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Islamic Finance 2018
Slow Growth Is The New Normal

S&P Global Ratings believes the Islamic finance industry will continue to expand this year but lose momentum in 2018. The industry’s assets reached $2 trillion at year-end 2016, slightly below our September forecast due to local currency depreciation in some core Islamic finance countries and their tepid economic performance. On the other hand, sukuk issuance accelerated in the first half of 2017, which portends a good year for 2017. However, we think that 2018 is less certain as we don’t see some of the large issuances of last year repeating next year.

We’ve spotted a few trends that will shape the industry’s growth and trends in the second half of 2017 and 2018. On the downside, these include subdued economic performances in core Islamic finance core countries primarily because of low (but stabilizing) oil prices. Fragmentation and the lack of integration by business line and geography is another factor impeding growth. Finally, despite positive strides in the past few months, the absence of a strong response to the longstanding debate about standardization will continue to stymy the industry. On the other hand, Islamic finance has much to offer the world’s economy. We see a natural connection between Islamic finance principles, responsible finance, Sustainable Development Goals (SDGs), and impact investing. All aim to create a more equitable financial system that has a positive tangible impact on the economy and population. The contribution of Islamic finance has so far been limited by the industry's relatively small size and structure.

Islamic finance remains concentrated in oil-exporting countries, with the Gulf Cooperation Council countries, plus Malaysia and Iran, accounting for more than 80% of the industry’s assets, which we estimate will reach $2.1 trillion by the end of 2017. A weaker economic performance in these core countries (except in Malaysia) has translated into lower growth opportunities for the industry. We therefore expect Islamic banks in core markets to suffer and grow more slowly than in the recent past. While sukuk issuance increased significantly in the first half of 2017 thanks to jumbo deals by some GCC countries, we think they were the exception rather than a new norm. We have observed some positive developments in standardization, particularly thanks to work by standard-setting bodies on central Sharia boards, sukuk reporting, and disclosure. However, the market has not yet reached the point where issuance of sukuk is as smooth and efficient as issuing conventional bonds. Some risks related to sukuk have also surfaced, reinforcing the need to restore credibility and clarity for investors.

What could help the industry achieve its full potential? In our view, standardization of Sharia interpretation, legal documentation, and market education are the keys to success. The moves toward central Sharia boards and external Sharia audits in some GCC countries are steps in the right direction. The streamlining of legal documents and greater clarity for investors about risks are also important to the future of the industry. Finally, the natural connection between the principles of Islamic finance and responsible finance, SDGs, and impact investing could unlock many opportunities.

We hope you enjoy the 2018 edition of our "Annual Outlook For Islamic Finance," and as always, we welcome and encourage your feedback about our research and insights.
التمويل الإسلامي في العام 2018: القطاع سيشهد تباطأً في النمو خلال الفترة القادمة

الدكتور محمد دمق
مدير أول ورئيس العالمي للتمويل الإسلامي

تعتبر وكالة "إس أن بي جوليف للتصنيفات الائتمانية" بأن قطاع التمويل الإسلامي سيواصل نموه هذا العام، لكنه سيقف بعضاً من زخمه في العام 2018. وصلت أصول القطاع في نهاية العام 2016 إلى 2 تريليون دولار أمريكي، أدان بقليل من توقعاتنا في شهر سبتمبر، بعد تراجع قيمة العملة المحلية في بعض الدول الرئيسية في التمويل الإسلامي وفرت أدنى اقتصادي. من جهة أخرى، تجارب إصدارات الصكوك في الصف الأول من العام 2017، مما يشير ببعض الجدية مع ذلك. نعتقد أن الصورة غير واضحة بالنسبة للعام 2018 لأننا لا نتوقع إصداراً سكيناً كبيراً يصعب ذلك التي صدرت هذا العام.

لقد رصدنا بعض التوجهات التي ستحدد شكل نمو القطاع وتوجهات المستثمرين فيه في النصف الثاني من العام 2017 والعام 2018. على الجانب السلبي، تتضمن هذه التوجهات تراجعًا بالأداء الاقتصادي في الدول الرئيسية في التمويل الإسلامي كنتيجة رئيسية لانخفاض أسعار النفط (المستقرة على الأقل). إذا تمثلت وحدة الكمال بين خطوط الأعمال والمخاطر الإدارية من العملاء الأخرى التي تعيق النمو. أخيراً، بالرغم من الخطوات الإيجابية التي اتخذت خلال الشهر القليل الماضية، فإننا لا نتعامل الإنتاجية القوية للقطاع الذي طال أمه حول توحيد المواصفات وسياق إعالة القطاع. من جهة أخرى، يمكن أن يكون التمويل الإسلامي تقدم أكثر في القطاع الأعمال. نرى أن هناك ارتباطًا طبيعيًا بين مستوى التمويل الإسلامي والمتوسط، وأهداف التنمية المستدامة، واستثمار التأثير. كلها تهدف إلى إنشاء أنظمة شاملة أكثر إشراقًا، تكون لها تأثيرًا إيجابياً لمنسوخًا على الاقتصاد والسكان. لا تزال مساهمة قطاع التمويل الإسلامي حتى الآن محدودة بسبب حجم ونسبة القطاع الصغيرة نسبيًا.

يفيد التمويل الإسلامي مرتكزاً بشكل رئيسي في الدول المصدرة للنفط، حيث تسحب دول مجلس التعاون الخليجي، بالإضافة إلى دول آسيا، إيران، على أكثر من 80% من أصول القطاع، والتي توقع أن تصل إلى 2.1 تريليون دولار أمريكي في نهاية العام 2017. قد أدى تراجع الأداء الاقتصادي في هذه الدول الرئيسية إلى تراجع فرص النمو في القطاع. لذلك، نتوقع أن تواجه البنوك الإسلامية في الأسواق الرئيسية تحديات وان تؤدي إلى التحولات الإدارية في القطاعات. إنها شهدت إصدارات الصكوك ارتفاعًا كبيرًا في النصف الأول من عام 2017 بفضل الإصدارات الصغيرة التي قامت بها بعض دول مجلس التعاون الخليجي، إلا أننا نعتقد أن هذا الارتفاع لا يجعل حالة استثنائية ولن يستمر على هذا النحو. لاحظنا بعض التقدم في توحيد المواصفات، وتحديداً في بعض القطاعات، العمل الذي قامت به نجاح وضع المعايير بخصوص المجالات الأساسية، وجميع تجارب حقول الصكوك، الإعداد. مع ذلك، ترى أن عملية إصدار الصكوك في السوق لا تزال دون مستوى مبادئ التمويل الإسلامي إدارة النمو وعمال经济体اً من حيث سهولة وفعالية الإجراءات. كما برزت بعض المخاطر المتعلقة بالصكوك، مما يؤكد الحاجة لاستعادة التقدم والاستقرار بالنسبة للمستثمرين.

ما الذي يمكن أن يساعد القطاع على تحقيق أقصى إمكاناته؟ من ال неделيات الرئيسية لنجاح القطاع من وجهة نظرنا توحيد تفسير الأحكام الشرعية والوثائق النحوية، وتفريق السوق. إن التمرکز نحو تطوير المجالات الشرعية المتقدمة في التشريع الخارجي في بعض دول مجلس التعاون الخليجي هو خطوات بالاتجاه الصحيح. كما أن تبسيط الوثائق القانونية وتفريد صورة أوضح عن المخاطر للمستثمرين، هو أيضاً عامل مهم لاستقرار القطاع. أخيراً، أن العلاقة الطبيعية ما بين مبادئ التمويل الإسلامي والتمويل المسؤول، وأهداف التنمية المستدامة، واستثمار التأثير يمكن أن يفتح المزيد من الفرص أمام القطاع.

نأمل بأن تقتضي وقتعاً مشروعاً في مطالعة نسخة العام 2018 من "النظرية المستقبليتين للقطاع التمويل الإسلامي"، وترحب دائماً بملاحظاتكم على أبحاثنا وأرائنا.
This book is supported by the Dubai International Financial Centre, in conjunction with the S&P Global Islamic Finance Conference, Dubai, October 3rd 2017.

As the leading financial hub for the Middle East, Africa and South Asia (MEASA) region, the Dubai International Financial Centre (DIFC) sits at the heart of a large and dynamic market of three billion people.

Unfortunately, this is also a region that is underserviced by financial services. Around 70% of the population are unbanked and the region is thirsty for infrastructure, with the IFC estimating a funding gap of over $100 billion annually. Islamic finance can play a key role in addressing these challenges.

Islamic finance is well suited to bridge the infrastructure funding gap given its asset-backed nature. Meanwhile, the global sukuk market is growing and demand for such capital continues to increase. Infrastructure investment is also crucial for development and has a strong ethical underpinning, which is very much in line with Sharia principles.

Islamic finance has an opportunity to increase financial inclusion to the unbanked in the MEASA region, particularly given the Muslim population mix. By embracing innovation and the FinTech revolution, it can leapfrog into a position of strength in the market. Currently, just a small fraction of global FinTech investment targets the MEASA region. DIFC is committed to redressing the financial inclusion imbalance and infrastructure investment shortfall through initiatives such as FinTech Hive at DIFC.

As the region’s first FinTech accelerator, FinTech Hive at DIFC brings together an emerging generation of technology leaders and entrepreneurs with regional financial services institutions, supporting their efforts to address the evolving needs of the region with digital financial solutions.

Other initiatives supporting Islamic FinTech include the Innovation Testing Licence, recently introduced by the Dubai Financial Services Authority (DFSA), which allows qualifying FinTech firms exemption from some of the usual regulatory requirements to develop and test their concepts within DIFC. Similarly, we continue to develop structures such as the new Intermediate Special Purpose Vehicle (ISPV) regime, which Islamic financial institutions can use to invest in infrastructure, complementing the existing Special Purpose Company (SPC) regime.

DIFC also maintains a close relationship with the Dubai Islamic Economy Development Centre (DIEDC), collaborating on our shared ambition to support Dubai’s growth into the global hub for Islamic financial industries.

The DIFC continues to build on its heritage as a leading regional financial hub by encouraging further collaboration, knowledge exchange and cooperation on emerging issues with a key focus on Islamic Finance.
Islamic Finance In 2018: Slow Growth Is The New Normal

Economic Conditions Are Not Helping

Islamic finance remains concentrated primarily in oil-exporting countries, with the Gulf Cooperation Council (GCC), Malaysia, and Iran accounting for more than 80% of the industry’s assets. The drop in oil prices and governments’ cuts to investment and current spending have reduced the industry’s growth prospects, in our view. While Malaysia’s economy continued to perform adequately, thanks to its diversification, the average growth rate in the GCC dropped significantly between 2012 and 2017. Iran, on the other hand, experienced a growth spurt in 2016 after certain sanctions were lifted and the oil sector picked up (see chart 1), but this growth is expected to moderate over the next three years. Meanwhile, Iran’s economy will continue to suffer from the scarcity of financing options and the remaining sanctions.

S&P Global Ratings believes the Islamic finance industry will continue to expand this year, but lose some momentum in 2018. The industry’s assets reached $2 trillion at year-end 2016, slightly below our September forecast. Even though sukuk issuance accelerated in the first half of this year and will likely stay strong in the second half, we don’t believe this growth rate is sustainable. We think stronger growth is possible if, together, supervisory bodies and market participants achieve greater standardization, resulting in a truly global industry.
Another factor explaining the muted industry growth is depreciation/devaluation of currencies in some countries. In particular, we’ve observed a marked impact of this on Islamic finance activity in Iran, Malaysia, Turkey, and Egypt, where exchange rates have deteriorated (see chart 2). As the U.S. dollar continues to strengthen in 2017 and 2018, we might see more of this effect. In this context, the Islamic finance industry was protected by the peg between the dollar and various GCC currencies.

Overall, we think the industry’s growth rate will stabilize at about 5% in 2017 and 2018, which is lower than the average over the past decade (see chart 3). More recent industry entrants, such as Morocco and Oman, will likely show stronger growth, but their contribution to the overall Islamic finance industry will likely remain small.

**Islamic Banks In The GCC Face A Tough Year**

We expect the slowdown at Islamic banks in the GCC will persist in 2017 after asset growth declined to 5.3% in 2016 from 10.7% in 2014. In our base-case scenario, we assume that asset growth will stabilize at about 5% as governments’ spending cuts and revenue-boosting initiatives, such as new taxes, reduce Islamic banks’ growth opportunities in the corporate and retail sectors.

We see banks becoming more cautious and selective in their lending activities, triggering stiffer competition. Yet we don’t expect this will happen uniformly in all GCC countries. Although the economic slowdown will likely remain pronounced in Saudi Arabia, Islamic banks’ growth accelerated there in 2016, thanks to their strategy of increasing business among corporates and small and midsize enterprises (SMEs). By contrast, the decline in economic activity was steeper in Qatar, where a mix of lower liquidity and government spending cuts prompted banks to curtail their expansion plans. Qatar’s placement under sanction by some Arab countries could also further weaken prospects for its Islamic finance industry in 2017.
growth was about nil in Kuwait over the past year, hit by the depreciation of certain foreign currencies and the ensuing impact on the financials of some leading Kuwaiti Islamic banks. Despite the United Arab Emirates (UAE)’s tepid economic performance and the drop in real estate prices, Islamic banks continued to expand by high single digits.

