

# **ISLAMIC FINANCE OUTLOOK 2015**

September 2014



**STANDARD & POOR'S  
RATINGS SERVICES**

McGRAW HILL FINANCIAL



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# ISLAMIC FINANCE 2015: WE EXPECT STRONG SHORT-TERM GROWTH, BUT GREATER INTEGRATION REMAINS A CHALLENGE

*By: Zeynep Holmes and Mohamed Damak*

Taking stock of 2014 developments, we note that Islamic finance is steadily making good on the trends we identified in our previous publications. We believe the whole industry is making steady progress in feeding the short-term appetites of a heavily demand-driven industry. Yet, to ensure sustained diversification and attract players and investors outside its traditional sphere, the industry must evolve from its state as a collection of local markets over the medium term.

Standard & Poor's Ratings Services believes that assets held by Islamic financial institutions worldwide--which we estimate at about \$1.8 trillion--are likely to sustain double-digit growth over the coming few years to reach about \$3 trillion. We think that the sound economic resilience of the industry's twin engines, Malaysia and the Gulf Cooperation Council (GCC; comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates), will help the industry sustain strong growth rates.

So far in 2014, we have witnessed maiden sovereign sukuk issues by Maldives, Senegal, South Africa, and the U.K., highlighting the key role of governments in spearheading the development of the industry. We believe that sovereign issues will not only help the industry to mature, but also pave the way for the private sector and for the development of capital markets in countries where they are still nascent.

While our research in 2014 has highlighted the industry's many achievements, it has also striven to identify upcoming hurdles the market will have to face to ensure its integration. For example, international developments such as the Basel III framework could provide an incentive for further regulatory cooperation. But in order to fulfill its global aspirations, Islamic finance will also have to expand its reach beyond specific regions. We believe the industry can achieve this goal over time, helped by the credibility it has gained over the past three decades and the increasing appetite of new players now looking at the industry as an alternative to finance their real economies.

For more than a decade, Standard & Poor's has served market participants in Islamic finance with its independent and objective credit opinions. We are honored to have received several awards in 2014, including "Best Rating Agency", the "International Takaful Award" (for the seventh consecutive year), the "Asset Triple A Award" (fourth consecutive year), and the "Islamic Finance News Award" (third consecutive year). Our in-house global team of dedicated analysts not only monitors the credit quality of the companies and instruments we rate, but is also involved in formulating coherent, transparent rating methodologies and timely opinions about trends shaping the Islamic finance industry.

Our position as a leading credit rating agency and our commitment to analytical and service excellence will further assist in the maturation of the Islamic finance industry as it strives to enter the mainstream of the world economy.



**Zeynep Holmes**

*Managing Director  
Regional Head of Eastern  
Europe, Middle East &  
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**Dr. Mohamed  
Damak**

*Global Head of Islamic  
Finance*

We hope that you enjoy the 2015 edition of our annual outlook for Islamic finance. Since its launch in 2006, it has showcased our wide-ranging Islamic finance research and thought leadership, produced by our dedicated team of analysts. More detailed analyses about the Islamic institutions and instruments mentioned in this report, as well as our ratings and analyses, are made available on the following Web sites: [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge) and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.com) (subscription).

As always, we welcome and encourage your feedback on our research and insights.

## التمويل الإسلامي 2015:

### نتوقع نمواً قوياً على المدى القصير، لكن تحقيق اندماج أكبر لا يزال يشكل تحدياً

زينب هولميرز / محمد دمق

نلاحظ من تقييم نتائج تطورات العام 2014، بأن التمويل الإسلامي يتقدم بشكل جيد نحو التوجهات التي حددناها في منشوراتنا السابقة. نعتقد بأن القطاع ككل يحقق تقدماً مطرداً في تزويد الرغبات قصيرة الأجل لقطاع يحركه الطلب بشدة. مع ذلك، يتعين على القطاع، لضمان التنوع المستدام ولجذب الشركات والمستثمرين من خارج نطاقه التقليدي، التطور من حالته كمجموعة من الأسواق المحلية على المدى المتوسط.

تعتقد وكالة "ستاندرد آند بورز" بأنه من المرجح أن تحافظ الأصول التي تحتفظ بها المؤسسات المالية الإسلامية في أنحاء العالم والتي تُقدرها بنحو 1.8 ترليون دولار أمريكي على نمو من رقمين خلال السنوات القليلة القادمة لتصل إلى نحو 3 ترليون دولار أمريكي. نعتقد بأن المرونة الاقتصادية القوية لكل من ماليزيا ودول مجلس التعاون الخليجي (المكون من البحرين، والكويت، وعمان، وقطر، والسعودية، والإمارات)، المحرك المزوج للقطاع، ستساعد القطاع في الحفاظ على معدلات نمو قوية.

شهدنا حتى الآن من العام 2014 إصدارات صكوك سيادية أولية من قبل جزر المالديف، والسنغال، وجنوب أفريقيا، والمملكة المتحدة، ما يبرز الدور الكبير للحكومات في قيادة تقدم هذا القطاع. ونعتقد بأن الإصدارات السيادية لن يقتصر دورها فقط على مساعدة القطاع على النضج، بل ستمهد الطريق للقطاع الخاص ولتطوير أسواق رأس المال في الدول التي لا تزال ناشئة فيها.

وبينما سألنا بحثنا الضوء في العام 2014 على الإنجازات العديدة للقطاع، فقد سعى أيضاً لتحديد العقبات القادمة التي سيواجهها السوق لضمان اندماجه. على سبيل المثال، يمكن أن تُشكل التطورات الدولية، كإطار اتفاقية بازل 3، حافزاً للمزيد من التعاون التنظيمي. ولكن، على قطاع التمويل الإسلامي لكي يحقق طموحاته العالمية أن يتوسع أيضاً إلى ما هو أبعد من حدود مناطق معينة. نعتقد بأن القطاع قادر إلى الوصول إلى هذا الهدف مع مرور الوقت، بفضل المصداقية التي اكتسبها خلال العقود الثلاث الماضية والرغبة المتصاعدة للشركات الجديدة التي تنظر إلى القطاع الآن كبديل لتمويل اقتصاداتها.

تُزوّد وكالة "ستاندرد آند بورز" منذ ما يزيد عن العقد، شركاء السوق في قطاع التمويل الإسلامي بأرائها الائتمانية المستقلة والموضوعية. وإنه ليشر لنا الفوز بعدة جوائز في العام 2014، من ضمنها "جائزة أفضل وكالة تصنيف"، و"جائزة التكافل الدولية" (للسنة السابعة على التوالي)، و"جائزة تريبل A لمجلة أسيت" (للسنة الرابعة على التوالي)، و"جائزة أخبار التمويل الإسلامي" (للسنة الثالثة على التوالي). لا يقتصر دور فريقنا العالمي من المحللين المتخصصين على مراقبة الجودة الائتمانية للشركات والأدوات المالية التي نقوم بتصنيفها فحسب، بل يشارك أيضاً في صياغة منهجيات تصنيف مترابطة وشفافة وتقديم الآراء في الوقت المناسب حول التوجهات التي تحدد ملامح قطاع التمويل الإسلامي.

مكانتنا كوكالة رائدة في التصنيف الائتماني وملزمة بالتميز التحليلي وفي تقديم الخدمات ستساعد أكثر في نضج قطاع التمويل الإسلامي الذي يسعى للدخول في قلب الاقتصاد العالمي.

نأمل بأن تستفيدوا من قراءة نسخة العام 2015 من التوقعات السنوية للتمويل الإسلامي. فمنذ العام 2006 وهي تستعرض بحوث التمويل الإسلامي التي يجريها فريقنا المتخصص من المحللين. للمزيد من التحليلات المفصلة حول المؤسسات الإسلامية والأوراق المالية الواردة في هذا التقرير، وكذلك حول تصنيفاتنا وتحليلاتنا، يمكنكم زيارة المواقع الإلكترونية التالية على شبكة الإنترنت:

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نرحب دائماً بملاحظاتكم ومقترحاتكم حول أبحاثنا ورؤيتنا.

## ACKNOWLEDGEMENT



Dubai  
International  
Financial  
Centre



“This book is supported by the Dubai International Financial Centre in conjunction with the Standard & Poor’s Islamic Finance Conference, Dubai, October 14th 2014”

Dubai has the elements needed to become the world’s capital for Islamic economy, supported by DIFC as a hub for Islamic Finance. The Centre offers the necessary regulation and legislation for Islamic Finance institutions to develop and sell Shari’ah compliant products that are relevant to the region and across the globe.

Islamic finance also is witnessing a multitude of innovations in terms of product offerings. This has seen Islamic finance expand from simple commercial banking activities to encompass more sophisticated structured finance, sukuk and risk management solutions. This is fuelling further growth and the need for Islamic financial institutions and other specialized service providers.

In April 2014, Emirates REIT (CEIC) Limited (“Emirates REIT” or the “REIT”), the first Shari’a compliant regulated real estate investment trust incorporated in the DIFC, its shares have been admitted to the Official List of Securities of the Dubai Financial Services Authority (“DFSA”). A successful international initial public offering through Nasdaq Dubai was 3.5 times over-subscribed.

## AWARDS

# STANDARD & POOR'S AWARDS

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### **The International Takaful Awards 2014**

Best Rating Agency

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### **The Asset Triple A Awards 2014 Islamic Finance**

Best Rating Agency for Islamic Finance

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### **Islamic Finance News 2014**

Best Islamic Rating Agency

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### **The International Takaful Awards 2013**

Best Rating Agency

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### **The Asset Triple A Awards 2013 Islamic Finance**

Best Rating Agency for Islamic Finance

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### **Islamic Finance News 2013**

Best Islamic Rating Agency

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### **The Asset Triple A Awards 2012 Islamic Finance**

Best Rating Agency for Islamic Finance

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### **The International Takaful Awards 2012**

Best Rating Agency

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### **Islamic Finance News 2012**

Best Islamic Rating Agency

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### **The International Takaful Awards 2011**

Best Rating Agency

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### **Intelligent Insurer Awards 2011**

Global Best Rating Agency

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### **Reactions London Market Awards 2011**

Best Rating Agency

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### **The Asset Triple A Awards 2011 Islamic Finance**

Best Rating Agency for Islamic Finance

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### **The International Takaful Awards 2010**

Best Rating Agency

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### **The International Takaful Awards 2009**

Best Rating Agency

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### **The International Takaful Awards 2008**

Best Rating Agency

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### **Islamic Finance News Award 2007**

Best Islamic Rating Agency

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# AFTER A MIXED 2013, THE GLOBAL SUKUK MARKET LOOKS PROMISING IN 2014

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Despite some headwinds, Standard & Poor's Ratings Services believes the long-term prospects for the sukuk industry remain promising as regulators continue to build and strengthen their frameworks to minimize barriers in the market and deepen liquidity. Malaysia already benefits from a broad sukuk investor base and liquid debt market. So the increased interest from issuers, notably in the Middle East and Asia, in tapping the Malaysian ringgit and U.S. dollar market should in our view continue over the next few years as Malaysia cements its leading position in the industry. (Watch the related CreditMatters TV segment titled "After A Mixed 2013, The Global Sukuk Market Looks Brighter In 2014," dated Feb. 4, 2014.)

After a slowdown in 2013, with sukuk volumes declining by 13%, we anticipate that the sukuk industry will expand again in 2014, partly driven by corporate and infrastructure issuers in the Gulf. What's more, total issuance will exceed \$100 billion for the third year in a row if yields remain attractive for issuers. And, after weakening in 2013, we believe issuance could pick up again in Malaysia in 2014 as its investment program resumes.

## OVERVIEW

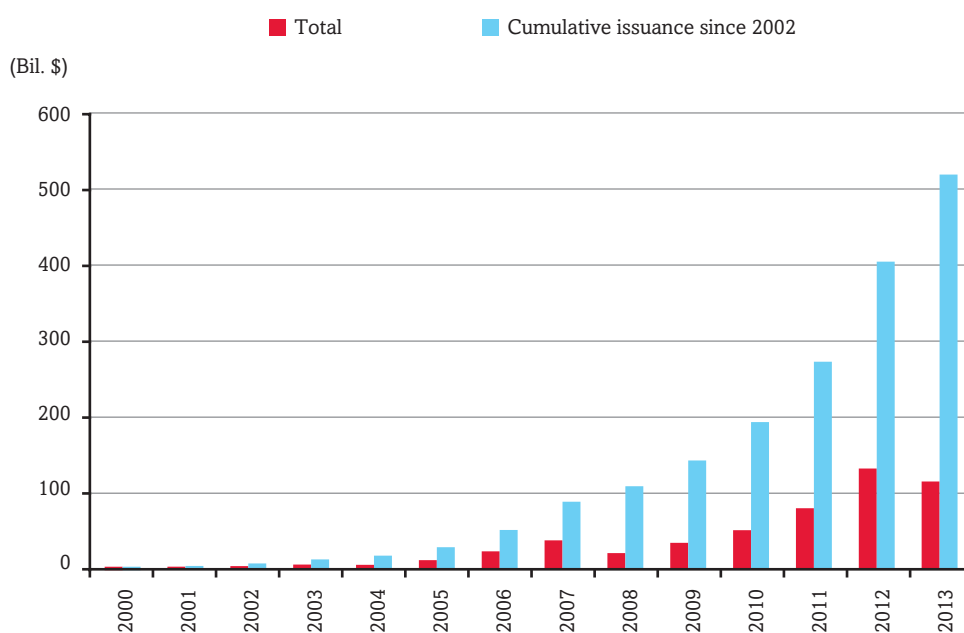
- Growth in sukuk issuance should resume in 2014, and exceed \$100 billion.
- We anticipate double-digit growth in issuance by Gulf corporate and infrastructure entities, due in part to large infrastructure financing needs.
- Increasing private issuance could signal a change in the sukuk market characteristics.
- Sovereign sukuk could be slowly emerging as an alternative to fund growth in African countries.
- We believe a regulatory push is necessary to strengthen frameworks, lower barriers to entry, and deepen liquidity in the sukuk markets.



## Changing Market Characteristics

Global sukuk issuance declined by 13% in 2013 (see chart 1). This slowdown coincided with the U.S Federal Reserve's (Fed's) announcement that it would taper its quantitative easing program. As the dominant sukuk issuer, Malaysia experienced a 25% decline in 2013, in the context of slower investment growth. Over the past decade, a large public investment program has spurred issuance in Malaysia. Now that the country is adopting private sector investment, we believe non-sovereign issuance could accelerate in 2014-2015, continuing the trend witnessed in 2013 at a global level.

**CHART 1**  
**WORLDWIDE SUKUK ISSUANCE 2000-2013**



Note: Data shows sukuk issued in a given year, including sukuk that have already matured by year-end.  
Sources: Standard & Poor's, Zawya Sukuk Monitor Database [as of Jan. 27, 2014].

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We contend that there are two main regions for sukuk issuance. The first is Asia, particularly Malaysia. The second is Gulf Cooperation Council (GCC) countries (comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates or UAE). Of the latter, we see the UAE and Saudi Arabia continuing to lead sukuk issuance owing to our projections that the relatively strong investment and GDP growth in these countries should be maintained in 2014.

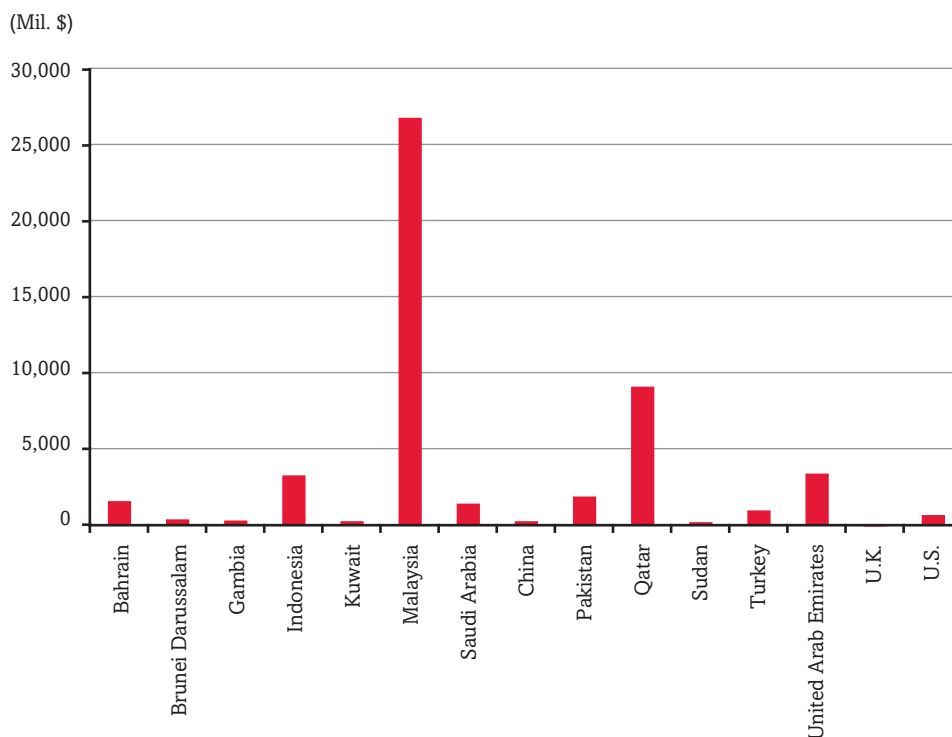
At the same time, we believe that global growth in sukuk issuance could be further supported through:

- Stabilizing or improving investment projections in key markets such as Malaysia.
- Meeting the high demand for infrastructure spending across the GCC, where we expect issuance to continue climbing at a double-digit pace in the next two years.
- Supportive regulations in the UAE, and the use of sukuk for repurchase transactions with the Central Bank of West African States (BCEAO).
- Sovereign issuance, which could assist the development of sukuk markets in African countries looking to fund growth and diversify fiscal funding.

## SUKUK OUTLOOK

In addition, refinancing activities could boost the sukuk market as a result of the stock of both Islamic and conventional financings maturing in 2014. We estimate that about \$50 billion of sukuk will mature in 2014 (see chart 2).

**CHART 2**  
**GEOGRAPHIC BREAKDOWN OF SUKUK MATURING IN 2014**



© Standard & Poor's 2014.

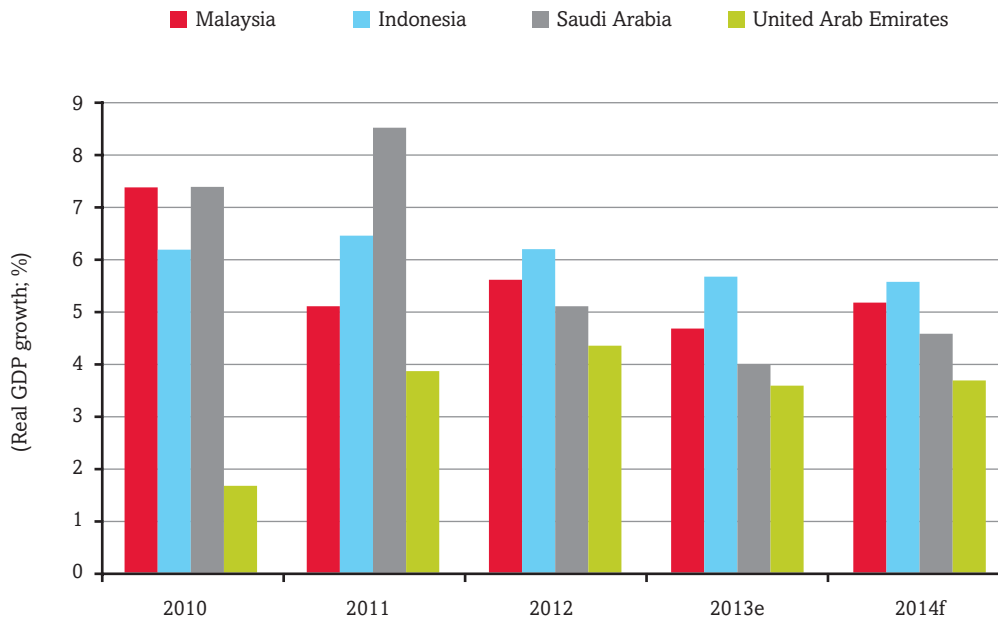
### **Economic Conditions Remain Favorable, Although Some Risks Remain**

Our economists are projecting relatively strong economic growth in key sukuk issuing countries including Malaysia, Saudi Arabia, and the UAE in 2014. That said, we expect Malaysia's public investment program to continue to drive sukuk issuance throughout the year.

Malaysia continued to dominate sukuk issuance in 2013, although its issuance was weaker than in previous years. On a positive note, our concerns regarding the potential fallout from an economic hard landing in China have faded. As a result, we maintain our base-case GDP growth forecasts for Asia-Pacific and notably Malaysia (at 5.2% in 2014; see chart 3).

We also forecast that oil prices will remain close to \$100 per barrel (see "Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions," Nov. 20, 2013, on RatingsDirect). Furthermore, we see good economic prospects in major Gulf countries, which should translate into lending and balance-sheet growth opportunities for the banks. This, in turn, should trigger some issuance in the debt capital markets. Issuance from Saudi Arabia, as well as key hydrocarbon exporters with large infrastructure needs such as the UAE and Qatar, should benefit from a robust economy in 2014.

**CHART 3  
REAL GDP GROWTH IN MALAYSIA, INDONESIA, SAUDI ARABIA, AND THE  
UNITED ARAB EMIRATES 2010–2014F**



e-Estimated. f--Forecast. Source: Standard & Poor's.

© Standard & Poor's 2014.

Despite a sustained period of political and social unrest in some Middle Eastern and North African countries since 2011, we anticipate resilient economic growth in 2014 (see “Diverging Fortunes Prevail As Stability Eludes Some MENA Sovereigns,” published Dec. 17, 2013). We also forecast that oil production will increase in Bahrain and Kuwait. In this context, Bahrain might resume a stronger level of sukuk issuance. Indeed, local currency sukuk issuance across GCC states may continue to be used as a means of developing the local capital markets. On the downside, although not part of our base-case credit scenario, a significant drop in oil prices or an increase in geopolitical tensions could affect economic stability and adversely affect issuance in the region.

### **Economic Growth And Regulation Support UAE And Qatari Banks’ Issuance**

Traditionally, financial institutions in the UAE and Saudi Arabia have led sukuk issuance in the Gulf, with sporadic issues from Qatar. In 2013, two conventional Saudi banks issued sukuk totaling \$1.5 billion, representing 42.3% of total regional issuance, whereas issuance by Islamic banks in the UAE represented 57.7% of regional issuance.

We expect to see a healthy issuance volume in the GCC in 2014 as a result of the supportive economy and regulatory developments. However, we believe the Fed’s move to taper its quantitative easing program could influence issuance through a shift toward local currencies from dollar-denominated issuances. Banks in Saudi Arabia will likely continue to display double-digit credit growth in 2014, which could add further support for sukuk issuance.

There were visible signs of recovery in credit growth in 2013, which we believe will accelerate in 2014 owing to the strong business environment and a number of new projects announced. In addition, the UAE

## SUKUK OUTLOOK

central bank announced the final form of its tightening of large lending exposures rules in November 2013 (see “,” published Jan. 13, 2014). We expect this regulation to push GREs toward the debt and sukuk markets in the medium term.

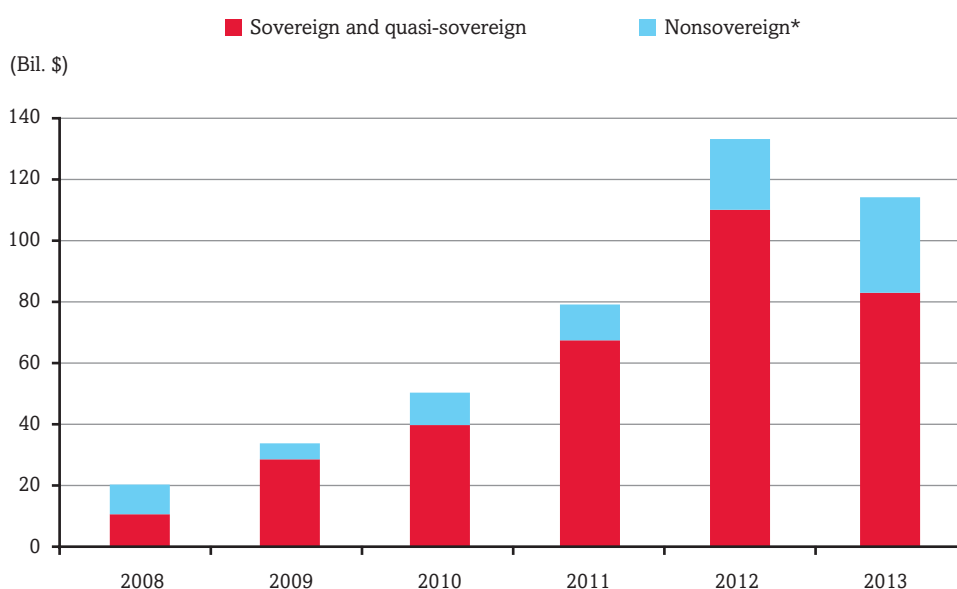
We also witnessed some innovation in the market as banks issued sukuk to strengthen their capital ratios. Dubai Islamic Bank, for example, issued a \$1 billion Tier I perpetual note in March, while The Saudi British Bank issued a Tier II subordinated note of Saudi Arabian riyal 4 billion (\$1.1 billion) in November 2013.

In Qatar, despite a slowdown in credit growth largely due to administrative delays in certain projects in 2013, we expect credit growth to accelerate in 2014. The Qatari Islamic banks continue to maintain strong credit growth and we anticipate that they will become more active issuers of sukuk over the next few years (see “Qatar’s Islamic Banks Are On A Fast Track To Growth,” published Sept. 16, 2013).

### Sovereign Issuers Dominate, But Will It Last?

We believe sovereign and sovereign-related issuance, including corporate and infrastructure GREs, will continue to dominate the sukuk market in 2014, as it has in past years (see chart 4). Sovereign and quasi-sovereign sukuk, which accounted for 75% of the total in 2013, are primarily issued in Malaysia. External issuance out of Malaysia slowed in the second half of 2013, reflecting the country’s investment cutbacks. That said, we expect Malaysia’s public investment program, as illustrated by the \$2 billion dual tranche in 2011, will continue to influence sukuk issuance in 2014-2015. Looking ahead, favorable economic environment in Asia and GCC member states, embracing China’s economic soft landing and the still-strong investment pipeline in Malaysia, provide good prospects in terms of sukuk volumes.

**CHART 4**  
**BREAKDOWN OF TOTAL SUKUK ISSUANCE BY SOVEREIGN-RELATED AND**  
**NONSOVEREIGN ISSUERS 2008-2013**  
**AS OF JAN. 27, 2014**



\*Defined as Corporate issuance by Zawya Sukuk Monitor.

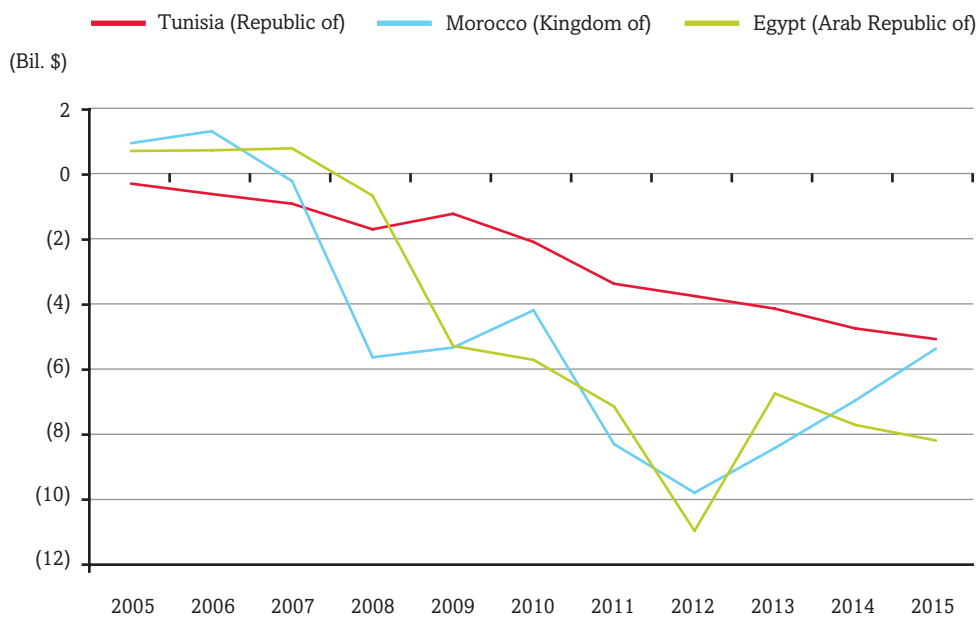
Note: Data show sukuk issued in a given year, including sukuk that have already matured by year-end.

Sources: Standard & Poor's and Zawya Sukuk Monitor Database.

