.

Set out on the following page is an example of a typical sukuk al-murabaha structure;

³ *Kuveyt Türk Participation Bank A.Ş, 2015, Participation bank lecture notes*

Figure 2.8: Structure of sukuk al-murabaha



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

b) Salam Sukuk: In its simplest form, a salam contract involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. The purchase price of the assets is typically referred to as the salam capital and is paid at the time of entering into the salam contract. The assets sold under the salam contract are referred to as al-muslam fhi, delivery of which is deferred until a future date⁴.

A salam contract may be construed as being synonymous with the objective of a forward sale contract. Forward sale contracts are generally forbidden under Shari'a unless the element of uncertainty (gharar) inherent in such contracts is effectively eradicated. For this reason, certain criteria must be met in order for a salam contract to be Shari'a compliant.

Although the use of salam has been, and is, utilised by some institutions for short-term liquidity purposes, its use as the platform for issuing sukuk, as an alternative to conventional bonds, is rare in comparison to some of the more prevalent structures like sukuk al-ijara. The limited use of this structure can be attributed to a number of factors, namely the non-tradability of the sukuk and the requirement that the originator must be

⁴ Kuveyt Türk Participation Bank A.Ş., 2015 Participation bank lecture notes

able to deliver certain “standardised” assets to the issuer at certain future dates which may be difficult where the originator’s business model does not provide for this.

When structuring a sukuk issuance as a sukuk al-salam, the first step will involve analysing what exactly the business of the originator entails and what “standardised” assets (if any) the originator is able to deliver to support the issuance of the sukuk.

c) Istisna Sukuk: Broadly speaking, istisna translates as being ‘to order a manufacturer to manufacture a specific good for the purchaser’. Under an istisna, it is important that the price and specification of the good to be manufactured are agreed at the outset⁵.

In the modern day context of Islamic finance, the istisna has developed into a particularly useful tool in the Islamic funding of the construction phase of a project – it is often regarded as being similar to a fixed-price “turnkey” contract. In order to enable investors to receive a return during the period where assets are being constructed under an istisna arrangement, some advisory board member have permitted the use of a forward lease arrangement (known as ijara mawsufah f al-dimmah) alongside such istisna arrangement.

Accordingly, sukuk al-istisna often combines an istisna arrangement with a forward lease arrangement – whilst the istisna is the method through which the investors can advance funds to an originator, the ijara provides the most compatible payment method to those investors.

d) Bai Bithaman Ajil (BBA): Bai Bithaman Ajil is a “deferred payment sale”, which works like a murabaha contract, but with payment generally made on a deferred basis.

2.2.5.3.1.2 Lease agreement based sukuk types

a) Ijara Sukuk: The most commonly used sukuk structure is that of sukuk al-ijara. The popularity of this structure can be attributed to a number of different factors; some commentators have described it as the classical sukuk structure from which all other sukuk structures have developed, whilst others highlight its simplicity and its favour

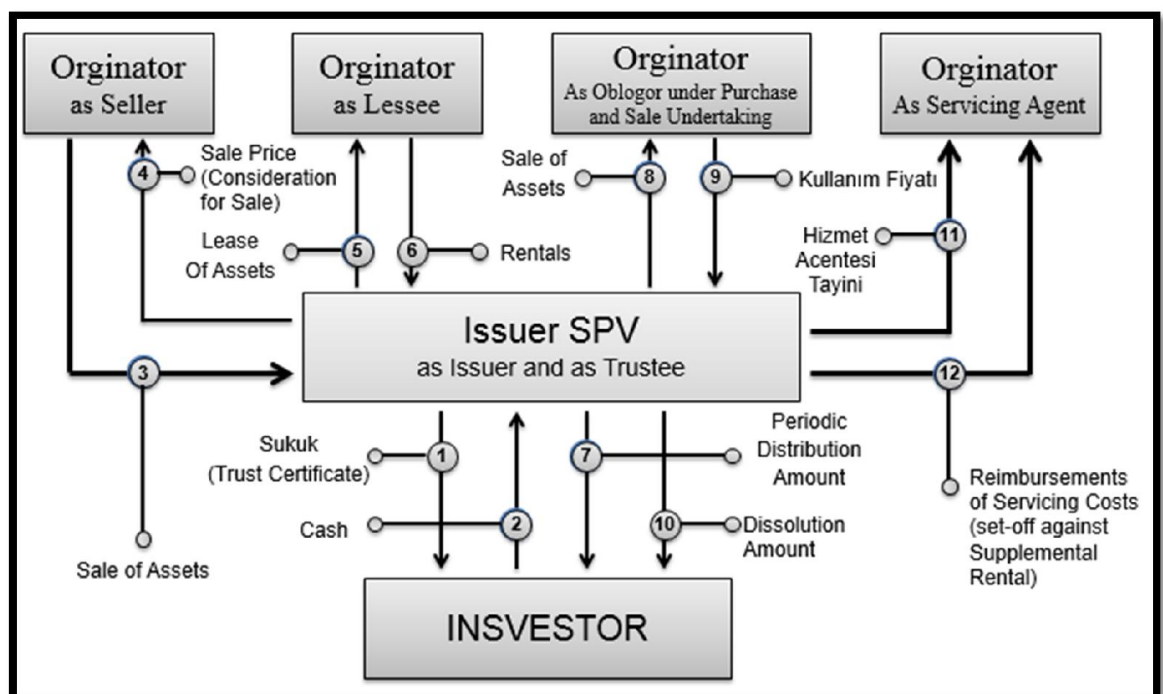
⁵ Kuveyt Türk Participation Bank A.Ş, 2015, *Participation bank lecture notes*

with advisory board member as the key contributing factors. In the Islamic finance industry, the term “ijara” is broadly understood to mean the ‘transfer of the usufruct of an asset to another person in exchange for a rent claimed from him’ or, more literally, a “lease”.

In order to generate returns for investors, all sukuk structures rely upon either the performance of an underlying asset or a contractual arrangement with respect to that asset. The ijara is particularly useful in this respect as it can be used in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile and method of calculation in order to generate a profit. In addition, the use of a purchase undertaking is widely accepted in the context of sukuk al-ijara without advisory board objections. These characteristics make ijara relatively straightforward to adapt for use in the underlying structure for a sukuk issuance.

Set out below is an example of a sukuk al-ijara structure, based upon a sale and leaseback approach ;

Figure 2.9: Structure of sukuk al-Ijara



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

Key features of the underlying structure

Set out below is a summary of the basic requirements that should be considered when using ijara as the underlying structure for the sukuk issuance:

- i) The consideration (rentals) must be at an agreed rate and for an agreed period;
- ii) The subject of the ijara must have a valuable use (i.e. things without a usufruct cannot be leased),
- iii) The ownership of the asset(s) must remain with the trustee and only the usufruct right may be transferred to the originator (therefore anything which can be consumed cannot be leased by way of an ijara),
- iv) As ownership of the asset(s) must remain with the trustee, the liabilities arising from the ownership must also rest with the trustee (as owner) - an asset remains the risk of the trustee throughout the lease period (in the sense that any harm or loss caused by the factors beyond the control of the originator is borne by the trustee),
- v) Any liabilities relating to the use of the asset(s), however, rest with the originator (as lessee),
- vi) The Originator (as lessee) cannot use an asset for any purpose other than the purpose specified in the ijara (or lease) agreement (if no purpose is specified, the Originator can use such asset for the purpose it would be used for in the normal course of its business),
- vii) The asset(s) must be clearly identified in the ijara (and identifiable in practice),
- viii) Rental must be determined at the time of contract for the whole period of the ijara. Although it is possible to split the term of the ijara into smaller rental periods where different amounts of rent may be calculated for each such rental period, the amount of rental must be fixed at the start of each such rental period and advisory board will consider each rental period as a separate lease,
- ix) If an asset has totally lost the function for which it was leased, and no repair is possible, the ijara shall terminate on the day on which such loss (a “total loss”) has been caused. If there has been a total loss, the trustee may have the right/ability to substitute or replace the affected asset - although, in reality, it would only look to do so if the originator (as service agent) is able to use the

insurance (or takaful) or any other total loss proceeds to procure substitute or replacement assets,

- x) If a total loss is caused by the misuse or negligence of the originator, the originator will be liable to compensate the trustee for depreciation in the value of the affected asset, as it was immediately before such total loss
- xi) In the event that an asset has only suffered partial loss or damage, the ijara will continue to survive with respect to that asset.

Table 2.2: Required documentation for ijara sukuk transactions⁶

Document	Parties	Summary/Purpose
Sale and Purchase Agreement	Originator (as Seller) and Trustee (as Purchaser)	From trustee's (and the investors') perspective, this is the document that gives ownership of revenue-generating assets (i.e. the assets). From originator's perspective, this is the document under which it receives funding.
Lease (Ijara) Agreement	Trustee (as Lessor) and Originator (as Lessee)	Trustee leases the assets back to originator in a manner that: gives originator possession and use of the i. Assets so that its principal business can continue without interruption; and through Rentals it generates a return for ii. Trustee (and the investors).
Service Agency Agreement	Trustee (as Lessor / Principal) and Originator (as Servicing Agent)	Allows trustee to pass responsibility for major maintenance, insurance (or takaful) and payment of taxes (i.e. an owner's obligations) back to originator. Any reimbursement amounts or service charges payable to servicing agent are set off against (i) a corresponding 'supplementary

⁶ DFC (Dubai Financial Center), *Sukuk Examples Workbook 2013*

		rental' under the Ijara or (ii) an additional amount which is added to the exercise price (payable under the purchase undertaking or the sale undertaking, as applicable).
Purchase Undertaking (Wa'ad)	Granted by Originator (as Obligor) in favour of Trustee	Allows trustee to sell the assets back to originator if an event of default occurs or at maturity, in return for which originator is required to pay all outstanding amounts (through an exercise price) so that trustee can pay the investors.
Sale Undertaking (Wa'ad)	Granted by Trustee in favour of Originator (as Obligor)	Allows originator to buy the assets back from trustee in limited circumstances (e.g. the occurrence of a tax event), in return for which originator is required to pay all outstanding amounts (through an exercise price) so that trustee can pay the investors.
Substitution Undertaking (Wa'ad) Optional	Granted by Trustee in favour of Originator (as Obligor)	Allows originator to substitute the assets (which it may need to sell or otherwise dispose of) for some other assets having at least the same value and revenue-generating properties.

Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

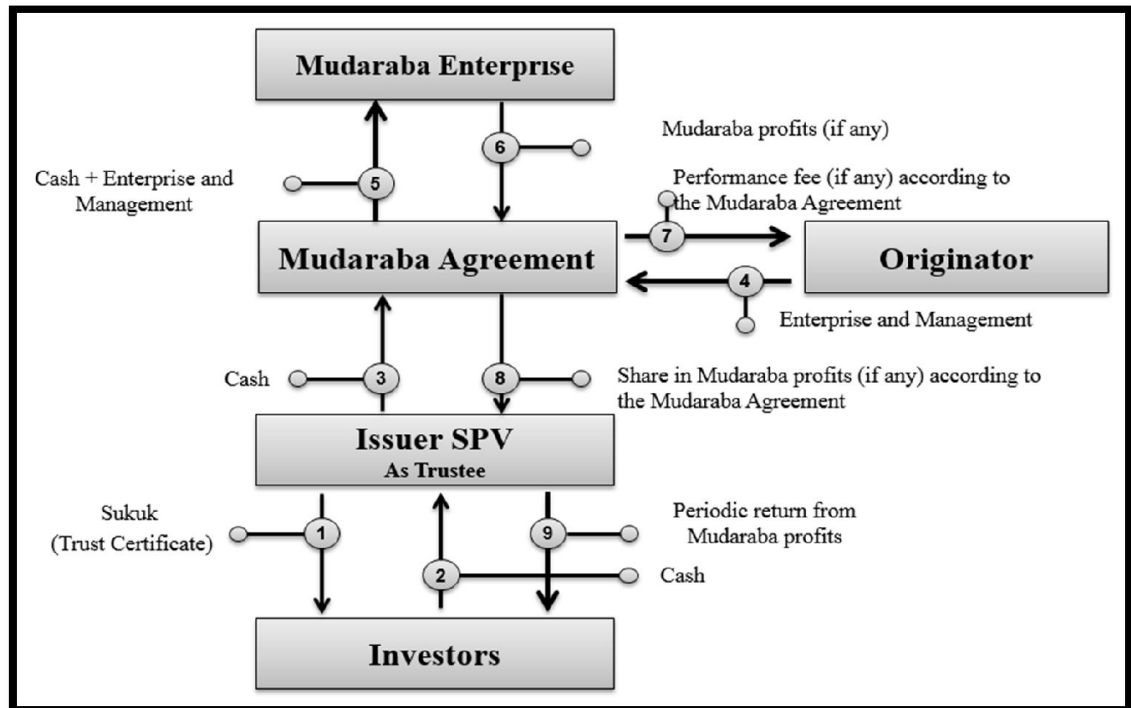
2.2.5.3.1.3 Partnership agreement based lease certificates

a) Mudaraba Sukuk (Labor-Capital Partnership) : In the Islamic finance industry, the term mudaraba is broadly understood to refer to a form of equity-based partnership arrangement whereby one partner provides capital (the Rab al-Maal) and the other provides managerial skills (the mudarib).

The same characteristics of the mudaraba structure can also be adapted for use as the underlying structure in a sukuk issuance as each investor's purchase of sukuk would represent units of equal value in the mudaraba capital, and are registered in the names of

the sukuk certificate holders on the basis of undivided ownership of shares in the mudaraba capital. The returns to the investors would represent accrued profit from the mudaraba capital at a pre-agreed ratio between the Rab al-Maal and the mudarib, which would then pass to the investors according to each investor's percentage of investments in sukuk mudaraba⁷.

Figure 2.10: Structure of sukuk al-mudaraba



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

b) Musharaka Sukuk (Capital Partnership): The term musharaka is derived from the word shirkah, which means partnership. In its simplest form, a musharaka arrangement is a partnership arrangement between two (or more) parties, where each partner makes a capital contribution to the partnership (i.e. to the musharaka), in the form of either cash contributions or contributions in kind⁸.

Essentially, a musharaka is akin to an unincorporated joint venture but may, if required, take the form of a legal entity. The musharaka partners share the profits of the musharaka in pre-agreed proportions and share the losses of the musharaka in proportion to their initial capital investment.

⁷ Kuveyt Türk Participation Bank A.Ş., 2015, Participation bank lecture notes

⁸ Kuveyt Türk Participation Bank A.Ş., 2015, Participation bank lecture notes

Musharaka arrangements can be structured in a number of different ways; however, in practice the following two structures are utilised for the purposes of issuing sukuk.

These are:

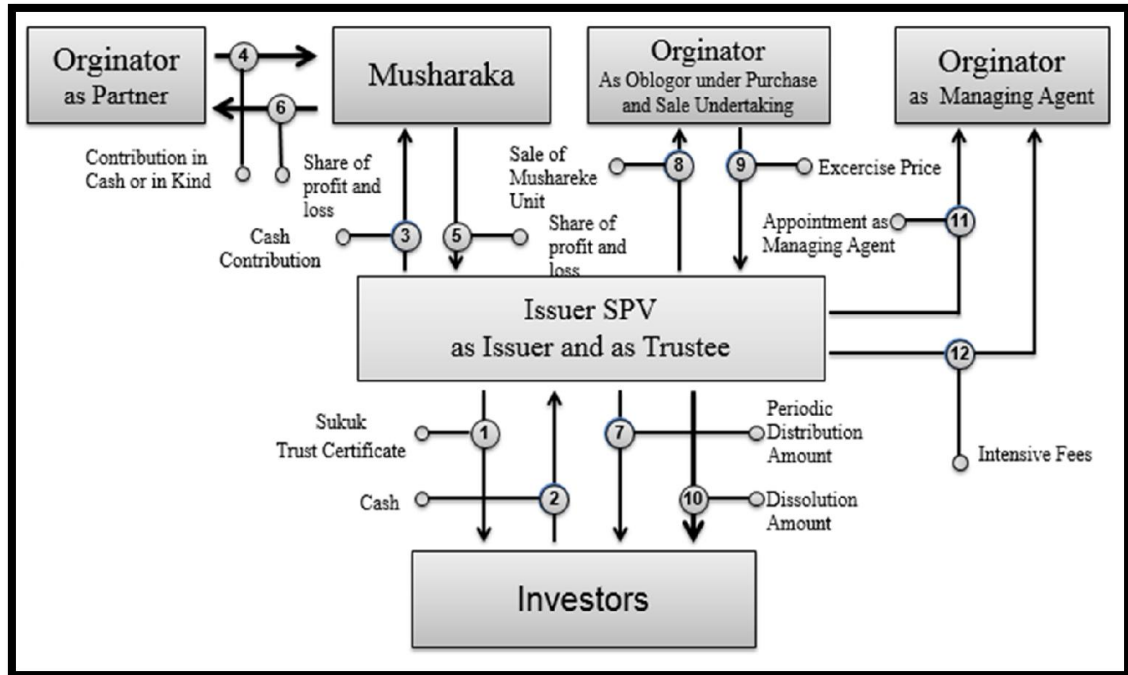
- a) Shirkat al-'Aqd – commonly referred to the 'business plan' musharaka; it is an arrangement pursuant to which the originator and the trustee agree to combine their efforts and resources (typically in the form of cash and/or other asset from the originator and the trustee) towards a common objective,
- b) Shirkat al-Melk – commonly referred to the 'co-ownership' musharaka; it is an arrangement pursuant to which either
 - (i) the originator and the trustee contribute cash to the musharaka to purchase an asset together or
 - (ii) the originator sells an ownership interest in an asset to the trustee as a result of which the originator and the trustee become co-owners of that asset.

When structuring a sukuk issuance pursuant to a shirkat al-melk structure, the first step is often to analyse what exactly the business of an originator entails and what assets (if any) are available to support the sukuk issuance. At the outset, if it is not possible to identify a tangible asset that is capable, from a legal and advisory board's perspective, of being contributed to the musharaka itself, it will be necessary to consider the shirkat al-'aqd structure.

All sukuk structures rely upon the performance of an underlying asset or arrangement in order to generate returns for investors. The musharaka is no different in this respect and can be implemented in a manner that provides for regular payments throughout the life of the sukuk, together with the flexibility to tailor the payment profile and method of calculation in order to generate a profit. These characteristics make musharaka relatively straightforward to adapt for use in the underlying structure for a sukuk issuance.

Set out below is an example of a sukuk al-musharaka structure, based upon a shirkat al-'aqd arrangement ;

Figure 2.11: Structure of musharaka sukuk



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

2.2.5.3.2 Trading function based classification

Trading based lease certificates are lease certificates issued to finance the purchase of certain assets or rights by asset lease company (ALC) in order to be sold on deferred payment basis to companies.

In the issue of trading-based lease certificates, ALC is under obligation to purchase the base assets or rights from the spot market and to resell them on deferred payment basis at a price above their cost, by no later than the business day immediately following the date of transfer of the funds collected from issuance to its account. If this transaction is not executed within the said period of time, the funds collected upon issue of lease certificates shall be refunded to investors by no later than the second business day following the date of transfer to the account of ALC.

The assets or rights on the basis of which lease certificates are issued under this article are required to be traded in Borsa Istanbul A.Ş (Istanbul Exchange) or in other liquid markets.

- i) Corporate Sukuk
- ii) Sovereign Sukuk
- iii) Convertible Sukuk
- iv) Subordinated Sukuk
- v) Stapled Sukuk
- vi) Asset Backed Sukuk
- vii) Project Financing Sukuk

2.2.5.3.4 *Asset representation based classification*

There are two different types in this category which are asset backed and asset based sukuk. Asset backed sukuk involves granting the investor (sukuk holder) a share of a tangible asset or business venture along with a corresponding share of the total risk (commensurate with this ownership).

This structure must include below items;

- i) There is a true sale transaction, where the originator sells the underlying assets to a special purpose vehicle (SPV) that holds these assets and issues the sukuk backed by them,
- ii) The buyers of sukuk don't have recourse to the originator if payments are less than usual,
- iii) A true sale implies that the assets of the issuer will not be added to the assets of the originator in the event of default and liquidation,
- iv) The sukuk holders must assume any losses in case of impairment of sukuk assets,
- v) Asset backed sukuk is, thus, closer to equity than debt, and for that reason is not so popular in the market of sukuk offerings.