As the economic cycle turns, we think GCC Islamic banks’ asset quality indicators will deteriorate in the second half of this year and in 2018. Such weakening was not noticeable in 2016 because--as is typical--banks had started to restructure their exposures to adapt to the shift in the economic environment. Therefore we saw an increase in restructured loans in the GCC last year, but not a marked increase in banks’ nonperforming loans (NPLs) or cost of risk. We think the deterioration will be more visible in 2017 and 2018. Overall, we believe that subcontractors, SMEs, and expatriate retail exposures will bear the brunt of the turning economic cycle and contribute prominently to the formation of new NPLs over that period.

GCC Islamic banks’ profitability will therefore deteriorate again in 2017 and 2018, in our opinion; we foresee several factors coming into play:

- Cost of funding has increased, and this squeezed banks’ intermediation margins in 2016. Although the pressure eased a bit after some governments issued international bonds and unlocked payments to contractors, we think the cost of funding will remain inflated in 2017-2018. The U.S. Federal Reserve (Fed)’s recent rate hike, which some GCC central banks have emulated, could result in deposits shifting to profit-sharing investment accounts (PSIAs) from unremunerated current accounts. If this happens, it would raise the cost of funding even further. Very few Islamic banks have set aside significant amounts of profit-equalization reserves, which they build in good years and use to smooth returns to PSIAs holders if needed.

- Cost of risk is on the rise. We also foresee higher credit losses in the coming two years, due to relatively weak economic conditions. Exposure to subcontractors, SMEs, and retail customers (especially expatriates) will likely fuel the upward trend for credit losses.

In general therefore, we expect Islamic banks’ revenue growth will decelerate, and that they will focus on their cost bases to mitigate the impact (for example, by pruning branches). Like their conventional counterparts, GCC Islamic banks, through their relatively low cost bases, should be able to protect their profitability somewhat over the next two years, however. Although consolidation might be a way forward in some GCC markets, we expect mergers will remain an exception in 2017-2018 rather than the norm.

Capitalization is generally a positive factor for GCC Islamic banks. We note, however, that it has reduced because previous rapid financing growth was not matched by additional capital. Few GCC banks have issued capital-boosting sukuk and those that have, are primarily in the UAE, Qatar, and Saudi Arabia.

**Sukuk Activity Recovered This Year, But 2018 Is Less Certain**

The sukuk market gave a strong showing in the first half of 2017 compared with the same period in 2016, thanks primarily to the jumbo issuances of GCC governments (see chart 4). We believe this performance stemmed mainly from the good liquidity conditions in the GCC and more generally in the global financial market. Although we expect issuance numbers will stay solid for the rest of 2017, we consider it unlikely that some of the large transactions seen in the first half of the year will be repeated in 2018. We also continue to believe that the process for issuing sukuk is deterring some issuers from tapping the market. However, we note that the Islamic finance industry’s standard-setting bodies have made some progress on that front this year.
Most of the investors in sukuk are in the GCC (see chart 5). Within this universe, we understand that banks are playing the biggest role. Over the past two years, we have observed a reduction of liquidity in GCC banking systems, due to reduced deposit inflows as a result of low oil prices and high dependence on deposits from governments and their related entities. This situation started to reverse in the first half of 2017 after oil prices stabilized and governments issued large bonds and injected liquidity locally. Moreover, in our view, GCC banks tend to keep sizable amounts of cash and money market instruments on their balance sheets. In the currently difficult operating environment, marked by few opportunities for lending growth, we think some banks might invest a portion of their liquidity in assets that generate higher income than cash and money market instruments. In this context, bonds and sukuk appear more attractive than interbank or central bank deposits.

On another note, global liquidity remained abundant in the first half of 2017 and we expect this will continue until the year’s end. The European Central Bank (ECB)’s Quantitative Easing (QE) program, the slow increase in the Fed’s interest rates, and good liquidity in some Asian countries will continue to support demand for both bonds and sukuk. The cost of funding might start rising, however, as the Fed increases its rates and the ECB tapers its QE program. We expect an additional 25 basis-point rise in the Fed’s rates by the end of 2017, after the recent increase in June. However, we see the ECB’s QE program coming to a close only by the end of 2018, or in 2019 if external conditions (such as commodity prices and exchange rates) become more deflationary. We also see interest rates starting to move in 2019.

Given the currently low interest rates in developed markets, emerging-market issuers with good credit stories might still be on investors’ radar, as shown by the significant oversubscription of some recent transactions. Consequently, we believe liquidity will continue to leak into the sukuk industry from developed

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**Chart 4 - Sukuk Issuance Volumes**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total sukuk issuance (Bil.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>100</td>
</tr>
<tr>
<td>2012</td>
<td>120</td>
</tr>
<tr>
<td>2013</td>
<td>140</td>
</tr>
<tr>
<td>2014</td>
<td>160</td>
</tr>
<tr>
<td>2015</td>
<td>180</td>
</tr>
<tr>
<td>2016</td>
<td>200</td>
</tr>
<tr>
<td>1H2016</td>
<td>80</td>
</tr>
<tr>
<td>1H2017*</td>
<td>100</td>
</tr>
</tbody>
</table>

*S&P Global Ratings has used data as of June 15, 2017, as a proxy for the market’s performance the first half of 2017 because the next two weeks will coincide with the end of Ramadan, which is a period when sukuk market activity is usually slow.

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**Chart 5 - Investors In Sukuk**

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Middle East</td>
<td>70%</td>
</tr>
<tr>
<td>Europe</td>
<td>20%</td>
</tr>
<tr>
<td>U.S.</td>
<td>10%</td>
</tr>
<tr>
<td>Asia</td>
<td>5%</td>
</tr>
</tbody>
</table>


© Standard & Poor’s 2017.
markets, although at a slower pace because of recent developments in the GCC. There has been some progress on reducing the complexity of issuance, but it is not sufficient, in our view. It is still more time-consuming and complex to tap the sukuk market than to issue a conventional bond, even though this situation has improved over the years.

Positively, in the first half of 2017, we saw the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and other financial industry heavyweights pushing the market toward greater standardization. The AAOIFI has issued exposure drafts on central Sharia boards and sukuk accounting that aim to address the complexity related to Sharia compliance and legal structuring of sukuk. But the process for issuing sukuk is still not as smooth as that for a conventional bond. Until we reach that point, we think issuers will continue to show a preference for bonds.

The Takaful Sector Is Vulnerable To The Less-Supportive Environment

Growth of gross takaful (insurance) contributions was flat in 2016 compared with 2015, and we expect this will be the case in 2017-2018, all other factors unchanged. Yet we believe the takaful industry has ample room for growth if aided by regulatory incentives and further development in other Islamic finance segments.

Insurance penetration in core Islamic finance markets is still low, with premiums in the six GCC countries averaging 1%-2% of GDP, compared with over 6% in more developed markets. Some recent regulatory actions, such as the introduction of a compulsory health insurance scheme in Dubai, for example, have created growth opportunities for participating companies. In our opinion, rising demand for life and savings products, or the introduction of further compulsory coverage, could further stimulate growth. At the same time, we believe tightening risk-based regulations in some markets will help create stronger takaful players but could increase operating costs, particularly for some smaller companies.

What’s Next For Islamic Finance

Standardization can support expansion

Numerous institutions have looked at Islamic finance and the sukuk market and eventually walked away, rather than go through all the steps required for issuance. Having standardized Sharia compliance and legal documentation, as well as more information for prospective issuers, could help the market move forward. Sharia is still interpreted in different ways across the various Islamic finance markets. However, the industry appears to be going in the right direction with the proposal for central Sharia boards.

Also, in our view standardization could go one step further, through establishing globally accepted guidelines and adopting a post-transaction audit rather than pre-transaction approval. We believe a suite of standard products, ranging from debt-like to equity-like instruments, could help the industry regain its appeal. The risk-and-reward equation for investors should also be clarified. Some sukuk are sold as fixed-income instruments although they are not. Such an approach could destabilize the market if investors were to face a sukuk default. Issuances in Saudi Arabia, instruments with residual asset risks or structures that are based on a number of assumptions, should be well explained and understood by investors.

Responsible finance, sustainable development goals, and impact investing

We see a natural connection between Islamic finance principles, responsible finance, sustainable development goals, and impact investing. All aim to create financial systems that are more equitable and have a positive tangible impact on the economy and population. Greater involvement of multilateral institutions (MLIs)
in Islamic finance--through sukuk issuance and Islamic products, as well as stricter application of the principle of profit and loss sharing--could create growth opportunities for the industry. The contribution of Islamic finance has so far been limited by the industry’s relatively small size and by its structure, consisting of a collection of diverse markets. Beyond Islamic finance instruments, zakat (alms giving) and waqf (charity) could prove particularly useful in the future in financing social infrastructure, such as affordable housing, health care, or education.

**Resolution regime or profit and loss sharing?**

In the aftermath of the global financial crisis, regulators have created resolution regimes to deal with failing systemically important banks without injecting taxpayers’ money or destabilizing the financial system. For conventional banks, this involves building a buffer of loss-absorbing liabilities that protect senior creditors in case of major stress. Regulators in core Islamic finance markets have not yet implemented resolution regimes, but could do so over the next few years.

In our view, a resolution regime could fit in with Islamic finance because profit and loss sharing is one of the industry’s key principles. Possible prerequisites for such a regime could be that issuers make it clear to investors that instruments might be used to offset losses (similar to what the Malaysian Central Bank did when it created loss-sharing deposits) and clarify the conditions under which this might happen. In addition, creditors should receive adequate compensation for the additional risk.

**A United Industry Is A Stronger Industry**

In our opinion, Islamic finance markets need amalgamation to transform them into a truly global industry. But there are already several success stories, and these could entice new players into the market. For instance, some issuers could benefit from observing Islamic finance in Malaysia, where we understand the process of issuing sukuk is as smooth as that for conventional bonds. Another example could be found in cross-border acquisitions, which might result in more cohesive Sharia interpretation. Closer integration may also lead to increasing sukuk issuance, which could reduce takaful operators’ exposure to riskier real estate and equities investments or help banks manage their liquidity. Sukuk could also provide investment funds with additional fixed-income revenue, and encourage a shift toward more profit-and-loss sharing instruments. In addition, Islamic banks could start offering takaful products more systematically if the relevant regulation were in place.

We believe progress would be aided if regulators acted to create a more supportive regulatory environment, while scholars, MLIs, and lawyers worked together to achieve standardization. What’s more, universities could provide the necessary training and knowledge to create the next generation of Islamic finance professionals. Overall, we believe that, united and more integrated, the industry will become stronger.
Global Sukuk Market Outlook: The Surge In Sukuk Issuance Isn’t The New Normal

The sukuk market performed strongly in the first half of 2017, but doesn’t augur an enduring trend. Issuance increased by 37.7% in the first six months of this year, compared with the same period of 2016, underpinned primarily by the jumbo issuances of some Gulf Cooperation Council (GCC) countries’ governments.

What’s behind the surge? Sovereign issuers turned to sukuk as they had time on their side, wanted to diversify their investor base, and to benefit from the good liquidity conditions in local and global financial markets.

While S&P Global Ratings expects the volume of sukuk issuance to remain strong in 2017, this is likely to be the exception rather than a new norm. The large transactions in the first half of 2017 are unlikely to be repeated in 2018, in our view. We also continue to believe that the relatively complex process for issuing sukuk continues to deter some issuers. However, we note that some progress has recently been made by the Islamic finance industry standard-setting bodies.

First-Half Issuance Augurs A Good Year

Total sukuk issuance in the first half of 2017 increased significantly compared with the same period last year (see chart 1). This was primarily driven by the jumbo local and foreign currency issuances by some GCC governments (see chart 2), including the $9 billion sukuk issued by Saudi Arabia in April 2017, which was one of the largest sukuk issued globally to date.

While this augurs a good year, we think it represents an exception rather than a new norm as some of the large issuances of 2017 are unlikely to be repeated in 2018.

We expect that total issuance will be around $75 billion-$80 billion in 2017, up from our...
previous expectations of $60 billion–$65 billion. Two main reasons explain our updated forecast:

- Governments are not under pressure to raise funds quickly and want to diversify their investor base,
- Regional and global liquidity remains good.

Governments are under less pressure to raise funds

Over the past 18 months, the stabilization of oil prices, the policy response of GCC governments, and the issuance of large bonds helped to reduce liquidity pressure on some GCC governments. After tapping the conventional markets, they have now turned to the sukuk market to diversify their investor base and tap pockets of local and regional liquidity. We still foresee significant financing needs for GCC governments, which we estimate at around $275 billion between 2017 and 2019. We think that around 50% will be debt-financed, through a combination of bonds and sukuk. Governments are likely to continue to prefer bonds over sukuk, however.

