

# Taboglu & Demirhan

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### Lease Certificates: an Alternative Instrument for Financing

As a result of the increase in demand of alternative instruments for Islamic finance in Turkish market, the Capital Markets Board (the "CMB") has issued the Communiqué on the Principles regarding Lease Certificates and Asset Leasing Companies on 1 April 2010 (the "Communiqué"). Through issuance of the Communiqué, the CMB aims to encourage an Islamic way of financing and to create a new era in the Turkish capital markets. The Communiqué enables private sector companies to raise funds through issuance of lease certificates.

Lease certificates are non-interest bearing bonds which have the same functions with ijara sukuk whereby the investors received coupon payments based on the lease income.

The principles regarding lease certificates have been strictly regulated by the CMB in order to give investors, especially retail investors, a wide range of protection.



This article aims to present the main concepts of lease certificates along with the principles and procedures applied to the issuance of lease certificates.

### The Concept of Lease Certificates

Lease certificates are only issued by an asset leasing company (the "ALC") which functions as a special purpose vehicle. Accordingly, an ALC initially acquires certain assets from a company at a certain price, and then leases the same back to the source company for a fixed term. The ALCs raise funds by issuing lease certificates in an amount equal to the acquisition price of the assets and pays such amount to the source company. Meanwhile, the ALCs distribute the rentals collected from the source companies to the investors as coupon payments. At maturity, the ALCs sell the assets back to the source company with a pre-determined value.

#### The Concept of Asset Leasing Companies

Since trusts are not regulated under the Turkish Law, the ALCs may be incorporated as joint stock companies by brokerage houses, banks and source companies.

The Communiqué imposes certain restrictions on the ALCs and foresees certain conditions which shall be explicitly indicated in the articles of associations of the ALCs in order to provide a wide range of protection to the investors. Additionally, the articles of associations of the ALCs are required to be pre-approved by the CMB. The affirmative opinion of the Banking Regulation and Supervision Agency is also required for the banks which apply to incorporate an ALC.

The ALCs may be incorporated only for conducting

following activities which are required to be explicitly stated in their articles of association:

(i) Issuance of lease certificates;

(ii) Acquiring and renting assets on its own behalf and for the account of lease certificate holders;

(iii) Making payments in relation to the income derived from the assets to the lease certificate holders; and

(iv) Transferring the assets back to the source company pursuant to the terms and

conditions determined in advance at the end of the lease term.

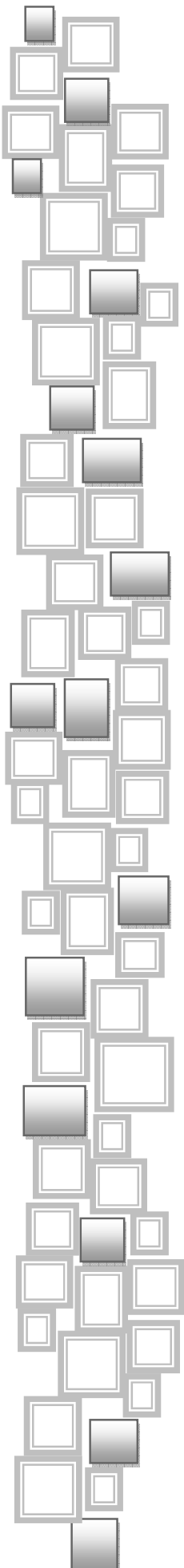
Other than those listed above, the ALCs are strictly prohibited to (i) utilize any kind of loan or incur any kind of liabilities; (ii) use the assets acquired except for the performance of its main activities listed above; (iii) establish rights in rem on the assets for the benefit of third parties; and (iv) transfer the assets to third parties other than source company as long as source company fulfills its all obligations arising from the relevant lease agreement.

Under the Communiqué, ALCs are strictly restricted to purchase assets of different source companies simultaneously.

**"Emerging markets as a group have proved they can sustain high growth and attract capital. There is tremendous dynamism but there is a huge unfinished agenda."**

**- Lars Thunell**

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It is also mandatory for the ALCs to create a pre-emption right in favor of the source company in the land registry when the land is transferred to the ALCs.