Asset-based sukuk, on the other hand, involve the issuer purchasing the underlying assets and then investing, trading or leasing them on behalf the investors (sukuk holders), using the funds raised through the issued certificates (sukuk). This structure, most often, takes the guise of a sale-lease to the originator and is embedded with a binding promise (wa'ad mulzim) from the originator to repurchase the underlying

assets at maturity. In this structure, the sukuk holders can only require the originator to purchase the underlying assets. As such, the sukuk holders have an unsecured debt claim against the originator embodied in the payment of the purchase price following an execution of the binding purchase promise. This implies that sukuk holders don't have full recourse to the underlying assets and the underlying assets are not used as collateral. Asset based sukuk only grants beneficial ownership to the sukuk holders, so that in case of default, the investor would be left without any claim on these assets. In this structure, the originator typically transfers to the investors only the beneficial ownership of the SPV issuer. But advisory board stipulates a transfer of assets to sukuk holders. However, since investors have no recourse to the assets, the structure doesn't pay any attention to the asset risk, but rather concentrates on the creditworthiness of the sukuk sponsor.

As understood above text, when issueing asset backed sukuk, there will be lots of operational documents so that it will take lots of time. Because of these operations, this kind of issuance will be much more costly. On the contrary to this situation, asset based sukuk doesn't include this kind of cost. For this reason, issuers select asset based sukuk in the World. Nearly %95 of issued sukuk in the World is based on asset backed sukuk.

There are agreements which should be taken when issuing sukuk. It shows that how much issueing a sukuk

- i) Buying and selling agreements (Originator-ALC)
- ii) Repurchasing agreements (Originator-ALC)
- iii) Transferring agreements (Originator-ALC)
- iv) Rental agreements (Originator-ALC)
- v) Broker-Originator agreements
- vi) Insurance, management agreements (Originator-ALC)
- vii) Declaration of Agency (ALC-Investors)
- viii) Partnership agreements (Musharaka and Mudaraba Sukuk)
- ix) Guarantee agreements

2.2.5.4 Risks of sukuk

Sukuk is a debt instrument like securities and bonds, however; it is different from them, since sukuk is based on an asset or a project. Considering securities and bonds, since they remain uncovered, in the case of issuer default, it is resorted to issuer assets. When it comes to default, since there is no guarantee, they are more risky than sukuk. Furthermore, sukuk is issued for a real purposed job, bankruptcy can happen only because of breakdown of current conjuncture or an unexpected situation. Besides, there is an asset which is allocated to each sukuk by law. These situations make sukuk less risky than other debt securities.

The possible risks of sukuk are listed as following⁹:

- a) Macro Risk
- b) Management Risk
- c) Liquidity Risk
- d) Price Risk
- e) Exchange Rate Risk
- f) Advisory Board Risk

a) Macro Risk

Macro risk refers to financial risk that is associated with macroeconomic or political factors. There are at least three different ways this phrase is applied. It can refer to economic or financial risk found in stocks and funds, to political risk found in different countries, and to the impact of economic or financial variables on political risk. Macro risk can also refer to types of economic factors which influence the volatility over time of investments, assets, portfolios, and the intrinsic value of companies.

Macro risk associated with stocks, funds, and portfolios is usually of concern to financial planners, securities traders, and investors with longer time horizons. Some of the macroeconomic variables that generate macro risk include unemployment rates,

⁹ Şensoy, Necdet, Sukuk Prictice workbook, 2013

price indexes, monetary policy variables, interest rates, exchange rates, housing starts, agricultural exports, and even commodity prices such as gold.

Sukuk is issued by government or private sector. As it is a debt security based on an asset or a trade, it is affected by economic and political factors that affect the issuer. In case of any economic or political risks, the first effect will be sukuk price on the secondary market. In case of positive macroeconomic developments, individuals and institutions who invest the sukuk, will gain additionally capital earnings with increasing of its price. Otherwise, they can lose both rental income and a part of capital earnings. The second effect of macro risk is directly related with issuer. If sukuk is based on a project like musharaka or mudaraba, when the project faces any troubles, it affects directly sukuk price and accordingly investors. If project is not completed, investors will be faced with losing capital earnings. Investor will be right-holder on assets included by project. It means that investor faces the risk of trade. However there is no such risk in Malaysia, because yield and capital are guaranteed by trustee. On the sukuk based on leasing or asset, in the case of negative macroeconomic situations, issuer may be incapacitated become not to discharge. Investor tries to collect debts via Asset Leasing Companies (ALC). Loss in value of asset is risk for investors.

b) Management Risk

Management risk is the possibility of losing company management's talent of discharging its management functions.

If company management cannot manage the company, it can be pressed their debts not to pay back. If it cannot discharge, sukuk investors are directly affected. It resorts different methods for collection according to sukuk types. For example, for leasing sukuk, leased asset is sold and investor collects the debt with revenue from selling.

c) Liquidity Risk

Probability of loss arising from a situation where sale of illiquid assets will yield less than their fair value, or illiquid assets will not be sold at the desired time due to lack of buyers. Because sukuk is a new term in global market and especially Turkey, there is no developed sukuk market. Secondary market, which is able to increase or ignite sukuk

issuance, is not developed enough. Liquidity ratio of sukuk market cannot be compared with securities and bonds. The criterion of liquidity varies from country to country. For instance; sukuk market is so developed in Malaysia, however; the same does not go for Turkey. Because of liquidity risk, it becomes difficult that investors invest in Turkey. In order sukuk markets to develop faster and saver, it should be definitely liquid.

The reasons why market in Turkey is not liquid can be listed like following:

- i) Not taking action directly in debt securities market of Istanbul Stock Exchange by participation banks,
- ii) Existence of an intermediary between participation banks and customers,
- iii) Not be able to campaign about publicity, advertisement and sales by participation banks
- iv) Not be able Islamic mutual funds to develop enough, therefore not be able huge volume sukuk to be issued,
- v) Smaller asset size of participation banks than conventional banks, for example; size of 4 participation banks in Turkey is smaller than half of the biggest conventional banks,
- vi) Able to enter this sector by conventional banks, pension funds and mutual fund as of 2014.

d) Price Risk

Pricing secondary market lease certificate

Since traded lease certificates are based on fixed yield in Turkey, yield ratio is predetermined. When pricing these kinds of certificates, the method, which is used for fixed rate securities, is used.

Pricing treasury bond

UP= Unit Price

NV= Nominal Value

r= Interest Rate (annual)

DtM= Dates to Maturity

$$UP = \frac{NV}{1+(r*DtM/365)} \quad (2.1)$$

Example : A Treasury bond whose days to maturity is 128 has 35% of interest rate; what is the unit price?

$$UP = \frac{100,000}{1+(35\%*128/365)} = 89,067$$

Pricing bond

If compound interest rate is used, it is converted to simple interest rate. Then, interest revenue is calculated by using this simple interest rate as following:

$$\text{Bond Return} = (\text{Capital}/100)*(\text{Simple Interest}/365)*\text{Number of Days} \quad (2.2)$$

Example

Maturity Date: 06.03.2010

Today: 23.05.2008

DtM: 652

Bond Return = $(5000/100)*(15.5/365)*652 = 1384.38$

Unit prices of sukuk having fixed return like Islamic leasing or murabaha are calculated like in the example. Unit prices of sukuk based on musharaka or mudaraba are calculated in a different ways. Because these types of sukuk is based on projects, unit prices are tried to be calculated by finding today's value of their cash flows. There are two factors affecting sukuk price. One of them is changes in market rates, the other one is changes in cash flows or situation of project.

e) Exchange Rate Risk

Exchange rate risk is probability of loss caused by uncertainty created by changes of exchange rates. Probability of decrease in value of domestic currency over against foreign currency causes exchange rate risk. If there is no balance between assets and liabilities of a company, this situation generates profit or loss. In order to prevent exchange rate risk in companies using foreign currency borrowing, exchange rate can be fixed. If issued sukuk is based on foreign currency, both investor and issuer of sukuk will be affected by changes in exchange rates¹⁰. If sukuk is based on a project or enterprise partnership, probability of being affected of project by changes in exchange rate is very high. As it affects existence of project, it affects automatically issuer.

f) Advisory Board Risk

Advisory board in participation banks consists of educated people in finance and theology who check the compliance of instruments with Islamic financial principle.

Sukuk can only be issued if they are checked and approved by advisory board. All sukuk models which are planned to be issued are explained to advisory board by related working unit. Related advisory board members assess the model and process of it according to Islamic financial principle. Advisory board risk emerges in the case of withdrawal of approval (fetwa or Islamic financial principles) by board because of some reasons like misleading, misunderstanding and so on. Considering the system of Islamic banking in today's world is controversial, this risk can be emerged. We saw the most obvious example of this in Malaysia. In 2008, firstly, advisory board approved issued sukuk, however they withdrew their approval. Therefore, issued sukuk number decreased in a while. This effect can be easily seen in the graphs below. In our country this situation occurred in the Revenue Indexed Security (RIS). Because the members of advisory board withdrew the fetwa (approving) about RIS, participation banks demanded for government issued RIS have finished. The reason is that government gave guarantee to the RIS of bridges and highways and this guarantee is not allowed in Islamic jurisprudence.

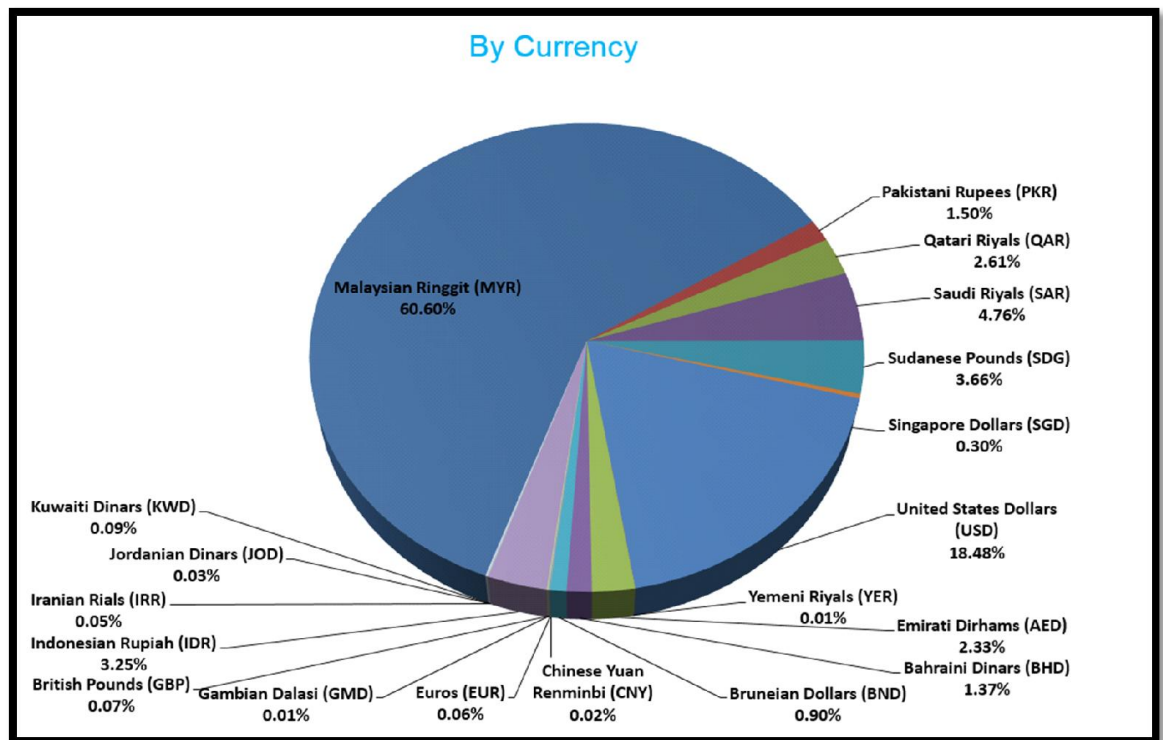
¹⁰ http://tr.wikipedia.org/wiki/Kur_riski, [accessed 15 January 2015]

2.2.5.5 Sukuk market in the world

There are 14 types of sukuk applied and supplied to markets in the world. All types of sukuk are available in Malaysia and %60 of all sukuk in the world is issued in this country. Percent 80 of sukuk issued in Malaysia and in other countries consist of murabaha, musharaka and ijara types of sukuk. Because most of sukuk is issued in Malaysia the currency of sukuk is Malaysian Ringit. Islamic banks in this country can intensively issue sukuk and hold them in their portfolios. Treasury departments of banks can easily use these sukuk in their portfolios to manage their liquidity. Every type of sukuk is issued in Malaysia and all of them is indexed upon fixed return. Hence it seems like transactions in bonds market. The reason why sukuk is issued with fixed returns is that they are guaranteed by finance companies which are in trustee structure and that they are asset based sukuk instead of asset backed structure. That's why this structure in Malaysia is heavily criticized. There are no return guaranteeing companies in Turkey and Middle East because participation banks do not find acceptable this kind of return.

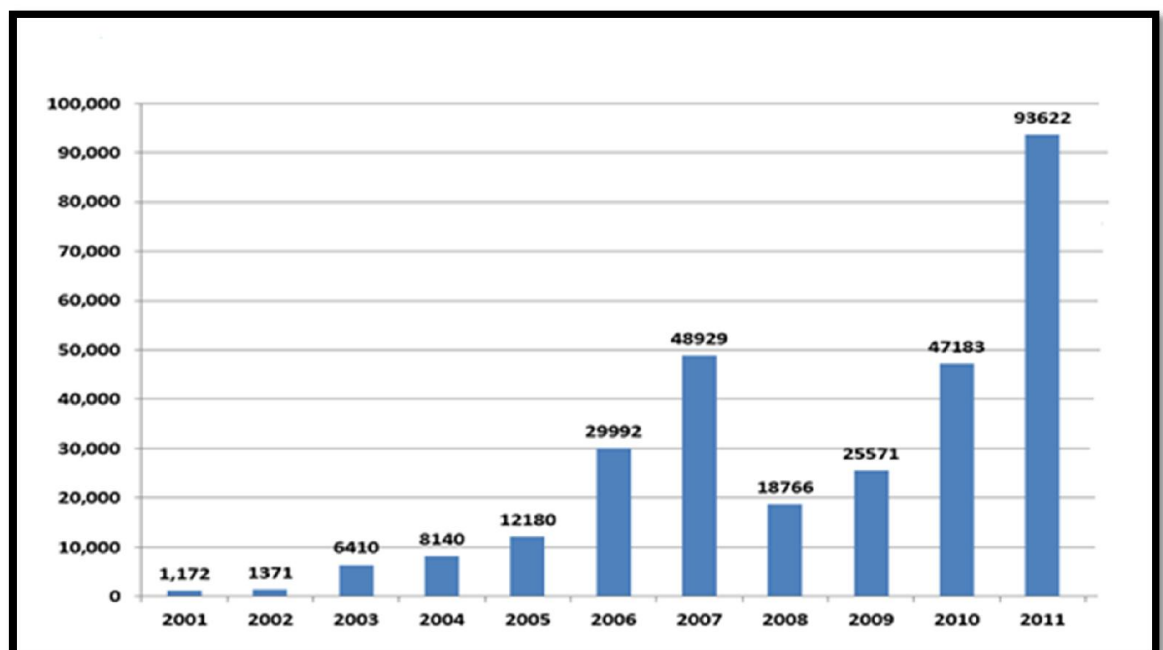
The following graphs show the data of sukuk markets in the world in 2013.

Figure 2.12: Global sukuk issues



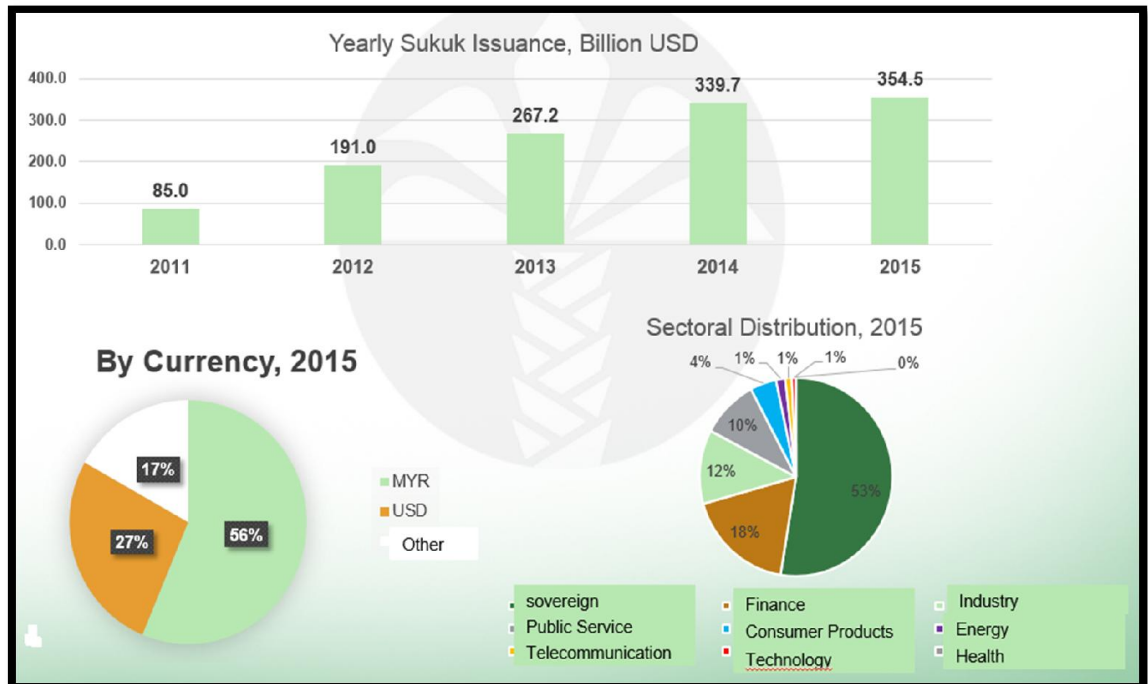
Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

Figure 2.13: Global sukuk issues (2001-2011)



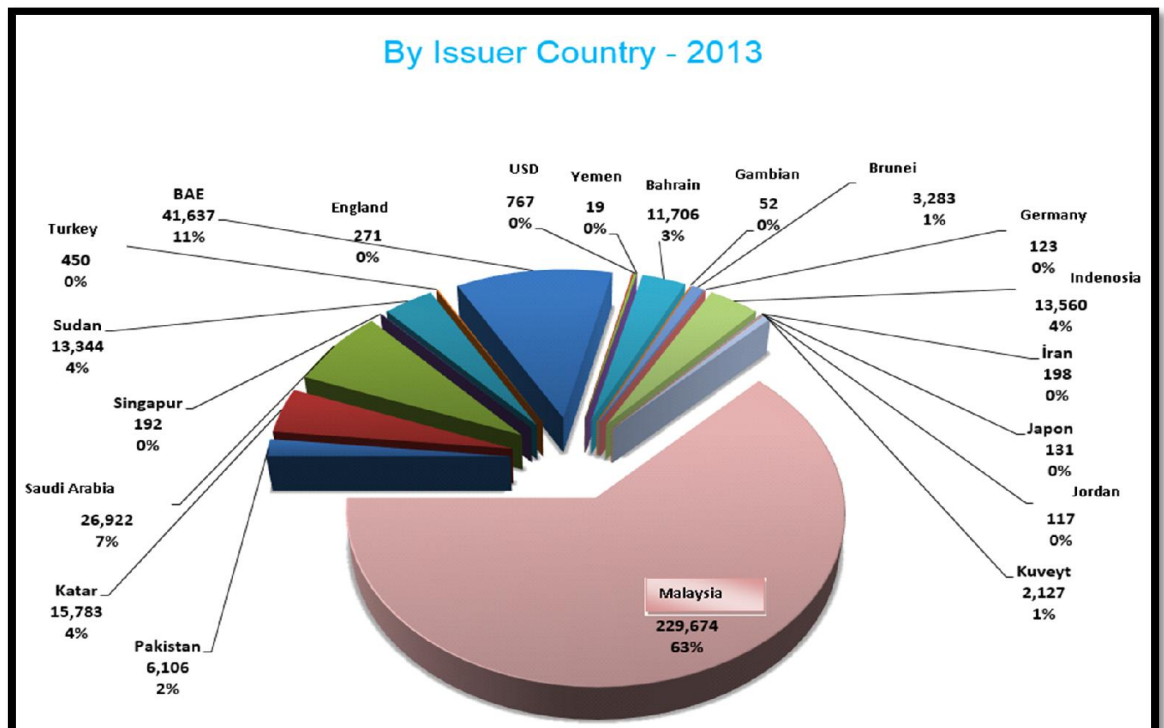
Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

Figure 2.14: Global sukuk issues (2011-2015)