Regional and global liquidity remain good

GCC investors are among the main investors in sukuk (see chart 3). Within this universe, we understand that banks are playing the biggest role. Over the past two years, we have observed a reduction in liquidity in GCC banking systems due to lower deposit inflow. This situation started to reverse in the first half of 2017, thanks to the stabilization of oil prices. Moreover, we observe that GCC banks tend to keep sizable amounts of cash and money market instruments on their balance sheets. In their current challenging operating environment, marked by lower opportunities for lending, we think that some of them might divert a portion of their liquidity toward assets that generate higher income compared with cash and money market instruments. In this context, bonds and sukuk appear more attractive than interbank deposits or deposits with the central banks.
Global liquidity also remained abundant in the first half of 2017 and we expect this situation to continue in the second half. The European Central Bank (ECB) Quantitative Easing (QE) Program, the slow increase in the U.S. Federal Reserve Bank (the Fed) interest rates, and good liquidity in some Asian countries will continue to support market activity for both bonds and sukuk. The cost of funding might be on the rise though as the Fed increases its rates and the ECB starts to taper its QE program. We expect an additional 25-basis-point increase in Fed rates by the end of 2017, after the recent 25-bps increase in June 2017. However, we see the ECB normalizing over a very long period of time, with its QE program brought to (close to) zero by the end of 2018—with the risk of further delays into 2019 if external conditions (commodity prices, exchange rate) turn more deflationary—and interest rates starting to move in 2019. Given the low interest rates in developed markets, emerging-market issuers with good credit stories might still be on investors’ radars, as shown by the large oversubscription rates of some recent transactions. Therefore, we believe liquidity will continue to leak into the sukuk industry from developed markets.

**Geopolitical risks**

It remains to be seen if the recent developments in Qatar will impact issuance out of the country. Qatar was placed under sanctions by a group of governments that cut diplomatic ties and trade and transport links. This event is likely, in our view, to deter the appetite of some investors to invest in sukuk issued by Qatar-based entities in the short term. The longer term impact will depend on how the situation evolves.

**Reduce Complexity, And The Market Will Grow To Its Full Potential**

Issuing sukuk is still more time-consuming and complex than issuing bonds, but the time and cost gap has reduced over the years. Positively, in the first half of 2017, we have seen the Accounting and Auditing Organization for Islamic

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### Chart 3 - Who Invests In Sukuk?

- The Middle East
- Europe
- U.S.
- Asia

GCC--Gulf Cooperation Council. Data are based on 29 sukuk issued in U.S. dollars during 2014-2016. Source: S&P Global Ratings and Sukuk.com

© Standard & Poor’s 2017.

Financial Institutions (AAOIFI) along with other heavyweights in the financial industry, pushing the market toward greater standardization. AAOIFI issued standard exposure drafts on Central Sharia Boards and sukuk accounting.

While the AAOIFI’s actions respond directly to the complexity related to Sharia compliance and legal structuring of sukuk, the process of sukuk issuance is still not as smooth as the process for issuing a conventional bond. Until we reach that point, we think that issuers will tend to have a preference for bonds.

Numerous issuers have looked at the sukuk market and decided to eventually walk away faced with the steps that must be completed. In order to respond to this issue, standard-setting bodies have identified the following areas for improvement:

- Sharia compliance
- Legal documentation,
- Market education,
- Government issuance as an example for the market.
**Sharia compliance**

Sharia was interpreted in different manners across the various Islamic finance core markets, resulting in limited interaction between them. The market appears to have moved in the right direction with the proposal for central Sharia boards. However, we believe that standardization could be taken one step further by establishing standards that would be accepted globally, as well as moving from ex ante approval to ex post audit.

**Legal documentation**

Lawyers have made significant strides in standardizing the legal documentation of sukuk but we are still not yet at a point where the documents are as streamlined as for conventional bonds. In addition, we have observed in some structures requests from scholars to introduce what we consider as uncertainties in the legal provisions to ensure the respect of the principle of profit and loss sharing. Such an approach could destabilize the market if investors were faced with a sukuk default. Investors expect that sukuk sponsors would intervene to avoid such a situation. However, we discount this support and rate to the contractual obligations of the sponsors as we believe that Sharia scholars will prevent any extension of support beyond contractual obligations.

**Government issuance**

Sukuk issuance by governments and their related entities is necessary to set an example for private sector issuers to follow. The lack of high-quality liquid assets (HQLA) and the progressive increase in the regulatory requirements for banks' liquidity coverage ratios will further escalate Islamic financial institutions' appetite for HQLA-eligible sukuk. Given the high amount of liquid assets sitting on the balance sheet of these institutions and governments' significant financing needs in the GCC, more issuance of HQLA-eligible sukuk could be a win-win situation. Moreover, it could open the way further for private sector issuers.
Presale: SABB Sukuk Ltd.

This presale report is based on information as of Aug. 8, 2017. This report does not constitute a recommendation to buy, hold, or sell securities.

Profile

US$2 billion dollar-denominated sukuk program: Assigned ‘BBB+’ issue rating to the senior tranche.

Transaction Summary

This presale report is based on information dated Aug. 8, 2017, and is posted in conjunction with the US$2 billion dollar-denominated sukuk program (trust certificates) by SABB Sukuk Ltd. (SABB Sukuk), an exempted company incorporated with limited liability in the Cayman Islands. Under the transaction documents, SABB Sukuk will enter, among other contracts, into a Murabaha and a Mudaraba agreement with The Saudi British Bank (SABB; BBB+/Stable/A-2).

Rationale

The ‘BBB+’ issue rating on the senior tranche of the program reflects the rating on SABB because the transaction fulfils our conditions for rating sukuk at the same level of its sponsor (see “Methodology For Rating Sukuk,” published Jan. 19, 2015, on RatingsDirect):

- SABB will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts and the principal amount at the maturity of the sukuk or in the case of an early dissolution event (through the Murabaha agreement). Moreover, we are of the view that the performance of the Mudaraba contract will not interfere with the Murabaha contract;
- The obligations of SABB are irrevocable and unconditional;
- These obligations will rank pari passu with SABB’s other senior unsecured obligations;
- Under the sukuk legal documentation, SABB will undertake to cover all the costs related to the transaction; and
- There is no total loss event defined as part of the legal documentation of the program.

We therefore equalize our rating on the senior tranche of the sukuk with our foreign currency issuer credit rating on SABB. If SABB Sukuk issues a subordinated tranche of sukuk under this program, we will adjust the rating based on the terms and conditions of the drawdown. This report does not constitute a recommendation to buy, hold, or sell the trust certificates. S&P Global Ratings neither
A sukuk program that comprise sufficient contractual obligations for full and timely repayment

The transaction involves SABB Sukuk, an exempted company incorporated with limited liability in the Cayman Islands, for issuing rated trust certificates. We understand that the issuer will use:

- Up to 49% of the sukuk proceeds to acquire a portfolio of commodities (Murabaha assets).
- At least 51% of the sukuk proceeds to invest in accordance with the Mudaraba agreement with SABB.

For the senior tranche, under the Murabaha agreement, SABB will undertake to pay sufficient amounts to fund the periodic distribution amounts and the principal repayment at the maturity of the sukuk or in case of an early dissolution event. The obligations of SABB under the Murabaha agreement are unconditional and will rank pari passu with SABB’s other senior unsecured obligations. Moreover, we are of the view that the performance of the Mudaraba contract will not interfere with the Murabaha contract. The revenues generated by the Mudaraba will be used by the issuer in case of need. However, as the revenues of the Murabaha are calibrated to cover the issuer’s obligations toward investors, the scenario of the special-purpose vehicle using the Mudaraba revenues appears remote.

SABB will also cover all the costs related to the transaction arising under the sukuk documentation.

**Total Loss Event**

There is no total loss event defined as part of the legal documentation of the program.
Presale:
Hong Kong Sukuk 2017 Ltd.

This presale report is based on information as of Jan. 24, 2017. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the preliminary ratings should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

Transaction Summary
This presale report is based on information dated Jan. 24, 2017, and is posted in conjunction with the planned U.S. dollar-denominated sukuk (trust certificates) by Hong Kong Sukuk 2017 Ltd. (HK Sukuk), a special purpose vehicle, incorporated in Hong Kong. Under the sukuk documents, HK Sukuk will enter, among other contracts, into a lease agreement, Murabaha and purchase undertaking with Hong Kong (Special Administrative Region) (HKSAR, AAA/Negative/A-1+).

Rationale
The preliminary ‘AAA’ issue rating on the proposed issue reflects the issuer credit rating on HKSAR because the transaction fulfils the five conditions of our criteria for rating sukuk (see “Methodology For Rating Sukuk,” published Jan. 19, 2015, on RatingsDirect):

- HKSAR will provide sufficient and timely contractual obligations for the payment of the periodic distribution amounts (through the lease agreement) and the principal amount (through the purchase undertaking and the Murabaha agreement).

- The obligations of HKSAR are irrevocable and unconditional.
Islamic Finance Outlook
2018 Edition

Sukuk

- These external obligations will rank equally with HKSAR’s other unsecured external debt based on the legal documentation of the sukuk and our sovereign rating methodology.

- Under the sukuk legal documentation, HKSAR will undertake to cover all the costs related to the transaction.

- We assess as remote the risk that a total loss event jeopardizes the full and timely repayment of the trust certificates. Our opinion is based on our expectations that the portfolio of real estate and tangible assets (lease assets portfolio) will be diversified. We may revise our view, especially if the structure of the portfolio of underlying assets changes. HKSAR’s legal obligations under the sukuk terms and conditions might leave investors exposed to residual asset risks. HKSAR has the obligation to ensure that the assets are covered by insurance and to make up any shortfall between insurance proceeds and the principal amount, in the event of a total loss, unless HKSAR proves that it has complied with its insurance obligations.

Under our sukuk and sovereign criteria, the sukuk rating is therefore equalized with the foreign currency issuer credit rating on HKSAR. The preliminary rating on the trust certificates is based on draft documentation. Should final documentation differ substantially from the draft version, we could change the rating on the trust certificates. This report does not constitute a recommendation to buy, hold, or sell the trust certificates. S&P Global Ratings neither structures sukuk transactions nor provides opinions concerning compliance of the proposed transaction with Sharia.

### Table 1 – Hong Kong Sukuk 2017 Ltd. Transaction Details

<table>
<thead>
<tr>
<th>Issuer, Trustee</th>
<th>Hong Kong Sukuk 2017 Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligor</td>
<td>Hong Kong Special Administrative Region</td>
</tr>
<tr>
<td>Arrangers</td>
<td>Standard Chartered, HSBC, CIMB, and National Bank of Abu Dhabi PJSC.</td>
</tr>
<tr>
<td>Principal Paying Agent</td>
<td>Deutsche Bank AG, Hong Kong Branch</td>
</tr>
<tr>
<td>Delegate</td>
<td>DB Trustee (Hong Kong)</td>
</tr>
<tr>
<td>Governing Law</td>
<td>English Law and laws of Hong Kong</td>
</tr>
</tbody>
</table>

**A Sukuk issue that comprises sufficient contractual obligations for full and timely repayment**

The transaction involves Hong Kong Sukuk 2017 Ltd., a special-purpose company incorporated in Hong Kong for issuing rated trust certificates. We understand that the issuer will use the proceeds of the sukuk to acquire beneficial interest in a pool of underlying assets including:

- At least 34% of the sukuk proceeds for a portfolio of real estate/tangible assets (lease assets).

- At most 66% of the sukuk proceeds for a portfolio of commodities.

Under the lease agreement, HKSAR prior to each periodic distribution date, will pay rentals, to the lessor (the issuer), which amount was calibrated to match the amount payable as periodic distribution to sukuk holders. The obligations of HKSAR under the lease agreement are unconditional and will rank equally with HKSAR’s other unsecured external debt based on our sovereign criteria.

At the maturity date of the transaction or upon the occurrence of an early dissolution event, HKSAR will pay the exercise price under the purchase undertaking and the deferred payment price under the Murabaha agreement. The execution of the purchase undertaking and
the Murabaha agreement will allow the issuer to receive 100% of the principal amount of the trust certificates that will be used to pay back the investors at the scheduled maturity or upon the occurrence of a dissolution event (see chart 2). The obligations of HKSAR under the purchase undertaking and the Murabaha agreements are unconditional and will rank equally with HHKSAR’s other unsecured external debt based on our sovereign criteria.

At the maturity date of the transaction or upon the occurrence of an early dissolution event, HKSAR will pay the exercise price under the purchase undertaking and the deferred payment price under the Murabaha agreement. The execution of the purchase undertaking and the Murabaha agreement will allow the issuer to receive 100% of the principal amount of the trust certificates that will be used to pay back the investors at the scheduled maturity or upon the occurrence of a dissolution event (see chart 2). The obligations of HKSAR under the purchase undertaking and the Murabaha agreements are unconditional and will rank equally with HHKSAR’s other unsecured external debt based on our sovereign criteria.

