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**Corporate Sukuk: Building
the ecosystem to finance
sustainable infrastructure**
Deloitte Islamic Finance insights
series: Leading by engaging

1926
2016

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Foreword from Deloitte



Dr. Hatim El Tahir, FCIS
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It is a pleasure to share with you this whitepaper, which is based on a recent industry forum held in Istanbul, Turkey, combined with the insights and first-hand experience of many leading industry experts and Islamic Finance practitioners.

As the Islamic capital market begins to pivot toward the development of its ecosystem, it will be challenged with a number of internal and external factors that will impact on building its operational and functional infrastructure.

Institutions offering Islamic financial services (IIFSs) will need to make strategic decisions to realign their business models, human capital and business capabilities, and attempt to innovate for the growth of the Islamic 'debt capital market'. The latter, which is evidently much needed, is driven by the rise in capital investment for infrastructure projects in many countries across the world.

In this whitepaper we attempt to address some of the key regulatory and practice issues that this new asset class may encounter. Indeed, some of these have been extensively considered during our

industry forums and deliberations. We have structured the discussion into three focus practice areas, namely: regulation, markets, and business support and guidance. It was not possible, understandably, for this whitepaper to cover every aspect of these interlinked practice areas, but yet it has, in one way or another, attempted to address the key influencing factors of building a viable case for corporate Sukuk as the default choice for funding infrastructure projects.

That said, the discussion has benefited from, and been deepened by, the invaluable contributions of leading industry practitioners and researchers. Deloitte is grateful for their dedication and generous time given to contributing to and enriching the debate with their insights and experience.

This paper is part of a series on Islamic Finance, *Leading by Engaging*, produced by the Deloitte ME Islamic Finance Knowledge Center (IFKC). We hope that you enjoy reading this whitepaper and gain useful insights from it.

Foreword from the AAOIFI



Dr. Hamed Hassan Merah
Secretary General, AAOIFI

At the outset, on behalf of AAOIFI, I would like to commend the efforts exerted by Deloitte on this Sukuk project and I congratulate their management for the rewarding outcome.

The AAOIFI Sukuk project is underway, including a comprehensive project for the revision of Sharia' standards on Sukuk, in line with the developments in the field over the last two decades or so, in conjunction with another project on accounting standards, which aims to comprehensively review, and, if necessary, revise the existing financial accounting standards on investment in Sukuk, shares and similar instruments (FAS 25) and define the Sukuk issuer accounting treatment.

In the meantime, AAOIFI plans to hold a workshop on accounting matters for Sukuk in October 2016 in Al Khobar, Kingdom of Saudi Arabia. This workshop is expected to bring together a host of Islamic Finance experts and practitioners. Moreover, AAOIFI is currently embarking on several projects that will address specific industry issues. The AAOIFI Accounting Board has approved the new

strategy for standards development and the way forward. It reviewed a draft financial accounting standard on Murabaha, and also discussed preliminary studies on Ijarah and Sukuk standards. Other projects include a research project on the impact of IFRS 9 on Islamic Finance, provisions and reserves, Zakah, Khayar and Wa'ad (Islamic derivatives), general presentation and disclosures for Islamic banks and the framework review, among others.

Acknowledgments

Deloitte is grateful to acknowledge the support of a number of institutions and their contributions toward the making of this whitepaper and its points of view. We salute their courage and spirit to work with us in addressing industry issues which we aim to share with all industry stakeholders worldwide.

While the whitepaper has benefited greatly from their contributions, the views expressed herein are solely those of the authors and do not necessarily reflect the views of Deloitte.

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Executive summary

The context

The Asian Development Bank estimated in 2010 that developing Asian countries have an infrastructure spending need of US\$8 trillion over the ten years to 2020; the vast majority of this is needed for roads, railroads, power plants, and power transmission. Globally, as much as US\$78 trillion is expected to be spent on infrastructure through the years 2014-2025. The major drivers of this unprecedented amount of global infrastructure spending over the next ten years include:

1. The urgent need to upgrade U.S. infrastructure.
2. European infrastructure spending to bounce back post the European sovereign debt crisis.
3. Continued urbanization, especially among emerging market countries.

More recently, the Global Infrastructure Forum was established by the Multilateral Development Banks (MDBs) to help bridge the infrastructure gap as key for achieving the Sustainable Development Goals (SDGs). This will provide a forum for countries and development partners to work together by building on existing multilateral collaboration mechanisms, and to “improve alignment and coordination among established and new infrastructure initiatives, multilateral and national development banks, United Nation agencies, national institutions, development partners, and the private sector.” (the Addis Ababa Action Agenda (AAAA), Para 14).

Responding and building leading practice agility

This whitepaper seeks to discuss some of the key practice developments toward building an efficient corporate Sukuk market that is able to drive growth and help finance infrastructure in several markets around the world, and take its share of these huge infrastructure financing requirements.

The following discussion provides insight into the views and expectations of a number of industry thought leaders and professionals, whose chief emphasis has been to assess and address the practical corporate laws and investment mechanisms that impact on the structuring and marketing of corporate Sukuk as an alternative project financing tool for infrastructure projects.

Across all three practices, our whitepaper provides insights aligned to the following:

- **Financial reporting and disclosure** – Mohammad Majd Bakir provides a full account of the AAOIFI’s recent reviews of standards and initiatives in promoting leading practices. The emphasis here is on the Sukuk project and its pertinent accounting, Sharia’ and legal dimensions.
- **Global corporate support initiative** – Abdulaziz Alsaiani and Canan Ozkan discuss the role of the World Bank’s Islamic Finance Development Center and mandate for supporting the growth of the industry worldwide from Istanbul, Turkey.

- **A western appetite for infrastructure corporate Sukuk** – Claire O’Connor argues that ‘the development of robust and enduring liquidity is a principal factor to ensure the viability of Islamic Finance and this includes having a viable secondary market.’
- **Risk management strategy** – Osman Ahmed analyzes how corporate Sukuk can create value for issuers and investors alike, and argues that corporate Sukuk can be an effective tool for the assets and liabilities management strategy.
- **Market trend and structures** – Nihat Gumus explores the emerging Islamic capital market in Turkey and reviews regulatory and policy development, and the prospects for a Sukuk market in the country.
- **Case study: Sustainable energy Sukuk** – Metin Tekeci examines a landmark energy Sukuk and provides practical insights on structuring the Sukuk, leveraging supporting laws and the investment environment in Turkey.

Policy development and initiatives

The standard also needs to be evaluated vis-à-vis the requirements of the new IFRS 7 and 9 and IAS 32, etc.

The AAOIFI's comprehensive Sukuk project: Summary update

Sukuk are amongst the most important, rapidly growing, and popular Islamic Finance tools, and they are now deemed a standalone industry per se. Considering the ever evolving forms and types of Sukuk, as well as the emerging related issues, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) decided to revisit its Sharia' standard on Sukuk, which was issued 13 years ago, and which at the time provided landmark Sharia' guidance to the industry.

Why revisions are needed Sharia' standard

AAOIFI's project aims to comprehensively amend the existing Sharia' standard on Sukuk to account for the practical applications of Sukuk, and their emerging applications while covering the technicalities of all issuance stages.

Project targets: Key issues being addressed

Sharia' standard

- The Sharia' and legal nature of Sukuk as financial securities.
- Nature of asset ownership by Sukuk holders across legal jurisdictions (Sharia', legal, and beneficial ownership).
- Risks associated with Sukuk.

- Types of Sukuk according to risks associated with their assets (asset-backed, asset-based, and full ownership Sukuk).
- The right of Sukuk holders to have recourse to Sukuk assets.
- Differences between ordinary and sovereign Sukuk.
- Sukuk rating by rating agencies based on an issuer's solvency and quality of Sukuk assets.
- New structures: Hybrid Sukuk and exchangeable and convertible Sukuk, and Sukuk relating to tier 1 and tier 2 capital.
- The nature, conditions and uses of Sukuk asset purchases undertaken by the issuer, and treatment of cases of non-fulfillment.
- The nature of repurchase in the Sukuk asset repurchase undertaken by the issuer (originator), and treatment in cases of non-fulfillment.
- The Special Purpose Vehicle's (SVP) role.
- Cost, expenses and taxes relating to Sukuk issuance or Sukuk assets.
- Zakah of Sukuk.
- Sukuk trading and requirements for pooling of underlying debts, tangible assets, services and rights.
- Legal and accounting considerations for Sukuk (perspectives of the issuers and Sukuk holders).