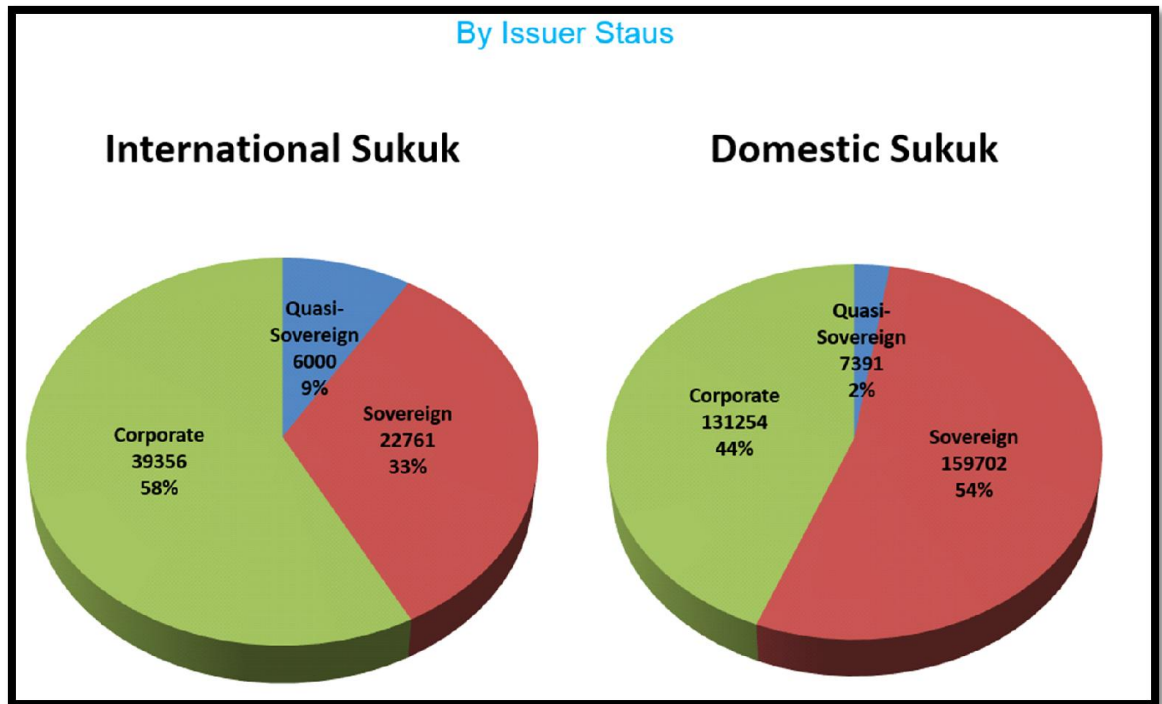
Source: Kılınc, Ragıp Ali, Kuveyt Turk Participation Bank, Investment Banking Presentation, 2015

Figure 2.15: Global sukuk issues



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

Figure 2.16: Global sukuk issues (in Malaysia)



Source: DFC (Dubai Financial Center), Sukuk Examples Workbook 2013

2.2.5.6 Sukuk market in Turkey

Capital Market Board published the first communique about the lease certificates in Turkey in April 1st, 2010. Structure of sukuk anticipated in the communique is Islamic leasing. Thanks to communique, issuing sukuk for financial institutions and firms in Turkey has been possible. With legislative regulations in January 2011, tax exceptions about sukuk are set similar to conventional bonds. In the end of the year of 2011, Kuveyt Turk Participation Bank issued the first sukuk with this new legal framework. However, sukuk market was not be able to improve because the legal infrastructure was not completely prepared; the market was so new and not known; the number of actors in this market was a few and actors were not huge enough. The market came to life with the state, as a huge actor, started to issue sukuk in 2012, and other actors have started to enter this market.

It can be said that there is reflection of the mixture of Middle East and Malaysia models in order form a special model for Turkey, with the well ranged leasing certificates

communiqué of CMB in 2013 published. Despite five types of leasing certificates are defined in the new communiqué, type of sukuk based on management contract which is one of five, contains almost the whole sukuk types in the world. Furthermore, the door was left open for approving a new type of sukuk by CMB and presenting new models to the market.

Corporates/institutions use the sukuk for providing fund from CMB on the attempt of creating liquidity opportunities for ones need the money to do a business.

Since participation banks have difficulty to find instruments as working condition, issued sukuk in Turkey mostly serve/will serve participation banks. Sukuk will be a frequently used instrument in the treasury departments and capital markets by the participation banks. In this respect, different types of instruments, based on this instrument, are building and are being brought into force.

Table 2.3: Leasing certificate issued in Turkey

Issuer	Type of Currency	Amount (Million)	Issue Date	Return	Maturity
Albaraka Turk	USD	200	07/05/2013	7.75	05/07/2023
Asya Sukuk	USD	250	28/03/2013	-	28/03/2023
Bereket Varlik	USD	350	30/06/2014	6.25	30/06/2019
Secretariat of Treasury	USD	1250	10/10/2013	4.557	10/10/2018
Secretariat of Treasury	USD	1500	26/09/2012	2.803	26/03/2018
Secretariat of Treasury	TRY	1817	21/08/2013	9	19/08/2015
Secretariat of Treasury	USD	1250	10/10/2013	4.557	10/10/2018
Secretariat of Treasury	USD	1000	25/11/2014	4.489	25/11/2024
Secretariat of Treasury	TRY	1332	19/02/2014	10.6	17/02/2016
Secretariat of Treasury	TRY	1840	01/10/2014	9.68	28/09/2016
Secretariat of Treasury	TRY	1801	18/02/2015	7.8	15/02/2017
KT Lease Certificate	USD	500	26/06/2014	5.162	26/06/2019
KT Lease Certificate	TRY	70	20/11/2014	8.77	14/05/2015

KT Lease Certificate	TRY	30	20/11/2014	9.14	19/11/2015
KT Lease Certificate	TRY	14	03/03/2015	9.35	02/06/2015
KT Lease Certificate	TRY	65	20/02/2015	9.5	08/08/2015
KT Lease Certificate	TRY	200	13/02/2015	9.50	01/06/2015
KT Lease Certificate	TRY	70	24/03/2015	8.9	02/06/2015
KT Lease Certificate	TRY	80	24/03/2015	9.72	15/09/2015
KT Sukuk Varlık Kir.	USD	350	31/10/2011	5.875	31/10/2016
TF Varlık Kirlama	USD	500	02/05/2013	3.95	02/05/2018
TF Varlık Kirlama	USD	500	24/04/2014	5.375	24/04/2019
TF Varlık Kirlama	MYR	800	30/06/2014	6	28/06/2019
TF Varlık Kirlama	MYR	150	11/02/2015	5.9	11/02/2020
TF Varlık Kirlama	TRY	60	27/01/2015	8.75	24/07/2015
TF Varlık Kirlama	TRY	80	23/02/2015	9.68	21/08/2015
TF Varlık Kiralama	TRY	100	19/03/2015	13.95	03/17/2020

Source: Kılınç, Ragıp Ali, Kuveyt Turk Participation Bank, Investment Banking Presentation, 2015

Advantages of lease certificate for participation bank

- i) The opportunities of using the fund surplus for the lowest and most profitable instruments
- ii) Steady and safe instrument which works out liquidity squeeze of participation banks
- iii) A different instrument which can be turned into cash and sold to customer when there is a need
- iv) Contributing to develop current market for setting up different type of mutual funds
- v) Reaching new customers and thanks to this, increase in volume and profit

Contribution of sukuk for the market

- i) Sukuk is a newborn important instrument for the market in order to develop capital markets. Participation banks can use this instrument to make investment funds. Especially in pension funds, this is only instrument in order to gain constant return apart from participation accounts for funds,

- ii) It will be a model and reference with every single sukuk issue for future exports of firms and institutions.
- iii) Sukuk has been a newborn area which is used in treasury and capital markets by participation banks, and therefore Undersecretariat of the Treasury can find different and long term fund. Thus, the possibility of sticking to only one source has decreased.
- iv) Sukuk is a way of accessing long term funds for banks and firms. These funds will serve the development of country by using in investment projects.
- v) Sukuk both supports production and employment, and provides qualitative financing for current deficit. On that sense, it contributes to national economy.
- vi) Sukuk has a function that attracts lots of investors from all over the world to Turkey and gives them a chance to meet Turkish assets.
- vii) Sukuk is a qualitative instrument which makes relationships between Turkish capital markets and world's ones, especially Middle East and Asia, stronger, and contributes to Istanbul in order to be finance center.
- viii) Capital markets will develop and become deeper with investment funds are composed of sukuk by pension companies, intermediaries, participation banks and commercial banks.
- ix) Customer base will expand with establishing pension companies and buying intermediaries by participation banks, and introducing capital markets to all participation banks' customers.
- x) Undersecretariat of the Treasury and Turkish companies will be able to procure long term and low sourced funds from customers in Asia and Middle East.
- xi) Fund surplus of participation banks will be kept inside country with instruments on Central Bank of the Turkish Republic and Istanbul stock exchange.
- xii) With increasing number of instruments based on Islamic banking in Istanbul stock exchange, long term and low cost funds from Asia and Middle East will come to Turkey.

2.2.5.7 Lease certificate regulations in Turkey

Capital Market Board has set up the most well rounded legal infrastructure in 2013 by publishing the communiqué about lease certificate. When CMB built the communiqué, by analyzing the examples of Malaysia and Middle East, CMB tried to produce a different type of a model. Then, when considering all other practices in the world, there is a difference between sukuk types and names in related communiqué. Furthermore, related communiqué is called as lease certificates, however actually, Islamic leasing, which is sub-branch of sukuk, is called as lease certificates. Sukuk types of Malaysia is so flexible; on the other hand, regulations in Middle East are stricter. The model, which CMB is trying to create, can be identified between these two models. If the model is flexible like in Malaysia, attracting investors in Middle East to Turkey market can be difficult. If the model is strict like in Middle East, Sukuk market will be weak because it cannot develop and expand.

Lease certificates can be issued by offering to public or not offering. The issuances by not offering to public can be classified in two types, which are private placement and selling to qualitative investor. It is necessary that lease certificates, which are offered to public, are traded at the exchange.

Valuation report has to be prepared by assessment companies in order to check the consistency between declared value of assets and real value.

With new lease certificate communiqué, there are 5 types of lease certificates, which are based on¹¹;

- a) Ownership
- b) Management Agreement
- c) Trading
- d) Partnership
- e) EPC (engineering, procurement and construction) contract

¹¹ CMB, Communiqué On Lease Certificates (III-61.1), **Official Gazzette**, 28670; 7 June 2013

or through combined use of those listed above by ALCs

Applications for approval of prospectus or issue document relating to capital market instruments, which are not cited in this article but are not included in the scope of other regulations of the Board either, and are by nature accepted by the Board as a lease certificate, will also be handled and responded by application of the provisions of this Communiqué by analogy.

Because lease certificates are new born in the market, in order to create continuity and safety in this market, CMB has added following articles to related communicate about above-mentioned certificates. With these articles, lease certificates have been a more secure financial investment instrument for investors. Moreover, these articles have a function to prevent possible misappropriation.

- i) Until redemption of lease certificates, the assets and rights included in the portfolio of an ALC cannot be disposed of for any purpose other than collateralization, even in the case of transfer of management or supervision of ALC to public authorities, and cannot be pledged, or shown as a collateral, or attached for any purpose including the collection of public receivables, or included in bankrupt's estate, or be subject to an interlocutory injunction.
- ii) Holders of lease certificates are proportionately entitled to have the revenues obtained from base assets and rights for the issuance of the certificates. If required so in the issuance process, at the end of maturity the assets and rights are sold by ALC to originator or to third parties and the proceeds of sale are distributed to lease certificate holders in proportion to their shares therein.
- iii) Lease certificates are redeemed within the frame of the principles set forth in the prospectus or in the case of sales without public offering, in the agreement relating thereto.
- iv) The measures and actions including the sale of base assets or rights to indemnify probable losses of lease certificates holders to be taken by the board of directors of ALC in order to protect interests of investors in the case of failure of fund users or third parties in performance of their payment obligations towards ALC, are required to have been set down in agreements at the stage of issuance application made to the Board.

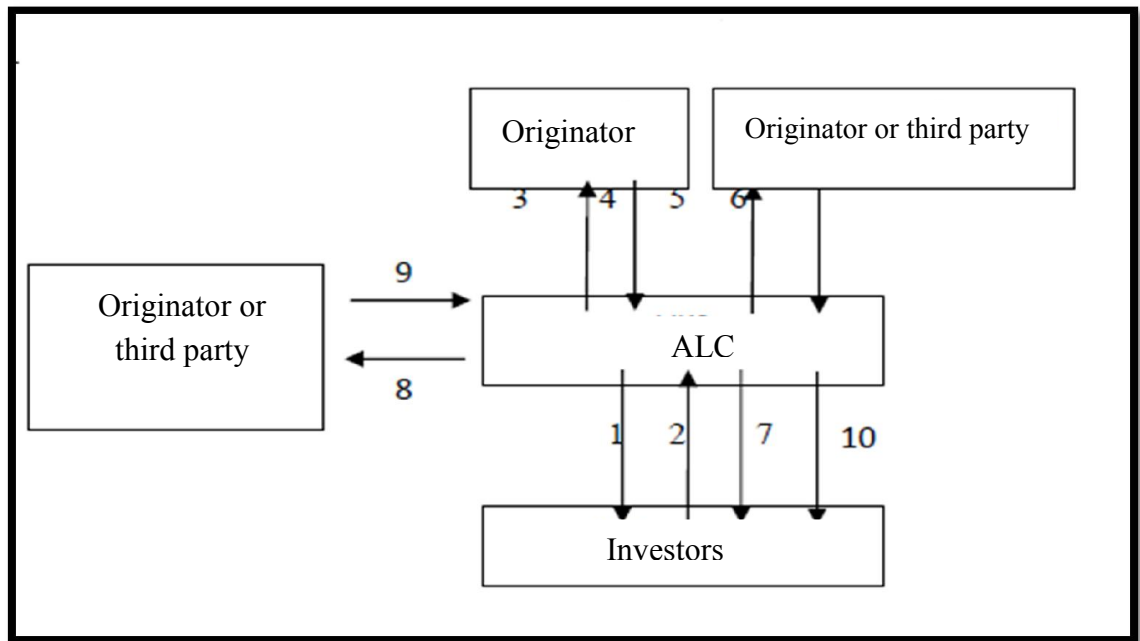
a) Lease certificates based on ownership

Lease certificates based on ownership is certificates that are issued for leasing to Originator and third parties, or being managed on behalf of ALC, in aim to finance assets and shares which are transferred from Originator by ALC.

As part of issuance, following articles have to be applied.

- i) It is necessary that arranging an agreement concerning transfer of underlying asset and share to ALC, fulfilling needed processes for transferring and in case of delinquency ALC owes directly power of appointment about assets and shares.
- ii) Issuance amount of lease certificates based on ownership cannot excess 90% of fair value which is determined on valuation report.
- iii) If underlying asset is fixed property and originator demands, right of repurchase have to be annotated on land register.
- iv) Absence of any real and personal right in defiance of lease certificate's owners, and absence of seizure and cautionary judgment on assets and shares are necessary.

Figure 2.17: Process of certificate issuance



Source: CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

- i) Issuer ALC issues lease certificate.
- ii) Investors buy certificates by paying to ALC
- iii) ALC transfers funds collected from investors to originator in aim to purchase asset.
- iv) Originator transfers the property of asset to ALC.
- v) ALC lease the asset to originator or third party until maturity of certificates.
- vi) Originator or third party pays rental payment.
- vii) ALC uses the rental payment, getting from contractor, in periodical payment to investors.
- viii) In maturity date, ALC sells the asset to originator or third party on fair value.
- ix) ALC collects sale price of asset.
- x) ALC pays principal payments to the owners of lease certificates.

It can be said that lease certificate based on ownership resembles in sukuk based on lease in international practice, concerning the features of it. Therefore, process and agreements resemble in abovementioned sukuk concerning also content. A great majority of issued sukuk in Turkey is based on ownership. This kind of sukuk can be easily purchased and sold on secondary market thanks to both pricing easily and being legitimate according to Islamic financial principle. This kind of sukuk, in which changing hands of certificate means that changing hands of asset, can be traded on secondary market. These sukuk, which are issued by state, avert instrument squeeze on liquidity management of participation banks by using actively asset and liabilities management of participation banks. With getting deeper secondary market, financial actors will use more frequent. Liquidity squeeze is one of the most important risks, which are encountered by banks. The same situation is valid for participation banks. Commercial banks manage liquidity with lots of instruments, however; participation banks have limited number of instruments. This instrument relieves participation banks on the market, and provides them to play an active role. Yet, firstly, numbers of issuance should increase, issuers should be very confidential and these instruments should reach a certain size on the secondary market.

b) Lease certificates based on management agreement

Lease certificates based on management agreement are certificates being issued in aim to transfer to ALC. In this context, an agreement, which is about managing of originator's assets and shares on behalf of ALC, is arranged between originator and ALC. Rules about generating ALC income and, calculating of it, have to be arranged.

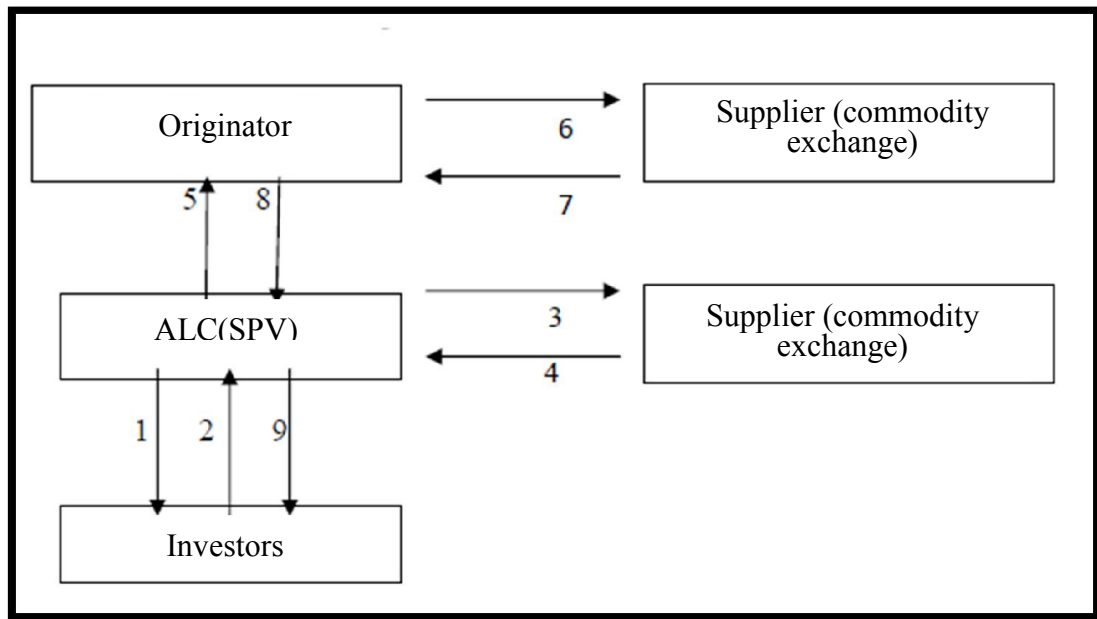
Especially in some sukuk types like sukuk based on ownership or buying-selling, processes like land registration takes lots of time because of changing hand of assets. Because of these reasons, issuance of sukuk may be delayed and expensive according to the market, it may be deterred for issuers. As the solution of this problem, the way of managing assets without changing hands can be traced instead of changing hands method. With this method, investor wanting issue sukuk can attain his goal by issuing sukuk based on management agreement. In this case, assets are not changed hands, and originator manages assets on behalf on ALC. In this way, issuer will get rid of expenses and waste of time.

c) Lease certificates based on trading

It is possible that selling a commodity to a party needing fund for the settlements on fixed profit share and, getting this party finance by selling aforementioned commodity to third parties in cash in commodity exchange. Abovementioned process can be financed by ALC with issued certificates. Certificates based on buying-selling are bills that indicate the claim.

In issuance of lease certificates based on buying-selling, ALC has to sell assets and shares for the settlements in one day after the date funds are transferred to account, at the latest. In the case of not selling these assets and shares, funds collected from lease certificate issuance are sent back to investor in two days after the day funds are transferred to ALC's account, at the latest.

Figure 2.18: Process of issuance of lease certificates based on buying-selling



Source: CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

- i) ALC issues the lease certificate.
- ii) Investors pay to ALC.
- iii) ALC buys the instrument demanded by customer from supplier, which is commodity exchange.
- iv) Supplier delivers the instrument to ALC or keeps it on behalf of ALC.
- v) ALC sells the instrument to originator.
- vi) Originator sells the instrument in commodity exchange.
- vii) Originator gets finance by collecting the sale price.
- viii) Originator pays dividend and instrument cost periodically or totally in the maturity date.
- ix) ALC pays dividends to investors periodically, and pay the principal amount in the maturity date.