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From a sovereign perspective, sukuk can give governments access to a new investor base by diversifying their sources of fiscal funding. Sukuk issued to foreign investors can also help to cover external financing needs and support reserve building. This is important for countries with sizable external funding needs, such as those in North Africa, but less so for GCC countries (see charts 5 and 6). We believe that for investors looking to buy Islamic bonds outside of traditional markets like Asia and the GCC region, Africa may soon offer a fresh alternative. In recent years, Senegal and South Africa have indicated that they are looking to issue sukuk, while North African countries such as Tunisia, Egypt, and Morocco have finalized or are finalizing their legal frameworks to promote sukuk issuance.

**CHART 5  
CURRENT ACCOUNT BALANCES--NORTH AFRICA**



Source: Standard & Poor's.  
© Standard & Poor's 2014.

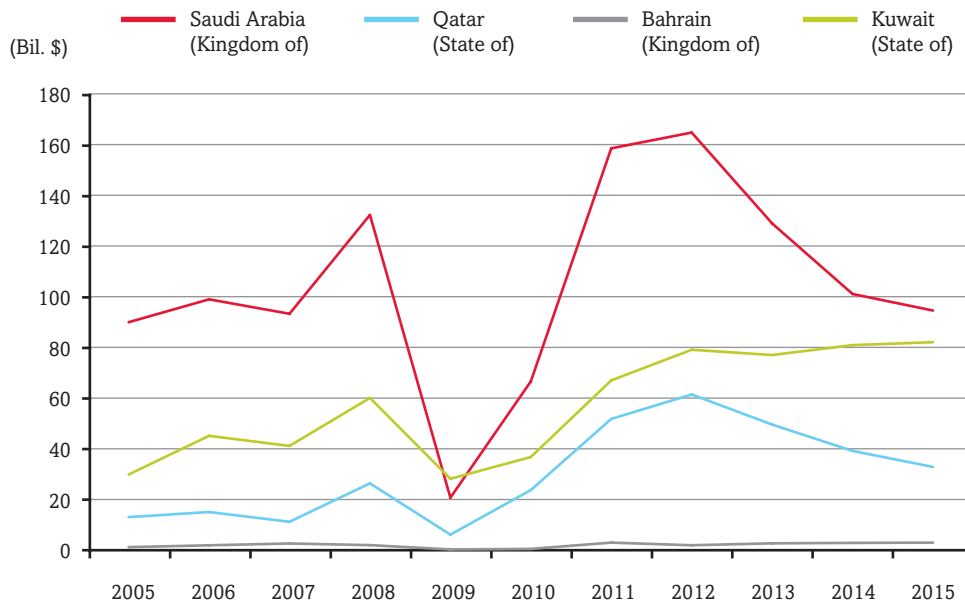
Elsewhere in Africa, the small (\$62 million) Nigerian sharia-compliant bond issued by Osun state in the southwest of the country in October 2013 may signal the start of a fresh source of sukuk. And Senegal's plan to issue a \$200 million sukuk in the first quarter of 2014 to fund infrastructure projects is drawing on support from the Islamic Development Bank.

We believe that the use of Islamic finance could help Africa pay for multibillion dollars' worth of infrastructure projects a year and help fund countries' fiscal deficits. African nations are also looking to diversify their funding sources and gain access to a pool of wealthy investors from the Middle East--investors who can only invest in sharia-compliant products. In 2012, for instance, Sudan sold \$160 million worth of sukuk while Gambia has been issuing short-term sukuk over the past few years.

### **Corporate Issuance Could Accelerate In 2014-2015**

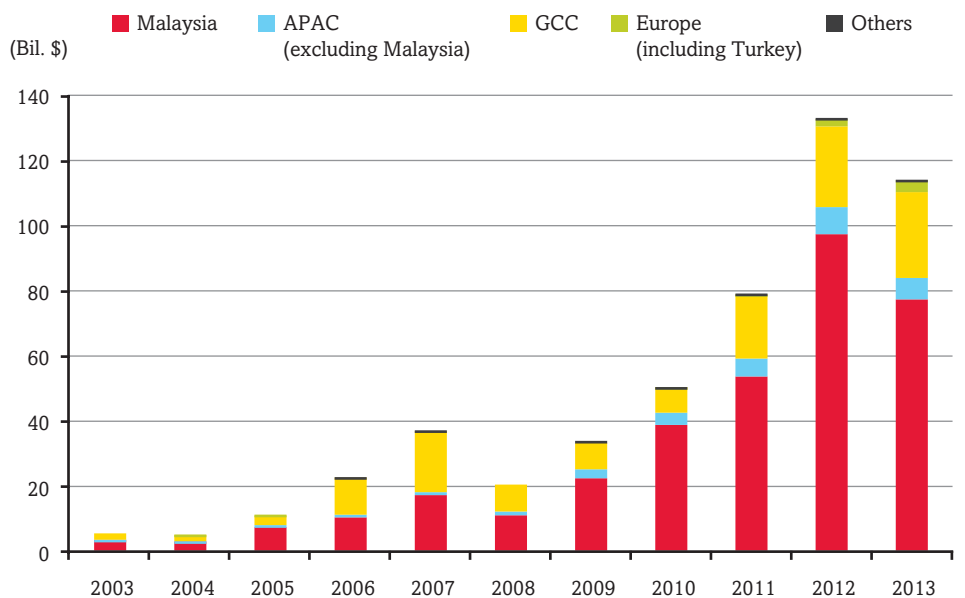
For the first time since 2007, corporate issuance rose in 2013 as sovereign issuance declined. As a sign of possibly changing market characteristics, non-sovereign issuance increased by 20%, while sovereign

**CHART 6  
CURRENT ACCOUNT BALANCES--SELECTED  
GULF COOPERATION COUNCIL COUNTRIES**



Source: Standard & Poor's. © Standard & Poor's 2014.

**CHART 7  
TOTAL SUKUK ISSUANCE BY MAJOR REGION 2003-2013  
AS OF JAN. 27, 2014**



APAC (excluding Malaysia) = Australia, Hong Kong, Indonesia, Pakistan, Brunei, Singapore, Japan, Iran, China, Maldives, Philippines, South Korea, Sri Lanka, Afghanistan, and Thailand. GCC = Bahrain, Qatar, Saudi Arabia, United Arab Emirates, Kuwait, and Oman. Europe (including Turkey) = Germany, U.K., Turkey, France, Ireland, Russia, Sweden, and Luxembourg. Others = U.S., Sudan, Gambia, Jordan, Yemen, Kazakhstan, and Nigeria. Sources: Standard & Poor's and Zawya Sukuk Monitor Database.

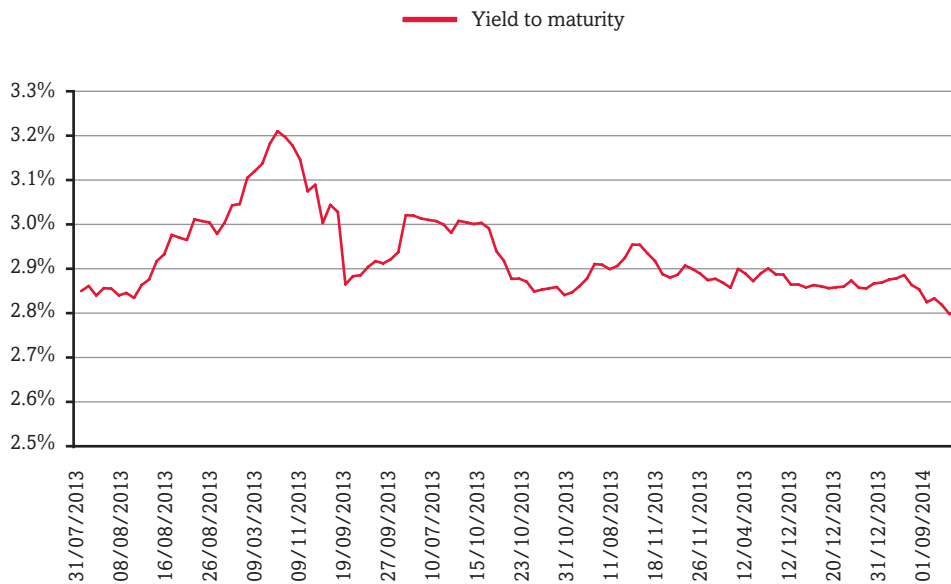
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issuance declined sharply by 26%. Global sukuk market activity across all asset classes largely reflected the trend in Malaysia, which is driven by sovereign and quasi-sovereign debt issuance. As Malaysia follows its policy of supporting private sector investment, we believe non-sovereign issuance could accelerate in 2014-2015, continuing the trend witnessed at the global level. However, a handful of jumbo-size issuances, like we've seen in the past two years from government and government-related issuers, could easily negate this trend.

We believe that the demand for sukuk from GCC corporate and infrastructure issuers is likely to continue to grow in the year ahead after posting a solid increase of 17% in 2013 (2012: 24%) to reach \$28.2 billion (see chart 7). Prospects for 2014 largely depend on the direction of interest rates, and to a lesser extent on the relative attractiveness and pricing of other forms of conventional financing compared with sukuk.

Sukuk issuance at historically low rates and long tenors by companies such as Saudi Electricity Co., and Dubai Electricity and Water Authority signal to us an increasing depth and maturity of the regional Islamic finance market (see chart 8). These large issuances favor denomination in U.S. dollars to attract international investors, and the Saudi Electricity issue broke a record in tenor with its 30-year maturity, illustrating that the market is broadening and innovating.

**CHART 8**  
**S&P MENA SUKUK INDEX**



The S&P MENA Sukuk Index is designed to provide exposure to global Islamic fixed-income securities, also known as sukuk. The index includes U.S. dollar-denominated investment-grade sukuk issued in the Middle East and African market, which have been screened for Shariah compliance. Source: S&P Dow Jones Indices.

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## SUKUK OUTLOOK

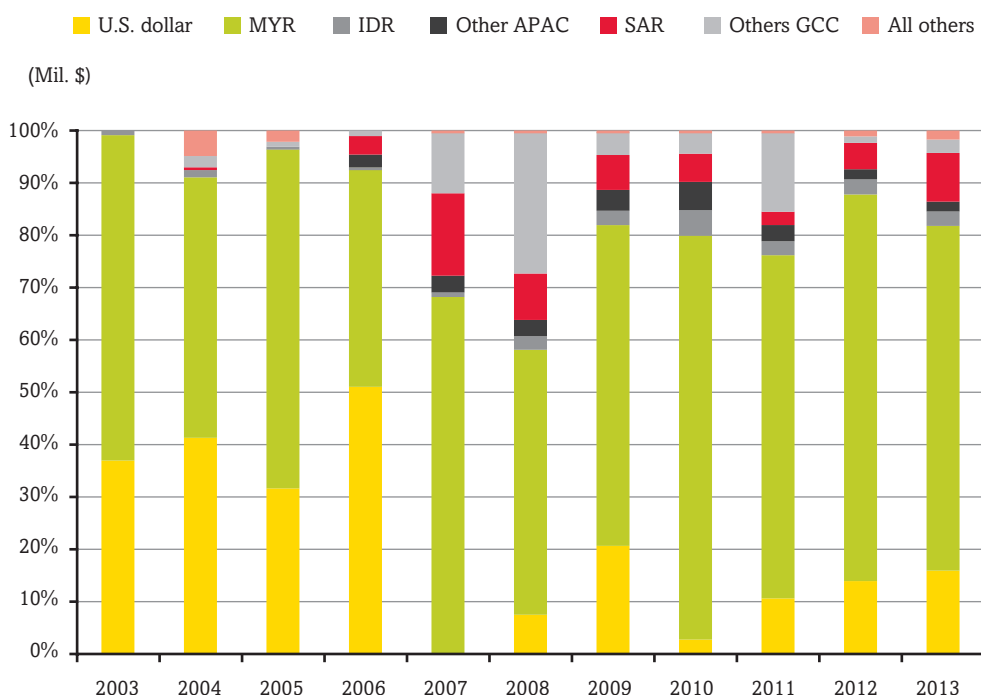
### Domestic Regulations And A Push From Multilateral Institutions Place Sukuk Center Stage

#### Regulatory developments may support sukuk activities

Regulation is a hot topic that we expect to remain center stage over the next few years. The huge demand for finance and the growing popularity of sukuk as a mainstream asset class among fixed-income investors in Asia and the Gulf is pushing countries to establish or enhance their regulatory frameworks.

Malaysia is working to cement its position at the head of the sukuk market by attracting global issuers and investors. Over many years, it has built up a strong Islamic debt capital market--alongside its conventional capital market--with well-defined regulation, standard sukuk structures, and a large pool of liquidity. Its successful \$2 billion dual-tranche issue in 2011 further contributed to increase supply in the market, deepening liquidity and broadening the acceptance of sukuk structures, including to GCC-based investors. We believe that more non-Malaysian issuers will issue in the Malaysian market in local currency and U.S. dollars in 2014 (see chart 9).

**CHART 9**  
**BREAKDOWN OF GLOBAL SUKUK ISSUANCE BY CURRENCY 2003-2013**  
**AS OF JAN. 27, 2014**



MYR--Malaysian ringgit. IDR--Indonesian rupiah. SAR--South African rand. GCC--Gulf Cooperation Countries.  
Note: Estimated amounts based on external databases. Sources: Standard & Poor's and Zawya Sukuk Monitor Database.

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Elsewhere, we view positively moves to emulate the Malaysian model. Authorities in Dubai and Turkey, for instance, are sponsoring the definition of a clear sukuk framework, to enable the gradual emergence of new Islamic finance "hubs." Similarly, we note that in July 2013 Hong Kong passed an ordinance to create a level playing field for sukuk. This should, in turn, improve the supply-demand characteristics of the global sukuk market.



The gradual implementation of the Basel III framework for GCC banks--already in place in Saudi Arabia since Jan. 1, 2013--could help sustain sukuk activity over the next 2-3 years. Higher capital charges for bank financing toward long-term projects is likely to push GCC banks to tap the international debt capital markets more frequently, including in the form of sukuk. Such developments may in themselves be reinforced by the lower involvement of European financial institutions in long-term lending to the region, as part of their strategy to shore up their regulatory capital ratios.

### **The increased involvement of multilateral institutions may further stimulate sukuk activity**

We note that multilateral institutions, either Islamic or states with large Muslim populations, are forming a second layer of support and development of the sukuk market above that of domestic initiatives.

The Islamic Development Bank (IDB), the Asian Development Bank (ADB), and various forums and organizations that gather central banks, are natural and prominent players. These entities partner with domestic regulators to find practical solutions to facilitate intermediation and economic and financial integration. Such initiatives can benefit the Islamic debt capital markets in countries currently not core to the sukuk market. Several recent examples include:

- The Central Bank of West African States (BCEAO) in sub-Saharan Africa, which has agreed that banks can use sukuk issued by Senegal in their repurchase transactions. We understand that the Senegalese sukuk is the first one of a series that will be issued by West African states, and sponsored by the IDB.
- An announcement by the IDB that it would add a \$10 billion sukuk program on the Nasdaq Dubai Exchange to its two existing programs in London and Malaysia. The IDB's initiative opens up the possibility of higher and more recurrent sukuk activity out of Dubai, and potentially a ripple effect through the GCC region owing to the IDB's high profile. We consider that the size and number of issuances are critical components of deepening liquidity in the marketplace.
- ADB's announcement that it could consider issuing sukuk or establishing a multi-billion dollar sukuk program to help its member countries finance their infrastructure project pipelines.
- The strong global support garnered for the International Islamic Liquidity Management's (IILM's) first \$490 million issuance from its \$2 billion sukuk program. This program could further support cross-border capital flows and issuance, in our view. The IILM was founded in 2010 by central banks, monetary authorities, and multilateral organizations to provide Islamic banks with a viable alternative for managing liquidity. We believe globally accepted standards are necessary to minimize barriers for issuers. This will in turn facilitate issuing exercise and allow the industry to achieve critical volumes and deepen liquidity that is so critical for Islamic financial institutions.

### **The Market Is Evolving, But There's Still Some Way To Go**

The sukuk market continues to evolve and innovate. Last year saw the introduction of Tier 1 hybrid sukuk in bank capital structures, longer-term tenors (Saudi Electricity Co.'s 30-year Islamic finance tranche, for example), and corporate and infrastructure sukuk 144A programs enter the market. By contrast, the Islamic capital markets have not yet seen significant diversity beyond the traditional Ijara, Mudaraba, and Murabaha structures, or structured and project finance sukuk. What's more, long-term institutional investors (such as pension and institutional funds) dedicated to investment in sukuk finance are notably missing in key markets such as the GCC, along with an absence of any significant secondary market trading in sukuk in key markets. Without standardization and a long-term investment architecture to support the industry, we are of the opinion that it is unlikely that the sukuk market will reach a new dimension.

# DESPITE PLAYERS' GLOBAL ASPIRATIONS, LACK OF INTEGRATION KEEPS SUKUK ISSUANCE A LOCAL AFFAIR

Published: April 15, 2014

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The sukuk market operates as a collection of local markets, of which the strongest by far is Malaysia's. Over 40% of worldwide issuance in 2013 was short-term sukuk issued in ringgit by just one issuer--the Central Bank of Malaysia. Moreover, issuance in domestic currencies continued to significantly outpace issuance in "hard" currencies such as U.S. dollars.

Over the past 10 years, local sukuk issuance in Malaysia and the countries in the Gulf Cooperation Council (GCC) region has helped fuel impressive growth in domestic sukuk. But of the \$117 billion in sukuk issued in 2013, only 16% was truly "international"--that is, listed on major exchanges and generally issued in hard currencies. Most international sukuk are listed on one or more of the following exchanges: Irish Stock Exchange, Nasdaq Dubai, Singapore Stock Exchange, Bursa Malaysia, London Stock Exchange. If a sukuk is listed on a local/regional stock exchange, Standard & Poor's Ratings Services classifies it as international if it is issued in foreign currency.

Most international issuances to date have originated from Malaysia or the GCC. Since 2001, we have seen only about 20 international sukuk from issuers domiciled outside these countries, for a total amount of around \$10 billion.

However, interest from issuers outside these traditional markets has increased, chiefly because Sharia-compliance attracts deep-pocketed Middle Eastern and Asian investors. We understand that about half of sukuk investors invest in such instruments for religious reasons. We also estimate that about 60% of investors in sukuk issued by entities domiciled outside the GCC and Malaysia were from the Middle East and Asia.

## OVERVIEW

- The sukuk market remains a collection of regional/local markets.
- International issuances represented only 16% of total issuances in 2013, of which few originated outside the biggest sukuk markets of Malaysia and the GCC member states.
- When entities domiciled outside these countries have issued sukuk, around 60% of the investors have been from the Middle East and Asia.
- Sukuk are usually issued at a premium compared with conventional bonds, but higher standardization and liquidity may cause yields to align.

Standard & Poor's rates sukuk valued at more than \$50 billion in total. As a provider of credit opinions, we do not assess the Sharia-compliance of an issue or an issuer. We focus on the creditworthiness of the issue, which we determine according to our methodology (see "Standard & Poor's Approach To Rating Sukuk," published on Sept. 17, 2007).

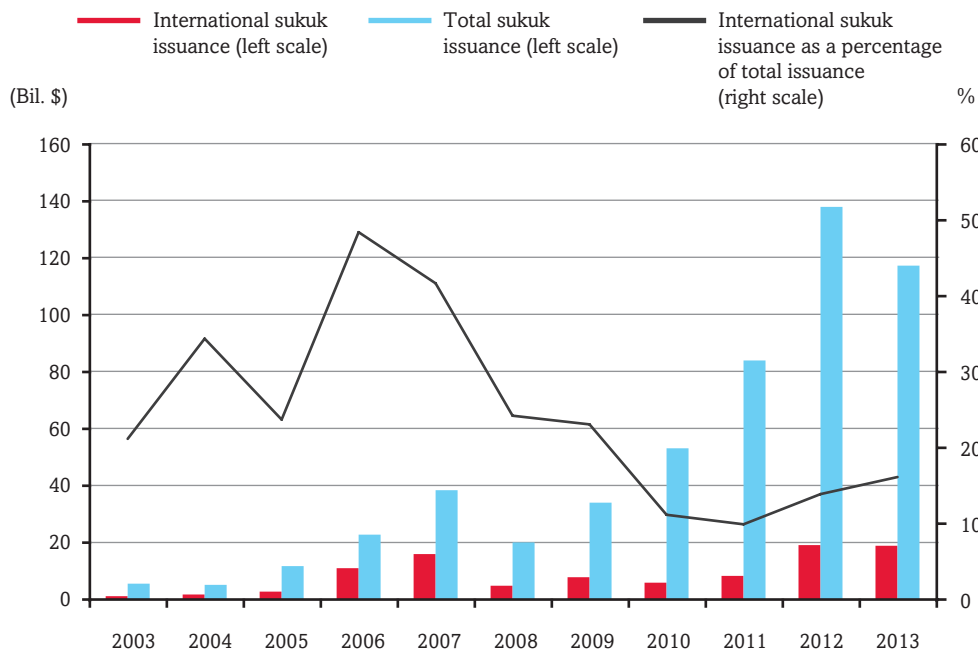
The structured nature and lower liquidity of sukuk means that these instruments are generally priced at a premium compared with conventional bonds, so attracting sukuk investors comes at a cost. In future, we expect this premium to reduce as sukuk documentation becomes more standardized and liquidity stronger.

### Most Sukuk Issuance Occurs Locally

Domestic sukuk markets have grown strongly over the past decade, particularly in Malaysia, where issuance totaled \$82.1 billion in 2013, and to a lesser extent in the GCC (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates), where issuance reached \$26.5 billion. Malaysian issuance is dominated by one issuer, the Central Bank of Malaysia, which issued more than \$50 billion of short-term sukuk in 2013, to provide domestic Islamic banks with liquidity management instruments. We have also seen a few issuers from GCC countries, China, and Singapore taking advantage of the breadth of the Malaysian sukuk market in 2013 to issue small amounts. We expect this trend to continue in the future.

In 2013, of the \$117 billion issued, only 16% was international, down from more than 48% of the total in 2006 (see chart 1).

**CHART 1  
INTERNATIONAL AND TOTAL SUKUK ISSUANCE 2003-2013**



Source: Zawya and Standard & Poor's.

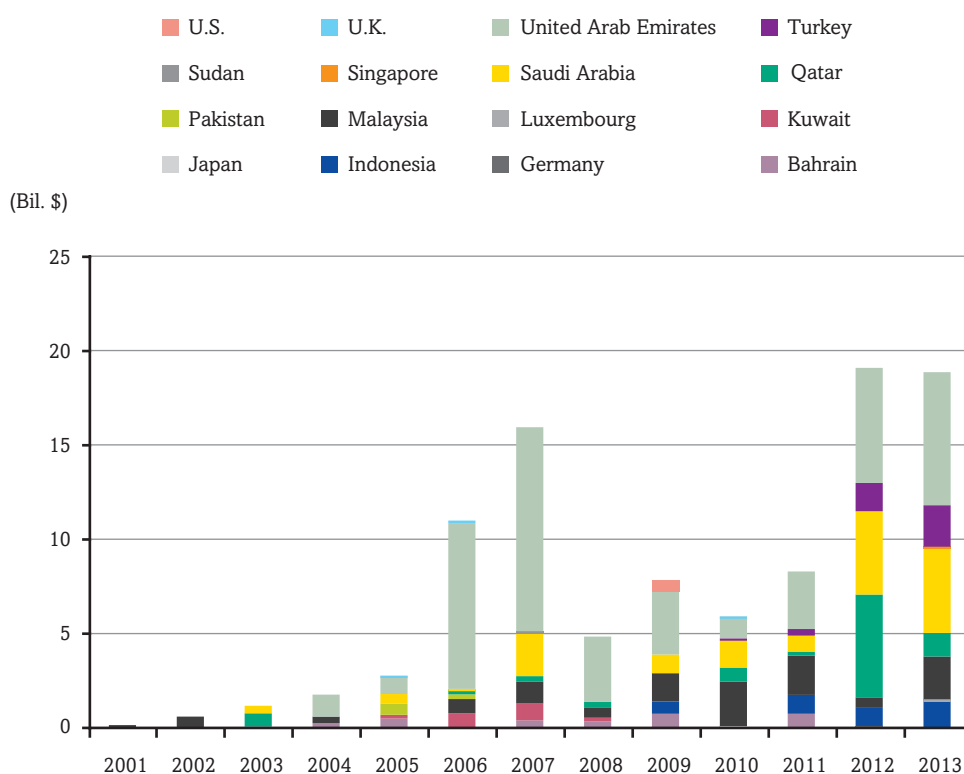
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## SUKUK OUTLOOK

International issuance has not only fallen as a percentage of the total, it has also fallen slightly in absolute terms. Just \$18.9 billion was issued in 2013, compared with \$19.1 billion in 2012; some sukuk issuances were not repeated. However, we anticipate that international sukuk issuance may return to growth as part of the financing for investment projects in core markets. While international issuance by entities domiciled outside traditional markets now represents only a small share of sukuk issued worldwide, we have seen stronger interest from nontraditional issuers in regions such as North Africa, sub-Saharan Africa, Europe, and countries such as Russia. That said, while issuance in these countries may support market development, we expect progress to be slow.

Most international sukuk originate in the GCC. Around 75% of those issued in the past decade were originated by issuers from Middle Eastern countries (see chart 2), mainly issuers from the United Arab Emirates, followed by Saudi Arabian and Qatari issuers. Over the past few years, new players have entered the international issuance market--especially from Indonesia and Turkey--eager to attract a new investor class. Over the past three years, Indonesia has issued three sovereign sukuk of \$1.0 billion-\$1.5 billion each. Meanwhile, Turkish issuers--including the government--have tapped the international issuance market for a total of about \$4 billion.

**CHART 2**  
**GEOGRAPHIC DISTRIBUTION OF INTERNATIONAL SUKUK ISSUANCES**



Source: Zawya and Standard & Poor's.

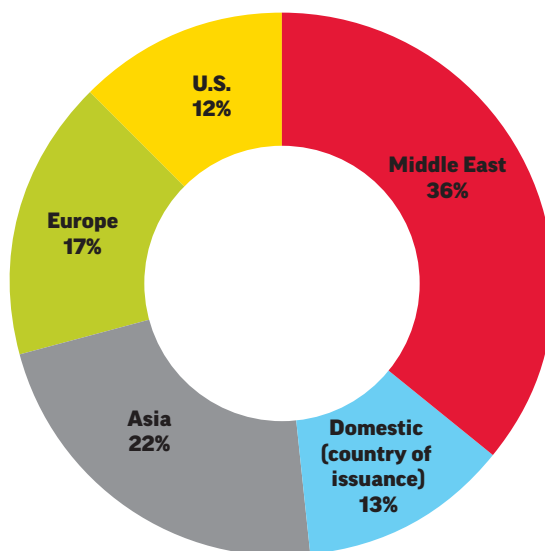
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We expect this trend to continue as issuers in certain other countries have announced their willingness to tap this market to diversify their investor base and attract funding in a foreign currency. However, this does not imply a shift in the composition of the international sukuk market.

### **Investors In International Sukuk Chiefly Come From The Middle East And Asia**

Narrowing our focus to sukuk issued by entities domiciled outside the GCC and Malaysia, data we have compiled from various sources indicates that, from 2001 to 2013, a high proportion of investors for such international sukuk came from the Middle East and Asia. These investors represent an average of about 60% of sukuk investors; 36.0% were from the Middle East and 22.4% from Asia. The remaining investors were mainly from Europe (16.8%) or the U.S. (12.3%; see chart 3). That said, because the data are based on a limited number of sukuk, we consider these figures to be indicative.

**CHART 3  
INVESTOR LOCATIONS WEIGHTED BY INVESTMENT SIZE**



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### **Sharia compliance attracts over half of sukuk investors**

We understand that a significant share of investors come to the market primarily for religious reasons. According to the annual Sukuk Perceptions and Forecast Study published by Thomson Reuters and Zawya, just over half of sukuk investors said that they chose sukuk instruments due to a religious mandate. These investors typically include Islamic banks, takaful companies, Islamic funds, and high-net-worth individual investors. The other half is either interested in the yield offered by sukuk or the diversification it brings to their portfolios.