- On-balance sheet and off-balance sheet structures.
- Role and responsibilities of Sharia' supervisory boards with respect to Sukuk issuance and monitoring.
- Responsibilities of issuers and Sukuk holders for defective contractual terms and conditions.
- Listing Sukuk on global financial markets and exchanges, and Sharia' requirements for documentation, disclosures and listing.
- Sukuk issuance by conventional financial institutions, with respect to Sukuk structures and the use of Sukuk proceeds.
- Submission of Sukuk and their disputes to different laws, and a Sharia'-compliant arbitration process.

Accounting standard

Accounting standard on investments

The AAOIFI project is being initiated along with a comprehensive project for the revision of the Sharia' standard on Sukuk, which should be read with that of the simultaneous revision project for the Sharia' standard itself. The project aims to comprehensively review, and, if necessary, revise the existing financial accounting standard on investment in Sukuk, shares and similar instruments (FAS 25).

The said standard (i.e. FAS 25) neither covers several practical applications of the Sukuk market, and their emerging applications in certain respects, nor does it tackle technicalities relating to all issuance stages, from structuring through to listing.



Accounting of unlisted Sukuk and sovereign Sukuk should be covered, and accounting practices under different jurisdictions need to be discussed and evaluated at both ends. Additionally, various stakeholders, including regulators and accounting bodies, may need to be engaged in order to develop a universally acceptable standard. The standard also needs to be evaluated vis-à-vis the requirements of the new IFRS 7 and 9 and IAS 32, etc.

Accounting for Sukuk issuers

Accounting for Sukuk issuers needs to be addressed. Although certain, or rather most, Sukuk issuers do not fall within the scope of AAOIFI, it is time to consider suggesting accounting for Sukuk issuers (particularly for IFIs issuing Sukuk).

Additionally, various stakeholders, including regulators and accounting bodies, may need to be engaged in order to develop a universally acceptable standard

Accounting standards

Key areas of coverage

- Accounting and reporting differences for various types of instruments and structures.
- Accounting and reporting differences with IFRS and other reporting requirements.
- Accounting for impairment.
- Accounting treatment for Sukuk asset replacement, intangible assets of Sukuk, and taxes on Sukuk or Sukuk assets.
- Computation of fair value of Sukuk instruments.
- Minimum disclosures for Sukuk.
- Accounting in the hands of the issuer/originator.
- Sukuk non-compliance, with corresponding accounting treatments and reporting requirements.

Certain key considerations on the accounting of Sukuk

- Are Sukuk financial instruments?
- Debt instrument vs. equity instrument vs. quasi equity instrument: the right approach.
- AAOIFI standards inconsistency: three classifications on the liability side, but two classifications in investments. Is this correct?
- Can IFRS 9 and IFRS 13 be applied on Sukuk?
- Which valuation models will be used?
- Should it be valuation of instrument or of the underlying asset?
- Accounting suggestions for debt-type, equity-type and quasi-equity type instruments.
- Sharia' implications and issues that may impact accounting and/or vice versa?
- Reputation risk – Sharia' compliance and accounting linkage – does it really matter?

- Should AAOIFI define issuer accounting? If no, what about inconsistency? If yes, should it be defined only for IFIs issuing Sukuk or for the common entities issuing Sukuk?
- On balance sheet vs. off balance sheet: the right approach and implications, as well as the benefits.

Progress updates and finalization targets
The project is progressing at a reasonable pace. The Sharia' standard working group was formed in the first half of 2015 and commenced its work. Several meetings of the working group have been held and two workshops have been conducted with industry practitioners in Malaysia and Bahrain. Work on the Sharia' standard is in the advanced stages.

An accounting standard working group has also been formed and the secretariat has already commenced the technical background work. The AAOIFI Accounting Board (in July 2016) reviewed the key issues and considerations for the process and has already provided its strategic guidance to the working group to come up with a robust, comprehensive standard. The accounting standard work is planned to be completed towards the end of 2016.

World Bank Global Islamic Finance Development Center: Role and activities

The Islamic Finance industry exceeded the US\$1.88 trillion level by 2015 (IFSB Secretariat Workings¹). This rapid growth raises a need for a developed financial sector, a comprehensive regulation and supervision framework, standardization of products, and risk management from both a micro- and macro-prudential perspective. Research activities and the

The AAOIFI Accounting Board (in July 2016) reviewed the key issues and considerations for the process and has already provided its strategic guidance to the working group

1. Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.).

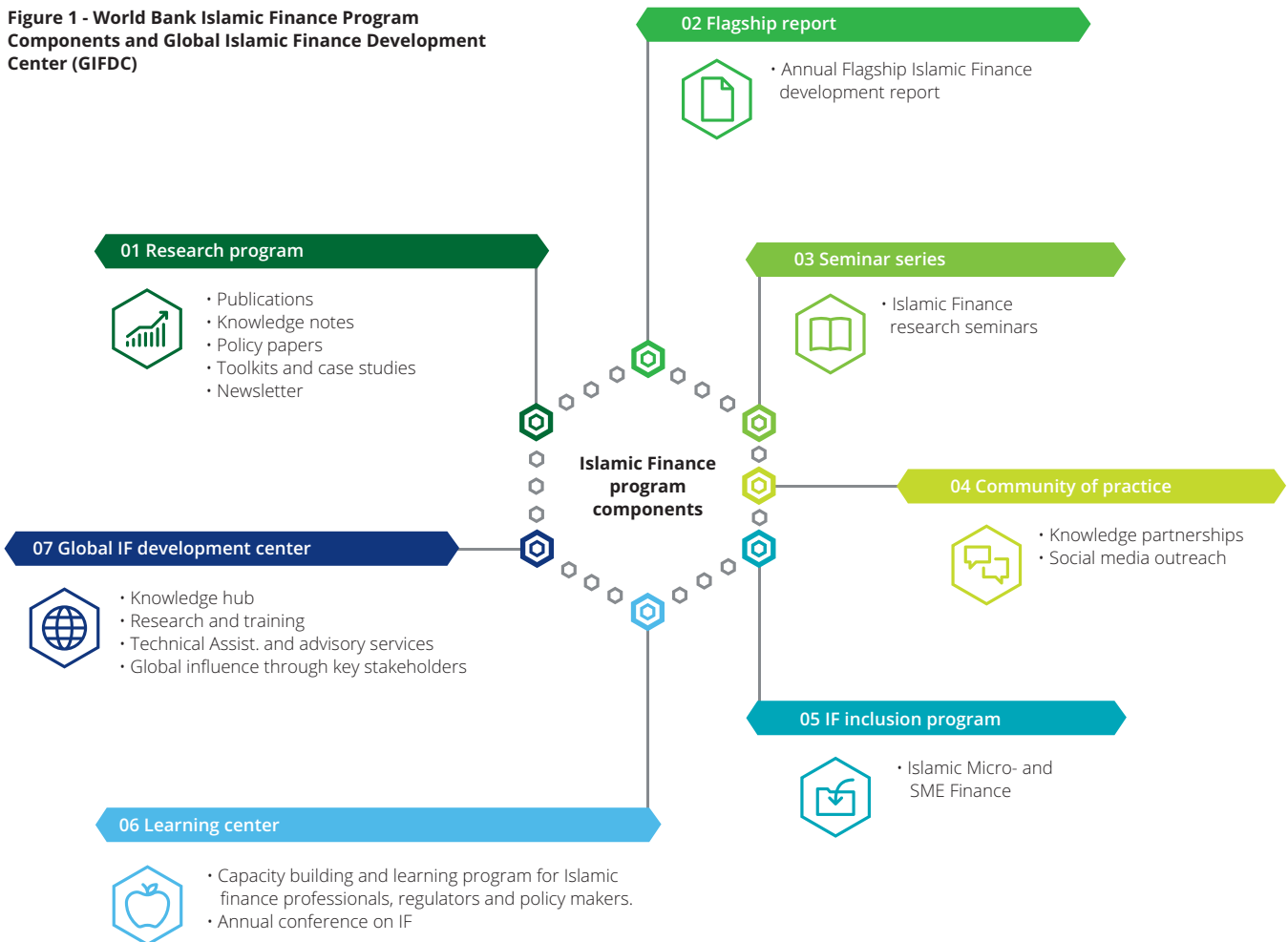
utilization of best practices are required for the development of principles and standards that financial institutions and market participants who engage in Islamic Finance might rely on. This will in turn promote the contribution of Islamic Finance tools to overall economic development. With its commitment to its twin goals of eliminating extreme poverty by 2030 and boosting shared prosperity, the World Bank established a knowledge hub and development center in 2013 called the Global Islamic Finance

Development Center, based in Istanbul. The center aims to help World Bank member countries interested in developing Islamic Finance to promote growth and development. Figure 1 shows the broader program and its various components related to the World Bank's engagement in Islamic Finance. This clearly shows a diversity of activities to serve the different needs of the sector.