This type of sukuk is called murabaha sukuk in international literature. Trading murabaha sukuk on the secondary market do not obey the Islamic financial principle. Therefore, trading these certificates on BIST debt securities market, intermediary firm and trading on OTC market can break the principles of participation banks. According

to Islamic financial principle, it is not accepted that selling an instrument without possessing it completely. Persons and institutions that buy this type of sukuk have to keep it until the maturity date. It is considered appropriately that this type of sukuk is developed for pension funds. Trading of this sukuk will not be needed since these funds do not have trouble in terms of liquidation management, considering current pension system and long maturity due. If it is needed, this situation can be tolerated by using other types of sukuk.

d) Special provisions about lease certificates based on partnership

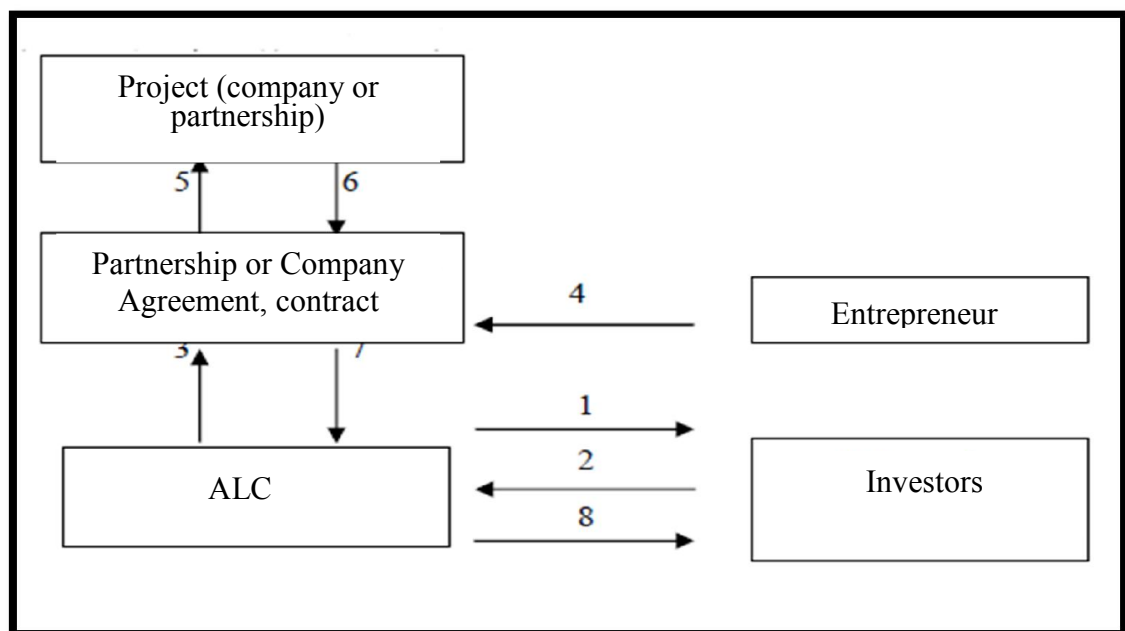
Certificates based on partnership can be issued as two types in international interest-free market. First of these is labor-capital partnership in which one side makes an effort, share its own knowledge and experience; other side is the financier of the partnership. The other type of partnership is profit-loss participations in which both sides jointly finance an investment and also face the consequences of this investment. This partnership can be both ordinary partnership and corporation. These sukuk types are based on musharaka and mudaraba, which are essential instruments of participation banks. Issuing sukuk through these instruments is made possible by CMB by law. In order to usage of these legal sukuk types, great effort should be made. It seems difficult that this rarely using instrument in participation banks become effective since it is sold as instrument in the market, number of investors in high, return is not clear and it is risky commercially. In Malaysia, there are firms called trustee, which is intermediary between issuer and investor. When sukuk is issued, return ratio is fixed by guaranteeing thanks to trustee. By this means, this sukuk can be traded in the secondary market. However this system is not applied in Turkey yet. Approving this structure by advisory committee of participation banks causes a disturbance because guaranteeing the return before the trade is not approved by Islamic financial principle.

In the law, issuance way of sukuk and regulations, which issuers have to obey to, are explained in following way. Price of issue of lease certificate based on partnership cannot excess 90% of the fair value, which is determined by valuation report. Collaborative venture can be managed by one of the partners or appointed one by partners. Arrangements about recovery of possible losses incurred by ill will of third parties, is arranged in partnership agreement, corporate or article of incorporation.

i) Labor-capital partnerships and certificates based on them¹²

This is a partnership in which one party invests capital and the other invests his experience, knowledge and effort. Investor and entrepreneur come together to run a project. In this type of partnership, all project finance is met by investor. In the end of project, gained profit is shared between investor and entrepreneur in predetermined ratio. Before the project, any fixed income is not guaranteed to any party. As long as not existing of a mistake of investor or ill will of him, in the case of project loss, all loss is met by investor. Issued certificates based on labor-capital partnership agreement means coownership and, it gives investor right to have share. The issuer of certificate gives shares of aforementioned venture's capital stock to investors by ALC. Agreement is drawn up by investors and ALC. Profit sharing rate is mentioned in this agreement. On the contract expiry, initial capital and gained profit are paid in the rate of their shares.

Figure 2.19: Issuance process of certificate based on labor – capital partnership



Source: CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

¹² CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

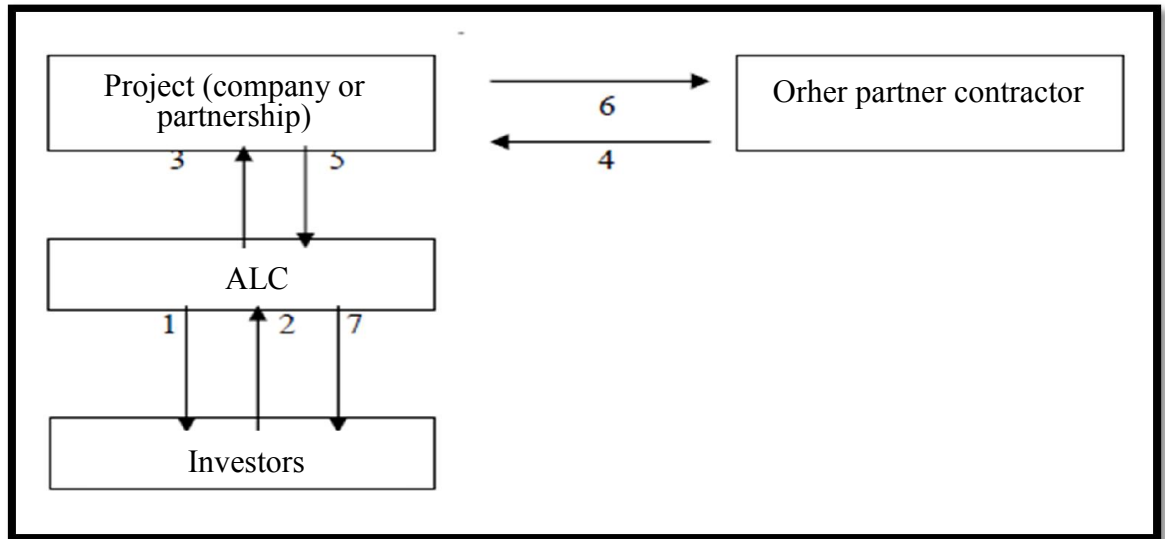
- i) ALC issues lease certificate.
- ii) Investors pay the payment.
- iii) ALC makes a joint venture on behalf of investors.
- iv) Entrepreneur puts his knowledge and effort
- v) Ordinary partnership, which represents the joint venture, is established.
- vi) If entrepreneur makes a profit, profit is apportioned between ALC and entrepreneur on stated ratio in the agreement.
- vii) ALC gets a share from profit because intermediation.
- viii) ALC pays dividends to investors periodically. In the end, assets of joint venture and share of ALC are distributed on the market price by selling by ALC.

ii) Profit/loss participation investments and certificates based on them¹³

These are agreements, in which both sides jointly finance an investment and also face the consequences of this investment as distinct from labor-capital partnership. Before the project, any fixed income is not guaranteed to any party. Profits are shared by predetermined ratio in this system. In the case of loss, all parties have to bear it on the rate of their own capitals. Certificates based on profit-loss participation investment are used to fund a current project or to establish a new one. Certificate owners are owners of projects on the rate of their shares. Profit sharing rate is mentioned in this agreement.

¹³ CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

Figure 2.20: Issuance process of certificate based on profit-loss participation investment



Source: CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

- i) ALC issues lease certificate.
- ii) Investors pay the payment.
- iii) ALC makes a joint venture on behalf of investors.
- iv) Third party invests capital and profit-loss participation investment is established.
- v) Profit-loss gained from project is apportioned.
- vi) Third party gets his share.
- vii) ALC pays dividends to investors periodically.

If third party is also manager, there can be an extra fee for him. Joint venture is liquidated in the end of project. Assets of joint venture are distributed to all parties in the rate of shares by selling on the market price.

e) Engineering, procurement and construction (EPC) contract

EPC contract-based lease certificates are lease certificates issued for the purpose of creation of works pursuant to an EPC contract to which ALC is a party as work owner.

In the issues covered by this article, ALC enters as the owner into the EPC contract in its own name and in the account of lease certificate holders. As part of EPC contract-based lease certificates issues, in addition to EPC contract, other agreements fit for the

intended purposes, such as service contract, contracts of construction in return for flats or lands, or partnership agreement may also be signed.

ALC may make the resulting works the subject matter of a sale contract either by leasing first or directly without leasing. As of the end of maturity of lease certificates, the sale price should be fully collected by ALC, and the proceeds of sale should be paid to lease certificate holders¹⁴.

The amount of issue of EPC contract-based lease certificates cannot exceed 90% of fair value determined in the appraisal report prepared pursuant to CMB communiqué.

2.2.5.8 Asset lease companies (ALC)¹⁵

Where the price of work is paid in advance by ALC, the contractor is required to establish a pledge on movables or real properties or give similar other guarantees in favor of ALC in order to ensure precise and timely completion of the work.

Principles on foundation and articles of association of ALCs:

ALCs may be founded by:

- a) Banks;
- b) Intermediary institutions which operates in any one of portfolio brokerage,
- c) Mortgage finance institutions;
- d) Real estate investment companies listed in the exchange;
- e) Public corporations included in first and second groups determined within the
- f) Companies which are granted a long-term investment grade rating upon demand
- g) Companies of which 51% or more of capital shares are held directly by the general custody services or underwriting activities; frame of Board's corporate

¹⁴ CML, Licensing Workbook, Capital Market Instruments 1, 2015, www.spl.org.tr

¹⁵ CMB, Communiqué On Lease Certificates (III-61.1), **Official Gazzette**, 28670; 7 June 2013

governance regulations; in the currency which the issue is denominated ; and Undersecretariat of Treasury.

However, founders listed in sub-paragraphs (d), (e), (f) and (g) of this first paragraph may found an ALC only for issues of lease certificates where they are the fund user. This is specifically stated in the ALC's articles of association.

- i) ALC may not engage in any commercial activities other than those specifically listed in its articles of association approved by the Board, and may not encumber its assets and rights by any real right or pledge established in favor of third parties except for those specifically permitted by its articles of association, and may not dispose of these assets and rights to the detriment of interests of lease certificate holders. Furthermore, ALC may, under any name whatsoever, not borrow credits or loans, and not use its assets and rights for any purpose other than performance of operations listed in its articles of association.
- ii) It is required to receive prior consent of the Board for articles of association of ALC.
- iii) ALC's becoming a party to merger and split-up transactions, and amendments to its articles of association; and a person's becoming a shareholder of ALC by directly or indirectly acquiring shares representing 10% or more of the capital of ALC, or share acquisitions as a result of which a shareholder's shares exceed 10%, 20%, 33% or 50% of capital of ALC, or share transfers as a result of which a shareholder's shares fall below these thresholds; and transfer of shares giving managerial or voting privileges, regardless of the share ratio thereof, are subject to a prior consent of the Board.
- iv) Transfer of shares by a person which directly or indirectly does not reach or remains between the rates of capital of ALC, as specified in third paragraph hereinabove, will be reported to the Board within 15 days following the date of transfer.
- v) An ALC which has not filed an issuance application to the Board within one year following the date of approval of its articles of association, is required to file an issuance application, or change its fields of business, or decide to be

dissolved and start liquidation proceedings, within one month following the end of the said period of one year.

ALC's management and documentation and recording systems

ALC is responsible for obeying the rules stated on lease certificates communiqué, when issuing lease certificates¹⁶.

- i) The assets and rights on the basis of which each tenor of lease certificates is issued, and the revenues obtained and the costs incurred thereof, are separately monitored on the accounting records of ALC on the basis of the relevant lease certificates.
- ii) Assets, rights and liabilities included in the financial position statement of ALC are grouped under the relevant rank of lease certificates, and are sequenced according to the liquidity principle, and are reported with the tenor of lease certificates with the closest redemption date being at the top. In the comprehensive income statement of ALC, income and expenses of each tenor of lease certificates are reported in a separate group.
- iii) In order to issue lease certificates and to realize base transactions of issue, ALC should enter into the required agreements with fund users.
- iv) If and when fund user and ALC founder are the same person in the case of issue of lease certificates, the material base transactions thereof, including, but not limited to, sales of assets and rights, or realization of assets and rights pledged in favor of lease certificate holders, may be executed only if and to the extent the independent director or directors have affirmed the decision relating thereto. The responsibility of such decisions is borne by ALC board of director.
- v) ALC board of directors is responsible for making collections from assets and rights, and for payment of these revenues to lease certificate holders in proportion to their shares.
- vi) ALC may only make expenditures required to be incurred for issue of lease certificates, and performance of base transactions of issue, and continuity of its activities and operations pursuant to the applicable laws. Accordingly,

¹⁶ CMB, Communiqué On Lease Certificates (III-61.1), **Official Gazette**, 28670; 7 June 2013

ALC cannot incur expenditures in conflict with arm's length principle. The responsibility of expenditures is borne by ALC board of directors.

As is also understood from articles, assets procured for issuance of each sukuk, are separately recognized and traced. In this way, every sukuk issued by ALC will be independent from each other. It is prevented that possible clashes of interests between ALC and investors. With communiques prepared by CMB, it is tried that guaranteeing the investors and preventing the abusing of issuers.

2.2.6 Open Market Operations with CBRT

The CBRT, with an aim to effectively regulate the money supply and liquidity in the economy within the framework of monetary policy targets, may conduct open market operations such as outright purchase and sale of securities against Turkish Lira, purchase and repurchase, lending and borrowing of securities and lending and borrowing of Turkish Lira deposits, and act as an intermediary in these operations¹⁷.

Open market operations to be carried out by the CBRT and their procedures and conditions as well as the instruments bearing high liquidity and low risk levels that are subject to open market operations are determined by the Bank.

With open market operations, Central Bank aims to affect that:

- i) The banks' reserves,
- ii) Monetary base and money supply,
- iii) Interest rates and,
- iv) Credit institutions.

Lease certificates on open market operations

CBTR open market operations are performed by preparing agreements which is agreeable to conventional banks via sovereign securities. That is why participation

¹⁷ <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+TR/TCMB+TR/Main+Menu/Piyasalar/Acik+Piyasa+Islemleri>, [accessed 2 January 2015]

banks cannot establish a market presence until 2013. With the regulations in 2013, participation banks have had a very important instrument for the sake of solution of liquidity problem. Starting to use this instrument with lease certificates means that lease certificates are so improver instrument for participation banks.

In order participation banks to use this instrument in accordance with their own principles:

- i) A new CBTR open market operations order and frame contract, which is in accordance with participation banks' principles, was prepared.
- ii) CBTR open market operations practice direction was changed.

All new changes have been inserted the current CBTR open market operations practice direction. Participation banks wanting to enter the CBTR open market operations can perform this operation by accepting to obey the CBTR open market operations practice direction. They must sign agreement of open money market operation which has special section for participation bank in their OMO documents¹⁸. When examining the changes in directions and operations, all inscriptions about interest have been abrogated. Agreements have been arranged in order to make real buying-selling lease certificates. Withdrawal right is also a way out as in forward transactions in this product. In this case, the right belongs to CBTR. Since all these transactions are real, they have to be recognized.

Benefits of CBRT open market operations for participation banks

- i) The need of saving huge amount of liquidity will decrease with opportunity of providing liquidity from CBTR.
- ii) New sukuk investments will get easy.
- iii) Lease certificates on portfolios of participation banks will be used on CBTR open market operations in case of liquidity need.
- iv) These operations will provide convenience to asset-liability management of participation banks.

¹⁸ http://www.tcmb.gov.tr/wps/wcm/connect/a9a7f10c-f7bc-4f5d-bcdc-5a50cc84a713/20141022_AP%C4%B0_Talimat%C4%B1.pdf?MOD=AJPERES, [accessed 28 January 2015]

- v) Participation banks will have a chance to arbitrage by profiting the difference between ratio of CBTR and ratio of market yield ratio.

2.2.7 Buying and Selling Sukuk with Repurchase Agreement (Repo)

This can be technically explained as a method of creating short-term fund. Seller sells his securities by undertaking to buy in a fixed price agreed upon at the forward date. The aim of exchanged securities is providing guarantee for saver. Therefore, properties like government bonds, treasury bonds, and revenue sharing certificates are preferred as guarantee. Repo is sales agreement according to law of obligations, account and instrument created fund according to banking law, short-term investment according to saver.

Securities which can be used in repo are government bonds, treasury bonds, bank bills, bank guaranteed bills, debt securities issued by state partnership administration and mass housing administration, publicly-traded debt securities except for asset backed securities. Besides, stock shares have been started to use in Istanbul Stock Exchange. Securities are stored on CBTR block accounts or Istanbul Stock Exchange. Instead of delivering treasury bonds and government bonds, a receipt is made out. In the maturity date of repo, the customer delivers the receipt and the amount is paid him in cash. Two methods are applied in order to calculate the amount on the maturity date:

- i) By using interest rate, adding interest
- ii) Considering current conditions, forecasting the price of treasury bonds on the maturity.

This instrument is not be used by participation banks. First reason is that there is no market fulfilled the participation banks' principles. The second one is the necessity of setting up a infrastructure to being over the counter market. Participation banks plan the market to enter in force in September 2016 within the scope of the project of Istanbul stock exchange and, settlement and custody bank. The market will be different from current repo market. This topic was covered in 2.2.8 Promissory of Transactions of Lease Certificate.

In order transactions to be made on over the counter market, there has to be enough lease certificates on the portfolio of participation banks. Funds can be created by selling these certificates to customer on condition that repurchase. Withdrawal right belongs to participation banks. In order operations to be performed, participation banks have to be a member of central registry agency and, set up infrastructure of securities. It is planned that this infrastructure will be set up in 2015-2016. Thanks to this, participation banks can perform operations like repo. Customers' liquid assets will be made use of thanks to this. Participation banks will reach to needed liquid with this product/market. However, advisory board prefers that these operations are performed if required, it should not be widespread.

The process of undertaken transactions of lease certificates is following:

- i) All public and private certificates on the portfolio of participation banks can be issued.
- ii) Customer buys a certificate about the agreed price from participation banks via cash in hand. At the same time, certificates are transferred from Takasbank or Central Register Agency in the name of customer. Transferring certificates means that customer undertakes to repurchase on the maturity. With repurchasing, certificates are transferred back to participation banks. Customer makes profit as much as difference between purchasing price and selling price.
- iii) Withdrawal right belongs to participation banks. On the maturity, they can use this right.

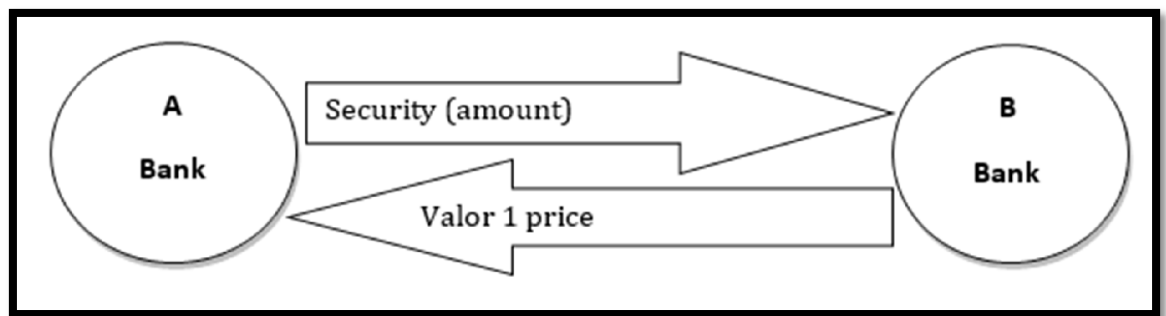
2.2.8 Commitment Transactions of Lease Certificates

Since participation banks cannot use market of current repo and reverse repo, they use murahaba method to appreciate advantage liquidities. With lease certificates issuance of Undersecretariat of the Treasury, participation banks were paved the way for appreciating their liquidity on the domestic market. However, in order participation banks to use lease certificates in like repo markets, following model which is approved by 4 participation banks and advisory board in 2014, has to be used.