The articles of associations of the ALCs shall also include a provision stating that in case the commitments given to lease certificate holders are not fulfilled, then the asset behind the lease certificates shall be sold and the sale proceeds shall be distributed to lease certificate holders pro rata their stakes.

#### **Issuance and Sale of Lease Certificates**

The issuance and sale procedure of lease certificates are similar to the issuance and sale of other capital markets instruments. For issuance and sale, lease certificates must be registered with the CMB as per the procedure detailed in the Communiqué. Lease certificates registered with the CMB may be sold via public offering and private placement.

If lease certificates are to be offered to public, the application to the CMB must be made through a brokerage house, and an offering circular and prospectus must be prepared to specify the principles of sale. Offering circular and prospectus must also be co-signed by the brokerage house conducting the sale procedure and the ALC. The ALC issuing the certificates is responsible for the accuracy and correctness of all information included in such documents. If the brokerage house, on the other hand, has not used its utmost attention, then it shall also be liable with the ALC.

Subsequent to registration of lease certificates to be sold via public offering with the CMB, the offering circular shall be registered with the relevant Trade Registry and published in the Turkish Trade Registry Gazette within 15 days from the registration date.

In case of sales through private placement, there is no need to prepare an offering circular. Subsequent to the registration of lease certificates with the CMB, the ALC realizes the sale transactions and informs the CMB of the sale results.

All changes which may affect the investment decision of the investors shall be disclosed in accordance with the public disclosure requirements of the CMB. Additionally, all changes which arise from the source company and the ALC and which may affect the price and liquidity of lease certificates and the rights of lease certificate holders shall be disclosed in accordance with the public disclosure rules.

ALCs are also required to inform the CMB of the assets backing the lease certificates sold via public offering as well as the payments made to holders of such certificates on quarterly basis until the cancellation of such certificates. In case sales are made through private placement such notification shall be made on semiannual basis.

#### **Tax Benefits for Lease Certificates**

In order to encourage the issuance and sale of lease certificates, lease certificates are provided with significant tax benefits through the amendments made by Law no. 6111, known as tax amnesty law, to relevant tax legislation.

First of all the revenue derived from lease certificates are considered as security income and subject to 10% of withholding tax so that the revenue derived from lease certificates becomes equal to other security incomes in terms of tax legislation. Additionally, the ALCs are exempted from the corporate tax. The ALCs pay no value added tax for the transfers of the assets backing the lease certificates and are also exempted from the stamp tax for conveyance of assets. Besides, the ALCs do not pay any duty or fees arising out of the title deed transfers.

#### **Issues Faced in Practice**

Despite the significant support both by the CMB and the Government, no lease certificates have been issued yet in accordance with the Communiqué. The main concerns regarding lease certificates are set forth below:

- Although the CMB strictly regulates the issuance of lease certificates and incorporation of ALCs, the lack of guarantor mechanism under the Communiqué cause the investors to refrain from investing in lease certificates.
- It is also lobbied that the ALCs should be incorporated as a trust not as a joint stock company. Therefore, an institution being similar with trusts is asked to be regulated under Turkish legislation.
- Additionally, the companies, especially banks, do not want to remove the assets backing the lease certificates from their balance sheet. Instead of ownership transfer for such assets, the CMB is asked to regulate an alternative formula for the transfer of the ownership without removing from the balance sheet.

#### **Conclusion**

Having introduced the Communiqué, the CMB has brought to an end the discussions over introduction of an alternative instrument for Islamic finance. Although the CMB tries to regulate the principles regarding lease certificates and the ALCs in its all respects and despite the significant tax support, there are still questions for the use of lease certificates as an instrument for financing. Therefore, the CMB is motivated to amend the Communiqué in order to remove the question marks in minds. Hopefully, the CMB will finalize such amendment within a short period, and the Turkish markets will gain an active era for lease certificates.

*The aim of this 10<sup>th</sup>-dailies is to give an executive summary on certain legal matters. This has been prepared for information purposes only and does not constitute any legal advice. Thus, one should not rely on it for specific advice. For further information or advice please contact Taboglu & Demirhan, a full-service law firm based in Istanbul.*