The activities of the center aim to improve the general understanding of Islamic

The center aims to help World Bank member countries interested in developing Islamic Finance to promote growth and development

Figure 1 - World Bank Islamic Finance Program Components and Global Islamic Finance Development Center (GIFDC)

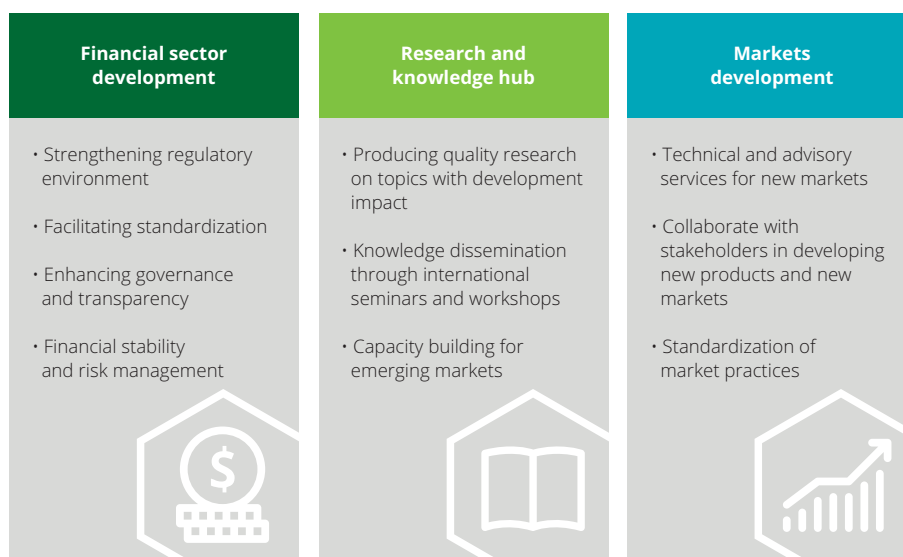


Finance globally and support regulators and policymakers in introducing and maintaining a sustainable enabling environment for the fruitful development of the Islamic Finance industry (Figure 2). The activities can be classified by three categories: i. Development of financial sectors in client countries, ii. Research, iii. Development of markets.

countries. Long-term investment financing through alternative financial instruments, especially Islamic Finance, has been high on the G20 agenda and is expected to continue to be so in the upcoming G20 meetings. The conference focused on the role of Sukuk markets in creating long-term financing opportunities and concluded that the success would largely

In the area of policy recommendation, the GIFDC is providing advisory and technical assistance to member countries interested in developing their financial sectors to enable Islamic Finance. As an example of these types of activities, the GIFDC is currently engaged in a project that includes making a technical review of capital market regulations and the legal framework to develop and enable the Sukuk market in an OIC (Organization of Islamic Cooperation) country.

Figure 2 - Categories of the Global Islamic Finance Development Center activities

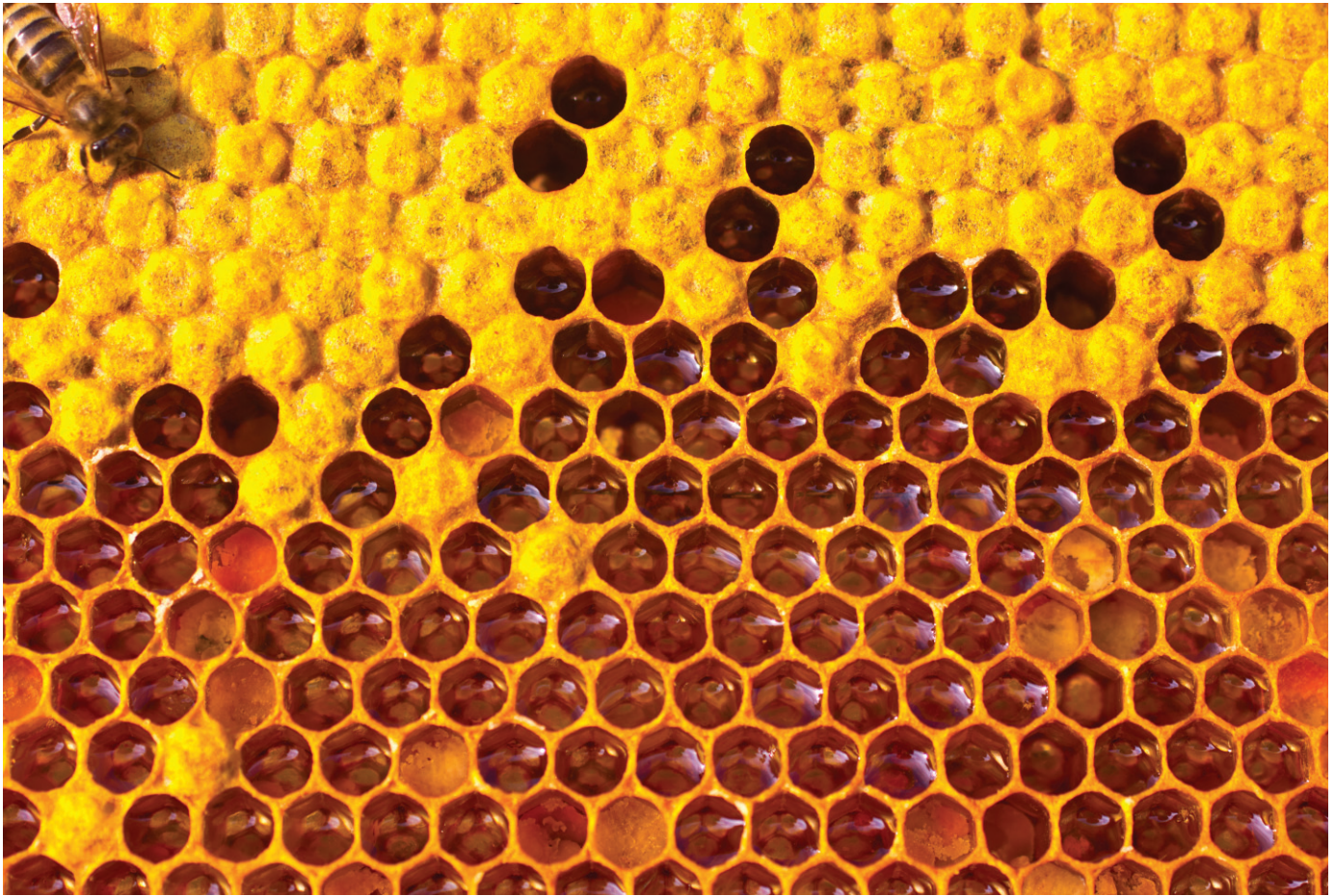


The GIFDC is undertaking theoretical and empirical research in the areas relating to the relevance of Islamic Finance to economic development, banking, capital markets, insurance, non-bank financial institutions, microfinance, and financial inclusion

The GIFDC is undertaking theoretical and empirical research in the areas relating to the relevance of Islamic Finance to economic development, banking, capital markets, insurance, non-bank financial institutions, microfinance, and financial inclusion. The World Bank, jointly with the Capital Markets Board (CMB) of Turkey and Borsa Istanbul, organized the G20 international conference on “Mobilizing Islamic Finance for Long-Term Investment Financing” in Istanbul, Turkey on November 18-19, 2015. The conference was attended by more than 250 participants drawn from public and private sector experts, academicians and market practitioners representing over 15

depend on the development of institutional investors, a regulatory and legal framework to encourage asset-based finance, Takaful (Islamic insurance), and the diversification of financial products for mobilization and risk management. Drawing on research undertaken by the Center for SMEs, the best business practices that utilize Islamic Finance as an alternative financing for SMEs were discussed. Following on from these research activities, it was suggested that new Sharia’-compliant product development in the area of SMEs should take place for their inclusion in the financial sector.