The Model of trading lease certificate

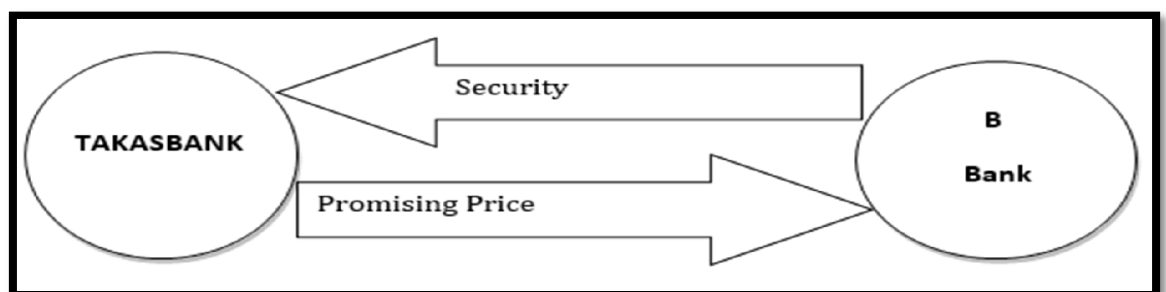
Participation banks having liquidity problem meet cash need by selling certificates on their own portfolios to another bank having cash in hand.

Figure 2.21: Commitment transactions of lease certificates- first phase



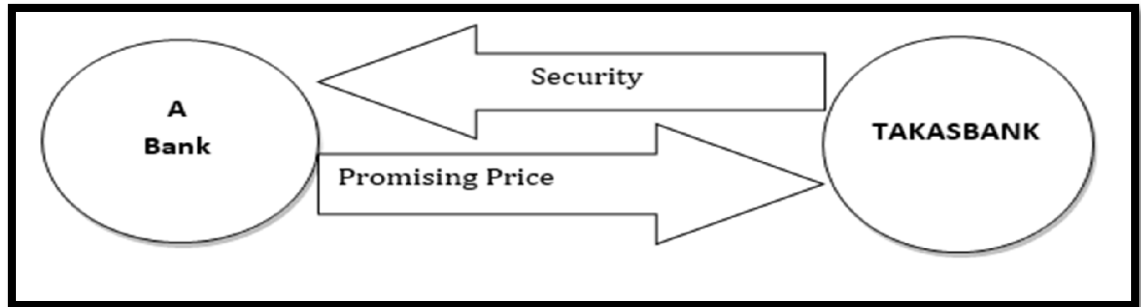
B Bank purchases lease certificates from A bank. The operation of purchasing is real sell and buy. B Bank pays to A bank. A Bank hands the certificates over. The process is performed within the frame of Istanbul Stock Exchange bartering rules.

Figure 2.22: Commitment transactions of lease certificates-second phase



On the second phase, settlement and custody bank purchases the certificates on the predetermined price, and pays to B bank.

Figure 2.23: Commitment transactions of lease certificates- third phase



A Bank repurchases the certificate by paying the predetermined amount and settlement and custody bank transfers it to account of A bank.

Operation procedures

The bank having lease certificate and needing cash, which is A bank, enters the value of purchasing and selling to the screen. Opposite parties do not know who enters these values. The parties know each other after the transaction is realized. On the other hand, the bank having cash and wanting to purchase lease certificate, which is B bank, enters the own value on the screen.

Pricing of lease certificate

Parties determine the price between each other according to market price. After determining price between the parties, Istanbul Stock Exchange can demand additional assurance about a certain percentage of trading size. There are 3 conditions that have to be fulfilled. First one is when transaction is performed; certificates have to be transferred to the other party's account. Second one, all transactions have to be recognized. Lastly, transactions have to be performed in accordance with participation banks' principles. It is planned that the market in September, 2016 by setting up the infrastructure of market designed in this model. Enough amount of lease certificate should be issued in aim both conventional banks and participation banks to use affectively this model. This model will serve well participation banks. Since they cannot open participation account shorter 30 days, they cannot appreciating the assets of retails and corporations especially in less than one month. Participation banks will serve a new instrument to customer, wanting to appreciate their liquid assets with short-term lease

certificates funds or money market funds, thanks to this market. In this way, participation banks can both attract new customers and take a big step with the aim of increasing the share of themselves on the banking and capital markets. For instance, companies, whose daily revenue is TL 1 million, want to appreciate cash in hands. Because of cash flow volatility, it seems difficult that they invest longer than 30 days. Therefore, they use their money by creating an overnight deposit or by purchasing liquid funds. In this way, they can gain a high amount of yield. When we consider they appreciate their 1 million TL with yield ratio of a year repo which is 7.5 percent since January 2015, they will gain TL 75,000 of yield which is a huge amount. Thanks to this yield, their bargaining power will be got stronger by undercutting their goods. Because of this, high revenue companies can rarely work with participation banks. With this instrument, market share of participation banks on corporate and business sector will increase. Paying dividend in a period shorter than 30 days will both cause a difficult situation in current trading conditions and make participation banks familiar with conventional banks. However, in today's high inflation period, managing daily funds is an inevitable situation. Since money loses in value in current inflation rate. Companies and individuals demand to appreciate their assets in aim to prevent loss. As long as the amount, this is used for valuation, increases, amount of possible profits and loss also increases. There is no instrument fitting this usage. Above mentioned model will seem as a solution for this situation and agreed model by advisory boards of participation banks.

2.2.9 The International Islamic Liquidity Management Corporation (IILM)

IILM was set up in aim Islamic banking to make liquidity management easy and find new instruments. CBTR was a shareholder of IILM on 25 October 2015 by signing the treaty establishing IILM. Other shareholders of it are central banks of Malaysia, Indonesia, Luxemburg, Nigeria, UAE, Kuwait, Qatar and Mauritius and, Islamic Development Bank.

With sukuk issuances of IILM, it is aimed that integration of Islamic banks to current financial system by making liquidity management easy, creating a riskless indicator for

pricing and, creating an increase in the depth of financial markets. In this context, it is expected that accepting sukuk issuances of IILM on the interbank borrowing as guarantee, trading them on secondary market by financial institutions, accepting them on short-term finance provided by Central Banks as guarantee, accepting them as reserve investment instruments of central banks¹⁹.

IILM sukuk is issued as short term and dollar denominated with high credit rate (S&P: A1). On that sense, IILM sukuk is the only one which is short-term, high credit rate and issued based on public assets.

Benefits of IILM

- i) In the periods of crisis, making liquidity management of Islamic financial institutions easy,
- ii) Encouraging regionally and globally integration of Islamic interbank markets,
- iii) Promoting competitive capacity of Islamic financial institutions,
- iv) Creating a riskless indicator for pricing with regular issues,
- v) Helping to development of domestic Islamic interbank markets.

Sukuk Issuance of IILM: IILM issued first 3 month maturity sukuk, whose worth is USD 490 million on August 2013; second one, whose worth is USD 860 million on January 2014. First sukuk is renewed on November 2013 and February 2014.

Table 2.4: Primary dealer banks on issuance

Issuance Date	Primary Dealer Bank
26 August 2013	1. Standard Chartered Bank 2. Kuwait Finance House 3. KBL Private Bankers 4. Al Baraka Turk 5. National Bank of Abu Dhabi 6. Qatar National Bank 7. Malayan Bank Berhad (Maybank)

¹⁹ CBRT, IILM Presentation, 2014

26 November 2013	1. Standard Chartered Bank
20 January 2014	2. Kuwait Finance House
25 February 2014	3. KBL Private Bankers
	4. Al Baraka Türk
	5. National Bank of Abu Dhabi
	6. Qatar National Bank
	7. Abu Dhabi Islamic Bank
	8. Maybank Islamic Berhad
	9. CIMB Islamic Bank Berhad

These kinds of instruments are much-needed in order Islamic Bank to manage easily their liquidity. However, since there are lots of Islamic banks, needing this instrument, demand exceeds the supply. One other factor is that not creating liquid assets domestically-denominated because the instrument is dollar-denominated.

It can be said that liquid instruments domestically-denominated have not developed except Malaysia. There is low possibility that Commodity murabaha method based on palm oil, which is used in order to solve Islamic liquidity problem in Malaysia, is not accepted and applied in Middle East and Turkey, because this method is called as trick sales. Mentioning this method briefly, two parties come together in an organized market, which is based on palm oil, not platinum. They sell the product and undertake to repurchase it at the agreed date. This method is not accepted by Islamic financial principle. Since dual structure is not accepted by Turkey and Middle East, abovementioned interbank model was built.

2.2.10 Wakala

Wakala is an Arabic term. It is derived from the term of ‘appoint’. In this system, one party deputizes the other one. First party who deputizes is client, the other one is agent. Client sends liquidity to agent in order to invest. According to agreement, client wants to get a profit at the maturity. Because the yield is not guaranteed, Wakala is accepted

by Islamic financial principle. In agreement, two type of yields are mentioned, which are expected yield and generated yield. Dividend ratio is calculated as the following:

Expected Yield: EY

Generated Yield: GY

If $EY < GY$, dividend is EY.

If $GY < EY$, dividend is GY.

If $EY = GY$, dividend is equal to EY and GY.

If $GY < 0$, negative dividend ratio is applied.

Example:

Money Invested: TL 100,000

Effective Date: 1 January

Maturity Date: 31 January

Period: 31 days

EY: 5%

GY: 5%

Agent expense: TL 100

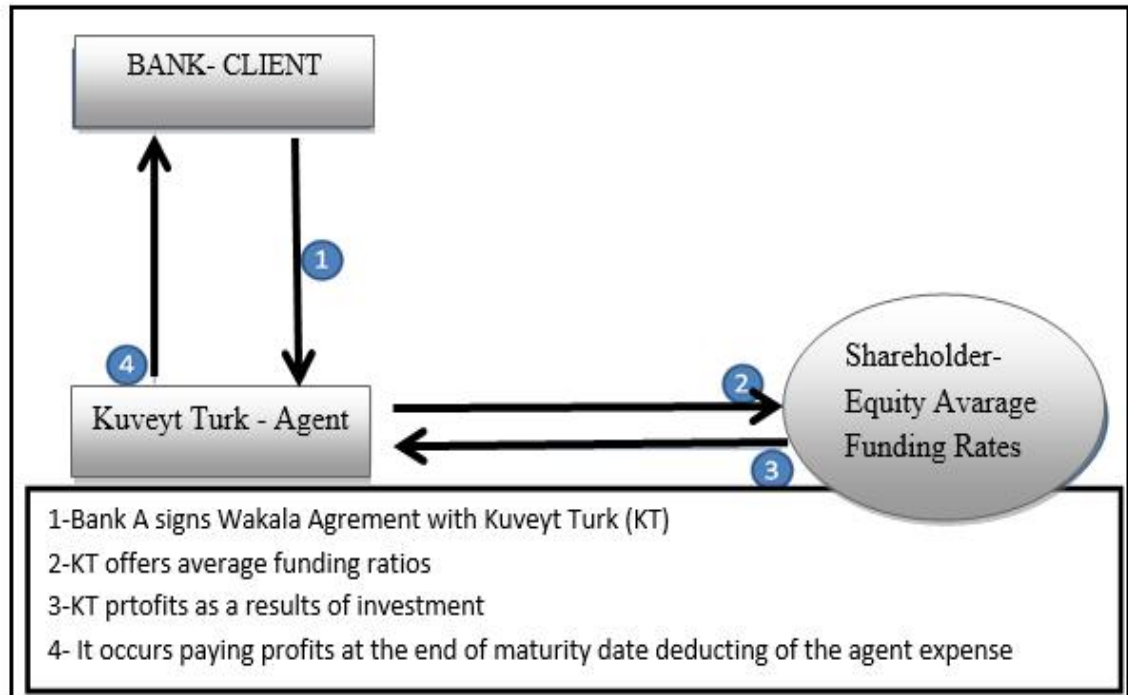
Agent expense is paid at the maturity.

Amount paid at the maturity = Money Invested + (Money Invested * EY * (Period/360)) -

Agent Expense = $100,000 + (100,000 * 5\% * (31/360)) - 100$

= 100,330.56

Figure 2.24: Graphically display format of wakala



Source: Torlak, Övgü, Kuveyt Turk Participation Bank A.Ş, Treasury Workbook, 2014

Wakala is an essential and alternative way to manage liquidity excess. It gives client long-term financial planning opportunity. It is used in interbank transactions, asset management, mutual funds and syndications. It is commonly used in the Middle East especially in interbank borrowing. In Turkey, participation banks can use it only interbank transaction with banks abroad. In order participation banks to use it in Turkey, legislations have to be changed and participation banks should set up an appropriate infrastructure. All accounts should be traced separately. Profit and loss should be registered separately in each customer's account. Fund collecting by Wakala can be used in limited customers in number as applications of funds. If wakala is used by all customers and payments are paid based on predetermined price, participation banks functionally resemble to conventional banks, since conventional banks guarantees yield based on predetermined ratio. However, in the case of applying on interbank transactions and limited number of customers, it will be useful for participation banks in aim to solve some problems like liquidity management and fund management.

3. FOREIGN EXCHANGE MARKETS

3.1 GENERAL DEFINITIONS

They are organizational structures which make possible to buy or sell foreign currencies and exchanging two different foreign currencies. In other words, it is a market which supply and demand of foreign currencies meet in there. Foreign Exchange Markets functioning "Intermediary of Purchasing Power" , easy access of credits and hedging.

Features of FX Markets

- i) Buyers and sellers don't encounter directly in FX Markets.
- ii) FX Markets doesn't like a Stock Exchange Markets.
- iii) FX Markets are built by huge banks.
- iv) Contracts can be arranged according to customers in FX Markets.
- v) FX Markets are global markets.
- vi) FX Markets can be accessible all times.
- vii) FX Markets are close to perfect competition markets.

Actors of FX Markets

- a) Banks and non-bank financial organizations
- b) People and firms making foreign trade and foreign investment
- c) Speculators and Arbitrators
- d) Central Banks and Treasuries
- e) Brokers
- f) Traders avoiding inflation

Interbank Market: This market consists of transactions between banks in order to close out their positions. This is called as "interbank FX Market" and "Interbank of Foreign Exchange". If a bank sells foreign currency less than it buys, FX reserve will increase.

This means open/long position. If banks buy Foreign Currency less than it sells, it means open/short position.

Retail Market: It consists of transactions which are done by between customers and bank and non-bank financial institutions.

FX Markets unit, which is under the treasury department in participation banks is ;

- i) Managing FX Asset risk
- ii) Provide convenient level for FX positions of banks
- iii) Selling or buying foreign currency and precious metals with other banks
- iv) Determine prices of commodities and foreign currencies for customers
- v) Making profits via arbitrage and positions

As wrote above, participation banks make foreign currency transactions depend on spot transactions except derivatives because spot transactions look suitable according to Islamic financial principle. So, Islamic banks are very active in spot foreign exchange markets. However, due to Islamic financial principles, Islamic banks cannot make derivative transactions except forward. Forward is done by certain banks and customers with limited numbers. Participation banks are also doing swap which has two transactions. First transaction is spot sale and, second transaction is forward buy. These two transactions have to be done separate and arranged in different contracts. In addition, it is done for between banks and big institutional customers.

3.2 FX MARKET INSTRUMENTS

- a) Spot FX
- b) Forward
- c) Forex Markets
- d) Precious Metals
- e) Treasury Platforms

3.2.1 Spot FX Markets

The amount of domestic currency in exchange for foreign currency is delivered simultaneously in Spot FX Markets. Transaction date and due date are different in Money Markets and FX Markets because of geographic timezone. Trade of foreign currency is not physical, it is done by correspondent accounts. Delivery date is after two dates from transaction date.

- i) FX Rate: In general expression, price of foreign currency is called as FX Rate or rate of exchange. In other words, it is the rate of exchange between domestic currency and foreign currency.
- i) Direct Quotation: FX Rate is the amount of domestic currency for one unit foreign currency. 2.05 TL/dollar, 1 dollar = 2,05 TL (European Method) Turkey use this approach.
- ii) Indirect Quotation: FX Rate is the amount of foreign currency for one unit domestic currency. 2.05 TL/dollar, 1 TL = 0,49 Dolar (American Method)
- iii) Cross exchange rate: In domestic markets, exchange rate of two foreign currency is cross exchange rate. Euro/\$ = 1.33
- iv) There are two FX Rates bid rate and ask rate, former is lower than later. Difference consists profit and cost of banks.
- v) Spread is the difference between ask rate and bid rate. It should showed annually and in percentages to compare with other rates.
- vi) Pip is generally used for spreads. 1 pip = 1/10,000 or 0.01%
- vii) Fourth digit after comma is pip
- viii) Fifth digit after comma is fractional pip

Base currency and pair currency

One currency is always dominant in every currency pairs. It is called as the base currency. Base currency is the first currency in a currency pair. It is also constant when determining exchange rate.

Euro always dominates global currencies. EUR/USD, EUR/GBP, EUR/CHF, EUR/JPY, EUR/CAD, etc. Second currency according to dominance is Sterling. USD is third one.

Knowing base currency is important when making trade with a foreign currency since it determines value of foreign currencies. Pair currency is the second currency in a currency pair.

Factors affecting exchange rate margin

- i) Transaction Volume
- ii) Stability of FX Markets
- iii) Margin broadens in effective markets
- iv) Exchange rate between banks and exchange rate for customers are different
- v) Financial positions of institutions
- vi) Untidiness of FX Markets

Exchange rates in markets are nominal exchange rates. In that, the value of foreign currency according to domestic currency or vice versa. Real exchange rate derived from according to domestic and foreign inflation.

$$\text{Real exchange rate} = \text{Nominal exchange rate} \times (\text{foreign inf.} / \text{domestic inf.}) \quad (3.1)$$

Arbitrage in the exchange market

Arbitrage is generally defined as the practice of buying and selling of economical assets such as stock shares, foreign currency, commodities or output factors in order to make profit out of the differences in their price in different market at the same time.

- i) Securing gains out of the differences in exchange rates of currency in different markets in the same time.
- ii) Buying currency from the lower value market and selling it to a more expensive one can bring profit. This is called spatial arbitrage (geographical arbitrage)

- iii) Arbitrage executed over cross exchange rates is called three pointed arbitrage
- iv) The arbitrage in the cases where there exists a rate margin, where buying and selling margins are different than zero is called arbitrage on marginal arbitrage.

The terms and definitions listed above do neither constitute of any judicial issue nor open the way to debates the participation banks use them as such. What is vital to Islamic banking regarding spot markets is that the currency or the asset under process should be bought and sold simultaneously. Additionally all the commodities under process should be physically received or a record of the receipt should be given. Also all the practice in spot markets should not include any manipulation-driven selling and buying of assets. If these conditions are fulfilled the participation banks may normally conduct their activity in the spot market. The margin of buying and selling in the spot exchange rate should be determined by the bank itself. If the cited margin is too high the probability that it will not work in the market is high too. If the margin is too low, the increase in demand will make the bank not able to create the supply or to offer the planned service. That's why the margin that the bank decided upon is generally in accordance with the market. The real difference between these markets spots in derivative products.

3.2.2 Forward

Forward is defined as a pre-agreed contract between parties in order to decide the price and value of an asset that will be received in the future. Forward contract are practised in order to avoid fluctuations in price. They are made between two parties, the selling and the receiving party. They decide upon the value, price and maturity of the exchange.

Advantages

- i) Control over exchange rate risks.
- ii) It avoids the fluctuations in foreign exchange rate in case of import export, maturity or cash proceeds by determining the exchange rate in advance.

- iii) It avoids the risk of unexpected changes in profit rate of cash.

The difference of future delivery method is that the agreement and contract of the exchange is done in the present day while the receipt of the currency and the amount of money in the pre-agreed price is done in a future moment. The rate applied in these future delivery agreements is called 'forward rate'. Forward rates are generally referred in comparison with spot rates. If the forward rate is higher than the spot rate the difference is called forward premium. If the opposite is seen, the forward rate being lower than the spot rate then the negative difference is called forward discount. In case they are equal flat rates are imposed. The interest parity theory decides that the differences between forward rates and spot rates, or premium and discounts are equal to the interest rates of the countries in question. The theory holds that the currency of the higher interest rate country makes a discount par to the difference between that and the low interest rate currency; on the other hand the low interest rate currency makes a premium equal to the difference in the values.