### **Premium For International Sukuk Issuance Hasn't Deterred Issuers To Date**

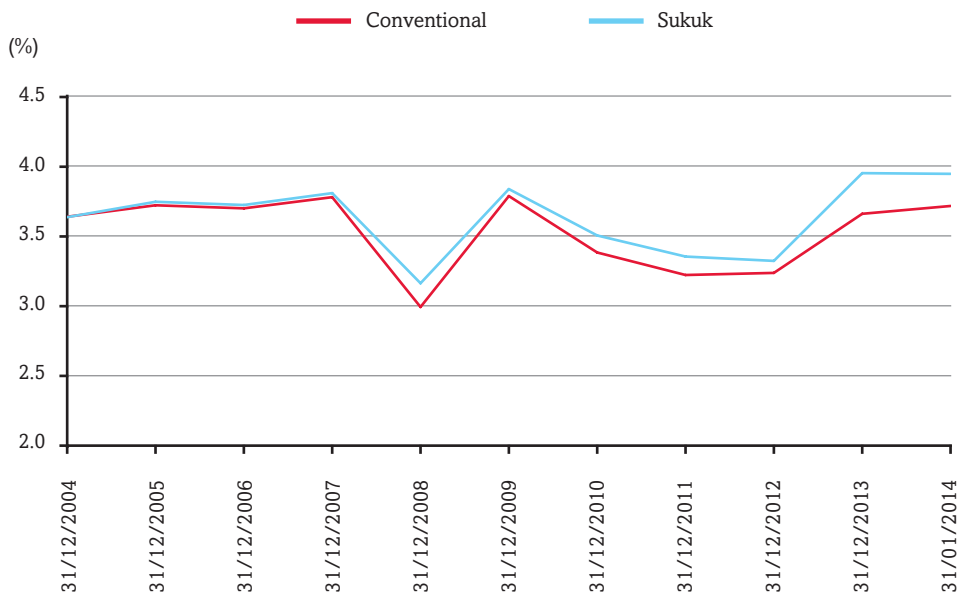
Owing to their structured nature and lower liquidity, sukuk are generally more expensive to issue than conventional bonds because they are priced at a premium (see chart 4). However, this premium does not seem to us to have acted as a serious brake on market development. In addition, the costs attached to

## SUKUK OUTLOOK

structuring sukuk seem to us to be of secondary importance to large issuers. That said, aligning the profit rate for sukuk instruments with the interest rate of conventional bonds that have similar characteristics may encourage the most cost-sensitive issuers to diversify into sukuk.

We understand that a few issuers, particularly in the corporate or project finance space in the Gulf, have recently raised sukuk at a cost below that required to issue comparable conventional bonds. In our view, the reduced cost was underpinned by very strong demand for sukuk in a region where the amount issued remains small.

**CHART 4**  
**MALAYSIAN GOVERNMENT FIVE-YEAR SUKUK**  
**AND CONVENTIONAL BOND YIELDS**



Source: Central Bank of Malaysia.

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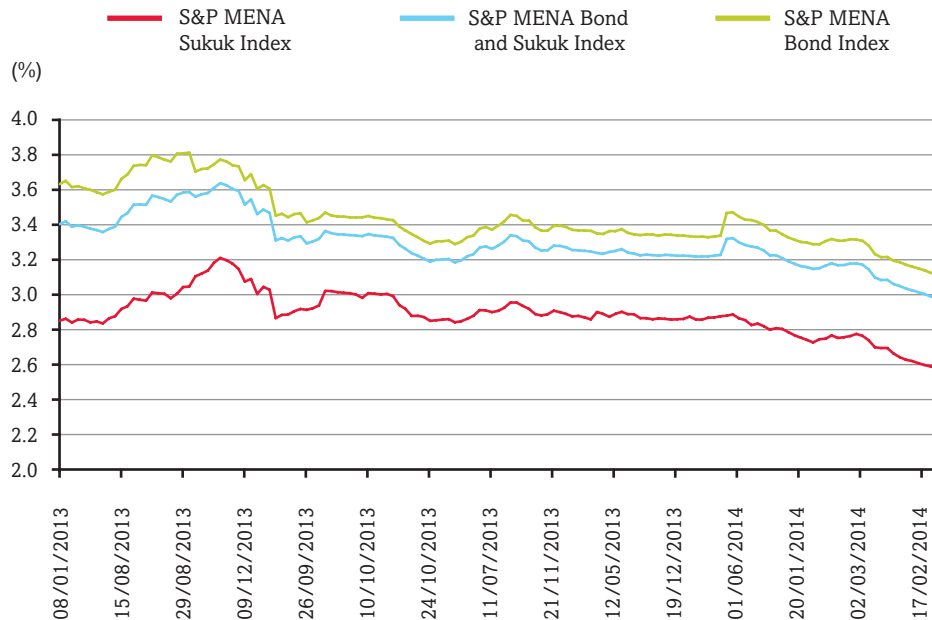
Yields on sukuk and conventional bonds with similar characteristics remain very strongly correlated, as shown by the synchronized moves of the yields on S&P Dow Jones MENA bonds and sukuk indices (see chart 5). The chart shows lower yield for sukuk index compared with bond index, because the composition of these indices are different.

### **Standardization Could Boost International Sukuk Issuance And Push Sukuk Pricing Down**

We anticipate that the premium for sukuk issuance over conventional bonds rates would decline if sukuk documentation were more highly standardized and default resolution mechanisms clearer. This could boost international sukuk issuance, which would help investors and issuers alike. Better standardization would:

- Enable investors to trust that their investments complied with Sharia law; in the past, some Sharia scholars have questioned the compliance of certain instruments.

**CHART 5  
S&P MENA SUKUK AND CONVENTIONAL BOND INDICES YIELDS**



MENA—Europe, the Middle East, and Africa.

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- Further lower issuance costs, because issuers could use standard documentation on which there was already a readily available, accepted religious opinion.
- Increase the predictability of the post-default process, benefiting both investors and issuers and reducing yield to comparable levels with conventional bonds.

Despite these advantages, standardized and universally accepted sukuk documentation that lays down a clear default resolution process has yet to emerge. Its creation may further spur the development of the industry and its internationalization.

Although the sukuk market has grown strongly and diversified over the past decade, it will be some years before it becomes more integrated. We understand that, in the next few years, several new issuers may tap the international sukuk market in order to broaden their investor base. This may help jumpstart the market. However, we believe that increasing standardization will provide a more-solid base and enable faster growth of a truly global marketplace for sukuk.

# **ISLAMIC FINANCE COULD MAKE INROADS INTO NORTH AFRICA**

Published: February 18, 2014

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After tremendous global success over the past decade, with total assets estimated at about \$1.4 trillion, Islamic finance could make inroads in North Africa. Large current account deficits and declining conventional financing sources are prompting governments from Arab spring countries to consider opportunities offered by Islamic finance. Standard & Poor's Ratings Services has observed this development in the North African countries where it rates banks--Egypt, Tunisia, and Morocco. These sovereigns have recently taken steps to implement policies to develop Islamic finance: Both Tunisia and Egypt implemented new regulatory frameworks for sukuk issuance in late 2013; and in January 2014, the Moroccan cabinet approved the legal foundation for Islamic banks. (Watch the related CreditMatters TV video, "Nouvelles Perspectives Pour La Finance Islamique En Afrique Du Nord," posted Feb. 18, 2014.)

Nevertheless, we believe that Islamic finance in this region has yet to demonstrate its economic added value beyond enabling products abiding with Islamic law. Yet, such added value could materialize through creating access to a new class of investors or customers or by offering Sharia-compliant products at costs comparable with their conventional counterparts. Wealth in Maghreb countries is much lower than in other regions where growth in Islamic finance has accelerated. Stiff price competition in some of the North African markets indicates that customers in these regions are relatively more sensitive to the costs associated with banking products. In our opinion, the success of Islamic banks in North Africa would be closely related to their capacity to offer products at a cost comparable with conventional banking activities.

## **OVERVIEW**

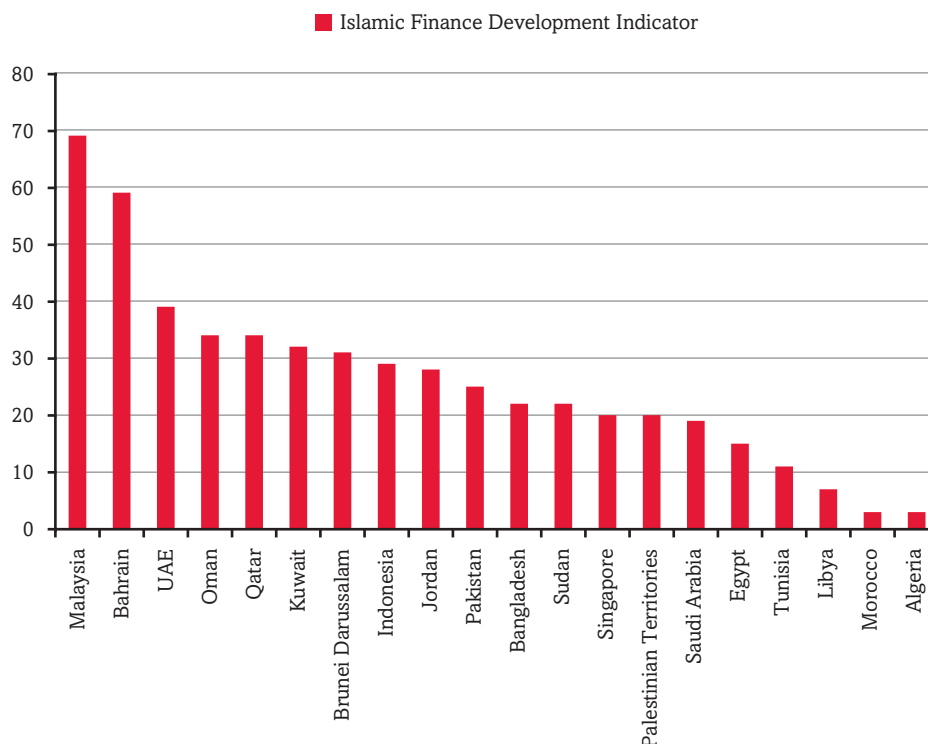
- Islamic finance in North Africa remains underdeveloped but regulatory changes are now creating an enabling environment for its growth.
- Tunisia plans to issue sukuk aiming at the attraction of a new class of investors, and Morocco is laying the legal foundation for Islamic banks.
- We believe that to compete successfully against conventional banking, Islamic banking products in North Africa will have to be priced competitively

## **Still In Its Infancy**

Islamic finance first appeared in North Africa in the 1970s and it remains embryonic, as shown by the Islamic Finance Development Indicator (IFDI), a composite weighted index created by the Islamic Corporation for the Development of the Private Sector (ICD) and Thomson Reuters. IFDI provides an aggregate assessment of the evolution of Islamic finance based on five pillars: quantitative developments, knowledge, corporate and social responsibility, governance, and awareness (see chart 1).



**CHART 1**  
**ICD-THOMSON REUTERS ISLAMIC FINANCE DEVELOPMENT**  
**INDICATOR FOR SELECTED COUNTRIES**



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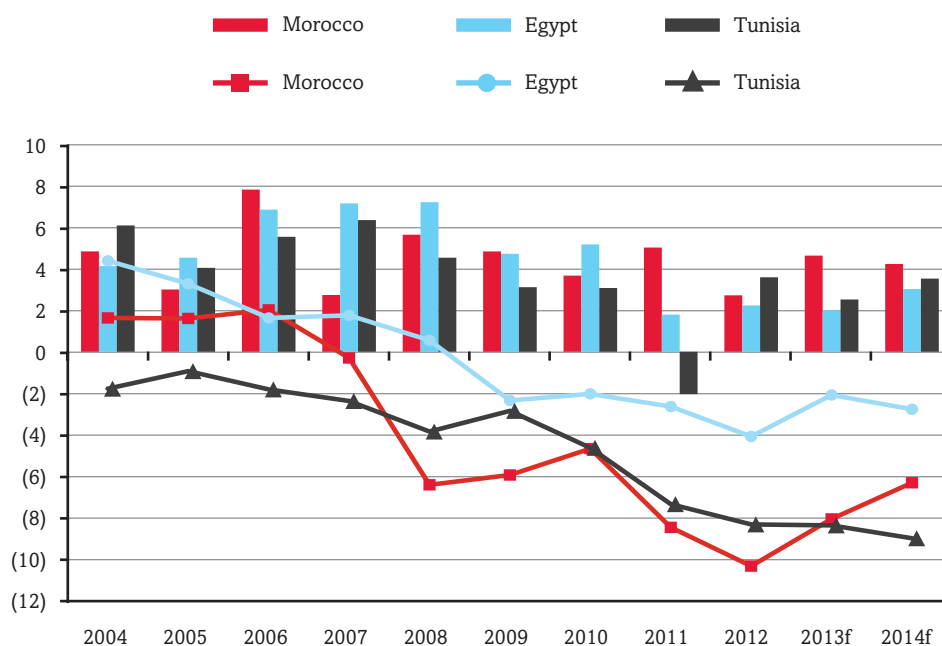
Only a limited number of players are active in Islamic finance (banking, insurance, and funds) in North Africa. They represent between 1% and 5% of their respective industries (see table 1). Overall, North Africa's contribution to global Islamic banking assets stood at about 1% at mid-year 2013. This minimal development is linked to the low-key presence of Islamic finance in the public debate until recently. Sharia-compliant banking previously presented an attractiveness that was at best exotic for regulators and banks active in these markets. Now, the perception is changing and public awareness is increasing. We therefore believe that Islamic finance could make some advances in North Africa over the coming two to three years.

**TABLE 1: ISLAMIC FINANCE STATISTICS IN NORTH AFRICA**

Country	Total Islamic banking assets (bil. \$)	Islamic banks	Takaful companies	Islamic funds
Algeria	N.A.	2	1	0
Egypt	11.6	4	5	12
Libya	N.A.	0	1	0
Morocco	0	0	0	2
Tunisia	0.6	3	2	3
Total North Africa	12.2	9	9	17
Global	985.1	363	216	636
% of which is North Africa	1.20	2.50	4.20	2.70

N.A.--Not available.

**CHART 2  
CURRENT ACCOUNT DEFICIT AND GDP GROWTH IN NORTH AFRICA**



Note: The bar chart depicts the real GDP growth.  
The line chart depicts the current account balance as a percentage of the GDP. f--Forecast.

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**The Arab Spring Has Heightened Interest In Islamic Finance Options In North Africa**

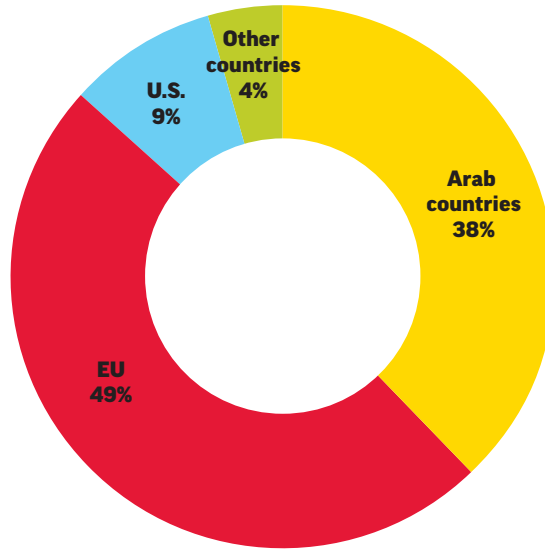
The revolutions in Tunisia and Egypt and the constitutional reforms in Morocco brought conservative parties to the driving seat of the political scene. These parties are more inclined to cooperate with Gulf countries and are more interested in the development of Islamic finance compared with previous regimes that turned more toward western powers and conventional banking.

In addition, the economic slowdown in Europe together with political instability in Tunisia and Egypt caused a major slump in these countries' economic performance, increased their current account deficits, and widened their financing needs (see chart 2).

The limited capacity of multilateral lending institutions to satisfy all these needs pushed some of the North African countries to turn to Gulf countries for foreign direct investment and financial support and to consider the sukuk market as an alternative to raise foreign currency funds (see charts 3, 4, and 5). To facilitate this, in late 2013, the National Constituent Assembly in Tunisia and the parliament in Egypt approved laws governing sukuk issuances. We understand that Tunisia aims to tap the sukuk market for about \$500 million in 2014.

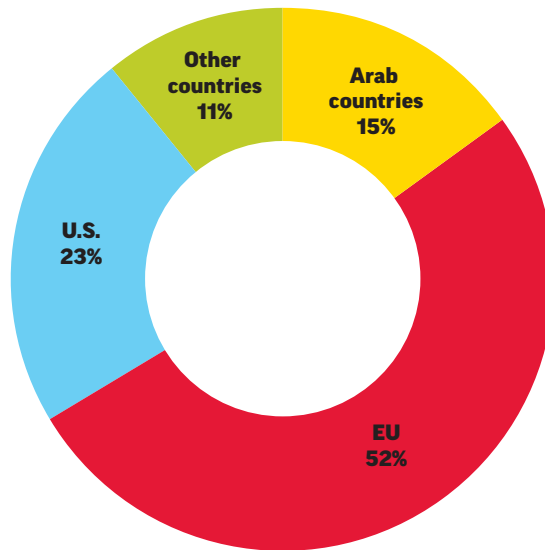
In January 2014, the Moroccan cabinet approved the legal terms organizing the activities and the development of Islamic finance, after they were authorized by the central bank in 2007. Approval was delayed as the country dealt with the negative impacts of the economic recession in Europe and the setbacks caused by the Arab spring. The bill has yet to be endorsed by the parliament.

**CHART 3**  
**TUNISIA -- FOREIGN DIRECT INVESTMENT BY COUNTRY OF ORIGIN**  
**AS OF END-2012**



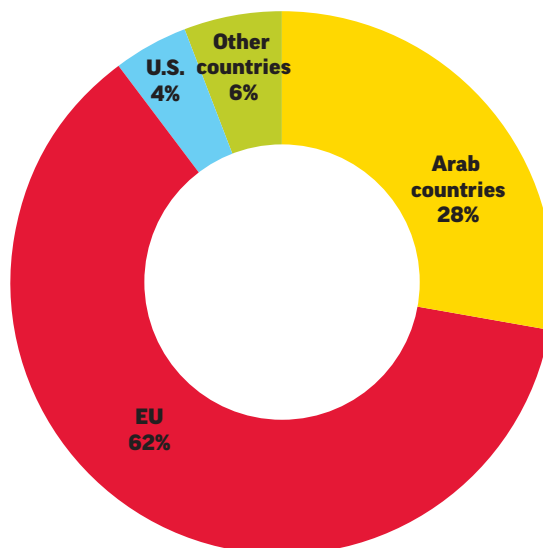
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**CHART 4**  
**EGYPT -- FOREIGN DIRECT INVESTMENT BY COUNTRY OF ORIGIN**  
**AS OF JUNE 2013**



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**CHART 5  
MOROCCO -- FOREIGN DIRECT INVESTMENT BY COUNTRY OF ORIGIN  
AS OF END-2011**



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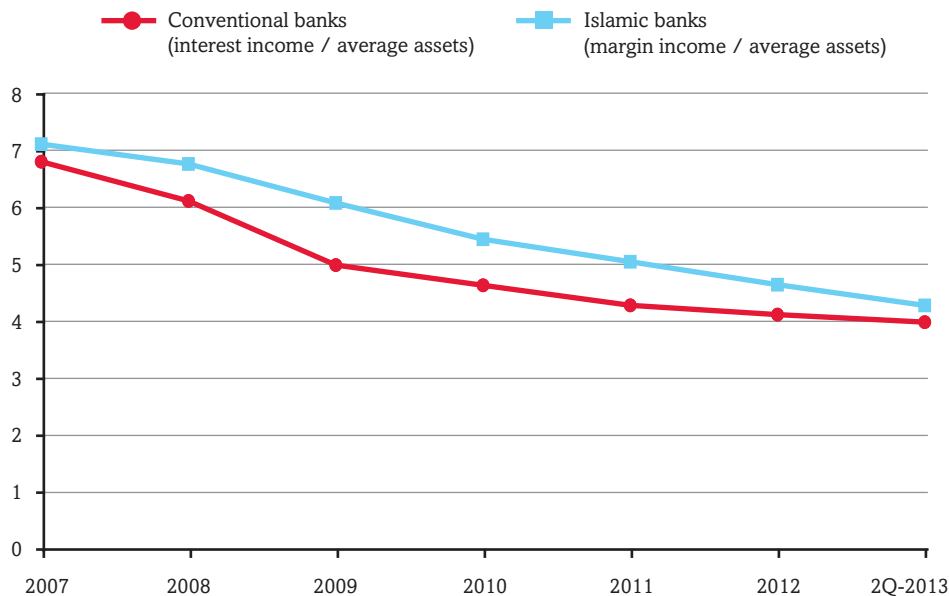
### **Success Will Depend On Ability To Add Economic Value**

Regulatory changes are creating an enabling environment for the development of Islamic finance in North Africa. However, its success will depend on its ability to demonstrate its economic added value in this part of the world. In our view, this could be achieved either through creating access to a new class of customers and investors or by offering Islamic products at costs comparable with conventional counterparts, both for corporate and retail products.

Sovereign issuance of sukuk could help meet sizable funding needs as other financing alternatives have diminished. In our view, corporate and financial institutions could follow sovereigns' lead and issue sukuk when it provides access to an untapped class of investors. We expect the process to be very gradual, however, because local banks and corporates are slowly familiarizing themselves with Islamic finance and the sukuk markets as a credible financing alternative.

In Morocco, upon approval of the pending legislation, we think that some banks will be interested in developing Islamic windows to tap the unexploited potential of this market. However, we do not foresee a radical change in corporate or consumer behavior. Although a considerable portion of the retail and corporate customers may have a natural bias toward Islamic financial products, ultimately, the price difference will be a chief determinant, in our view. Historically, Islamic financial products were more expensive than their conventional counterparts due to their structured nature or lower liquidity (see chart 6), particularly in Gulf countries. We think it may not be the case in North African countries, where price competition is already stiff because banks compete for a relatively narrow band of clients.

**CHART 6  
COST OF PRODUCTS -- ISLAMIC BANKS VERSUS  
CONVENTIONAL BANKS IN THE GULF**



Note: Based on banks rated by Standard & Poor's.

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### Islamic Products Could Help Finance Infrastructure Needs

The asset backing principle embedded in Islamic finance and the significant infrastructure needs in North African countries could work hand-in-hand, in our opinion. Traditional financiers, such as bilateral financiers and multilateral development institutions, have been very active in infrastructure financing in North Africa. Their total commitments exceeded \$4.9 billion in 2012. However, the capacity of these institutions to satisfy the full demand for infrastructure financing is limited. We think that North African countries will need to attract additional financing sources. We believe that Islamic finance can be a good fit for infrastructure and project finance because banks lack the long-term funding that these projects require. Several projects in renewable energy, transport infrastructure, and communication are ongoing or expected to be launched in the future in North African countries. Using sukuk to finance some of these projects could help diversify investors' base and tap an additional pool of resources.

S&P's Rating Actions are determined by Ratings Committee. This commentary has not been determined by Ratings Committee. The opinions expressed in this article do not represent a change to or affirmation of Ratings Services' opinion of the creditworthiness of any entity / entities (named or inferred) or the likely direction of ratings.

# **ISLAMIC FINANCE SLOWLY UNFOLDS IN KAZAKHSTAN**

Published: June 9, 2014

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It's still very early days for Islamic finance in Kazakhstan, and there are some important roadblocks to remove to enable its gradual growth, in Standard & Poor's Ratings Services' opinion. If this growth materializes, Kazakhstan might over time become a regional Islamic finance hub.

In this FAQ, we address questions from market participants about the progress of Islamic finance in Kazakhstan.

## **Frequently Asked Questions**

### **How has Islamic finance developed in Kazakhstan to date?**

Kazakhstan rolled out Islamic finance regulation in 2009, becoming the first member of the Commonwealth of Independent States (CIS) to do so. At that time, the State Agency for Regulation and Regional Financial Center of Almaty predicted that by 2020, Islamic finance would account for 10% of Kazakhstan's GDP. Yet, five years down the road, Islamic finance hasn't really taken off despite the country's strong investment pipeline and its predominantly Muslim population.

With total assets of less than \$200 million at year-end 2013, by our estimate, Kazakhstan's Islamic finance is still embryonic. One Islamic bank is active, and we understand that a few other Sharia compliant finance companies have established very small operations as Islamic finance players. These include a leasing company, a takaful insurance company, and an investment fund, among others.

Al Hilal Bank JSC (AHB, not rated)--established in 2010 as part of an intergovernmental agreement between Kazakhstan and the United Arab Emirates (not rated)--has the most Islamic finance assets.

A few additional regulatory amendments have followed, including allowing the Kazakh state to issue sukuk as of 2011. In 2012, the Development Bank of Kazakhstan issued the first sukuk for Malaysian ringgit (MYR) 240 million out of a total program of MYR1.5 billion.

Joint Stock Company Zaman-Bank announced on May 22, 2013, that it had signed a strategic partnership agreement with The Islamic Corporation for the Development of the Private Sector, the private sector arm of the Islamic Development Bank (AAA/Stable/A-1+), to convert Zaman-Bank to an Islamic bank. To this end, ICD gained 5% of Zaman-Bank's share capital in late 2013 and will own up to 30% in late 2014 via an additional equity injection. Zaman-Bank is a marginal player in the Kazakh banking system, though.

### **Why is Islamic finance still in its infancy in Kazakhstan?**

We think product offering is insufficient, market demand is still to be estimated, and the industry needs regulatory fine-tuning.

The banking system is recovering slowly after the burst of the credit and real estate bubble in 2008, bringing an abrupt end to years of banks using wholesale funds to aggressively expand their lending. Banks suffered severely in the aftermath of the crisis, leading to some defaults and bailouts. The banking system still has many problem assets and its profitability is weak. Consequently, its appeal to foreign investors, including in Islamic finance, has decreased markedly since 2008.

With its 70% Muslim population, Kazakhstan has yet to demonstrate its potential as an Islamic finance market, in our opinion. We understand that the regulator has not yet conducted a study to estimate the potential for Islamic financial services in the country, nor has existing regulation been enough to spur the development of Islamic finance offerings. We think that the potential of Islamic finance will closely hinge on banks' ability to offer competitive products compared with conventional finance products.

In our view, there is room for some improvement to the current regulatory environment that would remove growth impediments. For instance, regulation does not authorize conventional banks to create Islamic windows, which has left them behind in the race to create Islamic product offerings.

The treatment of Islamic deposits is another example that is holding growth in check. Kazakhstan's deposit insurance mechanism excludes these deposits and regulation does not allow banks to support their Islamic deposits if the profitability of the underlying assets is low or negative. This treatment diminishes the appeal of Islamic deposits, discouraging all but the most sophisticated clients with higher risk tolerance.

In addition, the current regulation does not require banks to set aside regulatory capital on the assets financed by Islamic investment accounts. Banks may also exclude assets in Islamic accounts from their overall asset pools if they become insolvent. In our opinion, this could lead to sizable undercapitalization of Islamic banks operating in Kazakhstan and could make creditors' rights very uncertain.

### **How could Islamic finance enhance the Kazakh banking system?**

Islamic finance could help the country to access a new class of investors looking for Sharia compliant products. According to our data, sukuk issuance by entities domiciled outside the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) and Malaysia attracts pronounced interest from Middle Eastern and Asian investors, which together make up about 60% of the investor base in these instruments, on average (see "Despite Players' Global Aspirations, Lack Of Integration Keeps Sukuk Issuance A Local Affair," published April 15, 2014, on RatingsDirect). Moreover, we anticipate that the total volume of sukuk issuance worldwide will exceed \$100 billion in 2014, suggesting that investors' appetite for this asset class is high. Despite some headwinds in 2014, we think Kazakhstan's economic prospects over the next few years will be favorable. The country has a substantial investment pipeline and could use sukuk to attract external financing. In particular, the asset-backing principle of Islamic finance where each financial transaction refers to a tangible, identifiable underlying asset makes sukuk a good match for infrastructure project financing.

Islamic finance could help to widen banking penetration, which the World Bank estimates at about 40% in Kazakhstan. The Kazakh financial system currently comprises 38 banks serving a population of approximately 17 million, with the top 10 banks controlling roughly 80% of assets. Therefore, midsize and small banks may find it difficult to compete head-on with large players. Expanding Islamic finance offerings could enable banks to win new clients and could offer banks the ability to differentiate themselves strategically in a competitive industry. However, this alone will not be enough to propel the development of Islamic finance.

## SPOTLIGHT ON...

Over time, Islamic finance could strengthen regional integration. Kazakhstan has indicated it aims to become an Islamic financial hub in the CIS. We believe that if and when the local Islamic finance industry makes solid inroads in Kazakhstan, the country could serve as a CIS Islamic finance platform. At the same time, Kazakhstan could attract higher foreign investments from investors who are willing to use it as a starting point for regional expansion.

### **What are the main factors for fueling the successful development of Islamic finance in a banking system?**

Over the past two decades, we have observed Islamic finance successful development in countries such as Malaysia and the United Arab Emirates, among others.

For Islamic finance to develop in a given market, we see the following factors as essential:

- Securing the political and business community's willingness and support,
- Establishing a central Sharia supervisory body,
- Pricing competitively,
- Introducing liquidity management instruments, and
- Educating human resources on Islamic finance specificities.

Obtaining the political and business community's willingness and support is the main success factor by far, in our opinion. Once present, this can accelerate regulatory revisions and quickly broaden public awareness. The eligibility of Islamic bank deposits for deposit guarantees and the clarification of default resolution mechanisms are among the major pillars for regulators to carefully explore in Kazakhstan, in our view.