The GIFDC is planning an event in the not-too-distant future with the Capital Markets Authority (CMA) in Saudi Arabia. The event will bring together various stakeholders from the Islamic Finance industry, capital market regulatory bodies, multilateral development banks (MDBs), institutional investors, and policymakers with the main objective of discussing the potential for Sukuk market development, including addressing related issues and challenges, and generating ideas on how Sukuk markets can contribute to long-term economic growth within the GCC region. This set of activities involves working closely with client countries on enhancing their legal and institutional infrastructure.



The establishment of a legal and regulatory framework for corporates as well as Islamic banks, capital markets, and Islamic Finance practices, such as the investment and pension funds sector, insurance, microfinance and SME financing, is the sine qua non for the overall development of Islamic Finance. Only in such an environment can new Islamic Finance products be developed and introduced to the preferences of both domestic and international investors. These efforts will be conducive to Islamic Finance and will also pave the way for the vision of utilizing Islamic Finance as an alternative financing tool for long-term investments.

GIFDC is currently engaged in a project that includes making a technical review of capital market regulations and the legal framework to develop and enable the Sukuk market in an OIC (Organization of Islamic Cooperation) country

Practices and markets

Recognizing infrastructure as an asset class in its own right facilitates not only a potential increase in investment fund allocation but also innovative methods of funding. One such instrument being considered is the corporate Sukuk

A western appetite for infrastructure corporate Sukuk - A bearing on the development of Islamic Finance

Unglamorous as it may be, infrastructure investment is vital for economic growth, and traditionally deals have been financed through banks and governments. Globally there is an undeniable need for infrastructure development, with the OECD estimating that a minimum of US\$71 trillion would be needed by 2030. The UK government has identified a circa £480 billion national infrastructure pipeline up to the end of 2021, comprising over 600 major projects. Importantly around 50% of this investment is earmarked for financing and delivery by the private sector.

Recognizing infrastructure as an asset class in its own right facilitates not only a potential increase in investment fund allocation but also innovative methods of funding. One such instrument being considered is the corporate Sukuk. Theoretically a Sharia'-compliant Sukuk is risk sharing in nature, providing for undivided shares in ownership of, inter alia, the assets of particular projects or activities that have a strong link to the real economy. Conceptually, therefore, the characteristics of a Sukuk or 'Islamic Finance bond' should provide for compelling interest and appetite as an alternative financing method.

However, there is inherent, systemic and operational risk associated with corporate Sukuk – the primary risk being the overriding purpose for and development of Islamic Finance.

Together with the lack of Islamic jurisprudence, it is the diverging jurisdictional, political, economic,

corporate and investor landscapes and their agendas that challenge the very purpose for and hampering of the development of Islamic Finance. Whilst these drivers are distinct, they are also interrelated. This has resulted in the introduction of a significant range of stakeholders, who, by virtue of their agendas, will allocate different priorities to the risk profile of the development and sustainability of Islamic Finance and thereby corporate Sukuk in its truest sense.

To date the majority of corporate Sukuk have been transacted 'off-market', thereby limiting the opportunity to disseminate information and create an understanding of the corporate Sukuk as currently practiced and transacted. This impacts not only the potential for education and understanding, but arguably exposes the practice of corporate Sukuk to manipulation and circumvention of Sharia', and, thus, the credibility of Islamic Finance itself.

The structure of corporate Sukuk is evolving into an increasing 'complexity of transactions' within a transaction, using a combination and variety of Sharia'-compliant modes of financing. This effectively renders each corporate Sukuk bespoke. The result impacts the potential for international standard-setting bodies such as IFSB, IIFM and AAOIFI to bring about market unification in best practices in order to achieve some form of standardization and harmonization. This ultimately affects the ability to create a robust, transparent and efficient Islamic Finance industry.

The profound influence of Sharia' scholars on the activities and operations of Islamic

Finance has become a distinguishing and controversial characteristic of the industry, and therefore an influence that must be held to account. The divergence of views amongst scholars should not be used as a justification for the lack of explanation, reasoning and disclosure in regard to interpretation of Sharia' compliance (as is arguably the current Western practice), nor for stretching the boundaries of innovation beyond the true spirit and principles of Sharia'. Equally, advantage should not be taken where jurisdictional legislation and regulation may create loopholes for the circumvention of Sharia' compliance. However, such behavior may become an increasing issue in the race to exploit the potential of corporate Sukuk.

The development of robust and enduring liquidity is a principal factor to ensure the viability of Islamic Finance, and this includes having a viable secondary market. Together, the volume and depth of products, ability to transact, and diversity of investors willing to transact, are key components in developing liquidity.

The issuance of corporate Sukuk onto a capital market has limiting factors in its ability to address liquidity as a whole. The size of each issue could potentially veil the reality of lack of volume, restriction of geographical spread and depth of the market itself. Given the nature of infrastructure and potential volatility of markets, investors may well prefer to 'sit on' their investment outside of a capital market. Achieving a sound secondary capital market for Islamic Finance may therefore continue to be elusive, with a singular transactional market developing instead.

Most Western corporates and investors, being accustomed to plain vanilla corporate bond issues, lack the knowledge to understand the differing approach to assets, risk and contractual relationships that are involved in a corporate Sukuk and

Islamic Finance. The industry currently lacks the resources and expertise to translate such critical understanding and knowledge into a user-friendly, transparent and complete package. It requires an approach and language that is real and correlates to the users' investment and financing decisions, particularly in terms of risks and rewards. In addition, the participation of rating agencies appears to be limited to the worthiness of the 'ultimate' corporate issuer and quality of any guarantors and their guarantees. The consequences will ultimately affect the credibility of Islamic Finance and investor confidence.

Whilst it cannot be ignored that potential investors in corporate Sukuk may be sourced from a broader base than that of corporate bonds, and that certain Western jurisdictions are assertively looking to attract Islamic Finance, both may prove to be less of a reality. The challenges of low oil and commodity prices in the Middle East and Asia, and global interest rate adjustments, have been compounded by the continuing shockwaves emanating within the European Union from the Brexit decision. More recently the European Commission's challenge to Ireland's tax regime will provide pause for thought, particularly as Ireland has been progressive in its embracing of Islamic Finance and corporate Sukuk.

Therefore the current circumstances that are driving development are potentially creating a singular transactional market alongside insular domestic markets, both of which lack the means to create liquidity. The threat of Sharia' non-compliance exists, compounded by the potential for manipulation and avoidance. The danger of creating a platform for hijacking and surrendering the very spirit of Islamic Finance through agendas is genuine.

Corporate Sukuk: Creating value for asset and liability management

In conventional financial theory, asset liability management (ALM) is basically a balance sheet management tool. It involves taking an integrated approach to strategic balance sheet management. It deals with on balance sheet items, off balance sheet items and behind balance sheet issues.

A. On balance sheet items:

The on balance sheet items on the side of assets include: Islamic facilities, investments, treasury and fixed assets. The on balance sheet items on the liabilities side are debts, investment accounts and, owners' equity.

B. Off balance sheet items:

The off balance sheet items include the contingent assets and liabilities, and fiduciary investments. In Islamic banking they include restricted Mudaraba investment accounts, Wakala

Most Western corporates and investors, being accustomed to plain vanilla corporate bond issues, lack the knowledge to understand the differing approach to assets, risk and contractual relationships that are involved in a corporate Sukuk

investments & investment funds, and their respective assets.