Example: Forward

- i) Elma Ltd. Sti. exports an asset of the cost of TL 200,000 for € 100,000 with an export credit of two months. The company wants to agree upon its profit in TL because its costs is in TL. That's why it operates a transaction Euro/TL forward of two month maturity in the value of € 100,000.
$$\text{Forward rate} = 2.22 \text{ } 100,000 \times 2.22 = \text{TL } 222.000$$
- ii) At this point the company brings the € 100,000 it will takes TL 222,000 from the bank. In this way the company has stabilized its profit of the transaction of TL 200,000 cost.
- iii) The company will not be affected by the fluctuations in exchange market so that the rate increase or decrease will not affect the client. The forward practice has avoided any probable profit or loss.

Participation banks will be able to conclude forward transaction in accordance with the conditions listed above. Participation banks differ from the commercial banks in this direction in two points. Firstly the participation banks state that one of the parties in the agreement should have the withdrawal right from the contract or the agreement. An

important issue in this is which of the firms will be given this right? It is to be given to the dominating party. For example the participation banks put it as such; between client-bank transactions, the dominant party is the bank while between bank-state or bank-bank transactions, they give this right to the other side. The second important difference is that participation banks choose to make forward transactions with institutional companies that are more in need, while they refrain from doing so with retail client or client that is affected by speculations.

This is the reason why Islamic banks do not perform practices in goods or currency based derivative markets. Giving one party the possibility to withdraw from the contract in forward and swap transactions is an indicator that these banks will not operate in those markets.

3.2.3 Forex Markets

FOREX – In its core forex is defined as a country's trading its currency for that of another's. Forex or the trading of currencies has been operating for long years in the international exchange markets as a result of the need for currency rising from trade, investment, risk avoidance or speculative grounds. To put it simple to take TL 150 for USD 100 for the rate of USD 1 = TL 1.50 is a forex operation. These decentralized currency operations made for investment purposes have seen a wide spread and a rise in competition worldwide.

These operations known as forex give investors the possibility to make operations regarding currency trade or money in exchange of oil, gold or other commodities until a certain level. This level is called leverage rate and it can vary from 1 to 50, 1 to 100 and even 1 to 400.

Leverage rate: if we are to explain by an example: if there is no leverage in a forex operation and the rate is 1 USD=1.50 TL you can sell your TL 100 to USD 67. If your purpose in doing this is to make profit out of dollar your expectation is for dollar to increase in value compared to TL. If the dollar rate increase to 1.70 then you will be

able to buy 114 TL from your 67 USD as $67 \times 1.70 = 114$ TL. In other words your profit will be 14 TL.

If there is leverage, the company operating in forex for a 100 to 1 leverage rate will make a proposal to the investor that goes so: by paying TL 1,000 the company will give the investor a credit of TL 100,000 for exchange transactions. But the investors will not take the money as cash. The company will pay the investor each amount of gain secured through the changes in rate. So if the investor will be as if he sells TL 100,000 for USD 66,667 at the rate 1 USD = 1.50 TL. If rate increases to 1.70, then the investor will take TL 113,334 in exchange of USD 66,667. So he will be able to gain TL 13,334 for the first amount of TL 1,000.

This is precisely what makes forex transactions appealing worldwide, their probability of generating high amounts of money with low amounts of investment. A lot of investors that are attracted by the false advertisements of these transactions as continuously generating profits have invested all their savings in these methods. But they do not only make profits, but they also lose what they already had. That comes as the result of the markets acting different perceptions and expectations.

If we start from our example, investing TL 1,000 in a 100 to 1 leverage rate and in an exchange rate of 1 USD = 1.50 TL and getting a 100,00 credit for that would cause us a TL 6.667 loss in case exchange rate falls to 1.40. If the fall is experienced step by step the investor will lose its TL 1,000 even without reaching 1.40. If we consider the degree to which exchange rates are affected by the global events and the price fluctuations the probability of the rates going differently from what is expected so losing all the investment is high.

General characteristics of forex markets

- i) They are the markets with the largest volume of transactions in the world
- ii) They operate 5 days a week 24 hours a day
- iii) The risk level, the probability of total loss or huge gain is high
- iv) CMBT has intervened in the leverage rates and has stabilized it into 1/100

- v) The volume of work of this market in a day is 4-5 trillion dollar worldwide. 60 percent of the transactions are led in Europe where Britain leads with approx. 2 trillion dollar
- vi) There are countries with much higher levels of leverage rate
- vii) The volume of work in Turkey is 5 billion TL daily

When we look at the statistics above, it is understandable that such practices of operating in transactions without a certain asset, just by using perceptions and expectations and using these debatable ways to become rich, generate debate under normal market conditions. Many unprofessional investors or client enters the market and exit it as they lose big amounts of money.

Participation banks do not operate on such ground given their lack of necessity and their speculative and manipulative based profile. In this line, these banks do not operate on future or option practices of the organised markets, just because they do not rely on physical receipt or do not hold the withdrawal option for parties while they do apply forward operations that are adapted to withdrawal and physical receipt procedures.

Anyway, the Board of Control of the banks do not approve of the usage of such 'correct' procedures as forward if they are to be used in line with forex practices. The situation may vary in different countries anyway. If we look at the Malaysian case, we can see that practices such as forward and option are widely spread. The structures needed for the conclusion of such transactions are acceptable for neither for the Turkish nor the Middle Eastern market.

3.2.4 Precious Metals

According to Article 32 of the Turkish constitution regarding protection of the Turkish currency all banks are able to trade on precious metals. According to this law, gold, silver and platinum are counted as such too. Considering the attention the Turkish people give to gold and the amount of transactions involving gold in Turkey understandably has reached a high level of gold banking. Meanwhile silver has never gained such popularity and is operated in a small number of banks. Banks use the gold

for arbitrage, position purposes or for the require reserve of the Central Bank of Turkey. Banks make profit from the margin between selling and buying of precious metals.

Some of the banks use the proportion 995/1000 for their gold account so that the transactions can be based on physical receiving, while others require 1000/1000 meaning that they keep pure gold. So in a possible transaction between these banks the bank with 1000/1000 will have an excessive of 0.5 percent meaning that for each 1kg of gold, it has 5gr more than the other side. In this point the bank's gold will look more valuable than the other bank's.

Physical traits of gold:

9 carat : it contains 33% (9/24) of pure gold, it is the cheapest type and price of gold

14 carat: it contains 58% (14/24) of pure gold. It is the most commonly found in Turkey and the one used in presents.

18 carat: it contains 75% (18/24) of pure gold, it is mostly used in jewellery with precious stones. It is also spread in Turkey.

22 carat: it contains 92(22/24) of pure gold and is one of the best investments and decorations present.

1 ounce: = 31.1035 gram (is used for gold and silver)

If the price of gold per ounce is divided by this number its price in the parameter of 1gr/USD is found. The result is multiplied by the exchange rate of dollar and so we can find the price of gold in TL.

Gold reserves: The banks' gold reserves by 2013 reached 200 tons while 25 tons in 2010. If this amount is added to the gold funds of the financial system it reaches 210 tons. The leaders in this sector are Kuveyt Turk and Is Bank with more than 10 percent of the share.

Gold loan: TEB (Turkish Economic Bank) is the leader in the sector with an amount of 17 tons of gold credit, or the 37 percent of share by 2013. Participation banks can not use gold directly as loan because of their working principle.

Determination of Gold Prices

- i) Gold is a metal of financial value that operates worldwide.
- ii) It opens with Far East markets and closes up with the American ones. It's constantly trading.
- iii) All economical events worldwide affect the gold prices.
- iv) The USA which is the most affective actor in determining gold prices. Economical events and policies implemented by USA institutions directly affect gold prices.
- v) Prices directly affects jewellery sector as it brings changes in demand level. The worldwide demand for gold is 3000-3500 tons per year. The most active actors in jewellery sector are Turkey, India and China.
- vi) Gold price is defined in dollar in international markets. Thus every change in dollar value or rate will directly affect it too.
- vii) Gold is an asset that can generate liquidity. It is exchangeable worldwide. From the Turkish investor perspective, the change in USD/TL brings changes in gold rates too. If the currency increases, gold prices increase and vice-versa.

If we look at how precious metals are operated in participation banks, we can see that participation banks consider gold and silver as currency, thus they trade or use these precious metals like money. It can be bought and sold in cash, but not on installment sales or loans. That is why participation banks are not able to use gold like commercial banks so that they can not fund gold directly. For this reason it is very hard to make transaction on gold. The gold collected is sent to the CBT. The other remaining part is used in arbitrage. Gold is cheaper than abroad so that the export increase more in winter period. Gold is more expensive than Europe in summer period because of wedding party in Turkey. The import increase in summer time. Additionally the fact that keeping gold reserves abroad is economically more suitable drives these banks towards keeping it in London rather than Istanbul. The fact that CBT allows for this procedure makes it even more plausible and common.

3.2.5 Treasury Platforms

The treasury platform is a software that allows for determination of prices for Spot-Forward FX and Precious Metals operations. Platform that allows for the performance of all bank practices under one platform rather than many. It follows and calculates the best prices and also matches the client with the best price limits with the seller banks with an open limit. The bank is not able to take a position in the transactions made by the client. It also cuts up the costs of the work in the treasury as it conducts most of the work in the sector. The banks grant this service only to high amount performers. Technology has been implemented in many sectors of banking we can see.

Main characteristics

- i) The system involves not only TL/currency (TL/\$, TL/€) operations, it also provides parity (\$/€) and precious metals operations too.
- ii) It can perform forward, gold and foreign currency transactions.
- iii) The limit is determined by the bank after looking at the past activities of the client. The margin is determined by the marketing and product development department of the bank. They also provide info on daily basis.
- iv) The contract of the usage of the platform is prepared by the bank for the client. It can also operate manually by the indications of the client.
- v) The rates are automatically decided after the calculation of the margin given to the client by the bank.
- vi) Operations done in the platform cannot be undone.

This is a software that is the technological turn to the already existing products used by the participation banks. That is why there is no issue in them using it.

4. EQUITY SHARES

4.1 GENERAL DEFINITION

The buying and selling practices of equity shares by intermediary institutions are regulated under the laws of CMB. CMB has transferred the power to direct these transactions in OTC markets to the banks too always in accordance with its laws. Thus, participation banks conduct equity shares operations as agency, only by intermediary institutions determined by the new laws of CMB under new the license. These practices are not the main activities of banks, the operations take place in intermediary companies bound to the banks. These companies conduct all company activities such investment consult, buying or selling stock shares, forex operations, loans for stock shares and bono issuance. When participation banks will establish an intermediary company, they are able to selling and buying of stock shares and plus the issaunce management and consultant. The other practices are not suitable for the principles of these banks so the other transactions will not be conducted. It will be explained in detail below why these banks trade a few on stock shares.

If we look at the total value of the stock shares of the companies in BIST, the market cap is just 250 billion dollar. If Islamic financial principle implements on stock shares in BIST, the caps and number of stock shares would fall fifth-fifth down. If it is again processed under the clause of the amount of the shares open to the public being tradable they go down even more. It gets worse if we look at the volume of activity of the companies. That is because the major part of the stock share volumes consist of directly by the banks. So the reason participation banks are not active in the capital markets because there is no benefits for them considered the situation.

Equity share: The unit of capital of a company. The people who buy shares of a company become a shareholder of the company. The shareholder defines the relation between the company and the owner.

Rights granted by ownership of shares:

- i) Right to partnership
- ii) Voting right for ownership
- iii) Profit and advance profit share
- iv) Priority right (privilege)
- v) The right to get shares
- vi) Right to information
- vii) Right to liquidation

Buying shares of a firm operating or non, in the open market, means becoming a partner in the company thus entering trade according to certain theories. If the shares constitute to a big part then buying them means becoming a partner in ownership, it practically means getting into business. The company publishes its operations in accordance to AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). As long as those interested in buying or selling shares act in accordance to these regulations there is no issue deriving.

4.2 SHARES AND DETERMINATION OF SHARES OF BANKS IN ACCORDIANCE WITH ISLAMIC REGULATIONS²⁰

The selling and buying operations according to Islamic regulations is done as below. These standards are accepted by AAOIFI.

- a) Field of activity
- b) Analysis by financial measures
- c) Debt percentage in the SFP (30%)

In this valuation the firm's published financial tables in accordance to the CMB regulations is considered (valid for open market companies).

²⁰ http://www.katilimendeksi.org/subpage/21/endeks_kurallari, [accessed 25 April 2015]

4.2.1 Analysis By Field Of Activity

Main activity field;

- i) Interest rate based finance, trade, service, intermediary (banking, insurance, financial renting, factoring and other interest rate based activities),
- ii) Alcoholic beverages,
- iii) Gambling,
- iv) Pork and similar products
- v) Written and electronic media, publications, advertising
- vi) Tourism, entertainment
- vii) Tobacco products
- viii) Weapons
- ix) Deferred trade of gold, silver and currency

Companies operating in the fields above are considered not suitable for stock share buying. In order to understand the operating field of a company, its main contract is analysed. If there is one or more of the fields above cited as an activity field for the company and if its daily activity is not suitable for the participation banks than buying or selling of stock shares is not conducted. Or in the other case, if a company has these activities in its contract but refrains from conducting them, then shares may be bought or sold according to financial ratios.

4.2.2 Analysis By Financial Measures

i) The companies that fit the conditions below may be considered as alternatives to buying or selling shares:

- a) Total interest loans / market value < 30%
- b) Interest-generating cash and other goods / market value < 30%
- c) Revenues from activities considered not proper to Islamic regulations / total revenues < 5%

By revenues, the total amount of profit of the company is meant. It includes trade revenues, interest revenues, other activity generated revenues plus extra activity financial revenues. The loans taken for leasing purposes in accordance to the participation banks' principles will not be included in the total loans with interest. If the revenues from activities related to banned fields such as alcoholic beverages or pork products when added to the revenues from the interest rate are bigger than 5%, these companies are taken off the list. If the firms do not fulfil these requirements, share buying or selling activities with them should not be conducted. Anyway if the contract of the company offers proofs of activities suitable to the participation banks there will be no need to look at the rates.

ii) When the company does not state in its official license the conduction of the above listed activities but its annual revenue reports show evidence of it, its rate regulations cited in point become valid. If the conditions are not fulfilled then transactions with them are not allowed.

iii) In case firms have conducted side activities directly or are linked to third parts doing activities that are listed above, the calculation regarding revenue rates should be applied. If they are suitable interaction is plausible.

iv) If the firm is known to conduct activities listed above but no official public data can be found then information is to be required from the public and the firm also. If the firm does not fulfil the conditions listed or the information is still absent then interaction should not be taken.

4.2.3 Debt Percentage in the Balance Sheet (30%)

If the total debt the company has to conventional banks over total assets is more than 30% this firm is not considered appropriate for interaction. If its loans are taken from the participation banks and are footnoted as such then they will not be included in the total sum.

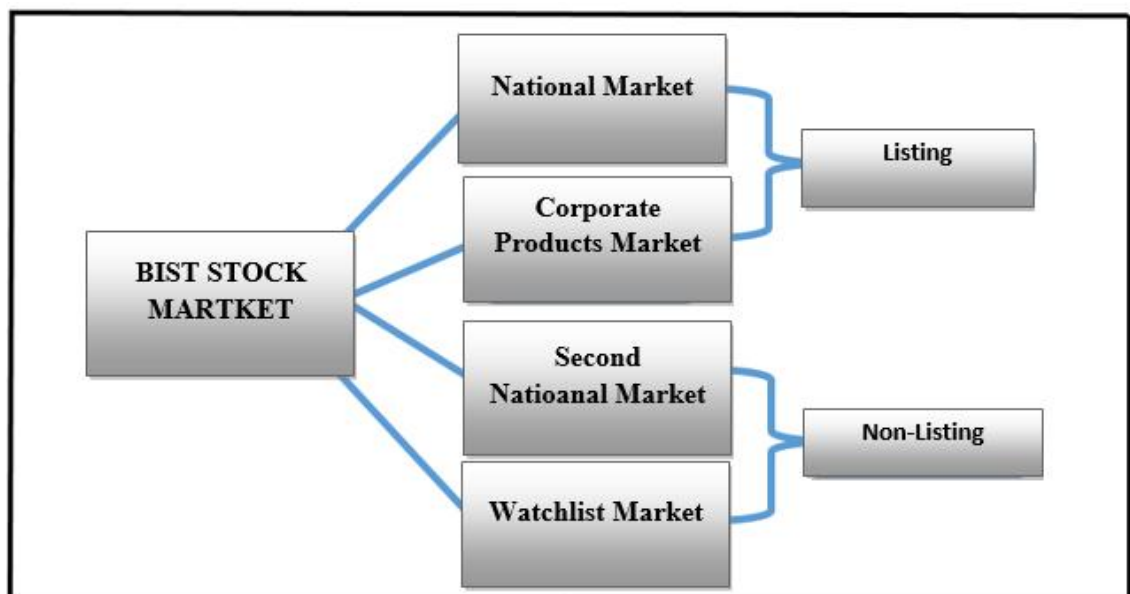
The 30% only includes loans running on interest not on trade loans or debts because they operate on late interest. Because the interest running on debt or trade receivables is difficult to understand from the balance sheet and because as a rule of accounting these components only contain trade debts and receivables they are not taken into account.

Debts/Market Value rate can be alternative of the criteria in the financial rate, total assets can be used for firms who don't be traded in markets. In addition, Debts/Market Value has affects on the number of stocks. Changing of list can leads to problems for customers, firms, and participation banks because one firm in appropriated list cannot appropriate for Islamic financial rules after 3 months. Value of total assets are not volatile like market value, this rate seems more stable.

4.3 STOCK EXCHANGES²¹ AND RULES OF BUY-SELL

There are four types main stock exchanges in BIST and these stock exchanges work according to criterias of BIST

Figure 4.1: BIST stock market



Source: <http://borsaistanbul.com/urunler-ve-piyasalar>, [accessed 12 May 2015]

²¹ <http://www.tim.com.tr/egitim/hisse-senedi-piyasalari.pdf>, [accessed 21 February 2015]

National Market is the biggest market of BIST. Firms having quotation criteria's are traded in this market. If stocks in this market are convenient for 4.2 section criteria, trading this stocks are legal according to Islamic financial principle.

Second National Market is for SME's and firms don't having quotation criteria. This firms can find resources for their investment, sell their stocks in this market. Situation of the stocks in this market are like national market.

Corporate Products Market consists of securities investment associations, real estate investment trusts, venture capital investment trusts, stock exchange participation certificates and covered warrants. In this market, securities investment associations, real estate investment trusts, venture capital investment trusts, stock exchange participation certificates and covered warrants have to be convenient 4.2 section criteria's to be convenient for Islamic financial principles. Warrants in the market are not convenient for principles of participation banks. Warrants have to include forward product criterias according to Islamic financial principle.

Watchlist Companies Market is established for; unusual situations for firms and transactions of stock shares; lack of information given by firms; to protect investors; and when a stock share of company is removed, permanently or not, from market, to give informations to investors and watch companies.

We examined the rules about buy-sell of stock shares. However, not only 4.2 section criterias are necessary for participation bank, but also some Islamic financial principles are neccassary to buy and sell. Without these rules, selling or buying stock shares are not convenient for Islamic financial principles. For example short or long sell or buy of stock shares and transactions on credit are not suitable according to Islamic financial principles. Therefore, these transactions are not convenient for participation banks.

Short selling of stock share: Selling of capital market products and order of this selling have to be ordered as short transaction. Occurred transactions of short selling of stock shares are stated in Daily Bulletin in respect to dividend, in all price level amount and the number of contracts are stated.

According to regulations of BIST “List of Margin Trading and Transactions of Short Selling of the Stock Share” constitute all shares and stock exchange investment funds except watchlist market and option trading platform. Therefore, shares and stock exchange investment funds in the National Market and Second National Market can be traded as margin trading and transactions of short selling of the stock shares. However, according to new law of Capital Market Board, shares and transactions in the lists of C and D cannot be traded as margin trading and transactions of short selling of the stock shares. In addition trading in stock exchange is necessary for these transactions²².

Somebody cannot sell a product if s/he doesn't have this product according to Islamic financial principles. Therefore, this transaction cannot be done via participation banks. Firstly, ownership have to exist and then selling can be exist, except attorney selling. Opposite of this is not convenient for Islamic financial principles.