We think a single authority on Sharia compliant issues under a central body minimizes the risk of conflicting Sharia opinions. These differences in opinion have tarnished the industry's credibility in the past and called into question the compliance of some products in some countries and regions. A few countries, such as Malaysia, have established a central Sharia supervisory body, at the central bank level. However, establishing this in some countries could create possible conflicts with the constitution or the population's secular nature.

In some countries, Islamic products are priced at a premium compared with conventional products. Although the structured nature of the products and their lower liquidity--compared with conventional products--justified these premiums, we believe that this pricing may hinder the industry's growth in countries where banking competition is already stiff. (For further details, see "Islamic Finance Could Make Inroads Into North Africa," published Feb. 18, 2014).

One of the main impediments to Islamic finance's development has been the lack of instruments for banks to manage their liquidity efficiently. In some cases, Islamic banks had either to invest their excess cash in liquid, but low yielding assets or to turn to more rewarding riskier, but less liquid products. Malaysia's central bank has resolved this issue by becoming the largest issuer of local short-term sukuk used by the banking system to manage its liquidity by replacing its lower margin or riskier products. In 2013, the Malaysian central bank issued about \$50 billion of short-term ringgit-denominated sukuk, which makes it by far the largest issuer of sukuk globally.

As the industry continues to expand, competition to attract and retain the best talent could become an obstacle for future growth. A few countries--for example France and the U.K.--have started to invest in the education of the next generation of Islamic financiers to curb this risk.

### **What's the future of Islamic finance in Kazakhstan?**

We believe Kazakhstan's Islamic finance activity will gradually expand over the next years. During this period, we think Islamic finance will complement conventional bank offerings and provide an additional avenue to respond to domestic financing needs.



Firstly, we think that regulatory changes, if and when they occur, will likely respond to current weaknesses, especially conventional banks' launching of Islamic windows and the deposit guarantee eligibility of profit-sharing investment accounts. We believe, moreover, that government support will be critical in offering Sharia compliant liquidity management instruments for the banking system and paving the way for private sector sukuk issuance. The government may decide to use sukuk to finance some of its investment plans. However, we think that the industry's competitiveness compared with that of conventional finance--via sukuk issuance or banking activity--will largely determine its success.

# BASEL III OFFERS AN OPPORTUNITY FOR ISLAMIC BANKS TO STRENGTHEN THEIR CAPITALIZATION AND LIQUIDITY MANAGEMENT

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Standard & Poor's Ratings Services believes the Islamic Financial Services Board's (IFSB) revised capital requirements for Basel III could help to strengthen the Islamic finance industry.

The December 2013 IFSB-15 standard for Islamic financial institutions sets out how Islamic banks will implement Basel III. The IFSB is likely to release its guidance note on the parameters and calculation of the liquidity coverage ratio and net stable funding ratio in early 2015. In our opinion, the introduction of a liquidity coverage ratio might address some of the industry's long-standing weaknesses, particularly the lack of high quality liquid assets (HQLA).

## OVERVIEW

- The introduction of new capital buffers under the Basel III standard may make the Islamic finance industry more resilient to the cyclical nature of its operations.
- The implementation of Basel III will be neutral for Islamic banks' quality of capital as it mainly comprises common equity.
- The lack of high quality liquid assets and the treatment of profit sharing investment accounts are the main challenges that Islamic financial institutions will face in implementing Basel III, in our opinion.
- Basel III could give the industry an opportunity to resolve some of its long standing weaknesses.

Our base-case scenario assumes that there will be no major changes in Islamic banks' quality of capital, which we see as strong on average. At the same time, we believe that raising capital requirements through the introduction of new capital buffers will help to make the industry more resilient. These buffers will ultimately help Islamic banks to cope better with the cyclical nature of the economies of the countries in which they operate and major business activities. Most of the Islamic financial institutions that we rate operate in emerging economies and also tend to have fairly significant exposure to the real estate sector.

While we continue to view the liquidity of the Islamic financial institutions that we rate as adequate on average, we think that Basel III implementation creates an opportunity for the industry to develop a new range of HQLA to address the chronic lack of such instruments.

Over the past few years, the Central Bank of Malaysia has tackled the lack of HQLA by becoming the largest issuer of short-term sukuk, providing Malaysian Islamic banks with much needed liquidity management instruments. Other central banks, the International Islamic Liquidity Management Corporates (IILM), and the Islamic Development Bank (IDB) may follow suit, providing the industry with new liquidity management instruments. Basel III implementation may also encourage highly-rated sovereigns and corporates to list their sukuk on developed and liquid markets to make them eligible for HQLA inclusion.

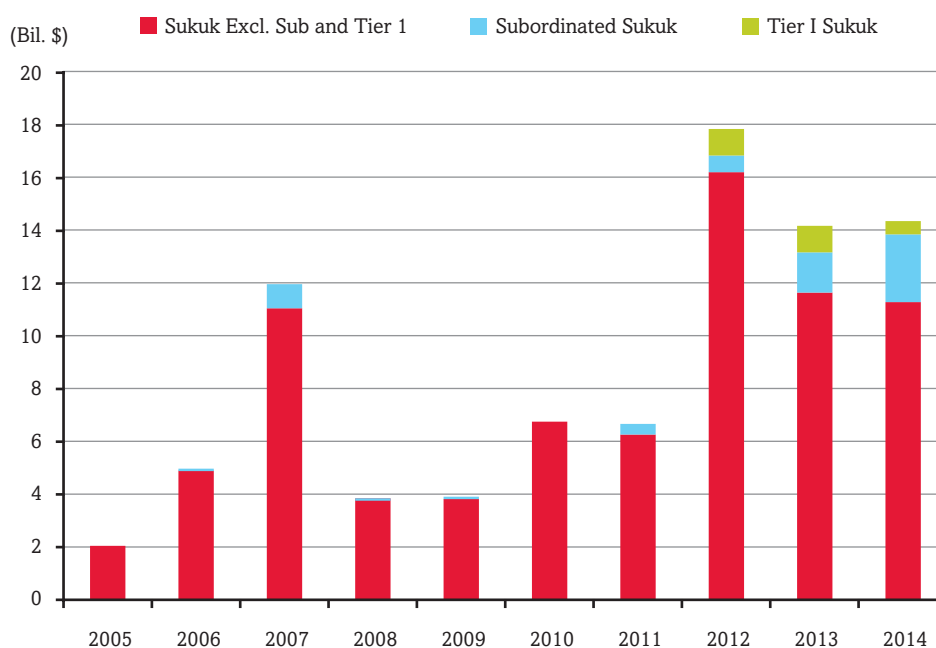
The implementation of Basel III will also test the treatment of profit sharing investment accounts (PSIAs) from a liquidity and funding perspective. PSIA holders are, in theory, obliged to share any losses, but this could increase their volatility and liquidity coverage requirements and reduce their role as stable funding sources.

### Basel III May Strengthen The Resilience Of The Industry

Basel III's primary goal is to increase the level, quality, and global consistency of regulatory capital and standardize the required deductions and adjustments. According to the standard, each bank's Tier 1 capital should enable it to absorb losses while remaining a going concern. Basel III categorizes Tier 2 capital as a "gone concern" reserve to protect creditors in the event of an insolvency, and abolishes Tier 3 capital altogether. Basel III also states that Tier 1 capital should predominantly comprise common equity and retained earnings, with a tighter definition of common equity Tier 1.

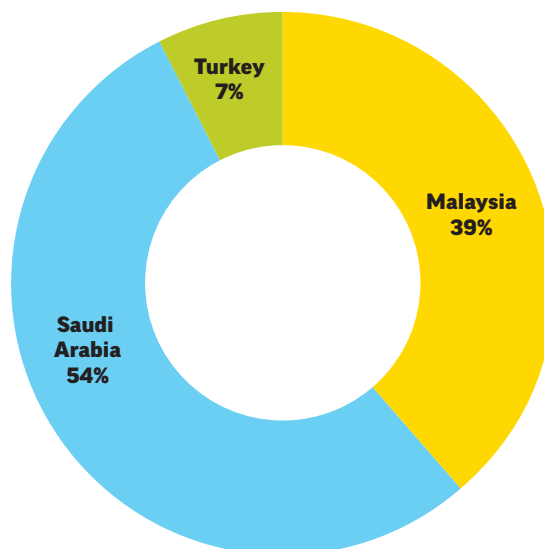
We expect the revision of the capital definitions to have a limited impact on Islamic banks' quality of capital as most of their capital already comprises common equity. The recourse to Tier 2 capital instruments--primarily subordinated sukuk issuance--has been limited over the past 10 years, and Tier 3 capital instruments are nonexistent. Over this period, Islamic banks have issued \$86.1 billion of sukuk in total, \$6.2 billion of which comprised Tier 2 instruments (see charts 1 and 2) issued mainly by banks in Saudi Arabia, Malaysia, and Turkey.

**CHART 1  
TOTAL SUKUK ISSUED BY ISLAMIC FINANCIAL INSTITUTIONS**



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**CHART 2  
DISTRIBUTION OF TIER II INSTRUMENTS BY COUNTRY**



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Over the past two years, we have seen Tier 1 sukuk issuance from three United Arab Emirates (UAE) Islamic banks totaling \$2.5 billion. Issuers of these sukuk claim that they qualify as Additional Tier 1 (AT1) capital under Basel III. The IFSB defines sukuk eligible for AT1 inclusion as musharaka sukuk, where the underlying asset is the whole business of the issuing bank. Moreover, the IFSB specifies that these sukuk should be able to absorb losses. We expect to see additional issuances eligible for AT1 over the next two years as countries start to implement Basel III. The oversubscription rates of the three Tier 1 sukuk already issued and their tight pricing suggest a very strong market appetite, which we expect to linger unless market conditions shift over the next few months. From a rating perspective and given the current composition of rated Islamic banks' capital structures, we do not expect to change our assessment of the quality of capital of the banks that we rate (see Table 1). Tier 1 sukuk may be eligible for intermediate equity content if their terms and conditions are consistent with our criteria.

**TABLE 1: QUALITY OF CAPITAL OF RATED ISLAMIC BANKS**

Entity	Rating	CET1/Total capital (%)
Al Baraka Banking Group B.S.C.	BB+/Negative/B	92.7
Albaraka Turk Katilim Bankasi AS	BB/Negative/B	72.6
Al Rajhi Bank	A+/Stable/A-1	94.4
Jordan Islamic Bank	BB-/Negative/B	98.0
Kuwait Finance House	A-/Negative/A-2	98.4
Qatar Islamic Bank (S.A.Q)	A-/Stable/A-1	94.9
Sharjah Islamic Bank	BBB+/Stable/A-2	98.9

**Higher Basel III Capital Requirements Are Neutral For Islamic Banks**

Basel III significantly increases capital requirements for trading-related counterparty risks to address Basel II deficiencies that were highlighted in the financial crisis. Basel III calls for the use of stressed inputs in the calculation of potential future counterparty exposures and the introduction

of a capital charge against potential mark-to-market losses arising from deteriorating counterparty creditworthiness, short of actual default. It also includes an increase in the correlation assumptions for exposures to other financial institutions--with embedded incentives to move over-the-counter trading to central counterparties and exchanges--and increased capital charges in other areas such as wrong way risk. This risk arises when the probability of default and the exposure at default are positively correlated, as banks experienced in the case of asset-backed securities hedged with monoline insurers. We think that the impact of these additional capital requirements on Islamic financial institutions will be minimal, given their limited use of derivatives and securitizations. Very few structures have been recognized as Sharia-compliant, and they are not currently widely used by the industry.

### **The Alpha Factor Will Determine Islamic Financial Institutions' Regulatory Capitalization**

We believe the alpha factor--the requirement that banks hold regulatory capital to cover their displaced commercial risk--will determine Islamic financial institutions' regulatory capitalization. The alpha factor is not a Basel III innovation, but a specific adjustment at the discretion of national regulators that was introduced with Basel II adoption. Displaced commercial risk is defined by the industry as the risk that Islamic banks might have to absorb a portion of the losses that should have been borne by PSIA holders to avoid a significant withdrawal of funds. The lower the alpha factor, the lower the displaced commercial risk and the higher the probability of passing through losses to PSIA holders. In this scenario, the capital requirements on PSIA exposures will be low and the overall capitalization of an Islamic financial institution would be weaker than for a similar conventional institution. In our risk-adjusted capital measure, we do not adjust for the presence of PSIA's and assume they behave like conventional deposits. We believe that there is a strong incentive for Islamic banks to support PSIA holders through a reduction in the mudharib fee--the fee the bank takes for managing PSIA holders' funds--through the use of profit equalization reserves and investment risk reserves if they have been set aside, or through direct support from shareholders to PSIA holders.

### **Islamic Finance Principles Limit Leverage**

Basel III introduced a consistent leverage ratio measure, and the IFSB-15 standard outlines its calculation for Islamic banks. The ratio's numerator is made of CET1 capital. Its denominator contains on-balance-sheet nonderivative exposures, net of specific provisions and valuation adjustments, without factoring in the effects of credit risk mitigation, and off-balance-sheet items with different credit conversion factors. The calculation excludes restricted profit sharing investment account financed assets, while it includes unrestricted profit sharing investment account financed assets, subject to their weighting by the alpha parameter applicable to the specific Islamic bank in its capital adequacy calculation. The national regulator can set the leverage ratio at an individual bank or country level. Regulators will have the flexibility to use the ratio to control leverage buildup in an upturn scenario, or to limit deleveraging in a downturn scenario.

In our view, leverage for Islamic banks is less problematic than for conventional financial institutions. Two Islamic finance principles limit leverage--the asset backing principle and the prohibition of speculation. The asset backing principle states that all transactions have to be backed by an underlying asset and anchors Islamic financial transactions to the real economy, making recourse to highly leveraged operations virtually impossible. The prohibition of speculation reduces the acceptability of leveraged transactions from a Sharia perspective. We believe there are only two products that contribute to the buildup of leverage in Islamic finance--commodity Murabaha, the sale and buyback of commodity assets--and sukuk issuance where the performance of the sukuk is delinked from that of the underlying assets. Basel III's introduction of the leverage ratio may limit leverage buildup resulting from the use of these instruments in the future.

## **BANKS**

### **Liquidity And Stable Funding Requirements May Help To Resolve Long-Standing Weaknesses**

The Basel Committee on Banking Supervision (BCBS) has published two papers on the new international standards for liquidity and structural funding. The short-term liquidity metric--the liquidity coverage ratio (LCR)--requires banks to maintain high quality, unencumbered assets that exceed their stressed cash outflows over a 30-day horizon. The structural funding metric--the net stable funding ratio (NSFR)--effectively assesses the behavioral maturity of each side of the balance sheet over a one-year horizon. Haircuts are applied to each category of assets and liabilities according to their liquidity and expected stability in a stressed scenario, and the available stable funding must exceed the required stable funding.

The BCBS made specific reference to Islamic banks' liquidity, because their HQLA can be insufficient. The committee gave the national supervisors the discretion to define Sharia compliant financial products, including sukuk, as alternative HQLA subject to haircuts that they can impose. The intention is to take into account the specificities of being Sharia compliant and the associated practical challenges. The availability of level 1 HQLA, apart from cash and central banks' reserves, is currently low in Islamic finance, and central banks, except for the Central Bank of Malaysia and to a lesser extent the Central Bank of Bahrain, have not been very active in issuing short-term sukuk that they could use for the LCR. In addition, most of the government sukuk are either not listed on developed markets or listed, but not actively traded. The IILM issuances remain small compared with the overall size of the industry.

Another challenge to the implementation of the LCR stems from the treatment of PSIA's. The calculation will probably exclude restricted PSIA's as they are not commingled with other sources of Islamic bank funding and their assets are held separately and off balance sheet. The run-off rates on unrestricted PSIA's and whether these will be viewed by regulators as equivalent to deposits for conventional financial institutions are still to be determined. In addition, deposit insurance systems barely exist in most of the countries where Islamic finance is expanding, and most PSIA's have short maturities.

An initial IFSB quantitative impact study of 32 banks in seven countries highlighted that Islamic banks can meet the LCR, based on cash and central bank reserves that are present in their assets. The IFSB reported an average LCR for these banks of 241% and an average NSFR of 120%. HQLA consisted primarily of cash and central bank reserves. We have developed our own ratio to help us assess the adequacy of banks' funding and liquidity profiles (see " ," published on RatingsDirect on July 17, 2013). Specifically, we look at two ratios--the stable funding ratio and the broad liquid assets to short-term wholesale funding ratio. For the stable funding ratio calculation, we consider customer deposits with all maturities, including unrestricted PSIA's, for Islamic banks to be a stable source of funding and do not apply any haircut. These ratios, together with other factors, inform our assessment of a bank's funding and liquidity profile. We assess the funding and liquidity profiles of Islamic banks that we rate as "adequate."

Basel III creates a window of opportunity for the industry to resolve long standing weaknesses related to the lack of liquidity management instruments. We think that regulators, the IILM, and the IDB could play an important role through the issuance of sukuk that may qualify as HQLA. This could also prompt sovereign issuers and corporates with high credit quality to list their sukuk in developed and liquid capital markets.

**TABLE 2: STANDARD & POOR'S SELECTED FUNDING AND LIQUIDITY RATIOS****Standard & Poor's Selected Funding And Liquidity Ratios**

	<b>Al Baraka Banking Group B.S.C.</b>	<b>Albaraka Turk Katilim Bankasi AS</b>	<b>Al Rajhi Bank</b>	<b>Jordan Islamic Bank</b>	<b>Kuwait Finance House</b>	<b>Qatar Islamic Bank (S.A.Q)</b>	<b>Kuwait Islamic Bank</b>	<b>Average</b>
<b>Stable funding ratio (%)</b>								
2013	127.50	107.29	129.37	130.27	100.19	120.13	120.40	119.3
2012	122.24	98.92	133.90	124.56	90.25	122.13	121.60	116.2
2011	135.50	106.67	132.99	172.73	97.96	121.48	118.82	126.6
2010	125.84	106.42	132.33	164.87	93.96	113.31	115.34	121.7
<b>Broad liquid assets/short-term wholesale funding (x)</b>								
2013	5.94	1.92	19.89	63.95	1.94	3.58	4.14	14.5
2012	5.20	1.41	33.85	51.42	1.23	2.65	8.90	14.9
2011	8.71	1.92	23.07	64.53	1.90	2.21	4.53	15.3
2010	9.89	2.49	10.11	24.54	1.34	1.79	2.62	7.5
<b>Funding and liquidity Assessment</b>								
	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate	

# **PRESALE: JANY SUKUK COMPANY LIMITED**

Published: September 4, 2014

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*This presale report is based on information as of June 19, 2014. 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 ratings on the proposed issue. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the ratings on the proposed issue should not be construed as evidence of final ratings. If Standard & Poor's does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, Standard & Poor's reserves the right to withdraw or revise its ratings.*

**PROFILE**

- U.S. Dollar-Denominated Fixed-Profit-Rate Lease Certificates Due 2019: 'BB'
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**Transaction Summary**

JANY Sukuk Company Limited, a trustee incorporated in the Cayman Islands, plans to issue U.S. dollar-denominated sukuk (trust certificates) with a fixed profit rate. JANY Sukuk Company Limited will enter into a Murabaha agreement for 49% of the issued amount and a Wakala agreement for 51% of the issued amount with J. Aron & Company, a subsidiary of The Goldman Sachs Group Inc. (GSG; A-/Negative/A-2). J. Aron & Company engages in the marketing and trading of commodities, including crude oil and petroleum products, natural gas, metals, electricity, coal, agricultural and other commodity products.

Under our criteria, the proposed trust certificates qualify as sukuk with full credit enhancement mechanisms provided by GSG through its guarantee of the obligations of J. Aron & Company under the Murabaha agreement.

The guarantee provided by GSG is full, irrevocable, and unconditional. It will rank pari passu with all other GSG unsecured and unsubordinated obligations.

The guaranteed obligations include the payment of the Murabaha deferred price, upon the occurrence of a trust dissolution event or on the scheduled dissolution date of the trust. The deferred price would be sufficient to fund the payment of the face amount, the last periodic distribution amount prior to the dissolution of the trust, and any additional periodic distribution amounts accruing for a period of 14 days.

Early dissolution events include the scenario where after a grace period of 14 days the profit of the Wakala assets falls short of the periodic distribution amount and J. Aron & Company doesn't step in to cover the shortfall from its own funds.



## Rationale

The 'A-' rating on the proposed sukuk trust certificates reflects the 'A-' rating on GSG, owing to the guarantee provided by GSG on J. Aron & Company obligations under the Murabaha agreement. The rating is based on draft documentation. If the final documentation differs substantially from the draft version, we could consider a rating action on the sukuk. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures transactions nor provides opinions with regard to compliance of the proposed transaction with Sharia.

**TABLE 1: TRANSACTION PROFILE**

Issuer, buyer, and seller of the underlying assets	JANY Sukuk Company Limited
Obligor, buyer, and manager of the underlying assets	J. Aron & Company
Periodic distribution rate	Fixed profit rate determined at the closing of the transaction
Arranger and manager	Goldman Sachs International
Trustee	The issuer
Delegate	BNY Mellon Corporate Trustee Services Limited
Principal paying agent	The Bank of New York Mellon, London Branch
Governing law	English law and the law of the State of New York for the guarantee
Guarantor	Goldman Sachs Group Inc.

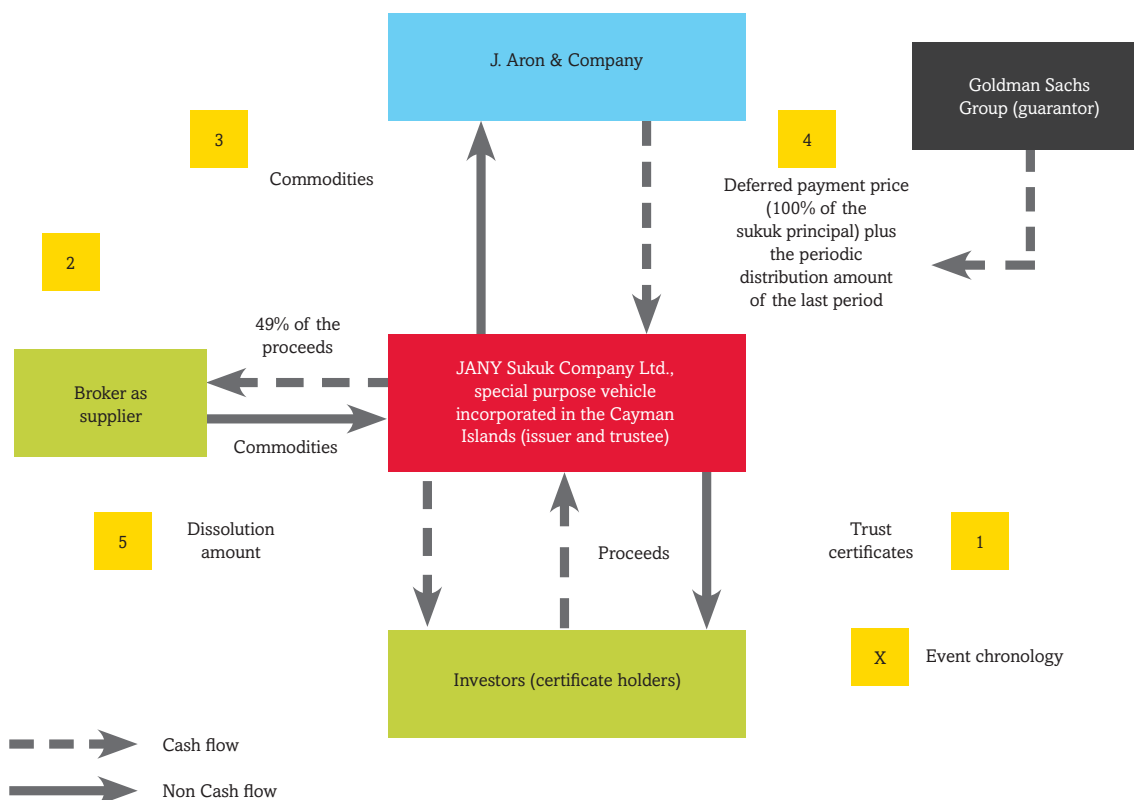
The transaction involves a special-purpose company incorporated in accordance with the laws of the Cayman Islands for issuing rated sukuk trust certificates. The proceeds of the sukuk will ultimately be used to acquire commodities to be managed by J. Aron & Company. On the closing date of the sukuk, the issuer will buy commodities assets from the market (49% of the proceeds, called hereinafter Murabaha assets; the first leg of the sukuk) and from J. Aron & Company (51% of the proceeds, called hereinafter Wakala assets; the second leg of the sukuk). The issuer will subsequently enter into simultaneous Murabaha and Wakala agreements with J. Aron & Company pursuant to which:

- The Murabaha assets will be sold to J. Aron & Company with a deferred price equivalent to 100% of the principal amount of the sukuk, the periodic distribution amount due upon the occurrence of a trust dissolution event or on the scheduled trust dissolution date, and any additional periodic distribution amounts accruing for a period of 14 days (see chart 1); and
- The Wakala assets will be transferred to J. Aron & Company as Wakeel (asset manager) against the payment of periodic Wakala revenues, which will serve as the basis for the payment of the periodic profit distribution to sukuk holders (see chart 2).

GSG's guarantee of the obligations of J. Aron & Company under the Murabaha agreement, is full, irrevocable, unconditional, and will rank pari passu with all other unsecured and unsubordinated obligations of GSG.

We equalize the rating on the sukuk with that on GSG. We base our ratings on GSG on its "strong" business position (as our criteria define the term), reflecting its market position as one of the largest and best-managed investment banks in the world. We believe its capital and earnings are "adequate," primarily based on our forecast for GSG's risk-adjusted capital (RAC) ratio, our measure of a bank's capital. Its risk position is "moderate," which reflects the complexity of its investment-banking focused business model. We regard its funding as "average" and its liquidity as "adequate." We also incorporate two notches of uplift into our long-term rating on GSG, reflecting our expectation that it would receive extraordinary support from the U.S. government in a crisis.

**CHART 1  
CHRONOLOGY OF EVENTS FOR THE PRINCIPAL: THE MUHARABA LEG OF THE SUKUK**



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The outlook on the long-term rating on GSG is negative. It reflects the potential negative impact that recently finalized regulations (particularly the Volcker Rule) could have on the company's ability to maintain its franchise. Our outlook on the long-term rating on the holding company of GSG incorporates our ongoing evaluation of the degree to which we will continue to incorporate extraordinary government support into our ratings on U.S. bank holding companies that we view as systemically important in the U.S. financial system.

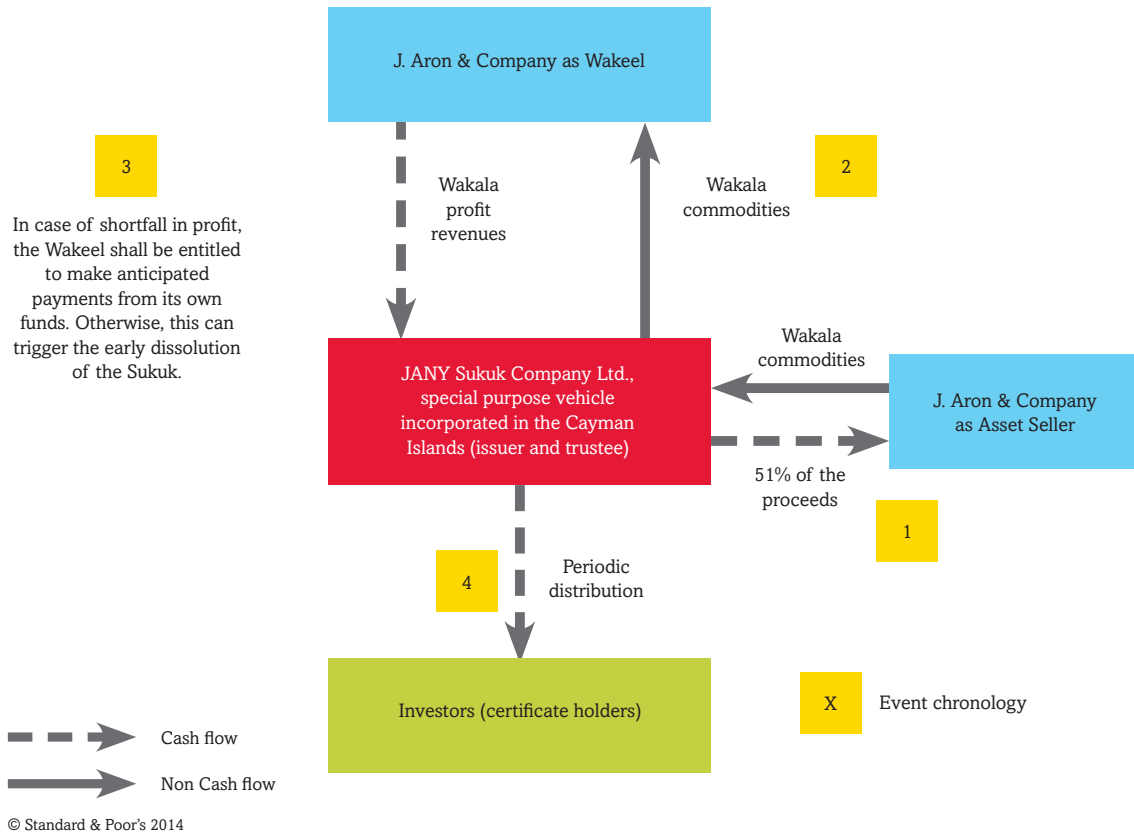
**Early Dissolution In Case Of Underperformance Of The Wakala Assets**

In the event the profit generated from the underlying assets is not sufficient to pay the profit owed to the sukuk holders, we expect J. Aron & Company to make up the shortfall from its own funds. Moreover, the sukuk terms and conditions specify that if the Wakala revenues and the support provided by J. Aron & Company fall short of the periodic distribution amount, this could trigger an early dissolution of the trust:

- By an extraordinary resolution that at least 50% of the sukuk holders' request;
- At the request of the holders of at least 20% of the sukuk; or
- At the discretion of the delegate, BNY Mellon N.A.