C. The behind balance sheet related to ALM in Islamic banking:

The behind balance sheet issues related to ALM in Islamic banking are information technology, banking regulation such as central bank requirements, and international regulation, such as Basel requirements and IFSB. It should certainly be pointed out clearly that the ALM is different from:

- **Treasury management** - because treasury management deals with treasury assets and funding. Funding in this context is the process of placing money with banks and issuing commercial papers. Subsequently, treasury management deals with part of balance sheet management, i.e., the ALM, and is therefore a subset of ALM.
- **Asset management** - because asset management deals with one side of the balance sheet while ALM deals with both sides (assets and liabilities). Fundamentally, asset management addresses and deals with portfolio management, asset allocation strategies, and market and credit risks.
- **Trading risk management** - trading is the selling and buying of stocks, Sukuk (bonds), options and future contracts (if Sharia' compliant in the case of Islamic banks). In this way, trading deals with one activity of the bank while ALM deals with all activities, and the former is considered as part of the latter.
- **Risk management** - because risk management is concerned with risk element of the business. It focuses on controlling risk and uses risk measurement techniques, such as gap, duration and value-at-risk. On the other hand, ALM deals with both risk

and return, and is for everyone in the bank. Moreover, ALM should involve people in treasury, operations, branch management, audit, dealers, marketing etc.

Creating value in Islamic Finance

Different types of techniques are evidently employed in Islamic banking practices.

Below are some of the common measures used:

- Determining the financial goals and objectives of the Islamic financial institutions in line with the Sharia' Board guidelines and principals.
- Creating an Asset / Liability Management Committee (ALCO) in Islamic banks.
- Creating a proper management information system (MIS) in Islamic banks.

- Applying ALM tools to analyze the current balance sheet of Islamic banks (tools such as simulation and modeling and sensitivity analysis).
- Determining and implementing the strategies for transforming the current balance sheets of Islamic banks to the ideal balance sheet, through asset sales, asset swaps, securitization, derivatives, newly engineered Sharia'-compliant securities, etc.
- Utilizing risk management strategies based on the goals and objectives of Islamic banks.

Sukuk as a tool for asset and liability management

The securitization process is a financial tool that enhances the liquidity of a firm or a financial institution. Risk/return participation is emphasized in Islamic Finance. Due to the fact that securitization incorporates risk/return participation characteristics, it can be utilized very efficiently in the Islamic financial systems, especially for ALM in Islamic banks.

In this context, Sukuk issues could be considered as Islamic investment certificates that would help enormously in the ALM of Islamic banks. Sukuk certificates are securitized assets and therefore belong to the category of asset-backed securities. However, Sukuk certificates are backed by Sharia' compatible streams of income and

Sukuk certificates are backed by Sharia' compatible streams of income and tangible assets. One can consider these certificates as a "Sharia'-compatible instrument for ALM."

tangible assets. One can consider these certificates as a "Sharia'-compatible instrument for ALM".

In principle, any form of Islamic securitization design must exclude Riba, which is a form of usury, Gharar, a form of deception in trade or trading of risk where asymmetric information and risk profile exists in a contract, and Maysir, described as a highly speculative form of trade or gambling.

Provided Sharia' requirements are met, Sukuk issues are intrinsically financial instruments that mobilize funds using the balance sheet, credibility and feasibility of proposed projects (asset-based). They are negotiable in the secondary markets, meaning Sukuk are structured finance certificates.

Therefore, Sukuk can be very effective in managing liquidity in Islamic financial institutions and meeting short-term liquidity management and ALM requirements. Sukuk can be developed through the securitization of assets that represent the proportionate ownership of the holder in illiquid or tradable assets. Trading of such securities is permissible from the Sharia' perspective, as this is equivalent to the sale/purchase of the holder's proportionate share in the assets, which is allowed in Sharia'. Examples include the Malaysia Ijarah Sukuk, Qatar Global Sukuk, Dubai Global Sukuk, Sudan Government Sukuk, Central Bank of Sudan Sukuk.

Sukuk instruments for ALM include short- and/or long-term Sukuk that are traded on the official exchanges (secondary market trading). This type of Sukuk can provide the necessary instruments and facilities to resolve the liquidity problems faced by most Islamic financial institutions. Here the Sukuk are issued based on various Islamic financial contracts and hence there are various Sukuk issuances, such as Ijarah Sukuk (under two years), Musharaka Sukuk (under two years), Mudaraba Sukuk, Salam Sukuk and Istisna Sukuk.

Islamic financial institutions can leverage the attractiveness of Sukuk to mobilize more resources through investing in Sukuk instruments. Sukuk can be pretty attractive for investors if priced

competitively, Sharia'-compliant, A-rated instruments, eligible for listing on an exchange (to enhance liquidity), varying in terms of available maturities (short to long), and can structure various risk/return profiles based on the underlying assets.

However, to issue Sukuk for sustainable ALM purposes, IFIs should be certain about the availability of qualifying assets (the Sukuk pool), determine the asset value of the Sukuk pool at the time of repayment, segregate the Sukuk pool from other portfolios, and eliminate or minimize the impact of any restrictive covenants in the existing documentation that may prevent the selection of assets into the Sukuk pool.

To emphasize, Sukuk issuers must have underlying assets that exist in a form that is well defined and legally enforceable.

The prospects and potential of the Sukuk market in Turkey

The roots of Islamic Finance in Turkey can be traced back to the late 1980s when the first Islamic banks, or participation banks as they are called in Turkey, started to be established. Since that time, the Islamic Finance sector has developed based mainly upon Islamic banks. The Islamic banking sector represented a relatively small portion of the entire banking sector during the 1990s. Indeed, until 2003 the sector could only reach a proportion of 2.01% of the whole banking sector in terms of asset size. However, the sector witnessed a stage of remarkable growth between 2003 and 2015. In this period, total assets of participation banks increased from TRY 5.11 billion to TRY 120.25 billion, corresponding to around a 30% cumulative average annual growth rate. In comparison, the growth rate of the entire banking sector during this time was around 20%. Meanwhile the share of total

Sukuk instruments for ALM include short and/or long-term Sukuk that are traded on the official exchanges (secondary market trading)

participation bank assets in the total banking sector increased to 5.1 by the end of 2015.

Unfortunately, the participation banking sector could not achieve such a strong performance on the market side. Despite some attempts to create a participation index composed of listed equity shares in compliance with the requirements of Islamic Finance, there has been little development of Islamic capital market instruments and asset management practices.

The opening of the Lease Certificate Market at Borsa Istanbul and the dollar and Turkish lira denominated Sukuk issuances by the Turkish Treasury paved the way for further development

The Sukuk market in Turkey is still in its infancy, especially when compared to its banking counterpart. However, remarkable developments have occurred since 2010, including a Turkish participation bank, namely Kuwait Turk, issuing the first Sukuk amounting to US\$500 million through the over the counter market. In 2011, an additional US\$750 billion was issued via the same method.

September 2012 represented a turning point for the development of the market. The opening of the Lease Certificate Market at Borsa Istanbul and the dollar and Turkish lira denominated Sukuk issuances by the Turkish Treasury paved the way for further development. During 2012, three Sukuk issuances were

realized, amounting to around US\$2.3 billion and TRY 1.6 billion. Between 2013 and the end of 2015, around US\$10 billion and TRY 10 billion were raised through 74 Sukuk issuances. While the issuer of 55% of the total dollar denominated Sukuk issuances between 2012 and 2015 was the Islamic Development Bank Group, the Turkish government accounted for the remaining 45%. During the same period, 33% of the total TRY-denominated Sukuk were issued by corporates while the government accounted for 67%.

Regulatory infrastructure for Sukuk in Turkey

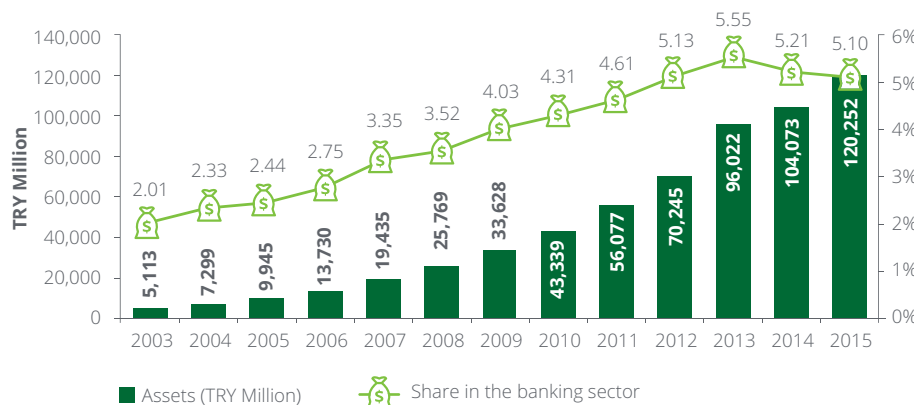
On the government side, the issuance of public Sukuk is done by the SPV established by the Turkish Treasury. The issues by the Treasury are regulated under article 7/A of the Law on the Regulation of Public Finance and Debt Management numbered 4749.