All HKSAR obligations under the sukuk contracts are irrevocable, and will rank equally with HKSAR’s other external debt. HKSAR will also cover all the costs related to the transaction arising from the sukuk documentation.

**Total Loss Event**

While the risk of a total loss event is mentioned in the documentation for the sukuk (specifically for the lease assets portfolio), we assess as remote the risk that a total loss event jeopardizes the full and timely repayment of the sukuk. Our opinion is based on our expectations that the lease assets portfolio will be diversified. We may revise our view, especially if the structure of the portfolio of underlying assets changes. HKSAR’s legal obligations under the sukuk terms and conditions might
leave investors exposed to residual asset risks. HKSAR has the obligation to ensure that the assets are covered by insurance and to make up any shortfall between insurance proceeds and the principal amount, in the event of a total loss, unless HKSAR proves that it has complied with its insurance obligations. Such a condition might result in a scenario where a default of the sukuk is possible while the obligor/issuer have not defaulted on their contractual obligations. This risk is mitigated by our view that a total loss event is remote, based on the expected composition of the portfolio of underlying assets.
Presale: EQUATE Sukuk SPC Ltd.

This presale report is based on information as of Nov. 29, 2016. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the preliminary ratings should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

Proposed US$2 billion sukuk program: assigned preliminary ‘BBB+’ issue ratings

Transaction Summary

This presale report is posted in conjunction with the planned issuance of a US$2 billion sukuk program (trust certificates) by EQUATE Sukuk SPC Ltd. (Equate SPC), a special-purpose vehicle incorporated in the Dubai Financial Centre (DIFC). Under the sukuk documentation, Equate SPC will enter into a Murabaha, a lease agreement, and a purchase undertaking with EQUATE Petrochemical Co K.S.C.C. (Equate; BBB+/Stable/A-2).

Rationale

- The preliminary ‘BBB+’ issue rating on the proposed sukuk program reflects the issuer credit rating on Equate. This is based on our view that the transaction fulfills the five conditions of our criteria for rating sukuk (see “Methodology For Rating Sukuk,” published Jan. 19, 2015, on RatingsDirect):

- Equate will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts (through the lease agreement) and the principal amount (through the purchase undertaking and the Murabaha agreement).

- Equate’s obligations are irrevocable and unconditional.
- These obligations will rank pari passu with Equate’s other unsecured unsubordinated financial obligations.

- Under the sukuk legal documentation, Equate will undertake to cover all the costs related to the transaction.

- We assess as remote the risks that a total loss event (TLE) would jeopardize the full and timely repayments of the trust certificates.

Therefore, we equalize the preliminary rating on the sukuk program with the issuer credit rating on Equate.

The preliminary rating on the sukuk program is based on draft documentation. Should final documentation differ substantially from the draft version, we could change the rating on the trust certificates. This report does not constitute a recommendation to buy, hold, or sell the trust certificates. S&P Global Ratings neither structures sukuk transactions, nor provides opinions with regards to compliance of the proposed transaction with Sharia.

A sukuk program that comprises sufficient contractual obligations for full and timely repayment

The transaction involves Equate SPC, a special-purpose company incorporated in the DIFC for issuing rated trust certificates. We understand that Equate SPC will use the proceeds of the sukuk to acquire beneficial interest in a pool of underlying assets as follows:

- 52% of the sukuk proceeds for a portfolio of real estate/tangible assets (lease assets).
- 48% of the sukuk proceeds for a portfolio of commodities.

### Table 1 - EQUATE Sukuk SPC Ltd. Transaction Details

<table>
<thead>
<tr>
<th>Role</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer, trustee</td>
<td>Equate Sukuk SPC Ltd.</td>
</tr>
<tr>
<td>Sponsor</td>
<td>EQUATE Petrochemical Company K.S.C.C.</td>
</tr>
<tr>
<td>Arrangers</td>
<td>Citibank</td>
</tr>
<tr>
<td>Principal paying agent</td>
<td>Citibank N.A. London Branch</td>
</tr>
<tr>
<td>Delegate</td>
<td>Citibank N.A. London Branch</td>
</tr>
<tr>
<td>Governing law</td>
<td>English Law and laws of Kuwait</td>
</tr>
</tbody>
</table>

### Periodic distribution payments

Under the lease agreement, prior to each periodic distribution date, Equate will pay rentals to the lessor (the issuer, Equate SPC), which amount was calibrated to perfectly match the amount payable as periodic distribution to sukuk holders. Equate’s obligations under the lease agreement are unconditional and will rank pari passu with Equate’s other senior unsecured obligations.

### Chart 1 - Periodic Distributions Payment
At the maturity date of the transaction or upon the occurrence of an early dissolution event, Equate will pay the exercise price under the purchase undertaking agreement and the deferred payment price under the Murabaha agreement. The execution of the purchase undertaking and the Murabaha agreement will allow the issuer to receive 100% of the principal amount of the trust certificates that will be used to pay back the investors at the scheduled maturity or upon the occurrence of a dissolution event (see chart 2). Equate’s obligations under the purchase undertaking and the Murabaha agreements are unconditional and will rank pari passu with Equate’s other senior unsecured obligations.

All of Equate’s obligations under the sukuk documentation are irrevocable, unsubordinated, and will rank pari passu with all Equate’s other unsubordinated financial obligations. Equate will also cover all the costs related to the transaction under the sukuk documentation.

**Total Loss Event**

While a risk of a TLE is mentioned in the sukuk documentation (specifically for the lease assets portfolio), we assess as remote the risks that a TLE jeopardizes the full and timely repayments of the sukuk. Our opinion is based on our expectations that the lease assets portfolio, part of any drawdown, will be made of a diversified portfolio of assets. Notwithstanding, we will reassess the remoteness of TLEs for each drawdown separately based on the actual composition of the real estate/tangible assets portfolio, and this could lead us to assign a different rating to the sukuk program if our initial assumptions are not met. Equate’s legal obligations under the sukuk terms and conditions might leave investors exposed to residual assets risks. Equate has the obligation to ensure that the assets are covered by insurance as well as the obligation to make up any shortfall between insurance proceeds and the principal amount, in case of TLE, unless the company proves beyond any doubt that it has complied with its insurance obligations. The latter might result in a scenario in which a sukuk default is possible while the sponsor/issuer has not defaulted on its contractual obligations. Regarding Equate SPC and its proposed sukuk program, in our view, this TLE risk is mitigated by the expected composition of the portfolio of the underlying assets.
Spotlight on...

Is Sukuk Issuance Suffering From The Liquidity Drop In Gulf Countries?

In 2016, the volume of sukuk issuance was muted, particularly compared with conventional bond issuance in Gulf Cooperation Council (GCC) countries. Some market participants attributed this performance to the decline in liquidity in GCC countries where a large portion of investors in sukuk are domiciled.

While S&P Global Ratings has observed this drop in liquidity, we still believe that, compared with global peers, Gulf banks still carry a hefty part of their assets in liquid forms. Moreover, we believe that the less supportive economic environment is translating into fewer lending opportunities and might encourage banks to reallocate some assets to the bond and sukuk market. We, therefore, believe that the dip in sukuk issuance is instead mainly underpinned by the complexity related to the issuance process.

Who Invests In Sukuk?

To answer this question, we looked at a sample of 29 sukuk issued in U.S. dollars during 2014-2016. Our sample included 12 sukuk issued by GCC-domiciled issuers and 17 sukuk issued by non-GCC-domiciled issuers. The results show that about 50% of sukuk investors are based in the GCC. This was followed by Asian and European investors, which accounted for 23% and 19% of the investor base, respectively. U.S.-based investors made up only 8% and invested mainly in sovereign sukuk issued in Asia and GCC countries. However, given the small number of sukuk in our sample, we consider this data to be only indicative of sukuk investors’ distribution. In our opinion, there are two main factors that explain this investor breakdown:

Sukuk are still a local rather than a global capital market funding instrument

Sukuk have gained significant popularity in recent years, but issuers remain primarily domiciled in Islamic finance core markets (GCC countries and Malaysia), and there is a limited but growing involvement of issuers domiciled...
in other countries (Indonesia, Pakistan, Hong Kong, etc.). The distribution of sukuk investors shows a bias toward local investors. For example, for sukuk issued in the GCC countries, 62% of investors were based in the same region (see chart 1). However, there is also a relatively high level of involvement of Western investors, which contributed around 27% of investments. Such involvement is likely not driven by the search for Sharia compliance but rather by yields. We believe that the involvement of Western investors in the sukuk market could be increased through more market education on sukuk and the risks involved.

Liquidity in developed markets is still abundant, but the window might start slowly closing in the next 12-18 months

Sukuk have attracted investors from developed markets and this will probably continue until there is a shift in the liquidity conditions in these markets. The European Central Bank’s quantitative easing (QE), for example, has resulted in some leakages of liquidity toward emerging market instruments, including sukuk as shown by the 19% of Europe-based investors in our sukuk sample. We think that this is due to the low interest rates in some European countries. By contrast, the contribution of U.S. investors dropped over the past three years, and we think this might be attributed to the tapering of the U.S. Federal Reserve’s QE followed by the start of the interest rate increasing cycle. Our economists project two to three rate increases from the Federal Reserve for 2017, which augurs for an even lower involvement of U.S. investors going forward. Another reason for the muted involvement of U.S. investors is purely regulatory. In our sample, only 12 issuances were open to qualified institutional buyers in the U.S. (144A issuance).

Did The Drop In GCC Liquidity Impact Sukuk Issuance?

We understand that GCC Islamic banks are among the main investors in sukuk. The Islamic finance industry remains dominated by banking, which accounted for over 80% of the industry’s $2.1 trillion assets at year-end 2016. This statement is somewhat confirmed by the distribution of the sukuk market’s investor base.

Over the past two years, we have observed a reduction in liquidity in GCC banking systems. We use system-level data rather than Islamic banking data because not all the central banks in the region publish granular data on Islamic banks. We have confirmed our finding by looking at a representative sample of 16 Islamic banks in the GCC with total assets of $438.5 billion at June 30, 2016. Growth in GCC banks’ customer deposits slowed to 2.4% in the first nine months of 2016, compared to 5.4% in 2015. We expect this trend will continue in 2017 and 2018. This is because governments and their related
entities--whose deposits depend on oil prices--contributed between 12% and 35% of the total deposits of GCC banks at Sept. 30, 2016, and we project that oil prices will stabilize at around $50 per barrel in 2017-2018.

Despite this drop, we think that GCC banks still have some cards to play. We view their funding profile as strong by international standards, as it is mostly dominated by core customer deposits with an average loan to deposit ratio of 91% at Sept. 30, 2016. Moreover, GCC banks tend to keep sizable amounts of cash and money market instruments on their balance sheets (around 18% of total assets at Sept. 30, 2016; see chart 2). It is worth noting that this ratio has dropped from around 22% at year-end 2014, yet compares favorably with global peers. In their current challenging operating environment marked by lower opportunities for growth, we think that some GCC banks might divert a portion of this liquidity toward assets that generate higher income. In this context, bonds and sukuk are attractive compared with interbank deposits or deposits with the central banks.

Another way to assess the impact of the liquidity drop in GCC countries is to look at the oversubscription rates. To that end, we increased our sample to 42 sukuk issued in U.S. dollars over 2014-2016. Our results show that on average, sukuk issuers were offered 2.9x the amount of the money they asked for in 2016. This ratio dropped from 3.3x and 3.9x in 2015 and 2014, respectively (see chart 3), confirming to some extent the drop in liquidity noted above. However, given these figures, we think that liquidity shrinkage was not the main reason behind the drop in sukuk issuance in the GCC in 2016 and believe that in 2017 some of GCC governments might look seriously at the pockets of liquidity still available in their Islamic banking system.
Sukuk, Bonds, Or Both?

The decision to issue sukuk or bonds ultimately lies with the issuer and depends on many factors. These include the cost of issuance, the capacity of the market to absorb the transaction, the issuer’s target investor base, how ready the issuer’s regulatory and legal environment is for sukuk issuance, and the complexity of structuring sukuk. We think that the latter factor is one of the main reasons behind the muted sukuk issuance in 2016 and believe that it will continue to weigh on volumes in 2017. Therefore, we are of the view that standardization of legal documentation and Sharia interpretation is an important milestone to boosting issuance volumes. A partial solution that was proposed by the market is to establish large issuance programs to be able to tap the market at the right time. Furthermore, based on recent oversubscription rates for sukuk in our sample, we do not see the market’s absorption capacity as a major deterrent for sukuk issuance. We would have seen it as one if issuers had come to the market with a large amount of issuances, such as some of the conventional bond issuances done by GCC countries in the past 12 months. However, we have observed the Indonesian government, for example, place $2.25 billion in sukuk in 2016, with an oversubscription rate of about 3x.