Although there are no legal obligations to request such early dissolution, under the scenario that the 20% quorum of the investors necessary to request the early dissolution of the sukuk is not formed, we believe that the delegate has a strong incentive to call for the early dissolution of the sukuk to protect investors' interests. GSG and J Aron & Company have also indicated to us that they have

**CHART 2**  
**CHRONOLOGY OF EVENTS FOR THE PERIODIC DISTRIBUTION: THE WAKALA LEG OF THE SUKUK**



strong incentive to protect their reputation and avoid an adverse performance of the transaction. Still, from a legal standpoint, the liquidity support to be provided by J. Aron & Company in case of adverse performance of the underlying assets is optional. The assumptions of support from J. Aron & Company and if not, the triggering of the early dissolution, are central to our rating on the transaction. The early dissolution call would ultimately activate the GSG guarantee on the principal and the periodic distribution amount of the last period prior to the dissolution (180 days plus 14 days profit for the grace period).

### Qualification As Sukuk With Full Credit Enhancement

The proposed structure qualifies as sukuk with full credit enhancement mechanisms under our criteria. The credit enhancement covers both the principal and the last periodic distribution. The credit enhancement on the principal and the last periodic distribution is provided by GSG through the guarantee of J. Aron & Company obligations under the Murabaha agreement. These obligations are activated either at the maturity of the transaction or if an early dissolution event occurs.

### Default Event

The sukuk documentation indicates that GSG's insolvency, if it occurred, does not constitute an event of default of the transaction. Given that we equalize our rating on the sukuk with our rating on GSG, in the event of insolvency or default of GSG on its financial obligations, we may withdraw our rating on the sukuk.

# **PRESALE:**

## **BEREKET VARLIK KIRALAMA A.S. SUKUK LEASE CERTIFICATES**

Published: June 20, 2014

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*This presale report is based on information as of June 20, 2014. 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 Standard & Poor's does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, Standard & Poor's reserves the right to withdraw or revise its ratings*

## **PROFILE**

- U.S. Dollar-Denominated Fixed-Profit-Rate Lease Certificates Due 2019: 'BB'

## **Transaction Overview**

Bereket Varlik Kiralama A.S., an asset lease company in the form of a joint-stock company incorporated in Turkey, plans to issue U.S. dollar-denominated Sukuk ("lease certificates," as defined in the transaction's draft documentation) with a fixed profit rate. Bereket Varlik Kiralama will enter into a Murabaha agreement for 49% of the issued amount and an initial asset sale and purchase agreement for 51% of the issued amount with Albaraka Turk Katilim Bankasi AS (Albaraka Turk; BB/Negative/B), a subsidiary of Al Baraka Banking Group B.S.C. (BB+/Negative/B).

Under our criteria, the lease certificates qualify as Sukuk, with full credit enhancement mechanisms provided by Albaraka Turk. These mechanisms cover both the principal amount and the periodic distribution amounts payable to Sukuk holders. The principal amount is covered through Albaraka Turk's obligations under the Murabaha agreement and the "asset sale and purchase undertaking" (key credit document). These obligations include the payment of the Murabaha deferred price--which consists of 49% of the proceeds of the issue of the certificates (the principal) plus the profit component of the deferred payment price--and the exercise price of the purchase undertaking (51% of the principal) around the scheduled maturity. These payments will be sufficient for the issuer's timely repayment of the Sukuk principal amount, and we therefore equalized the rating on the lease certificates with the long-term rating on Albaraka Turk. All of Albaraka Turk's obligations under the Murabaha contract and the purchase undertaking are unsubordinated and will rank pari passu with Albaraka Turk's other senior unsecured obligations. These contractual obligations also underpin the equalization of the Sukuk rating with that on Albaraka Turk.

The periodic distribution amount is covered by the fixed profit amount of the deferred payment price under the Murabaha agreement. This amount will be paid by Albaraka Turk under the Murabaha

contract one business day before the payment of each periodic distribution. The amount to be paid will be set in the final documentation, but, according to Albaraka Turk, it will exactly match the periodic distribution amounts due to Sukuk holders.

All of Albaraka Turk’s obligations under the Murabaha contract and the purchase undertaking are unconditional and unsubordinated, and will rank pari passu with Albaraka Turk’s other senior unsecured obligations.

Possible early dissolution events include a scenario where the issuer defaults on paying the periodic distribution amount and the default remains unresolved for 14 days. Under such a scenario, the Sukuk can be redeemed at the request of at least 25% of the holders of the principal outstanding. However, as periodic distribution amounts will be funded through payments from Albaraka Turk under the Murabaha agreement, this scenario could occur only upon a default of Albaraka Turk.

## Rationale

The preliminary ‘BB’ rating on the lease certificates reflects the rating on Albaraka Turk (BB/Negative/B), owing to the full credit enhancement mechanisms provided by Albaraka Turk on both the principal and the periodic distribution amounts. We note that the preliminary rating is based on draft documentation. Should final documentation differ substantially from the draft version or should the fixed profit amount under the Murabaha agreement not match the periodic distribution amount to Sukuk holders, we could consider a rating action on the Sukuk. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor’s neither structures transactions nor provides opinions with regard to compliance of the proposed transaction with Sharia.

**TABLE 1: TRANSACTION PROFILE**

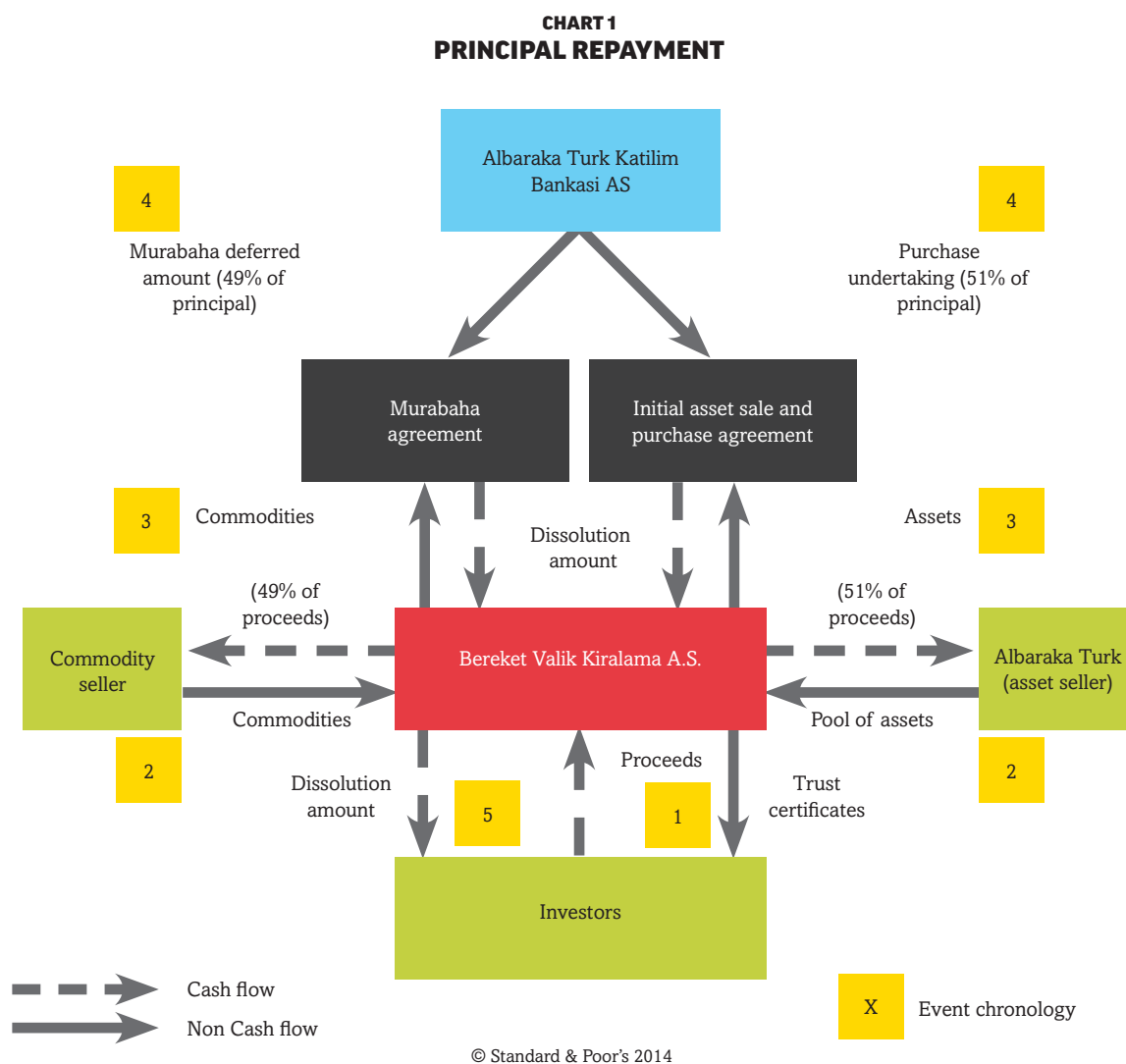
Issuer, buyer, and seller of the underlying assets	Bereket Varlik Kiralama A.S.
Obligor, buyer, and manager of the underlying assets	Albaraka Turk Katilim Bankasi AS
Periodic distribution rate	Fixed profit rate determined at the closing of the transaction
Trustee and representative	BNY Mellon Corporate Trustee Services Limited
Principal paying agent	The Bank of New York Mellon, London Branch
Governing law	English and Turkish law

The transaction involves an asset lease company incorporated in Turkey in accordance with Turkish laws for issuing rated Sukuk certificates (lease certificates, as defined in the documentation). The proceeds of the Sukuk will be used to acquire a pool of underlying assets including government sukuk, other eligible portfolio assets, and Sharia-compliant investments to be managed by Albaraka Turk in its capacity as managing agent. Upon closing of the transaction, the issuer will buy commodities assets from the market (49% of the proceeds, the first leg of the sukuk) and certain assets from Albaraka Turk (51% of the proceeds called thereafter “initial” assets, the second leg of the Sukuk). The issuer will subsequently enter into a simultaneous Murabaha and initial asset sale and purchase agreements with Albaraka Turk, pursuant to which the following is expected to occur:

- Under the Murabaha agreement, on or near the closing date, Bereket Varlik Kiralama (the “commodity seller”) will sell the commodities with a spot delivery, but on deferred payment terms, to Albaraka Turk (the “commodity purchaser”). According to the terms of the Murabaha agreement, Albaraka Turk irrevocably and unconditionally undertakes to pay the issuer, one business day prior to each periodic distribution date, an amount equal to the outstanding fixed profit amount of the deferred payment price. This amount to be paid will be set in the final documentation but, according to Albaraka Turk, will exactly match the periodic distribution amounts due to sukuk holders. The profit generated by the initial assets will be retained by Albaraka Turk (see chart 1).

## BANKS

- At the maturity date of the transaction, Albaraka Turk will pay the issuer the deferred principal amount under the Murabaha agreement. The amount will equal 49% of the Sukuk principal amount. At the same time, the initial assets will be sold to Albaraka Turk at face value (51% of the Sukuk principal amount) in accordance with the purchase undertaking. The execution of these two contracts will allow the issuer to receive 100% of the principal amount of the Sukuk that will be used to pay back the investors at the scheduled maturity or upon the occurrence of a dissolution event (see chart 2).

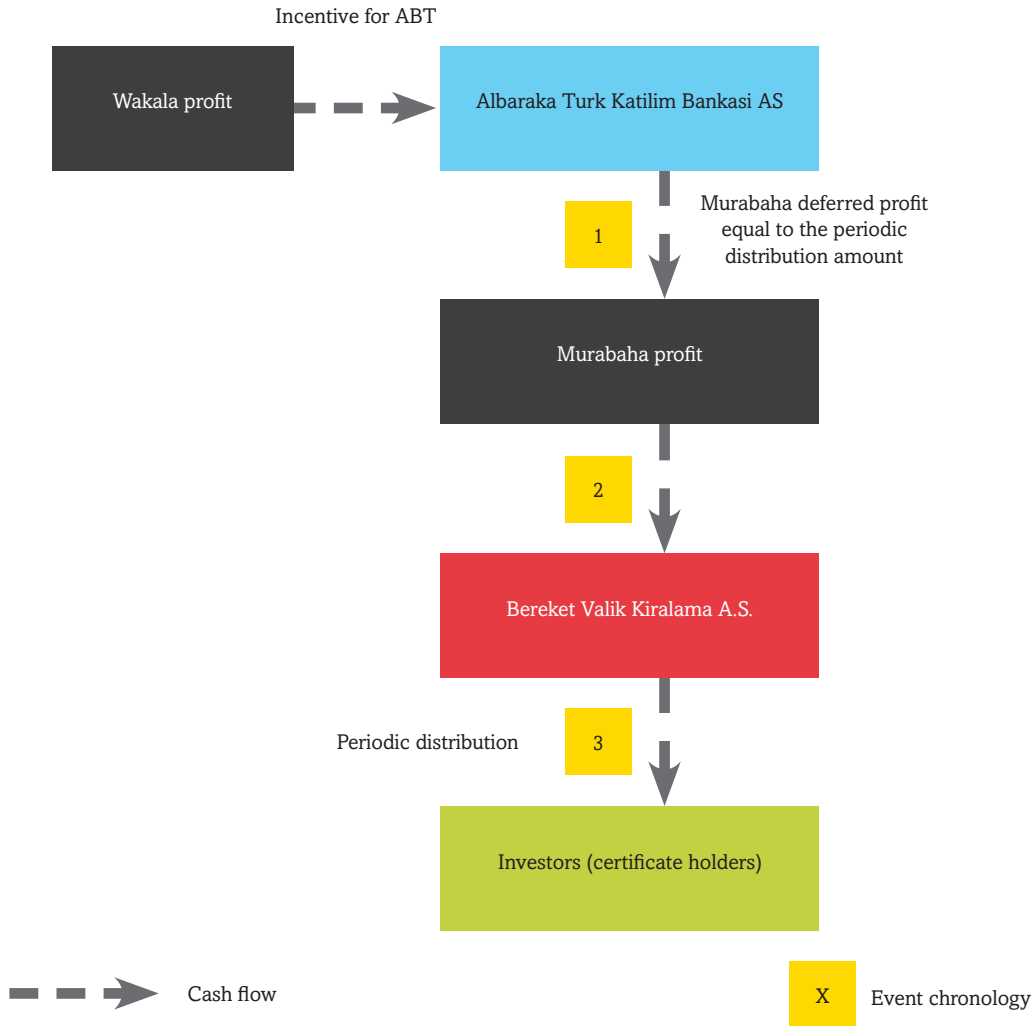


All of Albaraka Turk's obligations under the Murabaha contract and the purchase undertaking are unsubordinated and will rank pari passu with Albaraka Turk's other senior unsecured obligations. These contractual obligations underpin the equalization of the Sukuk rating with that of Albaraka Turk.

### Early Dissolution Events

Early dissolution events include a scenario where the issuer defaults on paying the periodic distribution amount and the default continues for 14 or more days. However, because periodic distribution amounts will be funded through payments from Albaraka Turk under the Murabaha agreement, this scenario would occur only if Albaraka Turk defaulted on its obligations.

**CHART 2  
PERIODIC DISTRIBUTION**



**Qualification As Sukuk With Full Credit Enhancement**

The proposed structure qualifies as Sukuk with full credit enhancement mechanisms under our criteria. The credit enhancement covers both the principal and the periodic distributions. The credit enhancement on the principal is covered by Albaraka Turk's commitment to buy back the initial assets at par value and pay the deferred payment price in accordance with the terms of the Murabaha agreement, which together make up the full principal amount. The amount of the periodic distribution amount is based on the issuer receiving the fixed profit amount under the Murabaha agreement, which would be sufficient to allow the issuer to honor its financial obligation toward Sukuk holders in a timely manner.

# HOW STANDARD & POOR'S RATES SHARIA-COMPLIANT INSURANCE AND REINSURANCE COMPANIES

Published: February 20, 2014

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In May 2013, Standard & Poor's Ratings Services introduced revised criteria that specify how we rate insurance and reinsurance companies worldwide. The aim is to improve the transparency and global consistency of our ratings methodology. This aim and our criteria also apply to our analysis of explicitly Sharia law-compliant takaful and Islamic cooperative (tawuni) insurers and reinsurers around the world. Although not specific to these sectors, our insurance criteria in our view appropriately capture the unique and varied features of takaful and Sharia-compliant cooperative company analysis. Here, we summarize our approach to rating takaful and tawuni under our insurance criteria, which we reference in the Related Criteria section at the end of this report.

It should be clearly understood that neither our ratings nor our analysis seek to assess Sharia-compliance as such. Our insurer financial strength ratings are a current opinion of the financial security characteristics of the ability of an insurance or reinsurance organization to pay under its policies and contracts in accordance with their terms. When we do consider Sharia-compliance, we regard the structure and mechanisms designed to achieve such compliance as essentially matters of management and governance. The religious context in which the company operates is not part of the credit rating decision.

**How We Determine The Anchor**

Under our revised insurance and reinsurance ratings criteria, we establish an analytic "anchor," which is a preliminary indication of the financial strength of a company under review based on our assessment of its fundamental business risk and financial risk profiles (see table 1).

TABLE 1: ANCHOR										
Financial risk profile										
Business risk profile	Extremely strong	Very strong	Strong	Moderately strong	Upper adequate	Lower adequate	Less than adequate	Weak	Very weak	Extremely weak
Excellent	aa+	aa	aa-	a+	a	a-	bbb+	bbb-	N/A	N/A
Very strong	aa	aa-	aa- or a+	a+ or a	a	a-	bbb	bb+	bb	N/A
Strong	a+	a+ or a	a or a-	a-	a-	bbb+	bbb	bb+	bb-	b+
Satisfactory	a or a-	a-	a-	bbb+	bbb+	bbb	bbb-	bb	bb-	b
Fair	bbb+	bbb+	bbb+ or bbb	bbb	bbb	bbb-	bb+	bb	b+	b
Vulnerable	bbb-	bbb-	bbb-	bb+	bb+	bb+	bb	bb-	b	b
Highly vulnerable	bb-	bb-	bb-	bb-	bb-	bb-	b+	b	b	b- or lower

Note: When outcomes in adjacent cells diverge by two or more notches, the anchor may be set one notch higher or lower based on relative business risk or financial risk strength or weakness within the cell or a trend in these risks. N/A--Not applicable. From: "Insurers: Rating Methodology," May 7, 2013.



### **Case in point: A mid-market takaful insurer**

Take the case of a hypothetical and, for illustration, a simple but well-managed and increasingly successful mid-market takaful insurer in Saudi Arabia. We would likely assess its business risk profile as “satisfactory,” resulting from our assessment of its competitive position as “adequate” and industry and country risk assessment as “intermediate,” which holds for all of the insurers we rate in the Kingdom.

Similarly, its financial risk profile may well be “lower adequate” when our risk-based capital model takes into account the company’s steadily growing book of underwritten risk exposure relative to a still depleted capital base. Like many other Saudi Arabia-based insurers today, our example company is still in its first five years of operation, and is only gradually rebuilding its capital base back toward the original, initial public offering level of SAR200 million, given initial start-up costs and early operational losses.

However, with its investments principally in cash or near-cash deposited in religiously acceptable funds across a number of strongly rated banks, we are likely to view the risk position as “intermediate.” Meanwhile, we are most likely to view financial flexibility as “adequate,” given our view of the company’s currently low needs for additional cash or capital, offset by its ability to improve solvency either by slowing the rate of business growth, or by ceding more risk to reinsurers. Over a somewhat longer timescale, there is also the possibility of raising additional capital from shareholders. As chart 1 shows, this combination of a satisfactory business risk profile and a lower adequate financial risk profile results in an anchor of ‘bbb’.

### **How We Apply Rating Modifiers**

This anchor assessment, which is derived in the same way for both conventional and Sharia-compliant companies, may then be adjusted upward or downward by twin analytic modifiers—enterprise risk management (ERM) and management and governance—to determine an indicative stand-alone credit profile (SACP). However, if the twin modifiers are judged to be neutral, then no modification occurs, and both the anchor and the indicative SACP will be set at the same level (see chart 1).

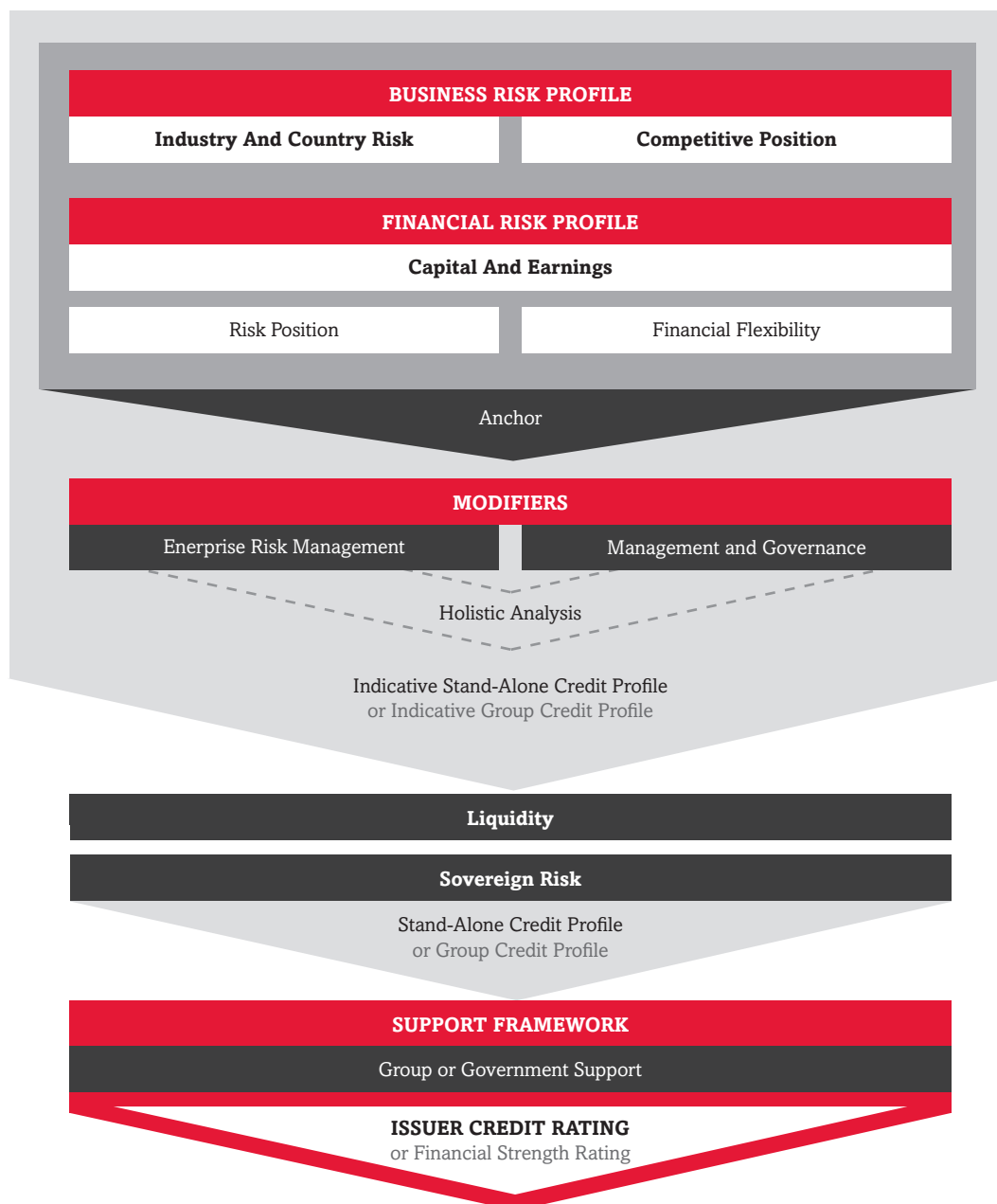
Continuing the example started above and proceeding through the flowchart, the anchor of ‘bbb’ would then be subject to our ERM and management and governance analysis, and then to what we term holistic analysis. Assuming that ERM is at least adequate (an outcome that is certain if both risk management culture and risk controls are assessed are at least adequate), and management and governance satisfactory, then absent a further adjustment based on holistic analysis, we set the indicative group credit profile (or SACP if this were a subsidiary company within a wider group) at ‘bbb’. Given this company’s cash-based investment strategies, liquidity is unlikely to be an issue, and the sovereign rating of Saudi Arabia at AA-/Positive/A-1+ is not a constraint. In this example, therefore, we would almost certainly assign a ‘BBB’ rating. We would also likely assign a stable outlook if we have no particular expectation of the business risk, financial risk, or other modifying factors changing over the upcoming two-year outlook period for an investment-grade rating.

### **Key Aspects Of Sharia Compliance Figure Into Our Management And Governance Analysis**

Clearly, there are important aspects of Sharia-compliance that our revised criteria may not directly address. These would include features such as the Sharia Board and its ethical oversight of a company’s products, investments, and other activities. Sharia-compliance may also include a degree of profit-sharing between policyholders and shareholders, and a nonconventional operating structure with, for example, separate operating and shareholder accounts, and various intra-account transfers such as “wakala” or “mudharaba” fees, or the “qard hasan” interest-free loan from shareholders to make up any deficit on the operating or policyholder account. Our approach to these features is to assess that they are working effectively and are not reducing financial strength. However, we would factor any perceived shortfalls in respect of these Sharia-related features into our assessment of management and governance. Even losses on the operating/policyholder account can be more a matter of management than of fundamental operating performance if

**CHART 1  
INSURANCE RATINGS FRAMEWORK**

To produce a long-term rating on an operating insurance company, Standard & Poor's assesses eight ratings factors, adjusts them in a holistic analysis, and assesses sovereign risk. Lastly, we analyze the potential for the insurer to benefit from extraordinary group or government support.



repeated deficits are largely the result of excessively high wakala (management) fees that create a loss on the operating account while generating profits on the shareholder account.

**We Acknowledge The Significance Of Sharia Compliance**

Analytically, we believe that the principal fundamentals of the creditworthiness of insurers and reinsurers are similar whether conventional, mutual, cooperative, or Sharia-compliant. Financial strength primarily

derives from sufficient solvency capital and liquidity relative to underwritten liabilities and ongoing risk exposure, and is also dependent over time on the establishment of a sustainable, non-loss-making competitive position and, often crucially, on effective management, risk management, and governance. Our revised criteria therefore tend to specifically address these factors.

While carrying out our analysis, we remain cognizant of the significance of Sharia-compliance in many of the world's markets, particularly in the Middle East and Asia. We are fully aware of the advantages that an ethical approach can bring in terms of reputation, access to certain classes of business (such as family takaful life business), and even, potentially, in the form of goodwill from the authorities if they are keen to see the development of a thriving Sharia-compliant insurance and reinsurance (retakaful) sector. Similarly, we also acknowledge the potential loss of reputation in what is often regarded as a confidence-sensitive industry were a Sharia-compliant company to fall significantly short of the standards that an effective Sharia Board would typically demand.

# GCC'S LOW INSURANCE PENETRATION GIVES MALAYSIA A HEADSTART IN ISLAMIC INSURANCE

Published: September 10, 2014

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In Malaysia, Sharia-compliant insurance, known as takaful, has become increasingly popular with investors, the policyholder community (takaful fund members), and the government. Malaysian takaful companies have developed a track record of generating profits in the form of fund surpluses, and of making distribution payments to members (also known as "hibah").

This stands in marked contrast with the performance and status of the takaful sector in the Gulf Cooperation Council (GCC) states, even though the Gulf is the largest takaful market. Takaful has not truly flourished in any of the six GCC states, even if we treat the Saudi market as wholly takaful. In the GCC, only five takaful companies in our portfolio of 16 generated fund surpluses in 2013, and none of the five were based in the largest GCC insurance market, the United Arab Emirates (UAE). No GCC takaful company paid hibah to fund members and overall shareholder funds declined for the sector in 2013.