For the issues by other institutions, the Turkish Capital Market Board announced its Communique on Lease Certificates in June 2013, enabling the issuance of five new types of Sukuk, namely Sukuk based upon:

- Ownership (Ijarah)
- Management Contract (Ijarah and Wakala)
- Buying and Selling (Murabaha)
- Partnership (Mudaraba and Musharaka)
- Work Contract (Istisna)

Through the communique a new arrangement was made revising the status of SPVs. The new legislation clarified the legal status of SPVs to be established as joint stock companies and opened up the way for the SPVs to issue more than one Sukuk from the same or different issuers. The SPV can issue the Sukuk either through public offering or through private placement. Issued Sukuk should be registered with the Central Registry Agency. The definition of the underlying assets has been extended in accordance with the Capital Market Law, enabling the deployment of not only real assets but also usufruct for underlying assets. In order to mitigate the risks associated with any possible conflict of interest issues, an independent board member requirement has been put in place for SPVs and important decisions have been made subject to the positive vote of that independent member. In order to protect investor rights, SPVs are required to keep a track record of the underlying assets and obligations considering different Sukuk through separate accounts. In addition, a pledge requirement for assets and rights has been put in place and it is stated that only specific types of companies can issue Wakala and Murabaha Sukuk. For instance, in the case of Wakala Sukuk only banks and specific intermediaries can be the issuer.

Figure 3 - Asset size of Turkish participation banks and share in total banking assets



Another important step in the development of Sukuk was the decision of the Central Bank of the Turkish Republic (CBRT) in October and November 2012 to update its related legislations, enabling the acceptance of Sukuk issued by the Turkish Treasury as collateral in foreign exchange transactions, in liquidity support operations and within the interbank money market.

Regarding the tax treatment of Sukuk, significant developments have taken place since 2011 in order to provide a level playing field compared to the tax treatment of conventional bonds. Through new regulation, all operations concerning Sukuk issuances have been exempted from value-added tax, stamp tax and corporate tax. However, for real persons the income from Sukuk investments are subject to 10% withdrawal tax just like conventional fixed income securities. No additional income tax is paid other than this amount. In the case of corporates, the withdrawal tax rate for income from

buying and selling of Sukuk and income from periodic payments is zero percent. Based on the regulations since 2011 there remain no differences between the tax treatments of Sukuk and conventional bonds.

Of relevance to Sukuk, the Capital Market Board of Turkey published a communique on investment funds on July 9th, 2013. The communique is concerned with the establishment and operation of various kinds of investment funds, and the articles on venture capital investment funds, real estate investment funds, infrastructure real estate investment funds and participation funds are of importance in relation to Islamic capital markets. Through the communique the establishment and operation rules of possible Islamic funds are also determined. Together with this communique, some arrangements have been made with respect to taxation, summarized in the table on the right.

The new legislation clarified the legal status of SPVs to be established as joint stock companies and opened up the way for the SPVs to issue more than one Sukuk from the same or different issuers

Table 1 - The regulatory environment for Sukuk issuance in Turkey

Legislation regulating Sukuk issuances	<ul style="list-style-type: none"> • The Law on Regulation of Public Finance and Debt Management for Government Sukuk Issuance • June 2013-dated communique of the Capital Market Board of Turkey on the issuance of Lease Certificates 	<ul style="list-style-type: none"> • July 2013- dated communique of the Capital Market Board of Turkey on Investment Funds
Types of eligible Sukuk structures	<ul style="list-style-type: none"> • Ownership (Ijarah) • Management Contract (Ijarah and Wakala) • Buying and Selling (Murabaha) 	<ul style="list-style-type: none"> • Partnership (Mudaraba and Musharaka) • Work Contract (Istisna)
Monetary policy and liquidity risk management	<ul style="list-style-type: none"> • Sukuk is accepted as collateral in foreign exchange transactions, in liquidity support operations and within the interbank money market 	
Tax treatment of Sukuk	<ul style="list-style-type: none"> • Same as conventional debt instruments • For real persons, 10% withdrawal tax and no additional income tax 	<ul style="list-style-type: none"> • For corporates, 0% withdrawal tax and no income tax • No value-added tax, stamp duty or corporate tax for issuance processes
Secondary market trading	<ul style="list-style-type: none"> • Sukuk can be listed on the Borsa Istanbul Debt Instruments Market 	

Table 2 - Tax treatment of some investment funds in Turkey

	The taxation of the fund	The taxation of investors
Venture capital investment funds	<ul style="list-style-type: none"> Earnings of the fund are exempt from any tax 	<ul style="list-style-type: none"> Institutional Investors <ul style="list-style-type: none"> No withdrawal tax when selling participation certificates No corporate tax on the earnings from the funds Individual investors <ul style="list-style-type: none"> All earnings via participation certificates are exempt from income tax
Real estate investment funds	<ul style="list-style-type: none"> Earnings of the fund are exempt from any tax 	<ul style="list-style-type: none"> Institutional investors <ul style="list-style-type: none"> No corporate tax on the earnings from the funds Individual Investors <ul style="list-style-type: none"> 10% withdrawal tax on earnings from participation certificates
Infrastructure real investment funds	<ul style="list-style-type: none"> Earnings of the fund are exempt from any tax 	<ul style="list-style-type: none"> Institutional investors <ul style="list-style-type: none"> No withdrawal tax when selling participation certificates 20% corporate tax on earnings from the funds Individual Investors <ul style="list-style-type: none"> No withdrawal tax when selling participation certificates No tax on earnings from the funds up to a certain amount
Participation funds	<ul style="list-style-type: none"> Earnings of the fund are exempt from any tax 	<ul style="list-style-type: none"> Institutional investors <ul style="list-style-type: none"> No corporate tax on earnings from the funds Individual Investors <ul style="list-style-type: none"> 10% withdrawal tax on earnings from participation certificates

Policy recommendations for the growth of the corporate Sukuk market in Turkey

The corporate Sukuk market has been an important ingredient of the global Sukuk sector since 2001. Until 2008 corporate Sukuk issuances took the biggest share among global issuances. However, after the global financial crisis, the picture changed in favor of sovereign and quasi-sovereign institutions. Despite this development, the increase in the absolute amount of corporate Sukuk issuances continued to grow, pointing to the huge potential of both international and

domestic markets for private sector firms to finance their operations and investments.

Islamic Finance in Turkey has developed mainly based on Islamic banking while Islamic capital market instruments received little attention until 2010. Since that date, developments began on both the Sukuk and other capital market instruments side. In 2012, the government issued its first Sukuk listed on the Lease Certificate Market established at Borsa Istanbul in the same year. In 2013, the Capital Market Board of Turkey enacted

The awareness of and literacy in Sukuk should be developed among private sector firms together with human capital development in the area

some regulations on Sukuk and on investment funds, which paved the way for Islamic capital market institutions and instruments to grow. Significant tax benefits are provided regarding the issuance of Sukuk, and the establishment and operation of Islamic investment schemes.

Despite these developments, Islamic capital market instruments, and the Sukuk and especially corporate Sukuk market still have a long way to go in Turkey. The following are some key points for the corporate Sukuk market to develop further:

- The awareness of and literacy in Sukuk should be developed among private sector firms together with human capital development in the area.
- The potential sectors for the development of the corporate Sukuk market are information technology, telecommunication, education, health, real estate, energy and natural resources, automotive, textile, defense and aviation, electronics, logistics, recycling and agriculture.
- Mechanisms should be established for the rating of Sukuk.
- A special regulation might be useful for the establishment and operation of SPVs.

- Mechanisms should be designed for the establishment of Sharia' Boards to ensure the Sharia'-compliance of Sukuk and investment schemes.
- Effective corporate governance practices should be ensured.