If this types of transactions don't close up at the evening in markets, they can be subject of borrowing transactions and margin tradings. One speculative transactions lead to another speculative transaction, then volatility increase and prices don't stand at their normal level. However, these transactions are beneficial for the market, benefit is not prolonged. Like hot money good in short term but leads to structural problems in long term. If speculators are not professional or lucky they will be affected very bad. They are also individual investor, so they cannot enter the market easily. Warrant and FX transactions have many examples of this.

Long position in the stock shares: This transaction is the opposite version of short selling of the stock shares. However, they have almost same results. Difference between them is the fact that when you are in short position at the stock share you borrow stock shares, but when you are in long position at the the stock shares you borrow money / find loan. Both of two transactions are not convenient for the participation banks.

Margin Trading: It is the transaction of buying stock with credits. Rules of this transaction is maden by CMB. If a stock is convenient for Islamic financial principles, margin trading is also convenient. Because, buying stock means the increase of share and increase of rights to manage firms. This aim looks suitable according to Islamic

²² <http://borsaistanbul.com/urunler-ve-piyasalar/piyasalar/pay-piyasasi/kredili-islem-ve-aciga-satis>, [accessed 1 May 2015]

financial principles. But if investor does this transaction for speculation and s/he thinks about selling share after a time, it is not suitable according to Islamic financial principles. Because of the fact that, if somebody in a bad situation, you cannot give to his/her credit having high cost according to Islamic financial principles. Therefore it is not convenient for participation banks. None of participation banks don't be intermediary of this transaction.

Borrowed Share Market Transactions: These transactions are done by speculators who want to trade always and short position in a stock shares. For example, someone supposes decreasing of one stock shares, then selling this stock share in short position. Before the end of today, if she doesn't take back shares, she will be in short position. She must have share in her hand to exchange so she needs to borrow share. Borrower wants to take a profit. But it is not convenient according to Islamic financial principles. You will give shares with interest and you will take back share with fungible.

Table 4.1: The First 50 islamic stocks shares in BIST

Code	Stock Name		Code	Stock Name
ADESE	Adese Shopping C.		HEKTS	Hektaş
AFYON	Afyon Cement		INDES	Indeks Comp.
AKCNS	Akçansa		KARTN	Kartonsan
AKSA	Aksa		KIPA	Tesco Kipa
ALBRK	Albaraka Turk		KONYA	Konya Cement
ALCAR	Alarko Carrier		KRSTL	Kristal Cola
ALKIM	Alkim Chem.		LOGO	Logo Software
ASLAN	Aslan Cement		MEPET	Metro Oil
ASUZU	Anadolu Isuzu		MRDIN	Mardin Cement
AYGAZ	Aygaz		NUHCM	Nuh Cement
BFREN	Bosch Brake Syst.		PETKM	Petkim
BIMAS	Bim		PETUN	Pınar Meet and Flour
BOLUC	Bolu Cement		PNSUT	Pınar Süt
BRISA	Brisa		PRKME	Park Elek.
BUCIM	Bursa Cement		SELEC	Selçuk Ecza Deposu
CEMTS	Çemtaş		SODA	Soda Industry
CIMSA	Çimsa		TATGD	Tat Food
EGEEN	Ege Industry		THYAO	Türk Airlines
EGSER	Ege Ceramik		TKNSA	Teknosa
ENKAI	Enka		TMSN	Tümosan Motor ve Tractor
ERBOS	Erbosan		TTRAK	Türk Tractor
EREGL	Ereğli		ULKER	Ülker
FROTO	Ford Otosan		ULUSE	Ulusoy Elec
GENTS	Gentaş		VESBE	Vestel
GOODY	Good-Year		YGGYO	Yeni Gimat GMYO

Source: http://www.katilimendeksi.org/subpage/21/endeks_kurallari [accessed 20 April 2015]

5. MUTUAL FUNDS

Although CMB disallows banks to offer equity shares directly to the customers, banks are authorized to offer mutual funds. However mutual funds in Turkey are primarily comprised of bonds&bills and equity shares, albeit the latter is less common. Unsuitability of bills&bonds, inability to issue sukuk until 2012, unentity of sukuk market as of January 2015 and a short number of equity shares that are admissible according to Islamic jurisprudence disable participation banks to carry business in mutual funds. In January 2015, CMB made TEFAS membership obligatory. After this regulation participation banks are enabled to offer mutual funds through intermediary firms. However it would be accurate to state that mutual fund transactions are hardly present in participation banks apart from pension funds. As a matter of fact, mutual fund is considered as an underdeveloped area except liquid funds. For Turkey, there is much progress to be made in respect of this matter.

5.1 MUTUAL FUNDS IN GENERAL

Definition: It is essential to explain “portfolio” in order to give a proper understanding of mutual funds. A portfolio is a collection of investments held by a person or an institution such as capital market instruments (equity shares, bills&bonds, lease certificate, repo) and precious metals e.g. gold²³.

Mutual funds through the funds collected from the public money, manage the portfolios consisting of capital market agents, such as, stocks, bonds, rental certificates, private sector debt securities, reverse repo, gold and other precious metals. Each investor provides participation right by purchasing a participation share that represents a portion of the portfolio that fund included. Account owners can appreciate their savings through purchasing stock and rent certificate from companies, intermediary firms and stock exchanges. However making security investment requires knowledge and expertise. Also since individual savings typically aren't be able to reach sufficient size,

²³ <http://www.spk.gov.tr/indexpage.aspx?pageid=253&submenuheader=null>, [accessed 10 May 2015]

distributions of risk may not be made at the portfolios purchased through these savings. Risk may be important in terms of both principal capital and portfolio return. Therefore mutual funds called as collective investment corporations were created in the capital market.

Informing about the following concepts together with the above definition of the mutual fund will ensure a proper understanding of the definition²⁴.

Portfolio Management: Portfolio Management refers to the collection of activities regarding the portfolio assets trade (the investment agents such as, stocks, lease certificate, security, and bonds) and collection of these assets' returns (such as interest and dividends) in accordance with the limits permitted by legislation and standing rules. Portfolio management involves all kinds of research and analysis activities constituting a reference for decisions regarding the assets trade.

Fund: Fund is a type of asset that is used to operate the portfolios with the public collected money on behalf of the share owners in accordance with risk distribution policy and faithful ownership principles.

Share of Participation: Share of participation points out that how many shares the investor have participated to the fund portfolio. We can liken the participation shares of mutual funds to the partnership shares of the companies. Through the same way with how investors become a partner of a company purchasing partnership share and have rights over it, similarly, portfolio partnership is obtained with participation shares in mutual funds. However, the partnership share owners have rights over the company management, participation share owners don't have rights over fund management.

Mutual fund investor's gains

Profit can be made by mutual funds through three ways.

²⁴ <http://www.spk.gov.tr/displayfile.aspx?action=displayfile&pageid=78&fn=78.pdf>, [accessed 12 May 2015]

- a) Dividends, interest or lease certificate income/profits: First of all dividends and/or interest revenue can be obtained through the securities that funds included. All profits obtained through fund is reflected to the fund portfolio value.
- b) Trading the assets included in portfolios: The price of the fund owned securities can be increased. If the fund sells this security, of which price increases, capital gain will be obtained. This obtained capital gain or loss is reflected to the fund portfolio value.
- c) Rising of the market value of securities: If the mutual fund holds and does not sell the security, price of which increases, the price of participation shares increases. If the total value of mutual funds is high, it indicates that the investment is high-quality.

When investors sell their participation shares, they get their respective shares from value increases/decreases which has been realized so far.

Mutual fund seller's gains:

Mutual fund founder is nothing but a portfolio management company, and it will get management charge over total portfolio value. Proceeds are financed through the fund on a daily basis and paid to the founder on a monthly basis. Since the distribution channels of portfolio management companies are the banks, the banks take the vast majority of fund management proceeds. Since the party funds sale is important in respect of mutual fund sale, the party who realised the fund sale will get a large amount of the management proceeds. This rate varies depending on the agreement between the parties.

5.2 MUTUAL FUND TYPES²⁵

- a) Securities Mutual Funds
- b) Exchange Traded Funds
- c) Hedge Mutual Funds
- d) Foreign Mutual Funds
- e) Venture Capital Mutual Funds
- f) Real Estate Mutual Funds

5.2.1 Securities Mutual Funds

Debt Security Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds invested at the public and/or private sector debt agents.

For the fund established in this way to be an Islamic fund, it shouldn't include security, bond, VDMK or finance bond, but government or private sector lease certificates should be included in the portfolio in accordance with Islamic finance principles. The remaining 20% should be appreciated with participation accounts and stocks compatible with Islamic principles.

Stock Share Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds invested with the shares of the companies in the scope of privatization and issuer companies established in Turkey.

The stocks should be completely compatible with AAOIFI rules. In the same way the remaining 20% should be appreciated with financial instruments compatible with Islamic principles.

Precious Metals Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds invested with publicly-traded gold and other precious metals and capital market instruments based on the precious metals.

²⁵ Communiqué Mutual Fund (III-52.1), **Official Gazette**, 28701, 9 July 2013

For the precious metals fund to be an Islamic fund, fund's findings should be existed clearly, and should be maintained in favour of the purchaser. When desired, removing from the fund should physically be possible. Of course, considering the costs of fund, the founder can create additional obligations regarding physical inputs and outputs to the fund. The commodity can be the subject of any loan trading operations on condition that fund meets the essential requirements and loaned asset shouldn't be traded. Otherwise since it will create a derivative transaction, unavailable goods will be traded. The rules specified here regarding borrow and lend operations are valid for the other funds.

Fund Basket Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds with the participation shares of the other funds and stock market mutual funds.

Foreign Securities Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds invested with foreign private and public sector capital market agents.

The funds invested abroad also are examined by members of the advisory board as well. Because, every fund considered compatible with Islamic principles may not conform to Islamic finance principles.

Money Market Fund: Umbrella funds, 80% of which fund portfolio and all portfolio constantly includes the funds with up to a maximum of 184 days to maturity, and high liquidity of the capital market agents and maximum weighted average maturity of its portfolio of 45 days. Liquid fund at the old law corresponds money market fund at the new law. The operation principle of the liquid fund is based on repo-reverse repo market in BIST structure. Since the participation banks can't open an account less than 30 days, it is considered as a most proper instrument to appreciate the daily or weekly unused money. However operation of repo and reverse repo market is contrary to Islamic finance principles, funds in this style can not be created. Furthermore since such a lease certificate which may continuously a subject of trading and with great operation volume, doesn't exist in the market, establishment and management of lease certificate fund with high liquidity seems very difficult. For this purpose, excessively

lease certificates and accordingly, lease certificates with a number of maturity options have been required in the market. However, for this fund to be operated, market described in the 1.2.8 number section must be opened. Otherwise, legal permission for the processing of this kind of fund, discussing with government agencies regarding cost reduce and a participation bank with broad portfolio which will provide liquidity for this funds are required.

Variable Fund: Umbrella funds, 80% of which fund portfolio constantly includes the funds which are not included by the other kinds of funds mentioned above due to portfolio limitations. This kind of fund changes continuously due to instruments it has included. However, financial instruments to be included will be subject to the fund limitations established by capital market board (CMB). Some of these limitations are fund investment permission on participation account up to 10% of portfolio size, fund investment permission on an issuing capital market instruments up to 10% of portfolio size. These restrictions are the general limitations established by CMB to reduce the risk level of the fund.

Foreign Funds: A fund with dollar or foreign currency inclusion can be created in the country. Fund's name will vary according to the investment instruments. When the financial instruments with foreign origin are purchased and the rate of these instruments is over %20, it becomes foreign security fund and foreign securities invested value rate minimum must be 80%. When the financial instruments with Turkish origin are considered, fund's name will vary according to the fund inclusion. The funds established on the base of dollar are appreciated with CBRT sales rate and TL based quoted.

Participation Fund: Umbrella funds, which entire portfolio constantly includes the funds with lease certificates, participation accounts, partnership shares, gold and other precious metals and the other funds approved by board and the funds with money and capital market instruments that are not based on interest. This kind of fund describes the funds that were included in the system currently by CMB and created in accordance with Islamic principles. This doesn't mean that it is unique Islamic fund. Because the

stock fund, 80% of the which portfolio constantly are invested to the stocks compatible with Islamic principles and remaining %20 of that are invested to the lease certificates, is also an Islamic fund. In this respect this fund type represents a flexible fund that doesn't take CMB fund limitations into consideration so much. Because financial instruments of the participation banks is limited, if it subject to additional fund limitations, it will make its operation in this market more difficult. We can say that participation banks almost don't exist in this market. For the last two years, it began to make feel its presence by means of the funds in the pension system, it is due to contribution of the state with %25 ratio to pension system. Nevertheless the same growth level was performed at the other pension companies.

5.2.2 Exchange Traded Funds

Exchange Traded Funds (ETF) are the mutual funds with a index reference and aiming to reflect the performance of the index to investors and its shares are operated in the stock market.

ETF are issued as index-based and securities covered by the related index are invested according to the ratios of their index weights. In this way, for example an investor wishing to invest into BIST 30 index, performs it through investing to ETF instead of taking the shares in the index separately and benefit from the return of the index by this way.

Exchange Traded Funds are the portfolios that are created by means of purchase of the securities covered with the reference index with cash collected from investors by authorized outside brokers. These funds reflect the reference index shares or returns of other instruments (gold, bonds, foreign exchange, etc.) and bears the risk of it. ETF shares can be traded in shares market by intermediary firms²⁶.

The participation index, created in partnership with Bizim Investment Securities Companies and participation banks as compatible with Islamic principles, exists in

²⁶ Communiqué Exchange Traded Fund (III-52.2), **Official Gazette**, 28701, 27 November 2013

Turkey. However the stock shares in the participation banks have not been widespread because of stock shares in the market and being bank shares weighted of Borsa Istanbul. Therefore, participation index is not drawing considerable interest. Gold Plus gold mutual fund established by Kuwait Turk participation bank leading the gold and silver section in banking sector, and Silver Plus silver mutual fund are two other stock market mutual funds created as compatible with Islamic principles. As its name implies, focusing their activities on gold and silver, they trade these precious metals with little costs through stock market. These funds, growing too fast before Gold and silver they based on become extreme speculative, have subjected to lost of interest due to these precious metals become extreme speculative and almost all banks offer trade through these metals. The difference between these funds and exchange traded funds is that the correlation ratio of stock market investment funds is minimum of 90%. Fund Manager may insert the %90 based asset into the fund as the case and invest repo with the rest of it. In addition, the liquid cash in the fund can be appreciated in repo. If the fund to be created by participation banks, under typical conditions, the participation banks don't appreciate their assets through interest included instruments, borrow or lend, be subject of borrow markets.

5.2.3 Hedge Funds

Hedge mutual funds, unlike other investment funds without using any comparison criteria and regardless of market return, implement the investment strategies aiming at absolute return provision, and use various investment instruments, primarily derivatives in accordance with this purpose. It doesn't differ from security mutual funds except swap contracts and over the counter option contracts in respect of assets to be taken in hedge fund portfolio. However, hedge funds, unlike security mutual fund, are able to perform free sale and credit securities operation. Also open positions amount to be subjected due to derivatives and total open positions amount and borrowing limits are probable to be determined in the rules of procedure of the fund without depending on the limitations contained in the related communique.

Participation banks can manage such funds through management companies. However, in doing so, as with other funds, they should consider the assets included in the fund. In the essence of these funds, making a lot of money by taking excessive risk are aimed. This is because why they provided implementation of the products and processes which may be an element of extreme risk, such as, swaps, options, buying and selling out to be allowed. However, most of the products mentioned in the law aren't compatible with Islamic finance principles. These kinds of derivatives products don't desire to be widespread in the sector. Nevertheless these kind of funds can be managed through assets, such as, sukuk, participation accounts and gold with less risk under hedge mutual fund.

5.2.4 Foreign Funds

The foreign mutual funds are mutual funds which are created abroad and collective investment institutions. The rules these mutual funds will subject to don't differ from the rules mentioned so far. The assets included in this fund should be compatible with the Islamic finance principles as in the other types of funds.

5.2.5 Real Estate Funds

They are the properties that do not have legal entity, created by portfolio management companies and real estate portfolio management companies that have permission from the board, as perpetual or temporary compatible with a regulation law, with the money collected from qualified investors in exchange for participation shares, by aiming to operate portfolio constituted from assets and operations specified below, in accordance with the provisions of law²⁷. However, fund is a corporate entity limited with deed office registration and cancellation and correction operations based on the registration.

²⁷ Communiqué Real Estate Investment Fund (III-52.3), **Official Gazette**, 28871, 3 January 2014

- a) Real estate and rights based on properties
- b) Including in the scope of privatization, the shares belonging to anonymous partnerships established in Turkey, the private sector and the public debt securities
- c) Foreign private sector, public debt securities and anonymous partnerships shares,
- d) Term deposit and participation account,
- e) Mutual fund participation shares.
- e) Repo ve reverse repo operations,
- g) Lease certificates and property certificates,
- h) Varants and certificates,
- i) Takasbank money market operations,
- j) Cash deposits and premiums of derivative financial instruments operations,
- k) Specially designed foreign investment agents approved by board.

Both the funds described so far and the types of these funds are often can encountered abroad. However, real estate funds haven't developed as all funds except liquid funds. Even beyond the development, because they have not been created, any example of this fund doesn't exist in the market. With the new regulations, the release of such funds are expected.

Renting, trading with the properties, and realizing these operations under a fund, any aspect contrary to Islamic finance principles doesn't exist. Just as in other funds, it is important in these funds that a financial instrument that carries the phrase of interest or with return shouldn't be purchased and even a subject of operation. At least 80 percent of total value of the real estate funds should be created from property investments and the remaining 20 percent of it can be created from using above-mentioned financial products. However, even if 1 percent inclusion of financial products mentioned at the e, g, h, and j articles in real estate funds can make this fund contrary to Islamic finance principles. The creation of such funds by market players and sell of the funds to the investors are planned. The growth of the property sector and increase in value continuously will increase the need for these funds.

5.2.6 Venture Capital Funds

They are the properties not having legal entity, created by portfolio management companies and venture capital portfolio management companies that has permission from the board, as perpetual or temporary compatible with a regulation law, with the money collected from qualified investors in exchange for participation shares or with their sharings, by aiming to operate portfolio constituted from assets and operations specified below, in accordance with the provisions of law²⁸.

- a) Venture capital investments,
- b) Including in the scope of privatization, the shares belonging to anonymous partnerships established in Turkey, the private sector and the public debt instrument
- c) Foreign private sector and public debt securities and anonymous partnerships shares.
- d) Term deposit and participation account,
- e) Mutual fund participation shares.
- f) Repo ve reverse repo operations,
- g) Varants and certificates,
- h) Lease certificates and property certificates
- i) Takasbank money market operations,
- j) Cash deposits and premiums of derivative financial instruments operations,
- k) Specially designed foreign investmen agents, and loan participation notes approved by board,
- l) The other investment instruments approved by the board.

We can liken the properties of this fund to the property mutual funds described above. Only 80 percent of venture capital is needed rather than 80 percent of property investment in the fund. They almost exhibit the same properties in accordance with Islamic finance principles. The business must not include interest, pork or alcohol selling or the property can not rent to these companies which do these works.

²⁸ Communiqué Venture Capital Funds (III-52.4) **Official Gazette**, 28874; 7 January 2014

We can liken the venture capital to the business partnership, such as, musharaka and mudaraba. As musharaka and mudaraba are essential products of Islamic finance, venture capital and real estate funds must also be essential products for Islamic capital market products. There is not any fund created in this formation in Turkey.

5.3 BASIC PRINCIPLES OF MUTUAL FUNDS²⁹

Deploying The Risk Policy : Through this policy, mutual funds can probably distribute the risk to the extent that individuals won't be able to afford with their opportunities.

Professional Administration : Securities markets, as of the qualities, are the technical markets, requiring a specific know-how and the developments of these markets must be followed closely. The movements observed in these markets are appreciated by professionals to understand what they mean and required operations (trading etc.) are performed.

Securities Portfolio Management : While mutual funds making investments for various assets within certain restrictions, main objectives are to obtain positive profitability through security trading and their interests.

Fiduciary Property : Mutual funds based on fiduciary property ownership. Fiduciary ownership belongs to its founder. Saving owners give the fund related operation authority to the founder. The fund authority transfer realizes via fund internal regulations. Founder is obliged to administrate the fund by retaining the saving owner rights within the framework of this agreement (internal regulations).

Protection of the Property Holdings : Although the fund isn't a juristic personality the fund's assets are separate from the founder's. In accordance with the law of capital market, fund property holdings are judgement-proof, can not be collateralized, and judgement-proof by third parties. So the fund's assets are under the coverage of the protection of the law.