Although there are many structural differences between the two insurance markets, Standard & Poor's Ratings Services considers insurance penetration (premiums/GDP) to be key to Malaysia's success. In addition, the Malaysian insurance market is dominated by life savings, a line of business that has hardly started to develop in the GCC region. In Malaysia, insurance penetration is four times higher than the average level in the GCC. Even if we compare non-life insurance penetration in Malaysia to the whole GCC market, Malaysians spend twice as much per capita on non-life risk protection as their peers in the GCC region.

## OVERVIEW

- The benefits of insurance are much more widely recognized in Malaysia than in the GCC region.
- Social and religious structures in the GCC countries have inhibited the use of insurance as a risk management tool, meaning that demand is largely driven by compulsory covers.
- The Malaysian market, by contrast, is dominated by life insurance and savings products, which are less risky and offer a more predictable and viable operational platform than non-life lines of business.

Takaful products offer a Sharia-compliant risk management solution by enabling fund members to share asset and personal risks on a mutual fund basis. While Standard & Poor's welcomes their spread across the Islamic world, there is no doubt that takaful has offered investors and fund members mixed success.

In comparing the GCC region and Malaysia, we have used aggregated data for nine takaful companies in Malaysia and 16 takaful companies in the GCC region. We consider the aggregated data from these

companies to be representative of each market. We used the annual results for each fund run by the companies to calculate results by fund year, and the annual results from each operator to give us results by operator year.

### **Acceptance Of Insurance Helps Both Conventional And Takaful Sectors To Grow**

Malaysia has proved more open to the benefits of insurance. Takaful companies both complement and compete with the conventional insurance sector, regardless of religious persuasion, and in 2013 the takaful sector there represented some 13% of total market premiums. Of the 45 insurance companies regulated by Bank Negara in 2013, 12 are classified as takaful and the overall performance of companies in this sector indicates that they perform in line with market averages.

By contrast, in the GCC countries, social and religious resistance to the use of insurance has shifted the focus to compulsory covers. By mandating the use of motor and medical insurance, especially to cover the large expatriate communities, GCC regulators have enforced the use of insurance, perhaps before the concept has been accepted locally.

Continued resistance to the concept of insurance has left the market dominated by compulsory lines of business and weakened by fierce price competition. Overall, performance in the GCC takaful sector remains poor.

### **Takaful Operators In The GCC Underperform Their Conventional Peers**

In the GCC, we estimate that the takaful sector generates little more than 10% of total market premiums. The sector is dominated by medical and motor insurance and the provision of life savings products is still undeveloped in the region. Fierce price competition makes it difficult for insurers, particularly smaller companies, to generate earnings. Because most takaful companies are small, their expense costs weigh on their profitability.

In the 2011-2013 period, takaful funds suffered a net deficit of 7% of net contributions (premiums) earned, on a deteriorating trend; similarly, we estimate deteriorating losses of over 2% on fund assets. Of the 48 takaful fund years in the GCC, only 19 (40%) produced any fund surpluses. In contrast, GCC operators' performances show a three-year return on equity of 6% and a return on assets of around 5% (before provisions for fund deficits). This compares unfavorably with the GCC's conventional insurance sector, where companies typically generate underwriting profits and stronger returns for investors. We estimate GCC conventional insurers generated an average return on equity of about 10% in 2011-2013.

### **Family Takaful Provides Malaysian Operators With Solid Business**

In Malaysia, takaful operators make up about 13% of the total insurance market. Including conventional insurers, life savings generate almost two-thirds of total market business; in the takaful sector, the dominance of life products is even more pronounced. Contributions to family takaful funds comprised over 75% of total takaful contributions in 2013.

In our view, family takaful is less risky and volatile than general (non-life) takaful products because typically fund members bear the investment risk of savings products, operators tend to assess the attaching morbidity/mortality risk prudentially, and the product attracts longer-term policyholder commitments. This provides operators with a more predictable and viable platform.

From 2011 to 2013, Malaysia's takaful funds achieved an average surplus of 32% of net premiums earned, and an 8% surplus on assets. Of 51 separate fund years in 2011-2013, covering life and

## INSURANCE

general business, fewer than 10% recorded any deficit. Of the five fund years with deficits, two were family fund years and three were general fund years. Malaysian operators achieved a 2011-2013 three-year average return on equity of 17% and an average return on assets of 12%. Of the 27 operator-years considered in this period, only six (22%) recorded a deficit. We consider the Malaysian takaful sector to be functionally and consistently profitable at both the fund and operator level.

### Malaysian Companies Also Benefit From Lower Capital Needs And Stronger Risk Positions

In our view, family takaful demands much less capital than general business risks, relative to net contributions. Family takaful has yet to develop in the GCC, in our view, but it exceeds 75% of total contributions in Malaysia. Malaysian operators therefore exhibit lower shareholders' funds to net contribution ratios than their GCC counterparts. Malaysian companies also generate and maintain fund surpluses, which further reinforce capital.

We have insufficient information to produce risk-adjusted capital models for all the companies we used to compare the two regions. Instead, we have calculated a simple solvency ratio (shareholder funds/net premium written) to act as an indicator. This ratio suggests that the GCC takaful companies, even after full provision for accumulated takaful fund deficits, hold higher capital levels per unit of net contribution than their Malaysian peers. Malaysian companies have an average solvency ratio below 100%, while GCC companies average about 200%. Trends in the ratio point to steady weakening of the solvency ratio strengths as premium (contribution) volume growth outpaces earnings growth (see table 1).

Family takaful businesses are asset-intensive. As a proxy for capitalization levels, we calculate the ratio of shareholders' funds to total assets. We find that Malaysian takaful operators exhibit gradually increasing capital levels to support growing asset size.

**TABLE 1: SOLVENCY TRENDS**

(%)	GCC			Malaysia		
	2013	2012	2011	2013	2012	2011
Total shareholders' funds/net premium written	147	189	203	47	39	38
Shareholders' funds/total assets				11.2	10	9.3

Risk positions in Malaysia also tend to be lower than in the GCC. The Malaysian regulator requires that takaful funds hold minimum levels of securely rated liquid assets. GCC takaful companies, by contrast, tend to hold more of their assets as equity and real estate. These more-risky assets can erode capital adequacy. GCC takaful companies' poorer underwriting performance track record also suggests that they have higher risk positions.

Risk positions in Malaysia also tend to be lower than in the GCC. The Malaysian regulator requires that takaful funds hold minimum levels of securely rated liquid assets. GCC takaful companies, by contrast, tend to hold more of their assets as equity and real estate. These more-risky assets can erode capital adequacy. GCC takaful companies' poorer underwriting performance track record also suggests that they have higher risk positions.

### Contrasting And Comparing Credit Strengths

We do not rate any of the Malaysian takaful companies. However, based on our high-level overview, we expect that the typical Malaysian operator has at least an adequate competitive position, sustainable

positive earnings, and adequate capitalization, suggesting that we could rate the company in the 'BBB' category or above.

Our ratings for GCC takaful companies cluster in the 'BB' to 'BBB-' range. In our opinion, although the sector benefits from its robust capitalization, this is offset by less-than-adequate competitive positions, weak earnings, and higher risk profiles.

### **Malaysia Is Likely To Lengthen Its Lead**

We see the future as positive for the takaful sector in Malaysia and across Asia generally. The significant regional focus on family business seems to offer a more predictable and sustainable business model, from which all stakeholders can benefit. Recent changes in Malaysian regulations require family and general businesses to be separated into different legal entities within five years. This entails holding separate minimum capital and could result in some consolidation within the general takaful space.

In the GCC we view prospects for the takaful sector as less certain, even allowing for disparities among the six member countries. In our opinion, the takaful sector will continue to grow more quickly than conventional insurance sector, but earnings will continue to be modest at best, for both members and operators. We view the GCC insurance sector as overpopulated and this has promoted fierce regional competition. Although policyholders may benefit in the short term, businesses need to generate profits to fund the demands of their growth. Takaful operators cannot attract new capital if they offer no rewards.

No takaful company in the GCC has a significant market share, but a few trade successfully and distribute surpluses to fund members. As in Malaysia, we consider market consolidation among GCC takaful companies to be a natural means of correcting earnings weaknesses, along with more robust pricing.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.



# **INSURANCE IN SAUDI ARABIA: THE PRICE WAR MAY BE OVER BUT THE FIGHT FOR MARKET SHARE CONTINUES**

Published: September 3, 2014

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Although competition to win large, prestigious corporate accounts remains intense, Standard & Poor's Ratings Services believes that the insurance price war that raged in Saudi Arabia during 2012-2013 has now largely ended. Anecdotal evidence suggests that market tariffs for the sector's principal lines of group medical and motor insurance have risen by an average of some 20% so far in 2014, and several companies have told us that policyholders have accepted price hikes of up to 40% on persistently loss-making accounts. Despite ongoing competitive pressures between the 34 local insurers in the sector, we expect these insurers to maintain today's stronger pricing into 2015 and beyond because the insurance regulator, Saudi Arabian Monetary Agency (SAMA), has taken a number of steps to encourage the maintenance of reasonable pricing and prudential reserving. (Watch the related CMTV segment titled "Insurance In Saudi Arabia In 2014," dated Sept. 10, 2014.)

After various more modest initiatives failed to turn the decline in tariffs around in 2013, SAMA ultimately dealt the price war a fatal blow by openly reminding the Kingdom's licensed consulting actuaries of their duty to ensure prudent reserving at the companies with which they work. This had an immediate effect as all Saudi Arabian insurers are obliged to have their reserves signed off by a consulting actuary, and external auditors cannot contest the actuaries' calculations. As a result, the 2013 year-end accounts at most Saudi Arabia-based insurers and reinsurers saw very significant reserve strengthening both in respect of incurred liabilities and the unexpired risk of insurance policies that were still in force, many of which appeared to be severely underpriced. SAMA has also recently implemented a requirement that new clients provide insurers with their claims history. When combined with the requirement to apply actuarial pricing, these changes should enable insurers and their actuaries (particularly those providing corporate medical insurance) to price risks based on the risk profile of individual customers and clients, rather than basing tariffs on market average data.

**OVERVIEW**

- Saudi Arabia's insurance regulator, SAMA, has largely succeeded in stopping the local insurance price war of 2012-2013.
  - It has achieved this by indirectly obliging insurers to strengthen their technical reserves and by insisting upon "actuarial pricing" for new business written.
  - Reserve strengthening led to significant reported losses at most insurers in 2013 and some 15 companies are now having to recapitalize. However, we expect the sector's main players to maintain the technical profitability they have already regained in 2014.
-



We believe the enforcement of actuarial pricing by external consulting actuaries will allow larger insurers to factor their economies of scale into premium quotations. Their generally lower overall expense ratios (expenses as a percentage of premium income) should permit large, cost-effective companies to apply actuarial pricing that is below the rate calculated as appropriate for smaller peers that have higher fixed costs relative to turnover. We therefore expect expense control to become just as important to most insurance management teams as market share has been in the recent past.

**TABLE 1: SAUDI ARABIA INSURANCE AND REINSURANCE:  
SIX MONTHS' CUMULATIVE TO JUNE 30, 2014, BY 2013 GPW**

(Mil. SAR)	Shareholders' funds	GPW	Market share (%)	Comp. Net Inc.
Tawuniya	1,821.0	2,972.1	19.5	180.4
MedGulf Coop.	1,091.4	2,482.5	16.3	95.5
BUPA Arabia	747.9	2,798.2	18.3	36.8
United Coop. Ass. (UCA)	219.2	580.5	3.8	(17.0)
Trade Union Coop.	257.9	412.0	2.7	(10.0)
AXA Coop.	201.6	497.8	3.3	10.1
Malath	277.7	575.5	3.8	(13.3)
Allianz S.F. Coop.	169.7	402.7	2.6	(3.1)
Al Rajhi Coop.	102.0	519.1	3.4	15.5
SAICO Coop.	58.8	422.1	2.8	7.0
Arabia Coop.	52.5	275.2	1.8	(11.5)
Wataniya Ins. (BBB/Stable)	56.4	246.6	1.6	(1.6)
Gulf Union Coop.	117.8	228.4	1.5	(7.8)
Khaleeji/Gulf Gen.	188.6	251.9	1.7	3.1
Weqaya Takaful	(no figures released)			
Wala'a (Saudi United)	185.1	356.7	2.3	(21.7)
ACIG Coop.	106.4	132.2	0.9	4.1
Al Alamiya Coop.	86.3	149.0	1.0	(26.0)
Arabian Shield Coop.	238.3	281.3	1.8	1.5
Buruj Coop.	73.6	210.5	1.4	3.1
Al Sagr Coop.	326.8	127.4	0.8	5.7
ACE Arabia Coop.	173.8	148.1	1.0	(0.3)
Sanad Coop.	46.6	109.1	0.7	(22.7)
Al Ahlia Coop.	25.6	143.6	0.9	(0.3)
Salama Coop.	31.3	182.0	1.2	4.1
SABB Takaful	349.3	95.7	0.6	3.4
Solidarity Takaful	296.9	74.8	0.5	(45.0)
Waf'a (S. Indian)	27.2	120.8	0.8	(2.4)
Al Ahli Takaful	149.6	127.7	0.8	10.0
Amana Coop.	174.1	251.8	1.6	(32.1)
Alinma-Tokio Marine	102.0	56.6	0.4	(16.8)
Saudi Enaya Coop.	274.8	25.3	0.2	(24.7)
Al Jazira Takaful Ta'awuni	349.1	4.9	0.0	0.7
MetLife AIG ANB	136.0	1.0	0.0	(11.5)
TOTAL INSURANCE	8,515.3	15,263.1	100.0	113.2
Saudi Re	829.9	390.4	-	(10.9)
TOTAL INS. & REINS.	9,345.2	15,653.5	-	102.3

Source: Company interim accounts published on Tadawul Web site. SAR--Saudi riyal. Comp Net. Inc.--Comprehensive net income. GPW--Gross premium written.

## INSURANCE

### **The Recovery May Be Stronger Than Current Figures Suggest**

So far in 2014, motor insurance appears to have experienced the strongest recovery, but pricing in medical insurance is also significantly improving. Only the larger corporate accounts still achieve the best terms when purchasing group medical cover. However, we do not think the already-improved first-half results shown in Table 1 fully reflect the extent of the recovery that is currently occurring.

Now that the regulatory insistence upon prudent actuarial pricing and reserving has made it difficult for local companies to compete almost purely on exceptionally low tariffs, we expect insurers to seek to differentiate themselves through a greater emphasis on quality of service, the design and range of products offered and, perhaps more controversially, their willingness to defer previously up-front premium payments to later and later in the contract life. This latter tactic risks exacerbating the accounting impact of an existing regulatory requirement whereby insurers must provision as a bad and doubtful debt any premium not received within 90 days of policy inception, even when a company has little or no reason to believe that the premium will not eventually be paid. This requirement inflates provisions and so deflates reported earnings until such a time as the receipt of the deferred premium allows the provision to be released. However, in a time of rapid premium growth--such as that currently prevailing in Saudi Arabia--the increase in provisions on new business will tend to outstrip the release of provisions, thereby leading to a prolonged phase of understated earnings.

In addition, the widespread and often substantial reserve strengthening of late 2013 may also be distorting the insurance sector's 2014 results (see "Saudi Arabian Insurers' Reserve Strengthening Indicates Weaker Results For 2013, But Improvement Is Likely This Year," published on RatingsDirect on Jan. 24, 2014). If, as many insurers still maintain, a sizable proportion of the extra reserving that external actuaries demanded was overly prudent, then we may well see reserve releases boosting the third- and fourth-quarter results for 2014. Indeed, some insurers are already tentatively starting to release a part of the additional reserves they set aside last year. However, other companies that anticipate strong results on their 2014 underwriting account have indicated to us that they may opt to deliberately maintain a degree of over-reserving. This would enable them to create a hidden reserve for future use, notably as a smoothing mechanism against the effects of any above-average losses incurred in future years.

Some weaker companies apart, we therefore anticipate that, on average across the Saudi Arabian insurance sector, the underlying economic reality may be that the market recovery is even stronger than current interim and even year-end 2014 results may suggest.

### **Our Conclusion On Measures To Restore The Sector**

On the whole, we anticipate that the Saudi Arabia insurance sector will see a sustained return to both technical underwriting and overall profitability, with recent tariff increases proving sufficient to more than offset the effects of ongoing over-provisioning. This implies that SAMA's intervention to restore prudence across the sector in 2013 will have ultimately proved successful. That said, the consulting actuaries' sudden shift to extreme prudence may in a number of cases have almost killed the client; some 15 insurers are currently proposing rights issues to raise new capital to bring their shareholders' funds back above the regulatory minima of SAR (Saudi riyal) 100 million (US\$26.7 million) for primary insurers and at least SAR200 million for insurers that also hold a license to write inward reinsurance.

In our view, some questions still remain:

- Will regulators and actuaries continue to enforce pricing and actuarial conservatism, or will they allow an eventual renewal of the price war?
- Will SAMA take advantage of the current hiatus in the market to promote merger and acquisition within Saudi Arabia's still somewhat overcrowded insurance sector?

We consider it extremely unlikely that SAMA will allow a general return to soft pricing, and we therefore expect the sector to report satisfactory technical underwriting profits through to 2016 and even beyond. On average, we anticipate that net combined ratios (claims and expenses as a percentage of premiums) will typically be about 95%, and could be consistently better at some companies. Meanwhile, having delegated formal responsibility for ensuring appropriate reserving and accounting to licensed actuaries and auditors, the implicit threat of censure from the regulator should prove sufficient to ensure that practitioners from both professions seek to maintain high standards, even without explicit intervention by the regulator.

For the sector's smaller insurance companies, the only sustainable way to achieve and maintain economies of scale may prove to be eventual merger with competitors to increase combined revenues and thereby dilute their expense ratios. However, in the well-regulated context of the Saudi Arabian insurance sector, we do not expect to see overt examples of corporate collapse. That said, SAMA representatives have several times publicly indicated that, in their view, 34 locally incorporated insurance companies is too many. This is why SAMA has issued no new insurance licenses, and we consider it possible that the authorities could put pressure on senior management teams and on core shareholder groups to merge.

### **Concentration Is Still A Problem**

Although year-on-year growth in most non-life lines of business is strong, the sector's premium volumes--both gross and net of reinsurance--remain highly concentrated in the compulsory lines of business: group medical and motor. These two lines represent 76.3% of the gross total (see table 2). They also represent 90.5% of the SAR19.2 billion of net premium written in 2013.

The figures in Table 2 also highlight some additional features of the Saudi Arabian insurance market over the past few years:

- Life-related protection and savings premiums remain very modest, at just 3.3% of the sector's total premium income, and declined in both percentage and absolute terms in 2013.
- Retained risk on commercial and industrial lines business remains relatively low.
- Net loss ratios were already rising in 2012 as the price war started. The significant increase in loss ratios in 2013 reflects the impact of the price war and--particularly for medical, motor, and engineering--the actuarially driven reserve-strengthening exercise that took place at year-end.

In addition to the above, an unprecedented series of large industrial and commercial fire losses across Saudi Arabia has also caused a considerable increase in the 2013 loss ratio for fire (property) cover. The fires severely affected the results of certain insurers and reinsurers but, so far in 2014, we have not seen any continuation of these large losses.

### **How Do These Trends Affect Our Ratings?**

The trends and issues we've observed inform our ratings analysis for individual Saudi Arabian insurers and reinsurers. When we published our article, "Saudi Arabian Insurers' Reserve Strengthening Indicates Weaker Results For 2013, But Improvement Is Likely This Year," on Jan. 24, 2014, we already anticipated the disappointing results for 2013 and their effect on shareholders' funds that are clearly apparent in Table 3 below. We similarly expected much-improved overall profitability in 2014, even if specific companies may continue to suffer. Because our analysis is forward-looking, our ratings give greater weight to the expected sustainable improvement in earnings in 2014 and beyond than to the effects of the losses in 2013, which we consider to be temporary, in most cases.

## INSURANCE

**TABLE 2: KSA INSURANCE: GROSS PREMIUM WRITTEN, BY LINE OF BUSINESS, 2011-2013**

(%)	2011 (Mil.SAR)	% of total	2012 (Mil.SAR)	% of total	2013 (Mil.SAR)	% of total	2013 growth	2013 retention ratio	2012 net loss ratio	2013 net loss ratio
Medical	9,708	52.5	11,285	53.3	12,895	51.1	14.3	88.8	81.4	94.1
Motor	3,922	21.2	4,689	22.1	6,355	25.2	35.5	93.9	78.5	96.9
Fire	1,157	6.3	1,348	6.4	1,665	6.6	23.5	16.9	50.5	113.8
Engineering	913	4.9	1,077	5.1	1,200	4.8	11.4	15.0	31.0	56.1
Accident and liability and other	632	3.4	691	3.3	941	3.7	36.2	41.6	25.3	29.2
Marine	634	3.4	743	3.5	740	2.9	(0.4)	32.7	41.8	44.6
Energy	361	2.0	385	1.8	456	1.8	18.4	1.8	9.3	17.5
Aviation	272	1.5	67	0.3	144	0.6	114.9	2.8	22.0	26.4
Total non-life	17,599	95.1	20,285	95.8	24,396	96.7	20.3	76.0	77.6	92.9
Life protection and savings	905	4.9	889	4.2	845	3.3	(4.9)	84.5	-	-
Grand total	18,504	100.0	21,174	100.0	25,241	100.0	19.2	76.2	-	-

Source: The Saudi Insurance Market Report, 2013, published by SAMA, June 2014. SAR--Saudi riyal.

Therefore, we did not change any of our ratings on Saudi Arabia-based insurers in 2014, although we revised some outlooks to negative, where company-specific concerns existed. We expect our ratings to remain generally stable, principally based on positive capital and earnings trends, reinforced in certain cases by explicit capital increases.

**TABLE 3: KSA INSURANCE AND REINSURANCE, 2011-2013 (TABLE RANKED BY 2013 GROSS PREMIUMS)**

(Mil. SAR)	--Shareholders' funds--			--Gross premium written--			--Market share (%)--	--Comprehensive net-- income--		
	2013	2012	2011	2013	2012	2011	2013	2013	2012	2011
Tawuniya	1,640.6	2,142.9	2,048.9	5,605.0	5,634.7	4,431.2	22.8	(501.2)	358.0	432.0
MedGulf Coop.	995.9	1,186.2	1,173.5	4,137.5	3,318.0	2,811.1	16.8	(192.5)	201.3	204.9
BUPA Arabia	767.1	634.0	526.5	3,177.5	2,194.3	1,993.3	12.9	132.9	113.9	29.6
United Coop. Ass.	236.0	319.9	317.6	1,293.0	1,024.1	1,069.0	5.3	(83.5)	22.4	42.5
Trade Union Coop.	270.0	312.3	294.5	877.2	560.8	538.1	3.6	(42.4)	26.5	17.9
AXA Coop.	191.4	180.4	170.8	775.6	460.5	427.8	3.1	11.0	9.6	(12.7)
Malath Coop.	291.0	322.5	280.5	770.9	558.1	600.9	3.1	(31.6)	42.0	17.9
Allianz S.F. Coop.	172.9	166.9	158.0	745.9	621.2	683.7	3.0	6.0	8.9	(0.4)
Al Rajhi Coop.	86.5	108.8	109.3	689.7	600.9	493.3	2.8	(22.3)	(0.6)	(32.9)
SAICO Coop.	51.7	78.7	64.4	623.9	567.9	548.4	2.5	(27.0)	14.3	(7.8)
Arabia Coop.	64.0	167.1	173.8	586.3	653.9	565.1	2.4	(101.8)	(2.9)	13.3
Wataniya Ins. Co.	58.0	91.9	83.4	486.8	363.9	322.6	2.0	(33.3)	10.9	(12.0)
Gulf Union Coop.	125.6	154.9	149.1	387.5	417.5	328.8	1.6	(29.2)	5.7	(63.0)
Khaleeji/Gulf Gen.	185.5	179.6	168.9	370.1	370.6	877.8	1.5	5.9	10.7	(28.1)
Weqaya Takaful	39.9	130.6	116.8	351.0	286.6	110.1	1.4	(90.7)	13.8	(40.3)
Wala'a (Saudi United)	206.8	175.1	154.5	347.2	234.1	278.6	1.4	31.6	20.7	4.4
ACIG Coop.	102.3	89.9	19.1	347.0	186.8	168.4	1.4	12.3	(23.4)	(10.5)
Arabian Shield	236.8	234.6	230.6	333.3	331.5	274.2	1.4	2.2	4.1	11.2
Al Alamiya Coop.	113.1	137.4	136.3	330.9	248.1	227.9	1.3	(24.3)	0.7	(21.2)
Buruj Coop.	70.5	67.2	85.1	279.3	233.5	103.8	1.1	3.3	(17.9)	(15.9)
Al Sagr Coop.	334.0	282.7	254.9	263.1	327.2	234.7	1.1	50.6	28.1	32.0
ACE Arabia Coop.	174.1	162.5	140.9	249.1	208.6	224.7	1.0	11.6	21.6	13.2
Sanad Coop.	69.2	106.1	107.1	228.0	182.3	231.3	0.9	(36.9)	(1.0)	(27.7)
Al Ahlia Coop.	26.0	44.5	32.7	219.4	235.6	257.7	0.9	(18.5)	11.8	(5.1)
Salama Coop.	27.2	69.0	85.0	218.3	204.3	218.7	0.9	(41.8)	(16.0)	2.5
SABB Takaful	344.6	334.4	326.2	207.2	222.6	267.9	0.8	10.2	8.6	5.7
Solidarity Takaful	341.9	432.9	470.7	204.6	26.3	0.1	0.8	(91.0)	(37.8)	(84.3)
Waf'a (S. Indian)	29.5	35.4	51.1	196.9	162.5	93.9	0.8	(6.6)	(15.7)	(2.3)
Al Ahli Takaful	139.6	134.4	135.6	140.2	153.5	188.0	0.6	5.3	(1.2)	(5.8)
Amana Coop.	206.2	218.0	254.5	83.4	54.1	289.8	0.3	(11.8)	(36.5)	(65.5)
Alinma-Tokio Marine	118.8	152.0	-	50.9	0.3	-	0.2	(33.2)	(42.1)	-
Saudi Enaya Coop.	299.6	356.1	-	49.7	-	-	0.2	(57.0)	(36.9)	-
Al Jazira Takaful Ta'awuni	348.4	-	-	-	-	-	-	2.9	-	-
MetLife AIG ANB	147.1	-	-	-	-	-	-	(18.1)	-	-
<b>TOTAL INSURANCE</b>	<b>8,511.8</b>	<b>9,208.8</b>	<b>8,320.3</b>	<b>24,626.4</b>	<b>20,644.3</b>	<b>18,860.9</b>	<b>100.0</b>	<b>(1,208.7)</b>	<b>701.7</b>	<b>391.6</b>
Saudi Re	821.8	939.0	930.0	420.1	245.0	159.6	-	(117.2)	9.0	(54.4)
<b>TOTAL INS. &amp; REINS.</b>	<b>9,333.6</b>	<b>10,147.8</b>	<b>9,250.3</b>	<b>25,046.4</b>	<b>20,889.3</b>	<b>19,020.5</b>	<b>-</b>	<b>(1,325.9)</b>	<b>710.6</b>	<b>337.2</b>

NOTE: The combined total of figures published by individual insurers do not exactly reconcile with the total market statistics published by SAMA; Shareholders' funds before dividend distribution. Source for this table: Company audited accounts. SAR--Saudi riyal.

# **WHY CORPORATE AND INFRASTRUCTURE SUKUK ISSUANCE IS DECLINING, DESPITE HEALTHY PROSPECTS**

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Issuance of corporate and infrastructure sukuk (securities that conform with Islamic law) has trended downward this year in the Gulf region and Malaysia, despite continued supportive market conditions such as low interest rates and appetite from investors looking to put Islamic assets on their book. Issuance in the Gulf Cooperation Council (GCC) fell 33% in the first eight months of the year to Aug. 31, 2014, on the same period of 2013, to US\$6.5 billion (see chart 1). Performance was somewhat better in Malaysia, the largest market for corporate and infrastructure sukuk, declining about 7% over the same period. By contrast, total sukuk issuance—including from financial institutions and sovereigns—performed far better, growing by 19% in the GCC and by 6% in Malaysia over the same period.

Standard & Poor's Ratings Services attributes much of the drop in corporate and infrastructure sukuk to cheap and ample bank liquidity, which has made issuers less reliant on the capital markets. However, these entities' refinancing needs are set to rise substantially over the next two years, which could trigger an increase in sukuk issuance in 2015-2017.

## **OVERVIEW**

- Issuance of corporate and infrastructure sukuk has fallen short of our expectations this year in the Gulf Cooperation Council (GCC) and Malaysia, dropping 33% and 7%, respectively, in the first eight months of 2014 on the comparable period of 2013.
- By contrast, total sukuk issuance (including financial institutions and sovereigns) grew by 19% in the GCC and by 6% in Malaysia over the same period.
- We attribute the decline in corporate and infrastructure sukuk in large part to cheap and ample bank liquidity, the small pool of sukuk issuers, and seasonal factors, such as the early Ramadan this year.
- We nevertheless believe corporate and infrastructure sukuk issuance will increase again over the next few years as companies' refinancing needs grow and as entities establish themselves as sukuk issuers.