Case Study: TRY100 million Wakala Sukuk in the energy sector

The first example of Wakala Sukuk structure in the Turkish real economy sector

I. A brief overview of the short history and legal infrastructure of the Turkish Sukuk market

Modern Turkish Islamic banking history dates back to the early 1980s. The legal infrastructure was unified with conventional banking under Banking Law Nr.5411² in 2005. The Turkish Sukuk market, in relation to its Islamic banking roots in Turkey, emerged relatively late

when compared to its global peers in Islamic Finance.

The legal framework of Sukuk in Turkey started to emerge under the Capital Market regulations with the initial Serial III-43 Communique on Lease Certificates in 2010. Until the enactment of Omnibus Law Nr. 6111, which enables an isolation of the tax burden on the Jarah Sukuk issuances, the applicability of Sukuk remained a theoretical discussion, especially for non-bank real economy sector companies in the Turkish market. The first issuance was the sovereign Sukuk issuances of the Turkish Undersecretariat of the Treasury in 2012.

At the end of 2012 and in mid 2013, the new Capital Markets Law Nr.6362³ and the new Communique in Lease Certificates (Serial 61.1)⁴ (the Communique, hereafter),

were enacted and provided the biggest leverage for market players to issue their private sector Sukuk. The transactions completed until 2016, though not very frequent in number, proved that the Sukuk market had significant potential to become a complementary solution to conventional bonds and loans in Turkey.

Sukuk types listed under the Communique, to structure an issuance are:

1. Ownership (Ijarah)
2. Management Contract (Wakala)
3. Trade (Murabaha)
4. Partnership (Mudaraba)
5. Construction contract (Istisna).

All these types of Sukuk, or any hybrid types that would be accepted by the Capital Markets Board, may be issued through public offering, through private placement or sales to qualified investors only.

A unique feature of Turkish Sukuk regulation, compared to its global benchmark, is that SPVs or "Asset Leasing Companies- ALCs"⁵ are permitted to issue multiple Sukuk concurrently on behalf of different originator companies, subject to the approval of the Capital Markets Board. This permission mitigates the cost of establishment and running an SPV, and concentrates a knowledge base on the subject matter. The financial reporting of the asset base of different Sukuk issuances is segregated in the financial statements. The liquidation process in case of default is also defined to be

A unique feature of Turkish Sukuk regulation, compared to its global benchmark, is that SPVs or "Asset Leasing Companies- ALCs" are permitted to issue multiple Sukuk concurrently on behalf of different originator companies, subject to the approval of the Capital Markets Board

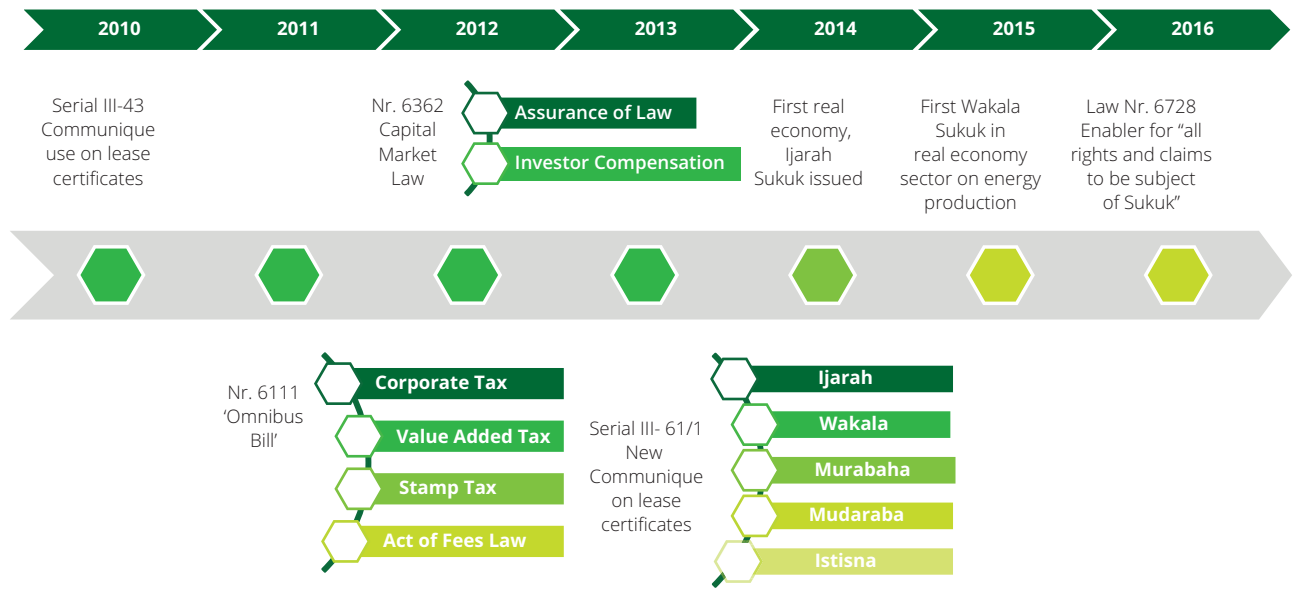
2. Turkish Banking Law 5411 https://www.bddk.org.tr/websitesi/english/Legislation/14905banking_law_december_2013.pdf

3. Capital Market Law 6362 <http://www.cmb.gov.tr/displayfile.aspx?action=displayfile&pageid=87&fn=87.pdf&submenuheader=null>

4. Communique on Lease Certificates, published by Capital Markets Board of Turkey <http://www.spk.gov.tr/apps/teblig/displayteblig.aspx?id=473&ct=f&action=displayfile>

5. SPV (Special Purpose Vehicle), also used legally as "Asset Leasing Company" in Turkish Legislature, is a capital market institution incorporated as a joint stock company exclusively for the purpose of issuing lease certificates

Figure 4 - Legal infrastructure of Sukuk in Turkey and milestones in Turkish real economy



managed and executed by the Investor Compensation Center (ICC), a public legal entity established under the Capital Market Law.

With the new Law Nr 6728⁶, published in August 2016, the proposed types of Sukuk structures in the Communique have also become tax isolated, which is expected to enable the financing of many projects by Sukuk.

II. Case study from Turkey: Energy Sukuk issuance

This article also elaborates on the first Sukuk issuance in the Turkish energy sector, structured under a Wakala agreement in March 2015.

ZORLU ENERGY A.S., a listed energy company in Borsa Istanbul, was rated as an investment grade in the issuance currency of Turkish Lira by the JCR-Eurasia rating company. The investment grade rating is required to be eligible to issue Sukuk under the Wakala structure as per the Lease Certificates Communique in Turkey.

Upon initial discussions with Capital Markets Board experts in September 2014, the company applied to the Energy Market Regulatory Authority (EMRA) of Turkey for Sukuk issuance permission. Upon finalizing the EMRA approval, the issuer, TFKB Asset Leasing Company- SPV, started the legal and Sharia' documentation to issue a TRY100 million – Wakala Sukuk.⁷

The investment grade rating is required to be eligible to issue Sukuk under the Wakala structure as per the Lease Certificates communique in Turkey

6. The "Law Amending Certain Laws to Improve the Investment Climate" No. 6728 (the "Law No. 6728") was enacted on 15 July 2016 and published in the Official Gazette No. 29796 dated 9 August 2016.
 7. Announcement from Zorlu Energy on Public Disclosure platform. <https://www.kap.org.tr/Bildirim/425205>

Table 3 - Transaction summary

Originator	Zorlu Energy
Issuer	TFKB ALC (a subsidiary of Turkiye Finans Participation Bank)
Purpose	Energy Production Finance
Principal	TRY 100 million
Periodic distribution return	3 months
Return	13.95% per annum
Issue type	Private placement to qualified investors
Tenor	5 years
Issue date	March 24, 2015
Structure	Wakala
Underlying	Energy Production and Sales
Listing	Not listed - ISIN: TRDTFBV32015
Governing law	Turkish Capital Markets Law, Commercial Law
Regulatory approval	Energy Market Regulatory Authority of Turkey
Legal counsel	Turkiye Finans Legal Team
Sharia' advisor	Ishak Emin Aktepe (Ph. D)

On March 24, 2015, the issuance was completed successfully, with Turkiye Finans Participation Bank as the sole investor.