On the pricing side, we have observed over the past three years some transactions being placed at competitive periodic distribution rates versus conventional instruments and versus the theoretical cost of funding in U.S. dollars of the sponsor. We have estimated the latter using credit default swap spreads on the issuers based on a sample of 13 sovereign sukuk. On average, issuers saved non-negligible costs compared with their theoretical cost of funding. This is underpinned by the significant market demand for the sukuk issued by these sovereigns, which were oversubscribed by 3.9x on average. The pricing benefit is the exception rather than the rule, however, and might not be applicable to private-sector issuers where sukuk pricing is generally similar or slightly higher compared with conventional funding. We believe that the sukuk market, alongside the conventional capital market, could play a greater role in closing the funding gap of core countries issuers, and other countries interested in Islamic finance, over the next few years. This will depend, however, on the market participants’ capacity to deliver tangible progress on the standardization of legal documentation and Sharia interpretation. The establishment of large programs could also help.

The Role Of Sukuk In Sovereign Financing

In our opinion, the liquidity decline in the GCC banking system does not appear to have been a main factor in lower sukuk issuance over 2016, and, conversely, could actually indicate upside for sovereign sukuk issuance over the next few years. We estimate GCC sovereigns financing needs at around $275 billion over the next three years, the majority of which pertains to Saudi Arabia. We expect these countries will predominantly use debt financing, albeit narrowly over assets, to plug the needs. Sukuk comprise only a small amount of total outstanding issuance, as discussed above, however work has been carried out by various governments over the past few years, particularly by Kuwait and Saudi, to establish the necessary legal frameworks for their issuance. Further, we would expect sukuk will attract the aforementioned pockets of liquidity, with scope for reasonable scale issues. With the backdrop of weakening global liquidity, this potential source of financing could become a more attractive financing prospect for GCC governments and is an additional source of external liquidity relevant for our sovereign rating analysis.
AAOIFI Proposes Recommendations For Central Sharia Boards

A Step In The Right Direction

S&P Global Ratings believes the proposal by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for centralized Sharia boards, if implemented in countries active in Islamic finance, will help the industry move toward greater standardization and harmonization in Sharia interpretations.

Centralized Sharia boards are independent bodies that operate at a national level, compared with internal Sharia boards at banks themselves. In our opinion, the lack of such standardization has prevented the industry from achieving a greater degree of global integration, and accounts for its current fragmentation. The lack of standardization has also created an additional layer of complexity for Islamic financial market instruments, particularly sukuk, and has deterred some potential issuers from tapping the market. We think AAOIFI’s proposals represent a step in the right direction. As a further step, we believe the industry could benefit from additional recommendations about how national boards could interact and cooperate, accelerating global standardization.

Central Sharia Boards Would Promote Greater Standardization

S&P Global Ratings believes that AAOIFI’s proposals will help achieve a greater level of standardization in the Islamic finance industry. Lack of standardization is one of the main roadblocks the industry, especially the sukuk market, faces (see the Related Research section for articles we have published on this topic). We are of the view that such obstacles have deterred some issuers from tapping the sukuk market in the past few years. Moreover, in our view, differences in Sharia interpretation across jurisdictions may have prevented some investors, sensitive to Sharia compliance, from investing in some instruments due to questions about adherence to Sharia rules.
AAOIFI proposes a number of recommendations regarding the selection of board members, their remuneration, and general functioning, which we believe will help regulators implement such approaches in jurisdictions where they do not yet exist. To date several countries have chosen this route, but the responsibilities of their boards can vary. The draft also proposes to limit the term of board members to three to five years, which in our view could help in the transfer of Sharia knowledge and decision documentation. The shortage of Sharia scholars and the presence of some prominent scholars on a significant number of Sharia boards are generally viewed by the market as a major impediment to the development of the Islamic finance industry. Moreover, by documenting their decisions, boards could help push the industry toward greater innovation. Boards would need to spend less time on recurring issues related to Sharia compliance, allowing scholars to spend more time on innovation. The AAOIFI recommendation to appoint financial experts to the boards, along with Sharia scholars, would strengthen the boards further.

We also think that the presence of centralized Sharia boards could enhance the quality of national supervision of the Islamic finance industry. We believe the boards could play a proactive role in case of noncompliance with Sharia, though the AAOIFI recommends that most board functions be passive in nature, providing “fatwa” or advice to local authorities or regulators when asked. We think this could help achieve greater market discipline, coupled with the move toward external Sharia auditing that some core Islamic finance markets are implementing. External Sharia audits could, in our opinion, help increase the transparency of the industry when it comes to Sharia compliance. Until now, this role was played by internal Sharia auditors for Islamic banks, posing the risk of conflict of interest and not involving public disclosure. Sharia audits are rarely conducted for sukuk, for example, except when they are issued by Islamic financial institutions generally subject to Sharia surveillance. AAOIFI recommends that among other roles, centralized Sharia boards will alert authorities in case of risks related to compliance and propose proactive solutions. This would help increase the stability of the Islamic finance industry locally and strengthen its credibility, in our opinion.

**Greater Standardization Would Make The Industry More Attractive**

For issuers, greater standardization of Sharia interpretation could also help facilitate sukuk issuance and increase its attractiveness. We see the lack of standardization of legal documentation and Sharia interpretation as one of the main reasons behind muted activity on the sukuk market over the past couple of years. Several issuers in core Islamic finance countries decided to tap the conventional markets because that process is more efficient than for issuing sukuk (see the Related Research section). We therefore think that AAOIFI’s recommendations will help create the necessary infrastructure to respond to this weakness.

We also believe that greater standardization could also increase the industry’s attractiveness for corporate and retail customers because it would reinforce the credibility of the products offered and reduce doubts about non-Sharia compliance. It also reduces the possibility of Sharia arbitrage by issuers and banks.
National Standardization Is The First Step Toward Global Standardization

We think AAOIFI’s proposal could benefit from recommendations on the ways national boards could interact on regional and global levels to push forward standardization. One way to achieve such standardization could come through the adoption of AAOIFI Sharia standards, for example, as the draft suggests. Such an approach will lend greater consistency across countries where Islamic finance is developing and could spur greater integration within the industry. Although AAOIFI has published numerous standards, Sharia boards appear to have significant leeway in making decisions regarding compliance. This has resulted in variations in Sharia requirements across the industry, with Malaysia being seen by market participants as the least conservative jurisdiction and Saudi Arabia as the most conservative. Given the current slowdown of Islamic finance activity, we believe some standardization could help reposition the industry for future growth, increase its attractiveness to new players, and support the integration of economies where Islamic finance is present.

Why Are These Proposals Important To Our Ratings?

While S&P Global Ratings does not comment on Sharia compliance as part of its ratings, we think that the risks related to a perception of Sharia noncompliance could have a significant negative impact on the stability of the industry or on rated issuers. For example, a bank that is perceived as non-Sharia-compliant could lose some of its deposits, especially from corporate and retail clients that are sensitive to Sharia in their business dealings. This, in turn, could significantly pressure the bank’s funding and liquidity. Comments made by a prominent Sharia scholar in 2007 that a large portion of sukuk issued was not compliant with Sharia shut that market for few months, leading to an overhaul of legal documentation pertaining to such instruments. At the level of an individual sukuk issue, the risks of an instrument being perceived as non-Sharia-compliant could result in repayment difficulties and pose a risk of default. While we do not assess this risk as such, we do incorporate it into our analysis of funding and liquidity of a financial institution or a corporate that issues sukuk.
Sukuk Accounting Proposal Takes The Standardization Debate To A New Level

In the recent past, we’ve observed some ambiguity in how legal obligations of sukuk sponsors are worded, which according to our understanding was primarily in response to some Sharia scholars’ requests. However, if the AAOIFI’s proposal is adopted, lawyers and sukuk structurers could have a basis for strengthening legal protection for sukuk holders.

Financial Accounting Standard 29 Clarifies Types Of Sukuk

In our view, the AAOIFI’s exposure draft of its proposed financial accounting standard No. 29 will help achieve greater clarity on the different types of sukuk in the market. The proposal distinguishes between two broad types of sukuk—on balance sheet and off balance sheet—based on the effective control of the underlying assets. Moreover, it proposes to classify on-balance-sheet sukuk either as a liability, quasi equity, or equity. We are of the view that the proposal not only recognizes that sukuk can be issued in the form of a liability of its sponsor, but also paves the way for strengthening the legal documentation for this type of sukuk.

Recently, we’ve noted that the documentation for sukuk that would be classified as a liability appears somewhat vague with regard to the legal obligations of the sponsor. Language that is subject to legal interpretation, and does not create firm obligations, was introduced by certain lawyers in response to some Sharia scholars’ concerns that sukuk might create a liability between the sponsor and the investors, which in their view goes against the principles of Sharia. To restore the fixed-income characteristics of this type of sukuk, some lawyers subsequently made the creation of

S&P Global Ratings believes the proposal by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for centralized Sharia boards, if implemented in countries active in Islamic finance, will help the industry move toward greater standardization and harmonization in Sharia interpretations.

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contractual obligations between the sponsor and the special purpose vehicle issuing the sukuk a prerequisite to closing a sukuk transaction.

We believe the AAOIFI’s proposal, if adopted, could bring much needed clarity on whether sukuk can be structured and issued as liability instruments. Coupled with the AAOIFI’s previous proposal on centralized Sharia boards, we think this could strengthen the case for standardizing the legal and Sharia aspects of sukuk. We also think the proposal could benefit from recognizing any independent contractual or promissory arrangements associated with sukuk issuance as part of a sukuk’s core contracts. In most cases, these contracts create a financial liability for the sponsor to pay back investors, thereby exposing sukuk holders to risks related to the sponsor’s incapacity to honor its obligations. We consider the presence of such contracts to be an important factor for holders of liability-type sukuk, especially those investors whose interest is not primarily motivated by the Sharia-compliant nature of the transaction. The proposal also mentions the possibility of classifying sukuk as equity or quasi equity. While we have observed issuance of such instruments over the past few years, in the Gulf Cooperation Council (GCC) and elsewhere, they remain the exception rather than the norm. The cost of issuing these types of instruments is usually higher than for the liability type, since the risks are higher. We therefore think liability-type sukuk will continue to dominate the sukuk market.

Another aspect requiring further clarification pertains to the rules for the tradability of liability-type sukuk. For a long time, sukuk were considered a buy-and-hold investment. However, as the market matured and attracted more issuers and investors beyond those seeking Sharia compliance, tradability became an important factor and a way to enhance the liquidity of sukuk instruments in the secondary market. In our view, the Basel III liquidity coverage ratio (LCR) requirement will increase the demand for high-quality liquid assets in the Islamic finance industry. Sukuk issued by governments, highly rated corporate entities, and multilaterals can play a role in helping the industry comply with that requirement. Yet achieving LCR compliance would necessitate not only unified rules for sukuk tradability but also the listing of sukuk on established markets.

**Greater Standardization Would Make The Industry More Attractive**

For issuers, greater standardization of legal documentation and Sharia interpretation could also help facilitate sukuk issuance and increase its attractiveness. We see the lack of standardization of legal documentation and Sharia interpretation as one of the main reasons behind muted activity on the sukuk market over the past few years, although we have seen some signs of revival in the first quarter of 2017. Several issuers in core Islamic finance countries have tapped the conventional markets because of the relative ease of that process (see “Is Sukuk Issuance Suffering From The Liquidity Drop In Gulf Countries?,” published Feb. 6, 2017, on RatingsDirect). We therefore think the AAOIFI’s proposals will further fuel the debate regarding the infrastructure to address shortcomings of the sukuk issuance process.

**Why The Proposal Is Important To Our Ratings**

In our methodology for rating sukuk, published in 2015, we outlined five conditions that a sukuk has to fulfil in order to be rated at the same level as its sponsor. One of these conditions is the sufficiency of the sponsor’s contractual obligations for repayment of the sukuk holders (that is, the principal, including all or the last periodic distribution amount in a scenario of early dissolution). If implemented, The AAOIFI’s proposal, by enabling the classification of a sukuk as a liability, will help strengthen the legal documentation of sukuk in our view, assuming the AAOIFI also recognizes the additional independent contractual or
Spotlight on...

promissory arrangements associated with sukuk issuance as part of a sukuk’s core contracts.

Our methodology also recognizes that some sukuk instruments may carry equity-like features, such as the deferability of periodic distribution, the write-down of the principal on a going- or gone-concern basis, or the subordination of the sponsor’s obligations. We can reflect the effect of those characteristics through the deduction of additional notches to derive our rating on the sukuk. The notching is generally from the level of the sponsor’s stand-alone credit profile (SACP). Equity-like features do not imply that we would not rate a sukuk; rather, we would not assign a rating if there is a lack of sufficient contractual obligations, or if the sponsor’s legal obligations are revocable. We have observed several issuances of Tier I or Tier II sukuk in GCC countries, as well as in Turkey where we have rated some of these instruments on average three notches lower than the SACP of their sponsors. In the GCC, we haven’t rated this type of instrument, but based on their characteristics, the rating would generally be several notches below the sponsor’s SACP (three to four notches, or more). We have previously assigned equity content to certain sukuk instruments in our risk-adjusted capital ratio calculation.
Sukuk Are A Natural Fit For Africa, But Not A Simple One

The global sukuk market jumped out of the gates in the first half of 2017 thanks to jumbo issuances by Gulf Cooperation Council (GCC) countries. Africa, however, did not contribute to the trend with landmark issuance. Indeed, only $2 billion of sukuk has been issued so far by a handful of African sovereigns, mainly since 2014.