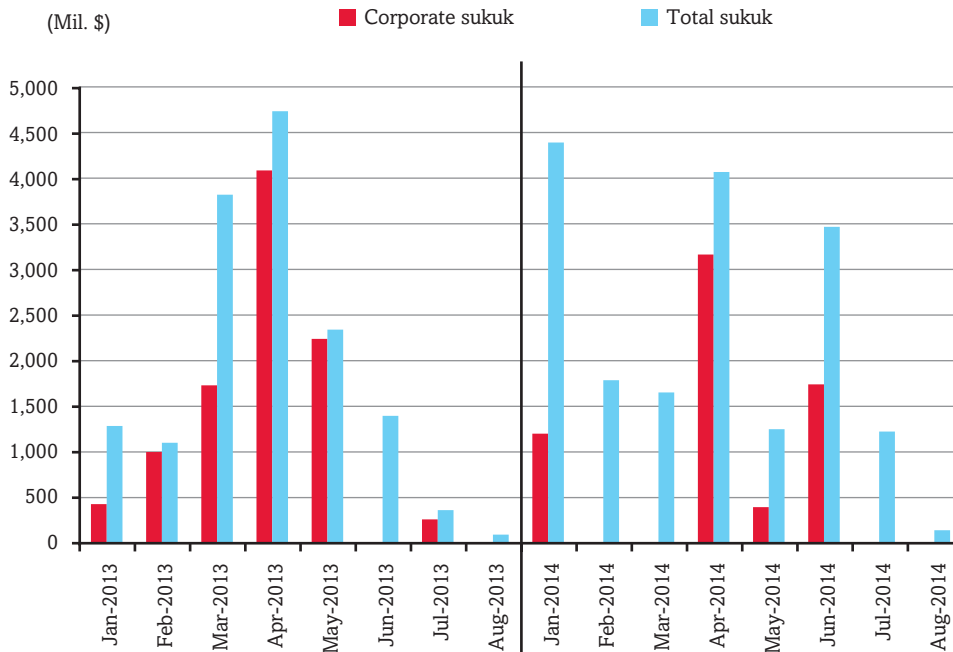
## **What's Behind The Decline?**

We attribute the disappointing performance of the corporate and infrastructure sectors compared with total issuance (including financial institutions and sovereigns) to several factors:

### **The small number of corporate and infrastructure entities that currently issue sukuk in the GCC and Asia.**

The small pool means that if even a few key issuers have no compelling need to tap the capital markets

**CHART 1  
GCC TOTAL SUKUK ISSUANCE VERSUS CORPORATE SUKUK ISSUANCE\***



\*January-August 2014 and January-August 2014. Source: Zawya and S&P.

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in a given year or have refinanced or redeemed debt in recent years, the resulting pullback in issuance can have a big impact on overall volumes. For example, the Dubai Electricity and Water Authority (DEWA) and Sadara Chemical Co. contributed significantly to corporate and infrastructure sukuk issuance in the GCC in 2013 but have issued no new capital market debt in 2014.

**The continued abundant supply of bank liquidity and low prevailing interest rates.**

Low-priced bank debt continues to be an attractive option for issuers in the GCC and Malaysia relative to the capital markets. According to various market sources, loans as a proportion of total GCC funding have increased from just under 50% in 2012 to just over 60% of total funding in 2014. We've also observed that corporate and infrastructure issuers are increasingly turning to conventional issuance over sukuk, based on the issuance levels in the second and third quarters this year relative to levels in the fourth quarter of 2013, when sukuk predominated. For example, corporate and infrastructure sukuk issuance has decreased to \$6.5 billion so far this year, while corporate bond issuance has increased by approximately the same amount. We note that possible reasons for the switch could be that the bond market remains relatively more established than the sukuk market beyond a certain size and tenor of issuance, although trends will become clearer when full-year data to Dec. 31, 2014, becomes available.

**Seasonal factors.**

Ramadan, which came early in the third quarter this year, is typically a period of quieter activity in the GCC capital markets, and its timing may have been a factor in the lull.

In light of these factors, this year-on-year snapshot of corporate and infrastructure sukuk issuance trends may not be an accurate reflection of appetite for the instrument, in our view. We continue to

## CORPORATE / INFRASTRUCTURE

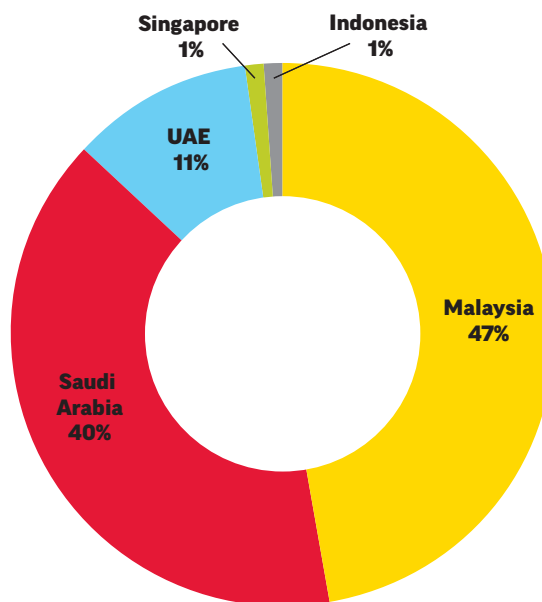
believe that corporate and infrastructure issuance in the GCC and Malaysia will expand to ultimately mirror the degree of issuance and evolution of the capital markets at large.

### Despite The Hiccup This Year, The Market Will Likely Keep Growing

We expect that if conditions remain broadly conducive to the development of the capital markets, prospects for greater issuance and more diversity in corporate and infrastructure issuance across entities will grow as well. We've observed, for example, that certain corporate and infrastructure issuers have established a successful presence in the sukuk market and are coming back with second, third, and fourth issuances, each at compellingly low rates relative to the initial issuance. Examples in the GCC include Saudi Electricity Co., Majid Al Futtaim, and real estate firms Aldar, Dar Al Arkan, and Emaar. The bulk of corporate and infrastructure sukuk issuance is in Malaysia and Saudi Arabia (see chart 2).

By our estimates, approximately \$17 billion of sukuk in the GCC (across all sectors) will mature between July 2014 and December 2016, which is equivalent to 65% of primary issuance in the year to Dec. 31, 2013. The resulting refinancing needs could also boost sukuk issuance by corporate and infrastructure entities over this period.

**CHART 2**  
**BREAKDOWN OF CORPORATE AND INFRASTRUCTURE SUKUK ISSUANCE BY TOP FIVE ISSUING COUNTRIES (FIRST EIGHT MONTHS 2014)**



Source: Zawya, S&P.

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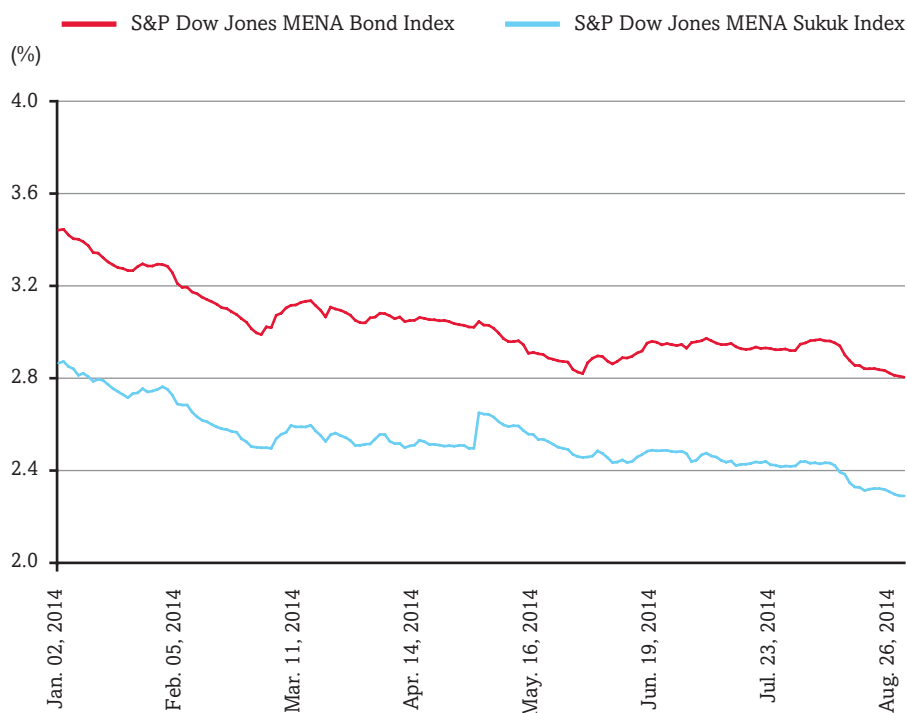
The growing volumes of sukuk issuance across all sectors (including financial institutions and sovereigns) in the GCC and Malaysia continue to reflect, in our view, favorable market conditions overall for this asset class, including:



**Low interest and profit rates.**

The S&P Dow Jones MENA Sukuk Index and MENA Bond Index fell to 2.3% and 2.8%, respectively, at the end of August 2014, from 2.88% and 3.34% on Dec. 31, 2013 (see chart 3). That said, the U.S. Federal Reserve's tapering of quantitative easing could affect interest rates over the coming year, in turn affecting GCC and Malaysian sukuk yields.

**CHART 3  
YIELD TO MATURITY--STANDARD & POOR'S MENA SUKUK AND BOND INDEX**



Source: Standard & Poor's.

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**Sustained healthy commodity prices.**

We expect oil prices to average above \$95 per barrel (for Brent crude) over the next three years and beyond. Healthy oil prices will support GCC countries' infrastructure expansion programs, which in turn we expect to be supported in part by capital market offerings, including sukuk.

**Robust economic growth conditions.**

We anticipate about 5% GDP growth on average across the GCC in 2014. Malaysia has also witnessed a slight pickup in economic growth during 2014, and we expect Malaysian GDP growth to average 5.5% for fiscal 2015 and 2016. Healthy economic growth would likely encourage the GCC and Malaysia to push forward with infrastructure spending, so supporting further capital market issuance.

**Continued infrastructure needs across the GCC and Asia.**

Infrastructure plans include much-needed investments in power and water systems and expansion related to events such as the FIFA World Cup in Qatar in 2020. The Asian Development Bank projects that national infrastructure investment needs are \$8 trillion over the 2010-2020 period, or \$730 billion

## CORPORATE / INFRASTRUCTURE

per year. India and Indonesia have some of the largest infrastructure development plans in the region, and China plans to spend about 9% of its GDP, on average, on infrastructure.

### **Rising government issuance.**

Although corporate and infrastructure issuance has faltered so far this year, a healthy increase in government and financial institution issuance has more than compensated for the drop. Government issuance in particular has risen substantially in the GCC, with countries such as Dubai and Qatar tapping the market more demonstrably. Meanwhile, government issuance accounts for about 71% of sukuk volumes in Malaysia. Dubai, in particular, has led the way by establishing the Dubai Islamic Economy Development Centre in December 2013. The Centre's key objectives include promoting Dubai regionally and globally as a hub for shariah-compliant goods and financial and nonfinancial services, building a database on Islamic economic activities, and encouraging recourse to arbitration in disputes related to Islamic economic activities. The Qatari market for local currency-denominated sukuk was supported by the recent issuances conducted in the past year and the Qatar Exchange's initiatives to promote a domestic fixed-income market.

### **Innovation.**

Corporate and infrastructure issuers have yet to fully exploit innovations such as hybrid sukuk instruments (with the exception of entities such as food and beverage producer Almarai in the GCC). However, a number of banks, including Abu Dhabi Islamic Bank and Dubai Islamic Bank, have explored this product and used it to increase their capitalization--particularly to prepare for Basel III capital adequacy requirements. In addition, issuers across all sectors have continued to push the term boundaries on sukuk, with a few notable issuers, such as Saudi Electricity Co. and the Dubai government, issuing their longest-dated bonds ever this year, with 30-year and 15-year terms, respectively.

### **Healthy dollarization levels in the GCC.**

Although the Far East markets have shown a shift toward further local currency issuance (with negligible issuance in any currency other than Malaysian Ringgit according to latest data for the year to August 2014), the GCC dollarization component of the market remains robust at about 66% of total issuance across the corporate and infrastructure sectors. The latter reflects the importance, particularly for GCC issuers, of engaging international markets as subscribers to sukuk issues. Frequent sukuk issuers, such as Saudi Electricity Co., have now successfully issued under the SEC's Rule 144A, which allows foreign entities to sell certain securities to U.S. investors, for two years running. This has helped internationalize the end market for GCC sukuk issuance. The Malaysian market, by contrast, has relied less on international subscription, and local currency issuance has been sufficient to meet the needs of the market amid economic uncertainties in emerging markets.

We expect issuance volumes to remain Malaysian Ringgit-based in the near future given that the Ringgit's liquidity in the Malaysian banking system remains healthy and funding costs attractive. However, we believe Malaysia's central bank may raise its overnight policy rate (OPR) from 3.0% to 3.5% in 2014 to combat inflation. This may push the interest rates for corporate issuers and boost issuance U.S. dollar sukuk issuance.

### **What's Ahead For Sukuk Issuance?**

We believe demand for sukuk across all sectors is likely to continue growing in the Gulf over the long term at similar rates observed over the first eight months of this year. We also believe there will be 8%-10% growth in Malaysia's sukuk market across all sectors over the period 2014-2015, absent any significant volatility in interest rates. This will likely be driven primarily by the Malaysian government's plans to attract \$450 billion of new investment under its Economic Transformation Program. Added to this, we expect that the higher-rated corporations and banks will look to refinance and extend maturities. Palm oil producers will be one of the growth drivers of sukuk issuance in the region, in our view.

Regulatory support will be important for the market as well. As we examined in our published Jan. 13, 2014, in November 2013, the UAE Central Bank tightened the lending caps for banks while allowing for exemptions in certain rated bonds and sukuk. We generally believe this will support the issuance in the UAE over the medium term.

In contrast, we think corporate and infrastructure issuance is likely to remain volatile and difficult to predict. It will likely remain largely a function of the specific needs of the corporate and infrastructure entities that comprise the pool of sukuk issuers in the GCC and Malaysia. We also think that absent important government strategies to promote sukuk, corporate and infrastructure issuers will remain relatively comfortable switching back and forth between sukuk and conventional issuance as the prevailing conditions change, especially regarding pricing and maturity terms. That said, we believe that certain factors support an improvement in corporate and infrastructure sukuk issuance, such as companies' growing capital market refinancing needs (in particular in the GCC) over the next few years and as entities establish themselves as sukuk issuers.

Continued high levels of bank liquidity and uncertainty among investors about compliance standards related to sukuk continue to hold back growth of the corporate and infrastructure sukuk market, in our view. In addition, the creation of local (or perhaps regional) institutional investment frameworks--for example, to enable pension or insurance funds to invest in sukuk--would go some way, we believe, toward creating a deeper and more liquid sukuk market.

# **SAUDI ELECTRICITY GLOBAL SUKUK CO. 3 PROPOSED TRUST CERTIFICATES ASSIGNED 'AA-' RATING**

Published: March 24, 2014

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DUBAI (Standard & Poor's) March 24, 2014--Standard & Poor's Ratings Services today assigned its 'AA-' issue rating to the proposed ijara trust certificates to be launched by Saudi Electricity Global SUKUK Co. 3, a special-purpose vehicle incorporated in the Cayman Islands.

These proposed trust certificates benefit from a purchase undertaking provided by Saudi Electric Co. (SEC; AA-/Positive/--) that is designed to return principal and accrued periodic distribution payments in a timely manner and to redeem the full value of the certificates at maturity. We equalize the rating on the proposed trust certificates with our long-term corporate credit rating on SEC, reflecting our expectation that they will rank *pari passu* with the company's other unsecured obligations.

Saudi Electricity Global SUKUK Co. 3, as the issuer and trustee, will invest the proceeds of the proposed trust certificates to purchase Sharia-compliant ijara assets from SEC that it will subsequently leaseback to SEC. The lease payments from SEC to the issuer will be based on periodic distribution payments (a profit payment), which will cover the issuer's debt service obligations toward the certificate holders over the term of the proposed certificates. Certificate holders have a beneficial interest in the trust that holds the ijara assets, but do not have direct recourse to those assets.

Upon maturity of the trust certificates or the occurrence of a dissolution event, the trustee, acting on behalf of certificate holders, is entitled to exercise a purchase undertaking requiring SEC to purchase the assets at a price covering the aggregate face amount outstanding of the certificates and accrued and unpaid periodic distribution amounts, according to the terms of the certificates.

We have not evaluated whether the trust certificates are Sharia-compliant. The ratings solely represent our opinion about the likelihood of full and timely repayment of the trust certificates issued under the program.

We derive our rating on SEC from our 'bb' anchor, one notch of uplift from our "positive" comparable ratings analysis, and our view of the likelihood of "almost certain" extraordinary support from the government of Saudi Arabia to SEC in the event of financial distress.

# INTERNATIONAL ISLAMIC LIQUIDITY MANAGEMENT 2 SA'S US\$500 MILLION LANDMARK ISLAMIC FINANCE PROGRAM ASSIGNED 'A-1' RATING

Published: April 4, 2013

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## OVERVIEW

- International Islamic Liquidity Management 2 SA is a financing vehicle established to issue short-term Sharia-compliant money-market instruments backed by long-term sovereign sukuk.
  - We assigned our 'A-1' rating to the vehicle.
  - The rating reflects, among others, the vehicle's eligibility criteria that require assets to have an 'A-1' rating, and structural considerations, including principal, profit, and liquidity tests governing new issuances.
  - The rating also incorporates liquidity support currently in the form of a US\$500 million primary-dealer agreement with Standard Chartered Bank.
  - We also consider the intended bankruptcy-remote nature of the program in assigning the rating.
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(Watch the related CreditMatters TV segment titled, "How International Islamic Liquidity Management's Landmark Finance Program Affects Islamic Finance," dated May 9, 2013.)

NEW YORK (Standard & Poor's) April 4, 2013--Standard & Poor's Ratings Services said today that it has assigned its 'A-1' rating to International Islamic Liquidity Management 2 SA's US\$500 million Islamic finance program. The vehicle has been established with the sole purpose of purchasing sovereign, sovereign-linked or supranational sukuk assets with long-term ratings that correspond to an 'A-1' rating. In addition, the vehicle is to issue short-term Sharia-compliant certificates with maturity profiles of less than one year. The program is the first financing vehicle created for issuing such Sharia-compliant certificates. It will target Islamic commercial banks, who currently face a lack of adequate Sharia-compliant money-market instruments for liquidity management.

The rating on the program depends on the asset eligibility criteria of the vehicle, which among other requirements, limit the purchase of assets to those having a long-term rating corresponding to 'A-1'. Additionally, the transaction benefits from conditions restricting the issuance of certificates, which include minimum levels of liquidity, nondefaulted assets, and sufficient cash flows to cover profit and expenses of the vehicle.

Moreover, the vehicle benefits from liquidity support in the form of primary dealer agreements from 'A-1' rated financial institutions, currently provided through a US\$500 million primary dealer agreement

## SOVEREIGN / STRUCTURED FINANCE

with Standard Chartered Bank (AA-/A-1+). Under the agreement, Standard Chartered Bank is required to purchase up to US\$500 million in certificates in any single auction. Also, the transaction is exposed to BNP Paribas Securities Services, Luxembourg Branch (A+/A-1), in its role as bank account provider. Under our counterparty criteria, BNP Paribas holds a rating that is sufficient to support the rating on the program.

The International Islamic Liquidity Management 2 SA vehicle is structured to be bankruptcy-remote, thereby mitigating the potential for an insolvency of the program upon an insolvency of the owner, International Islamic Liquidity Management Corp. (IILM). The structure benefits from an additional feature in the form of a golden share held by a nominee trustee, thereby restricting the ability of IILM to unilaterally change the incorporation documentation of the vehicle to the potential detriment of the certificate holders. Additionally, there are limitations of the transfer of the shares held by IILM to other parties.

IILM will act as the program administrator of the vehicle. It is an international institution established in October 2010 by central banks from key Islamic finance jurisdictions and one multilateral institution, to address the lack of Sharia-compliant liquidity tools available to Islamic financial institutions. IILM was created pursuant to the International Islamic Liquidity Management Corporation Act of Malaysia, and is governed by the Articles of Agreement among its members. Under its mandate, it is charged with the role of issuing and holding U.S.-dollar-denominated sukuk with the intent of creating and distributing short-term Sharia-compliant financial instruments.

### Standard & Poor's 17G-7 Disclosure Report

SEC Rule 17g-7 requires an NRSRO, for any report accompanying a credit rating relating to an asset-backed security as defined in the Rule, to include a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

# PRESALE: SHARJAH SUKUK LIMITED

Published: September 2, 2014

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*This presale report is based on information as of Aug. 13, 2014. 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 ratings on the proposed issue. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the ratings should not be construed as evidence of final ratings. If Standard & Poor's does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, Standard & Poor's reserves the right to withdraw or revise its ratings*

## PROFILE

- U.S. Dollar-Denominated Ijara Sukuk Trust Certificates: Assigned 'A' Rating

## Transaction Overview

Sharjah Sukuk Limited, a trustee incorporated in the Cayman Islands, wholly owned by the Emirate of Sharjah (A/Stable/A-1), plans to issue U.S. dollar-denominated sukuk (trust certificates).

The sukuk issuance shall be made via an "Ijara" (leasing) contract. We understand that the government is using this structure to raise funds in compliance with Sharia law. The assets underlying the lease will be government-owned buildings and land in Sharjah. Under the transaction, the government will sell a pool of property assets to Sharjah Sukuk Limited.

Under our criteria, the proposed trust certificates qualify as sukuk with full credit enhancement mechanisms provided by the government of Sharjah through its obligations to:

- Make rental payments on the lease assets equal to the periodic distribution payments under the lease agreement.
- Pay the "exercise price," which will equal the U.S. dollar amount outstanding face value of the certificates, plus accrued and unpaid periodic distribution amounts under the "purchase undertaking."

These payments cover both periodic distribution and the principal of the Sukuk at maturity. In the case of a total loss event, we expect the government of Sharjah will irrevocably and unconditionally indemnify the trustee, Sharjah Sukuk Limited, for the full reinstatement value. We therefore equalize the rating on the certificates with the long-term rating on the Emirate of Sharjah. All of Sharjah's obligations under the transaction documents are unsubordinated and will rank pari passu with the other senior unsecured obligations. These contractual obligations also underpin the equalization of the sukuk rating with that on Sharjah.

## Rationale

The 'A' rating on the proposed sukuk trust certificates reflects the 'A' rating on Sharjah, owing to its obligations under the transaction documents. The rating is based on draft documentation. If the final

## SOVEREIGN / STRUCTURED FINANCE

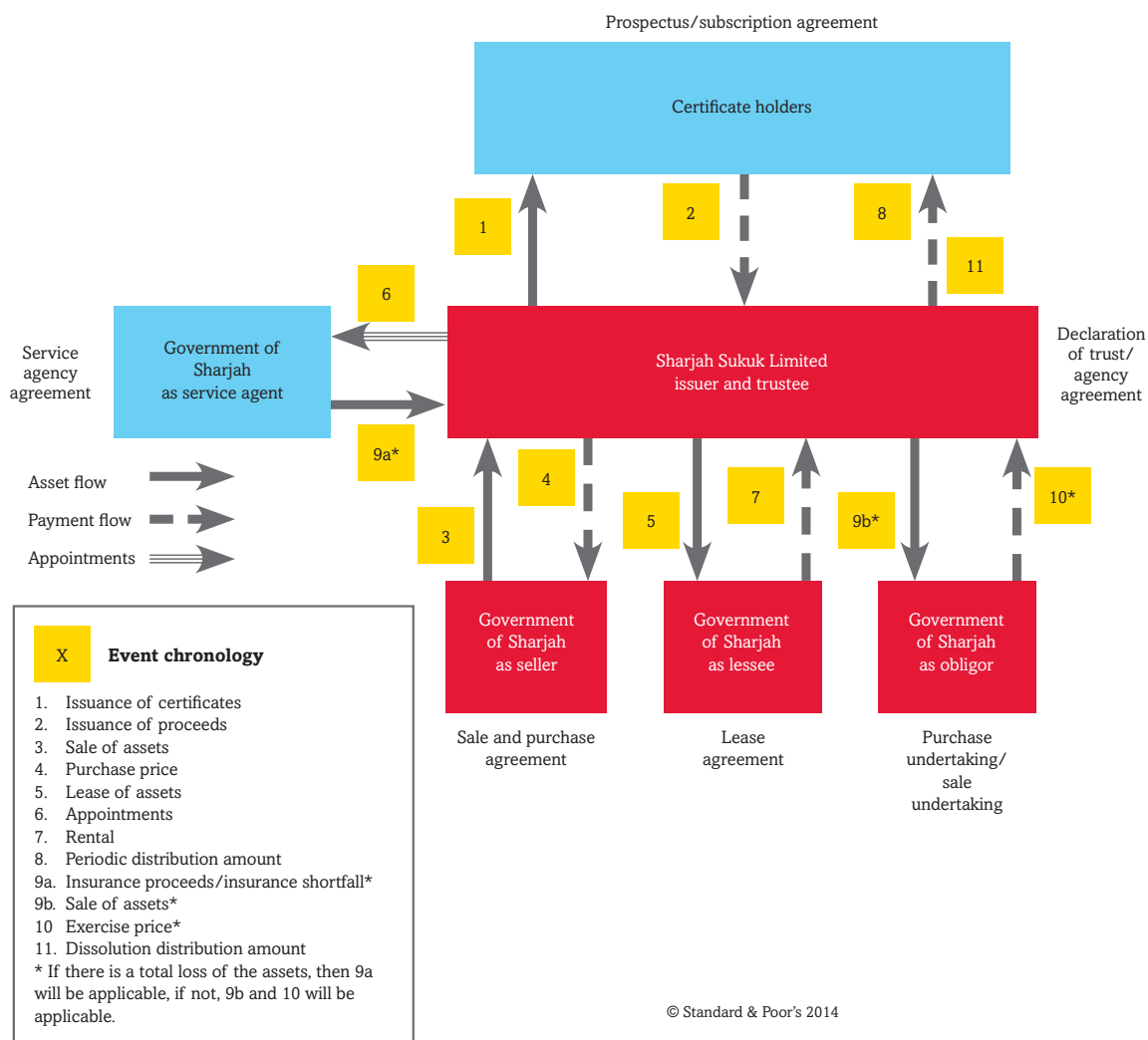
documentation differs substantially from the draft version, we could consider a rating action on the sukuk. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures transactions nor provides opinions with regard to compliance of the proposed transaction with Sharia.

The transaction involves a special-purpose company incorporated in accordance with the laws of the Cayman Islands for issuing rated sukuk trust certificates. We believe the reason behind the transaction is to raise funds for the government of Sharjah in accordance with Islamic principles.

**TABLE 1: TRANSACTION PROFILE**

Issuer, trustee, buyer of the underlying assets, lessor	Sharjah Sukuk Limited
Seller of the underlying assets, lessee, service agent	Government of Sharjah
Periodic distribution rate	Fixed profit rate determined at the closing of the transaction
Principal paying agent	HSBC Bank PLC
Governing law	English, Cayman Islands, Emirate of Sharjah, and UAE federal law

**CHART 1  
TRANSACTION STRUCTURE**





On the closing date of the sukuk, Sharjah Sukuk Limited will buy a portfolio of land assets and buildings from Sharjah. Sharjah Sukuk Limited will lease the assets back to the government in return for periodic rent payments. Although we do not consider leasing payments as financial obligations, we would treat them as akin to financial obligations because we understand that the government is using this structure to raise funds in compliance with Sharia law. We therefore believe that the government will treat its payment obligations under the sukuk transaction documents with equal importance as it would conventional financial obligations. This assumption is central to our rating as it underpins our expectations of timely debt service repayment for sukuk holders.

We equalize the rating on the sukuk with that on Sharjah. The ratings on Sharjah are supported by the government's limited fiscal risks--the government has low spending responsibilities because the cost of providing public services in the emirate is covered by the United Arab Emirates (UAE) federal government to a significant extent--and its comparatively wealthy and diverse economy. We also believe that, under certain circumstances, Sharjah would receive extraordinary financial support from the UAE if needed. However, we do not anticipate that the need will arise.

### **Total Loss Event**

As per the lease agreement, a total loss event is described as any occurrence that renders the whole of the lease assets permanently unfit for any economic use, after accounting for any insurances payable or other indemnity granted by a third party with regards to the lease assets. The expropriation, nationalization, requisition, confiscation, attachment, sequestration, or execution of any legal process in respect of the whole of the lease assets would also be described as a total loss event.