The issuance was the CMB's first approval for the Wakala structure for a non-bank corporation, and the first and only Sukuk issuance to date in the energy sector, as of September 2016.⁸

III. Business and financing challenges of energy Sukuk issuance

- **Investment horizon:** The energy market requires long-term investment, especially on the business infrastructure side, such as for plants, property and equipment. The non-compatibility between the energy business model and the conventional bond market is eliminated by the Sukuk investor's special appetite for longer maturity.
- **Preliminary approvals:** Energy Market Regulatory Authority - EMRA approval is required for issuing Sukuk for energy companies. The regulatory authority restricts activities only to electricity production, therefore the business model is less flexible in terms of covenants, which requires a thorough analysis of the production and sales capacity by the investors.
- **Restriction on asset transfers:** Energy companies cannot pledge or sell any type of their physical assets to third parties as per the energy legislature, which in turn means the structuring can only be modeled on the Wakala model.
- **Tax cost aversion:** The originator and the investor require a tax-immune structuring solution that would compete with the conventional bond alternative;

The non-compatibility between the energy business model and the conventional bond market is eliminated by the Sukuk investor's special appetite for longer maturity

this leads the issuer to formulate the issuance under the Wakala structure, which does not require any asset transfer, which is subject to taxation in Turkey.

- **Sharia' permissibility:** Electricity production and sales by the Wakeel is perfectly permissible from a Sharia' perspective.
- **Investment grade rating:** An investment grade rating in Turkish Lira is required by the Communique to employ the Wakala structure for any originator company, regardless of the industry in which it operates.
- **Documentation load:** Contracts and documentation on the transaction are comparable to the conventional bond documentation set, thanks to CMB regulation, thus enabling a viable option for finance departments. Additional documentation required for this lightweight structure does not hurt the funding cost or bear any surprising fees.

IV. Outlook and conclusions

The energy industry is a quasi-perfect suit in terms of issuing Sukuk according to its business model. The increasing number of

8. Announcement from Turkiye Finans as an investor

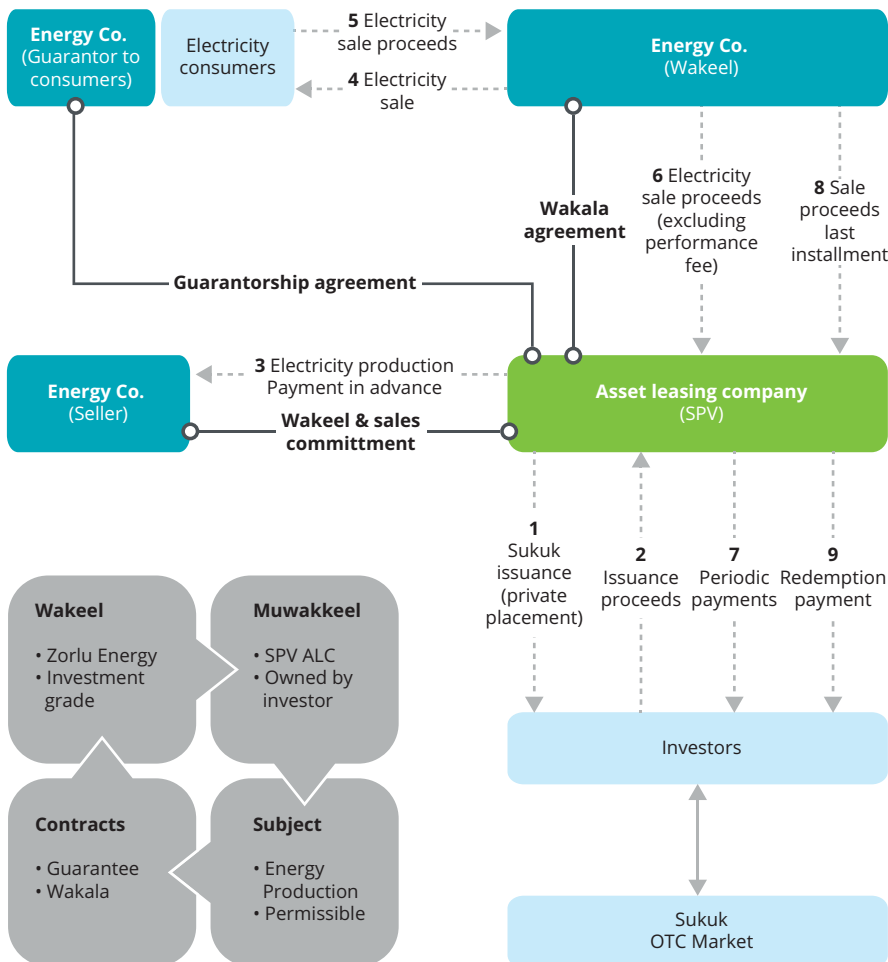
<http://www.turkiyefinans.com.tr/Lists/BasinBultenlerimiz/Attachments/289/TF-Zorlu-Enerji-Ihraci-20150330.pdf>

energy companies – including the ones based on renewable energy (wind and solar), and recent subventions granted by government into this sector, would be a leverage for issuer companies and a motivation for investors.

Enabling regulation and transparency in the industry, on the other side, is decreasing the Sharia’ permissibility risk, and hence support to attract more Sukuk investors in the near future.

The Turkish energy industry is anticipated to apply this Wakala Sukuk model more in the future, in a bid to restructure funding maturity and diversify the investor base.

Figure 5 - Wakala Sukuk issuance in energy sector



Enabling regulation and transparency in the industry, on the other side, is decreasing the Sharia’ permissibility risk, and hence support to attract more Sukuk investors in the near future

Key takeaways

The AAOIFI, the IFSB and IIFM are likely to continue sharpening their strategic industry support in adopting leading practices, and help building the infrastructure of the broader Islamic capital market

The ecosystem of the Sukuk market appears to be at a turning point. Even though there have been considerable efforts and progress made around regulation, practice standardization and Sharia' governance in capital market structures, these efforts are still in need of improvement and development. However, there are solid signs that several markets around the world are proactively establishing enabling environment for corporate Sukuk markets in one way or another, namely in Malaysia, Turkey and in the GCC, such as Bahrain, KSA, UAE and Qatar, and at least two Central European countries, all of which are ready to fund medium- and long-term infrastructure and capital investment projects.

The AAOIFI, the IFSB and IIFM are likely to continue sharpening their strategic industry support in adopting leading practices, and help building the infrastructure of the broader Islamic capital market, while developing new standards for more specific asset classes such as the corporate Sukuk. On the other

hand, regulators, capital market professionals, and industry self-regulatory organizations will need to engender increased agility in their operations and strategic business priorities, and also shift gear to take advantage of the opportunities looming to fund the huge infrastructure projects in MENA, Asia, the Sub-Saharan continent and elsewhere in the world.

The issues

1. Enabling environment: Creating an efficient capital market remains front and center

- Despite strenuous efforts from industry standard-setting bodies and various regulatory bodies, the Islamic capital market remains underdeveloped and far from being able to offer efficient and competitive debt capital market assets.
- Corporate laws need to be improved, in particular the SPV and bankruptcy laws.

2. Innovation is the key to growth in the debt capital market

- Although innovation in products and services has been a recurring theme in our industry for a number of years, several IIFMs remain lagging behind in developing corporate and project financing services and products.
- The volume and depth of products, ability to transact, and diverse investors willing to transact are key components in developing liquidity.

3. Ownership and asset transfers

- Sukuk issuers must have underlying assets that exist in a form that is well defined and legally enforceable.

- Land registry laws should be reviewed and rewritten to support the true sale of assets.

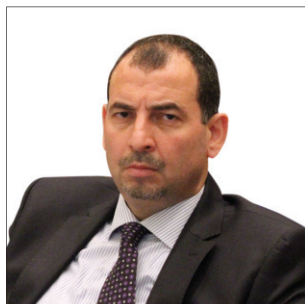
Success in addressing these issues and the development of an efficient and competitive Islamic capital market and corporate Sukuk in particular will likely require across-the-board effort, and more distinctly:

- Improvement of capital market regulatory and policy frameworks.
- Innovation across multiple subsectors of debt and equity markets.
- Development of the right competencies and expertise in capital markets.
- Enhancement of education and awareness among investors and issuers.
- More efficient investment in adapting leading practices and governance.
- Strategizing of the marketing of corporate Sukuk and other Islamic asset classes amongst other traditional western financial markets.

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