This may appear surprising since S&P Global Ratings believes Africa's infrastructure development needs represent a fertile environment for sukuk because of the need for tangible assets as part of these Islamic finance transactions. What’s more, we believe African sukuk can provide diversification benefits for Islamic investors as well as additional financing opportunities. Plus, we think sovereign sukuk issuance could, in the long term, facilitate the development of Sharia-compliant private-sector sukuk on the continent.

Despite sukuk’s widespread appeal to investors, we expect that only a few African countries will tap the sukuk market over the next 12-18 months because issuing this Islamic financial instrument is not a simple matter. Among the challenges are the lack of clear legal and tax regimes to support a thriving sukuk market, and in many cases, the complexity of structuring the instrument that can slow entry to market. In addition, local regulators have yet to implement a framework to ensure the proper conduct of Islamic finance in their respective jurisdictions.

In what is a positive trend, multilateral institutions are becoming increasingly involved in enabling their African members to enter the sukuk market. This was illustrated by Senegal’s and Côte d’Ivoire’s issuance of sukuk in 2014-2015, aided by technical support from the Islamic Corporation for the Development of the Private Sector (ICD). We see this technical support as effective and believe that several African countries can attract foreign investors because of their large infrastructure projects.

Infrastructure Needs Remain High, But Fiscal Flexibility Is Declining

African governments’ capital expenditures will likely increase in the face of sizable long-term development and infrastructure needs. We estimate average GDP per capita for sub-Saharan African sovereigns at below $2,000
by the end of 2017, reflecting low wealth levels across the continent. Populations continue to grow in many African countries, requiring significant capital investment in infrastructure projects, ranging from those to ensure consistent power supply to transportation networks that can facilitate trade.

However, high reliance on commodity exports continues to take its toll on many African economies and public finances in 2016, resulting in necessary fiscal consolidation measures.

Domestic debt financing has become more expensive as high policy rates, designed to tame inflationary expectations, are passed through into treasury bill interest rates. However, for larger issuers such as Nigeria and Kenya with fewer concessional facilities, external issuance can provide a significantly cheaper option than domestic markets. We therefore think that sukuk could be an attractive diversification tool for foreign currency issuers, assuming that the pricing is closer or similar to conventional debt. Over the past few years, we have seen a narrowing of the differential between sukuk and conventional bond pricing, as the market is becoming more familiar with sukuk and through the use of more standardized and simple sukuk structures.

The Hurdles To Issuing Sukuk

African governments need to address a number of legal hurdles to issuing sukuk, in our view. We believe clear legislation is a prerequisite to sukuk being used more often as an alternative funding instrument, and that tax regimes are equally important as a growth stimulus for the market. Sharia-compliant instruments require the same treatment as conventional instruments for investors to consider them a viable investment option.

For instance, South Africa has made permanent amendments to its legal and tax laws so it can solicit the market in the future. In West Africa, the regulatory framework for sukuk in Senegal is applicable to the other seven countries in the West Africa Economic and Monetary Union (WAEMU): Benin, Burkina Faso, Côte d’Ivoire, Guinea Bissau, Mali, Niger, and Togo. After the Senegalese government debuted with two tranches in 2014 and 2016 for a total of CFA franc (XOF) 250 billion (about $425 million), Côte d’Ivoire followed suit later in 2015 with the first tranche of its XOF300 billion program for 2015-2020. Togo became the third country in the WAEMU zone to make its debut after launching a XOF150 billion sukuk in July 2016. We believe neighboring countries of the WAEMU zone are likely to enter the market more quickly and easily as a result of the common framework applicable to their economic zone.

So that issuers can tap the market effectively, regulators will have to make some adjustments to ensure the proper conduct of Islamic finance in their jurisdictions, in our opinion. These include not only tax and legal considerations, but also Sharia governance issues. Sharia is still interpreted in different ways across the various Islamic finance markets. This has resulted in a lack of communication and cooperation between the various jurisdictions where the industry is present and more importantly a lack of investors’ interest in some instruments that might be perceived as non-compliant with Sharia. Lastly, central banks could encourage the use of Islamic finance instruments through the creation of specific windows to help the liquidity of Islamic finance instruments, as the Central Bank of West African States did when Senegal issued its first sukuk.

Support From Multilateral Institutions Could Accelerate Entry

The involvement of multilateral institutions (MLIs) could foster increased issuance and provide a good head start to its African members. We think the Islamic Development Bank’s African members are well positioned to
attract foreign sukuk investors. This would allow them to attract a wider investor base and new liquidity pools.

We have seen that technical assistance from MLIs, like the Islamic Development Bank and the Islamic Corporation for the Development of the Private Sector, and from domestic institutions such as central banks, has expedited African sovereign sukuk issues, particularly in WAEMU. The ICD initially partnered with Senegal’s central government and other institutions to help establish the necessary framework to issue sukuk in WAEMU. The Senegalese and Cote d’Ivoire sukuk are meant to be the first in a series that will be issued by West African states and supported by the ICD. However, we expect progress to be very slow as the complexity related to issuing sukuk usually deters the appetite of some issuers, which only accentuates the need for a greater standardization in the industry. MLIs and standard-setting bodies are aware of this challenge and have begun to carry out corrective measures. For example, The Accounting and Auditing Organization for Islamic Financial Institutions came out with a proposal for central Sharia boards, which if implemented could boost the standardization of Sharia interpretation. The Islamic Financial Services Board and others have made proposals in the areas of sukuk disclosure and accounting practices which could help lawyers in the design of a standardized set of legal documentation. We are of the view that greater standardization could help the market to reach its full potential.
GCC Islamic Banks Stay On Course Through Glum Operating Conditions

S&P Global Ratings believes that the weak economic environment will continue to dampen the financial performance of Islamic banks in Gulf Cooperation Council (GCC; Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates) countries in 2017 and 2018.

The end of the commodities super-cycle has sparked a fall in the economic growth and prospects of the GCC region, implying both lower growth opportunities and deteriorating liquidity for its conventional and Islamic banking systems.

We foresee further declines in GCC banks’ asset quality and profitability indicators in 2017-2018. Still, we think that the banks have built sufficient buffers to make the overall impact on their financial profiles manageable.

By global and regional standards, the Islamic banks in our sample (see Appendix) continued to display strong asset quality indicators, profitability, and capitalization in 2016. We think that the current environment is creating an opportunity for the local regulators to start inching closer to a more stringent application of Islamic finance’s profit and loss sharing principle. We have seen a few attempts in the industry to move in this direction, through the issuance of Tier 1 and Tier 2 sukuk with loss absorption at the point of nonviability (generally defined as a breach of the local regulatory capital ratios). We expect such issuance will continue, albeit slowly, over the next two years.

Islamic Banks' Growth Has Moderated And Will Continue To Ease, Except In Saudi Arabia

The drop in the oil price since the second half of 2014 has put the brakes on GCC economies and squeezed growth opportunities for their banking systems. S&P Global Ratings forecasts oil prices will stabilize at US$50 per barrel in 2017 and 2018, with unweighted average GDP growth in the six GCC countries at 1.9% in
2017 and 2.4% in 2018, after 2.3% in 2016. We consequently expect the slowdown in growth at both conventional and Islamic banks in the region will persist. Asset growth stabilized at 6.4% in 2016 for Islamic and conventional banks in our sample, compared with 6.6% and 6.9% respectively in 2015 (see chart 1). In our base-case scenario, we assume that asset growth will drop to about 5% as governments’ spending cuts and revenue-boosting initiatives, such as tax introductions, reduce opportunities in the corporate and retail sectors. We see banks becoming more cautious and selective in chasing high-quality lending opportunities, triggering stiffer competition.

The story is not the same for all GCC countries, however. Although the economic slowdown was and will remain more pronounced in Saudi Arabia, Islamic banks’ growth accelerated there in 2016, thanks to their strategy to increase their foray into the corporate and small and midsize (SME) sectors. By contrast, the slowdown was...
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deeper in Qatar, where a mix of lower liquidity and government spending cuts prompted banks to curtail their pace of expansion. Asset growth was about nil in Kuwait over the past year, hit by the depreciation of some foreign currencies and the ensuing impact on the financials of some leading Kuwaiti Islamic banks. Lastly, despite the tepid economy and the drop in real estate prices in the UAE, Islamic banks continued to expand at high single digit figure.

**When The Cycle Turns, Asset Quality Indicators Deteriorate With A Lag**

The asset quality indicators of GCC Islamic banks remain on a par with those of their conventional counterparts. Both Islamic and conventional banks are well entrenched in their local real economies in the GCC. As the economic cycle turns, we think that asset quality indicators will continue to deteriorate in 2017-2018. The weakening that has already occurred was not noticeable in 2016 because—as is typical—banks started to restructure their exposures to adapt to the shift in the economic environment. Therefore, we saw an increase in restructured loans in the GCC in 2016, but we didn’t observe a marked increase in nonperforming loans (NPLs) or cost of risk. We think the deterioration will be more visible in 2017-2018. Although some market participants maintain that Islamic banks will fare much better than their conventional counterparts due to the asset backing principle inherent to Islamic finance, we think they will be on equal footing. We factor in that bankruptcy laws remain underdeveloped, and the foreclosure of underlying assets remains generally difficult in most GCC countries, especially because the predominant type of collateral is real estate. Overall, we think that subcontractors, SMEs, and expatriate retail exposures will bear the brunt of the turning economic cycle and prominently contribute to the formation of new NPLs in 2017 and 2018.

In our base-case scenario, we exclude the materialization of concentration risk, which is a fact of life in the GCC. We also see as positive the buffers that GCC Islamic banks have built in previous years, when the cycle was more supportive. The ratio of NPLs to total loans was 3.1% on average for our sample at year-end 2016, with an average coverage ratio of 133.9%. Under our base-case scenario, we think NPLs could increase to 4%-5% over the next two years: Credit losses could climb by more than 50% over the same period (see table 2).

### Table 2 - Asset Quality Comparison: Islamic And Conventional Banks

<table>
<thead>
<tr>
<th>Islamic banks (%)</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonperforming advances ratio</td>
<td>4.5</td>
<td>3.8</td>
<td>3.3</td>
<td>3</td>
<td>3.1</td>
</tr>
<tr>
<td>Nonperforming advances coverage</td>
<td>102.9</td>
<td>102.8</td>
<td>108.4</td>
<td>128.8</td>
<td>133.9</td>
</tr>
<tr>
<td>New loan loss provisions/average customer loans</td>
<td>1</td>
<td>1</td>
<td>0.9</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>New loan loss provisions/operating revenues</td>
<td>18</td>
<td>16.9</td>
<td>15.5</td>
<td>16</td>
<td>17.9</td>
</tr>
<tr>
<td>Conventional banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonperforming advances ratio</td>
<td>4.3</td>
<td>3.3</td>
<td>2.7</td>
<td>2.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Nonperforming advances coverage</td>
<td>106.8</td>
<td>131.7</td>
<td>164.6</td>
<td>162.7</td>
<td>149.4</td>
</tr>
<tr>
<td>New loan loss provisions/average customer loans</td>
<td>1</td>
<td>1</td>
<td>0.8</td>
<td>0.9</td>
<td>1.2</td>
</tr>
<tr>
<td>New loan loss provisions/operating revenues</td>
<td>18</td>
<td>17.8</td>
<td>14.4</td>
<td>15.5</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Source: S&P Global Ratings.
**Funding Has Weakened, But Liquidity Is Still Sound**

Growth in customer deposits slowed to 6% in 2016, compared with 9% in 2015 for the Islamic banks in our sample. We expect this trend will continue in 2017 and 2018, as governments and their related entities, whose deposits largely depend on oil prices, contribute between 20% and 40% of the total deposits in GCC banking systems. This is somewhat counterbalanced by Islamic banks’ natural tendency to attract retail depositors because of their Sharia-compliant nature. In addition, we consider that the funding profiles of GCC Islamic banks remain strong by international standards. Core customer deposits mostly dominate in funding profiles, and banks’ use of wholesale funding sources remains limited. The use of sukuk as a funding source is limited, and we don’t think this will change dramatically anytime soon. Most recent sukuk issues by GCC banks were capital-boosting sukuk (primarily in the form of Tier 1 sukuk) as their pricing was attractive compared with banks’ cost of common equity. We don’t anticipate many sukuk issues from GCC Islamic banks in 2017-2018.