Under the service agency agreement, the service agent (the government of Sharjah) is obliged to take out insurance against a total loss event at least equal to the full reinstatement value of the lease assets, or alternatively to indemnify the trustee for the full reinstatement value in case of a total loss event. The full reinstatement value is defined as the face amount of the certificates outstanding together with any accrued periodic distribution amount and outstanding service charge. We expect the government of Sharjah will not take out the necessary insurance and will, as a result, irrevocably and unconditionally indemnify the trustee, Sharjah Sukuk Limited, for the full reinstatement value should a total loss event occur. In our view, this exposes investors to Sharjah's credit risks rather than to those of a third party.

### **Qualification As Sukuk With Full Credit Enhancement**

The proposed structure qualifies as sukuk with full credit enhancement mechanisms under our criteria. That is underpinned by the obligations of Sharjah to make certain payments under the Ijara contracts, which will be sufficient to cover both periodic distribution and the principal of the sukuk at maturity or in the case of a total loss event.

# PRESALE: REPUBLIC OF SOUTH AFRICA SUKUK CERTIFICATES

Published: September 9, 2014

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*This presale report is based on information as of Aug. 12, 2014. 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 ratings. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the ratings should not be construed as evidence of final ratings. If Standard & Poor's does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, Standard & Poor's reserves the right to withdraw or revise its ratings.*

## PROFILE

- U.S. Dollar-Denominated Ijara Sukuk Trust Certificates: Assigned 'BBB-' Rating

## Transaction Overview

ZAR Sovereign Capital Fund Proprietary Limited, a trustee incorporated in South Africa, plans to issue U.S. dollar-denominated sukuk (trust certificates). The proposed certificates, Republic of South Africa Sukuk No. 1 Trust, will be used for the purchase of usufruct interest related to land owned by the Republic of South Africa (foreign currency BBB-/Stable/A-3; local currency BBB+/Stable/A-2).

The sukuk issuance shall be made via an "Ijara" (leasing) contract. We understand that the Republic of South Africa is using this structure to raise funds in compliance with Sharia law. The assets underlying the lease will be government-owned land in South Africa.

Under our criteria, the proposed trust certificates qualify as sukuk with full credit enhancement mechanisms provided by the Republic of South Africa through its obligations to:

- Make rental payments on the lease assets equal to the periodic distribution payments under the lease agreement; and
- Pay the "exercise price," which will equal the U.S. dollar amount outstanding face value of the certificates, plus accrued and unpaid periodic distribution amounts under the "purchase undertaking" at the maturity of the sukuk.

These payments cover both periodic distribution and the principal of the sukuk at maturity. In the case of a total loss event, we expect the Republic of South Africa will indemnify the trustee, ZAR Sovereign Capital Fund Proprietary Limited, for the principal amount and accrued periodic distribution payments.

South Africa's obligations under the transaction documents will rank pari passu with its other senior unsecured obligations. We believe that the Republic of South Africa will consider its payment

obligations under the transaction equally important as its conventional bond obligations. We therefore equalize the rating on the proposed certificates with the long-term rating on South Africa.

## Rationale

The 'BBB-' rating on the proposed sukuk trust certificates reflects the 'BBB-' rating on South Africa, owing to the sovereign's obligations under the transaction documents. The rating is based on draft documentation. If the final documentation differs substantially from the draft version, we could consider a rating action on the sukuk. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures transactions nor provides opinions with regard to compliance of the proposed transaction with Sharia.

**TABLE 1: TRANSACTION PROFILE**

Issuer, Trustee, buyer of the underlying assets, Lessor	ZAR Sovereign Capital Proprietary Limited
Seller of the underlying assets, Lessee, Service Agent	Government of South Africa
Periodic distribution rate	Fixed profit rate determined at the closing of the transaction
Principal paying agent	Citibank N.A., London Branch
Governing law	South African Law

The transaction involves a special-purpose company incorporated in accordance with the laws of South Africa for issuing rated sukuk trust certificates. We believe the reason behind the transaction is to raise funds for the Republic of South Africa in accordance with Islamic principles, in part, to repay maturing debt.

On the closing date of the sukuk, ZAR Sovereign Capital Fund Proprietary Limited will apply the proceeds in payment to the Republic of South Africa in consideration for the grant and transfer of a usufruct interest in certain properties. ZAR Sovereign Capital Fund Proprietary Limited will lease the assets back to the Republic of South Africa in return for periodic rent payments. We understand that the Republic of South Africa is using this structure to raise funds in compliance with Sharia law. We therefore believe that the Republic of South Africa will treat its payment obligations under the sukuk transaction documents with equal importance as it would its conventional financial obligations. This expectation is central to our rating as it underpins our expectations of full and timely debt service repayment for sukuk holders. We therefore equalize the rating on the sukuk with the ratings on South Africa (see "South Africa Long-Term FC Rating Lowered To 'BBB-'; LC Rating Lowered To 'BBB+' On Ongoing Weak Growth; Outlook Stable," published on June 13, 2014).

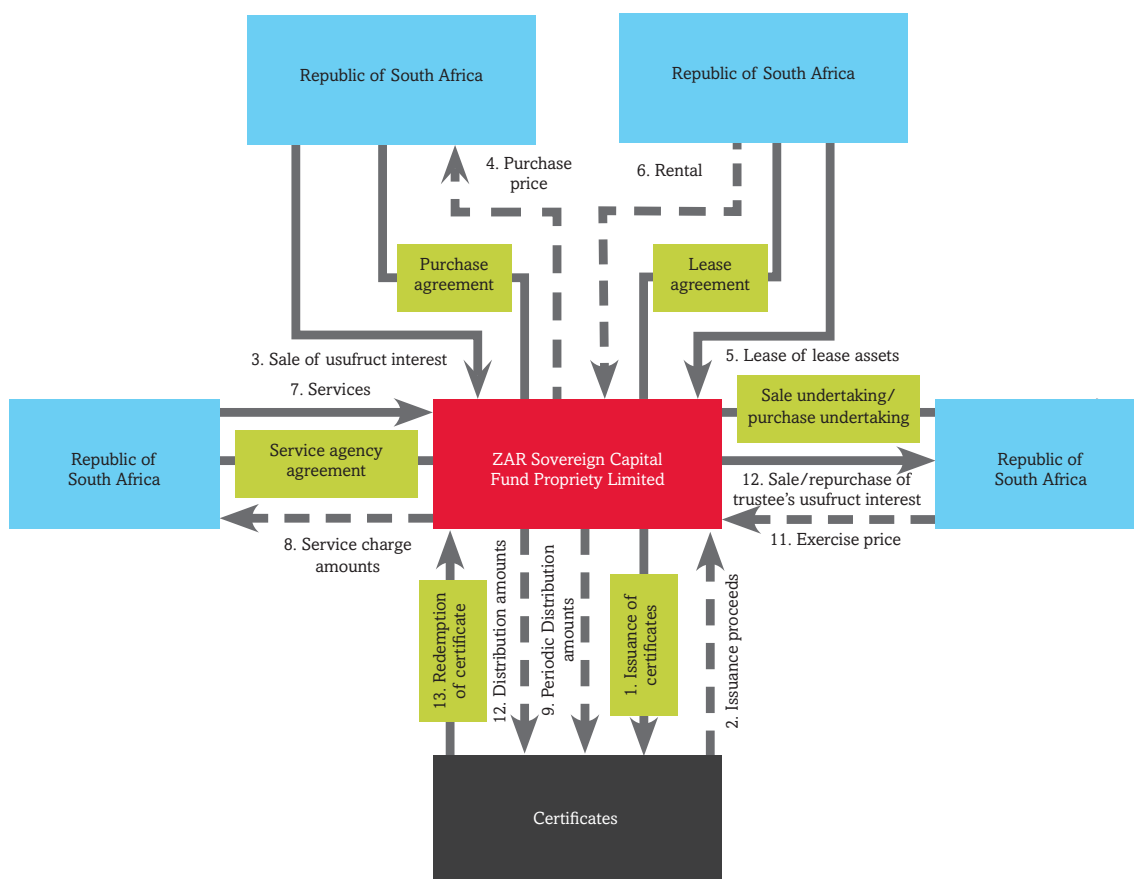
The ratings on South Africa are supported by our view that the administration under President Jacob Zuma is ensuring broad and largely pragmatic policy continuity, and that South Africa has strong institutions and deep financial markets.

Our ratings on South Africa are constrained by sizable current account deficits, the funding of which heavily depends upon potentially volatile portfolio flows. This could expose the economy to a sudden shift in capital flows due to changes in global risk appetite (due, for example, to the U.S. Federal Reserve tapering off its asset purchase scheme), or to rapid market reappraisals of prospective returns in the event of policy slippage. The ratings are also constrained by slow GDP growth, which may heighten fiscal and external pressures.

## Total Loss Events

As per the lease agreement, a total loss event is described as occurrences that render the whole of the lease assets permanently unfit for any economic use, after accounting for any insurances payable

**CHART 1  
TRANSACTION STRUCTURE**



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or other indemnity granted by a third party with regards to the lease assets. The expropriation, nationalization, requisition, confiscation, attachment, sequestration, or execution of any legal process in respect of the whole of the lease assets would also be described as a total loss event.

Under the service agency agreement, the Republic of South Africa is obliged to take out insurance against a total loss event at least equal to the full reinstatement value of the lease assets, or alternatively to indemnify the trustee for the full reinstatement value in case of a total loss event. The full reinstatement value is defined as the face amount of the certificates outstanding 30 days of the rental period. We expect the Republic of South Africa will, rather than taking out the insurance, use the option to indemnify the trustee, ZAR Sovereign Capital Fund Proprietary Limited, for the partial or full reinstatement value should a total loss event occur. This supports our view that the value of the sukuk is linked to South Africa's creditworthiness and not exposed to third party risks.

**Qualification As Sukuk With Full Credit Enhancement**

The proposed structure qualifies as sukuk with full credit enhancement mechanisms under our criteria. That is underpinned by the obligations of RSA to make certain payments under the Ijara contracts, which will be sufficient to cover both periodic distribution and the principal of the sukuk at maturity or in the case of a total loss event.

# PRESALE: LUXEMBOURG TREASURY SECURITIES SA

Published: September 18, 2014

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*This presale report is based on information as of Sept. 15, 2014. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of a final rating that differs from the rating on the proposed issue. The final rating will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the rating should not be construed as evidence of a final rating. If Standard & Poor's does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, Standard & Poor's reserves the right to withdraw or revise its rating.*

## PROFILE

- Euro-Denominated Fixed-Profit-Rate Sukuk Trust Certificates Due 2019 Assigned 'AAA' Rating

## Transaction Overview

Luxembourg Treasury Securities SA, a trustee incorporated in Luxembourg, wholly owned by the Grand Duchy of Luxembourg (AAA/Stable/A-1+), plans to issue euro-denominated sukuk (trust certificates).

The sukuk issuance shall be made via a leasing contract. We understand that the government is using such a structure to raise funds in compliance with Sharia law. The assets underlying the lease will be government-owned buildings and land in the Grand Duchy's boroughs of Luxembourg and Strassen. Under the transaction, the government will sell a pool of property assets to Luxembourg Treasury Securities SA.

Under our criteria, the proposed trust certificates qualify as sukuk with full credit enhancement mechanisms provided by the government of Luxembourg through its obligations to:

- Make rental payments on the lease assets, equal to the periodic distribution payments under the lease agreement.
- Pay the "exercise price," which will equal the euro amount outstanding face value of the certificates, plus accrued and unpaid periodic distribution amounts under the "purchase undertaking."

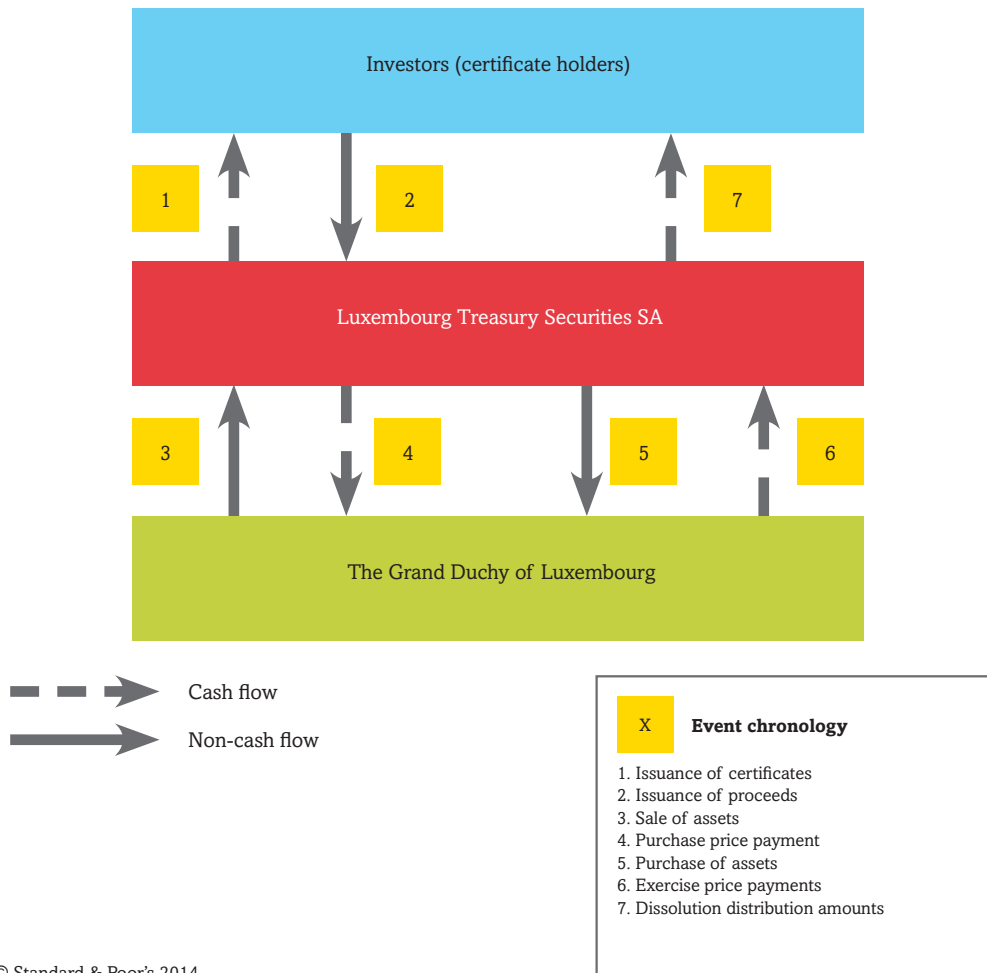
These payments cover both periodic distribution and the principal of the sukuk at maturity. In the case of a total loss event, we expect the government of Luxembourg will irrevocably and unconditionally indemnify the trustee, Luxembourg Treasury Securities SA, for the full reinstatement value. We therefore equalize the rating on the trust certificates with our long-term rating on Luxembourg. All of Luxembourg's obligations under the transaction documents are unsubordinated and will rank pari-passu with its other senior unsecured obligations. These contractual obligations also underpin the equalization of our rating on the sukuk with that on Luxembourg.

**Rationale**

The ‘AAA’ rating on the proposed sukuk trust certificates reflects the ‘AAA’ rating on Luxembourg (see “Luxembourg ‘AAA/A-1+’ Ratings Affirmed; Outlook Stable,” published March 28, 2014, on RatingsDirect), owing to its obligations under the transaction documents. The rating is based on draft documentation. If the final documentation differs substantially from the draft version, we could consider a rating action on the sukuk. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor’s neither structures transactions nor provides opinions with regard to compliance of the proposed transaction with Sharia.

The transaction involves a special-purpose company incorporated for issuing rated sukuk trust certificates in accordance with English law. We believe the reason behind the transaction is to raise funds for the government of Luxembourg in accordance with Islamic principles.

**CHART 1  
CHRONOLOGY OF EVENTS FOR THE PRINCIPAL**



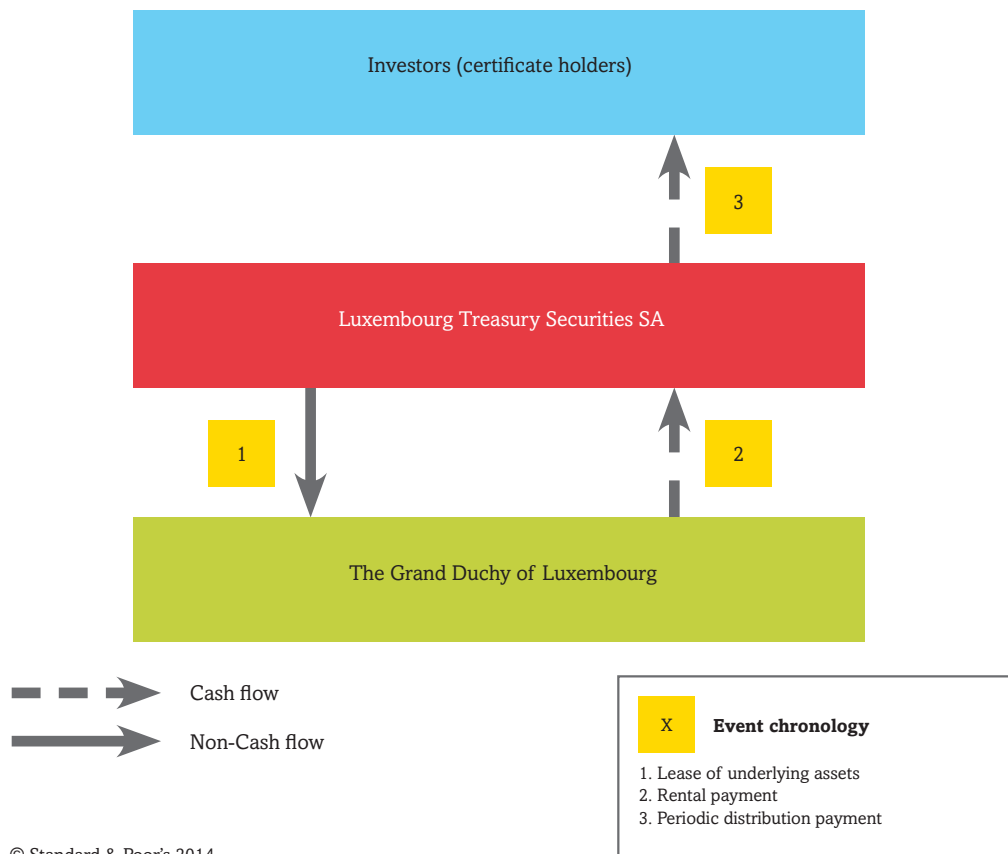
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**TABLE 1: TRANSACTION PROFILE**

Issuer, trustee, buyer of the underlying assets and lessor	Luxembourg Treasury Securities SA
Seller of the underlying assets, lessee, service agent and obligor	Grand Duchy of Luxembourg
Periodic distribution rate	Fixed profit rate determined at the transaction's close
Lead managers	BNP Paribas, HSBC Bank PLC
Delegate	BNP Paribas Trust Corporation UK Limited
Principal paying agent	BNP Paribas Securities Services, Luxembourg Branch
Governing law	English law for the certificates and the declaration of trust. Luxembourg law for the purchase, lease, the servicing agency and the agency

On the closing date of the sukuk, Luxembourg Treasury Securities SA will purchase a portfolio of land assets and buildings from Luxembourg. Luxembourg Treasury Securities SA will lease the assets back to the government in return for periodic rent payments. Although we do not consider leasing payments as financial obligations, we would treat them as akin to financial obligations because we understand that the government is using this structure to raise funds in compliance with Sharia law. We therefore believe that the government will treat its payment obligations under the sukuk transaction documents as equally important as conventional financial obligations. This assumption is central to our rating because it underpins our expectations of timely repayment for sukuk holders.

**CHART 2  
CHRONOLOGY OF EVENTS FOR THE PERIODIC DISTRIBUTION**



## SOVEREIGN / STRUCTURED FINANCE

We equalize the rating on the sukuk with that on Luxembourg. The ratings on Luxembourg continue to be supported by our view of its wealthy economy and growth prospects, effective institutional framework and governance, fiscal net asset position, and strong net external asset position (see our March 28, 2014, research update). Although Luxembourg's economic growth depends on its financial services sector, we believe the sector's size and diversity will help offset increasing regulatory scrutiny of the sector by the EU, and we anticipate that the government will maintain a strong budgetary position.

### **Total Loss Event**

As per the lease agreement, a total loss event is described as any occurrence that renders the whole of the lease assets permanently unfit for any economic use after taking into consideration any insurances payable or other indemnity granted by any third party in respect of the lease assets. In such a case, the repair or remedial work in respect thereof is wholly uneconomical.

Under the service agency agreement, the service agent (the government of Luxembourg) is obliged to take out insurance (on a takaful basis if possible) against a total loss event at least equal to the full reinstatement value of the lease assets. The full reinstatement value is defined as the face amount of the trust certificates outstanding, together with any accrued periodic distribution amount and outstanding service charge. We expect the government of Luxembourg will take out a partial insurance on a conventional basis and will, in case of any shortfall, irrevocably and unconditionally indemnify the trustee, Luxembourg Treasury Securities SA, for the full reinstatement value should a total loss event occur. In our view, this exposes investors to Luxembourg's sovereign credit risks rather than to those of a third party. In accordance with the service agency agreement, we would expect payment of the full reinstatement value to take place within 30 days of any total loss event, which complies with our criteria on timeliness of payments.

### **Qualification As Sukuk With Full Credit Enhancement**

The proposed structure qualifies as sukuk with full credit enhancement mechanisms under our criteria. That is underpinned by the obligations of Luxembourg to make certain payments under the lease agreement contracts, which will be sufficient to cover both periodic distribution and the principal of the sukuk at maturity or in the case of a total loss event.



## RATING LIST

# STANDARD & POOR'S RATING LIST

### ISSUER CREDIT RATINGS -- TAKAFULS & SHARIA-COMPLIANT INSURERS & ISLAMIC BANKS

Issuer	Country	Type	Rating
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB+/Negative/B
Al Baraka Turk Katilim Bankasi AS	Turkey	Bank	BB/Negative/B
Al Khaleej Takaful Group (unsolicited rating)	Qatar	Insurance	BBBpi
Al Rajhi Bank	Saudi Arabia	Bank	A+/Stable/A-1
Al Sagr Cooperative Insurance	Saudi Arabia	Insurance	BBB/Positive/--
Hannover ReTakaful B.S.C.	Bahrain	Insurance	A+/Stable/--
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
Jordan Islamic Bank	Jordan	Bank	BB-/Negative/B
Kuwait Finance House	Kuwait	Bank	A-/Stable/A-2
Malath Cooperative Insurance & Reinsurance Co.	Saudi Arabia	Insurance	BBB+/Stable/--
Mediterranean & Gulf Cooperative Insurance and Reinsurance Co.	Saudi Arabia	Insurance	A-/Negative/--
Noor Takaful Family PJSC	UAE	Insurance	BB+/Stable/--
Noor Takaful General	UAE	Insurance	BB+/Stable/--
Qatar Islamic Bank (S.A.Q.)	Qatar	Bank	A-/Stable/A-1
Sabana Shari'ah Compliant REIT	Singapore	Corporate	BBB-/Stable/--
Salama/Islamic Arab Insurance Co. (P.S.C.)	UAE	Insurance	BBB+/Stable/--
Saudi Re for Cooperative Reinsurance	Saudi Arabia	Insurance	BBB+/Stable/--
Sharjah Islamic Bank	UAE	Bank	BBB+/Stable/A-2
Takaful Re. Ltd	UAE	Insurance	BBB/Stable/--
Tawuniya/The Company for Cooperative Insurance	Saudi Arabia	Insurance	A/Stable/--
Wataniya Insurance Co.	Saudi Arabia	Insurance	BBB/Stable/--
Weqaya Takaful Insurance & Reinsurance Co.	Saudi Arabia	Insurance	BBB/Negative/--
Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	Insurance	BB/Stable/--

Source: Standard & Poor's Ratings Services. Note: Ratings as of 25 Sept 2014

## RATING LIST

### SUKUK CURRENTLY RATED BY STANDARD & POOR'S

Obligor	Country	Sukuk/Trust certificates	Sector	Original Date of Rating	LT FC Rating	Regional Scale
Islamic Development Bank	Saudi A.	IDB Trust Services Ltd.	Gov.	Various	AAA	--
Islamic Development Bank	Saudi A.	Tadamun Services Berhad	Gov.	2008	AAA	--
Emirate of Ras Al Khaimah	UAE	RAK Capital	Gov.	Various	A	--
Tourism Dev't and Inv't Co.	UAE	TDIC Sukuk Ltd	Gov.	2009	AA	--
General Electric	USA	GE Capital Sukuk Ltd.	FI	2009	AA+	--
Dar Al Arkan Real Est. Dvt. Co.	Saudi A.	Dar Al Arkan International Sukuk Co. II	Corp.	2010	B+	--
Government of Malaysia	Malaysia	1Malaysia Sukuk Global Bhd.	Gov.	2010	A-	--
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia I	Gov.	2011	BB+	--
Emaar Properties PJSC [1st issue]	UAE	Emaar Sukuk Ltd.	Corp.	2011	BBB-	--
Government of Malaysia	Malaysia	Wakala Global Sukuk (series 1 and 2)	Gov.	2011	A-	--
Sharjah Islamic Bank	UAE	SIB Sukuk Co. II Ltd (Sharjah Islamic Bank)	FI	2011	BBB+	--
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia II	Gov.	2011	BB+	--
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company (No3)	Gov.	2011	BBB	--
Abu Dhabi Commercial Bank	UAE	ADCB Islamic Finance (Cayman) Ltd Trust certificates	FI	2011	A	--
Majid Al Futtaim Holding	UAE	MAF Sukuk Ltd.	Corp.	2012	BBB	--
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co. (series 2)	Corp.	2012	AA-	--
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co. (series 1)	Corp.	2012	AA-	--
Banque Saudi Fransi	Saudi A.	BSF Sukuk	FI	2012	A	--
State of Qatar	QAT	SoQ Sukuk A (Qatar State)	Gov.	2012	AA	--
Emaar Properties PJSC [2nd issue]	UAE	Emaar Sukuk Ltd.	Corp.	2012	BBB	--
Development Bank of Kazakhstan	KAZ	Development Bank of Kazakhstan Program sukuk*	Gov.	2012	BBB+	--
Axiata Group Bhd.	Malaysia	Axiata SPV2 Bhd	Corp.	2012	BBB	--
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia III	Gov.	2012	BB+	axBBB+
Sime Darby Bhd.	Malaysia	Sime Darby Global Bhd.	Corp.	2013	A	axAAA
Sharjah Islamic Bank	UAE	SIB Sukuk Co. III Ltd.	FI	2013	BBB+	--
Dubai Electricity Water Authority	UAE	DEWA Sukuk 2013 Ltd.	Corp.	2013	BBB	--
Saudi Electric Co.	Saudi A.	Saudi Electricity Global SUKUK Co. 2	Corp.	2013	AA-	--
Albraka Turk Katilim Bankasi AS	Turkey	ABT Sukuk Ltd.	FI	2013	B	--
International Islamic Liquidity Management Center	Malaysia	International Islamic Liquidity Management 2 SA's	SF	2013	A-1	--
Dar Al Arkan Real Est. Dvt. Co.	Saudi A.	Dar Al-Arkan Sukuk Co. Ltd.	Corp.	2013	B+	--
Aldar Properties PJSC	UAE	Sukuk Funding (No. 3) Ltd.	Corp.	2013	BB+	--
Ooredoo (Tamweel)	QAT	Ooredoo Tamweel Ltd.	Corp.	2014	A-	--
Dubai Investment Park Dvt Co LLC	UAE	DIP Sukuk Ltd	Corp.	2014	BB+	--
Saudi Electric Co.	KSA	Saudi Electricity Global Sukuk III (tranches 1 & 2)	IFR	2014	AA-	--
Damac Real Estate Development	UAE	Alpha Star Holding Ltd. *(Damac Sukuk)	Corp.	2014	BB	--
Dar Al Arkan Real Est. Dvt. Co.	Saudi A.	Dar Al-Arkan Sukuk Co. Ltd.	Corp.	2013	B+	--
Emaar Malls Group LLC	UAE	Emaar Malls Group Sukuk	Corp.	2014	BBB-	--
Albraka Turk Katilim Bankasi AS	Turkey	Bereket Valik Kiralama A.S.	FI	2014	BB	--
Hong Kong (Special Administrative Region)	HK [China]	Hong Kong Sukuk 2014 Ltd.	Gov.	2014	AAA	CnAAA
Sharjah (Emirate of)	UAE	Sharjah Sukuk Limited	Gov.	2014	A	--
The Goldman Sachs Group Inc.	U.S.A.	JANY Sukuk Company Limited	FI	2014	A-	--
Republic of South Africa	South A.	ZAR Sovereign Capital Fund Proprietary Limited	Gov.	2014	BBB-	--
Grand Duchy of Luxembourg	Luxembourg	Luxembourg Treasury Securities SA	Gov.	2014	AAA	--

Source: RatingsDirect, as of 25 Sept 2014. \*\* International Islamic Liquidity Management Center

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