²⁹ www.spk.gov.tr, [accessed 20 March 2015]

The authorized institutions for operation: The mutual fund founders signing "Turkey Electronic Funds Distribution Platform Commitment" organized by the Bank, intermediary firms, portfolio management companies, and other organizations which can be included with the arrangements can operate in TEFAS. Participation banks are required to make operations at this platform on a date of 9 January 2015.

5.4 BENEFITS OF MUTUAL FUNDS

- i) The capital of the savings owner, in the other words its possession is managed by trusted professional and administrators.
- ii) Through the securities that can be included in mutual fund portfolio, can be diversified with fixed instruments such as, fixed income, foreign currency indexed, and the share of partnership, risk can be minimized.
- iii) Because return collection can be ensured by fund management through the control of securities valuation, it could be protected from the operations, such as, term tracking, collection, which require time and resource consumption
- iv) Earning potential which can not be obtained with small savings will offer opportunity of investment to the securities with greater earning potential
- v) Due to value increasements in the fund portfolio can be reflected to portfolio value on a daily basis, saving owner can cash the portfolio as either needed amount or all with all operated revenue.
- vi) Portfolio provides time and money savings due to trading in great amounts.

5.5 TEFAS (TURKEY ELECTRONIC FUNDS DISTRIBUTION PLATFORM)

It is an electronic platform allowing mutual fund participation documents trading via fund founders through distribution companies included in a central electronic platform, and also to exchange and storage to be realized in a full automation way with Takasbank - CRA system integration.

Only security mutual funds will be operated in TEFAS, ETF operated in BIST and the other funds to be sold to the qualified investors (hedge fund, protection aimed funds, venture capital mutual funds, and property mutual funds) will not be operated in TEFAS. Also depending on the fund founders wish, liquid funds included in the security mutual funds (money market funds), short-term bonds and bond funds can be operated optionally in TEFAS. The management fee allocation of TEFAS operated funds is determined by the law, and seller gets 35 percent of it and founder gets 65 percent of it. However, through the contract the allocation of the rates will be reversed³⁰.

Nevertheless participation banks, in accordance with the principles of operation, will not trade for all funds. It will mediate mutual funds created in accordance with Islamic principles. Bank, intermediary firms, portfolio management companies, and other organizations operate in TEFAS. Participation banks were required to make operations at this platform on a date of 9 January 2015. However, there don't have any trade in the platform because of non widespread of Islamic mutual fund.

Pension funds created in accordance with Islamic principles but can not be sold on platforms such as TEFAS or except individual pension system aren't included in the above list.

5.6 PARTICIPATION BANKS MUTUAL FUNDS

General comments made so far covers the description and contents of mutual funds mentioned in the CMB law. When mutual funds created in participation banks, in addition to the CMB restrictions mentioned above, participation banks principles are taken into account. Because stocks mutual funds are capital markets products, they are subject to AAOIFI rules. When mutual fund purchased, specified AAOIFI stocks rules are considered.

³⁰ www.takasbank.com.tr, [accessed 27 March 2015]

- a) Field of Activity
- b) Financial Ratios
 - i) Total interest credits/market value < 30%,
 - ii) Interest bearing cash and securities/market value < 30%,
 - iii) Revenue gained from the activities incompatible with Islamic principles/Total revenue < 5%,
- c) Indebtedness ratio in balance sheet (30%),

Since the stock shares included in the mutual funds portfolio in accordance with the rules mentioned above, these criterias aren't included in the mutual funds. When the other capital market products are the case, the above rules are becoming polemical.

Five percent interest income limitation in total revenue exists because: the current system in the world is based on a formation at interest. Since it is difficult for the companies not to be involved of interest, 5 percent share of the constraint has been brought into application. It is clear that the stock shares within the mutual funds will be subject to this limitation. However, inclusion of the securities and bonds at interest or the shares of the company dealing with pork in the mutual funds is incompatible with Islamic rules regardless of 5 percent restriction. Therefore, financial structure rates implementation for mutual funds is not correct. Because mutual funds portfolio managers have right to choose the financial product on purchase. When it comes to making a choice, financial rates mentioned above shouldn't be implemented.

It's no surprise that mutual funds are prohibited for inclusion the products incompatible with Islamic finance principles, such as security, bond, warrant, forward and option, in their portfolios regardless of the financial ratios of the mutual fund.

As for the indebtedness ratio of 30 percent, stocks purchase by installments is possible compatible with Islamic principles. Therefore, using of the funds from the participation banks as much as up to 30 percent of mutual funds

active sizes, they can trade stocks, property, commodity. However it is not a proper behaviour if they make trading operations in the area specified in stocks related section. It is not a proper behaviour if they make credit operations resulted from trade. They have to perform borrow and lend operations without any interest. The financial products incompatible with Islamic finance can not be included in mutual funds. Above-mentioned operations can not be performed within the mutual funds. If any statement like ‘incompatible operations can be performed’ exists in mutual funds standing rules, trading these funds is conditionally accepted. If it doesn’t perform the forbidden operations specified in standing rules, these kind of funds can be traded, otherwise their trade is not appropriate. Islamic funds created in Turkey and their size are given in the table given below. When we look at the table, we can say that Islamic funds almost haven’t been developed. Also, since the funds are small, there has been very little interest. Therefore, standard criterias and knowledge hasn’t been formed in this area. In this context, changing of some statements included in the some funds internal regulations will be more convenient. For example, it is important removal of the standing rules phrases which permits security, bond trading and trading for requirement.

Table 5.1: Available islamic funds and their sizes (January 2015)

Million TL	2010	2011	2012	2013	2014
Gold Plus ETF	4,000	10,000	33,500	21,500	13,000
Silver Plus ETF	0	0	9,000	3,500	3,000
Akbank B Type Sukuk Fund	0	0	0	5,000	5,000
BMD A Type Cunstruction Sector Fund	0		0	300	350
BMD A Type Gold and Enegy Variable Fund	0		0	300	350
Bank Asya Akasya A Type Variable Fund	0		0	140	150
TFK Sukuk Fund	0		0	250	300
Alkhair Capital A Type Participation Index Fund	3,000	3,000	3,000	3,000	3,000
Alkhair Capital A Type Variable Fund	1,000	1,000	1,000	1,000	1,000
Global Men. Değ. Sukuk Fund	0	0	0		
Asya Partic. Bank Sukuk fund	0	0	0	0	0
Total	8,000	14,000	46,500	39,000	29,000

Table 5.2: Available islamic pension funds and their sizes

	December 2013	December 2014
Companies that have Islamic fund	7	9
Number of Islamic funds	30	37
Size of pension funds	26.297.484.350	37.615.971.147
Size of Islamic funds	580.033.757	1.373.990.000
Sector share of Islamic funds	2,21%	3,65%

Table 5.3: Available islamic funds and their contents (January 2015)

Code	Fund Name	Portfolio Information
AAA	Asya Katilim Bankasi A.Ş. Akasya A Type Variable Fund	Equity Shares
		Private Sector Lease Certificate
ACE	Alkhair Capital Menkul Değ. A.Ş. A Type Participation Index Fund	Equity Shares
ACT	Alkhair Capital Menkul Değerler A.Ş. Istanbul A Type Variable Fund	Equity Shares
AIS	Akbank T.A.Ş. B Type Sukuk Fund	Public Lease Certificate
AYK	Asya Katilim Bankasi A.Ş. B Type Sukuk Fund	Equity Shares, GES, DIBS, Private Sector and Foreign Debt Instruments, VDMK, Gold and Precious Metals, BYF, Lease Certificate
BAA	Bizim Menkul Değerler A.Ş. A Type Gold and Enegy Variable Fund	Gold and Energy Sector Equity Shares
BKR	Bizim Menkul Değ. A.Ş. Türkiye Finans B Type Sukuk Fund	Public Lease Certificate
		Private Sector Lease Certificate
BZI	Bizim Menkul Değerler A.Ş. A Type Cunstruction Sector Fund	Equity Shares
GLS	Global Men. Değ. B Type Sukuk Fund	Foreign Stock, Private Sector, Sovereing Bonds

It is essential to analyse existing fund framework in Turkey in order to understand the reasons that disable funds to develop. Approximately 70-80 percent of existing funds in Turkey is compromised of liquid funds or short-term bonds indexed funds. These types of funds in participation banks have not been widespreaded because of lacking adequate number of lease certificates and inadequacy of legislation. Alternatives of these funds are yet to be created by participation banks. For participation banks, it seems that the sole financial process that macro fund owners can appreciate in short-term is product. Fund sector is not developed in conventional banking except liquid funds. Therefore, if liquid funds are excluded, both in Islamic and conventional fund sector have made very little progress so far. We can further inspect these reasons by analyzing fund proceeds

or insecurity/risk of fund dependent instruments. However, if we look into the state fosteraged pension funds, both participation banks and conventional banks have made major progress so far.

Table 5.4: Mutual fund sizes (February 2015)

Fund Type	Total Size(TL)	Equity Share (%)	Public Debt Bond(%)	Reverse Repo (%)	Stock Money Mar. (%)	Forg. Sec. (%)	Other (%)
MUTUAL FUNDS							
Total	37.880.150.679	5,57	11,72	21,62	11,60	1,16	48,33
Type A	2.014.384.431	73,88	10,70	6,87	0,79	0,01	7,76
Type B	35.865.766.247	1,77	11,78	22,44	12,20	1,22	50,59
PENSION FUNDS							
Total	39.153.347.319	13,18	57,92	6,61	1,26	1,16	19,86
INDIVIDUAL AND INSTITUTIONAL PRIVATE FUND MANAGEMENT							
Dec. 2014	7.740.000.000						
TOTAL					85.000.000.000		

Source: www.spk.gov.tr

Mutual funds, as lease certificates, come into market recently and it is obvious that they both will progress by time. As these two products are capital market products, and capital market products in participation banks almost have not been developed, they can't make sales directly through their own sales channels as conventional banks. As they haven't completed their infrastructure and regulatory obligations regarding mutual funds and lease certificates as of May 2015, they perform the sales of these products through intermediary firms. As these products have much potential to be developed, already being without enough revenue, and with much regulatory and operational obligations, they are a bit slow in reaching maturity. The participation bank customers must open an account within the branch channel-related participation bank to trade lease

certificate and mutual fund products. Also after opening an account on an intermediary firm with which the participation bank have partnership, realizing its operations via internet channel, can purchase capital market products over related intermediary firm. There has not existed enough profits for participation banks so that they are not so much willing to enter this market. Moreover, when they enter this market, they will totally encounter new regulations for themselves. It will take some time for participation bank to be active in capital markets or this new area like mutual funds, debt instruments and stock shares.

6. DATA AND METHOD

Revenue Indexed Securities (RIS) were issued in 2009 and 2010 by the government was purchased by three participation banks and wasn't purchased by one participation bank. After RIS, securities operations started in the participation banks. However later, as Mr. Hayrettin Karaman gave up approving RIS religion compatibility, RIS considered incompatible with Islamic finance, and securities and issuance operations ended in the participation banks. However, after lease certificate existed, and all participation banks considered this product compatible with Islamic finance principle, issuance, and transaction were started again. And over the years the instrument operation volume, issuing number of sukuk, securities stocks of participation banks have been increased rapidly. Participation banks, commercial banks or institutions or individuals seeking for financial certificate, participate in lease certificates tenders issued by the Undersecretariat of the Treasury or by the private sector and so purchase lease certificate (First hand). Lease certificates issued within the country, after being quoted in BIST, can be traded in the stock market Istanbul Debt Securities Market (second hand). As a result of full integration of all participation banks with this market, security investments will increase in the participation banks as in the conventional banks, and cash remained from fund will be used efficiently.

Security amount in the conventional banks constitutes of 25 percent of total assets in 2012 and 20 percent of total assets in 2013. These rates are in the 5 percent in participation banks in 2013. This low rate indicates that the rate of financial certificate in the participation banks portfolio will ensure more effective ready cashes use of the participation banks. As with that, through a linear regression analysis between all; securities stocks of the participation banks in TL in 2012, the active growth rates of participation banks, and security operation volume in BIST, the datas were tested. As dependent variant; security growth and assets growth, and as independent variant; financial certificate operation volume have been used in the analysis. The assets data through the increase rates over three months balance sheets are reduced on the monthly base. The participation banks' security purchase is realized on every six months resulting in big increases in securities stocks that's why the state issues financial

certificates on every six months. You can see the analysis-related data and regression analysis results in Table 6.2. As a result of this analysis, when the number of participation banks assets increase, security stocks increase and consequently the operation volume in second hand market at BIST increases. On condition that security stock change becomes fixed, it is seen that when the number of assets increases by 1 percent, then security operation volume increases by 3 percent. On condition that the number of assets change becomes fixed, it is seen that when security operation volume increases by 1 percent, then financial certificate operation volume reduces by 1.2 percent. The reduction reasons are almost the same with the reasons of that adjusted regression dependent variant expression ratio of independent variant is lower than estimated. Adjusted regression square increased up 0.58, that is, dependent variant expression ratio of independent variant is 58 percent. The relationship correlation between two dependent variants and one independent variant is significantly disrupted by the effects of the factors given below.

Unfavorable developments related to a participation bank, have slowed the growth of participation banks and growth increase speed was decreased drastically. The reasons of presence of four participation banks in sector and the participation bank having serious problems in the sector have shares over 30 percent affect negatively all the statistical data to be appreciated. In the same way as the reduction of participation banks assets cause an reduction in the number of investable funds, financial certificate purchases is reduced. Therefore, the financial certificate purchases of BES (individual pension funds) sourced mutual funds, growing very fast in the sector, couldn't make security supply increase due to this factor. Besides participation banks have to get certificate of authorization from CMB and affiliate Borsa Istanbul in order to operate lease certificate operation in BIST. Participation banks haven't operated directly in this market yet as of May 2015. In addition, as it could't establish systemic infrastructure yet a date of 2015 and failed to promote, it hasn't sold any financial certificate directly to customers. Financial certificate sales are realised through intermediary companies. Financial certificates are generally collected in the banks and pension funds. While pension funds holding the financial certificates in his hand until the maturity date, participation banks use them on OMO operations carried out together with Central Bank. For these reasons, financial certificate operation volume hasn't increased on the

second hand market as desired level. In addition, as being an alternative product, active promotion and marketing for financial certificates participation counts can not be made, retail sale is not possible at all.

We can express that via tests and analysis performed so far that by elimination of this negativity in the market, security stocks will be increased as much as the conventional banks or at least will get close to that level. More importantly, through completion of lease certificate trading infrastructure for customers and their memberships by participation banks and as the number and volume of Islamic funds increase, these developments will cause lease certificates volume and operation volume to increase significantly.

Table 6.1: Islamic finance data

Year	Month	Active Size	Securities (Except Foreign Money)	Sukuk Transaction Size
2012	10	66,788	1,707	9,737,801
	11	68,538	1,707	9,171,494
	12	70,280	1,707	4,693,706
2013	1	71,780	2,530	6,802,076
	2	73,300	2,530	11,917,013
	3	74,820	2,530	15,172,759
	4	77,570	2,520	26,466,343
	5	80,320	2,520	56,683,159
	6	83,047	2,520	25,685,532
	7	85,600	3,415	17,280,599
	8	88,120	3,415	31,143,915
	9	90,765	3,415	17,821,115
	10	92,765	3,410	13,466,284
	11	94,800	3,410	28,523,417
	12	96,074	3,410	15,440,464
2014	1	95,900	4,088	23,904,573
	2	95,700	4,088	69,741,074
	3	95,551	4,088	64,484,605

	4	97,000	4,071	22,973,431
	5	98,600	4,071	54,268,223
	6	100,398	4,071	56,216,660
	7	101,200	4,085	47,401,929
	8	102,000	4,085	64,565,006
	9	102,591	4,085	39,395,880
	10	103,100	3,858	78,962,169
	11	103,700	3,858	53,863,465
	12	104,162	3,858	29,039,589
2015	1	105,200	3,778	47,977,721
	2	106,335	3,767	62,934,579

Source: www.bddk.org.tr

* Because it is unfeasible to obtain the data of active size balance-sheets of Islamic finance, 3 month balance sheets are divided to months in order to appreciate the growth rate of participation banks.

* Data is obtained from BDDK.

Table 6.2: Analysis result

Regression Analysis	
Multivariate R	0.781016799
R Square	0.609987241
Adjusted R Square	0.57878622
Standard Error	0.490899897
Observation	28

Annova

	df	SS	MS	F	F Significance
Regression	2	9.422536431	4.711268215	19.55023349	0.00
Difference	25	6.02456771	0.240982708		
Sum	27	15.44710414			

	Coefficients	Standard Error	t Stat	P-value	Low %95	High %95	Low 95.0%	High 95.0%
Intersection	-0.07634	0.24824	-0.3075	0.76	-0.5876	0.43493	-0.58762	0.43493
X Variate 1 Asset Size	3.86975	0.72121	5.3656	0.00	2.3843	5.35511	2.38438	5.35511
X Variate2 Securities	-1.21912	0.84732	-1.438	0.16	-2.9642	0.52596	-2.96421	0.52596

7. CONCLUSION

The basic principle of banking is to put raised funds to use as a credit. However, banks can not grant a credit the collected funds for a variety of reasons, such as, shortage of liquidity, market risk, additional money. According to market conditions, and conjuncture, a certain portion of the collected funds should be maintained in the bank. The remaining funds within the bank is appreciated through various methods by bank's treasury unit, and bank's liquidity is administrated, besides that bank's gain is attempted to be increased by these operations. The amount of funds in the banks grows, the amount of funds in the treasury management almost grows in the same proportion. While total assets in the banks was TL 212 billion in 2002, the banks' total assets as of the end of 2014 reached TL 2 trillion. Ten times growth in assets volume has led treasury fund management growth almost ten times.

The banks used to perform banking activities by lending to the government instead of using a credit before the year of 2000 when inflation was high. Security stock proportion in bank balance sheet was near 50-60 percent. With inflation falling, banks returned to the actual banking operations and begun to give the collected money as credit. Banks security stocks proportion was declined between 15-20 percent. So the share of treasury unit in the banks from funds management has declined 3 times. However, due to approximately ten times growth in bank's assets between the years 2002-2014, rather than reducing its share in treasury management, has led increase in the fund amount under the treasury management. As missing or incorrect management of funds in the treasury management will affect negatively bank making the funds use and fund collection; managing the fund management effectively by treasury will increase competitiveness of the bank. With the development of the security and bond market, the banks' share in capital markets has also increased. With the new term, by issuing the private sector bonds very often it increased its share and have strengthened its position. Due to trading the stocks is performed through its subsidiary intermediary companies, stock shares operations aren't performed within the bank but performed through intermediary firms. Along with growth of the economy, increased imports and exports, foreign funds coming into the country, foreign exchange and foreign exchange

derivatives based operation volumes and profits arising from these operations have increased within the bank.

To summarize the above status in participation banks; as participation banks could not invest into savings bonds in high inflation periods and at that time the Islamic finance was too small, treasury and capital markets operations volume were so low. Treasury operations had focused on certain products, and the operations volume relatively was very small. As a result of the very fast growth of participation banks every year, its total assets have increased by more than 10 times in the last 10 years, while it was TL 9 billion at first, it exceeds TL 100 billion now. Therefore, treasury operations in participation banks and funds management has also become very important as in commercial banks. With increase at assets volume, risks and risk dimensions participation banks will face have increased. With development of financial certificate and financial certificate based products, although participation banks have provided different products for liquidity and treasury management, a variety of product range hasn't existed as in the commercial banks. At the treasury with managing the funds in non-competitive prices as well as in commercial banks effects directly the bank profit and bank's fund use rates. Foreign exchange operations also as in other banks has increased in participation banks. However, in accordance with the principles of operation, derivative products such as futures, options haven't performed within the participation bank. As forward and swap products are used in accordance with certain criterias, they are not as widespread and voluminous as in the other banks and very limited used by companies dealing with export-import operations and foreign exchange office.

To appreciate the capital markets size of participation banks; with the arrival of sukuk on the market, participation banks will develop in this market widely, and take place in debt instrument market although not as much as conventional banks. However, this situation differs a bit little in respect of stocks. Approximately, half of 400-450 of the stock shares traded on BIST are in accordance with Islamic financial principles. In respect of traded volume of stock shares, more than half are traded on bank stock shares, the other ones aren't used in important operations. This data indicates that, BIST stock share market is not so developed market except banks and a few scaled private

sector companies. Currently, when BIST stock share market compared with developed markets in the world, remains very small. In addition, when we appreciate stock shares traded in the market according to an additional criteria, trading scope gets smaller.

For the participation banks to be more active in this market, stock shares number compatible with Islamic financial principles has to be increased and and these stock shares have to surely be promising companies which have possible to grow in the future. Otherwise the participation banks will remain small players in the market.

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