GCC Islamic banks’ liquidity also remains strong by international standards. Banks tend to keep sizable amounts of cash and money market instruments (about 19% of total assets at year-end 2016 [see table 3]), owing to the lack of high-quality liquid assets. Moreover, most of the GCC governments’ issues (except in Oman and Bahrain) were conventional. Still, we think that some GCC governments might start to look at tapping the liquidity buffers of GCC Islamic banks through sukuk issuance in 2017-2018. The relatively lengthy and complex process related to sukuk issuance has so far dampened this trend, though, while also bringing sukuk standardization to the forefront of policymakers’ and market participants’ agendas.

**We See Profitability Dropping Further In 2017-2018**

GCC Islamic banks’ profitability will deteriorate again in 2017 and 2018, in our opinion. We foresee several factors coming into play.

Growth opportunities are becoming scarcer because of government spending cuts and lower disposable income for retail clients. We also think that banks will become selective and prioritize quality and risk profiles over quantity. This, in turn, will fuel competition and pressure on asset yields.

Cost of funding has increased, squeezing the intermediation margins of GCC Islamic banks in 2016. Although the pressure eased a bit after some governments issued international bonds and unlocked payments to contractors, we think cost of funding will remain inflated in 2017-2018. The U.S. Federal Reserve’s expected interest rate hikes, which GCC central banks will likely have to emulate, could result in deposits shifting from unremunerated current accounts to profit sharing investment accounts (PSIAs). If this happens, it would also hamper cost of funding. Very few banks have set aside significant amounts of

<table>
<thead>
<tr>
<th>Table 3 - GCC Islamic Banks: Key Funding And Liquidity Metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td>(%)</td>
</tr>
<tr>
<td>---------------------------------</td>
</tr>
<tr>
<td>Growth in customer deposits</td>
</tr>
<tr>
<td>Cash and money market instruments to total assets</td>
</tr>
<tr>
<td>Customer loans (net)/customer deposits</td>
</tr>
<tr>
<td>Core deposits/funding base</td>
</tr>
</tbody>
</table>

Source: S&P Global Ratings.
Banks

“profit equalization reserves” (Islamic banks set these aside in good years and use them to smooth returns to PSIA holders if needed). That said, we think that GCC Islamic banks are on an equal footing with their conventional counterparts as far as cost of funding is concerned.

We foresee increased credit losses in the coming two years due to the currently less supportive economic environment. Exposure to subcontractors, SMEs, and retail customers, especially expatriates, should lead the uptrend.

We therefore expect banks’ revenue growth will decelerate, and we think banks will focus on their cost base (by pruning branches, for instance) to mitigate the impact. As for their conventional counterparts, GCC Islamic banks, through their relatively low cost base, should protect their profitability somewhat in 2017 and 2018 (see table 4). Although consolidation might be a way forward in some GCC markets, we expect mergers will remain the exception in 2017-2018, rather than the new norm.

Strong Capital Buffers Provide Effective Shelter From Shocks

The GCC Islamic banks in our sample continued to display strong capitalization by international standards, with an unweighted average Tier 1 ratio of 17.2% at year-end 2016. A mix of still-good profitability, somewhat conservative dividend payouts, and lackluster growth explain the slight increase in this ratio compared with last year. We note, however, that capitalization still remains lower than past highs because previous rapid growth of financing was not matched with additional capital raising exercises for most banks in our sample (see chart 2).

A few GCC banks have issued capital boosting sukuk, primarily in the UAE, Qatar, and Saudi Arabia. The common characteristic of these sukuk is that they allow for loss absorption at some point (in case of a nonviability event for Tier 2 sukuk and generally at their issuer discretion for Tier 1 sukuk). We see these sukuk helping the industry to inch closer to one of Islamic finance’s cardinal principles, profit and loss sharing.

Table 4 - GCC Islamic Banks Return On Assets

<table>
<thead>
<tr>
<th>(%)</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Islamic margin to average earning assets</td>
<td>2.8</td>
<td>2.7</td>
<td>2.7</td>
<td>2.7</td>
<td>2.5</td>
</tr>
<tr>
<td>New loan loss provisions/average customer loans</td>
<td>1</td>
<td>1</td>
<td>0.9</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Core earnings to average adjusted assets</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Noninterest expenses/operating revenues</td>
<td>44.6</td>
<td>42.1</td>
<td>41.5</td>
<td>39.5</td>
<td>40.7</td>
</tr>
</tbody>
</table>

Source: S&P Global Ratings.

Chart 2 - Gulf Islamic Banks’ Capitalization

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We think that extension of loss absorption to some categories of liabilities could strengthen the resilience of GCC Islamic banks. Moreover, as the global financial system moves toward bailing in some categories of liabilities under bank resolution regimes, local regulators could follow suit, but only in the next several years, in our view.

We have incorporated some of these instruments in our total adjusted capital calculation for the GCC banks we rate. Under the terms and conditions of the instruments, their respective issuers could defer the periodic distribution payment on a discretionary basis.

### Appendix: Sample Of Islamic And Conventional Banks In The GCC

To assess the financial performance of Islamic and conventional banks in the GCC, S&P Global Ratings has used a sample of 17 Islamic banks and 28 conventional banks, each with total assets in excess of US$5 billion (see tables 5 and 6). We have not adjusted for the Islamic windows or activities of some conventional banks in our sample, owing to a lack of disclosure and the risk of distorting data because these windows or activities could benefit from the overall support of their respective groups in the form of funding or cost sharing, for example.

### Table 5 - Key Performance Indicators For S&P Global Ratings' Sample Of GCC Islamic Banks

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Country</th>
<th>Islamic bank ranking*</th>
<th>Overall ranking*</th>
<th>Assets (bil. US$)</th>
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</thead>
<tbody>
<tr>
<td>Al Rajhi Bank</td>
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### Table 6 - Key Performance Indicators For S&P Global Ratings' Sample Of GCC Conventional Banks

<table>
<thead>
<tr>
<th>Country</th>
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<th>Overall ranking*</th>
<th>Assets (bil. US$)</th>
</tr>
</thead>
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<td>1</td>
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<td>Banque Saudi Fransi</td>
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<td>Arab National Bank</td>
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<td>15</td>
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<td>Burgan Bank</td>
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<td>Gulf Bank</td>
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Islamic Insurers In The Gulf Cooperation Council Continue To Face Headwinds, Despite Better Overall Profits

Following years of annual growth in gross premiums of up to 20% in the Islamic (takaful and Islamic cooperative tawuni) insurance sector in the Gulf Cooperation Council (GCC), growth slowed significantly to less than 1% in 2016.

This was largely due to a slowdown in Saudi Arabia, which has the largest Islamic insurance market in the GCC. However, despite the slowdown, the pre-tax net income of the publicly listed companies in the sector improved materially to about US$683 million in 2016, from about US$274 million in 2015, mainly as a result of rate increases in Saudi Arabia following the introduction of actuarial pricing.

Notwithstanding the material improvement in overall pre-tax net income, it is still too early to announce good news for the sector as a whole. This is because the profits are still unevenly distributed across the sector, and historic rapid growth, combined with accumulated net losses, continues to erode the capital strength and damage the credit profiles of a number of companies in the sector. This is particularly true of some takaful companies in the United Arab Emirates (UAE), which are often competing with larger and more diversified conventional (non-Islamic) peers in an overcrowded market. The shorter track records and less-diversified businesses of these UAE takaful companies put them at a disadvantage now that stricter regulations are being adopted in the country.

In 2016, the combined gross premiums of Islamic insurers in the GCC reached nearly US$11 billion (based on available data from publicly listed companies), representing about 45%-50% of total global Islamic insurance premiums. Last year, around 87% of the Islamic insurance premiums in the GCC were written in Saudi Arabia, followed by the takaful sector in the UAE, with about 8% of premiums.
Growth In Gross Premiums Should Slowly Pick Up Again In 2017

The significant premium growth rates in the GCC’s Islamic insurance sector in 2014 and 2015 were mainly driven by the introduction of new mandatory covers, as well as strong increases in premium rates in Saudi Arabia, as new covers and actuarial pricing guidelines were adopted. However, now that more policies are adequately priced, overall premium growth has slowed (see chart 1). The slowdown in premium growth has also been influenced by lower economic activity across all GCC states, as governments are trying to reduce or delay their spending due to lower revenues from hydrocarbon sales.

We anticipate that overall premium growth in the Islamic insurance sector in the GCC will pick up again slightly in 2017, as economic conditions slowly improve and governments continue to privatize some of their services, which should benefit the insurance sector as a whole. However, we expect that overall premium growth in the conventional insurance sector in the GCC will grow faster, by about 10%, and outperform premium growth in the Islamic insurance sector, as conventional insurers often benefit from more diversified income streams.

Of all the Islamic insurance markets in the GCC, the takaful sector in the UAE showed the most favorable premium growth in 2016, with a rate of 6%. Rate increases for motor insurance and premium income from new covers (for example, extended compulsory medical insurance in Dubai) were the main drivers of this trend. Three of the greatest beneficiaries were ASCANA Takaful, which recorded year-on-year gross premium growth of 60% in 2016, followed by Takaful Emarat and Methaq Takaful, which both saw their premiums grow by more than 40% thanks to new extended compulsory medical business from the Dubai Health Scheme. As these examples show, there are still a number of fast-growing companies in the GCC’s Islamic insurance market, but measuring growth in percentage terms can be deceptive because many takaful companies are still growing from a relatively small base.

Underwriting Profitability Remains The Key Issue For Islamic Insurers

The publicly listed Islamic insurers in the GCC generated an estimated combined pre-tax profit of about US$683 million in 2016, compared to about US$274 million in 2015. We note that Saudi Arabia, where all 34 listed insurers operate on Islamic principles, was by far the most profitable insurance market in the GCC. Insurers operating in Saudi Arabia generated a total pre-tax profit of US$666 million in 2016, but the three most profitable companies booked about 64% of the total net profits. The 15 listed takaful companies in the other GCC states in our sample–Bahrain, Kuwait, Oman, Qatar, and UAE–only generated...
a combined profit of US$18 million, which is an improvement on a combined net loss of about $5 million in 2015, but in our view, is still a relatively weak result.

The eight listed takaful players in the UAE, which had a market share of 16% by gross premiums in 2016, performed particularly weakly compared to all 29 listed insurers in this market. These eight takaful companies suffered a combined net loss of US$24 million, while the remaining 21 listed insurers generated a combined profit of US$270 million. We acknowledge that the overall results of the takaful sector in the UAE were dragged down by one company that suffered exceptional losses of US$48 million in 2016 and US$44 million in 2015. However, five out of the eight listed takaful companies generated a net underwriting loss of US$64 million in 2016, versus US$32 million in 2015.

Operating performance therefore remains one of the key issues in the takaful sector in the UAE. This is because companies often write less-profitable personal lines and their premium income is too small to dilute their fixed operating costs. In addition, in 2016, some companies had to strengthen their reserves due to new regulations, which was an additional drag on their results.

However, there are also positive outliers in the UAE’s takaful sector. Only one company, Abu Dhabi National Takaful, consistently generates strong combined ratios and outperforms the average combined ratio of the listed conventional insurers in the market (see chart 2). Despite its relatively small size by gross premiums, the company benefits from its relatively low exposure to highly competitive personal lines and focuses instead on stronger performing commercial lines and family (life) business.

New risk-based regulations pose a significant challenge to many smaller and less-diversified insurers with tight capital buffers in the UAE. Takaful companies comprise a fair portion of this segment and a number of takaful insurers will therefore be particularly affected by the new rules, which will need to be fully implemented by the end of 2018. Based on year-end 2016 data, we note that the total shareholders’ equity of four out of eight listed takaful companies in the UAE was below the minimum capital requirement of US$27.2 million (UAE dirham [AED] 100 million), applicable under the new regulations.
Accumulated losses due to weak underwriting results at some UAE takaful companies have led in many cases to a decline in their overall capital positions. In addition, takaful companies often allocate a material proportion of their assets to illiquid real estate investments for Sharia compliance, which may cause additional volatility in their equity positions if real estate prices in the region continue to decline. We understand that at least one takaful company has announced plans to increase its capital through a rights issue, but believe that there is a risk that a number of other takaful players in the UAE may not be able to meet the regulatory capital requirements. They will therefore need to raise additional capital over time if they want to continue to operate in the market.

**More Consolidation Is Needed In The GCC Insurance Sector**

We remain of the opinion that there are too many insurance companies in the GCC, and that many of these players lack the scale to operate successfully in overcrowded and highly competitive markets. While we have seen a small number of merger announcements by takaful players in the GCC over the past year or so, we do not expect to see any transformative mergers in the near term. In our view, only well-resourced insurers with the capital strength and time to build scale and develop an effective competitive advantage will continue to prosper.

Only a rating committee may determine a rating action and this report does not constitute a rating action.
Research Update:
Islamic Development Bank
‘AAA/A-1+’ Ratings Affirmed; Outlook Remains Stable


Rationale

We base the ratings on IsDB’s very strong business profile and extremely strong financial profile. We assess IsDB’s stand-alone credit profile (SACP) at ‘aaa’.

Our assessment of IsDB’s business profile as very strong reflects the bank’s important policy role in promoting economic development across Muslim countries and communities. We also take into account the strong relationships that IsDB has with its shareholders—including through the Islamic solidarity agreement of the Organization of Islamic Cooperation (OIC)—and our expectation of continued preferred creditor treatment.

IsDB commenced operations in 1975 with a mandate to foster economic development and social progress in its member countries as well as in Muslim communities in nonmember countries. It currently has 57 member countries, with Guyana the most recent to join.

Over 2016, the bank’s main operational characteristics improved. IsDB’s disbursements in the 14 months ended Dec. 31, 2016, totaled Islamic dinar (ID)1.99 billion ($2.8 billion), compared with ID1.47 billion in the previous accounting period, the Hijra year 1436H (2015; Oct. 25, 2014 to Oct. 14, 2015).

Capitalization increased slightly due to continued paid-in capital contributions (ID203 million) and positive net income (ID307 million) over 2016. Going forward, the bank will report over a 12-month period starting Jan. 1.

IsDB’s role in developing Islamic finance markets has expanded through its issuance of benchmark sukuk and numerous private placements. This points to a sound funding profile, albeit with increasing structural reliance on the sukuk market.
The increased ceiling on the bank’s medium-term note program—to $25 billion from $10 billion—should help the bank maintain its strong liquidity and promote loan growth, thereby supporting the bank’s mandate. We do not expect the ongoing boycott of Qatar to hamper the bank’s operations.

We believe the international sukuk market, where IsDB is one of the largest highly rated issuers, will continue to develop in terms of liquidity and diversification, albeit slowly. We classify the bank’s sukuk investments based on our assessment of the sponsors, using our risk-adjusted capital (RAC) framework. We include these investments in our calculation of liquid assets.

In 2016, the RAC ratio increased by 150 basis points (bps) before adjustments and 340 bps after adjustments. The increases are largely explained by: i) the overall improvement in the credit quality of the sovereign portfolio; ii) an increase in the proportion of less risky sub-asset classes in the equity investment portfolio; and iii) slightly larger adjusted total equity on the balance sheet.

The bank’s 10 largest sovereign exposures constitute about 55% of the total portfolio. Turkey, the bank’s largest exposure, accounts for 10.8% of IsDB’s portfolio; Pakistan, 8.7%; Morocco 6.7%; Iran 6.0%; Indonesia 5.0%; Tunisia 4.0%; and Bahrain 3.9%.

Our ratings on some of these sovereigns improved over 2016. On Oct. 31, 2016, we raised our foreign-currency sovereign credit rating on Pakistan to ‘B’ from ‘B-’, reflecting improved macroeconomic stability. We also upgraded Indonesia to ‘BBB-’ from ‘BB-’ on reduced fiscal risks in June 2017. Consequently, not only have risk weights on sovereign exposures reduced in our unadjusted RAC calculation, but the adjustment charge for single-name exposures has also decreased.

We note that the composition of the equity investments portfolio slightly changed over 2016. Total exposure at default increased by 12% as a result of more investments in Collective Investment Undertakings. We also note that our RAC framework applies a relatively lower risk weight to this sub-asset class. Consequently, average risk weights on total equity exposure declined in our unadjusted RAC calculation.

IsDB’s capital comes from the contributions paid by member countries as well as its retained earnings. In 1434H (2013), its board of governors approved the bank’s fifth general capital increase (GCI). This elevated the bank’s authorized capital to ID100 billion from ID30 billion and its subscribed capital to ID50 billion from ID18 billion. The board also approved to pay in ID3.6 billion, a portion of the fourth GCI, over 20 years starting in 1437H (2016). This, along with previous GCI subscriptions and special capital increases, should lead to an additional ID2.4 billion being paid in over the next 10 years. Shareholders have supported the bank through the regular GCIs, albeit with a few member countries occasionally delaying their payments of capital installments.

More recently, Nigeria and Senegal have fallen behind with capital contributions, to the tune of ID106 million and ID6.5 million, respectively. Given Nigeria’s relative importance as the fourth-largest shareholder, and despite the recent macroeconomic strains faced by the country since oil prices fell, we view this as evidence of a potential, albeit moderate, deterioration in the bank’s policy importance. Pressure on our rating could emerge if these overdues are not resolved, if they are extended, or if they are repeated. At the end of 2016, capital overdue constituted 2.7% of total paid-up capital, up slightly from 2.2% one year earlier. It’s our understanding that the increase in late payments is from smaller shareholders. In addition, as per the decision made at the Islamic Summit of August 1433H (2012), IsDB’s board of governors has suspended Syria’s membership in the Organization of Islamic Cooperation and all its organs, which includes IsDB.
The bank has not distributed dividends to members. In accordance with the Articles of Agreement of the bank, annual net income is required to be transferred to the general reserve, until the total cumulative amount of the reserve equals 25% of the bank’s subscribed capital. In December 2016, this ratio was 4.9% compared with 4.8% the year before.

We note that all of IsDB’s voting shareholders are also borrowing members and, as such, can influence decision-making. To fulfill its development mandate while maintaining tight risk-control practices, the bank has continued to expand its presence by recently opening a gateway office in Bangladesh in addition to those in Turkey, Indonesia, and Nigeria, which are now fully operational.

Although IsDB operates in riskier countries than typical for a ‘AAA’ rated MLI, the bank’s operational portfolio has performed well, and the bank has never reported a write-off of a public-sector exposure. At financial year-end 2016, IsDB reported ID126 million in overdue obligations, equivalent to 1.05% of operating assets. However, this figure is not the total exposure to defaulting counterparties but rather the nonperforming portion. We understand that this figure would rise to approximately 7% if the full loan amount were included.

The bank has historically benefited from its government borrowers giving it preferred creditor treatment, and we expect that it will continue to do so. Roughly 70% of the bank’s impaired sovereign loans relate to sovereigns in special circumstances—those at war or without a functioning government.

IsDB’s total assets grew by just under 13% in 2016, compared with 7% in 1436H (2015). Net income grew by about ID150 million, owing to increased revenues from intermediation (equivalent to interest income) and higher investment return on the bank’s equity portfolio. We understand the pace of growth will be slower going forward, as realized capital gains from equity investments in 2016 were on a one-time basis and will likely not recur.

The bank’s leverage has increased over the past year, with gross debt to adjusted total assets climbing to 53% at the end of 2016, from 50% in October 2015, owing to sukuk liabilities. We expect the pace of leverage growth to slow over the coming years, in line with the bank’s prudential guidelines. Our funding and liquidity ratios for IsDB show a further improvement in coverage, indicating that the bank would be able to fulfil its mandate for at least one year under extremely stressed market conditions.

Operationally, IsDB’s liquidity needs are planned well ahead of actual disbursement, given the typically long-term life cycle of the projects it finances. Therefore, we do not expect any liquidity shortfall. IsDB can tap the liquid resources of the Special Account Resources Waqf Fund (an endowment fund held separate from IsDB’s balance sheet), further strengthening its liquidity.

**Outlook**

The stable outlook reflects our expectation that IsDB’s financial profile will remain extremely strong over the next 24 months. We also anticipate that the bank will continue to enjoy preferred creditor treatment and other strong shareholder support. However, we note that recent overdue capital payments could start to pressure the ratings if not cleared, or if instances of them being missed increase (aside from those nations under severe financial strain).

We could also lower the ratings if IsDB’s financial or risk management profile were to weaken, as indicated by continued significant increases in leverage or a pronounced weakening in the bank’s sovereign lending book. This could occur, for example, as a result of rising political and economic risks in the region, translating into arrears from any of IsDB’s larger borrowers. We could also lower the ratings if pressure on the bank’s liquidity profile were to emerge as larger redemptions start to come due.
### Issuer Credit Ratings -- Takafuls & Islamic Banks

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<tr>
<th>Issuer</th>
<th>Country</th>
<th>Type</th>
<th>Rating</th>
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<td>Bahrain</td>
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Ratings as of August 25, 2017

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<th>Sukuk/Trust certificates</th>
<th>Sector</th>
<th>Date of Rating</th>
<th>Program or Issued (S-equ Mn)</th>
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<tr>
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<td>Gov.</td>
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<td>QAT</td>
<td>SoQ Sukuk A Q.S.C.</td>
<td>Gov.</td>
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<td>SF</td>
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### Sukuk currently rated by S&P Global Ratings (continued)

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<tr>
<th>Obligor</th>
<th>Country</th>
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<td>Saudi A.</td>
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</table>
The Five Pillars Of Islamic Finance

The ban on interest
Interest must not be charged or paid on any financial transaction. Money has no intrinsic value and consequently cannot produce returns on its own. Rather, it is a vehicle to facilitate transactions.

The ban on uncertainty or speculation
Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

The ban on financing certain economic sectors
Financing of industries deemed unlawful by Sharia—such as weapons, pork, and gambling—is forbidden.

The profit- and loss-sharing principle
Parties to a financial transaction must share in the risks and rewards attached to it.

The asset-backing principle
Each financial transaction must refer to a tangible, identifiable underlying asset.

Vocabulary Of Islamic Finance

Bay salam
A sales contract where the price is paid in advance and the goods are delivered in the future, provided that the characteristics of the goods are fully defined and the date of delivery is set.

Diminishing musharaka
A form of partnership in which one of the partners undertakes to buy the equity share of the other partner gradually, until ownership is completely transferred to the buying partner.

Gharar
An exchange transaction in which one or both parties remain ignorant of an essential element of the transaction.

Halal
Lawful; permitted by Sharia.

Hamich Jiddiya
A refundable security deposit taken by an Islamic financial institution prior to establishing a contract.

Haram
Unlawful; prohibited by Sharia.

Ijara
Equivalent to lease financing in conventional finance. The purchase of the leased asset at the end of the rental period is optional.

Ijara muntahia bittamleek
A form of lease contract that offers the lessee the option to own the asset at the end of the lease period, either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.

Ijara wa iqtina
Lease purchasing, where the lessee is committed to buying the leased equipment during or at the end of the rental period.

Istisna
A contract that refers to an agreement to sell to a customer a nonexistent asset, which is to be manufactured or built according to the buyer’s specifications and is to be delivered on a specified date at a predetermined selling price.

Madaraba
A contract between a capital provider and a mudarib (skilled entrepreneur or managing partner), whereby the Islamic financial institution provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by such an enterprise or activity...
are shared in accordance with the terms of the mudaraba agreement, while losses are borne solely by the capital provider, unless the losses are due to the mudarib's misconduct, negligence, or breach of contractual terms.

**Murabaha**
The financing of a sale at a determined markup (cost plus profit margin).

**Musharaka**
A contract between an Islamic financial institution and a customer to provide capital to an enterprise, or for ownership of real estate or a moveable asset, either on a temporary or permanent basis. Profits generated by the enterprise or real estate/asset are shared in accordance with the terms of the musharaka agreement, while losses are shared in proportion to each partner’s share of capital.

**Profit equalization reserve**
The amount appropriated by an Islamic financial institution (IFI) from mudaraba income before allocating the mudarib share (fee; mudarib refers to the IFI as a manager of the profit sharing investment account [PSIA]), to maintain a certain level of return on investment for PSIA holders.

**Profit sharing investment account**
A financial instrument relatively similar to time deposits of conventional banks. According to the terms and conditions of profit sharing investment accounts (PSIAs), depositors are entitled to receive a share of a bank’s profits, but also obliged to bear potential losses pertaining to their investment in the bank. PSIAs can be restricted (whereby the depositor authorizes an Islamic financial institution (IFI) to invest its funds based on a mudaraba or wakala, with certain restrictions as to where, how, and for what purpose these funds are to be invested); or unrestricted (whereby the depositor authorizes the IFI to invest his funds based on mudaraba or wakala contracts without specifying any restrictions).

**Qard hasan**
A loan granted for welfare purposes or to bridge short-term funding requirements. Such a loan could also take the form of a nonremunerated deposit account. The borrower is required to repay only the principal.

**Retakaful**
A form of Islamic reinsurance that operates on the takaful model.

**Riba**
Usury.

**Sharia (or Shari'ah)**
Islamic law.

**Sukuk**
Trust certificates that are generally issued by a special-purpose vehicle (SPV or the issuer), the proceeds of which are, generally, on-lent to a corporate, financial institution, insurance company, sovereign, or local or regional government (the sponsor), for the purpose of raising funding according to Islamic principles. Sukuk are issued on the basis of one or more Islamic contracts (ijara, murabaha, wakala, among others), reflecting either investment or financing contracts.

**Takaful**
A form of Islamic mutual insurance based on the principle of mutual assistance.

**Urbun**
An amount taken from a purchaser or lessee when a contract is established, for the benefit of the Islamic financial institution, if the purchaser or lessee fails to execute the contract within the agreed term.

**Wadia**
An amount deposited whereby the depositor is guaranteed its funds in full on demand.

**Wakala**
An agency contract where the investment account holder (principal) appoints an Islamic financial institution (agent) to carry out an investment on its behalf, either with or without a fee.
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